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Between State and Market

Mass Privatization in Transition Economies

Edited by
Ira W. Lieberman
Stilpon S. Nestor
Raj M. Desai

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With the assistance of
Carol Gabyzon

THE WORLD BANK

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

This anthology represents the work of two institutions that, for over half a decade, have been extensively involved in promoting private sector growth in Central and Eastern Europe and in the Commonwealth of Independent States. In 1991 the Organisation for Economic Co-operation and Development (OECD) created a program, administered by the Centre for Co-operation with Economies in Transition (CCET), to provide policy advice and financial assistance to transition economies. Since the program's early days one of its central components has been privatization and private sector development. In February 1992 the CCET created the OECD Advisory Group on Privatization, a group of senior privatization officials and OECD country experts that has since met ten times.

The advisory group's objective is to provide a forum in which privatization policymakers from transition economies can share their experiences, benefit from the privatization experiences of OECD countries, and develop a network of contacts with which to exchange information. The group also disseminates privatization information through its publications.

The advisory group's fifth plenary session, in March 1994, focused on mass privatization as a novel way of rapidly developing a private sector in former centrally planned economies. The main findings of that meeting were published in a volume called *Mass Privatisation: An Initial Assessment*. As the title implies, the intention was to revisit this important subject at a later date so that the results of mass privatization could be comprehensively evaluated and the different national approaches compared. The World Bank, in particular the Private Sector Development Department—an active participant in the OECD-CCET advisory group since its inception—had played a leading role in advising transition governments on the design and implementation of voucher-based privatization programs since 1990. In 1994 the World Bank published a collection of essays detailing the results of mass privatization efforts in the Russian Federation, *Russia: Creating Private Enterprises and Efficient Markets*. The following year the World Bank published a short volume on the subject, examining four countries in which such schemes had been attempted, *Mass Privatization in Central and Eastern Europe and the Former Soviet Union: A Comparative Analysis*.

By 1996 the time was ripe to draw more definitive conclusions, and the eighth meeting of the Advisory Group on Privatization was devoted to this review. The meeting was organized in cooperation with the Private Sector Development Department of the World Bank, an active participant in the advisory group since its inception and one of the leading institutions advising transition governments on matters related to mass privatization. The meeting also included members of the World Bank's Europe and Central Asia Department who have been advising client countries on mass privatization.

This publication is the product of this joint effort. Most of the papers in parts 1 through 5 were presented at the tenth advisory group meeting. Their authors are among the world's most knowledgeable and respected commentators on privatization. Several are or have been involved in the process as senior policymakers and advisers. The papers examine the development and effectiveness of mass privatization programs from several angles and draw important conclusions based on extensive cross-country comparative analysis. Part 6 contains studies of national voucher privatization programs, written by experts with an intimate knowledge of each country's policies.

It is our pleasure to present this twenty-third publication in the World Bank's *Studies of Economies in Transformation* series, and to warmly thank its editors for putting together a comprehensive and insightful analytical tool for policymakers, practitioners, and other students of mass privatization, the "special child" of transition.

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Preface

This volume is the result of World Bank and OECD work initiated six years ago, around the time that a handful of countries in Central and Eastern Europe and the Commonwealth of Independent States—the Czech and Slovak Federal Republic, Lithuania, Poland, and Russia—began the monumental task of making private property the basis for productive economic relations, partly through the use of government-issued coupons or vouchers. Since 1994 thirteen other countries in the region have experimented with mass privatization programs. The present volume was originally conceived as a companion volume to a previous World Bank study. With the involvement of the World Bank's Private Sector Development Department in the OECD's Advisory Group on Privatization plenary meetings, however, the scope and content of this book has expanded considerably.

While the papers in parts 1 through 5 do not claim to analyze all the important issues, they do cover a diverse set of challenges to mass privatization programs. In addition, they show that the experience of mass privatization in formerly socialist nations—as brief as it is—has much to tell the world about the institutions of capitalism, about the establishment and enforcement of property rights, about reforming the public sector, and about the state's role in these affairs.

A comparative analysis of mass privatization suggests that the removal of enterprises from state control and the establishment of private cash flows are shaped by countries' institutional endowments and by the state's capacity to balance competing interests, manage social conflicts, and distribute the costs and benefits of reform. Experience with mass privatization also indicates that actual implementation of voucher-based privatization schemes requires that equal attention be paid to the problem of commercializing enterprises as to the problem of ensuring adequate public participation. The results of mass privatization show that there is no necessary *end point* to the process, after which a private sector will be clearly separated from the state. In many cases governments have remained the largest property owners, holding significant shares of privatized companies; thus government intervention in markets is not so much eliminated as it is transformed. Finally, the experience of mass privatization illustrates the problems of corporate finance and governance that exist in any economy.

Part 6 consists of studies of fifteen countries' experiments with mass privatization. In choosing countries, we wanted examples demonstrating the wide range of possible outcomes. For this reason the Slovak Republic and Uzbekistan are included, although the Slovak Republic ultimately abandoned the mass privatization program inherited from the Czechoslovak federation for alternative methods of selling state enterprises, while Uzbekistan did not use vouchers in its program and rejected free or nominal cost distribution of property rights.

A mass privatization program comprises a particular mix of public policies, and is thus tied to the reform agendas of governments. As such, the papers in this volume (especially the case studies in part 6) are aimed at moving targets. In the year since the first drafts of these papers were completed, much has changed in Eastern Europe and the Commonwealth of Independent States. In Bulgaria and Romania, for example, changes in governments provided some momentum to stalled privatization programs. In Albania, on the other hand, the privatization program that received favorable assessments a year ago broke down amid the government instability brought on by the collapse of several pyramid savings schemes and new elections in the first half of 1997. In the Czech Republic the government in power since 1993 came close to losing a no-confidence vote following scandals involving the lack of securities market regulation and the depreciation of the currency. Thus it is necessary to delimit the timeline for the papers in this volume: they are concerned primarily with the events occurring from the start of reform programs in countries in the region (between 1990 and 1992) until late 1996.

In developing this project, we received helpful suggestions from a number of people. Above all, we wish to thank Costas Michalopoulos, editor of the series in which this volume appears, who commented on all the chapters and case studies

and helped guide the project to completion. We also express a special gratitude to Magdi Iskander, director of the Private Sector Development Department at the World Bank, and Rainer Geiger, director of the Department for Financial, Fiscal, and Enterprise Affairs at the OECD, for their unyielding support and encouragement of the project from the beginning.

Most of the issues papers in parts 1 through 5 were presented at an OECD-sponsored meeting in 1996. We thank the formal chairs and discussants for the panels at which these papers were presented: Roman Češka of the Czech National Property Fund, Viktor Chjen of the government of Uzbekistan, Gheorghe Christescu of the State Property Fund of Romania, Eva Freyberg of the Polish Ministry of Privatization, David Glasgow of the Korona Investment Fund (Poland), John Nellis of the World Bank, Baijinnyam Ochbadrah of the Mongolian State Commission for Privatization, Sergei Oxanych of KINTO Investments and Securities (Ukraine), Väino Saarnet of the Estonian Privatization Agency, Algirdas Šemeta of the Lithuanian Securities Commission, Avtandil Silagadze of the Georgian Ministry of Privatization, Marko Simoneti of the Central and Eastern European Privatization Network (Slovenia), Dick Welch of the World Bank, Nigel Williams of Emerging Europe Asset Management (Czech Republic), and Vitali Zelenkin of the Russian Federal Committee for State Property Management. They, along with the other participants of the conference, helped refine the ideas presented in these papers.

Joel Hellman and Paul Siegelbaum reviewed the manuscript, providing detailed and perceptive comments without which we may have stumbled into inconsistencies and errors. The volume was edited Paul Holtz and Bruce Ross-Larson and laid out by Megan Klose and Glenn McGrath, all with American Writing Corporation. We thank them for their efforts to ensure readability and accuracy throughout. Carol Gabyzon worked tirelessly in preparing the original manuscript, in filling in gaps that remained, and in coordinating the volume's rewriting. Yamile Kahn and Carol Rosen, in the World Bank's External Affairs office, oversaw production of the volume. At the OECD, Mary Hodge maintained constant communication between Paris and Washington and ensured that the project was on track.

Thanks are also due to the staff of the Private Sector Development Department, including Mark Almeter, Jacqueline Ford, Kathleen Hall, Sarah Laidler, Eunok Lee, Shirley Wallace, and Ling-Sue Withers, who word processed successive drafts of these papers.

The collection of work presented here constitutes a unique testimony to the work of two institutions extensively involved in the transition economies, and their counterparts in these countries. The volume provides both a comparative, historical record of this experience as well as a valuable resource for decisionmakers of countries that are contemplating such reforms.

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Introduction
Mass Privatization in Comparative Perspective

Ira W. Lieberman

Mass privatization, sometimes referred to as voucher or coupon privatization, is an approach to privatization developed by the transition economies of Central and Eastern Europe and the newly independent states to privatize thousands of state-owned medium-size and large enterprises. Mass privatization is often contrasted with the "classic" or case-by-case approach to privatization developed in the United Kingdom and emulated by many industrial and most developing countries. Classic privatization proceeds under several implicit assumptions: that there are relatively few enterprises to privatize, that a market economy is already functioning in the country, and that capital is available domestically or can be attracted from abroad to purchase the enterprises being offered for sale.

Reformers in Central and Eastern Europe and the newly independent states started from a very different base (table 1). There were thousands of medium-size and large state-owned enterprises and hundreds of thousands of small state-owned enterprises (restaurants, retail stores, and others), all of which needed to be privatized. There was no basis for a market economy, particularly a critical mass of private companies to respond to market signals. There was a shortage of liquid wealth to purchase enterprises, and few companies were attractive to foreign investors. Moreover, the people of the region—who had always been told that the state's assets belonged to them—expected to be the beneficiaries of the privatization of state-held assets. Finally, it is doubtful that they would have readily accepted the alienation of these assets to foreign investors. For reforms such as mass privatization to succeed, it is essential to gain popular support and achieve some form of perceived distributive equity.

In many transition economies mass privatization was just one of many approaches to privatization—including restitution, leasing, management-employee buyouts, small-scale privatization of retail and service establishments, and case-by-case transactions through trade sales or public offerings. Most countries, however (Hungary is a major exception), used mass privatization as the primary vehicle to privatize medium-size and large industrial enterprises (that is, enterprises in the tradables sector). In some countries mass privatization was also used in sectors such as construction, agroprocessing, and housing.

Mass Privatization Defined

Mass privatization quickly transfers a substantial portion of publicly or state-owned assets to a diverse group of private owners—usually the majority of the population or citizens 18 years and older—who participate in share ownership directly or through financial intermediaries. Mass privatization usually involves the distribution of vouchers or coupons to the population for free or for a nominal charge. These vouchers can then be used to bid on or exchanged for shares in either the joint stock companies created from the former state-owned enterprises or in investment funds (quasi mutual funds) that intermediate ownership between citizens and the newly privatized enterprises. Shares in state-owned enterprises are usually sold at auctions.

Mass Privatization Contrasted with Case-By-Case Privatization

The goal of mass privatization is to privatize hundreds or even thousands of enterprises in a relatively short period,

Table 1 Basic economic indicators in transition economies, 1989–96

			Changes in structure of production and demand, 1990–95					
			Share of industry in GDP (percent)		Gross domestic investment (percentage of GDP)		Exports of goods and services (percentage of GDP)	
Country	Population, 1990 (millions)	GNP per capita, 1992[a]	1990	1995	1990	1995	1990	1995
Albania	3.2	n.a.	46.4	21.2	31.7[b]	16.5	7.2[c]	13.8
Armenia	3.7	2,500	51.8	35.4	47.1	8.8	35.0	23.7
Bulgaria	8.4	5,130	51.3	33.9	33.1[b]	20.9	33.1	49.1
Czech Republic	10.3	7,160	48.3	40.1	28.6	24.7	57.7[c]	51.6
Georgia	5.4	2,470	33.5	21.8	30.6	3.5	40.0	16.8
Kazakhstan	16.8	4,780	21.0	30.1	31.5[d]	22.0	n.a.	34.5
Kyrgyz Republic	4.5	2,820	35.9	23.9	24.3	15.7	29.2	26.3
Lithuania	3.7	3,710	43.3	35.7	34.0	19.2	54.2	57.8
Moldova	4.4	3,870	30.0[c]	28.3	n.a.	6.7	n.a.	35.2
Poland	38.5	4,880	50.1	39.4	25.6	17.0	28.6	27.9
Romania	22.7	2,750	48.7	40.2	30.2	25.7	16.7	27.6
Russian Federation	148.4	6,220	47.6	38.4[e]	30.1	25.0	18.9	22.3
Slovak Republic	5.3	5,620	59.1	33.2	33.2	28.3	26.5	62.9
Ukraine	51.9	5,010	45.0	41.8	n.a.	n.a.	n.a.	n.a.
Uzbekistan	22.4	2,600	30.8	33.7[e]	32.1	23.3[e]	29.0	n.a.

n.a. Not available.
a. Expressed in purchasing power parity (international) dollars.
b. 1989.
c. 1991.

while the window of opportunity for reform remains open. Among the countries discussed in this volume the number of privatized enterprises ranges from 250 in Albania to some 16,000 in Russia. Such efforts stand in contrast to the one enterprise at a time approach implied by "classical" or case-by-case privatization.

Mass privatization is largely a systems approach to privatization (see Ciobanu in this volume). The programs usually start with a selection process—for example, all medium-size and large enterprises in the tradables sector except very large or "strategic" enterprises (as in the Czech Republic, Kazakhstan, Lithuania, Moldova, Russia, and Ukraine), or a specific subset of enterprises nominated for the program (as in Albania, Poland, and Uzbekistan). By contrast, case-by-case privatization selects one or a few enterprises to be privatized and is being used in the region for the large or strategic enterprises left out of mass privatization.

Mass privatizations generally require "mass corporatization"—that is, a standardized approach to providing state-owned enterprises with a clear legal status and ownership structure. This allows a pipeline of state-owned enterprises to be legally converted, usually as open joint stock companies, and made ready for privatization. Features of mass corporatization may include standard corporate charters, an equal nominal share value for all the shares of the corporations included in the program, the use of adjusted book value as a starting point for initial valuation of the newly formed company (at least for opening balance sheet purposes), and the initial nomination of boards of directors. Many countries in the region have adopted the German-style dual board of directors system, in which independent directors form a supervisory board and managers form an executive board.

Mass privatizations generally have avoided restructuring prior to privatization, even in cases where substantial liabilities encumber an enterprise. The objective is to decentralize the restructuring process, placing this responsibility on the new private owners and removing it from the state. By contrast, in case-by-case privatization corporatization is normally tailored to the entity being privatized. Substantial passive or defensive restructuring usually occurs, such as financial engineering leading to debt and balance sheet restructuring.

Valuation goes to the core of case-by-case privatization. Financial advisers spend considerable effort trying to estimate the value of an enterprise using valuation approaches such as discounted cash flow or comparable sales comparison to the enterprise being sold. Subsequent marketing of the company and the sales process are geared toward reaching as close to the projected or estimated value as possible. Mass privatization, on the other hand, has generally relied on open, highly transparent auction processes to value enterprises based on

Growth and inflation				Foreign direct investment		
Estimated real GDP, 1996 (1989=100)	Estimated GDP growth, 1996 (percent)	Annual inflation, 1990–95 (percent)	Estimated inflation, end-1996 (percent)	Cumulative inflows, 1996 (millions of U.S. dollars)	Cumulative inflows per capita, 1989–96 (U.S. dollars)	Inflows per capita, 1996 (U.S. dollars)
87	8.5	63.7	19	295	92	30
39	4.5	1,716.7	6	47	13	9
68	−10.0	110.2	311	450	54	18
89	4.0	19.8	9	6,606	642	117
31	10.5	3,713.5	15	54	10	7
45	1.4	937.5	40	2,761	165	56
52	5.4	412.7	35	146	33	7
42	3.0	291.8	13	308	83	21
35	−8.0	420.7	15	150	35	11
104	6.0	132.4	19	4,957	128	60
88	4.3	135.0	57	1,434	63	24
51	−6.0	473.4	22	5,100	34	11
90	6.8	21.5	5	767	144	28
42	−10.0	1,209.5	40	1,167	23	9
84	1.6	387.5	64	342	15	2

d. 1992.
e. 1994.
Source: EBRD, various years; World Bank 1997.

bids by the public, using vouchers or voucher investment funds as financial intermediaries.

The Czech Republic operated the most complex bidding (and hence, valuation) process, allowing each wave (stage) of privatization to go through five bidding rounds (see Young in this volume and Shafik 1993). Other countries, such as Armenia and Russia, relied on simpler, one-round clearing mechanisms to allocate shares to bidders. Poland, which did not use open auctions, allowed only prequalified and selected investment funds to bid for enterprise shares in a "football pool" allocation process. Attempts by countries such as the Krgyz Republic to establish minimum valuations prior to auction, usually based on some inflation adjustment of book value, generally have not worked well in mass privatization programs. Adequate financial and accounting information on state-owned enterprises, essential for such valuation, generally has not been available, and in any case would have little bearing on the performance and valuation of these enterprises operating in a market economy.

Finally, mass privatization programs create market demand through vouchers and voucher investment funds. Governments have used public information campaigns to explain these processes to the public (see Duberman in this volume). But voucher investment funds have often driven demand, generating substantial interest on the part of the investing public through aggressive (and often distorted) promises of large returns on the vouchers placed with a particular fund. Mass privatization programs have emphasized the characteristics of the vouchers—who qualifies for them, how to distribute them—to ensure that demand is created and the public supports the program (Lieberman and others 1995). The basic objective of mass privatization was to create millions of new shareholders, hopefully making privatization and other pro-market reforms irreversible.

In case-by-case privatization, by contrast, demand creation is selective and targeted. When shares are sold to strategic investors, a prequalified subset of qualified buyers is usually targeted. In the event of an initial public offering, employees or the public may be targeted, but such sales generally involve a discount from the share price, which may reflect a discounting from the entire share offering as initially valued (as in the sales of British Telecom and British Gas).

Mass privatization, conceived in 1990–91 in Czechoslovakia, Lithuania, and Poland, has been substantially different than privatization as originally developed in the United Kingdom and as practiced in other industrial countries and much of the developing world. It was born out of the unique circumstances of transition in Central and Eastern Europe and the newly independent states, where the state owned almost all property—from the smallest retail bakery to the

largest utility. As such, an adapted form of mass privatization might be applicable to transition economies in Asia (including China and Vietnam) or to African countries where limited savings and conditions comparable to those in Central and Eastern Europe and the newly independent states make privatization desirable.

Mass Privatization in Transition Economies

The first five parts of this volume contain analytical papers focusing on the key components and features of mass privatization programs—including institutional aspects, legal frameworks, political economy, supply (enterprise selection or inclusion, corporatization, valuation) and demand (vouchers and the role of intermediaries such as investment funds) features, enterprise governance and property rights, sale of residual shares owned by the state following mass privatization, capital market links, and the external environment conditioning the performance and eventual restructuring of newly privatized enterprises (for example, stabilization programs, the role of commercial banks, and bankruptcy processes).[1]

This sixth part of the volume analyzes mass privatization programs in fifteen Central and Eastern European countries and newly independent states; it parallels an earlier work that focused on the Czech Republic, Lithuania, Poland, and Russia (Lieberman and others 1995). Thus eleven of the studies presented here are of programs not previously analyzed; the other four update the four countries studied earlier. The country studies address the nuts and bolts of mass privatization in each country, focusing on issues such as:

- *Supply.* How many enterprises are included in the program? How are they selected? What are the exceptions? How were they prepared for privatization?
- *Demand.* The use of vouchers and their characteristics, and the role of investment funds and their characteristics.
- *Sale of enterprises.* The auction process—national and regional auctions, valuation of enterprises, and auction-clearing mechanisms.
- *Unique characteristics of the program.* Including residual state share ownership, employee preferences, and capital market links.
- *Results.* Statistical and analytical analysis of outcomes: How many enterprises were privatized? What percentage of public enterprises, employees, assets, and so on is now in private hands? Was the process perceived as a success by the populations of these countries? How have the programs contributed to overall reform, to enterprise restructuring, and to capital market development? What problems have emerged? What next steps in privatization and other reforms are needed to complement mass privatization?

By the end of 1996 nine countries in the region had completed mass privatization programs, five had largely completed their programs, and three were still implementing their programs. This volume does not analyze Slovenia's or Mongolia's programs (Mongolia is outside the region), both of which have been fully implemented. Nor does it report on Azerbaijan's and Tajikistan's programs, which are just getting under way. Uzbekistan's program, also just getting under way, is discussed because of its unique design features.[2]

Basic Questions—and Answers

Within the context of the country studies and the analytical papers we asked ourselves five basic questions:

- Has mass privatization generally met its objectives as an efficient way to transfer ownership of industrial enterprises from the public to the private sector?
- Have mass privatization programs achieved some form of distributive equity, as envisaged by their designers?
- Who are the stakeholders in mass privatization, and who are the winners and losers?
- What were the programs' strengths and weaknesses?
- What are the critical next steps for countries that have implemented a mass privatization program?

Effectiveness

Mass privatization programs have been effective and efficient in rapidly privatizing thousands of medium-size and large enterprises. The systems approach implied by mass privatization was the most acceptable way the bulk of enterprises could be rapidly privatized and a strategic mass of private enterprises created. By the end of 1995 more than half of the region's industrial sector had been privatized in the countries that had used mass privatization (figure 1).

Distributive equity

Although the designers of mass privatization identified distributive equity as a goal, it soon became more narrowly defined as the need to give something to the public—namely vouchers that would convert to some form of share ownership (see Duberman in this volume). In most countries vouchers were distributed for free or for a nominal price to the

entire adult population. Some countries tried to use vouchers as a social tool. In Albania, for example, vouchers were distributed differently to different age groups, with the greatest number going to the elderly.

Reformers needed public support for privatization as well as for other reforms. It quickly became clear, however, that the public's expectations could never be fully met. Share distribution through vouchers was at best a small property inheritance following years of communist propaganda that the state's property belonged to the people.

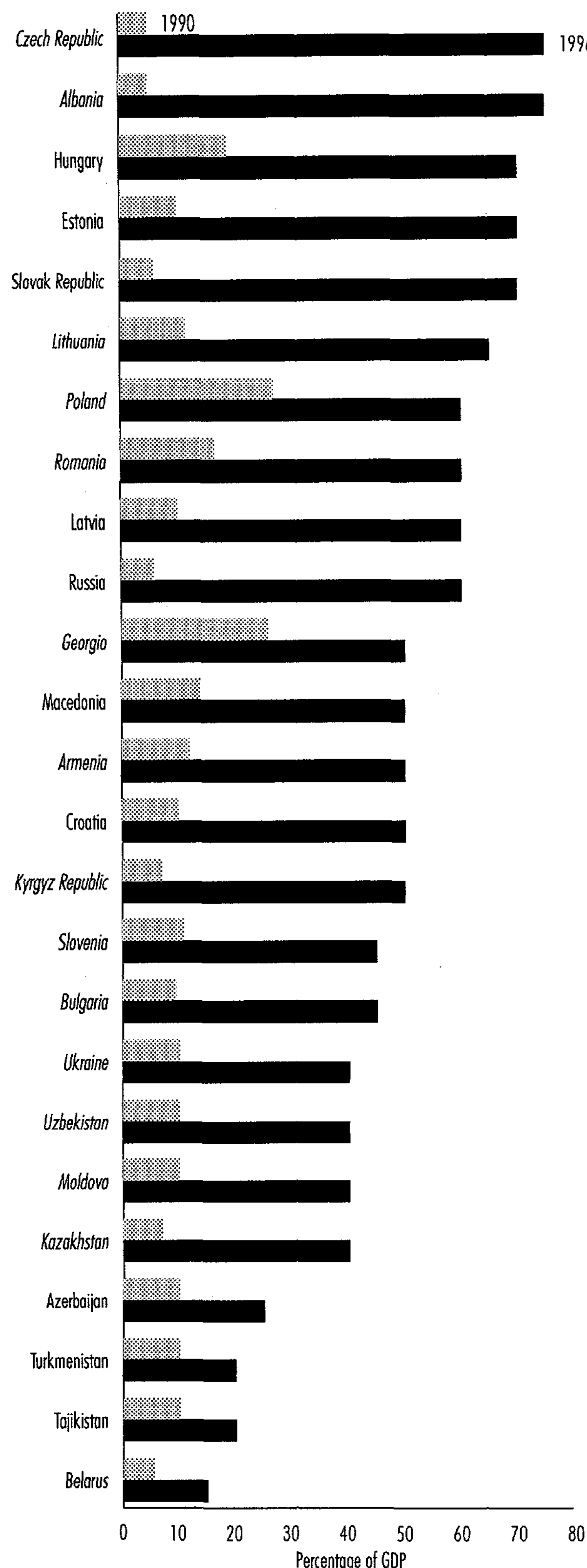
Also offsetting this populist strain in the programs was the concern that dispersed or fragmented ownership would create corporate governance problems. Moreover, political pressure emanating from other stakeholders—managers and workers, parliamentarians, line ministries—led to compromises that reduced the share of enterprises going to the public. In the end the public will probably see little financial return from these programs, and enterprise ownership will become increasingly concentrated in the hands of managers and employees (Russia), financial institutions as the managers and owners of investment funds (the Czech Republic, Poland), and the state as the largest residual shareholder (Kazkstan, Romania, Ukraine).

In addition, countries that tried to achieve equity using alternative privatization routes such as restitution (as in Albania) created undue complexities in their programs, slowing them down considerably. Thus distributive equity, one of the main objectives of mass privatization, has not materialized. Rather, it has been replaced by a less ambitious goal, of simply using vouchers to offer something of recognized value to the public.

Stakeholders, winners, and losers

Because mass privatization fundamentally transforms the basis for economic transactions, it also has significant distributional consequences. As such, mass privatization was bound to be intensely political, hotly contested from start to finish by the many stakeholders who stood to gain or lose. It is against this threat of continuous pressure that reformers in transition economies sought to build a bulwark of political support by using vouchers. Vouchers were meant to send two signals to the voucher-buying public. First, they were to represent an irreversible commitment by the state to withdraw from economic activity (see Nestor in this volume). Second, they were to "spread the wealth" by endowing an entire class of citizens with private property. In practice, vouchers neither

Figure 1 Private sector output in transition economies, 1990 and 1996



Note: Countries in italics have implemented mass privaitzation programs.
Source: World Bank and EBRD data.

proscribed the capacity of the state to intervene nor guaranteed the protection of private property. What mattered to reformers was that vouchers *symbolized* both depoliticization and the transfer of ownership.

Nevertheless, the public sector in transition economies—as elsewhere—formed the crux of a powerful coalition of vested interests with well-established claims to public resources and strong ties to the Communist party and its offspring. Thus the most protracted battles in transition economies have occurred between reformers in newly formed or newly elected governments and opposition members of parliament representing or allied with Communist and former Communist parties.

The Polish program, for example, was delayed by more than four years once it became captive to the October 1991 election campaign (see Lewandowski in this volume). In addition, over time the program lost some of its free-market features, as parliamentarians insisted on nationalistic changes in its institutional structure. Ukraine's Parliament repeatedly delayed mass privatization and supported in its place a leasing program that essentially handed over enterprises to worker cooperatives. Russia's Parliament established a parallel privatization institution to the State Property Committee, the Russian Federal Property Fund. The fund was given control over the sale of state shares and over the government's shares in privatized enterprises. The fund invariably invoked its right to retain a 20 percent ownership stake in federal properties being privatized, making the government the owner of substantial residual shareholdings in thousands of nominally privatized companies. Parliament also established an option allowing employees to purchase 51 percent of companies privatized under mass privatization—opening the door for powerful managers to take control of many privatized companies (see Blasi in this volume).

In some countries, such as Russia and Ukraine, the importance of the various regions could not be ignored. Russia's program was forced to take a decentralized, bottom-up approach to implementation that reflected the growing power of regional governors and their views on reform.

In most countries the political culture prevented mass privatization from completely privatizing state-owned enterprises. Even when governments privatized, they often retained large residual stakes, making them the largest single shareholder in the newly privatized enterprises and effectively muting the benefits of depoliticization (see Brom, Radygin, and Schwartz in this volume). In Romania, for example, the government set up holding companies to further privatization. Yet the State Ownership Fund retained a 70 percent interest in all commercial companies, and private ownership funds retained 30 percent. Even during the second mass privatization program, initiated in 1995, only 30 percent of shares are offered to the public for vouchers.

Kazakhstan's government created state holding companies along branch or industry lines to hold the 39 percent of shares to be left in state hands after privatization. The government recently recognized the adverse effects of the holdings on the operations of these enterprises and is now unwinding the holdings and selling its residual shareholdings. In almost all the countries studied the state has retained large residual shareholdings following the initial completion of mass privatization. These shares give the state a potentially powerful voice in how business is conducted and put a damper on free-market operations, even when that was not the original intention of state share retention (see Karlova in this volume).

Employees are important stakeholders in most mass privatization programs. One of the early rationales for mass privatization in countries like Poland, Russia, and Ukraine was to head off "spontaneous privatization" by enterprise managers. (The Czech government, by contrast, refused to provide preferential terms for employees during privatization.) Employee or insider preferences have ranged from the 51 percent control option in Russia's program to the 15 percent minority preference right in Poland's program. Ukraine was recently forced to offer a higher preferential percentage to managers (from 5 percent of shares to 10 percent) in order to convince large firms to join the program. Substantial insider ownership, as in Lithuania and Russia, slows restructuring and has led to governance problems (such as recognizing minority shareholder rights).

Still, one of the main failings of mass privatization in many countries arose from extensive external shareholdings in medium-size commercial companies. These companies are not naturally public companies and would generally be managed by an inside group of controlling shareholders. For many of these companies (which number some 10,000 of the 16,000 privatized in Russia) management-employee buyouts would have been a preferential privatization route. Vouchers could then have been used to privatize larger companies or to partly privatize holdings in large utilities that could support a large and diversified shareholding base.

Investment funds quickly became important stakeholders in many programs. In Kazakhstan, Poland, and Uzbekistan

they are the exclusive intermediaries through which the public can hold ownership. In the Czech Republic some 70 percent of the population placed their coupons with investment funds. Moreover, about fifteen funds, largely owned by banks, control half of the assets privatized under mass privatization. The problem with investment funds is in defining their role (see Pistor and Spicer in this volume). Western advisers to mass privatization generally viewed them as closed-end mutual funds, providing risk diversification for their investors and playing a potentially important role in capital market development. In some countries, such as Poland, funds are viewed as important agents for governance and restructuring of newly privatized firms, and offer the potential for capital market flotation as a way of providing a return to their shareholders. Investment funds failed to materialize in some countries, however. After observing fund scandals in Russia, investors in the Kyrgyz Republic avoided investment funds. Ironically, Russia's fund scandals had little to do with voucher funds. Rather, the problems arose from unlicensed cash funds that had no involvement in mass privatization.

Finally, the general public is a major stakeholder in all mass privatization programs. Yet, from a financial perspective, the public is likely to emerge as a substantial loser relative to initial expectations. Most investors hold shares in commercial companies that need to be restructured and in many cases will be liquidated or go bankrupt. But in a larger sense the public has gained significantly from mass privatization. The programs have taught the public about property rights (to vouchers, for example), financial instruments (shares), and markets (capital markets). They made companies provide information (however inadequate) to investors for the first time. They demonstrated transparent market processes through share auctions, and are starting to teach the public about shareholder rights and questions of governance. However imperfect some of these processes are, they are important elements of an emerging market economy.

Strengths and weaknesses

As noted, one of the greatest strengths of mass privatization is its ability to rapidly transform ownership in thousands of state enterprises. The programs established a critical mass of private enterprises on which the foundations of a market economy could be built. They also decentralized and largely depoliticized the difficult task of restructuring these enterprises.

The programs' main weakness is that, as a systemic approach to privatizing medium-size and large enterprises, mostly in the tradables sector, they did not allow for fine-tuning. Thus there was almost no restructuring prior to divestiture, leaving most enterprises in dire need of restructuring three to five years after the move to market began. To increase productivity and competitiveness, most Central and Eastern European countries and newly independent states must now pursue the difficult structural changes that mass privatization did not allow for. Mass privatization programs also failed to liquidate many nonviable state-owned enterprises. But since there was initially little political will to liquidate firms or initiate bankruptcy proceedings, these weaknesses should not be viewed as a failing of mass privatization as a method of privatization.

One of the most important residual problems from mass privatization is that in most cases the legal framework for the programs were cobbled together quickly, leaving a weak legal framework and poor enforcement mechanisms for ensuring that private property rights and contracts are respected. For example, in many countries share ownership has been vested in new private owners, yet it is not at all clear that titles for the land and buildings of the privatized enterprises have been conveyed or even exist. In addition, little effort has been made to develop comprehensive corporate laws and adequate securities laws, which are needed to protect minority shareholder rights and facilitate secondary trading in securities issues (see Webb in this volume).

A second residual problem is governance. Neither firms nor investment fund managers were adequately versed in Western governance norms—for example, the role of boards of directors, the need to provide and disclose information to boards and shareholders, and the importance of minority shareholder rights. Despite the fact that mass privatization programs almost universally registered newly privatized firms as joint stock companies and created board structures and corporate charters that conformed to Western norms, no one taught managers and new owners how to govern these firms. The Western corporate structure, essentially imposed on transition economies, took years to evolve in most advanced market economies (see Saba in this volume). Thus post-privatization corporate governance in the region is rife with problems, such as denying outside shareholders company information, diluting their influence, and even denying their initial ownership rights.

A third residual problem is residual ownership by governments, as noted earlier. Governments that expected to generate significant cash from their residual shareholdings have

found it difficult to sell these shares. In many respects residual share sales for hundreds and in some cases thousands of enterprises is like repeating mass privatization all over again—something governments in the region are not prepared to do. Moreover, domestic investors are apparently unwilling to purchase these shares, particularly if another party already owns a controlling stake in the enterprise. The Czech Republic has made the greatest effort to sell residual property holdings through a separate treasury institution, the National Property Fund, yet even this body has found it difficult to sell off holdings without adversely affecting the capital market and existing ownership blocks (see Schwartz in this volume).

Many governments also have retained large minority blocks of shares, often leaving the state as the largest shareholder in a company and posing governance problems that it is unable to deal with—precisely the problems that privatization was meant to alleviate (see Brom in this volume). That the state has "clawed back" into an ownership position in the face of privatization implicitly prevents market forces from functioning properly. Governments in many countries still have problems seeing themselves as a regulator rather than as an active player in the economy.

A problem related to corporate governance, but somewhat exogenous to mass privatization, is the role of the financial sector, particularly commercial banks, in bringing adequate discipline and external governance to newly privatized enterprises. In most countries attempts to create a commercial, privately owned banking system have moved in parallel or lagged behind mass privatization. Without commercial banks to finance restructuring and impose market discipline, an important element of external governance is missing (see Saba and Desai and Pistor in this volume).

An additional exogenous factor linked to mass privatization is the development of domestic capital markets. Many mass privatization programs were slow to recognize the natural link between privatization and the development of capital markets and secondary share trading. Equity markets are important because they allow new owners to buy and sell shares, a recognition of their property rights. Capital markets also provide external discipline for newly privatized public companies with respect to the provision, research, and analysis of information on these companies, as well as the movement of the companies' share prices in response to their performance. Moreover, investors' rights are best protected through well-regulated markets, as many countries in the region now recognize. Capital markets also provide a means for strong enterprises to raise permanent or long-term capital through new equity and bond issues (see Jedrzejczak and Simoneti in this volume). Most secondary trading in the shares of mass-privatized companies remains off the market—that is, it is not conducted on formal exchanges. Gradually, however, a small core of public companies is being listed in each market, providing the basis for emerging equity markets.

Mass privatization failed to attract much foreign direct or portfolio investment. For the most part mass privatization programs came at the early stages of reform, when countries were perceived as too risky for foreign investment. Moreover, medium-size and large tradable companies are not attractive to portfolio investors, who prefer to invest in natural resource companies and natural monopolies such as telecommunications and electricity. And in most cases little information was published outside the country on mass privatization auctions.

The approach taken by Estonia, which did not mount a mass privatization program but instead advertised companies for sale in the international business press, was better suited to attract foreign direct investment, albeit to a limited number of companies (Nellis 1996).

An exception is the Czech Republic's program, which attracted substantial publicity and exempted companies from mass privatization if a bona fide investor offered to purchase shares. The Czech program also attracted foreign investment fund management groups, with Vienna serving as an "off-shore" trading market for Czech shares. In addition, Russia's mass privatization program attracted substantial portfolio investment from abroad, with 300 of Russia's largest companies (including the major oil companies) selling a portion of their shares to foreign investors. Poland's mass privatization program has attracted foreign fund managers in a joint venture with domestic groups to manage its fifteen investment funds, which are at the heart of its program. These exceptions notwithstanding, mass privatization was poorly suited to foreign investment.

Critical next steps

These strengths and weaknesses clearly define the future agenda for most countries implementing mass privatization. Selling residual shares and other property holdings in an open and transparent way is critical to getting the region's governments out of the business of business. Governments must make the transition from market player to market regulator and facilitator. Capital market development and financial sector reform are important complementary reforms. So is strengthening the

legal framework in support of private business activities. Business education for enterprise managers and new owners in technical areas such as restructuring, financial management, and marketing are important, but so is education about enterprise governance and shareholder rights.

Finally, most countries need to move quickly to case-by-case privatization of large strategic companies to deepen the private sector orientation of the economy and to convey the benefits to the public that such privatization offers. These companies should also attract substantial foreign direct and portfolio investment if privatization is professionally prepared. The shift to case-by-case privatization will not be easy for many governments in the region because it demands stronger micro-level business and analytical skills than did mass privatization. In the case of natural monopolies, privatization should be complemented by well-articulated regulatory frameworks and institutions.

In conclusion, mass privatization achieved a great deal by creating a critical mass of private companies on which other market reforms can now build. But considerable effort will be needed to complete the privatization process, largely through case-by-case privatization of large strategic enterprises. Moreover, governments need to move from active intervention in the economy to facilitation and regulation as required.

Notes

1. Most of these papers were presented at an OECD–World Bank seminar, "Mass Privatization Policies: An Assessment of Results," held in Paris on 26–27 September 1996, that included representatives of each of the region's privatization agencies.

2. The Uzbeks do not consider their program to be mass privatization because it does not include vouchers and does not give anything away. It is included in this volume because it shares the characteristics of a mass privatization program except that it does not use vouchers.

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Table 2 A summary of mass privatization in Central and Eastern Europe and the Commonwealth of Independent States

Country	Governing law(s)	Voucher distribution, bidding, and allocation period	Supervision and oversight entities	Official number of medium-size and large state enterprises targeted for commercialization	Number of commercialized companies participating in mass privatization	Number of companies sold in mass privatization by end-1996
Albania	Law on the Sanctioning and Protection of Private Property, Free Initiative, and Privatization, 1991; amended 1994	May 1995–	National Agency for Privatization Ministry of Finance (1991–96) Ministry of Privatization (1996–)	833	400	97
Armenia	Law on the Privatization and Denationalization of State Enterprises and Incomplete Construction Objects, 1992	October 1994–March 1995	Privatization Board Privatization Commission (1994–96) Ministry of Privatization (1996-)	1,100	1,100	626
Bulgaria	Law on Transformation and Privatization of State-Owned and Municipal Enterprises, 1992; amended 1994	January 1996–	Bulgarian Privatization Agency Center for Mass Privatization Branch ministries and municipalities	3,485	968 (first auction, October 1996)	968
Czech Republic	Law on the Conditions and Transfer of State Property to Other Persons, 1991	First wave: May 1992–December 1992 Second wave: December 1993–November 1994	Ministry for State Property Administration and Privatization (1990–96) Ministry of Finance (1996–) National Property Fund	3,900	1,849 (first wave: 988; second wave: 861)	1,849
Georgia	Law on the Privatization of State-Owned Enterprises of the Republic of Georgia, 1991; amended 1994	June 1995–July 1996	Ministry for State Property Management	1,189	880	407
Kazakhstan	Law on Destatization and Privatization, 1991	April 1994–January 1996	State Committee for Property Territorial committees State Privatization Fund (1993–95) State Committee for Privatization (1995–)	n.a.	1,712	497
Kyrgyz Republic	Law on Denationalization and Privatization of State Property, 1994	January 1992–December 1992 Second attempt: March 1994–	State Property Fund	1,500	900	450
Lithuania	Law on Initial Privatization of State Enterprises, 1991; Law on the Privatization of State-Owned and Municipal Property, 1995	Vouchers: 1991–July 1995 Cash privatization: July 1995–	Central and regional privatization committees Ministry of Economy	8,457	6,661	5,666
Moldova	Law on Privatization, 1991	March 1993–November 1995	Ministry for Privatization and State Property Administration Branch ministries and municipalities	1,600	1,139	874

Concessions to insiders	Residual state ownership	Number of licensed investment funds, end-1996	Share ownership restriction for investment funds in privatized companies (percentage of share capital)	Esimated percentage of shares of all companies acquired by investment funds during voucher distributions	Other methods used for large- and medium-scale privatization
None	No shares retained by the state except for an industrial bakery (51 percent) and three electric distribution companies (70 percent), to be sold at cash and voucher auctions	1	10	0	Voucher auctions, cash sales of small enterprises, trade sales of large enterprises (none completed) Restitution program overlaps with voucher program, creating a major bottleneck to closure of transactions
20 percent of enterprise shares given to employees for free; additional 16 percent offered at nominal charge	None	2	40	0	Employee buyouts; 10 companies undergoing international tender, with additional companies to follow
20 percent of shares offered at 50 percent discount; possibility of installment sales and long-term leasing with option to purchase	2,500 companies will remain state-owned after the first wave; government will retain ownership of more than one-third of the shares in about 20 percent of these companies	92	34	80	Direct sales, tenders, auctions, management buyouts, spontaneous privatization
None	About 40 percent of original state-held assets in state hands; government retains veto powers in 45 strategic enterprises	434	20	71 in first wave, 63 in second	Cash sales of shares (to domestic and foreign investors), direct sales, public auctions, free transfers
5 percent of shares given to employees for free; 3 percent offered at 20 percent discount; 28 percent earmarked for voucher auctions bought by managers and employees using vouchers	69 percent of shares in 900 enterprises in state hands	9	20	4	Cash auctions and investment tenders planned for the remaining shares
10 percent of shares given to managers and employees as nonvoting stock; some firms gave another 5 percent to managers	39 percent of privatized enterprises, all earmarked for cash auction	169	31	40	Significant spontaneous privatization before voucher phase; other methods include cash-based auctions of small firms, case-by-case tenders of large firms (more than 5,000 employees) and natural resources companies, and employee ownership of state farms
5 percent of shares reserved for managers and employees	Residual state holdings in 580 enterprises	17	35	25	Some shares transferred to workers, several enterprises sold by tender
Initially, 10 percent of share capital could be sold to employees at concessionary prices; later concessions allowed managers and employees to acquire 50 percent of shares in noncompetitive bidding	15 percent of privatized enterprises in state hands	300–400 originally, reduced to 180 with stricter licensing	20	30	After voucher privatization, exclusively cash privatization (including international tenders) Management-employee buyouts, stock exchange auctions, and joint venture privatizations since early stages of privatization program
20 percent of shares sold to managers and employees at a nominal charge; agricultural suppliers received 50 percent of agroprocessing shares for free	State retains 16 percent of shares in privatized firms due to lack of demand; another 14 percent of the total stock in state hands	43 investment companies, 11 trust companies	25	44	Cash share auctions, asset sales, trade sales, international tender

Table continues on next page.

A summary of mass privatization in Central and Eastern Europe and the Commonwealth of Independent States (continued)

Country	Governing law(s)	Voucher distribution, bidding, and allocation period	Supervision and oversight entities	Official number of medium-size and large state enterprises targeted for commercialization	Number of commercialized companies participating in mass privatization	Number of companies sold in mass privatization by end-1996
Poland	Law on the Privatization of State-Owned Enterprises, 1990; Law on National Investment Funds and their Privatization, 1993	November 1995–	Ministry of Privatization (1990–95) Ministry of Treasury (1995–)	8,853	1,049	512
Romania	Law on the Privatization of Commercial Companies, 1991; Law on the Acceleration of Privatization, 1995	October 1992–June 1995 (canceled); August 1996–	National Agency for Privatization State Ownership Fund	6,280	3,900	n.a.
Russia	Law on the Privatization of State and Municipal Enterprises of the Russian Federation, 1991; amended 1992	August 1992–July 1994	Federal Committee on the Management of State Property Russian Federal Property Fund	20,000–26,000	16,000	15,052
Slovak Republic	Law on the Conditions and Transfer of State Property to Other Persons, 1991	May 1992–December 1992 (second wave canceled)	National Property Fund Ministry of Privatization Center for Mass Privatization at the Federal Ministry of Finance	n.a.	1,264 (first wave: 750; second wave: 514, subsequently canceled and replaced by bond privatization)	530 (as part of former Czechoslovakia)
Ukraine	Law on the Privatization of State Enterprise Assets, 1992	March 1992–July 1994 (suspended); December 1994–	State Property Fund	14,000	8,200	3,500
Uzbekistan	State Program for Advancing Denationalization and Privatization (cabinet order), 1994	No vouchers distributed	State Property Fund Center for Coordination of Securities Markets	11,800	3,631	2,300

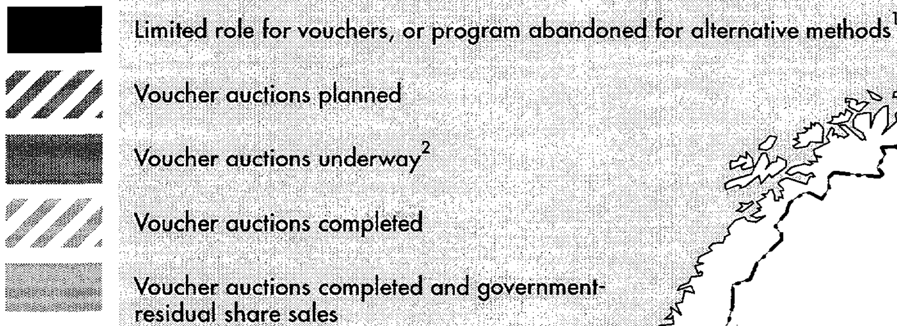
Concessions to insiders	Residual state ownership	Number of licensed investment funds, end-1996	Share ownership restriction for investment funds in privatized companies (percentage of share capital)	Esimated percentage of shares of all companies acquired by investment funds during voucher distributions	Other methods used for large- and medium-scale privatization
15 percent of share capital given to managers and employees for free	25 percent in Treasury (5 percent for Reprivatization Program and 20 percent for other uses)	15	33	60	Before and in parallel with mass privatization, methods used include liquidation privatization (mostly employee buyouts) and capital privatization (trade sales, international tenders, and initial public offerings)
10 percent of shares offered to employees at 10 percent discount; workers, suppliers, and customers in 1,840 agroprocessing enterprises given preferential access to 20-33 percent of shares	*Regies autonomes* still 100 percent state-owned; 70 percent of stock remains in state hands	5	10	15	Trade sales, open auctions, open and limited tenders, initial public offerings, management-employee buyouts, debt-equity swaps, liquidations
Closed subscriptions with following options: for managers and employees: 25 percent of shares for free and right to purchase an additional 10 percent at 30 percent discount; for employees: 51 percent of shares at multiple of book value; for managers: management contracts allowing managers to purchase 20 percent of voting capital at book value and employees to acquire 20 percent at a 30 percent discount (rarely used)	Average of 20 percent retained by Federal Property Fund and 5 percent by local implementing agency, sold through cash-based sales	>650	25	27	Investment tenders, cash auctions, *commercial competition* (cash auctions with social and production restrictions), loans-for-shares transactions (trust agreements with major banks)
None prior to partition of former Czechoslovakia; amendment allows tax relief on investment in management-employee buyouts	25 percent of enterprises excluded from privatization; unknown residual shareholdings in companies privatized following split of Czechoslovakia	165 from first wave	20, reduced to 10	50	Direct sales, public tenders, restitution and transfer of property to municipalities
Preferential pre-auction financing and leasing for worker cooperatives, closed subscriptions, 5 percent of shares offered to managers and employees at discount (raised to 10 percent in 1996)	30 percent in state hands	>350	25 if purchased by vouchers, 10 otherwise	75	Management-employee buyouts and leasing to employees, significant spontaneous privatization, public offerings, tenders to foreign and local investors, preferential leasing arrangements with share purchase options for managers and employees
23 percent of shares reserved for managers and employees at nominal charge	26 percent in state hands	30–50	35	n.a.	Auctions, direct sales, joint venture privatization, sale of shares on the stock exchange

EUROPE AND CENTRAL ASIA
STATUS OF MASS PRIVATIZATION PROGRAMS, DECEMBER 1996

- Limited role for vouchers, or program abandoned for alternative methods[1]
- Voucher auctions planned
- Voucher auctions underway[2]
- Voucher auctions completed
- Voucher auctions completed and government-residual share sales

1. The Slovak Republic moved to a new approach following the split of Czechoslovakia in 1993.

2. Uzbekistan's program was exclusively cash-based.



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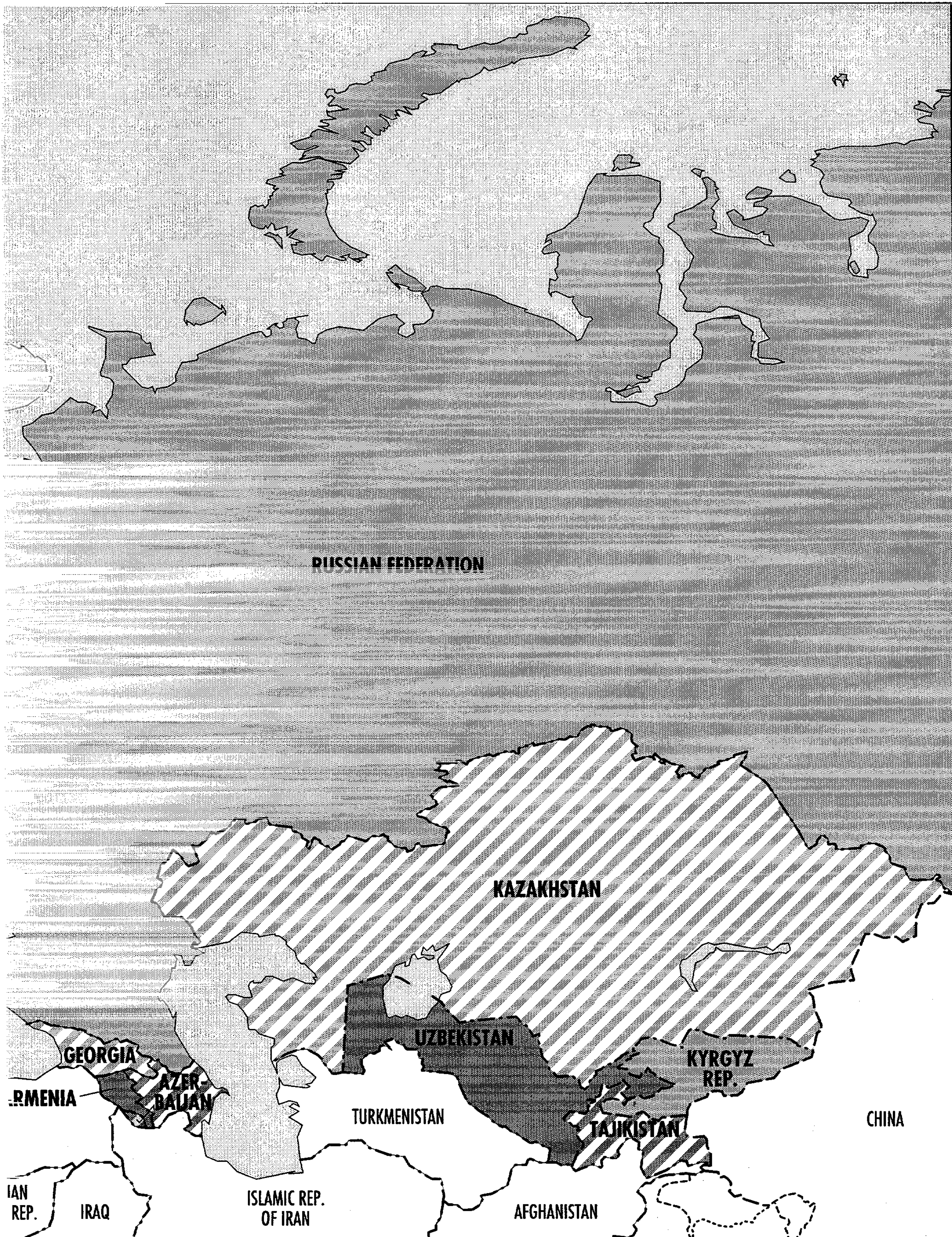

JULY

Part 1

Institutional and Legal Aspects

Institutional Aspects of Mass Privatization: A Comparative Overview

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Privatization is a highly political process. Even when it involves a relatively small part of the national economy, as in most OECD countries, the transfer of state ownership or control to private hands touches off intense political debate. In transition economies the political significance of privatization is as great as its economic importance. It is a systemic transformation on an economywide scale.

Big differences in policies are reflected in the institutional design of privatization programs. Countries with developed market economies have often pursued privatization on a piecemeal basis; no special institutional framework was considered necessary (Nestor and Nigon 1996, pp. 9–23). A sophisticated legal infrastructure meant that detailed regulation of privatization was largely unnecessary. Even where new institutions were created, their size was limited and they were usually accommodated within existing government structures (Carreau 1996, p. 123). Their role has been largely confined to oversight and strategic planning of privatization, while implementation was left to line ministries.

All transition economies, however, have adopted extensive privatization legislation. This usually consists of a framework law which describes the different methods that may be used in the process. Privatization institutions have been established by legislation and vested with considerable authority and discretion to formulate and implement privatization policies (Nestor 1993).

The magnitude of the privatization task and its systemic nature in transition economies have led to radical policy innovations. Many policymakers in these countries came to believe that speed and decentralization of economic decisionmaking were essential to successful reform. Such policymakers viewed a speedy wholesale property transformation as the only way to assign assets to agents who would use them efficiently or sell them to somebody who would—in other words, it was seen as one of the necessary conditions for developing efficient corporate governance. Politically, the creation of a large property-owning class is probably the most important reason such reforms are irreversible (Boycko, Shleifer, and Vishny 1996; Nellis 1994). In most cases this rapid transformation was achieved through mass privatization.

Institutions and Mass Privatization

Different countries have adopted different institutional arrangements for mass privatization. These arrangements depend on the willingness of government to proceed with speedy privatization (and abdicate economic control), the balance of power between different stakeholders in the privatization process, legal and institutional traditions, and the constitutional environment.

Privatizing an entire economy requires the creation of specific institutions. Only a few transition economies have tried to privatize by relying on existing line ministry structures; they include Latvia (until 1994) and Turkmenistan. In Latvia the failure to advance with privatization was acknowledged and a Privatization Agency was created. Turkmenistan's government seems unwilling to implement even the general privatization policies that it has espoused on paper.

In some countries, even though new privatization institutions were created, decisionmaking remained scattered

between different institutions, such as line ministries, property funds, and state-owned enterprises. Poland is one example, and the fact that both line ministries and state-owned enterprises can veto privatization decisions is probably the main reason Poland's privatization has gone slowly (Lewandowski 1994). Institutional conflict has also impeded privatization in Bulgaria and Romania.

A privatization institution can take one of two forms:

- It can be an independent state agency subject to political control only at the top. In some cases the agency's governance might be modeled along corporate lines; Germany's Treuhandanstalt, Hungary's APV Rt, and Estonia's Privatization Agency have separate supervisory and executive bodies and are granted considerable autonomy in planning their operational structure and privatization policy. The downside is that institutions of this type might not have the power to exercise political control over privatization and, therefore, to stand up to special interests.
- It can be a ministry, as in the Czech Republic, Poland, the Slovak Republic, and (for all practical purposes) Kazakhstan and Russia. In these cases the institution is part of the government, and its head participates in the council of ministers. The institution has no independent legal status, however, and little financial autonomy.

In countries that have adopted the agency approach, decisionmaking is relatively concentrated, privatization legislation is general, and the predominant policy is that of selling, not distributing, assets. Even in cases where political control over the agency is more direct, a separate corporate structure usually increases organizational and operational flexibility. Independent budgetary arrangements can also make a big difference if sales transactions are the main privatization method.

The mandate of a privatization institution is basically to formulate and propose privatization policies and to implement these policies while ensuring that the interests of the state and the society are adequately protected. This mandate suggests that the institutions operate under a certain tension. On the one hand, they are sellers of companies in a vast market for corporate control. On the other, they are highly visible public interest institutions, managing the "family silver."

This tension is not the same for all types of privatization institutions. It is more evident where traditional sales methods (public offerings, trade sales, management-employee buyouts) are used—that is, when the state seeks and deals with buyers of companies (or their assets). In mass privatization, however, the state distributes ownership to citizens. From an institutional perspective, this is quite a different task. Speed and expediency are still basic concerns (Lieberman and Rahuja 1994, pp. 10–11). So too is transparency. There are, however, no requirements for full valuation of the companies or for financial and operational restructuring. Nor is there any need for a substantial dealmaking capacity within the privatization institution. Also unnecessary is the capacity to supervise contractual undertakings that can be in force well into the "private" life of enterprises.

On the other hand, mass privatization requires an institution that has the political clout to impose a specific privatization approach on the various stakeholders in a large number of enterprises. Such institutions have to perform relatively simple tasks quickly and frequently rather than transaction-specific, complicated work. It follows, then, that if voucher privatization is the predominant method, a more political organization is a better institutional solution.

From an organizational perspective, independent privatization institutions have several advantages. Because they can be more flexible in their employment policies, they can attract and maintain qualified employees, which are indispensable in the implementation of an ambitious privatization program. Incentive schemes linked to performance might prove useful in this respect. Flexible schemes that allow for the use of foreign expertise even within a ministry were developed in both the Czech Republic and Russia.

The internal organization of the privatization institution can also play an important role in its operational efficiency. Transaction-specific privatization may require intimate knowledge of industries, which suggests a structure laid out along sectoral lines—as was the case with Germany's Treuhandanstalt. Mass privatization schemes such as Russia's, however, suggest an institution organized along functional lines, corresponding to the various stages of the process (privatization plan processing, policy planning, demand-side issues, and so on). In any case, some functions are centralized (for example, personnel and legal departments), as in any other large organization.

Concentration of decisionmaking is crucial in the design of a coherent and implementable mass privatization program. A single institution should be responsible for decisionmaking. However, regional decentralization of this institution may also be useful in large countries where local authorities are granted substantial autonomy. In Russia managing the privatization of roughly 30,000 medium- and

large-scale enterprises from Moscow would have been unthinkable (expect, perhaps, for the biggest 100 or so; Chubais and Vishevkaya 1993; Vacroux 1994, p. 35). Thus the essential organizational task in Russia was replicating the simple structure of the State Property Committee at the regional level. The downside of regional decentralization, however, is the creation of a dual chain of command—one from the central privatization institution, the other from the local authorities. Russian privatization has been delayed in many regions because of conflicting signals and interests of the two authorities. Thus regional decentralization should be implemented only when a country's size and constitutional context are such that central decisionmaking generates excessive administrative costs.

Supply-Side Issues

Successful mass privatization requires a steady supply of enterprise shares to be exchanged against vouchers (Lieberman 1995, pp.16–18). The voucher-investing public must be confident that the coupons are not just worthless pieces of paper but can be converted into valuable shares in the nation's businesses. Creating an adequate flow of shares, however, is often an uphill struggle. Privatization authorities have to fight against enterprise insiders, founding bodies and ministries, and (often) their own slow bureaucracies.

Direct institutional fiat by privatization institutions over the enterprises to be privatized is the most efficient solution. This approach is feasible when the lines of command between state-owned enterprises and the central government are solid and can be turned on their head for the purposes of privatization; this was more or less the case in the Czech and Slovak republics. In countries such as Poland and Russia, however, previous attempts at enterprise reform without privatization had weakened or severed the links between the state and its enterprises. Reasserting central control would have been politically and administratively unfeasible. As a result it was necessary to offer incentives to enterprise insiders to facilitate privatization.

In most countries corporatization is the main means of feeding the privatization pipeline with companies. All successful privatization programs have created a simple and straightforward procedure for corporatization; in both the Czech Republic and Russia model corporate charters were drawn up (Drabek 1993, p. 107; Black, Kraakman, and Hay 1996, p. 245). Most important, enterprises were valued at their (largely fictional) pre-reform book values. Countries such as Poland and Ukraine that opted for expensive valuations and a complicated approval process had trouble coming up with enough companies to supply the pipeline (Snelbecker 1995).

Different approaches have emerged for the formulation and approval of privatization plans. In the Czech Republic enterprise insiders could suggest ways to privatize their company but had to compete with outsiders, who were also given a chance to submit plans. Line ministries played a consultative role, but the final decision was made by the Ministry of Privatization. This approach implies a considerable institutional capacity within the ministry to process plans. In Russia, however, a weak central institutional capacity dictated the delegation of the all-important drafting and approval of the privatization plan to enterprise insiders (in cooperation with a local representative of the State Property Committee). To limit the enormous potential for abuse in such a setup, Russian law gave insiders only three options for privatization—as opposed to the unlimited menu available in the Czech case.

The main incentive for enterprises to participate in their own privatization is the perceived certainty that, sooner or later, the firm will be privatized anyway (Aghion, Blanchard, and Burgess 1994). This is one of the main reasons enterprises in many Central European countries started to restructure and operate commercially even before privatization. A hard budget constraint—through tough bankruptcy laws or fiscal controls—and the need to address it by seeking private investment accelerated mass privatization and encouraged the voluntary participation of many enterprises. In countries like Russia and Ukraine, however, this type of incentive may be weak: the lack of macroeconomic stabilization combined with enormous political uncertainties suggests that financial discipline cannot easily be imposed on enterprises (Kornai 1995, pp. 79–107 and 141–61).

The competence of other institutions not directly concerned with privatization is also important. In Poland antimonopoly bodies have been given extensive powers to halt corporatization if the enterprises seem to be in a dominant position, a power that has often been exercised. In theory the same wide-ranging powers are available to the Russian Antimonopoly Committee; in practice, however, it has taken little concrete action. In the Czech Republic the competition authorities have remained essentially toothless in the privatization process (Estrin and Caves 1995).

Finally, in some of the newly independent states sectoral ministries were transformed into holding companies that have

essentially maintained control over privatized companies—especially those put through the voucher system. This was done by retaining important minority stakes or by organizing cross-shareholdings among enterprises. Such semipublic bodies weaken confidence in privatization, slow it down, and introduce opacity to institutional structures already lacking transparency. Kazakhstan and the Kyrgyz Republic have started to dismantle such holdings, but they are still quite active in Uzbekistan.

Demand-Side Issues

Managing the distribution of vouchers to the population and establishing a bidding process are the other important tasks of the privatization institutions. The best arrangements, again, depend on a country's size and diversity, the number of state-owned enterprises, and the weighted importance of voucher privatization relative to other privatization methods.

The approach used to distribute vouchers depends largely on the nature of the vouchers—tradability, dematerialized or paper—and on the recipients. Most countries have distributed them through post offices; some countries have appointed local authorities as intermediaries, but that has not been a resounding success. In the Czech Republic receipts from voucher sales were used to cover the cost of the demand-side organization—voucher printing, distribution, and auctions. In some early systems (Latvia, Ukraine) the use of privatization accounts (usually in the state-owned savings bank) did not work well. This scheme excluded the possibility of outside intermediation, which is crucial to the development of demand. Allowing private subcontractors such as commercial banks to enter the voucher distribution system—under supervision from the finance ministry—might lower the costs of the system and create other commercial incentives.

The institutions that manage supply-side issues in Ukraine (the State Property Fund) and Kazakhstan (the State Committee for Property) are also responsible for organizing the demand side—most notably the bidding. In the Czech Republic a separate unit, the Centre for Mass Privatization, located within the Ministry of Finance, was responsible for all auction issues. This approach may be effective when auctions are nationwide, occur in waves, and are computerized.

Where auctions are largely a local, enterprise-specific affair, however, it makes little sense to duplicate the institutional structure of the supply-side agency in a new demand-side institution. The risk of creating institutional conflict outweighs the benefits of decongestion of privatization institutions. Indeed, one of the biggest problems in the early days of Russian voucher privatization was that insiders and local bosses, through the property funds (responsible for the organization of auctions), had the power to exclude outsiders from auctions. This was mainly because, until 1993, the property funds were under a command structure completely different from the State Property Committee (Lieberman and Rahuja 1994, pp. 10–11.).

The most important institutional aspect of the demand side is the role and regulation of intermediaries between the general public—the recipients of vouchers—and the enterprises being privatized (Simoneti and Tříska 1994; Coffee 1996). In Poland intermediaries were carefully designed to address two largely conflicting policy goals—a robust corporate governance environment for privatized enterprises and the protection of small shareholders, that is, the general public. Shareholder protection was to be achieved by allowing investment only in intermediaries (also a feature of Kazak privatization) and by providing for a long transition between the start of the program and the beginning of trading in investment fund certificates. The governance issue was addressed by ensuring that genuinely private managers were heading the funds and that the state's residual shareholding was a passive stake; both elements were missing from the otherwise similar first mass privatization in Romania—with disappointing results.

The problem with the Polish scheme was its aim for perfection. Its complicated structure and delicate balances made the drafting and approval process excruciatingly slow—and a slow process is an easy target for special interests (Winiecki 1994). The scheme was adopted five years after its conception, and the final plan was quite different from the original intention of its drafters.

The Czech approach was completely different. The emergence of intermediaries was not even anticipated by the institutional and legislative framework. Nevertheless, it is thanks mainly to private intermediaries (investment funds) that the scheme succeeded. The state introduced a rudimentary regulatory system ex post, crudely solving the corporate governance and investor protection dilemma by imposing a 30 percent ceiling on the funds' shareholdings in individual companies. In Lithuania and Russia the regulatory regime for privatization investment funds was also relatively free—though somewhat stricter than the Czech one. One lesson from the Czech approach is that overregulating private intermediaries might take a lot of steam out of the process. In

Bulgaria initial demand for vouchers suffered from high capital requirements for investment funds.

The Ownership Function

The exercise of ownership and control rights over state-owned enterprises is another important determinant of successful privatization. Where enterprises are essentially controlled by insiders, privatization may encounter several obstacles. The most serious is the hiving off of the most (potentially) profitable assets to management-controlled companies (so-called spontaneous privatization). This has happened in countries where central command lines broke down before privatization, as in Hungary and Russia. Moreover, enterprise insiders might be eager to retain privileges related to public ownership (such as job security or subsidies).

Where founding (line) ministries continue to exercise ownership, inconsistencies may arise between policies pursued by different parts of government. Bureaucracies might retain control over enterprises and create obstacles to privatization, as in Poland. Thus divesting ownership and control functions from line ministries in the pre-privatization period is an important first step toward the transfer of ownership.

In many countries property funds were created to take over line ministry powers. These funds are often structured along corporate lines, have a legal status of a private nature, and have an independent budget. Their task is to carry out privatization arrangements approved by the main privatization institution and assume the state's ownership and control functions during the period between the decision to privatize and the actual transfer to the new private owner.

In the Czech Republic, Russia, and the Slovak Republic the governing bodies of these funds were initially controlled by parliament. Especially in Russia, this was a source of friction because the fund (as well as its regional equivalents) was vested with considerable authority in the auction process and demand-side management. As a result the property fund was eventually made a subsidiary of the main privatization institution (Radygin 1995). In the Czech Republic the privatization minister headed the supervisory body of the National Property Fund and the deputy minister was its chief executive. This separation of privatization and ownership functions in two closely connected sister organizations was copied in other countries, such as Kazakhstan in 1995.

In traditional privatization transition economies (such as Estonia, the former German Democratic Republic, and Hungary) ownership functions were assigned to the privatization institution. In theory this appears to be a good solution for any country, since it allows for centralized, friction-free decisionmaking. With mass privatization, however, it could create managerial tension within the institution and might divert the organization from its primary task—privatization. Such muddling of purpose was evident in Romania's institutional scheme. There is a danger that this dual role could even paralyze the institution.

Residual share management, a hot issue in most mass privatization countries, need not concern privatizers, at least until the main wave of privatization is competed. Then, treasury arrangements such as Poland's might be appropriate as privatization becomes more transaction-specific.

Accountability

Privatization institutions are state bureaucracies with a politically sensitive task (Frischtak and Atiyas 1996). It is therefore essential to establish an effective system of accountability by which the executive, parliament, and the courts can thoroughly monitor and evaluate their operations. At the same time, privatization institutions require a wide margin of discretion. Striking an appropriate balance between these two objectives is a primary concern of architects of institutions.

Where the privatization institution is a ministry, there are no special rules on accountability. The minister reports on privatization issues to the council of ministers and to parliament. In Poland the Ministry of Privatization (now defunct) presented an annual report to parliament, which has a special committee on privatization.

Where the privatization institution is an autonomous state agency, the accountability system may be more complicated. In Ukraine parliament appoints the head of the State Property Fund, who is also a minister. In the Czech Republic and Estonia political control over the agencies is ensured by the presence of members of the government on their supervisory board, which has no executive responsibility. In Hungary, until recently, a minister oversaw the APV Rt.

Parliament's direct involvement in nominating or approving the appointment of top privatization officials may guarantee their capacity to act independently of government. Direct parliamentary control over the activities of the privatization institution, however, might make the institution vulnerable to short-term political considerations. The conflict over Russia's privatization policy in 1992–93 may have had more to do with

Parliament's broader political agenda and less to do with privatization policy.

In principle, mass privatization institutions do not need the flexibility and wide discretion required by their trade sales cousins—or successors. Nevertheless, some elbow room is needed when the privatization institution has to decide on a mix of traditional sales methods and voucher privatization. In the former Czechoslovakia this power was wisely coupled with ministerial (or even council of ministers) approval when the proposed transaction lacked adequate transparency (for example, direct sales to predetermined investors; Drabek 1993, p. 107).

In most countries financial accountability is assured by a state audit institution. Where privatization institutions combine selling with distribution and their task therefore has a large financial component, auditing may prove highly controversial. The value of the assets sold or the sales method used might be challenged, although no safe way exists to confirm the accuracy of the figures. Even so, review of privatization by an independent government agency is necessary for effective accountability.

Privatization legislation in transition economies usually does not provide for judicial review of decisions or transactions. The assumption is that the general rules for judicial review apply. While some countries have not yet completed reform of their legal infrastructure, most have the basic legal instruments in place. In almost all the judicial system is modeled along continental European lines. Three main avenues for the review of acts (or omissions) related to privatization are available—civil, administrative, and criminal.

All privatization institutions that are independent government agencies have a legal status, and implicitly have the right to enter into contracts and to stand before a court of law if there is a contractual dispute. The legal situation is not as clear for ministries. In most legal systems the state may act as a private person, but drawing the line between the state as a party to a contract and the state acting as public authority might prove problematic. Foreign investors, therefore, may seek to protect themselves by including specific dispute resolution clauses in privatization contracts.

Privatization institutions are state agencies and have the power to issue binding administrative decisions. In the context of mass privatization, most decisions are of this type rather than private law. Disputed decisions are reviewed by administrative tribunals, which in most continental legal systems form a separate court system. That is not so, at least for the time being, in many transition economies. Thus decisions by the Russian State Property Committees that are "binding" under privatization law can be reviewed by the *arbitrazh* courts; apart from adjudicating commercial disputes, the courts also review disputes arising from the implementation of economic regulation. That might be an advantage since the economic expertise required in reviewing privatization decisions is also relevant to commercial law issues. In fact, privatization issues make up a substantial part of the caseload of the arbitrazh courts.

A clear distinction between the administrative and civil law competence of privatization institutions may be important. Persons having the right to petition review of an administrative act, for example, may be different from those that would have such a right if the state were deemed to be acting, in the same case, in its private capacity. Admissibility of a petition is based on principles that differ in administrative and civil jurisdictions. Such jurisdictional confusion might also take place when the state exercises its ownership rights over state-owned enterprises. A clear definition of the administrative or civil law nature of state action in different areas of privatization might significantly increase legal certainty, and thus render the investment climate more secure.

Transparency

During privatization, transparency is vital for sustaining and strengthening political support. If the general public is faced with opaque institutional arrangements and receives little information about the process or possibilities for the average citizen, public support for privatization may wane (Nestor and Thomas 1995) There is, however, a distinction between transparency of the process and transparency of the (voucher) "investment" environment. In the first case maximum transparency should be the norm. In the second case there is a tradeoff to be made: a high degree of transparency might slow the process considerably since it would require a detailed valuation of every company in the mass privatization program according to international accounting standards, which would defeat the purpose of the program (Lewandowski and Szomburg 1990).

The emergence of intermediaries has eased the problem of company information, but has created the need for more transparency in the privatization investment funds themselves. In most countries, including the Czech Republic and Russia, the rules have been inadequate. Provisions on "fire walls," separation of the manager's and the fund's assets, and

periodic reporting of investments and of net asset values should be adopted at a relatively early stage following the distribution of shares to voucher holders; doing so would help expand capital markets in these countries. In addition, a lack of competent institutions has made it difficult for securities regulation to be properly implemented (Frydman, Pistor, and Rapaczynski 1996; Mertlik 1996).

Conflicts of interest are common in privatization; if not addressed, they may increase political tensions. Government officials may sometimes act as private consultants and enterprise managers may act as agents for prospective buyers. In the former Czechoslovakia, for example, some government officials became board members of investment funds, prompting an ex post regulatory response. The organization of public auctions also might cause public mistrust. Clear rules are essential, with sanctions for collusive tendering.

Public information is essential to the success of mass privatization programs. Most privatization institutions have created separate administrative units to disseminate information about their activities and acquaint the public with trends in privatization policy. Most important, the large-scale involvement of private institutions has generated further political support, due partly to promotion by these private agents.

Concluding Remarks

There is no institutional blueprint for privatization. Each country has an institutional structure that reflects its legal and economic development and its culture and traditions. Even so, some broad observations and recommendations can be made.

Privatization will continue to be one of the most important aspects of structural adjustment in transition economies—as well as in many OECD countries—for some time. As privatization advances, however, its aims and methods change considerably. Voucher privatization is part of early transition, reflecting the need for a systemic and rapid shift in the structure of property ownership (Boycko, Shleifer, and Vishny 1995). Traditional case-by-case privatization might go on much longer. Emphasis will shift over time as the number of enterprises in the pipeline gets smaller and harder to process. Institutional arrangements should reflect this evolutionary path. Early privatization institutions will (and should) fade out, much like the now-defunct Czech Ministry of Privatization and Germany's Treuhandanstalt. The job of privatizing (or controlling the ownership functions in) a few large companies might be better undertaken by new line ministries. In Hungary the Ministry of Industry and Trade is assuming responsibility for overseeing both the ownership and privatization of big stakes, mainly in utilities.

Privatization is a highly political process. Progress depends on broadly based public support. Its outcome has significant effects on many areas of economic life and, as a result, different interests compete to influence privatization policy. Accommodating these various stakeholders in a way that preserves a favorable political consensus without obstructing the speed and effectiveness of privatization is one of the most important and delicate tasks of institution building.

If privatization is to run smoothly, decisionmaking should be concentrated within one institution and, where necessary, its regional affiliates. A wide spread of decisionmaking authority could result in institutional infighting and a loss of confidence by the voucher recipients—the public. A separate institution to manage ownership in the enterprises to be privatized might be necessary to disengage enterprises from line ministries—which in the early stages of transition create obstacles to privatization—and to respond to specific technical functions related to the demand management of the process. But command structures between the main privatization institutions and these treasury institutions should be intimately linked so that bottlenecks are avoided when mass privatization is implemented.

Institution building should closely reflect privatization policy choices. Thus, where sales are the main privatization method, an independent agency might be best. With mass privatization, centralized administration by a ministry—at least at the initial stage—might be a more reliable course, since political clout, transparency, and accountability, rather than flexibility, should be paramount concerns. Internal organization will also depend on the mix and relative importance of privatization methods. In any case, some independence in managing resources (including human) and the possibility of their rapid redeployment according to policy implementation needs are essential for institutional efficiency in a rapidly changing economy.

State-owned enterprises can play an important role in initiating and implementing their own privatization, especially in countries where they already had a substantial degree of autonomy. This can be achieved with the use of proper incentives. Considerations of both transparency and allocative efficiency should be taken into account; competition from

outside investors in privatization plans should be encouraged. The granting of important incentives to insiders and the benefits of rapid privatization should be assessed against the loss of transparency they entail for mass privatization and the loss of confidence among the general public.

Accountability both to the executive branch of government and parliament is essential for privatization institutions. However, accountability does not mean that the government should intervene in the everyday management of privatization. Parliament must be regularly informed of privatization developments and play an active role in determining the general policy framework. It should also be consulted on the appointment of top privatization officials. Its active involvement in policy implementation, however, might render the process vulnerable to short-term political considerations.

Transparency is crucial in maintaining political acceptability for privatization. Conflict of interest provisions for government officials, enterprise insiders, and private agents as well as rules for auctions must be implemented. The most important factor is probably a continuing perception of honesty among the officials that implement the process. The adoption of rules that are easy to implement and do not require the interaction of many different institutions and individuals is another ingredient for the success of mass privatization. Simplicity is the mother of transparency.

Informing the public and explaining—through well-organized publicity campaigns—privatization, its results, and its benefits are fundamental for maintaining a favorable political climate. More than anything else, the public's sustained involvement in privatization is critical. This can be achieved through schemes in which participation cannot be easily monetized. At the same time, quality and quantity on the supply side should clearly indicate to the public that there is a real and substantial transfer of wealth under way.

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The Legal Framework for Mass Privatization

Douglas A. Webb

Mass privatization has been confined almost entirely to the transition economies of Central and Eastern Europe, the Baltics, and the newly independent states. Indeed, with the exception of Bolivia's capitalization program, there has been no mass privatization anywhere in Africa, Asia, the Middle East, or Latin America.[1] Thus experience is limited to a group of countries at a unique phase of transition, where macroeconomic reform, the emergence of a property-owning class, and the development of rules and institutions to support market-based contracting have proceeded at the same time as and with strong linkages to substance and sequencing.

The goal of mass privatization is said to be the removal or limitation of political control over economic activity (Boycko, Shleifer, and Vishny 1995). This process involves transferring control over property rights from politicians and bureaucrats to private owners. Once that has happened, several other things should follow. First, further reallocation of ownership as investors identify the highest-value use of those rights and acquire them from the initial owners. Second, restructuring of enterprises as the new owners demand better returns on their investments. Third, the state's response to the demands of new interest groups—such as shareholders and consumer advocates—and selective regulation to correct market failure.

This paper examines how and to what extent this transfer of control over property rights has occurred, looking mainly at Russia's mass privatization program. It considers the extent to which the laws developed to implement mass privatization have helped to fill in gaps in the legal protections of property rights. It concludes with some observations on the need for further legal reforms to consolidate the gains.

Evolution of Property and Shareholder Rights

Property rights in socialist state enterprises were—in theory—owned by the people, whose interests were represented and protected by the state. In practice, an elite oligarchy of individuals or groups (the party, executive committees, line ministries, local governments, managers, some employees) often obtained control over those rights. That control was sufficient, even if de facto rather than legal, to effectively displace the more generalized claims of the state.

Such alliances were powerful. Ministries had extensive powers to approve (or disapprove) many key elements of the operations of enterprises, such as the acquisition of foreign currency to import vital machinery or spare parts, access to subsidies or credits, and the appointment or removal of senior management. Local governments controlled access to land and were able to ensure that enterprises tied up much of their resources in social assets and benefits for employees and their families. Managers gained increasing autonomy in operational control and were able to sell assets to themselves at less than their true value or simply assume possession of those assets. And employees were able to assert ownership rights over the unallocated surpluses of the enterprises, carried on the books as "social funds."

Corporatization as a prelude to mass privatization

Mass privatization set out to outflank these claims—first by redefining the property rights of state enterprises and then by transferring those rights to private owners. Corporatization—that is, the conversion of each state enter-

prise into a joint stock company with an authorized capital divided into transferable shares, an endowment of assets and liabilities, a board of directors to represent the interests of shareholders, and managers appointed by the board (and therefore indirectly answerable to shareholders)—was the chosen path. Corporatization was an ideal way of redefining property rights because a company is a separate legal entity capable of owning and disposing of assets and incurring liabilities. Shareholders have no direct claim to the company's assets, only power to elect representatives to control the uses to which those assets are put. Once state enterprises were corporatized, the scope for competing claims to their assets was reduced (but not eliminated), and the control power of shareholders were vested in the privatization agency, not the line ministry.

Because of the large numbers of enterprises involved, corporatization was highly centralized. Typically, a standard charter was drawn up, setting out internal rules for the operation of the company. The charter was closely based on those used by joint stock companies in Western Europe. It was recognized that corporatization would become hopelessly bogged down if officials were given any discretion on whether an enterprise should be registered and therefore given corporate status. Accordingly, so long as the charter followed the prescribed form, the company would be registered and would then automatically become a separate legal entity.

The only unique element of any charter was the company's authorized share capital. How was this determined? The theoretically correct approach would have been to fix the market value of the assets of the enterprise and net out the liabilities—in other words, set the corporation's initial share capital as its net worth. In reality such a valuation would have been impractical. At the early stages of transition, market values for assets did not exist or were distorted by the absence of effective market-clearing mechanisms. Moreover, even a "best guess" might have allowed officials to intervene to check the assumptions used. To overcome this problem, the authorized share capital was fixed by referring to the book values of an enterprise's assets at the most recent balance-sheet date. This approach ensured a sort of rough justice—the same valuation techniques were applied to all enterprises. And it avoided any role for officials in checking the values, which would have opened the door to bribery and delays.

The downside of this approach was its arbitrariness. While it was probably the only practical solution to allow many enterprises to be corporatized in a short time, it meant that the founders of the company (which for these purposes meant the privatization agency) and the managers were not required to satisfy themselves as to the ownership rights of enterprise assets or to resolve any competing ownership claims. This problem was compounded by the fact that land usually did not appear in the books of an enterprise because it was regarded as an inalienable possession of the people that could not be owned or valued. If it did appear in the books, land was valued at a nominal sum. The failure to address these issues meant that there were still opportunities after corporatization for competing claims on the assets of a company, especially in the case of land.

In addition to defining (with some imperfections) the property rights of the company, corporatization defined the property rights of shareholders. Those rights lay in the shares themselves and in the powers granted to shareholders, primarily the power to vote on the appointment of the board of directors (or the supervisory board) and on certain major business decisions, such as the issue of new shares other than pro rata to existing shareholders and the sale of a substantial part of the assets of the company.

The importance of creating effective shareholder rights through corporatization cannot be overemphasized. Mass privatization means that property rights will pass from politicians to individual shareholders through corporatization, and will then be distributed as shares to the public. If shareholder rights are uncertain, effective ownership will not emerge until that uncertainty is resolved. A major weakness of the Russian program was its failure to develop clear, enforceable legal rules for company share registries. Registration of share ownership in the company share registry is crucial to shareholder rights. Yet company managers were able to disenfranchise groups thought likely to be hostile to management by failing to complete the registration process. Managers have also been able to control the timing of shareholder meetings to frustrate the exercise of shareholder voting rights.

Adequate corporations law

Most mass privatization programs paid little attention to the need for a modern corporations law as part of the privatization infrastructure (English 1991). In Russia in 1992, for example, there was only a rudimentary joint stock companies law that was mostly concerned with defining the different corporate forms to be permitted. It contained only sketchy provisions dealing with shareholder rights. While these deficiencies were partly

overcome by the inclusion in the standard charter adopted during corporatization of provisions dealing with shareholder rights, a reasonably comprehensive Law on Joint Stock Companies did not appear until January 1996. And in the Czech Republic, where privatization began in 1991, Parliament only passed wide-ranging amendments to the Commercial Code in April 1996. One of the most significant of these was the right of shareholders to sue a director for loss caused by the director's negligence (*Bulletin of Legal Developments,* 19 July 1996, p.1).

Since the completion of the Russian mass privatization program in 1994, there has been a continuing struggle between shareholders and corporate managers on shareholder rights (*Financial Times,* 6 September 1996). One recent high-profile clash was the decision by Russian authorities to cancel the visa of an American investment banker who was representing outside investors attempting to assert their rights as the holder of 44 percent of the share capital of a major Russian metal producer. Another was the successful attempt by a Russian commercial bank to replace the general director of the world's biggest nickel producer, in which the bank held a 38 percent shareholding. Where legal rules are uncertain or difficult to enforce, political interference that weakens property rights is possible.

In retrospect, there may have been insufficient recognition that companies in industrial countries operate within the context of a sophisticated body of rules (both legislative and judicial) and with the benefit of monitoring institutions (such as securities commissions and an active financial press). In Russia and other newly independent states privatization has been dominated by sales to employees (some 65 percent of Russian companies may be majority employee-owned), who typically are passive holders with few incentives to militantly exercise their voting rights. Although investment funds are significant outside shareholders, many are connected to banks or to enterprise insiders and are reluctant to or uninterested in seeking change through voting pressure on management.[2] Politically, this has meant that there has been little public demand for stronger laws to protect shareholders.

The three main rights of shareholders in a company are the right to vote and participate in the distribution of surpluses, the right to be protected from abuses by managers and other shareholders, and the right to dispose of shares. A corporations law will support the first two rights. For the third, the primary legal building block is a securities law and related enforcement institutions. Because of the obvious need for secondary share trading, securities market reform was widely recognized as a crucial part of mass privatization. Although those reforms lagged in Russia,[3] countries such as Bulgaria and the Czech Republic developed modern securities laws, trading mechanisms, and supervisory institutions in parallel with (or closely following) mass privatization programs.[4]

Private investment funds

The emergence of private investment funds to intermediate vouchers issued to the public has been a catalyst for securities market development in most countries. Although these funds have been a prominent feature of most mass privatizations, it has been quickly realized that rules were required to protect the interests of unsophisticated investors in these funds. The minimum capital requirements for these funds are typically low,[5] which makes them susceptible to moral hazard. Founders have little capital at risk, have incentives to make unrealistic promises in order to gather vouchers, and have few disincentives to mismanage or even to engage in fraud. Almost all transition economies using funds have opted for regulations that rely on:

- A structural separation of the fund from the management of the fund and the holding of its assets;
- Government licensing of the fund, the managers, and the asset custodian;
- Establishment of a supervisory board for each fund, responsible directly to the fund investors;
- Supervision of the fund by a government regulator.

Since the development of a critical mass of investment funds to absorb the vouchers issued under mass privatization was important for success, in most countries entry licensing was simple and automatic.[6] Thus heavy reliance has been placed on supervision, which generally has been a mix of prescriptive rules (either in the law or in the license of fund managers) and discretionary oversight by a regulatory body. Prescriptive rules are the backbone of supervision because they are partly self-enforcing. They also provide a framework for regular reporting to the regulator, and thereby leverage the scarce investigatory resources available to the regulator.

Discretionary regulation is required in case of complaints of wrongdoing, or if the regulator becomes aware of grounds for concern about solvency or compliance with the law. The Czech Ministry of Finance developed software to enable it to monitor the voucher points held by each fund and later its securities portfolio (Coffee 1996). In the spring of 1992, when the Harvard Fund and others started to offer what seemed to be extravagant payout guarantees, the ministry

required each fund to disclose the value of promised cash payments to determine the liquidity implications.

Overall, however, the record of the Russian and Czech regulators has not been impressive. Russia has seen the collapse of some funds, partly due to weak regional supervision. Effective regulation depends on rapid and timely information flow to the regulator, coupled with sufficient resources to assess that information and detect danger signs. Regulatory capacity is leveraged greatly by effective public scrutiny, through the media or the actions of individual investors. Such scrutiny is still scarce in most transition economies.

Some preliminary conclusions can be made concerning the effectiveness of the rules and institutions for investment fund licensing and supervision:

- Entry licensing of funds involved in mass privatization has been only slightly related to screening out undesirable managers. The main goal has been to create an institutional investor class, with corresponding benefits related to risk diversification and corporate governance.
- Supervision of funds beyond prescriptive rules is likely to be hampered by a lack of resources (the market supervision section of the Czech Ministry of Finance has a total of sixty-five staff, who are said to be inexperienced and badly paid).
- The design of the regulatory framework for funds has emphasized control of risk. But funds have significant incentives to be passive investors, except when they can trade a controlling block of shares to an outsider (as the Harvard Group is reported to have done when it sold a parcel of shares in a large Czech pulp and paper company). The regulatory design is based on models from the United States, where most funds are open-ended and there are strong competitive pressures to maintain high performance levels. These models may be less relevant in transition economies, where there is no direct competitive pressure on funds once the public voucher pool has been absorbed. In these countries shareholders cannot easily trade between funds to achieve better returns.
- There are signs of a possible market for control of managers, which would have two benefits. First, it would strengthen the exit option for dissatisfied investors by creating an opportunity for a raider to buy shares sufficiently cheaply to minimize the risk of a raid. Second, it would enhance the incentives for active management because of the fear of loss of control.

The laws creating and defining mass privatization programs might have seemed a useful vehicle for filling in some of the gaps in the preexisting laws required to support effective property ownership. This assumption, however, was unrealistic given the need to move quickly and decisively to implement programs and to avoid prolonged political debate. Instead, mass privatization laws were concerned mainly with allocating authority within government agencies and across levels of government, and with directing officials as to the necessary implementation steps.

Legal Infrastructure for Mass Privatization

Mass privatization using vouchers requires rules that authorize the program and confer authority and responsibility to carry it out, create shares or other ownership rights to be exchanged for the vouchers,[7] and create vouchers and provide for their transferability. These are the minimum legal conditions for the program and provide incentives to the three main interest groups (officials, enterprise managers, and the public) to carry it out.

Authorization of programs was assumed invariably to require enabling laws passed by the legislature. Most of those laws were among the earliest actions of the parliaments created during the regime changes of the early 1990s. The laws reflected the wish of legislators to retain a large measure of control over privatization—as in the categorization of "strategic" sectors or enterprises to be excluded from privatization.[8] Witness, too, the division of authority between a privatization agency in the executive branch responsible for implementation and a property fund answerable to parliament and charged with holding the state shares pending privatization.[9] Typically, the executive was required to issue detailed implementation procedures through secondary legislation.

The creation of vouchers as a settlement mechanism was particularly complex, requiring detailed rules on the content of the voucher, eligibility and issuance, transferability, the organization of voucher auctions, and the cancellation of vouchers when they were surrendered.

Countries differed in their approach to the transferability of vouchers. Some—the Czech Republic, Moldova, Ukraine—prohibited trading in vouchers.[10] Where vouchers were freely transferable from the outset—as in Georgia and Russia—they represented the first occasion in many years when negotiable securities were issued to the general public.[11]

Transferable vouchers were not registered, but bearer, securities. Had vouchers been issued in the name of the original holder, it would have been necessary to set up a central

registry. The cost of doing so would have been unjustifiable, and would have introduced major delays as buyers awaited the issue of replacement paper. It would also have required a system of settlement between sellers and buyers, which would have created problems of access for the public and opportunities to manipulate the market price. As bearer securities, vouchers could be transferred by delivery. This led to a "street" market for vouchers, and ultimately to the emergence of large-scale brokerage operations. It also led to fraud, since it was a simple matter to dispose of vouchers without formalities once they had been accumulated from the public against a promise to invest them on behalf of the initial holders.

The Czech law on large-scale privatization (Act 92/1991, on the Condition of Transfer of State-Owned Property to Other Persons) was adopted in February 1991 and was probably the first Eastern European privatization law to provide for the creation of "investment coupons" entitling the holder to exchange the coupons for shares in state enterprises or for an interest in an investment fund.[12] Although it shares many features of a socialist law, the law also deals with the rights of private parties, such as the transfer of intellectual property rights to new enterprises, preservation of labor contracts, and rights of buyers if any of the assets of the enterprise are missing at handover. In contrast, the later privatization laws of Russia and other newly independent states were essentially bureaucratic laws giving instructions to the administrators on actions to be taken during privatization.[13]

The Russian Law on Privatization of State and Municipal Enterprises of July 1991 and its accompanying Privatization Program (approved in 1992) were classic products of centrally planned law drafting, complete with targets for the number of enterprises to be sold and the proceeds to be received by the state, coupled with detailed instructions on actions to be taken by state agencies responsible for privatization. The privatization law in turn gave rise to more than sixty decrees, edicts, statutes, resolutions, and instructions.

What was the direct effect of these laws on the capacity of the legal system to support private business? Slight. Almost without exception, these laws did not embody significant legal reforms. It was assumed that the success of mass privatization would create its own incentives for those reforms. Moreover, a practical difficulty was that while reformers had control over mass privatization for a time, it was much less clear that they had authority or the support of other ministries for wide-ranging legal reforms going beyond the laws directly required for privatization.

More Legal Reforms Are Needed

Mass privatization has created a large corporate sector with a shareholder base comprising employees, managers, institutional investors, foreign investors, and the public. This mixed ownership has generated pressure for further legal reforms at both the enterprise and shareholder levels. Although there have been many legislative changes, much remains to be done (table 1).

Privatized companies require a legal system that provides certainty about property rights in business assets, allows creditors to take effective security for business loans, supports the creation of contracts, and provides protection against illegal interference with business operations. Glaring gaps in the legal framework in most countries include laws providing for lending on the security of assets (such as receivables and inventory) and reliable bankruptcy laws. Protection to businesses against anticompetitive behavior of monopolists is still weak, though countries such as Bulgaria, the Czech Republic, Hungary, and Poland have entered into agreements with the European Union that require them to harmonize competition laws with those of the Community.

Corporation and securities laws are required to clarify the rights of shareholders to vote their shares, to be protected from abuses by managers and other shareholders, and to provide simple and efficient methods of share trading. Such laws can also permit the access of privatized companies to securities markets as a source of equity capital. As companies come to the market seeking that capital, they will be required to adopt generally accepted accounting standards and to provide full financial disclosure. That, in turn, will improve the capacity of shareholders to hold managers accountable for financial performance.

Effective property rights must be enforced, both against private parties and encroachment by the state. Some rapid reformers, including Kazakhstan and Russia, are focusing on major reforms of their court systems, spurred by demands from investors in privatized enterprises for reliable dispute resolution systems. These reforms are likely to focus on training judges in the application of business laws and in the principles of independence. They are also likely to build the culture of service required for an effective judiciary, set up training institutes to improve the decisionmaking skills of judges, send judges abroad to observe judges at work in market economies, and improve access of the business community to information on judicial decisions.

Table 1. Mass privatization and legal reforms

Country	Has a mass privatization program been implemented?	With vouchers?	Joint stock companies law?	Securities law?	Competition law?
Albania	Yes	Yes	Yes	Yes	
Armenia	Yes	Yes	Yes	Yes	No
Azerbaijan	Yes	Yes	Yes	Yes	Yes
Belarus	No	No	Yes	No	No
Bosnia	Yes[a]	Yes	Yes	Yes	No
Bulgaria	Yes[a]	Yes	Yes	Yes	Yes
Croatia	Yes[a]	Yes	Yes	Yes	
Czech Republic	Yes	Yes	Yes	Yes	Yes
Estonia	No	No	Yes	Yes	Yes
FYR Macedonia	No	No	Yes	Yes	Yes
Georgia	Yes	Yes	Yes	No	Yes
Hungary	No	No	Yes	Yes	Yes
Kazakhstan	Yes	Yes	Yes	Yes	Yes
Kyrgyz Republic	Yes	Yes	Yes	Yes	Yes
Latvia	Yes	Yes	Yes	Yes	Yes
Lithuania	Yes	Yes	Yes	Yes	Yes
Moldova	Yes	Yes	Yes	Yes	Yes
Poland	Yes	No	Yes	Yes	Yes
Romania	Yes	Yes	Yes	Yes	Yes
Russia	Yes	Yes	Yes	Yes	Yes
Slovak Republic	No	No	Yes	Yes	Yes
Slovenia	Yes[a]	Yes	Yes	No	No
Tajikistan	No	No	No	No	No
Turkmenistan	No	No	Yes	Yes	No
Ukraine	Yes	Yes	Yes	Yes	Yes
Uzbekistan	Yes[a]	No	Yes	Yes	Yes

Note: The table reports only the presence or absence of the relevant law. It implies no judgment as to the adequacy of those laws in a market economy.
a. Program being prepared.
Source: World Bank 1996.

While mass privatization was largely effective in achieving the transfer of property rights to private owners, continuing legal reforms through the modernization of laws and the strengthening of legal institutions will be needed to ensure that those rights are able to be efficiently used and protected.

Notes

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1. A similar program may be adopted in Haiti.
2. In October 1995 a small bank in the Czech Republic bought shares in several investment funds with the intention of voting those shares in an effort to replace the managers of the funds. Under Czech law the holder of 10 percent of the shares in a fund can convene a general meeting and require a vote on the replacement of the manager, though a successful vote requires the support of a majority of the votes cast at the meeting. The regulatory authorities expressed concern about the share raid, though it is unclear on what grounds there could be an objection. But the shareholders in the bank, under pressure from other banks and fund managers, called a special meeting of the bank and fired the managers who had devised the raid.
3. Russia adopted a securities law in April 1996 to replace the previous patchwork of regulations, decrees, and instructions.
4. Poland plans to establish an over-the-counter market mainly for the purpose of trading the National Investment Fund participation units distributed through its mass privatization program.
5. The minimum capital requirement is $500 in Russia, though other countries have chosen significantly higher levels: Armenia ($20,000); Czech Republic ($33,000); and Bulgaria ($125,000).
6. Some licensing schemes, however, allow for a limited qualitative assessment of the skills of key personnel of the fund. Russia's scheme, for example, requires that if the fund manager is a company, one of the officers of the company must have either provided suitable references, passed an examination administered by the privatization agency, or provided a written promise to undergo training.
7. This paper does not consider the use of vouchers in housing privatization or as a mechanism for settling restitution claims. It is concerned only with the privatization of state enterprises though mass distribution schemes.
8. Privatization commenced in Ukraine in 1992. In 1994, however, Parliament intervened to block further privatizations until it had approved a list of enterprises not to be privatized. As a result privatization was stalled until early 1995, and the list of "strategic" enterprises grew to around 6,000.

9. Armenia's Privatization Commission is an extreme example of the division of authority for privatization. The commission is composed of ten members appointed by Parliament and ten members appointed by the president.

10. As a result foreign investors could not participate in the voucher program. This limitation provided significant arbitrage opportunities for investment funds. Where foreign investors could buy vouchers on the secondary market, as in Russia, they were able to directly acquire shares in the voucher auctions and to capture the trading gains that otherwise would have gone to domestic intermediaries.

11. Some vouchers were dematerialized, as in Latvia, where they were represented by credits at the Savings Bank. These balances were transferable but were not in the form of bearer securities.

12. The Latvian privatization law of March 1991 envisaged the use of vouchers, though specific authority for their issuance was not given until late 1992.

13. The classification of laws in the context of socialist systems into policy law, bureaucratic law, and juridical law was developed by Clarke (1991).

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The Political Context of Mass Privatization in Poland

Janusz Lewandowski

The unprecedented challenge of building a market economy in post-communist countries demands innovative approaches and fresh ideas, particularly to accelerate institutional reforms and increase social acceptance of market principles. Mass privatization is potentially an ideal response to this challenge. It ensures the speedy transfer of a mass of property from the public to the private sector, and it creates opportunities for citizens to participate in the transition and own a stake in the privatized economy.

Yet evidence from Poland—where the concept was born—demonstrates how political forces can diminish the potential benefits of mass privatization. Privatization is not just about economics, it is also about politics.

Philosophy Guiding Mass Privatization

Although mass privatization has occurred all over the world, it acquires special significance in transition economies:

- Transition economies have an unprecedented need to transform ownership—there are 8,600 state-owned enterprises in Poland and 215,000 state-owned enterprises in Russia, accounting for 80–90 percent of these economies.
- Populations in these countries are poor and lack disposable income, limiting effective demand for privatized assets.
- Experience with privatization is limited, public institutions are weak, and mature capital market structures (stock exchanges, financial intermediaries) are absent.
- Because state property was nominally owned by the people under communism, most arguments favor public distribution of such property with the dismantling of communism.

Given these circumstances, traditional models of privatization, borrowed from both industrial and developing countries, were inadequate.

The idea of voucher privatization

Mass privatization was a unique response to the post-communist challenge. The idea of distributing vouchers to promote equitable popular participation in privatization was elaborated by market-oriented advisers to the Solidarity movement in Gdansk, Poland, in mid-1988. Vouchers were intended to make up for an insufficient supply of capital; as a special type of investment currency, they would be allocated to all citizens and tradable for shares of privatized companies.

The concept was presented at a conference in November 1988—when communists were still in power—in response to a solicitation for proposals on how to transform the Polish economy. Because the question was theoretical, respondents were not concerned with political realities, which paved the way for the first public discussion on privatizing a socialist economy; until then discussions had focused on making public enterprises more efficient. Vouchers, it was argued, would not only be equitable and justified, they would also encourage active participation in a fledgling capital market. Because it was in such sharp contrast to the Western model of privatization, mass privatization provoked as much interest as resistance among the conference participants. At the time, however, the demise of communism and prospects for economic freedom could not be foreseen.

What was unique about Poland?

Although transition economies faced similar privatization dilemmas, each country had several distinctive features. In 1989 the traits specific to Poland included its relatively large number of private businesses and predominantly private agricultural sector, and its tradition of strong trade unions (Solidarity) and workers councils influencing the operations of state-owned enterprises. Though nominally owned by the state, during the 1980s state-owned enterprises resembled a quasi-group model of ownership. This second factor helped shape the social and political context of Polish privatization.

Neither privatization nor mass privatization were essential elements of the macroeconomic stabilization program ("shock therapy") launched in January 1990 by the first non-communist government, led by Tadeusz Mazowiecki. At the time the goal was to ease inflationary pressures, and public share offers were seen as the most appropriate way to reduce the inflation overhang from the market.

The strength of trade unions and workers councils created pressure for insider privatization. At the beginning of the 1990s, 47 percent of Poles favored employee ownership of privatized enterprises—a larger share than in any other member of the Council for Mutual Economic Assistance. Pressures for employee ownership were visible in the first half of 1990, when the Polish Parliament worked on the privatization law. A conflict emerged between supporters of capital privatization, to be carried out under normal competition, and defenders of employee share ownership schemes. Employee ownership, advocated by the representatives of Solidarity, was the natural evolution of the concept of self-management. A newly formed Workers Ownership Union, supported by foreign experts, became the main lobbyist for privatization with employee participation.

The battle ended in a compromise. The July 1990 Law on the Privatization of State-Owned Enterprises—the first of its kind in Central and Eastern Europe—established a multitrack approach to transforming ownership. Workers were limited to 20 percent of company shares (at 50 percent of the established price), but the possibility of workers gradually purchasing company assets was left open. The challenges of mass privatization aroused less concern, mainly because they were underestimated and misunderstood when the law was passed. Still, mass privatization had become the banner of the new political party, the Liberal Democratic Congress.

Poland's mass privatization model

Lech Walesa's victory in the late 1990 presidential elections led to changes in the privatization model. Implementation of mass privatization began when I was appointed Minister of Privatization in January 1991. The program had to overcome several obstacles:

- Resistance within government from supporters of traditional privatization methods.
- Resistance of consulting firms, which supported traditional privatization because it would increase demand for their services.
- Resistance of potential investors, because of the drastic changes the eventual issue of millions of vouchers would impose on the expected operations of the Warsaw Stock Exchange and the regulated capital market.

Although at this stage the program was not yet hindered by political controversies, there was also little pressure to accelerate its pace. The main challenges were economic and administrative concerns about implementing such a large program. However, support from international donors—including the U.K. Know-How Fund, the World Bank, the International Finance Corporation, the PHARE program, and the European Bank for Reconstruction and Development—helped focus attention on two issues that ultimately shaped the program: the feasibility of voucher distribution and the worsening finances of state-owned enterprises.

The financial crisis facing enterprises required that the program restructure certain parts of the public sector—a requirement that became at least as important as universal access to ownership rights. Thus national investment funds, which offered dispersed shareholdings and effective management, became part of the program. In June 1991 the program was presented to the government and the public.

The Polish model of mass privatization was designed to address several issues beyond distributing share certificates to all adult Poles. It also had to restructure 500 public enterprises included in the program, fill the corporate governance vacuum created by dispersed shareholding, build domestic managerial skills and draw on foreign fund managers, and deal with the effects on the emerging capital market of the massive distribution of securities. Thus Poland's mass privatization program, elaborated in a political vacuum, integrated expertise, safety, logistics, restructuring, and conformity with capital market rules.

Response to Mass Privatization

The public presentation of mass privatization provoked three main responses.

Debate among opinion makers

Poland's economic establishment responded to mass privatization with the same uncertainty it felt toward Leszek Balcerowicz's 1989–90 shock therapy program. In July 1991 the Privatization Council, an advisory board to the prime minister, announced its general acceptance of mass privatization—with some reservations. The Polish Economic Society criticized the proposal. And the Ministry of Privatization received negative media coverage during the fall 1991 parliamentary campaigns.

The most common criticisms of the programs:

- Because shareholdings would be dispersed, enterprises would not have a "real" owner.
- Because inflation was looming, poor citizens would be forced to sell their vouchers to meet consumption needs.
- Because the state's wealth might not be evenly distributed, certain investors could accumulate valuable assets at low prices.
- Because foreign experts were involved, there was no guarantee that national interests would be taken into account.

Uncertainty among the public

The announcement of the program excited public expectations but did not generate widespread support for mass privatization. Potential participants were dispersed and had trouble understanding the program, mainly because of its move away from vouchers and toward enterprise restructuring. For most citizens securities and bonds were an abstract concept. Shares in investment funds—rather than in enterprises—were even less familiar. Most people confused mass privatization with one of Walesa's campaign promises, that 100 million zloty would be distributed to each citizen. As a result it became difficult to assign a value to share certificates that were to be valued by the market, and the public lost faith in the promises of mass privatization.

Conflict among politicians

Initially, the main political powers were not openly critical of mass privatization. As time passed, however, conflicts emerged between Prime Minister Bielecki and Parliament. Members of Parliament were insulted that the program had been announced without their input, and began to attack the program during televised sessions. The scale of these attacks escalated as the October 1991 elections approached.

That same month, Parliament decided to create investment funds to facilitate privatization, but it also decided to delay the distribution of shares in these funds until alternative approaches could be assessed. The diverging views of the president, prime minister, and Parliament resulted in a program designed to gradually transform enterprises.

This slow progress inspired the Ministry of Privatization to act independently, and in October 1991 the ministry sent letters to all selected enterprises to confirm their participation in mass privatization. The ministry also drafted a mass privatization law and model contract for fund managers, developed a model for implementing mass privatization without separate legislation (based on the Commercial Code), and promoted mass privatization.

After the October 1991 parliamentary elections, Prime Minister Olszewski's cabinet declared the need to bring order to privatization. Still, mistrust of the process remained, and little progress was made—in part because of claims that Czechoslovakia's program, already under way, was more akin to "mass appropriation." In June 1992 Olszewski's cabinet was removed, and in July a new cabinet—formed from a coalition of seven parties—began revising the draft mass privatization law prepared by the Ministry of Privatization.

In September 1992 the draft law was sent to Parliament. It quickly became clear that passage of the law would depend more on the unity of the coalition government and compromise with the opposition than on the strengths of the law's arguments. Parliamentary committees worked on the law until March 1993, when it was again debated—and rejected. The government's inability to pass the law on mass privatization reflected the weaknesses of the coalition government and, ultimately, of Polish reformers.

Not to be deterred, the prime minister's office announced just after the law's defeat that the government was still committed to mass privatization, and would soon present a revised version of the program to Parliament. In just a few days supporters of mass privatization:

- Mobilized the public and the enterprises slated for privatization to exert pressure on Parliament.
- Developed promotional materials emphasizing the disastrous consequences of terminating the program.
- Sought compromise with leftists in Parliament, after exposing the anti-reform right.

- Neutralized the president's power base and alternative approaches.

On March 22, 1993, the Council of Ministers accepted the new proposal. The most significant change to the program was the creation of two types of enterprises—400 to serve as the base for the issue of universal share certificates (available to all citizens) and 200 for the issue of compensation share certificates (available to certain pensioners and state employees). In April 1993 Parliament passed the law, and it became effective in June 1993.

Institutional and Legal Structure of Mass Privatization

The final mass privatization program was more regulated and susceptible to political interference than the draft law sent to Parliament in 1992. The program's main principles and institutional players are described below.

Selection and supervision of enterprises

One of the biggest limitations of the program is that public enterprises were recruited into the program on a voluntary basis. As a result the goal of including 600 companies was not realized. About half of the companies contacted—representing 10 percent of national assets—agreed to participate in the program. Privatized companies are expected to operate as independent businesses. Statutes specify activities that require the approval of the company's board of directors. Each board is guided by its lead investment fund, which controls a third of the company's shares.

Investment funds

In December 1994 fifteen national investment funds were established in the form of joint stock companies. These funds are designed to increase the value of the assets in their portfolios by exercising shareholder rights. Fund authorities include a management board, a supervisory board, and shareholders. Fund operations are regulated by their corporate statutes. As noted above, each fund owns a lead shareholding (33 percent) in certain companies, together with a large number of minority shareholdings.

Fund managers

A fund's board of directors can contract a firm to manage the fund. In July 1995 fourteen funds signed management agreements; the remaining fund is using Polish experts to manage its portfolio. Because the primary responsibility of fund managers is to increase the value of fund assets over a ten-year period, managers have an incentive to participate in monthly meetings of each privatized company's board of directors to influence the company's strategy, performance, and finances. Fund managers are paid a fixed annual cash fee and a performance fee.

Selection Committee

The Selection Committee is responsible for choosing fund managers (following international open tender) and board members (screened for education and experience) and for overseeing implementation of the mass privatization program. The committee's nineteen members are appointed by the prime minister, labor unions, and Parliament.

Relationship between the Treasury and investment funds

The minister of privatization, acting on behalf of the Treasury, founded the fifteen investment funds. Once 60 percent of the shares of privatized companies have been transferred to the funds and up to 15 percent of shares have been transferred to employees and other entitled individuals, the Treasury maintains a 15–25 percent shareholding in each privatized company for social security and compensation purposes.

Citizen participation

Some 27.4 million adult Poles are entitled to participate in mass privatization by acquiring, for 20 zloty, a share certificate. Share certificates were issued in bearer form and were immediately transferable. Certificates do not carry any voting rights. Any dividends to the certificates are paid into the account of brokers appointed by the minister of privatization, for the benefit of shareholders.

Citizens are expected to open securities accounts with banks or brokers. Once investment funds have filed and declared effective their prospectuses, fund shares are expected to be admitted to the Warsaw Stock Exchange. Thereafter, any holder of a securities account will be able to exchange their share certificate for a share in each fund, and fund shares will be listed. Fund shares will carry voting rights, and shareholders will receive dividends though the securities investment account system maintained by licensed brokers.

Further Political Impediments—but Popular Support

The law on mass privatization went into effect on the heels of major political changes. In May 1993 President Walesa dis-

solved Parliament, marking the beginning of a transition period that has delayed implementation of mass privatization.

In 1994 the main conflict was over recruitment of state-owned enterprises. Because agrarian interests and Prime Minister Pawlak wanted to maintain control over certain enterprises, a number of large, financially stable public enterprises were not included in the program—further weakening the financial status of privatized companies. During 1995–96 both ruling parties competed for control of certain investment funds. Thus politics is exacerbating tensions within fund structures, particularly between commercially oriented fund managers and appointed board members. Nevertheless, the fifteen funds are in full operation, and during 1997 all should be listed on the Warsaw Stock Exchange—beginning the second, less politicized stage of mass privatization.

Despite the political battles, the public response to the distribution of share certificates has been positive. Initiated in late 1995, the distribution has attracted considerable attention and a growing number of investors. A February 1996 national referendum, however, came out against extending the mass privatization program. Paradoxically, the outcome of the referendum did not have a negative impact on the distribution of share certificates. By November 1996 more than 25 million Poles—95 percent of the adult population—were participating in mass privatization.

Conclusion

To secure the potential political and economic benefits of mass privatization, the program should be launched with political stamina, professional marketing, and administrative discipline during the early stages of economic transition. Political will can substitute for the technical perfection of the scheme. As other transition economies have demonstrated, mass privatization is easier in economies that are more centralized and that have stronger control over public finances.

Poland's mass privatization illustrates the costs of delay and disregard for the politics of privatization. Once political consensus is lost and partisan competition emerges, even the most innovative mass privatization program can be stalled at the conceptual stages—losing its political appeal. An early understanding of the value of mass privatization and its implementation can extend the "honeymoon" of transition and generate a stronger mandate for subsequent change—or at least allow for depoliticization of a substantial portion of the economy (as in Russia).

In the long run the superior design of Poland's mass privatization should accrue significant benefits for the economy. Still, those benefits cannot compensate for the political momentum that has been lost.

Part 2

Mechanics

The Demand Side of Voucher Privatization in Central and Eastern Europe

S. David Young

In the past five years more than a dozen countries in Central and Eastern Europe have privatized using voucher systems. Some programs have been completed; others are still under way. Although each country's program is distinctive, a clear pattern has emerged. The public is first issued vouchers (either at no cost or at a nominal charge), which are then used to acquire shares in privatizing companies. Citizens can either directly invest the vouchers or assign them to investment funds. After a public auction, shares are allocated to the winning bidders.[1] This system was first used in 1991–92 by the former Czechoslovakia and was later adopted, in various forms, by most other countries in the region.[2]

Why Mass Privatization?

The 1980s saw a dramatic rise in privatization in advanced market economies and in the emerging markets of Asia and Latin America. These countries used public offerings to privatize. This approach is ideal for countries with only a few high-value companies to privatize and, as in Western European and some Asian countries, with efficient stock exchanges that can facilitate the sale and distribution of shares.

In Eastern Europe, however, there are many enterprises to be privatized and stock markets are poorly developed. Eastern Europe is further hampered by low domestic savings and by the need for speed. Moreover, policymakers are in a hurry to create a critical mass of support for economic reform and transformation, lest transition stall. The Asian transition economies, China and Vietnam, can take a different approach to market development. Both countries have huge numbers of surplus agricultural workers, and a large private sector can be created simply by mobilizing, into factories, millions of otherwise idle farmhands. The high level of industrialization in Central and Eastern Europe precludes this approach. It is impossible to create a strong private sector without fast and aggressive privatization.

How, then, to quickly privatize thousands of state-owned companies in countries where a functioning market economy is absent, the large pools of domestic savings needed to buy shares do not exist, speed is critical, and public skepticism about the benefits of privatization is high? It is from this dilemma that mass privatization was born.

Design, Use, and Allocation of Vouchers

Most of the idiosyncrasies in Eastern European privatization, including auction design, are a result of the intensely political nature of the process. It is from this fact that the first and most important lesson of voucher privatization emerges: Voucher privatization is largely a political phenomenon, and must be judged as such.

The political nature of voucher privatization is borne out by the seemingly trivial decision of how to denominate vouchers. In Czechoslovakia, and later in the Czech Republic, the authorities tried to dissuade people from thinking of vouchers as substitute money by denominating them in points. Most other countries, however, have denominated vouchers in local currency. One possible motivation, as Boycko, Shleifer, and Vishny (1995) explain, is that currency denomination makes vouchers appear more like securities, giving a clearer impres-

sion that the government is making a gift to the public. In Russia this advantage was crucial because initial public acceptance of privatization was thought to be shakier than in Czechoslovakia and other transition economies. Another advantage of currency denomination is that it may increase the irreversibility of voucher privatization.

Privatization officials also must decide whether vouchers will be tradable. Allowing vouchers to be traded in secondary markets allows the rapid accumulation of significant blocks of shares, which can help improve corporate governance once companies have been privatized. Tradability has its drawbacks, however. In countries where vouchers are denominated in local currency, they can trade at a big discount to face value, threatening public acceptance of the program. Indeed, Russian vouchers sometimes sold at huge discounts, especially in the opening months of the program. Making vouchers tradable also makes it possible for foreigners to participate in voucher auctions, which can be seen as either an advantage or a disadvantage.[3] Allowing foreign participation may increase foreign investment in the country, which can bring benefits of knowledge transfer, enterprise restructuring, and improved access to world markets. Given the perception of voucher privatization as a giveaway to local citizens, however, even the most pro-Western governments are reluctant to permit foreigners access to voucher auctions. Most countries, including the Czech Republic, have reserved a portion of equity in selected enterprises for strategic buyers, foreign or domestic, and limited participation in the voucher auctions to locals.

Policymakers also must decide if each participant will receive an equal share, or whether some people receive preferential treatment based on age, work experience, or other criteria. Some countries—Lithuania, Russia, Slovenia, Ukraine—offered vouchers to every man, woman, and child, while others—the former Czechoslovakia, Moldova, Poland—limited participation to adults (normally defined as citizens 18 years old as of a certain date).[4] Czechoslovakia granted an equal number of vouchers to all participating citizens, a policy that continued with the Czech Republic's privatization wave in 1994. Poland, Russia, and Ukraine did the same, but most other countries have made concessions to some constituencies by granting additional vouchers or voucher credits. For example, Moldova, Slovenia, and the three Baltic states (Estonia, Latvia, and Lithuania) granted supplemental vouchers based on age and work experience, with older, more experienced workers receiving more vouchers than younger workers. Kazakhstan gave extra credits to rural residents, while in Slovenia vouchers have been used as compensation for unpaid wages.

Designers of mass privatization programs also must decide whether and how much to charge citizens for vouchers. If one purpose of mass privatization is to give the impression of a government giveaway, the cost to participate must be low or even free. But charging some fee, however modest, offers two advantages. It helps defray the costs of privatization and, more important, increases the likelihood that investors will take the process seriously.

The challenge for governments, therefore, is to ensure that the charge is sufficient to imply that citizens are affirming their support, but not so high that working people are discouraged from taking part. In Czechoslovakia, for example, the 1,035 koruna ($35) fee was roughly equivalent to the average weekly wage in the country at that time. The fact that more than 80 percent of eligible Czech and Slovak citizens bought and registered vouchers confirms that the charge was not excessive. Other countries, including Bulgaria, Poland, and Russia, set payments even lower to ensure that the poorest citizens could afford them. Some countries—notably Kazakhstan and Slovenia—have required no payment at all.

Whether they are sold or given away, vouchers are a limited-use currency. One of the main concerns of policymakers throughout the region has been to convince citizens that vouchers are worth something, despite their limited use. Like all auctions, voucher auctions are a search for value, and potential investors must believe that assets of value are being offered. Otherwise, even the most ambitious and sophisticated public education campaign will fail, participation rates will suffer, and the political rationale for mass privatization will be compromised. For that reason, the supply side of voucher privatization is more important than the demand side.

Each country must decide what assets can be bought with vouchers. This decision addresses the most obvious supply-side concern of mass privatization—which companies will be sold through voucher auctions. But governments also must decide how much of a company's equity will be offered, if shares will be set aside for employees (either as a giveaway or by means of a closed subscription), and whether other assets (such as apartments) can be bought with vouchers.

Arguably, the most important factor for success in any mass privatization is ensuring that enough shares in good companies are available to voucher investors. But the prominence sometimes given to worker and manager ownership can complicate things. Although some countries—the Czech

Republic, Estonia, Kazakhstan—have discouraged significant employee stakes in medium- and large-scale enterprises, most countries have granted important concessions to workers and managers. For example, in Poland's mass privatization the workers of privatizing companies were given 15 percent of the shares free of charge. Given the Yugoslav legacy of worker management, it is hardly surprising that Slovenia also granted important concessions to employees; in most companies 20–60 percent of shares are now owned by workers and managers. Latvia, Lithuania, Moldova, and Ukraine also granted significant blocks of shares to employees.

In Russia enterprises could choose from among three privatization options. Most opted for the one that granted 51 percent employee ownership. Recent research, however, has shown that managers often acquire still more shares after privatization, giving them majority control over their companies. Many observers have been critical of this approach not only because of the equity issues that it raises but also because of the inadequate restructuring that usually results. Defenders of the Russian approach, notably Boycko, Shleifer, and Vishny (1995), argue that the industrial lobby was too powerful and would have sabotaged any privatization effort that did not allow for high levels of employee ownership. They further claim that the only viable alternative to the program that was adopted was one that granted total control to employees. Whether correct or not, Russian privatization authorities certainly had to contend with a vastly more powerful industrial lobby than their counterparts in the Czech Republic.

Auction Design and Investor Behavior

The former Czechoslovakia held the world's first voucher auction. Although the programs adopted by other countries resemble the general voucher auction model first proposed by the Czechs and Slovaks, many features of the Czech auctions have been rejected.

As Boycko, Shleifer, and Vishny (1995, pp. 88–89) explain, voucher auctions in transition economies should meet four basic criteria: they should be administratively simple, millions of investors must be able to bid despite their ignorance of how auctions work and of the companies being privatized, investors must succeed in getting shares in the companies they bid for, and small investors should be able to acquire shares at the same price as professional money managers. Apart from meeting the second criterion, the Czech scheme was seen as deficient by observers in Russia and elsewhere, and so auction designs in other countries deviate in important ways from the Czech model.

The Czech voucher auction was complex, although the mechanics of the program were widely understood and caused few problems. There were teething pains, but these were attended to quickly and with little discomfort. Problems arose, however, from multiround bidding and the repricing rules adopted by auction officials at the end of each bidding round to achieve a rapid equilibrium between the supply side (company shares) and the demand side (allocation of voucher points). The auction was rigged, not to favor a particular constituency or bidding group but to ensure that few shares and voucher points would be left over when the auctions ended. Most other countries have chosen a simpler, single-round auction mechanism.[5]

Boycko, Shleifer, and Vishny argue that the political nature of mass privatization requires that investors receive shares in any company they bid for, especially for companies that are most favored by professional investors. Under the Czech voucher program no bidders received shares in any company that was oversubscribed by more than 25 percent.[6] Thus investors were sometimes disappointed.

Two features of the Czech program mitigated this problem, however. First, the top price for a share in any company was limited to 1,000 points (the value of a single voucher booklet). This approach ensured that any individual investor had enough points to acquire at least one share in even the most popular company. Second, the auction's systematic overpricing bias ensured that shares were more likely to be undersubscribed than oversubscribed, and any investor bidding for shares in an undersubscribed company would get them. The administrative complexity of this scheme did not appeal to other auction designers in the region. Russian authorities opted for a program in which investors would receive shares (or fractions of shares) in a single bidding round, even if an investor bid just one voucher for a highly popular company.

Although the Czech program apparently made it possible for different investors to acquire the same shares at different prices, here too the problem was mitigated by certain features of the auction. Czech investors understood from the outset that the auctions would take place over several bidding rounds, although the exact number of rounds was not known. Thus unsophisticated investors could refrain from investing in the first round, hoping to learn from the bids of professional fund managers.

Although fund managers also might have preferred to wait, and so avoid revealing their preferences, the uncertainty about the number of rounds and the knowledge that unused voucher points would be worthless when the auctions ended compelled most fund managers to bid their full allotment of points during the first round. Individual investors ran the same risk of holding worthless vouchers, but the consequences of failing to invest all available points were far less serious when only one voucher booklet was at stake.

Opinions differ on optimal auction design. Nevertheless, there is widespread consensus on one point: Voucher investors are, for the most part, rational. When transition began in Central and Eastern Europe, some observers feared that nearly fifty years of central planning (seventy-five years in Russia) had blunted people's economic instincts. Designers of voucher privatization programs were not deterred by this fear, having made the crucial assumption that their compatriots would be no less rational in their investing behavior than investors in advanced market economies. This confidence was well placed. Western business investors have discovered that the people of Central and Eastern Europe take to market reform with gusto. When properly trained and motivated, worker productivity improves dramatically. And consumer behavior, especially in Central Europe, is already converging with Western European norms, albeit at far lower income levels. In voucher auctions too, investors have exhibited broadly rational behavior.

The most telling evidence on this point comes from the Czech experience. Under the Czech scheme almost all shares had to be sold and most voucher points consumed. The political success of the program depended on achieving both goals. All shares were priced identically at the beginning of the auction. If all companies were priced the same, why not bid for the best? Research confirms that, indeed, demand in the first round was greatest for companies with the highest profits and sales growth and the least debt. After the first round, however, the auction officials deliberately manipulated prices to control the rate at which shares were sold and points consumed.

This manipulation was accomplished in two ways. First, shares were generally overpriced, both to quickly absorb voucher points and to reduce the probability of oversubscription. Second, shares were deliberately overpriced or underpriced, relative to one another, to steer investors away from companies that would otherwise be oversubscribed or toward companies that would otherwise be heavily undersubscribed. In other words, the authorities repriced shares in such a way that rational investors would downplay economic fundamentals, focusing instead on finding undervalued companies. That 93 percent of all shares were sold and 98 percent of voucher points were consumed by the end of the auction confirms both the success of the repricing policy and the rationality of Czech and Slovak investors.

Repricing would have failed if investors did not respond properly to the mispricing. More remarkable, deliberate mispricing was never formally revealed in public, and yet investors, individuals, and fund managers alike quickly understood the meaning of the signals that the authorities were hoping to convey in the auction prices. Not only were investors broadly rational in their behavior, but their actions demonstrated a subtlety of thinking that many observers would have assumed was beyond them.

Investment Funds, Capital Market Development, and Post-Privatization Governance

Czechs could either invest directly or assign their vouchers to an investment fund that would invest the vouchers on their behalf. Most other countries, among them Latvia, Moldova, and Russia, adopted similar policies. Such funds offer important advantages to voucher privatization programs. First, they can reduce logistical complexity by reducing the number of investors submitting bids. (This advantage is most obvious in countries, such as Kazakhstan and Slovenia, that limited company auctions to investment funds.) In such cases auction officials need only process bids from a few funds. In the Czech program, by contrast, auctions attracted several million participants.

Investment funds are more than just a way of reducing the complexity of voucher auction logistics. Competition among funds for vouchers can stimulate demand and encourage the participation of citizens who might otherwise ignore the program. This lesson was learned in the Czech program and has influenced policy in other countries. When voucher booklets first went on sale in Czechoslovakia in late 1991, demand was disappointing. Officials feared that citizen involvement would fall below the initial expectations of 4 million. Thanks to the aggressive advertising campaigns of Harvard Capital and its competitors, however, more than 8.5 million people joined the program. Encouraging the creation of investment funds has enabled governments to partly outsource the job of selling voucher privatization to the public.

Funds offer other advantages, including opportunities for diversification not otherwise available to individual investors. Also, inexperienced investors can use funds to opt out of the daunting task of picking stocks, thus removing one of the psychological barriers to participation. Funds may help consolidate shareholdings, thus increasing the likelihood that some owners will have large enough stakes in privatized companies to gain seats on company boards, thereby improving corporate governance.[7] The funds can also serve as the pioneers of an institutional investor industry that can fulfill the same sort of financial intermediation role that mutual funds and unit trusts perform in advanced market economies. But while funds can facilitate the creation and development of mature capital markets, there are other critical factors for success.

Poland's mass privatization program was not implemented until the summer of 1995, and investment funds (and the companies they acquired) are only now being listed on the Warsaw Stock Exchange. (Even so, the Polish market is the most transparent, liquid, and best-regulated stock exchange in Central and Eastern Europe.) Despite two waves of voucher privatization and more than 1,000 publicly traded companies—many of which have been traded since 1993—volume in Prague (the Czech Republic) is only one-third of Warsaw's, and most transactions continue to take place in the corrupt, murky world of off-exchange trading. Poland put a comprehensive regulatory infrastructure in place before privatization, while the Czechs preferred to privatize first, hoping to plug regulatory gaps after privatization.[8] The jury is still out on which approach is better. The Czechs did privatize much faster than the Poles, but the Poles can boast a stronger regulatory framework and, it may be argued, a deeper form of privatization.

The experience of these two Central European countries is instructive. Despite a speedy privatization program that put many shares into private hands, the Czech market has lagged the development and performance of Poland's. This contrast suggests another important lesson of voucher privatization: Voucher auctions, by themselves, are not sufficient for creating and developing liquid securities markets. Although voucher auctions can facilitate the creation of stock exchanges, any other advantages of this approach will be quickly lost unless adequate attention is paid to market regulation, minority shareholder protection, liquidity, and company disclosure.

Consider Estonia's experience. Despite a modest voucher privatization program that was never intended as the centerpiece of the country's privatization effort, the Tallinn stock exchange receives high marks from investors for its transparency, accessibility, liquidity, and the reporting standards required of listed companies. The result is a level of stock market trading activity that dwarfs its Baltic neighbors, including Lithuania, which not only has more than twice Estonia's population but also had a far more extensive voucher privatization program.

Notes

1. Poland's mass privatization program is a notable exception. Vouchers were issued but serve a different purpose than those in other programs. A Polish voucher entitles the buyer to one share in each of fifteen national investment funds. These vouchers were issued to citizens after the companies were selected by the funds, not before as in all other mass privatization programs.
2. The governments of Hungary and the former Yugoslav Republic of Macedonia have rejected mass privatization on the grounds that it does not inject badly needed capital into struggling state enterprises and that corporate governance will be weak.
3. Technically, it was possible for vouchers to be both tradable and limited to domestic investors, as in Lithuania. In other countries, however, tradability meant that any investor could buy the vouchers, including foreigners. This was the case in Russia, but owing to profound political and economic uncertainties, foreign participation was extremely limited.
4. Moldova limited participation to citizens with work experience in the country.
5. However, multiple rounds were possible, and occurred in the Kazak and Lithuanian programs. Multiround bidding offers two potential advantages over single-round auctions. First, the iterative bidding process can lead to more accurate pricing, although in Czechoslovakia auction officials deliberately injected noise into share prices. Second, multiple rounds can engage the local population in the art and practice of auctions in ways that single-bid auctions cannot. Single-round auctions are simpler to administer, however, and a single bidding round could enable privatized shares to reach secondary markets sooner, thus negating the potential advantage of more accurate pricing offered by multiround auctions.
6. This rule was the result of the country's commercial code, which prohibited stock splits (and, therefore, fractional shares). In fact, it could be argued that this rule necessitated multiple bidding rounds. If oversubscribed shares cannot be split, the only way for the market to clear is to offer the same shares in a later bidding round at a higher price.
7. The experience on this point is mixed, however. The Czech program created powerful institutional investors, but several of the largest funds appear more interested in using their shareholdings as a conduit for the commercial lending business of the banks that control them than aggressively restructuring the subject companies.
8. Poland's regulatory strategy was not entirely by design. Long delays in the privatization process are at least partly responsible for the country having a relatively complete regulatory apparatus in place before companies were privatized (and thus had shares that could be traded on secondary markets).

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The Supply Side of Mass Privatization: The Case of Moldova

Ceslav Ciobanu

August 27, 1996, marked the fifth anniversary of Moldova's independence. During these years Moldova implemented reforms that have secured its status as an independent nation-state. Because political reforms outpaced economic reforms and changes in popular attitudes, comprehensive economic reforms took time to implement. Moreover, some social and political forces were resistant to change, temporarily hindering reforms.

It quickly became clear to most Moldovan leaders, however, that economic independence and prosperity would not be possible without a radical change in Moldova's ownership structures and without a competitive private sector. Despite the diversity of beliefs influencing the development of economic reforms—including the concept of privatization—acceptable compromises were reached.

Progress to Date

Parliament designed and adopted Moldova's approach to privatization in 1990. Reflecting the sociopolitical environment of that time, the program ensured that each citizen would have an equal opportunity to purchase state property. Privatization was to proceed in two stages: mass privatization using national patrimony bonds and case-by-case cash privatization.

Several features distinguished the bonds used during mass privatization from similar tools (vouchers, coupons, checks) used in other countries. Bonds:

- were issued only to citizens of the Republic of Moldova;
- were registered documents whose value reflected the work experience of the citizens to whom they were issued (contributions to state property were also taken into account);
- could not be transferred to anyone other than immediate family members (to protect citizens against the dumping of bonds and to avoid the concentration of bonds among a small group of people);
- played an important role in stimulating demand for state property during privatization; and
- guaranteed equitable distribution of state property.

Bonds were issued to 95 percent of the public—90 percent of whom used them during mass privatization. The second stage, cash privatization, was designed to help revive the national economy and support the budget.

The privatization plan stipulated that a third of state property would be privatized for bonds and a third would be privatized for cash. It was hoped that privatizing two-thirds of state property would facilitate the rapid development of a private sector. Achieving these goals required an adequate legislative framework. During 1991–92 a series of laws designed to create a market economy were adopted, including the Land Code, Law on Amendment of the Constitution of the Republic of Moldova, Law on Ownership, Law on Entrepreneurship and Enterprises, Law on Joint Stock Companies, Law on Farming, Law on Foreign Investments, Law on Bankruptcy, and Law on Restriction of Monopolistic Activities and Development of Competition.

The Law on Privatization, adopted in July 1991, was of special importance. This law permitted privatization in almost all parts of the national economy, including the social sector. National property could be either completely or partly

privatized. Privatization was open to all citizens. The program was carried out through transfer of assets by auction and tender, sale of shares of state enterprises at auctions, privatization of property complexes (telecommunications services, tobacco processing, natural gas supply, perfumery and cosmetics) in accordance with projects approved by Parliament, and sale of blocks of shares (up to 60 percent of statutory capital) in financially viable enterprises through tenders to strategic investors.

The first privatization program, 1993–94

The legislative framework stipulated the development of two-year privatization programs approved by Parliament as laws. The first program, for 1993–94, was adopted in March 1993. Implementation started in July 1994. Implementation of the 1993–94 program was not possible immediately after its adoption because additional normative acts were needed to start mass privatization and to create needed infrastructure—including the development of information systems, the contracting of consulting and intermediary firms, and the creation of units responsible for organizing auctions and tenders.

The program included 1,618 objects—2,478 after they were split—to be privatized, along with state housing objects. Of the 2,478 objects, most were privatized for bonds at auctions and tenders, 44 were privatized for cash, and 19 large enterprises were partly (less than 20 percent) privatized.

Property that did not require intensive preparation but that could generate immediate socioeconomic benefits—including commercial centers, public catering services, social services, and other small enterprises—were scheduled to be privatized first. As experience was acquired and infrastructure improved, larger and more complex enterprises were to be included in the process. Things proceeded quite differently, however, with privatization of medium-size and large-scale enterprises preceding small-scale privatization. This development became one of the unique features of the Moldovan model. Another unique feature was the legislative provision that gave (without bonds) half the shares of agroprocessing companies to the farms that provided them with agricultural supplies.

The enterprises included in the 1993–94 program were divided, according to size, into two groups. Small objects, with a value of less than 1 million rubles as of 1 January 1992, were privatized as unit property complexes at open auctions.[1] Medium-size and large objects, with a value of more than 1 million rubles, were reorganized into joint stock companies and privatized at republican auctions (see below).

The republican system of subscription to shares, based on the Czech model, was of utmost importance to rapid, transparent, and accessible mass privatization in Moldova. This system helped accelerate mass privatization in the summer of 1994. Because of delays, however, program objectives were not completely realized. Of 2,478 enterprises, 755—just more than 30 percent—were privatized. Of these, 745 were privatized for bonds.

The second privatization program, 1995–96

In March 1995 Parliament adopted a new privatization program for 1995–96 for several reasons:

- *Legal*—stipulations of the 1993–94 program expired on 31 December 1994, creating a legislative vacuum;
- *Economic*—the need to start cash privatization;
- *Organizational*—during implementation of the 1993–94 program considerable experience was gained that had to be reflected in new legislation.

The main objectives of the 1995–96 program were to conclude mass privatization for bonds, create conditions for stabilizing, restructuring, and reviving the national economy through cash privatization, and ensure social protection during the transition.

The new program uses a different classification of enterprises subject to privatization. Small objects, with a value of less than 200,000 lei as of 1 January 1995, are privatized as unit property complexes at open outcry auctions and tenders. Medium-size and large objects, with a value of more than 200,000 lei, are privatized at republican auctions.

The 1995–96 program envisioned new objects, techniques, and payment systems for privatization. Thus the program includes a list of enterprises privatized solely for bonds, a list of enterprises privatized partly for bonds, and a list of enterprises privatized for cash. The state will retain a 30 percent or a 60 percent share in enterprises privatized partly for bonds, taking into account the enterprise's importance for the national economy. This approach avoids the use of the "golden share" as a rigid instrument to protect state interests; priority was given to more flexible market mechanisms.

The new program stipulates a transition from an ad hoc to a regular program for cash privatization, reflecting changes in political attitudes toward market reforms. Cash privatization involves small, medium-size, and large enterprises; premises of privatized objects and land lots distributed to citizens for private use; leased state buildings, offices, and construction sites that are not privatized as part of other enter-

prises; unused assets of state enterprises; and unfinished construction sites.

The 1995–96 program also established a new model of privatization: the transparent sale of large blocks of shares, with up to 60 percent of the capital of thirty-nine food, machine production, military, light industry, and other attractive enterprises offered to investors. Both domestic and foreign investors can purchase these blocks of shares. The remaining 40 percent of the shares are sold at republican auctions and to enterprise employees through a noncompetitive closed subscription process.

Enterprise privatization has paid close attention to the status of the land on which privatized enterprises are situated. The new program, which allows for these plots to be sold, takes one of the first steps toward creating a market for land, dismantling the existing barrier in this area (the Land Code allows purchase and sale of land starting only in 2001).

By January 1996, of 1,321 enterprises subject to complete privatization using bonds, 1,176 had been privatized—including 375 at republican auctions with subscription to shares, 437 at open outcry auctions, and 355 at public tenders. Only 59 of 190 enterprises that were scheduled to be sold as unit property complexes were actually sold. Some 3.1 million citizens participated in privatization, using 90 percent of the issued bonds.

These results represent not only quantitative indicators but also qualitative changes. Privatization has laid the foundation for the creation of a group of private owners, which in any modern state helps ensure social stability. Thus a basis was formed for a market economy supported by a securities market. The privatization model used in Moldova guaranteed transparency, swiftness, and fairness. Despite difficulties, the Moldovan experience qualifies as a success.

Citizen Participation in the Procurement of State Property

Moldova developed two important systems to ensure that privatization would proceed smoothly—one to disseminate information to the public, one to improve on open outcry auctions.

Information systems

The Ministry of Privatization created a permanent information center (with branch offices) to help mass privatization succeed. This system ensures that the public has access to information on the objects of and approaches to privatization. Covering the entire territory of Moldova, the system:

- publishes brochures, posters, and other printed materials;
- publishes four periodicals (*Privat Express*, *Privat Review*, *Privatizarea*, *Proprietarul*) and produces three television and radio shows;
- established hotlines to the Ministry of Privatization and its agencies;
- disseminates information to the public through mobile groups and organizes "privatization days" in different areas;
- publishes information on subscription and open outcry auctions in mass media outlets;
- organizes seminars and conferences on privatization and post-privatization issues;
- created a network of 115 bid collection sites to collect applications directly from bond holders;
- passed a decree allowing the creation of privatization investment funds (forty-three were established) and trust companies (eleven were established) to help citizens make informed investment decisions.

Broad public participation in privatization for bonds attests to the system's efficiency.

Republican auctions

Mass privatization called for a simple, efficient mechanism for collecting bonds, for applying to purchase state property, for processing the results of sales, and for registering the rights of new owners. The open outcry auctions used at the end of 1993 and the beginning of 1994 did not meet these requirements. The auctions were extremely expensive, required significant organizational effort, and took a lot of time. Such auctions were acceptable only for the privatization of small enterprises as unit property complexes. Thus, based on the experiences of other countries (primarily the Czech Republic), a system of subscription to shares through republican auctions was adopted. This system operated in parallel to the system of open outcry auctions and ensured public participation in the privatization of medium-size and large enterprises.

Republican auctions proceed as follows. At least seven days before the auction begins, the Ministry of Privatization publishes an information note listing the joint stock companies whose shares are being offered for sale. During the term (usually two weeks) defined in the information note, bond holders can subscribe to shares on their own or through trust companies or investment funds. Subscription consists of filling out a form, paying a fee to participate in the auction, and using the bond to pay for the shares requested. Applications are

submitted at one the 115 bid collection sites located throughout the republic. Each stage of collection and submission of information is subject to strict audit controls to reduce the possibility of error, distortion, and lost information. The Data Collection Center for Republican Auctions, where applications are processed, is a key element of the system.

Republican auctions have several advantages over open outcry auctions. They offer equal possibilities for all bond holders to buy shares of requested companies. They expedite privatization (hundreds of enterprises were sold at republican auctions; at the fifteenth auction the shares of 676 enterprises were put up for sale, 187 of them for the first time). They ensure an equilibrium between the demand and supply of shares. They eliminate the problem of determining the optimal size of blocks of different enterprises that are being sold. They are transparent, simple, and easily understood by participants. And they save a lot of time and money for both the state and the public.

All medium-size and large enterprises were exposed to privatization through republican auctions, and most of their shares (69.5 percent) were sold (table 1). Depending on the ratio of the demand for and offer of shares, enterprises that are sold at republican auctions are classified into five categories:

- *Less than 40 percent.* Because demand is much lower than the offer, shares are not sold and are put up for sale at a new auction at a lower price.
- *Between 40 and 67 percent.* Unbid shares are distributed among auction participants according to the number of shares they bid for. Because the sale price of shares is lowered, participants receive more shares than they bid for for the same number of bonds.
- *Between 67 and 100 percent.* Demand matches the offer and shares are sold at their initial price. Leftovers are offered at a new auction.

Table 1. Distribution of state shares in medium-size and large enterprises privatized at republican auctions

Distribution method	Quantity (millions)	Nominal value (millions of lei)	Share of state property distributed (percent)
To employees of privatized enterprises (up to 20 percent of shares)	64.7	491.7	17.7
Free distribution to suppliers of raw materials (up to 50 percent of shares)	23.2	356.3	12.8
Sold at republican auctions	254.1	1,928.9	69.5
Total	342.0	2,776.9	100.0

- *Between 100 and 300 percent.* Shares become more expensive and participants receive fewer shares than they bid for.
- *More than 300 percent.* Because demand is much higher than the offer, shares are not sold and are put up for sale at a new auction at a higher price.

Although republican auctions initially were regarded with skepticism, they proved their viability in the fall of 1994, allowing mass privatization to proceed fairly quickly. The sales procedure for the shares of enterprises included in the categories listed above was changed at the last republican auction, and shares were distributed to bidders in proportion to their bids.

Incorporation Process

Incorporation, the stage at which medium-size and large enterprises are prepared for republican auctions, is the most complex and controversial component of mass privatization. According to the Law on Privatization and other normative acts, incorporation transforms state and leased enterprises into open-end joint stock companies, is organized by each enterprise's privatization committee in conjunction with its administration, and requires development of a privatization plan.

Joint stock companies are established by the Ministry of Privatization through a constitutive declaration or by several founders through a constitutive agreement and meeting. As a successor of the reorganized enterprise, the joint stock company retains the right to use the land used by the enterprise.

Incorporation introduces a new corporate structure, the general meeting of shareholders, which elects an executive entity (management board) and auditing commission and represents the interests of shareholders. State registration takes place only with the authorization of the Ministry of Privatization. Employees maintain their working relations with the joint stock company, but shareholder-employees do not enjoy greater privileges than other shareholders.

Incorporation is simplified by the fact that normative acts contain a model constitutive agreement, statutes, privatization plan, list of subscribers for shares, and other necessary documents. Standardization of these documents allows for their computerized preparation and so reduces the time needed, lessens the possibility of errors, and increases efficiency in the processing of documents.

Reorganizing enterprises

Enterprise reorganization is key to mass privatization. The Ministry of Privatization, working with branch ministries and

departments, has helped ensure that reorganization takes place by:

- Approving the methodology for valuing property and determining the statutory capital of enterprises;
- Developing software to value property that was used at all territorial privatization agencies;
- Distributing standard forms to collect data that served as a basis for property valuation;
- Organizing seminars for enterprises' privatization committees that provided guidance on preparing documents.

Several steps were taken to simplify reorganization procedures and methodologies, reducing the time required to incorporate and auction enterprises. The staff of privatization committees was cut from eleven employees to four. The term of applications for shares without contest by members of an employee collective was reduced and the procedure for their subscription was simplified (closed subscription). One of the main documents, the privatization plan of enterprises, was improved and simplified, and began requiring data on the economic situation of enterprises.

Once the necessary documents are submitted, the Ministry of Privatization or its territorial agency signs a declaration on the establishment of a joint stock company, approves the statutes, and appoints the executive board from the members of the enterprise's privatization committee. To encourage enterprise managers to reorganize and privatize enterprises, the chairman of the executive board (usually the manager of the enterprise) is appointed for a three-year term, and other members of the board are appointed until the first general shareholder meeting. The establishment of the joint stock company is finalized by the adoption of the statutes and appointment of the executive board, the state registration of the enterprise, and its first issue of shares.

Incorporation takes more time and is more complex if it includes privatization of leased, collective, or multisector enterprises or if there are cash contributions to the statutory capital by members of employee collectives. At these enterprises a general meeting of employee collective members is called and the following activities are performed:

- Appointment of persons authorized to sign the constitutive contract of the joint stock company;
- Appointment of candidates to be included on the privatization committee;
- Determination of the amount of cash to be contributed to the statutory capital (only for enterprises included in the 1993–94 program) and the ceiling on individual cash contributions;
- Approval of the approach to determining the leasors' quotas from the private property of the leased enterprise.

As soon as the incorporation agreement has been signed and authenticated by the state notary, shares may be purchased (at par value), distributed (up to 50 percent) to the suppliers of agricultural raw materials (if the shares are of agroprocessing enterprises), and distributed in exchange for personal quotas of the leased product or deposited cash (closed subscription). By the end of the closed subscription process, a constituent meeting to set up the joint stock company is held, statutes are approved, administrative bodies are elected, and by-laws are drafted.

Evaluating reorganized enterprises' property

Evaluation of the property subject to privatization was carried out according to government methodologies. During the early stages of mass privatization evaluations—covering main assets, unfinished construction, equipment, and financial assets—were carried out by experts.

Evaluations were carried out using values of 1 January 1992 (expressed in conventional monetary units) that were then used during privatization to exchange bonds for shares. Property was also evaluated in real prices (in Moldovan lei) according to the opening balance sheet on the date of the reorganization of the enterprise, allowing the Ministry of Privatization to determine share capital and the par value of shares in Moldovan lei. During this process the need to change some aspects of this approach became increasingly obvious.

The ministry later implemented a computerized property evaluation program to speed up privatization, equipping each territorial agency with computers and training staff to use the software. Computerization saved the ministry considerable time in making calculations, simplifying correction procedures, and avoiding computation errors. Using the government's methodology, the program calculates the estimated value of a privatized enterprise's property and provides hard copies of the evaluations. The software was used to estimate the value of the property of 902 of the 1,139 enterprises that were included in the national auctions. The territorial agencies were connected by an electronic network that transmits the evaluation data to the Ministry of Privatization.

Drafting privatization plans

The privatization plan, one of the main documents used in the privatization of enterprises, must be developed by each enterprise's privatization committee and approved by the

Ministry of Privatization. Committees estimate the enterprise's property, determine the size of the share capital, evaluate the par value and number of shares of the company being founded, determine the portion of shares being passed at par value to employees and the portion being passed for free to suppliers of agricultural raw materials (in the case of agro-processing enterprises), and draft the enterprise's privatization plan. Only the privatization committee is authorized to sign the reorganization and privatization documents.

The privatization plan is drafted after all calculations have been made and contains basic financial indicators, information about the company's main activities, the company's former and current name, number of employees, and structure of share capital (according to the shareholders), as well as other information needed for potential buyers.

One section of the privatization plan details the enterprise's production (works, services), profits (or losses), profitability, and payables and receivables (based on the enterprise's condition at the end of the year prior to privatization and for the relevant trimester of the year in which it is being privatized). Data about economic, technical, and ecological risk factors are also included. The quality of the privatization plan depends on the accuracy of these calculations. To minimize the possibility of errors, these plans are reviewed by the territorial agencies and the Ministry of Privatization.

Calculating Share Prices

Privatization requires that two share prices and property complex prices be calculated: the nominal price and the initial auction price.

Nominal prices

Since there was supposed to be a strict equality between the value of state property subject to privatization and the value of the patrimonial bonds that were issued, nominal share prices of enterprises were calculated based on the value of the state property that was used to determine the value of issued bonds. The estimated value reflects the composition and balance sheet value of all properties as of 1 January 1992, but in prices as of 1 January 1993 (taking into account 1992 inflation).

Nominal share prices were calculated in conventional monetary units by dividing the estimated value of the state-owned property included in the share capital by the number of shares owned by the state in the joint stock company. Conventional monetary units were used because the national currency had not yet been issued; share prices were also expressed in Moldovan lei. One coupon (the components of bonds) was equivalent to 16,000 conventional monetary units.

Initial auction prices

Prices at the first five republican auctions were expressed in terms of coupon points (converted from conventional monetary units) and were equivalent to the nominal price of shares. Many enterprises were not sold during the first five auctions, however.

By September 1994 it had become evident that, despite efforts to balance the value of the state property subject to privatization and the value of the bonds, the value of the bonds was significantly greater. Two solutions were proposed: substantially increasing the nominal price of shares and changing the conversion scale from the nominal price to the initial auction price (which had been 1:1). The second approach was chosen, which allowed a 10–15 increase in share prices without affecting the popular view of privatization for patrimonial bonds.

In connection with this problem, the Ministry of Privatization developed methods for defining auction prices as well as asking prices for unique properties. Four ratios were defined that reflect the industry to which an enterprise belongs, its location in the republic, its placement in that location (center, central area, outlying district), and the real increase in property after 1 January 1992 (the date of property evaluation). The starting auction share price of less prestigious entities (sales and construction enterprises, enterprises repairing agricultural machines, and others) remained at the level of the nominal price (all ratios equal to 1:1).

The correlation between the initial auction price and the nominal price of profitable entities (wineries, trade-related enterprises, and others) was 3:1 or more. In many of these enterprises the initial auction price was raised by the Commission on Economic Reforms (a consultative body within the government), which provoked criticism from the Association of Professional Participants in the Capital Markets (an association of privatization investment funds and trust companies).

At fifteen republican auctions the initial auction price exceeded the nominal price by 3.87 times. During the final stage the problem of defining the initial auction price became critical and was reviewed by the Ministry of Privatization and the Commission on Economic Reforms and widely discussed in the media. Determining prices for the shares of privatized enterprises played an important role in the formation of a market mentality.

Post-Auction and Post-Privatization Activities

With many of the initial efforts required for privatization now complete, Moldova is focusing on a second generation of reforms to secure and stablize its transition to market: establishing shareholder registries, restructuring enterprises, and developing capital markets.

Establishing shareholder registries

In industrial countries people who buy or receive shares generally acquire shareholder rights once the transaction is registered in a shareholder registry. The lack of such registration in Moldova prevented shareholders from exercising their rights to sell their shares, receive dividends, and so on. Thus corporate governance, strategic investment, and enterprise restructuring were hindered.

The 1993–94 privatization program did not regulate the formation of shareholder registries. This legal void allowed for the compilation of duplicate and contradictory registries, complicated procedures for tracking shares and share circulation, and left room for mistakes and abuses in registrars' activities. Investment funds and trust companies insisted on being included in shareholder registries even though under the law they were not the true owners.

To overcome these problems, the 1995–96 program provided for the assurance of shareholder rights. The Ministry of Privatization ensured the creation and maintenance of individual shareholder registries for enterprises reorganized into joint stock companies during privatization. Regulations stipulated the formation of shareholder registry databases at each company, and a group to assist these companies was formed within the Ministry of Privatization.

The regulations established mechanisms for creating the shareholder registries, transmitting the databases to an independent registrar based on the contract between the company and the registrar, and organizing shareholder meetings and distributing shares. The third regulation was needed because the larger is the list of shareholders, the higher is the probability of abuses, blockage of share transactions, manipulation of registry information, and risk of breakdowns and technical errors.

These measures made it possible to prepare, in a short time, the registries of almost all enterprises privatized through republican auctions. By September 1996 the registries of 1,100 of the 1,139 enterprises had been prepared. The strict methodology for forming the shareholder registry established the relations between the registrar and the privatized company, allowed the adoption of standard contract forms regarding the maintenance of registries, and allowed the establishment of market prices for such services. Registries have played an important role in capital market development, training of professionals for this market, and stock exchange activity.

Restructuring enterprises

Privatized enterprises pass through a period of adjustment during which they face economic and financial difficulties, an acute lack of working capital, nonpayment among economic agents, fiscal burdens, and low demand for their goods. As a result enterprises require deep restructuring and a considerable inflow of investment aimed at reorganizing production and developing strategic decisionmaking capacities, marketing and supply policies, and accounting systems.

To help achieve the desired results, Moldova's government, assisted by international organizations, designed a restructuring program for privatized enterprises that trains and supports enterprises that consistently implement market-oriented reforms. Most of this assistance comes from the Agency for Enterprise Restructuring. In addition, a network of enterprises aimed at small and medium-size businesses has been created and the Western NIS Fund has started its activities. The European Bank for Reconstruction and Development has allocated $5 million to a project designed to modernize eight wine-making enterprises, and the World Bank is sponsoring a $35 million project aimed at developing the private sector and restructuring former state-owned enterprises.

The emerging capital market also offers vast possibilities for enterprise restructuring. Privatized companies can attract public and foreign investment by issuing securities. Interest in the Moldovan economy is rather strong. Investors are attracted by enterprises' initiative and transparency and by easy access to financial and economic information. Thus enterprises that have technically and economically grounded applications stand to benefit from multiple sources of financing. By September 1996 about thirty large privatized enterprises that play a strategic role in the Moldovan economy—sugar refineries, canneries, footwear manufacturing plants, and so on—had been restructured.

To support this process, the Ministry of Privatization researched existing and potential markets and developed marketing plans, created models for computing real production costs, drafted business plans and investment offers, and helped convert military-industrial enterprises to producers of consumer goods. These activities helped increase sales volume,

reorient production toward market-competitive goods, retain jobs, and so on.

Developing capital markets

Privatization promoted capital market development. Shares of privatized enterprises account for the vast majority—more than 90 percent, or 4.2 billion lei—of securities on the capital market. Investment funds and trust companies are an important element of this market's infrastructure: 65 percent of investment bonds have come through these entities.

Other positive signs of market development include:

- Establishment of an organized capital market, the Moldovan Stock Exchange, in June 1995;
- Development of a legal basis for the prompt registration of property rights;
- Establishment of the State Commission for the Securities Market—one of the first such institutions in the Commonwealth of Independent States with ministry status—to regulate the capital market;
- Legislative adjustments to meet international standards on information disclosure, diversification, protection of shareholder rights, and so on;
- Avoidance of financial pyramids and other financial frauds; and
- Creation of independent registrars, as well as of brokers and dealers.

The year 1996 marked a new stage in capital market development. Progress included an increase in the number of joint stock companies listed on the stock exchange, an increase in the volume and liquidity on the market, and development of a database on issuers, securities transactions, and professional participants in the capital market.

Problems that still need to be addressed include reorganizing the privatization investment funds into a more classical type of investment funds, creating conditions for attracting capital to privatized enterprises, establishing a secondary market for shares, developing market infrastructure, and improving the legal mechanisms governing secondary transactions.

Conclusion

Mass privatization in Moldova has been implemented in a rather short period. By September 1996, of the 2,235 enterprises scheduled to be privatized for bonds, the process had been completed for 95 percent. The list of companies slated for privatization represents more than half of Moldova's production potential, 93 percent of the agricultural raw material processing industry (including 78 percent of wine-making factories), 82 percent of light industry, 96 percent of trade-related industries, and 95 percent of public utilities. The share capital of privatized enterprises totals 4.3 billion lei ($950 million). About 200,000 flats, accounting for 83 percent of the state-owned housing fund, also have been privatized. Thus an important private sector has been created that will contribute to stabilization of the national economy and to integration with the global economy.

Massive public support has been a basic reason for privatization's success. The model used, national subscription and share auctions, proved its viability as a transparent and accessible system that allowed bond holders to make their own choices. The subscription period for shares for the fifteen auctions lasted 227 days. To ensure that privatization would succeed, a vast information campaign used local and national media outlets, distributed numerous informative and instructive publications, and established direct contacts with the public.

Mass privatization laid the groundwork for the creation and development of the capital market. More than 120 participants—including 43 investment funds, 11 trust companies, 28 brokers and dealers, and 31 independent registrars—participate in this market. Transactions have started at the Moldovan Stock Exchange.

The experience accumulated during the 1993–94 program was used to address deficiencies and accelerate progress under the 1995–96 program. Local specialists have been trained in privatization and market principles, consulting private business support centers that were founded with the support of foreign experts.

Moldova managed to avoid grave errors by avoiding the concentration of property among a small circle of owners, ensuring mass public participation, and organizing closely spaced auctions. Legalization of shareholder rights through a model of share registers, coordinated with the Ministry of Privatization, helped protect new owners and spurred capital market activity. Progress in these areas received a significant boost from technical assistance financed by the U.S. Agency for International Development and the World Bank. Conferences on privatization organized by the Organization for Economic Cooperation and Development, Central and Eastern European Privatization Network, and other international organizations also played an important role. The success of mass privatization has also been possible because of political consensus on the subject and because of the estab-

lishment of privatization authorities with special powers—the Ministry of Privatization and State Property Administration.

Moldova's experience provides several useful lessons for privatization efforts in other transition economies:

- Mechanisms for confirming new owners' rights must be worked out and applied as privatization begins;
- Responsibilities of the institutions involved in collecting and using property titles (bonds, vouchers, checks, coupons) must be defined before these institutions begin operating;
- Legal responsibilities and sanctions must be clearly defined for violations of the privatization process and for violations of the rights of owners of securities or privatized property;
- A balance must be struck between the value of the property slated for privatization and the value of the property titles issued to the public; and
- Mass privatization, even when implemented quickly, is no panacea. Although necessary for rapid economic reform, other economic, political, and social adjustments are also essential.

Note

1. The calculations are in rubles because the national currency, the Moldovan lei, was not issued until November 1993.

The Effects and Mechanics of Voucher Distribution in Kazakhstan

Yuzef E. Duberman

Voucher privatization in Kazakhstan is almost complete. Bidding is over, and verification and cleanup of the databases and shareholder registers of privatization investment funds is taking place. Privatization funds, which have collected the public's vouchers and acted as buyers at auctions, are restructuring to participate in the emerging secondary securities market.

At this point the main problems of voucher privatization have become apparent, as have the ways of solving these problems in a transition economy. This paper analyzes the basic aspects of voucher privatization in Kazakhstan to identify those elements that may be useful for other countries that have initiated this process.

Implementation of Kazakhstan's Program

Voucher privatizations are a relatively quick way to transfer state-owned property into private hands. As a rule, voucher privatizations have two main objectives: achieving economic expediency and efficiency and ensuring the equitable reallocation of assets. Equity concerns prevail for the designers of voucher privatization. Privatization is based on the deep-seated belief that at least part of the national property must be distributed to all citizens free of charge. Although the sociopolitical functions of voucher privatization differ across countries, their essence is the same in all transition economies.

Kazakhstan's approach to voucher privatization is unique in its use of coupons, which were distributed to the public for free. Coupons were used as a unified and specific payment instrument at coupon auctions. In Russia efforts to perfect the mechanisms of coupon privatization took place when voucher privatization was already under way and revealed weaknesses, including the preference of most Russian citizens to sell their liquid vouchers cheaply. The designers of Kazakhstan's privatization program decided to eliminate this possibility. Thus coupons were made nontransferable and individualized: they could not be sold, transferred, or granted to others. The only way to dispose of coupons was to transfer them to an investment fund as payment for shares in the state property being privatized.

Kazakhstan's citizens were not, however, protected from the temptation to quickly sell their right to privatized state property for little money. But the negative consequences of such a transaction significantly outweighed its advantages. The state, when giving coupons to citizens, was endowing them with property rights. Owners had to decide how to use those rights; otherwise the transfer would be nothing but a poor post-socialist substitute for property rights. By introducing strict limitations on the use of coupons, however, the state assumed some responsibility for their efficiency. As it turned out, the state was not able to fulfill this responsibility.

Distribution and Collection of Coupons

Privatization coupons were distributed to the public quickly. Within a short period more than 97 percent of Kazaks had received privatization coupons. Urban citizens received 100 coupons and rural citizens received 120. Coupons were issued as an authorized coupon book. Citizens had the right to invest all or part of their coupons in one or several investment funds through the National Bank branch of their choice.

Privatization funds were created based on the private property rights of their founders. The state had to develop legislation and training materials for fund managers. In all, 269 funds were established. Some funds conducted aggressive advertising campaigns to attract investors. These campaigns were not always entirely honest, however, and often asserted that citizens who invested their coupons in funds would receive large and fast dividends.

Initially, about 40 percent of citizens invested their coupons in funds, expecting the promised dividends. When these promises were not realized, there was widespread disappointment with coupon privatization, and the inflow of coupons into funds practically stopped. Recognizing that the social and political objectives of coupon privatization were in danger, the State Committee for Privatization, created in May 1995, conducted a large-scale information campaign that yielded some positive results. By 30 September 1995, the last day for investing coupons, 61 percent of distributed coupons were in the accounts of funds; the remaining 39 percent became invalid. By comparison, in Russia, where vouchers were liquid and not individualized—that is, more flexibly used as a payment instrument—less than half of all vouchers were drawn into circulation.

Organization and Conduct of Coupon Bidding

State shares subject to coupon bidding were sold at centralized coupon auctions that took place once a month in Almaty. At least forty-five days before each auction, an announcement was published on the objects being offered for auction so that interested funds could determine their bidding strategy beforehand.

At each auction 51 percent of the state shares of more than 100 joint stock companies (on average) were offered for sale. To prevent investment funds from acquiring controlling blocks of shares, funds could acquire no more than 10 percent of the shares of a single company. The negative consequences of these limitations later became apparent. Such limitations did not correspond to the nature or supposed function of the funds, which needed a controlling block of shares in order to function as investors. In addition, funds that wanted to accumulate large blocks of shares ignored the limitation by exchanging shares among themselves.

Another problem was that relatively few companies were offered for coupon auctions. Moreover, many of the companies offered were not very attractive to investors. At the suggestion of the State Committee for Privatization, the government began auctioning more companies, including those that were being privatized on a case-by-case basis and considered valuable to investors.

The book value of shares sold in the first fourteen coupon auctions totaled 728 million tenge, with 660 million coupons spent—making the average price of shares acquired for one coupon 1.1 tenge. The next seven auctions sold shares totaling 2,855 million tenge for 684 million coupons—an average of 4.2 tenge per coupon. The most significant growth took place at the last auction, where the average book value of shares acquired was 9.6 tenge per coupon. Overall, each coupon book "weighed" an average of 30,000 tenge (about $500), though their value varied considerably depending on whether funds were successful at acquiring shares at auctions and on the results of the sale of these shares at cash bidding. In general, however, the "property filling" of coupons is not high. It would have made more sense to put the shares of all companies subject to privatization up for coupon bidding and to reduce the amount of shares being offered to about 25 percent. This approach would raise the "property filling" of coupons, and blocks of shares offered for cash bidding would be more attractive for investors interested in acquiring controlling blocks of shares (rather than acquiring only 39 percent of the shares remaining after coupon sales and giving 10 percent of shares to company employees).

An electronic system for determining the winner of each block of shares in coupon privatization was introduced. After examining state property subject to sale, investment funds prepared bids and submitted them to the organizers of auctions in electronic form. Funds set prices in coupons that they would pay for various blocks of shares. The bids were collected and entered into a computer, where they were compared with the number of coupons on account for each fund and compared with each other. Funds that offered higher coupon "prices" were declared winners. The drawback of this approach is that auction participants could not correct their bids during bidding, and thus were unable to respond to competitors' bids. Funds had to guess the winning price, because it was impossible to determine that price in open competition.

During the seventh coupon auction an effort was made to conduct open bidding, creating the opportunity to increase the offered price during bidding. This auction lasted a very long time, however, creating problems for fund representatives that

had to travel to Almaty from all over Kazakhstan. In addition, this approach generated an enormous flood of coupons—3.5 million compared with an auction average of less than 500,000. Afterward, auction organizers returned to the previous method of bidding.

In all, state shares in more than 1,700 companies were offered at coupon auctions. About 70 percent of these were completely sold. The intensity of bidding increased after the ninth auction, averaging 140 companies an auction compared with about 60 before. State shares of enterprises from different sectors of the economy were sold at the auctions, though most enterprises were involved in procurement and sale of solid fuel. Most privatized enterprises had 100–1,000 employees.

Creating Shareholder Registries and Transforming Investment Funds

Once coupon bidding was over, funds were supposed to conduct a general shareholders meeting to exchange shares of funds for invested coupons. The Information Accounting Center, which maintains an electronic database on coupon circulation, provided the funds with registries of shareholder names for this purpose. These registries were only temporary, however, because analysis of shareholder data revealed a significant number of errors due to software failure, carelessness, and so on. In addition, many citizens who put their coupons in the investment funds later changed their address, name, or other identifying information. To correct the database and create final shareholder registries, a large-scale verification campaign is being carried out in which each Kazak citizen can submit information about their investment and make changes in data. All newspapers and local television stations provided information on the campaign and explained its purpose during August and September 1996.

The main purpose of the first general shareholders meeting is to determine how to transform an investment fund that has accumulated coupons from the public and used them at coupon auctions. Funds can choose one of two methods for transformation. A fund can become a full-fledged investment company that functions under the National Securities Commission in accordance with relevant laws. In this case a fund becomes an organization that is not authorized to function in any way except as a professional participant in the securities market. Funds that choose this approach should have considerable capital and experienced staff.

Because no more than 10 percent of the funds that participated in coupon auctions have the resources to act as investment companies, most are being transformed into joint stock companies that are authorized to carry out various activities, provide services that they choose, and pay dividends to shareholders from the profit gained from their activities. The challenge here is to create conditions that stimulate these companies to actively sell the shares they acquired at auctions for cash. Otherwise, citizens who invested coupons in funds will not receive dividends for a long time—leading to negative perceptions of privatization and distrust of government actions.

If funds do not actively sell their shares, it will hinder the development of the securities market and undermine the investment climate, since the government has relatively small blocks of shares (39 percent in most cases) that could be sold to strategic investors. This amount is not sufficient to attract such investors.

Conclusion

Kazakhstan's experience with coupon privatization confirms that the success of this approach is determined by several factors. The design of all the mechanisms of coupon privatization should be consistent with its objectives: both social objectives—distributing national property among the public and introducing the public to market relations—and economic objectives—identifying owners who are able to dispose of property efficiently and restructure the economy.

At the same time, coupon privatization should be closely coordinated with long-term objectives of economic and political reform and the next stages of privatization. In this respect coupon privatization in Kazakhstan has included a number of flaws that affected the public's perception of the market and the implementation of privatization in the form of cash bidding. To ensure success and achieve their objectives, designers of coupon privatizations should adopt strong mechanisms of control, verification, and correlation of data from different sources.

All privatization methods should be accompanied by mechanisms that protect against fraud and should be transparent for all participants, including coupon investors. The public should be informed of the basic features of the privatization scheme promptly, precisely, and in clear language. Before privatization starts, all its elements should be ready—

including an active promotion campaign, legislation, lists of companies offered for coupon bidding, corporatization processes for companies being privatized, and registration of share emission prospectuses.

Designers of coupon privatization must remember that it is closely linked to controversial political decisions and sensitive social problems. To succeed, the government must be firm, and should be supported by active public participation.

Part 3

Residual Share Management and Divestiture

On the Management and Sale of Residual State Shareholdings

Karla Brom

In most transition economies an enterprise is considered privatized even if only a fraction of its shares have been transferred into private hands. Thus privatization statistics can mask the new policy challenges that residual shareholding can create for state property funds and privatization agencies—that is, how to manage and eventually sell those shares.[1] Experience in the Czech Republic illustrates the issues relating to residual share management, and in Russia the issues relating to residual share sales.

Why Does the State Hold on to Shares?

There are two main reasons for governments' residual shareholdings in privatized enterprises in transition economies. Either the government retains a significant shareholding in a strategic enterprise for (mainly) political reasons or it retains shares to be sold later for cash, in the hope of raising revenue. Without a clear strategy for the continued management or eventual sale of the residual shareholdings (or both), it is unlikely that either policy goal can be realized. In mass-privatizing economies there is a third reason for residual shareholdings—inadequate demand for enterprise shares.

The political rationale for large residual stakes is that they serve as a controlling mechanism in strategic industries, especially in sectors with regulatory frameworks. The definition of strategic industries, however, has always been uncertain. Rapid technological evolution and the widespread dissemination of these innovations have rendered many ownership restrictions obsolete in what used to be natural monopolies or national security–related sectors. And while social considerations might justify certain measures if the future of many employees is precarious, they do not necessarily justify continuing state ownership of common (that is, voting) shares.

In fact, it is probably preferable for government to concentrate its efforts on implementing and enforcing a regulatory regime while holding a (temporary) golden share, giving the government a veto to protect or further its policy goals in that sector. This approach is especially relevant in large infrastructure enterprises since they require capital investment and know-how that are primarily available from strategic investors. Even where the strategic enterprise rationale prevails, residual shareholding should be temporary, with a full review in the medium term.

Retaining shares to raise revenues for the budget also has proven difficult. In mass-privatizing economies it is unlikely that a strategic investor will be willing to purchase a significant block of shares at book value if some shares have already been distributed to the public or to employees and managers for free. In fact, the opposite makes more sense—partial sale to a strategic investor, followed by partial sale to a wider range of investors.[2]

Of course, a government may hope to raise revenues from capital gains on sales of residual shares on a stock exchange. But this expectation is likely to be valid only for a few companies whose shares are liquid and are traded in highly liquid markets. Otherwise, the strategic behavior of future buyers plus the high transactions costs of a secondary offering will cancel most potential gains. The goal of maximizing budget revenues should also be weighed against the objective of enterprise reform.

Managing the State's Residual Shares

The state property fund (or other institutions charged with administering state assets prior to their privatization) is the main institution normally involved in residual share management. In most countries this institution was established solely to oversee and implement privatization—that is, to be a passive and temporary manager.

What happens, then, when this institution is given the added responsibility of representing the state in the management of partly privatized enterprises over a longer period? Consider the Czech Republic (see also Schwartz in this volume).

The Czech Republic has used three broad approaches to residual share management: passive, selective intervention to further privatization objectives, and active participation to force financial restructuring. Enterprises fell in these three categories roughly depending on their strategic role in the economy. The National Property Fund is the state's main agent in share management, but in forty-three cases that role was assigned to the Ministry of Industry.

The National Property Fund retains holdings in 945 enterprises, although it holds less than 19 percent in most (653 enterprises, or about 70 percent). Of the other 292 enterprises, it holds more than 34 percent in 182. It is in these enterprises that the property fund might be expected to be represented on executive or supervisory boards. The first challenge for the property fund is in identifying and appointing state representatives to enterprise boards. There is a shortage of experienced business people to serve as directors. Moreover, it may be difficult for appointees (who normally have other responsibilities) to devote the time needed to monitor enterprise performance, attend board meetings, and report back to the property fund. A more serious concern is that, given the fees that directors collect, they will begin to resist full privatization, since it may deprive them of those fees. The problem, then, is how to coordinate and supervise these individuals to ensure that they are acting in the state's interests and not their own.

Passive management

For many of the nonstrategic enterprises in its portfolio, the National Property Fund has instructed its representatives not to interfere with the firms' operations. Rather, they are expected to support the decisions of managers and other owners, provided those decisions do not to interfere with privatization plans.[3] This approach, however, can create problems. Given the broad base of share ownership after mass privatization, passive state shareholding can mean that there is no close monitoring of enterprise managers.

Active management

Different issues arise when governments are actively involved in the management of a company. In the Czech Republic this has happened in strategic industries, where the government decided that the enterprises were too important to be privatized and therefore retained a significant minority—or even a majority—shareholding. In this case problems arise not so much because the government maintains a sizeable shareholding but because there is a lack of transparency on government priorities for that enterprise.

Government shareholding may imply continued subsidies, directed credits, protection from bankruptcy, and so on. It also can send misleading signals to investors, who may assume that a company is a good investment (given government support) rather than recognizing that the company may be in serious financial or operational difficulty that necessitates that support.

The National Property Fund is not the only institution involved in the active management of strategic shareholdings. Representatives of line ministries also may represent the state in enterprises. This arrangement complicates the management process because managers may have easier access to and greater influence on their respective line ministries. Restructuring and sale can then fall prey to interests other than those of rapid and efficient privatization.

Nobody expects strategic enterprises to be privatized like any other enterprise, but governments must articulate a clear strategy for management, including a definite timetable for sale of the government's residual shares. Otherwise expectations, and even institutions, become entrenched and hamper future privatization efforts.[4]

What kind of residual share management is best?

When the state has substantial holdings in partly privatized companies and manages them actively, corporate governance is unlikely to improve. Experience also shows that when a government retains a residual stake there is a negative effect on the price of the initial offering. Moreover, the residual share sale is made more difficult, since investors perceive that government ownership has interfered with the company's operations. On the other hand, if the state is a passive investor with substantial holdings, it invites rent-seeking private investors.

This explains why many investors may feel more comfortable knowing that the government has a residual stake—it may provide an opportunity to alter the rules of the game in favor of the company.

Governments should elaborate a clear strategy for managing their residual share portfolios. This strategy should address issues such as the difference between temporary and permanent stakes in privatized companies, in terms of the institution responsible and the nature of their mandate. In the few cases where government has chosen to retain a long-term residual stake for political or strategic reasons, the institutions involved should be allowed to play an active role so that rent-seeking behavior by majority (or controlling minority) shareholders can be avoided. It is important, however, to clearly state the reason behind the retained shareholding, and to make commercial profitability a primary goal of the state asset manager.

Government functions of owning residual shares and regulating enterprises should be clearly separated. Although line ministries have industry-specific knowledge, it is inadvisable to involve them in company management given their vested interest in retaining control over industries in their sector and the barriers to competition that this dual function might produce. It may be a better use of scarce government resources to concentrate on effective and impartial regulation to create a level playing field for all entrants; this will, in turn, reduce the perceived need for government shareholding in most sectors.

Experience shows that the creation of state holding companies to manage long-term shareholdings hurts not only the performance and corporate governance of the enterprises, but also the development of a transparent regulatory framework that encourages competition and an efficient allocation of resources. This can create and strengthen vested interests that are foreign to the goals of economic efficiency and consumer welfare.

One solution to some of these problems is to contract out management of smaller temporary state shareholdings to professional asset managers who are given proper incentives to maximize future capital gains. The state should supervise asset managers, however, to ensure that they do not become a tool of management.

Selling Residual Shares

Any privatization raises many issues: ownership structure and corporate governance, sale price, share distribution, restructuring, and possible unemployment. With a residual share sale there are additional complicating factors, including revaluation and pricing, minority shareholder rights, use of proceeds, and so on. Moreover, the sale will probably be subject to more scrutiny by the public, the press, and parliament, and likely require more time and resources from the government agency responsible for orchestrating the sale. Thus full privatization should be the policy whenever possible.

Various methods have been used to sell residual shares—including sale to a strategic investor after mass privatization, trade sales followed by public offerings, and trade sales followed by voucher privatization. The method of the primary sale, however, tends to determine the effectiveness of the method used for the secondary one—which is why policymakers should have a well-developed plan for phased privatization. This plan should be reflected in the contractual or other arrangements with primary buyers and in the enterprise's privatization plan.

Russia's experience with post-privatization share sales demonstrates the potential conflicts of interest between state and nonstate shareholders when choosing a method for residual share sales (see also Radygin in this volume). The state, of course, seeks to maximize revenues for the budget (and will prefer an auction) but nonstate shareholders (in Russia, primarily managers and employees) want to consolidate ownership of the enterprise (and at the lowest possible price). None of these interested parties was particularly interested in any capital injection into the company that sale to a strategic investor might bring.

In 1995–96 Russia was not unlike other economies in the region. After a rapid initial privatization, the state was left with large residual shareholdings to sell, with presidential elections looming and popular support for economic reform waning. The main objective of the government's residual share sales was to raise revenues for the budget. In 1995 various techniques were used, including auctions and tenders. These methods, however, raised only 1.1 trillion rubles.

By the end of 1995 emphasis was placed on the sale of residual shareholdings in strategic enterprises through loans for shares; by now irregularities in this process are well documented. These sales alone raised about 5.1 trillion rubles (that is, nearly five times the amount from standard methods). Even so, while replenishing the budget, the Russian government may have done irreparable damage to the public's attitude toward privatization and the main players involved in it. Moreover, it is not clear that this scheme has done anything

to improve the corporate governance and efficiency of the enterprises involved. In that sense, then, it could be viewed as a failure of privatization policy.

Minority shareholder protection

Minority shareholder protection is another important consideration in choosing residual share sale methods. After the initial privatization of shares in Russia, most enterprises were left with an equity structure that included substantial insider ownership, with external ownership divided between investment funds, banks, and other outsiders, and a small holding by the state. In the residual share sale there was either demand for the shares (typically by one larger shareholder wanting to consolidate ownership) or there was none. In the first case the residual share sale simply became a battleground between two owners struggling to gain a controlling interest, with little concern for other shareholders. Moreover, managers had no incentive to provide accurate financial information, since doing so would only aid outsiders in the struggle for control. In theory, share prices in these sales should include a control premium, but they seldom do, given the lack of a basis for evaluating the enterprise's value. Thus the interests of small shareholders typically were subsumed to those of the parties struggling to gain control. Passive portfolio investors steer clear of these types of deals.[5]

What is the best way to sell residual shares?

When strategic investors are the initial buyers, it might be more efficient to have warrants, convertible bonds, or equivalent contractual arrangements for future sales. Experience has shown that when such arrangements are not in place, the value of residual shares can drop dramatically.

Given the poor state of enterprises in transition economies and the need for active restructuring policies, capital increases might be useful in future privatizations. This approach, however, should be well targeted and limited to enterprises that have effective restructuring plans or are in socially sensitive sectors and regions—or both. There should be transparency in the selection process for such capital increases, since they benefit (existing and new) private shareholders and are easily assailable from a political point of view.

Various techniques have been used for the sale of secondary tranches in capital markets. These include accelerated bookbuilding as well as block sales to institutional investors. Whatever the technique, price attrition and strategic behavior by large players in the market should be avoided through careful monitoring and effective sanctions. Competition among potential institutional investors and transparency in the bidding process are also essential for a successful secondary offering. Finally, timing, in terms of both the general condition of the market and the sequencing of transactions, is crucial.

The success of future privatizations and the credibility of the government's divestiture program depend on ensuring that the interests of primary shareholders are not jeopardized by the secondary sale. Clear-cut preemption and appraisal rights should be defined ex ante and respected throughout the privatization process. Where such rights did not exist at the time of the primary sale, there should still be consultation that takes into account the interests of existing shareholders, taking care to not create serious bottlenecks in decisionmaking.

Applying mass privatization techniques to residual shareholdings might be a politically attractive and low-cost approach (with minimal influence on corporate governance) when firms are controlled by strategic investors and the residual stakes do not amount to blocking minorities.[6] In this case transparency is crucial, since the primary shareholders are (directly or indirectly) the public.

Lessons for Mass-Privatizing Economies

The sale of 100 percent of the shares of a company is, in principle, the most efficient way to address the main objectives of privatization: higher economic efficiency through better corporate governance, and revenue for the state budget. Even so, full privatization is not always feasible.

Privatization is simply a means to improve the efficiency of enterprises and to support economic reform. Thus institutions, behavior, and the decisionmaking process are vital in forming post-privatization expectations and behavior. While residual shareholdings in transition economies may be hard to avoid, it is essential that as much thought be given to elaborating and announcing policies for residual share management and sale as was given to the initial privatization policy. Any valid concerns about residual shareholding, political or economic, must be weighed against the costs of continued state ownership.

Governments will be better served by focusing on implementing a sound regulatory framework for industry than by coordinating and mediating the conflicting interests of managers, employees, owners, and government agencies. In fact, residual sales can promote other goals related to economic

reform, including capital market development. Residual shares can play a role in the privatization of the social security system and thereby promote the development of large institutional investors, such as private pension funds. Some shares in privatized companies can be kept for a later contribution to the pension funds' startup assets or, even better, residual privatization receipts can be targeted for pension fund capitalization.

Finally, when considering the relative risks of partial privatization, mixed ownership is an important consideration. Actions by government, in whatever context, are necessarily political. Thus until an enterprise is fully private, it will be subject to the vagaries of politics, and in most cases mixed ownership will mean less than optimal efficiency gains.

Notes

1. Residual shareholdings are enterprise shares that the state continues to hold after an enterprise has been partly privatized. This does not include enterprises that continue to be owned entirely by the state after an initial wave of privatizations in which other enterprises were privatized.
2. If partial sale to a strategic investor were unsuccessful, it might make sense to include all shares in a voucher auction and allow them to be concentrated through purchase on the secondary market, rather than retaining a shareholding in the hope of eventually identifying a strategic investor.
3. One exception is dividend policy, where the National Property Fund has instructed its representatives to vote against dividend distribution in favor of reinvestment.
4. The problems with management of residual shareholdings are not unique to mass-privatizing economies. Hungary and Poland had similar problems organizing and controlling the management of residual shareholdings by government institutions.
5. In fact, as Radygin (in this volume) points out, while it is typical for portfolio investors to be interested in a company that has an important strategic investor, in Russia the opposite is true. Small investors perceived the presence of a large owner as a threat to their interests and potential dividends.
6. Finding strategic investors for voucher-privatized firms, although fine in theory, might be complicated and time consuming.

The Czech Approach to Residual Share Management

Andrew Schwartz

Despite early progress with mass privatization—the first large-scale privatization laws were passed in February 1991—and an economic policy predicated on the rapid divestment of state assets, the Czech government remains an important enterprise shareholder. In December 1994 the Czech National Property Fund (NPF), the repository for most state shares, retained shareholdings in 1,426 of 1,738 privatized enterprises. In April 1996 the NPF still owned shares in 968 enterprises.

The large residual share portfolio resulted from unintended consequences related to the Czech approach to privatization. The Czech state still owns many enterprise stakes that were expected to go to voucher holders, employees, and foreign investors but that went unallocated during voucher privatization. In addition, Czech reformers chose to retain state ownership in many enterprises, including so-called strategic enterprises and enterprises that might take a foreign partner.

State ownership is not confined to small stakes in small and medium-size companies. Of the twenty largest Czech industrial companies, the state (not including local governments) owns at least 46 percent of fourteen (*Mladá Fronta Dnes*, 25 May 1996). Thus, despite the government's emphasis on private sector development, the state will continue to play a prominent role in the economy.

Principles Guiding Share Management

The Czech Republic's approach to managing residual shares is driven by faith in the private sector and by disdain for government intervention. The state rarely uses its residual shareholdings to influence the operational decisions of enterprise managers. The government is not averse to milder forms of intervention, however, and—depending on an enterprise's political or economic importance and readiness for market competition—occasionally influences restructuring, investment, dividend, and personnel decisions. The government's distinctions between nonstrategic and strategic shares guide the Czech approach to residual share management.

The neoliberal view that the state should not actively intercede in corporate governance shapes the management of nonstrategic residual shares. The state does not use its nonstrategic residual shareholdings to influence corporate decisions, but rather to safeguard the value of the enterprise. Exceptions include privatized large conglomerates and troubled companies that the government assists with financial restructuring.

The state treats its strategic shareholdings differently. A privatization that may produce a large bankruptcy, encourage an unfavorable business alliance, or compromise vital state interests is deemed unacceptable for strategic enterprises. In these cases the Czech state usually retains a majority or large minority shareholding until it determines that the enterprise is ready to be privatized.

The Czech state uses three broad approaches to manage its strategic shares: financial restructuring, typically in preparation for further privatization; selective intervention (for example, through capital infusion or management changes), often in coordination with wider state aims; and passive monitoring, waiting for the right foreign partner or monitoring enterprises that have already concluded strategic

alliances. The state rarely, if ever, actively intervenes in enterprise operations.

Two policy implications can be drawn from the Czech experience:

- *Minority state shareholdings may complicate corporate governance,* as is typically the case in nonstrategic enterprises. Enterprise ownership structures will not become firmly established until the state sells its residual shares. In the meantime, private owners may be unwilling to commit capital and expertise. In addition, firm managers or private owners may be able to co-opt state-appointed board members to pursue private or corporate interests rather than state interests. Separating privatization institutions from line ministries, as the Czechs have done, may help minimize conflicts of interest. Alternatively, governments may consider using "golden share" arrangements or developing a regulatory apparatus to monitor enterprise behavior under certain circumstances.
- *State intervention in enterprise restructuring may assist overall economic recovery,* especially when the enterprise is strategic. The Czech case shows the state's potential to bring together interested parties to initiate financial restructuring or to downsize uncompetitive enterprises. However, state share ownership may prompt economically unfavorable choices if the process becomes overly politicized. Thus a consistent and transparent management strategy may be preferable to an ad hoc and opaque strategy.

Range of Management Approaches

As noted, the Czech approach to residual share management is embedded in the distinctions between nonstrategic and strategic enterprises. An enterprise is strategic if it is large or politically sensitive and the state retains a substantial ownership stake. Otherwise, the enterprise is nonstrategic.

The distinction between strategic and nonstrategic enterprises differs from that used in industrial countries, which generally designate as strategic large, powerful, or technologically advanced enterprises. The Czech government does not consider any privatized enterprise strategic, no matter how important it may be. Moreover, the list of strategic enterprises may change as policies shift or as strategic enterprise shares are privatized. For example, in 1995 the state transferred a 34 percent share in regional energy distributors to local administrators. Of the remaining 45 percent held by the NPF, 20 percent is slated for a strategic foreign investor and 25 percent is to be sold on the open market. There will be sixteen fewer strategic enterprises if these shares are privatized. On the other hand, state policy toward the national energy utility, ČEZ, is still evolving. Some analysts argue that ČEZ—which holds a monopoly on the country's energy production—should be reconfigured, perhaps broken up to increase competition. Such a move would change the state's share levels in ČEZ, as well as ČEZ's strategic enterprise status. Uncertainty also surrounds the disposition of state shares in steel enterprises and banks.

Strategic and nonstrategic enterprises generally can be distinguished by two features. First, the state tends to own relatively small stakes in nonstrategic enterprises. Although the state owns more than a third of shares in 17 percent of nonstrategic enterprises, it owns more than a third of shares in 88 percent of strategic enterprises. Second, while nonstrategic enterprises span the Czech economy, there are only fifty-nine strategic entities, including sixteen gas and electricity distributors, seven coal-related enterprises, five refineries or pipeline owners, four banks, three steel mills, the national energy utility, and an automobile manufacturer (tables 1 and 2).

Nonstrategic enterprises

The Czech management approach for nonstrategic enterprise shares is an outgrowth of the rapid privatization policy and the leadership's conviction that the state is not an efficient enterprise owner. The Czechs state's nonstrategic holdings are presumed to be temporary, to be sold as quickly as feasible. In the meantime, the state is legally obliged to safeguard the value of the enterprise. The state does not take an active role in enterprise management. The state's primary approach to managing its residual nonstrategic shares is passive management (table 3).

A quiet role for the state. The NPF was created to manage the Czech state's shareholdings; however, it was never intended to be a corporate manager. Rather, "the elemental task of the representative of the Fund [NPF] on the board of directors or supervisory boards is to ensure the realization of the approved privatization project and in the most expedient fashion,

Table 1. National Property Fund share portfolio, April 1996
(number of enterprises)

Type of enterprise	Ownership share 100%	67–99%	51–66%	34–50%	20–33%	0–19%	Total
Nonstrategic	19	33	42	62	113	650	909
Strategic	4	11	7	28	4	3	59
Total	23	42	50	90	120	653	968

Source: National Property Fund; author's calculations.

Table 2. Selected state shareholdings in strategic enterprises, April 1996

Sector	Stake (percent)	Managing ministry
Banks		
Investiční a poštovní banka	33	Finance
Komerční banka	49	Finance
ČSOB	90	Finance
Česká spořitelna	45	Finance
Utilities		
ČEZ	67	Industry
Sixteen regional energy distributors	45–49	Industry
Insurance		
Česká pojišťovna	26	Finance
Airlines		
ČSA	57	Transportation
Telecommunications		
SPT Telecom	52	Economy
České radiokomunikace	70	Economy
Steel		
Nová Huť	65	Industry
Vítkovice	68	Industry
Coal		
Mostecká uhelná	46	Industry
OKD	54	Industry
Severočeské doly	55	Industry
Four others	31–47	Industry
Refineries and petrochemicals		
Chemopetrol	61	Industry
Kaučuk	73	Industry
Sokolov	74	Industry
Manufacturing		
Aero Holding	62	Industry
Škoda Praha	55	Industry
Škoda-Mladá Boleslav	30	Industry

Source: National Property Fund; author's calculations.

according to the specified privatization method" (NPF 1995). Thus the NPF instructs its representatives to play a limited role in enterprise management. The NPF only encourages its representatives to help managers and owners with restructuring and management changes so long as new enterprise policies do not impede the eventual privatization of state shares. NPF regulations mandate that its representatives pay special attention to cases involving adjustments to enterprise statutes, changes in ownership structure, significant property sales, issues of convertible debt, shifts in basic capital, and negative or qualified reports from auditors (NPF 1995).

Surveys and interviews confirm that the state is a quiet owner. In a 1995 survey 82 percent of general directors and 64 percent of enterprise board members rated the NPF a 1 on a 1–3 scale (with 1 being most passive) of enterprise activity.[1] Interviews conducted by the author with industry and government officials also found that the state does not play an active role in shaping corporate policy. Moreover, the interviews found that the state typically is a passive manager even when it is a majority shareholder.

Table 3. Share management strategies in the Czech Republic

Approach	Examples
Active operational intervention, including production and price planning	None
Passive management, including temporary holding for privatization	Most nonstrategic enterprises
Financial restructuring, including privatization preparation	Indebted enterprises Refineries and petrochemical firms
Politically sensitive intervention	Coal mines Steel mills
Infrastructure development	Banks Utilities
Passive monitoring, including strategic partnership benefits	SPT Telecom Automobile manufacturers National airline

Dividend policy may be an exception to the Czech government's passive strategy, however. Although the government instructs its representatives in nonstrategic enterprises to support the decisions of supervisory boards in shareholder meetings, NPF regulations require that its representatives vote against dividend payouts at shareholder meetings when the state holds a majority stake (NPF 1995). NPF opposition to dividend payouts seems logical in those circumstances, since keeping profits in nonstrategic enterprises makes them easier to privatize. As a result of the state's antidividend policy, only five of the country's twenty largest firms paid dividends in the first quarter of 1996. Yet most government officials supported the 15–20 percent dividend payouts announced by Komerční banka—a strategic enterprise—in April 1996. In the past most government officials had encouraged Komerční banka (and other banks) to issue lower dividends and to use the remaining funds as provisions against bad debt. Thus government dividend policy is somewhat difficult to categorize.

Problems with state-appointed board members. The ways in which the NPF passively manages its shareholdings reveal why the state may not be an effective temporary owner. The main problems are in recruiting, monitoring, and maintaining the proper incentives for state employees who sit on enterprise boards.

The NPF has a hard time finding knowledgeable, honest people to fill openings in company board slots (many large Czech investment funds have the same problem). A recent survey found that state representatives sit on the boards of 177 enterprises (Šanda 1995). Most of these representatives are NPF employees, private businessmen, and (in a few cases) ministry officials. NPF-appointed board members generally are not experts in the enterprise's business, however. In addition, outsiders may not be able to properly monitor an enterprise; company boards usually meet just once a month or once every two months.

State monitoring is also a challenge. Although NPF appointees are required to submit detailed reports on board and shareholder meetings, the NPF cannot closely evaluate appointee performance. Monitoring is also difficult because privatization institutions are ephemeral; once privatization is complete, the NPF representatives will lose their jobs. The Ministry of Privatization, for example, was abolished in June 1996; the same is planned for the NPF. Thus the NPF may find its appointees supporting enterprise interests over state interests because enterprise managers are potential employers. Recruitment and supervision challenges help explain why the NPF sometimes transfers its ownership rights to line ministries in important cases.

The development of a lobby of government representatives who support continued state ownership—to the detriment of rapid privatization—is one risk of the passive approach to management. State board appointees receive many attractive benefits, chief among them a sizable income from sitting on enterprise boards that is often several times their outside income. If enterprises are privatized, representatives presumably lose their seats on these boards—and with them, the fees. To ease this potential conflict of interest, the NPF recently lowered to three the number of memberships on enterprise boards that one person may hold.

Why temporary share management may impede corporate governance. Perhaps the greatest risk of the Czech approach to share management lies not in the government's passive strategy but in the fact that the state's residual shareholdings are temporary. In many enterprises corporate governance may remain unsettled until the state sells its shares. Private owners have little incentive to make long-term investments when the government retains significant shareholdings. Managers also may have few incentives to support costly technological improvements; instead they may seize assets for short-term personal gain.

The dispersed ownership of many Czech enterprises exacerbates the risks of temporary state ownership. Under these circumstances relatively small stakes may well be decisive for corporate governance. For example, in one enterprise the NPF owns 22 percent of shares, the two largest investment funds together own 18 percent, individual shareholders own 40 percent, and the remaining 20 percent are scattered among other investment funds and employees. In this case the two investment funds, working together, decide on matters important to the enterprise. But what happens when these two owners disagree, and which one will the NPF representative support? On what basis? Clearly, the NPF representative is an appealing ally for both managers and other owners.

Are golden shares the answer? Golden shares are sometimes proposed as a solution to the inevitable dilemmas that arise when state representatives sit on enterprise boards. These shares, based on special provisions written into enterprise statutes that offer the golden shareholder extraordinary rights, are intended to substitute for minority share ownership.

Golden shares and other extraordinary provisions are popular in the Czech Republic. One common golden share provision requires that new owners maintain an enterprise's primary business activity. Several pharmaceutical companies and research companies have these golden shares. Another type of golden share protects the rights of consumers. The Czech state's golden share in regional gas and electric distributors requires that they serve all consumers within their region. Yet another type of golden share prohibits the sale of enterprises to foreign investors.

Some golden shares in transition economies have time provisions because the shares are designed to protect the state's interest in enterprises until ownership is completely privatized. Most Czech golden shares expire in 1997, five years after the state established many joint stock companies. Golden shares that prohibit sales to foreign investors often are not subject to time limits, however.

There are reasons to doubt the effectiveness of some golden shares. First, the Czech state cannot closely monitor golden shares in most enterprises. In a typical case, a golden share in a group of recently privatized research firms mandates that the firms create a fund to continue basic research. No such fund has been created, nor do the managers intend to establish such a fund. Although the NPF owns more than 20 percent of each company, the government has imposed no sanctions—most likely because government officials do not know

about the violation. Second, it is unclear what would be happen if a golden share arrangement were challenged in court; the Czech Commercial Code does not address golden shares. Third, the five-year limitation on most golden shares is unlikely to do more than delay new owners from carrying out their business plan. The establishment of reasonable, enforceable regulations ultimately may be the best alternative to the conflicts of interests that arise when the state is a passive owner.

The unforeseen outcomes of passive management can be traced to incomplete privatization. Reaccelerating privatization may now be the Czech state's best policy for managing residual shares. The sale of residual shares may be complicated by the lack of adequate regulation and liquidity in Czech capital markets, however. In addition, the state's minority shares may become undervalued if other owners have already consolidated control over a majority of enterprise shares. The state's minority shares may not easily find a buyer at a fair market price since majority owners dominate corporate decisionmaking. Nonetheless, questions about the management of residual shares in nonstrategic enterprises may become moot if the state can overcome the restraints of its capital market and quickly privatize its residual shares.

Strategic enterprises

The Czech approach to managing strategic shares tends to be fluid, customized to individual cases. Still, three broad share management strategies have emerged, listed below according to the degree of state intervention.

- When the Czech state helps *financially restructure* enterprises, often in preparation for further privatization, it uses its shareholdings both as leverage over the process and as an inducement to private interests during privatization. The need for financial restructuring is often linked to the preponderance of debts accumulated under central planning and during the first years of transition.
- When the Czech state, consistent with wider state aims, *selectively intervenes* in strategic enterprises, it influences enterprise management through its ownership stake and through subsidies, regulation, and (in rare cases) by forcing management changes. This approach is used for infrastructure assets and politically sensitive strategic enterprises.
- When the Czech state *passively monitors* its shares, it is waiting for the right foreign partner or it is monitoring enterprises that have concluded strategic alliances. Foreign strategic alliances are the most important because the state wants foreign strategic partners to provide market access, technological know-how, and capital investment.

Many interests play a role in managing strategic state shares: NPF and line ministry officials, enterprise managers, local politicians and administrators, and state economic ministers (including the prime minister). The role these interests play and their influence on state policy is enterprise- and situation-specific. Private shareholders rarely exercise an important voice in state share management.

Unlike in nonstrategic enterprises, line ministries often play an important role in strategic share management. In June 1994 the NPF signed over ownership rights in forty-two companies (and its golden share rights in three enterprises) to the Ministry of Industry and Trade. Of these, thirty-one enterprises were strategic. Several enterprises were then handed over to a special projects team organized by the ministry to oversee enterprise financial restructuring.

Nonetheless, lines of authority are often obscured. For example, it is not clear who—if anyone—has the final say in managing state bank shares; the chairman of the central bank, minister of finance, and chairman of the NPF are all charged with setting state policy. Even the influence of the special projects team at the Ministry of Industry and Trade depends on the political savvy of enterprise managers, the interests of outside actors (especially banks that are enterprise creditors), and the wider constraints (such as ideology) of state policy.

In some cases the Czech approach has succeeded. The state has restructured and privatized several enterprises. Others have been downsized. Yet state policy is sometimes mistrusted because the bargaining among interests is rarely made public. The possibility of negotiations becoming politicized increases when business arrangements are mysterious. In addition, share valuations may become unstable if the state, as a large stakeholder, does not clarify its priorities. This does not imply that state ownership in strategic enterprises must undermine share prices, however. Strategic enterprises SPT Telecom, ČEZ (the national utility), and Komerční banka are among the most liquid and stable issues on the Prague stock exchange.

Financial restructuring. The Czech state's success in financially restructuring enterprises is often overlooked. Many enterprises, burdened by debt and facing competitive markets for the first time, have been financially reorganized in preparation for privatization. As private companies, these firms have escaped state custodianship and bankruptcy. Moreover, in one

significant case—the absorption of oil and petrochemical companies Kaučuk and Chemopetrol into Unipetrol to facilitate the equity participation of a consortium of international oil interests—the state is reorganizing its enterprise holdings to advance strategic foreign investment. One indicator of success is that the state is no longer a significant shareholder in several important enterprises.

The fate of the conglomerates left over from central planning illustrates the Czech state's aggressiveness toward financially restructuring enterprises in preparation for privatization. To prepare the units of large conglomerates for privatization, the state selectively removed debt from enterprises' books through the Consolidation Bank or the NPF, or it recapitalized the creditor banks. In some cases the state offered guarantees of outstanding receivables. (These receivables had become a serious problem in 1990–91, when enterprises decided it was easier to owe suppliers rather than to ask capital-poor domestic banks for additional credit.)

The state bailout was a partial solution. Although the state addressed the stock problem by clearing enterprises' balance sheets, the flow problem—expressed as the hemorrhaging of red ink and the accumulation of interenterprise debt—persisted. In 1992 the explosion in interenterprise debt implied that 43 percent of all firms were insolvent, including nearly all the conglomerates (Klacek and Flek 1995). Although in theory an enterprise could simply be thrust on the open market—thereby releasing the state from further responsibility—if the enterprise were to become bankrupt, its debts would surely return to the state, perhaps in foreclosure. Thus the state needed to find owners who would not immediately strip enterprise assets and to satisfy creditors (mainly banks) that were still owed billions of crowns.

The Czech government sometimes induced creditors and managers to take on corporate restructuring in place of the state. This approach—often in the form of debt-equity swaps—has had mixed success. In the case of Aero Holding, for example, a debt-equity swap left the company without sufficient working capital; as a result the company was unable to meet its payroll. On the other hand, the apparent revival of Škoda Plzeň, the largest Czech engineering concern, may have been the consequence of the financial restructuring negotiated among the state, banks, managers, and ministry officials.[2]

In some cases the special projects team within the Ministry of Industry and Trade helped rebuild enterprise balance sheets. The restructuring team typically consisted of enterprise managers, a member of the supervisory board, ministry officials, and, in some cases, foreign advisers. As part of the restructuring process the special projects team enlisted the support of international agencies such as the U.S. Agency for International Development and the European Union's PHARE program, advised on debt restructuring negotiations, and on occasion pressed for the replacement of inefficient management (Storey 1996).

The special projects team helped coordinate a careful strategy for the financial restructuring of aircraft manufacturer Let, a subsidiary of Aero Holding. Part of the debt was exchanged for equity while other creditors were repaid, sometimes with airplanes. Similar financial restructuring occurred at Zetor, a troubled tractor manufacturer. The state Consolidation Bank, which assumed part of Zetor's old debts in exchange for equity, played an important role. Vladimír Dlouhý, the minister of industry and trade, called the Zetor case the best example of state financial restructuring (*Ekonom,* 2 May 1996). State-initiated financial restructuring will continue since the debt situation of many Czech companies is far from resolved.

Selective intervention. The Czech state selectively intervenes in infrastructure enterprises and in politically sensitive enterprises that are not ready for market competition. The approach to share management depends on the overall policies in each enterprise's industrial sector. Share management is successful in sectors, such as coal, where the state has maintained consistent policies. In other areas, such as steel mills, where the state has not adopted consistent policies, state aid has become politicized to the detriment of corporate restructuring.

Coal mines and steel mills are important, politically sensitive enterprises. These enterprises are critical suppliers to other large firms, carry hefty debt burdens, and employ thousands of workers in regions where alternative jobs may be scarce. It was universally assumed that these enterprises would fail if exposed to market forces without significant restructuring. In both sectors the state exercises its ownership leverage as part of a government strategy to sustain these enterprises, regardless of cost. The government is downsizing the coal industry, but it is struggling to restructure the steel industry. What accounts for the different outcomes?

In the coal-mining industry the state follows a plan. The state subsidizes coal producers to invest in the purchase of machinery and equipment. It also provides large subsidies for ecological cleanup. The state also protects coal companies against cheaper imports, especially from nearby Polish mines.

Most important, the state subsidizes coal companies to close mines. The state has supported generous and early retirement benefits to miners as a critical appendage to its mine closure initiatives.

No one doubts that the coal companies spend much of the state subsidies according to the state's intention. One proof is the radically decreased miner workforce. The workforce of the largest Czech mine, OKD, declined by 61 percent between 1990 and 1994, from nearly 90,000 workers to about 34,000 (Bébrová 1995). State officials and investment professionals expect mining to be a profitable industry in the future.

Overall, the steel industry presents a less sanguine picture than the coal companies. Whereas the state has initiated restructuring changes in the coal mining industry, it has been unable to restructure large steel mills. One reason may be that restructuring Czech coal producers is primarily an issue of downsizing. Restructuring steel companies, on the other hand, requires not merely downsizing but introducing advanced technology, modern methods of work organization and marketing, and sophisticated pricing techniques. A more important reason the restructuring of steel companies has lagged behind that of coal companies, however, may be the politicization of the state share management process.

Consider the cases of the two large neighboring Moravian steelworks Vítkovice and Nová Hut'. In April 1996 the Czech state owned more than half the shares in each company. Observers close to the situation agree that these mills have undergone minimal restructuring. Most blame the slow progress on a political struggle between the managers of the two enterprises. According to some experts (especially those associated with Vítkovice) these steelworks should be closely integrated, especially through the joint construction of a mini-mill. Other experts (especially those favoring Nová Hut') consider the mini-mill a problematic concept, associated more with the priorities of Vítkovice than with the best interests of Nová Hut' or the domestic steel industry as a whole. According to this view Vítkovice needs the mini-mill to secure its supply of crude steel, and ultimately to deflect attention from its lack of restructuring.

In any event, the state was unable to enforce working agreements between the two enterprise managers for several years. Eventually the state forced the replacement of the manager of Nová Hut'. But was it the right manager? Some analysts claim that the steelworks are working closer together and that restructuring is under way. Nová Hut', with the cooperation of Vítkovice and U.S.-based Kaiser Steel, recently signed an agreement to construct a new mini-mill. Others argue that the new mini-mill will not solve the greater problems of capital shortage and especially poor management. In that regard, some even argue that the ouster of Nová Hut's manager may signal the eventual death knell of the Czech steel industry.

For our purposes, however, the most important issue is not whether the economic result stemming from the resolution of the management struggle is ultimately better or worse. Rather, it is that the struggle between the two managers was fought on political, not economic, turf. Each manager had important political backers. Rumors connected one manager with one political party, the other manager with another political party. Interviews with state officials in the relevant ministries strongly suggest that key steel decisions, including personnel, were worked out in negotiations between politicians at senior levels, not mid-level bureaucrats. Thus Vítkovice's manager won a political victory.

The problems at Vítkovice and Nová Hut' were replicated elsewhere in the Czech steel industry. Only the manifestations differed. The Czech state is in the process of taking back a hastily privatized Czech steel mill, Poldi Kladno. The state had sold Poldi Kladno to owners with insufficient capital backing in a deal that was exposed as a classic case of political cronyism. The situation at Třinecké železárny, another recently privatized steelmaker, resembles that at Poldi, according to industry insiders. The lesson of the Czech steel experience is that government intervention in privatizing enterprises may be sensible, but only if there is a consistent state plan.[4]

The Czech state also has reorganized and fortified infrastructure enterprises prior to privatization. For the most part, however, Czech officials have not intervened in the daily operations of infrastructure companies. The state's approach to share ownership of banks demonstrates the effect of state policy that is coherent and broad but that usually does not affect corporate operations. A main objective of Czech policy during transition has been to protect and revive large domestic banks. In 1992, for example, the NPF directly recapitalized selected Czech banks with CZK 50 billion in five-year bonds, equivalent to 8 percent of all bank credit to enterprises (Desai 1996). By October 1993 the NPF had transferred 65 percent of large privatization revenues—equivalent to 5.2 percent of GNP—to the large banks and the Consolidation Bank. The state also has offered credit guarantees for risky loans; other loans were removed from

the banks' books, usually by the Consolidation Bank. In addition, the state has supported banks by postponing potentially destabilizing bankruptcy legislation. Finally, the state has protected large domestic banks by carefully controlling the issuance of bank licenses. Selective intervention has protected the large banks from both small domestic startups and foreign competition.

The state policy of supporting banks does not extend to intervention in bank operations. As a result state regulators have occasionally lost control over banks. When the banks were handling NPF subsidies, for example, they were unwilling to recapitalize the loans of potentially profitable firms. Instead, the banks propped up struggling firms that often happened to be their largest clients. Moreover, the state has been highly critical of the lending decisions of banks, as at times in Komerční banka's handling of Poldi Kladno's debts. And, in the case of strategic bank Investiční a poštovní banka, state officials from the NPF and the Central Bank readily concede that the state has limited influence over bank managers (*Mladá Fronta Dnes*, 3 May 1996).

Critics of state bank ownership claim that the state's hands-off management gives bank managers room to pursue personal interests at the expense of the interests of the state and shareholders, and that the state's bank shares should quickly be sold (Macháček 1996). Some state officials agree, contending that strategic bank shares should be fully privatized. Others, such as (now former) Minister of Finance Ivan Kočarník, argue that the state should retain a one-third "blocking stake" in certain banks to ensure a state veto over changes in bank by-laws. How far the NPF will lower its stake in bank stocks and encourage the entrance of new owners (or encourage strategic partnerships) is a matter of speculation.

Passive monitoring. In some cases the Czech state and a foreign strategic partner share ownership. The state usually retains substantial minority holdings but cedes managerial control to the foreign partner. The state's approach to share management in these enterprises is passive monitoring.

Passive monitoring is not passive management, the strategy used for nonstrategic enterprises. Rather, passive monitoring, in the form of microeconomic regulation, allows state representatives to actively oversee enterprise managers. However, even basic oversight of what are invariably complex operations can be demanding, time-consuming work for state officials who may enter the assignment with much to learn. Passive management, on the other hand, assigns state representatives an idle role relative to enterprise managers.

Prominent examples of strategic alliances include automobile manufacturer Škoda-Mladá Boleslav (70 percent owned by Volkswagen), telecommunications company SPT Telecom (27 percent owned by a Dutch-Swiss consortium), and the new oil refinery České rafinerie (formed from the reorganization of Kaučuk and Chemopetrol; 49 percent owned by an international oil consortium). The foreign strategic owners have vowed to inject capital and expertise into these enterprises.

The first strategic partnerships had mixed success. An agreement between the national airline, ČSA, and Air France ran into trouble when the Czechs accused Air France of imposing unprofitable routes on the airline. The sale agreement was later annulled, and ownership reverted to the Czech state.

The Czech state is also having trouble monitoring the country's most important joint venture, the Škoda-Mladá Boleslav–Volkswagen partnership. Volkswagen may cut its originally promised $5 billion investment in the factory. Moreover, Volkswagen reportedly has moved critical subcontracting operations to Germany. Still, no Czech that I interviewed considers this joint venture a failure, though all agree that the Czech state was an inexperienced negotiator at the outset. Volkswagen has revitalized the automobile plant; without foreign help it probably would have floundered (see the difficulties at Czech vehicle manufactures Tatra and Liaz).

From hard experience, the Czech state may have learned to incorporate tough penalties for nonperformance. (It is hard to know for sure because business contracts generally are not made public.) The Czech state reportedly has included tough penalties—including the potential loss of franchise—in contracts recently concluded with the foreign purchasers of SPT Telecom and České rafinerie. In the case of SPT Telecom the early returns are promising: the foreign partners appear to be infusing the capital investments originally promised. The inclusion of tough penalties for contract violations demonstrates the Czech state's resolve to control foreign direct investment.

One danger of passive monitoring is that Czech officials may have neither the enterprise-specific knowledge or the market or industry expertise to ensure that foreign partners are fulfilling their part of the bargain. East Asia's experience shows that it is hard for host countries—even those with considerable experience in dealing with foreign investment—to

control the behavior of foreign multinationals (Zysman, Doherty, and Schwartz forthcoming). Thus it may prove significant that managerial responsibility for SPT Telecom reportedly was transferred from the board of directors (where shareholders are represented proportionately) to an operations committee in which three of the five members are selected by the foreign partners.

Policy Recommendations

Post-communist governments may draw useful policy inferences from the Czech privatization experience. Post-communist states administer vast share portfolios, both as sole owner and in partnership with private interests. The Czech experience implies that state-private ownership arrangements—a common result of incomplete privatization—may unnecessarily jeopardize effective corporate governance. Thus, once the state has started privatization, the state should finish privatization. But when the state holds a controlling stake in a strategic enterprise and cannot exit easily as owner for noneconomic reasons, it can play a constructive role by articulating and at times implementing a concrete vision for financial restructuring.

Hazards of incomplete privatization

1. Passive state management may be problematic. It may be difficult for private owners to exercise corporate governance when the state is a passive minority shareholder. The problem is compounded when enterprise shares are dispersed among many owners. In such cases it may be difficult to replace managers, to change an enterprise's organizational culture, or to introduce advanced technology. An added risk is that the enterprise may become a source of patronage for managers. A temporary, inert state shareholding may insulate managers from the pressure to restructure.

2. Privatizers should consider separating privatization administrators from enterprise managers and ministry officials. Privatization may be delayed if enterprise officials and state-appointed privatization representatives have little interest in having the state exit as owner. Thus it may be risky to place representatives of privatization agencies on enterprise boards in which the state is a minority shareholder.

3. Carefully crafted golden shares may be a useful substitute for state minority ownership, but may not be sufficient as tools of corporate governance. As a golden shareholder the state may be able to establish credible limits on enterprise behavior. But the effectiveness of golden shares is limited. The dubious legal status of golden share arrangements and the need for new owners to exert managerial control over enterprises suggest that strict time limits on golden share arrangements may be useful. Over the long term the state may consider increasing regulatory capacity as a substitute for golden share provisions.

Advantages of a flexible, transparent approach to residual share management

4. Political will combined with flexible policies can generate workable formulas for would-be privatizers. During transition policymakers may leave room for purposeful state intervention in carefully selected cases—even intervention that may seem contrary to privatization objectives. The state is unlikely to be effective when intervention is not purposeful, however. In those instances the state should consider quickly exiting from ownership. States should try to strike an optimal balance between acting as a regulator and as an active owner.

5. Consistent and transparent procedures may make the state a more efficient manager. State decisionmaking can become overly politicized if state procedures are poorly defined and nontransparent. Consistent, transparent policymaking helps minimize delays in needed restructuring or downsizing. In addition, transparent state share management procedures may encourage foreign investment. Furthermore, shareholder rights are better preserved when the state is an open partner; capital markets operate optimally when information is available and reliable.

The Czech state may continue as a shareholder for some time given the limited capacity of Czech capital markets to absorb state shares and the reluctance of some state officials and managers to fully privatize. Consequently, residual share management issues will linger. Other transition economies should take note of privatization's limitations, even in post-communism's most avowedly liberal economy.

Notes

1. The survey included responses from 67 general directors and 227 representatives from enterprise boards. Of the companies surveyed, the largest shareholders (on average) were independent shareholders (25 percent) and the NPF or the state (14 percent; Quinn 1995).

2. In 1996 *Business Central Europe* rated Škoda Plzeň as the best Czech company and the second-best restructured company (behind automaker Škoda-Mladá Boleslav). However, officials at the Confederation of Industry, officials at the Ministry of Industry, and industry consultants were skeptical about Škoda Plzeň's prospects (Author's interviews 1996).

3. Some shareholders suspect that part of the state subsidies may end up in managers' pockets (Author's interviews 1996).
4. In 1991–92 the former Czech Minister of Industry Jan Vrba, with the assistance of an international consulting firm, drew up a comprehensive plan for reorganizing the Czech steel industry. However, the electoral triumph of Klaus's ODS-led coalition in the 1992 elections resulted in the replacement of Vrba with Vladimír Dlouhý and the abandonment of the Vrba plan.

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Residual Divestiture following Mass Privatization: The Russian Experience

Alexander Radygin

Mass (voucher) privatization in Russia in 1992–93 pursued a single objective: to distribute private ownership rights on a mass scale with minimal social conflict while bearing in mind future redistribution in favor of effective and responsible owners. Of the 240,000 enterprises at the beginning of privatization, by 30 July 1994 (the date the program ended) about 41 percent had been privatized. More than half of all small enterprises were privatized, and more than 20,000 joint stock companies were created from medium-size and large state enterprises; the shares of 16,500 of them were offered during voucher auctions. By the end of 1994, 40 million Russians held shares in the newly established joint stock companies or the voucher investment funds.

The most important result at this stage was the birth of new economic mechanisms and the development of an institutional and legal framework for the post-privatization functioning of Russian businesses. A corporate sector appeared, stock exchange and over-the-counter securities markets developed, and a transitional system of investment institutions was created. Tasks that were not completed during 1992–94—primarily restructuring enterprises and attracting investment—required a privatization model that would compensate enterprises for the noneconomic sale methods used during the first stage.

Features of Post-Voucher Privatization

Since July 1994 privatization, with its slowness and uncertainty, has resembled the situation in 1991, when framework legislation existed but privatization did not proceed, when politics and uncertainty became especially important, when lobbying sharply intensified, and when endless official declarations had no basis in reality. There are, however, new features that have become crucial for understanding current privatization efforts.

Boost investment—or the budget?

In 1992–94 investment was ignored as the goal of enterprise sales because the voucher model pursued different objectives. Then, despite assurances from leaders of the State Property Committee that the post-voucher ("cash") stage would be an era of investment, it became clear in 1995–96 that maximizing revenues for the federal budget was the main criterion for choosing the sales approach. To a large extent this outcome resulted from political considerations.

Efforts to sell off state shareholdings

Voluntary privatization, which had proceeded intensively in 1993, began steadily declining in 1994–95. At the same time, mass privatization had left the state with an enormous volume of shareholdings. The problem of selling these holdings became a key challenge for 1995–96 privatization policy and generated intense lobbying in this field.

The liberal branch of the government recognized that the state was incapable of managing these shareholdings and that economic conditions provided an opportunity to sell them. Yet organizing the efficient sale of this equity became nearly impossible for several reasons:

- The budget needed larger, more expensive, and faster sales;
- Getting rid of such a mass of holdings would have been

difficult given inadequate demand and the threat of stock market collapse;

- Equity sales of attractive enterprises would have been economically inefficient because of the obvious undervaluation of their assets, and difficult because of the lobbying and shifting control that occurred in some industries;
- It was unlikely that buyers could be found for the worst loss-makers;
- Politicians were unwilling to open themselves up to criticism just before elections.

Attempted legislative roadblocks

By the fall of 1995 the Duma had drafted a number of documents related to privatization: amendments to the 1991 law on privatization, a draft law on the alienation of shareholdings envisaging that Parliament should annually approve the list of federal shareholdings to be sold, four drafts of a framework law on nationalization (including nationalization initiated by employees), and about forty bills recommending the nationalization of some of the largest enterprises. The communist majority of the Duma, elected in December 1995, began creating conditions favoring the adoption of these documents. Any practical steps would be possible only after the June 1996 presidential elections, however.

Even the possibility that a law could be enacted directly affects the expectations of investors. Moreover, the drafts of the most significant acts take on a life of their own, affecting both the regulations related to them and the legislative structure as a whole. From an investor's perspective the economically unbalanced articles of the proposed bills are strongly destabilizing factors.

Struggle to retain control

The nomenclature's struggle to retain control in a number of industries sharply intensified when the government began discussing different options for the sale of federal shareholdings. In fact, a major conflict developed between functional and branch departments: budgetary considerations (to sell off the shareholdings) versus the need to retain the appearance of usefulness to the enterprises or, at least, to the government (to keep shareholdings). Politicians often favor the interests of the branch departments, primarily because they claim to efficiently manage federal property.

An obvious victory for the branch departments came in September 1995, when a giant holding company, Russian Metallurgy, was set up. Similar projects are under way in the machine building and petrochemical industries. The January 1996 resignation of Anatoly Chubais, the chairman of the State Property Committee, became a catalyst for new attempts to redivide property in the regions and in the economy during the spring and summer of 1996. It is also safe to assume that the law on financial-industrial groups, which went into effect in December 1995, will not so much promote industrial growth as consolidate the power of the financial-industrial alliances, giving them more clout with the authorities.

Institutional and legal framework

The basic guidelines for privatizing state and municipal enterprises, approved in July 1994, continue to guide the cash stage of privatization. Several key objectives were defined for the cash stage: enhancing the efficiency of the economy as a whole and of individual enterprises, forming a large group of private owners to help establish strategic owners, mobilizing investments for production, and contributing to social protection and to the protection of shareholder rights.

Some limitations were established, too—on particular industries and on formalizing federal ownership of ordinary shareholdings and the "golden share." Retained shareholdings were to be transferred to the institutions or persons authorized to manage them. The main objects to be privatized during the cash stage were state shareholdings in privatized enterprises and the real estate of the privatized enterprises.

The following sequence of privatization methods was envisaged for the sale of shares: free transfer or sale of shares to employees through a closed subscription; sale of equity (at least 15–25 percent of the charter capital) through investment tenders, commercial tenders, or auctions; and sale of remaining shares at specialized auctions, including interregional and nationwide auctions.

Enterprises were classified according to type of sale. With some exceptions (treasury enterprises, privatization of which was prohibited; enterprises with foreign interest; and enterprises for sale to partnerships with special preferences) all enterprises with a balance sheet value of fixed assets of more than 20 million rubles as of January 1994 were to be transformed into open joint stock companies. Their shares can be sold using any of the methods mentioned. All other enterprises are considered small and are to be privatized through auctions or commercial tenders.

The State Property Committee retained its previous stance on the valuation of assets—that the final sale price should be

determined during the auctions or tenders. At the same time the starting valuation threshold was raised and is now based on the book value as of 1 January 1994; that is, it takes into account the first revaluation of the fixed assets after 1 January 1992. Starting prices (including the price of equity being sold) range from 70 percent to 200 percent of the nominal price.

For joint stock companies that were approved for privatization prior to the enactment of the basic guidelines (with valuation based on balance sheet of 1 July 1992) the starting price of the shareholding to be sold may be increased by twenty times during the sale through tenders or auctions. The provisional methodology for determining the starting price of shares defines the starting price as the product of multiplying the nominal value of a share by a coefficient. This coefficient is calculated taking into account the change in value of an owner's equity (according to the balance sheet of an enterprise), the situation in the regional or industrial market (based on actual sales figures), and provisions of the basic guidelines. As a result the starting price may be 100 times higher than the nominal value of a company's equity. If the date of an auction or tender is moved by more than thirty days, the starting price should be reviewed.

Transparent information should be provided in the formal documents that are required for privatization—the company charter and privatization plan. Depending on the importance of the property being sold, a newspaper advertisement should indicate the date of sale, deadline for the submission of applications, methods of sale, location of enterprise, major types of operations (products), amount of charter capital, number of employees, number of shares to be sold, and starting price and special conditions (if any).

Problems in the sale of residual shareholdings

The 1992–94 privatization program failed to establish stable majorities for most groups of shareholders in privatized enterprises. In most cases the positions of the managers who had been in charge of the enterprise prior to privatization were strengthened. In the spring of 1994 insiders held, on average, 60–65 percent of privatized enterprises; outsiders held 18–22 percent and the state held no more than 17 percent. During 1994–95 two conflicting trends surfaced that were connected with the redistribution of initial ownership rights:

- A trend toward a closed structure of the new joint stock companies (guided by managers or by branch departments or regional authorities).
- A trend toward an erosion of the initial structure of equity ownership in favor of managers and—if there was an interest in a specific enterprise—of large outside shareholders (banks, investment funds, and so on).

The "cash" model of 1994–96 must be evaluated in the context of both trends because the struggle for control over privatized companies became the predominant feature during the residual sales of state shareholdings. There is a direct link between the method of primary sale and the structure of equity ownership, and between the structure of equity ownership and the choice of secondary (residual) sale method.

The interests of the state and other shareholders during the selection of the secondary sale method are in conflict. The state, as the recipient of revenues from the sale of its stake, prefers auction-type methods. Managers, as one of the largest stockholders and wanting to consolidate their control, prefer investment and commercial tenders, which allow them to tailor conditions to "their" buyers. Large outside shareholders prefer specialized auctions, which provide room for sudden action in the course of the struggle for the offered stake. Branch ministries and regional authorities try to block sales if they conflict with the interests of the nomenclature or regional financial and industrial elites. Such blocking sometimes dovetails with the interests of managers, who prefer to have the state among the large shareholders.

In this situation the seller (the state) does not face the problem of searching for a buyer because the buyer is obvious—the shareholders engaged in a struggle for control. The problem is how to sell the residual shareholding with the maximum benefit for the budget. If we apply this criterion, however, the failure of the 1995 sales can be explained by the fact that the state did not dictate the rules of the game. In other words, residual sales generate considerable budget revenues only if the consolidation of the controlling interest has not yet been finalized.

If control over the company has been established, attempts to sell using one of the existing options are doomed to failure because of the absence of buyers. To some extent this may be regarded as a monopoly situation, at least in cases when residual shareholdings were offered for sale but there was no real competition. Thus it is safe to assume that the 900 nonstrategic enterprises (of 7,000) offered for sale in 1995 had a competitive structure of equity ownership or that the consolidation of the controlling interest by dominant shareholders was drawing to a close.

Protection of small shareholder rights

In this context the problem of protecting the rights of small shareholders, especially when the consolidation of controlling interest is being completed, becomes extremely important. In 1995 the first general meetings of shareholders in privatized companies saw numerous scandals connected with discriminatory practices against small shareholders. The following infringements were most common:

- Dilution of the outside investors' share in the charter capital through the issue of new shares in connection with the revaluation of the charter capital (JSC Maritime Shipping Company, JSC Komineft);
- Dividends announced and approved at the shareholders meeting either not paid or paid only to some shareholders (usually the employees of the company);
- Intentional deletion of records from the register of shareholders (Krasnoyarsk aluminum plant) or keeping of records by the registrars dependent on the company.

During the first half of the 1990s company documents envisaged only a standard set of shareholder rights: the right to participate in shareholder meetings, the right to receive dividends, and the right to a share of company assets during liquidation. In July 1994 the State Property Committee issued three prohibitions designed to protect shareholders. These rules prohibit companies from issuing additional shares if more than 25 percent of their capital is owned by the state; increasing the amount of charter capital by changing the nominal value of previously issued shares (including any change in connection with the revaluation of the company's fixed assets) until 90 percent of the initial issue is sold; and purchasing and selling, transferring, or exchanging shares (stocks) if more than 25 percent of their charter capital is owned by the state.

The law on joint stock companies, which became effective 1 January 1996, also included some positive legal (though not yet actual) shifts:

- Following the Civil Code, it stipulated the preferential right of shareholders to acquire additionally placed shares in the company's voting stock in order to keep their share in the company's charter capital unchanged;
- Shareholders are allowed to demand that the company redeem their shares at a fair market price (determined by an independent auditor) in case of reorganization, large transactions, or changes in the company's charter that adversely affect the shareholders' legal status;
- Buyers that acquire 30 percent or more of ordinary shares must offer to buy the shares from shareholders at a price no lower than the average weighted price of acquiring the company's shares during the previous six months.

Privatization, 1995

The first eighteen months of cash privatization did not see a boom in Russian privatization. Thus enterprises still could not rely on privatization as a significant source of investment. Potential investment demand (which undoubtedly exists) has not been transformed into real demand. As noted above, privatization in 1995 pursued one predominant objective—financing the federal budget deficit. Budget revenues from privatization initially were expected to total 8.7 trillion rubles, but this amount was later adjusted to about 5.0 trillion rubles.

To evaluate the methods used in 1995 from a budgetary standpoint, we can analyze the revenues received from different privatization methods. Of the 7.3 trillion rubles received, more than 80 percent came during the last two months of 1995, when the loans-for-shares schemes were applied. These schemes brought 5.1 trillion rubles, or 70 percent of federal revenues received from privatization during 1995. Placement of the convertible bonds of LUKoil, which happened at the same time, provided an additional 12 percent of budget revenues.

Annual income from standard sale methods totaled 1.1 trillion rubles—15 percent of overall income—demonstrating the limited effectiveness of mass auctions and tenders as ways of replenishing the budget. Just under half of this amount came from enterprises of the fuel and energy complex. The concentration of income sources is even more notable: sales of shareholdings in 13 enterprises in different sectors provided more than 70 percent of this amount, 30 enterprises brought 75 percent, and 900 enterprises brought 90 percent. Thus the remaining shareholdings in 4,622 enterprises offered for sale in 1995 brought (together with income from the closed subscription among employees) only about 10 percent of the total.

Recognizing this trend, policymakers began emphasizing the sale of (potentially) more attractive large enterprises. In August 1995 the State Property Committee drew up a schedule for the sale of shareholdings in privatized enterprises for September–December 1995 that included 136 large Russian enterprises, among them the RAO Single Power Grid, lumber and wood processing plants, fuel and energy complexes, and geological companies. Auctions and specialized auctions dominated the methods of sale; forty-four investment tenders

were envisaged. Federal budget revenues from the sale of shareholdings in these 136 enterprises were expected to total 4–5 trillion rubles.

The relative attractiveness of the enterprises included in the schedule made it safe to assume that there would be demand for many of these stocks. Subordination of these sales to current budgetary needs, however, impeded the sound preparation of the enterprises prior to sale, which would have allowed a drastic increase in revenues from these transactions for both the budget and the enterprises themselves.

Sale methods

Three sale methods were used: specialized auctions, cash auctions, and investment tenders.

Specialized auctions. Specialized auctions essentially became a cash variety of the earlier voucher auctions. Specialized auctions sold shares through open bidding in which all the winners received their shares at the same price. To participate, investors had to submit an application indicating the amount of payment and number of shares to be purchased.

A total of 831 such auctions were announced in 1995. The first interregional and all-Russian auctions began in June 1995. By the end of the year thirty had taken place. Initially, with the starting price equal to twenty nominal values of shares, the average difference between the sales price and starting price was 2.5–3.0 times. As a result the twenty nominals ceiling for the starting price was raised.

Although sale prices in the 1995 auctions were, on average, 3.3 times higher than the starting price, a lot of problems remained on the demand side:

- Competition from state securities (including state savings bonds and municipal bonds);
- Competition from the loans-for-shares auctions, where significantly larger shareholdings or controlling interests were offered for sale;
- In several cases auctions did not take place at the announced time or were canceled after applications had been submitted;
- Attempts to sell shareholdings at prices higher than the market price;
- Special auctions for the sale of shares of oil and other companies turned into the primary placement of these shares, which complicated the setting of starting prices in the absence of market quotations (Malin 1996).

As was to be expected, legal persons dominated these auctions financially (84 percent of total funds), although 89 percent of applications were submitted by individuals. Most applications from individuals for more than 100 million rubles came from the managers of companies in which shares were sold. In most cases, though, the public did not take advantage of the opportunity to participate in the special auctions—despite it being practically the only way for small investors to acquire shares, since almost all the operators in the secondary market for corporate securities deal with large shareholdings.

Cash auctions. Although cash auctions were used more often than the other methods (4,052 auctions in 1995), they made a much smaller contribution to the budget than the loans-for-shares schemes and specialized auctions. Many of these auctions did not occur for several reasons, including:

- Absence of applications during sales of shares of unattractive enterprises;
- Absence of applications because of the high starting price of shares;
- Absence of applications because the controlling interest belonged to one investor;
- Refusal of the auction winner to conclude sales contract or to pay;
- Insolvency of the company;
- Necessary documents were not submitted to the property fund by the company or by the property management committee;
- Conflicts were presented to the arbitration courts for resolution due to violations of the law or the privatization plan (GKI 1996).

In a number of cases cash auctions (usually in the form of closed tenders) became the final stages of specialized auctions in which not all the offered shares had been sold. For example, in January 1996, 0.022 percent of the shares of Rostelecom were offered for sale in fourteen lots. The selling price was 3.8 rubles per share (20 percent lower than the secondary market price), with a starting price of 3.2 rubles.

Investment tenders. The criterion used to select the winner of an investment tender is the amount of investment discounted for the duration of the investment period at the Central Bank's refinancing rate on the date the results of the tender are decided. Tenders are open from a participation standpoint. Conditions of tender:

- The investment period should be less than three years or determined by the privatization plan;

- Purchased shareholdings must be paid for at their nominal value;
- At least 20 percent of the investment amount should be transferred to the issuer's bank account within a month of the conclusion of a contract;
- The issuer's outstanding debt should be repaid.

The last of these conditions is one of the most often used. For example, conditions of the repeated investment tender for 18.5 percent of the shares of the Yaroslavl mineral processing plant envisage that the total should include investment (lowered from 100 billion rubles to 60 billion rubles) and the sum of the enterprise's debt to the budget (36.8 billion rubles). Similar conditions were put forward at a number of commercial tenders. Another condition used during tenders is a moratorium on the sale of shares purchased at an investment tender until the investment program is fully executed. For example, this condition was attached to the sale of 16.7 percent of shares of LUKoil in December 1995.

In 1995, 556 shareholdings in Russian enterprises were offered for investment tenders. As with the cash auctions (and mostly for the same reasons), many tenders did not take place. For instance, of nineteen investment tenders announced by the Penza Regional property fund, ten did not take place because of the absence of applications (Kozak 1995). The main problems are the lack of local investors and investment resources, the long-term nature (and long-term returns) of investment, failure to fulfill investment obligations on the part of tender winners, and unclear land legislation.

There are many legal ways to obtain a shareholding in an enterprise without fulfilling investment obligations: the shareholding may be redeemed by the issuer through an affiliate; several affiliated companies may participate in a tender, with the winning company rejecting the transaction in favor of a partner company that offered a much lower price; there may be ways to manipulate the timing of bringing in investment; and so on. Such transgressions create the potential for subsequent annulment of transactions by courts. The system of investment tenders often is nothing more than a thinly veiled form of direct sale to an investor who is known in advance and who participates in drawing up an investment program and tailoring the terms of the tender.

Most investment tenders have had nothing to do with investment; rather, they were operations that consolidated stock to achieve control. In the best possible case—usually, when a foreign company wins the tender—a long-standing relationship is legally formalized. In 1995 foreign companies won twenty-six investment tenders. These investors tended to seek out low-risk investments, investing an average of $5–10 million in a wide range of sectors and regions. Foreign investment from these tenders totaled $280 million.

One of the best-known efforts to attract a strategic investor (although it did not take place) was the commercial tender with investment conditions for 49 percent of the shares of Sviazinvest, a financial holding company. Eighty-five regional telecommunications enterprises contributed 51 percent of their shares to Sviazinvest's charter capital. At the first stage of the tender 25 percent of the shares (plus one share) were offered with an investment program of $770 million for two years.

At the second stage (in 1996) the remaining 24 percent of the shares for sale were to be offered at special cash auctions for portfolio investors. Of this shareholding, 7 percent should have been reserved as an additional guarantee to the strategic investor until an international audit was completed. At the same time the controlling interest (51 percent plus one share) was to remain in federal hands. The tender's conformity to international standards was confirmed by the International Financial Corporation and the European Bank for Reconstruction and Development, which planned to purchase the company's stocks on the same terms as the winner of the tender.

In November 1995 the Italian telecommunications company STET was announced as the winner. In addition to the investment program, STET was to transfer more than 2.9 trillion rubles to Sviazinvest's budget for the acquired shareholding. The transaction failed, however, because of a conflict over the mechanism of payment for shares.

A number of reasons were offered for the failure of this transaction, the largest in the history of Russian privatization: the transaction was badly prepared, STET lacked sufficient funds, there were problems with the subsidiaries because many had been included in the holding against their will, the Ministry of Communications refused to provide institutional and technical support, the accidental character of STET's winning, and so on.

Still, the experience had a few positive features. First, it set an important precedent because the tender was organized by an international financial adviser that sold the offered stocks on the tender's terms and at a price not lower than the initial one. Second, according to Salomon Brothers the telecommunications enterprises were valued about seven times higher than current market quotations.

New methods of privatization at the cash stage

Two new methods of privatization were introduced at the cash stage: the loan-for-shares scheme and convertible bond issues.

Loans-for-shares scheme. In March 1995 a consortium of the largest Russian banks proposed to the government that state shareholdings in forty-three enterprises be transferred to the banks to be held in trust for five years. In exchange, the banks would provide loans to the government equal to the planned budgetary revenues from selling the shareholdings to strategic investors. Presidential Decree N478, issued on 11 May 1995, charged the government with developing a mechanism that would allow it to pledge and transfer company shares in federal ownership to legal persons for trust management.

The final decree on the procedures for pledging shares in federal ownership was signed in August 1995. The decree approved the mandatory terms of loan agreements as well as rules on holding auctions to conclude loan agreements and pledging the shares in federal ownership. The decree legally defined the term *bank consortium* for these purposes.

Auctions are considered to have taken place if there was more than one participant and each participant guaranteed that the credits would be extended in an amount equal to the starting price, using the shares as collateral.

Under the scheme a special auction commission decides on potential participants, the starting price of shareholdings (amount of loan), and additional conditions. Participants submit to the commission a tender indicating the amount of the loan. The party that offers the largest amount wins. Then the credit agreement, pledge agreement (in exchange for the loan), and commission agreement are signed with the winner. The commission agreement gives the commissioner (either the creditor or a designate) the right to sell the shareholding through any method except investment tender after 1 September 1996. The commissioner receives 30 percent of the difference between the sales price of shares and the amount of relevant liabilities and the federal budget receives 70 percent.

Annual interest on the loan is calculated as the equivalent amount in ECU at LIBOR + 0.5 percent for three-month deposits on the date the agreement is signed. Thus the interest rate is two to three times lower than the market rate.

The starting price is established by the commission based on 60–90 percent of the shareholding's market value (depending on its size). The starting prices of the auctions offered to the commission by the members of the bank consortium turned out to be two to five times lower than the approved ones.

The pledgee is entered into the state property register as the nominee holder of the corresponding stocks. It has the right to vote at will except on issues related to reorganization and liquidation, changes in foundation documents, change in charter capital, securities issues, some property transactions and loans, and participation in the establishment of organizations and subsidiary companies approved in the annual reports of the company. Twenty-nine enterprises appeared on the initial list approved by the State Property Committee. This list, which was compiled according to the banks' requests, included the majority of the most attractive large Russian enterprises.

Each enterprise on the list became the subject of bitter behind-the-scenes struggles. As a result eight enterprises were withdrawn from the list in December 1995. Several lumber and wood processing enterprises (Arkhangelsk and Solombala pulp and paper plants, Bratsk lumber plant) initiated court proceedings against the State Property Committee to block their auctions. The Ministry of Fuel and Energy also opposed the entry of its enterprises into the auctions, demanding a coordinating role in the management of shareholdings. The Beloretsk metallurgical plant also fought to be excluded from the list.

In a number of cases strong opposition on the part of enterprise managers resulted in additional requirements for the auctions. These requirements reflected both objective concerns (about the interests of the enterprises being ignored once revenues were transferred to the budget) and the desire of enterprise managers to control the sales process. Requirements included, among others, reducing the shareholding, prohibiting the sale until federal ownership had been formalized, repaying the enterprise's debts, raising the starting price by adding to the loan amount a similar investment amount for the enterprise's needs, combining the auction with an investment tender, and preventing foreign participation. Not all of the conditions put forward by the enterprises were satisfied. The greater was the lobbying ability of the enterprise, however, the more likely the conditions were to be satisfied.

Seventeen enterprises were offered at the auctions; for five (JSC Bor, Techsnabexport, West Siberian metallurgical plant, Kirovlesprom, Tuapse seaport) there were no bids. These auctions failed for different reasons. For example, JSC Bor (maritime transport) had huge debts and few prospects for marketing pulp and paper products. The twelve auctions that took

place brought the budget 5.1 trillion rubles, including 1.5 trillion of the repaid debts of enterprises to the state (compared with the 2–3 trillion rubles envisaged when the scheme included twenty-nine enterprises).

The loans-for-shares auctions revealed many of the scheme's procedural drawbacks:

- Possibility of prior collusion between auction participants;
- Participation in the auction of the bank authorized to collect bids and retainers;
- Problems related to setting the starting price;
- Problem of working out the list of enterprises between the functional and branch departments, regional authorities, and the enterprises themselves;
- Problem of verifying the authenticity of documents submitted by the applicant and conformity of the bank guarantee with legislative requirements;
- Problem of potential use of the state funds deposited with the commercial banks;
- Insufficient publicly available information on the issuers of pledged shares;
- Inconsistencies between regulatory acts.

From a legal standpoint the scheme was a loan agreement secured by a pledge of shares with the right of subsequent sale of the pledged collateral. According to international standards and transaction procedures, the scheme can be described as direct negotiations with previously identified banks and, to some extent, guaranteed underwriting. In reality, though, the scheme was a veiled acquisition of the shareholdings by enterprises themselves or their purchase by interested banks (financial-industrial groups). It would be naive to think that these auctions marked the beginning of competitive bidding. It would be more accurate to describe them as direct sales to buyers that were known in advance. The price was somewhat lower than during a de jure sale because formally the scheme was a pledge. In the end the scheme was tailored to the relatively limited resources of Russian commercial banks.

Under specific conditions this approach is acceptable for important sales. The question is how to guarantee the efficiency of each transaction for the state and for the enterprise over the medium term. Since it is possible that pledged shareholdings will not become the property of the banks, banks may have an incentive for asset stripping rather than strategic management. Although it is premature to assess the scheme at this stage, at least three further developments are possible:

- *Bank as owner.* If banks eventually acquire shareholdings then the efficient long-term management of the enterprise by the bank will be crucial. The conflict between Norilsky Nickel and ONEXIMbank is emblematic of the problem. This conflict will likely be solved only when the legal rights of all parties in managing the enterprise are clearly defined and conflicts of interest removed.
- *Bank as commissioner.* If banks decide to sell their shareholdings, the state will never get its 70 percent share of the difference between the sale amount and the state's liabilities to the bank. Shareholdings will be sold at the initial transaction price to buyers with zero surplus revenues, and only subsequently will the real sale with maximum profit take place. This is one of the scheme's most serious legal loopholes.
- *Redemption of shareholding by the state.* It is not clear what the state will do with the pledged shareholdings. If equity markets grow, then the possibility of the government redeeming these shares for their subsequent resale cannot be ruled out. The funds for this redemption may be obtained in the form of loans from new loans-for-shares schemes.

Convertible bond issues. The best-known (if only) example of a convertible bond issue was the successful issue by LUKoil, undertaken in accordance with specially enacted regulations. The issue helped attract investments to restructure the company's subsidiaries and pay off debts to the federal budget. The bonds were issued as bearer non–interest bearing coupon bonds. The issue was accompanied by the pledge of the federal shareholding, which amounted to 11 percent of the company's charter capital. Any legal entity or person could own the bonds. Issued bonds were exchanged for the company's shares, which were deposited with a financial institution once the federal ownership period expired. Bond placement was organized on a competitive basis among the underwriters, which then placed these papers in the secondary market.

The first (foreign) tranche was placed during the commercial tender among investment banks and financial companies in September 1995. Of 350,000 bonds with a nominal value of 4.5 million rubles, 320,000 were bought (GKI 1996). The biggest buyer was the U.S. oil company ARCO, which submitted a tender for $250 million. Budget revenues (more than 880 billion rubles) totaled about 12 percent of the federal budget's privatization revenues in 1995. The second (Russian) tranche consisted of 110,000 bonds, with each bond exchanged for

170 shares. In March 1996, when the term of the federal ownership expired, investors got the shares they had paid for six months earlier.

Conclusion

In 1996 budget revenues from privatization are expected to total 12,387 trillion rubles. In a way these funds help ensure that privatization will remain on the government's policy agenda. If political events in Russia remain unchanged, 1996 will be much like 1995 in the sense that most privatization measures will take place during the second half of the year.

In practical terms recent comments by some of the highest officials in the Russian government—that 1996 will signify a transition toward "pinpoint" privatization and an individual approach to enterprise privatization—may mean that the practice of selecting the most attractive enterprises for privatization will continue. Thus the objectives will be quite different from the original objectives of mass privatization: mobilizing investment, developing real strategic owners, and restructuring enterprises. It is easy to understand why potential investment demand has not been transformed into real demand. The solution to the problem—apart from obvious political and macroeconomic adjustments—lies primarily in strengthening institutions and developing new economic and legal mechanisms, including a stock market, corporate management, and investment institutions.

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Part 4

Securities Markets and Institutional Investors

Mass Privatization and Its Consequences for Capital Markets

Gregory Jedrzejczak

It has become apparent that mass privatization was only a first step toward installing private owners in privatized companies. Capital markets—markets for ownership and control rights over firms and assets—will also play an essential role in this process. The more general term *capital markets* (rather than *securities markets*) emphasizes the importance of trading in corporate ownership rights, that is, shares in limited liability, joint stock companies. Creating markets in other transferable financial contracts (securities) may also be desirable but is not as important during transition.

The role of capital markets in transition economies, relative to Western economies, goes beyond efficient trade in securities. On a fundamental level, co-ownership of a joint stock company is perhaps the most difficult market concept for transition economies to internalize. Secondary trade makes ownership a real commodity, and so brings ownership to the practical level of financial gains, risks, and losses. Post-privatization capital markets must be able to handle large volumes of trade following the extensive distribution of shares under mass privatization. These markets also must convert ownership titles from the simplified, short-cut approach of mass privatization to the regular, Western form of ownership (a properly registered, tradable commodity). Thus policymakers in transition economies must make complex choices about market institutions, their regulation, and their main participants.

Corporate governance has been at the heart of the mass privatization debate. In mature economies corporate governance can be classified as bank-based (Japan, Western Europe) or market-based systems (the United States). In bank-based financial systems banks are both lenders to and shareholders in large joint stock corporations. Because of their substantial equity and debt exposure, banks play a significant monitoring role and are represented on the boards of directors of owned or controlled companies (and thus have access to nonpublic information). Capital markets tend to be smaller and less liquid, and financial arrangements tend to be less transparent (at least to outsiders). Bank control over corporations need not be based on shareholding alone. Where banks can engage in brokerage, trust, or mutual fund business, they exercise control by voting on behalf of small investors. Alternatively, banks might write restrictive loan contracts or provide only short-term loans in order to retain influence over management. As the principal monitors, banks wield considerable influence over management appointments, particularly for firms in distress.

In transition economies commercial banks—both privatized and state-owned—are already the main players in emerging capital markets, acting as brokers, dealers, fund managers, custodians, and depositories. Some banks organize and run their own over-the-counter markets and clearance and settlement systems. Banks have several reasons for diversifying into the new securities business. First, banks are securing their market share by establishing links between the financial and industrial sectors. Their strategy is to attach themselves to good industrial clients in as many ways as possible. Second, it would be too risky for banks to become too specialized given high market and economic volatility. Third, privatization investment funds and brokerages are not always able to operate independently, and startup cross-subsidies are unavoidable.

These patterns have developed because most transition economies follow the continental European tradition of universal banking. Moreover, as long as information is unreliable, disclosure is limited, and legal protection of lending contracts is insufficient, banks that provide capital will insist on monitoring and—if necessary—controlling management to protect their investment. Arms-length finance only works when performance guarantees are reliable and enforceable. And control-oriented finance, which is more like the structures and instruments used under central planning, requires less institutional development and fewer brokers, organized exchanges, auditors, lawyers, and financial specialists.

These arrangements do not preclude the possibility of market-based control, however. As things stand large investors can deal directly with the managers of an enterprise, provide their own experts to evaluate the company, and trade with each other without benefit of an organized exchange. Undervalued privatized firms may eventually become a target of a hostile takeover or leveraged buyout. For that to happen, extensive disclosure of reliable financial information will be essential. Corporate governance by financial institutions in transition economies is constantly being redefined, and is moving toward more strategic participation.

Privatization investment funds are the most distinctive element of post-privatization capital markets. There are two types of funds: mandatory (as in Poland) or voluntary and market-driven (as in the Czech Republic). Large funds own more shares than any other single investor. In some ways such funds may facilitate the functioning of capital markets—by allowing investors to own part of a diversified (and thus lower-risk) portfolio of shares and so encouraging citizens to invest in shares, by making capital markets more efficient (the price for shares reflects all available information about the companies), and by monitoring and influencing the behavior of managers.

Such large funds may make it more difficult for capital markets to function smoothly, however, because they tend to trade large blocks of shares. All the exchanges in transition economies have difficulty handling blocks of shares and avoiding a large drop in price when a block is sold or a large increase when a block is purchased. A less formal trading system is usually adopted in which large institutional investors trade directly with each other without placing their orders on an organized exchange. Finally, the mandatory funds established by some mass privatization programs may be pressured by the government to become quasi-governmental holdings and cross-subsidize ailing firms from their portfolios.

Market Infrastructure

Most policymakers in transition economies support sophisticated, high-tech approaches to developing capital markets. The advantages of starting from scratch combined with widely available and affordable technology may be one reason. A desire to develop professional expertise and obtain soft financing from donors may be another reason.

Registration and transfer of stock ownership

All forms of shares are used in transition economies: paper share certificates physically transferred from sellers to buyers, paper certificates immobilized in depositories, and dematerialized securities where the only proof of ownership is an entry in a database (book entry). Shares are registered directly in the name of a shareholder or their nominee, or as bearer shares.

In most countries new data collection and processing technologies have resulted in an integrated approach to share registries, depositories, and clearance and settlement systems. Poland has an integrated system, though it has not yet passed the test of mass privatization. In the Czech and Slovak republics the central database established to allocate shares during mass privatization is used to register and transfer shares in secondary trade.

The absence of an independent ownership registry has been the biggest obstacle to regulated secondary trade in shares in most transition economies. Russia illustrates these difficulties. Enterprise managers control the registries and sometimes use them to hinder or manipulate trading in shares or the execution of ownership rights.

Trading systems

Stock exchanges exist in practically every transition economy, though with varying commercial success. A central stock exchange is not sufficient to support post-privatization capital markets, however. Two types of secondary markets have emerged: a market for blocks of shares (a block market) traded between sophisticated investors (privatization investment funds, strategic investors, domestic and foreign institutional investors, and so on) and a market for small amounts of shares mostly owned by employees and traded between unsophisticated investors (a retail market).

The main weaknesses of the block markets are their opaque trading mechanisms and poor price dissemination. For example, in the Czech Republic and Lithuania as much as

80 percent of trade in shares from mass privatization is completed directly between privatization investment funds, with very little price dissemination.

The weak points of the retail markets are their lack of fairness, high transactions costs, market fragmentation, high volatility of prices, and low liquidity. Trading frequency and liquidity vary significantly among shares and over time for the same issue. Also, some shares (companies) are traded nationwide, while others are limited to local markets. This setup leaves much room for arbitrage.

Clearance and settlement

Clearance and settlement do not create systemic problems as long as transactions are completed in bazaar-style cash-and-carry settlement where the buyer and seller deal directly with one another (exchanging cash for certificates). This is the current situation in many transition economies. Once the number of buyers and sellers grows and trade becomes more organized, however, inefficient clearance and settlement may seriously undermine market reliability by creating excessive counterparty risk of not completing a transaction. One way to cope with counterparty risk is to require the seller to provide the securities and the buyer to provide the payment before executing the trade—as is done, for example, by the RMS system in the Czech Republic. The main disadvantage of this approach is that it freezes money, in some cases for a long time, and makes short-term investments less attractive. In more advanced systems the members organize mutual guarantee funds. Such funds, however, require that brokers and dealers have access to significant capital, and may increase their fees substantially in less active markets.

Regulation

Capital markets are perhaps the most striking example of the incompatibility between regulations and institutions inherited from the command economy and those required by the new market environment. Regulation is intended to make capital markets fair, efficient, and transparent. Although most transition economies have promulgated laws to govern capital markets, the legal and regulatory frameworks governing most markets is still quite thin. Because the behavioral rules of market participants have not yet been established, most securities laws and related decrees reflect the theoretical knowledge of legislators rather than codify rules of the game and best practices. In addition, most judicial systems (courts) are not developed enough to deal with complex cases.

Poor enforcement of existing laws is a common problem in most transition economies. Enforcement is poor because of weak or nonexistent commercial courts and inefficient administration. Moreover, investors, market operators, and some managers of privatized companies have an interest in keeping regulation vague and unenforceable. Most post-privatization regulators came late to the markets and had to discipline markets already occupied by a range of actors, including brokers and dealers, market makers, speculators, and investors. Few traders were sophisticated by Western standards, but most were ready to take on substantial risk in exchange for high returns. Informal self-regulation and mutual trust (or distrust) between traders enforced standards of behavior. Information about product availability and prices was scarce, and its price was reflected in the high fees and margins charged by intermediaries. Under these conditions the objectives of market participants were ambiguous. On the one hand they wanted to maintain the existing system, with its premiums for better-informed and -connected investors. But they were also aware that such a system could not continue, and that in the long run more transparent and better-regulated markets would generate larger volumes of trade and therefore higher returns.

Thus government agencies and central banks will continue to play an important role in shaping capital markets. State property funds in particular are the biggest suppliers of shares and often license trust companies, investment funds, and investment companies dealing with privatization certificates. Problems arise, however, when different segments or functions of the markets are supervised by different parts of the government. In most transition economies supervision functions will be fragmented and overlapping for years to come.

A basic principle of a market economy is to leave as much regulation as possible to private parties (self-regulation) and for the government to regulate as little as possible. In transition economies exchanges, issuers, organizations of investors, and professional organizations of financial services providers are slowly becoming self-regulating organizations, operating as formal organizations or informal lobbyists. Government regulatory agencies should supervise the activities of these groups and give them official recognition and status. The best approach is to establish basic principles and standards and leave enforcement to participants (for example, through civil legal action). One risk with self-regulating organizations is that

they can oppose competition and create cartels or monopolies, especially if their self-regulation is sanctioned or enforced by government regulators without adequate oversight. In practice, however, transition economies are far from having a division of labor between official and self-regulating supervision. In most countries the government is reluctant to share power and distrusts market operators. Regardless of eventual arrangements, two essential components of government regulation are a company law and a securities law.

Company law

Company law remains the core of capital market regulation, particularly in markets for control. The general objective of company law is similar in all market economies: to mediate conflicts of interests between groups of claimants such as majority and minority shareholders, managers, and creditors. Company law must:

- Establish the company as a legal independent entity, with limited liability of owners and managers and free transferability of shares.
- Allocate powers between shareholders, directors, and managers, appoint and define the rights and duties of the board of directors, and appoint and define the responsibilities of managers.
- Secure shareholder rights to appoint directors, approve transfers of shares, access information, and audit.
- Authorize share types, voting rights, subscriptions, preemptive rights, and dividends.
- Allow for fundamental changes in corporate structures—their formation, their capital increase or decrease, and their merger, acquisition, and dissolution.

Securities law

While a company law regulates capital markets from the perspective of a specific company, securities law addresses the same issues from the market's perspective. A securities law usually focuses on publicly traded joint stock companies, leaving rules of private placement and secondary trade to more general civil contract regulations. This distinction is made because of the differences between unsophisticated investors (in the case of publicly traded companies) and sophisticated investors (in the case of private placements). A securities law should address and regulate areas that may affect the investment decisions of unsophisticated investors:

- Disclosure requirements related to initial public offerings and secondary market transactions.
- Basic requirements regarding market operators (brokers and dealers, exchanges, collective investment vehicles, registries, custodians, depositories, and so on).
- Protection of minority shareholder rights (acquisition of a substantial block of shares or takeover of a publicly owned company).
- Definitions and penalties for fraud, manipulation, and insider trading.
- Division of regulatory functions between the government and self-regulating organizations.

Enforcing securities laws is difficult. In some countries, including the Czech and Slovak republics, the ministry of finance is responsible for regulating securities markets. Some countries—Hungary, Moldova, Poland, Ukraine—have separate and independent securities commissions. Russia opted for a separate but quasi-independent commission. Most countries are now creating agencies that act independently of ministries and central banks and have an exclusive mandate for market supervision and enforcement.

Beyond Mass Privatization

Although trade related to mass privatization currently dominates markets and preoccupies policymakers in transition economies, rapid changes in the real sectors of these economies will soon bring more standard issues to the fore. The financial sector is the least sheltered economic activity, with the greatest exposure to massive cross-border flows of money and financial products. Rapid technological changes and increasing integration of financial markets are at the front line of broader trends in financial markets: globalization, deregulation, and technological revolution.

The advantage of location (being domestic) is rapidly disappearing, with few global centers for banking and financial services and a number of niches specialized in particular products or customers. The most important comparative advantages of domestic markets are better knowledge of local corporate and retail clients and more competitive costs of services. This second advantage should be strengthened by direct and indirect support for training, efforts to strengthen self-regulating organizations and professional standards, and regulations that do not impose excessive operational costs on market participants. Submitting to the temptation to impose protectionist measures favoring domestic providers of financial services will only backfire in the long run. A growing number of large privatized firms from transition economies are

borrowing directly from the international markets. Soon they will be able to make private placements of their equity or long-term debt instruments.

Universal banking, with its rapidly growing menu of services (including investment banking, brokerage, insurance, and funds management), and globalization of financial markets require consolidated supervision able to cover a variety of financial products. In the long run supervision should be consolidated by function and institutional integration.

Most transition economies have adopted the fundamental legal institutions of a civil society (civil codes, commercial codes, and so on), and a growing body of new laws reflects the requirements of a market economy. There is, however, a need to review legal systems to ensure their consistency with Western commercial practices. For efficient, market-based financial systems the most fundamental issues are ownership and contractual rights (including registration, protection, and deposit of securities, trust and custody contracts, execution of pledges, alienation of ownership in cases where collective ownership is terminated, and repatriation of incomes) and efficient corporate governance (including the role of supervisory boards, authorization procedures for new issues of capital, protection of minority shareholders, and prevention of insider trading).

Foreign investment, although vital, cannot substitute for domestic savings and long-term investments. The low level of savings in transition economies is a function of low per capita incomes but also of absent saving vehicles: pension funds, life insurance providers, investment funds, mortgage banks. High yields from treasury securities delay the development of new products. Unclear and hard to execute collateral rights established on real estate hinder mortgage banking.

Small and medium-size new firms and spinoffs from privatization are the biggest contributors to growth in transition economies. Capital limits may soon slow the growth of these firms because there is neither regulatory nor institutional capacity for tapping broader sources of financing. In particular, firms should be encouraged by proper (tax) regulation to open their books and go public.

Markets for risk management products (derivatives, swaps, currency hedges, and so on) are only now emerging. On the demand side the situation is complex—there are already cases where proper risk management could save firms from bankruptcy. But managers often do not understand importance of risk management, and so demand is low.

Governments have an obvious role in adopting and enforcing the regulatory framework governing capital markets. Governments may also have a less obvious role in creating market institutions and financing their development. Such involvement may be justified on two grounds: some core market institutions (such as the clearance and settlement system) have public good characteristics, and startup costs may be too high for market participants.

The results of active government policies have been mixed. On the one hand, the most successful capital markets in transition economies were established with significant organizational and financial involvement from the government (the Czech Republic, Poland) or with quasi-governmental foreign aid (Latvia, Moldova, Russia). Yet in many cases government interference in the market did not bring expected results or was counterproductive.

Conclusion

Restructuring of privatized enterprises and sectors cannot be done from the top (as privatization was). Rather, it is a permanent process driven by the day-to-day activities of managers acting under pressure from owners, other stakeholders, and the threat of takeover. Capital markets—markets for ownership and control rights—should play an essential role in restructuring.

Efficient post-privatization markets should aim to offer fair divestiture of shares by individuals who participated in mass privatization but do not want to be owners; help consolidate ownership, thus improving corporate governance of privatized companies; and allow adjustment of portfolios owned by strategic investors and major portfolio investors (investment funds). Mobilization of new financing through the sale of new shares or debt instruments is likely to remain comparatively small for some time. Bank loans are likely to continue to be the most important source of debt financing for enterprises.

Investment Funds in Mass Privatization and Beyond

Katharina Pistor and Andrew Spicer

This paper offers a tentative assessment of mass privatization based on the performance of investment privatization funds.[1] These funds were assigned a key role in mass privatization and beyond for emerging capital markets. Thus in many ways their performance reflects the overall success—or failure—of mass privatization.

Role of Investment Funds in Mass Privatization

Investment privatization funds were assigned an important role both during the implementation of privatization and during the development of financial institutions and capital markets after privatization (Lipton and Sachs 1990; Frydman and Rapaczynski 1994). These funds were intended to contribute to speedy implementation of privatization and to ensure its equity and fairness. Endowed with a pool of voucher capital acquired from citizens, funds could invest in a large number of companies, thereby diversifying their own risk as well as that of their investors. Funds were expected to amass necessary data on companies and to develop portfolio management expertise to make informed investment decisions. This, in turn, would create positive externalities. By identifying attractive investments and signaling them to other investors, funds were expected to improve the information available on the market.

Funds were also expected to solve one of the potential problems of mass privatization—widely dispersed share ownership in privatized companies. The architects of mass privatization recognized that this arrangement could result in a control vacuum in which small investors would be unable to monitor the management of the companies they owned. By pooling investment capital, funds were supposed to consolidate shares, an essential precondition for effective corporate governance.

Funds were also thought to serve important functions as financial intermediaries in emerging capital markets. Thriving on the returns of their original investments, funds were expected to attract additional capital from households and allocate it to the most productive use. In this way mass privatization would fuel the development of stock markets using the large supply of tradable equity created during the corporatization of state-owned enterprises.

By providing these services for the evolving market economy, funds also fulfilled an important political function. To the extent that funds could provide a link between productive assets and small private shareholders, they bolstered support for market reforms and created political legitimacy for privatization and other reform efforts.

Design of the funds

Mass privatization has differed across countries. The two best-known cases are Russia and the Czech Republic, the first two transition economies to experiment with large-scale privatization. At least thirteen other former socialist countries—Bulgaria, Georgia, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, the Slovak Republic, Slovenia, Ukraine, and Uzbekistan—are also implementing mass privatization programs involving investment funds or have completed them recently.

The mass privatization programs implemented by these countries followed the *free market model,* the *restricted market*

model, or the *regulated market model.* The main differences between these models are the process by which funds are established, the rules on the acquisition of voucher capital by investment funds, and the procedures governing the acquisition and composition of funds' portfolios.

The *free market model* offers the most choice for citizens and funds. The establishment of funds is left to market forces. The role of the state is limited to stipulating the procedures for establishing a fund, including the conditions it must fulfill to acquire a license. Funds accumulate their voucher capital from individual voucher holders. Voucher holders can choose between investing their vouchers directly in privatized companies or using them to acquire shares in funds. Thus funds compete for voucher capital. Funds acquire their assets in privatized companies in voucher auctions, where they also compete with other investors. Both Russia and the Czech Republic opted for this model, and it is now being implemented (with some variations) in Bulgaria, Georgia, the Kyrgyz Republic, Lithuania, Moldova, and Ukraine (table 1).

The *restricted market model* offers less choice to voucher holders. Voucher holders are precluded from investing directly in the shares of privatized enterprises. They must choose from among existing funds or forgo their investment entirely. As a result funds typically are the only bidders in voucher auctions. Thus the degree of competition at these auctions largely depends on the number of funds participating. Funds in this model are privately founded, just as in the free market model. Kazakhstan and Uzbekistan's mass privatizations used this approach.

Unlike the first two models, the *regulated market model* does not leave the creation of funds to the market. In addition, the structure—though not the specific composition—of funds' portfolios is regulated. Funds initially are founded by the state, but they are privatized as shares are issued to the public in return for vouchers. Voucher holders can invest only in funds, not directly in enterprise assets. In addition, the composition of the funds' portfolios is highly regulated. Funds are required to buy core stakes in a minimum number of companies and acquire minority stakes in the remaining companies. The composition of the initial portfolio may be changed through transactions on the secondary market, including swaps among the funds. However, the fund's ability to dispose of the core stakes is limited for several years. Poland is the only country that has used the regulated market model.

The three models have different tradeoffs. The free market model embodies the spirit of market reform and "privatizes" the privatization process (Frydman and Rapaczynski 1994; Boycko, Shleifer, and Vishny 1995). By contrast, the regulated market model allocates considerable decisionmaking to the state (Lipton and Sachs 1990) and thereby risks becoming heavily politicized. In Poland mass privatization was delayed for several years by political conflicts over the selection of companies to be included in privatization and of management companies for the fifteen investment funds established by the state. However, the close monitoring and regulation of the Polish funds and the capital market, as well as the (mostly foreign) expertise of their management companies, has helped the funds develop into viable intermediaries. The restricted market model's main drawback is that the success or failure of mass privatization is so closely tied to the success or failure of the funds. In addition, the model eliminates competition from investors other than funds from the voucher auctions and so increases the likelihood of collusion and insider deals among the funds in allocating privatized assets.

Post-privatization performance of the funds

Privatization must be complete before mass privatization can create effective property rights and provide the basis for capital market development. A meaningful assessment of the post-privatization experience is possible only for two countries, Russia and the Czech Republic. Because both countries adopted the free market model, it is not possible to analyze the implications of different privatization models for the post-privatization performance of investment funds. Still, comparing the experiences of the two countries allows us to draw important conclusions about the free market model and to make inferences about alternative models for mass privatization.

Once mass privatization ended, funds in Russia and the Czech Republic faced the challenge of staying in business with the portfolios they had acquired during privatization. Two years of post-privatization have revealed several trends. First, the number of funds in both countries has been reduced significantly—in Russia to the extent that the future of the funds as significant institutions in the capital market appears to be in question. Second, the financial markets in both countries show strong signs of concentration. In the Czech Republic this concentration directly affected the funds, many of which have been transformed into holding companies. In Russia banks have become major players in the financial markets, holding large blocks of shares in key enterprises. In

Table 1 Features of mass privatization programs, various countries

Country	Date	Were vouchers tradable?	Type of auctions	Did auction procedure stimulate the market?
Free market model				
Bulgaria	1995–	No	Centralized	Yes, resulting in price adjustments
Czech Republic	1992–94	No	Centralized	Yes, resulting in price adjustments and multiple bidding rounds
Georgia	1994–	Yes	Centralized	No
Kyrgyz Republic	1994–	Yes	Decentralized	No
Lithuania	1991–96	No	Decentralized	
Moldova	1993–95	Yes		Yes, resulting in multiple bidding rounds
Russia	1992–94	Yes	Decentralized[a]	No
Slovak Republic	1992–93 (partial)	No	Centralized	Yes, resulting in price adjustments and multiple bidding rounds
Ukraine	1994–	Yes	Decentralized	No
Restricted market model				
Kazakhstan	1994–96	No	Centralized	
Uzbekistan	1996–	No	Centralized	
Regulated market model				
Poland	1993–[97]	Yes	Centralized	No

a. Russia established a national auction system to sell large companies. Only 313 of the more than 14,000 companies privatized were sold in this system.
Source: EBRD 1995.

addition, a number of large funds have become part of financial or financial-industrial groups. Third, funds have not been able to raise significant new capital on the market. To the contrary, investors in both countries have grown wary of financial intermediaries in light of their experience with funds and other financial institutions during the transition.

Russian Voucher Funds: Crisis or Transformation?

At the end of 1993, 636 voucher funds were registered in Russia. By the fall of 1996 only 350 investment funds were active. During this period sixty-nine voucher funds transformed into a new organizational form, in most cases joint stock companies. Sixty-seven mergers also occurred. Analysts believe that only twenty-five to thirty funds have played an important role in the stock market and have active portfolios with long-term perspectives for survival.

Most of the original funds were rather small—as measured by the number of vouchers they accumulated—and by 1994 had little potential for developing into viable financial institutions. Thus a drop in the number of funds is not entirely surprising. Still, the decrease has been quite dramatic, and the small number of mergers and reorganizations does not account for the many funds that apparently have gone out of business. In addition, fund managers and market participants no longer believe that investment funds will play a major role in the future development of the securities market.

There are two main reasons voucher investment funds have failed to develop in Russia. First, many funds have been unable to earn sufficient profits to survive. In particular, voucher funds have had trouble maintaining sufficient cash flow to meet operating expenses and solidify investment decisions. Second, the Russian government has ignored the voucher funds when creating new mechanisms for collective investment in the securities market. A new type of fund, the unit fund, has been created that has many advantages for investors over voucher funds.

The cash-flow problem

One of the biggest problems faced by the voucher funds has been the inability to maintain sufficient cash flow to meet operating expenses and augment their portfolios. The illiquidity of the securities market, the lack of dividends from companies, and the illiquidity of the market for shares in the funds have left few opportunities for voucher funds to earn cash. Double taxation and insider control over corporations have added to these problems. Only the most successful funds have been able to attract sufficient cash to maintain long-term positions in potentially profitable companies.

Illiquid market for portfolio investments. A number of factors have contributed to the illiquidity of the stock in which funds invest. First, funds rarely have sufficient information to make informed decisions about investment in various companies (Frydman, Pistor, and Rapaczynski 1996). As a result they often are forced to make arbitrary decisions about where to invest their vouchers, which makes for weak portfolios.

Second, the general illiquidity of the Russian securities market makes it difficult for firms to sell their stakes. The Russian securities market has only thirty to forty consistently liquid

securities, which makes it difficult for funds to find buyers for other investments. Although funds were able to sell some of the better investments to strategic investors in the period immediately following voucher privatization, enabling them to earn short-term profits, this move also limited the long-term growth potential of the remaining stakes in their portfolios.

Few dividends from companies. Funds have earned little cash from collecting dividends from the companies in which they invested. Insider domination of the Russian voucher distribution resulted in voucher funds holding noncontrolling stakes in the companies in which they invested. Thus funds have trouble protecting the rights of shareholders and ensuring the proper payment of dividends.

The weak finances of these companies is an even bigger obstacle to the payment of dividends, however. Many companies need cash to restructure in response to new market conditions and cannot afford to pay dividends to shareholders. Funds should receive sizable rewards for their active participation in corporate restructuring, but in most cases they are long-term investments. One of the challenges facing the funds is to earn enough cash flow in the short run to be able to realize profits on their voucher investments.

Illiquid market for voucher fund securities. Funds also have a hard time increasing their capital by issuing new shares. For instance, Moscow's Dershava voucher fund attempted to create a market for its shares. During 1995, 6.8 percent of the fund's shares traded hands. However, the shares traded at 7,000 rubles a share, while the fund's net asset value is 12,000 rubles. Most funds, however, have not been able to develop a secondary market for their shares, which deprives them of an important source of cash for their operations.

Voucher funds also face a number of legal restrictions that make it difficult for them to create secondary trading in their shares. For instance, funds are prohibited from buying back the shares of their shareholders and thus have a limited ability to create share liquidity.

Double taxation system. The tax regime governing funds also hinders efforts to attract investment capital. Voucher funds face a double taxation system—they must pay taxes on their profits, and their shareholders must pay taxes on any dividends or profits they receive from the fund. Strategic investors pay less taxes if they invest directly in a company rather than through a voucher fund.

Moreover, profit taxes are not indexed for inflation, but are based on the difference between the nominal price of a share when it was bought and when it was sold. For example, in 1993 the book value of a stock the Dershava fund bought at voucher auctions was 80 million rubles. By mid-1996 the market value of that stock was 5 billion rubles. Although this increase only partially exceeds inflation rates for that period, the company would be responsible for paying taxes on the entire price appreciation were it to sell these shares.

Insider control over corporations. Insider control over privatized firms has been a major feature of mass privatization in Russia. Given the generous privileges granted to company insiders, managers and employees were able to secure control over, on average, 65 percent of company shares during privatization (Blasi and Shleifer 1996). Although many observers hoped that the size of the stake held by insiders would soon dwindle, this has not occurred. Instead, the relative share held by top managers may have increased (Shleifer and Vasiliev 1996).

In most Russian companies insider control has prevented enterprise reform: managers discouraged employees from selling their shares and in return guaranteed employment (Frydman, Pistor, and Rapaczynski 1996). This strategy has secured the position of managers and ensured the nominal survival of firms, but it has crowded out outside investors—including funds interested in improving the company's profitability. Funds acquired less than 7 percent of company shares and thus were too weak to exert much control over corporate governance (Frydman, Pistor, and Rapaczynski 1996).

Why have some funds succeeded?

As mentioned, only twenty to thirty Russian funds have been able to create portfolios with long-term potential. Two factors have contributed to the success of these funds. First, they have overcome cash-flow problems without selling the best prospects in their portfolios. Second, they have acquired substantial holdings in companies with strong prospects for long-term growth.

As noted above, some funds were also able to sell off a portion of their portfolio for cash. The bigger a fund's portfolio, the better able it was to sell off portions without depleting the value of all of its investments. This factor helps explain why, on the whole, the largest funds were the most successful funds. Some large funds also had advantages because they were part of a financial group that was able to supply short-

term capital in order to protect long-term investment. For instance, Alpha-Capital, one of the most successful and aggressive voucher funds, is part of the Alpha Group Consortium, which includes a bank, a real estate company, and a trading company.

In addition, most large funds have leveraged their portfolio investments to offer investment banking services. In fact, providing brokerage and financial services to companies in their portfolio is one of the most profitable activities for many fund managers. It is important, however, to distinguish between the profits of funds and the profits of their management companies. The management company is a separate legal entity that receives a fee for managing the fund. In many cases the management company provides and receives the profits from investment banking services. This arrangement precludes the shareholders of funds from receiving any of these fees, though it does provide incentives and cash for the management company to ensure the survival of the fund.

Finally, successful funds usually gained large or controlling stakes in a number of key firms so that they would be able to participate in decisionmaking and monitor their investment. To do so, many funds were forced to circumvent the law, which limited voucher fund investment initially to a 10 percent and since 1994 to a 25 percent stake in a single firm. One manager of a medium-size voucher fund used friends and affiliate firms to gain controlling shares in the best companies in his portfolio. Others achieved similar results as members of an investment group that cumulatively acquired controlling stakes in selected companies.

Is the start of unit funds the end of voucher funds?

The crisis surrounding voucher funds in Russia led the government to create a new class of mutual funds, unit investment funds, in July 1995. These funds will serve as the main vehicle for financial intermediation in the Russian securities market. Although many voucher funds expect to become unit funds, the mechanisms for transforming voucher funds into unit funds have not been created. Nor has there been any attempt to change legal conditions governing voucher funds—especially the tax regime—to enable them to compete with unit funds.

A number of factors distinguish unit funds from voucher funds. Unit funds are not organized as joint stock companies. They do not have shareholders, and their relationship with investors is governed by contractual trust indentures. As a result unit funds are not subject to corporate profit tax and therefore do not face the double taxation problems that constrain voucher funds.

Unlike the closed-end voucher funds, unit funds will be open-end funds that grant investors the right to redeem their shares. There are two types of unit funds. Open funds will be required to hold liquid assets, such as quoted corporate equities and government securities. Interval funds will be allowed to invest in less liquid assets, such as real estate or nonquoted securities. Instead of redeeming holdings on demand, interval funds will have a periodic redemption schedule.

New regulations for net asset evaluation, information disclosure, depository services, audit reports, tax payments, and portfolio standards were introduced before management companies were licensed to run the new unit funds. Strict procedures for applying to become a unit fund also have been adopted. Potential management companies of unit funds must submit investment plans, operating rules, and audited financial statements to the Federal Commission for the Securities Market before they can be licensed. This requirement has considerably slowed the establishment and licensing of the funds—the first three unit funds were not licensed until April 1996. By September 1996 only nine management companies had received unit fund licenses, and no unit funds had started accepting investments from the public. A number of foreign-run management companies are among the first licensees.

The rationale for unit funds: The failure of the market for financial intermediation

The unit funds were created to try to correct the failure of the market for financial intermediation in Russia. The Federal Commission for the Securities Market hopes that the new funds will attract into the market some of the $20–30 billion in hard currency that the government estimates the public holds in their homes (Federal Commission for the Securities Market 1996b). In other words, the public's lack of confidence in financial intermediaries drove the effort to create unit funds.

This lack of confidence developed from the negative experiences the Russian population had with nascent financial markets during privatization. Few Russians have seen substantial returns on their voucher investment. Moreover, thousands of unlicensed investment companies took advantage of the regulatory environment during privatization to attract cash investments from the Russian public. Massive advertising campaigns, guaranteed increases in share prices, promised returns of more than 1,000 percent a year, and gimmicks like

lotteries for cars and apartments attracted millions of Russians to invest in these financial companies. The best-known of these companies, MMM, was able to attract more than 5 million investors. During 1993–94 some 2,000 unlicensed investment companies were taking money from individual investors in Russia. More than 80 million Russians invested in these schemes, and 50-70 trillion rubles were lost (Federal Commission for the Securities Market 1996a).

These negative experiences generated deep public skepticism about financial intermediaries. For instance, in a 1995 survey of 303 Russians living in three cities, nine in ten said that they had little trust in investment companies (Lutsenko and Radaev 1996). The Federal Commission hopes that well-regulated and reliable unit funds will be able to overcome negative perceptions of financial investment.

Can the voucher funds be transformed into unit funds?

The transformation of voucher funds into unit funds has been considered the most likely way for voucher funds to continue to operate on the capital market. A 1995 survey of voucher funds found that 60 percent hoped to transform into unit funds. No transformation mechanism has been developed, however, and several factors impede the task of transformation.

First, voucher funds usually hold investments in long-term securities, while unit funds are designed for short-term investments. Thus it would be difficult for transformed voucher funds to meet the liquidity requirements of unit funds. Second, voucher funds face legal obstacles to transforming into unit trusts. As a result voucher funds would have to be liquidated and have their assets transferred to unit trusts. However, the costs of liquidation—particularly the tax liabilities—would be exorbitant.

Another hurdle is the coordination required to integrate voucher funds with unit funds. Voucher funds report to the State Committee on Property, while unit funds will report to the Federal Commission for the Securities Market. Moreover, the Central Bank's role in the capital markets is still unclear, especially since banks will sponsor unit funds. In addition, any changes in the tax policies of voucher funds will require the cooperation of the tax authorities.

Finally, the transformation of voucher funds into unit funds will create additional problems for setting up an effective self-regulating organization for unit funds. Self-regulation is considered one solution to the challenge of creating strong regulatory control over the emerging securities market. Although a successful self-regulating organization has been created for brokers and dealers, voucher funds have been unable to create an effective organization—and some observers doubt that such an organization would be legitimate even if it were formed. The creation of the unit funds provides a fresh opportunity to build regulatory capabilities, which the inclusion of voucher funds may make more difficult.

The future of the voucher funds

In 1996 it became apparent that voucher funds had failed to achieve the goals set by the architects of mass privatization. Moreover, many voucher funds have gone out of business, and the remaining funds are struggling to survive. Few industry experts believe that voucher funds will be major players in the development of capital markets in Russia, though a few of the largest may survive for several years. Instead, the urgent question about the future of voucher funds is whether a crisis will occur, causing 25 million shareholders to lose most of their investments, or whether new regulations will be developed that allow voucher funds to transform into new organizational forms—such as unit funds.

Investment Funds in the Czech Republic: Hedging or Governance?

Despite its much smaller size, the Czech Republic saw almost as many investment funds created during privatization as in Russia. More than 400 investment funds were established in the former Czechoslovakia for the first wave of mass privatization. Another 221 funds were set up for the second wave in the Czech Republic (Coffee 1996; Brom and Orenstein 1993). Despite differences in the design of mass privatization programs in the two countries (see Lieberman and others 1995) and the economic environment in which Czech funds operated, investment funds in the two countries faced similar obstacles. In particular, the long-term earning potential of Czech funds was by no means secured, and the uncertainty of transition threatened the long-term viability of many funds.

Thus if funds in the Czech Republic do markedly better than those in Russia, it may be because of differences in their mass privatization programs or in their macroeconomic environments. But if the fate of the Czech funds resembles that of their Russian counterparts, it would suggest that the structural features of mass privatization or of the model chosen by Russia and the Czech Republic should be reassessed.

Funds as agents of corporate governance

The Czech program offered several advantages to funds that were absent from the Russian program. Czech funds were allowed to buy up to 20 percent of stock in a single company, insiders did not obtain large holdings in their own companies, and the auction system allowed Czech funds to choose between different assets. Investors were able to compare not only the information available on the books but also the demand for different assets as reflected in the price offered in each bidding round. As a result Czech funds were able to position themselves as active shareholders.

Funds typically hold the legally permitted 20 percent in a large number of companies in their portfolio, and several funds often cumulatively hold a majority stake. As a result funds have been able to acquire seats on company boards. Although there is little systematic evidence on the behavior of funds as agents of corporate governance, data suggest that funds are often represented on a company's supervisory board as well as on its management board—apparently in response to the weak legal powers of the supervisory board.

Despite the strong representation of funds in the management of privatized companies, most funds are not active shareholders. Few fund representatives have taken steps to replace a company's management. The main exception is Harvard Capital and Consulting—the only large fund that was not established with the participation of a banks—which ousted the entire management board of the country's largest paper company during an extraordinary shareholder meeting. Available evidence suggests that fund ownership and fund board representation have had little impact on companies' restructuring efforts. Thus many observers believe that restructuring still lies ahead for many Czech enterprises.

Capital market development

Economic conditions have been much more favorable for investors in the Czech Republic than in Russia. Without the uncertainties created by high inflation, with the easier flow of information and lower transactions costs of a small country, and absent a highly distortive tax regime, the development of a liquid capital market should have been much easier in the Czech Republic.

Although the stock market has been more liquid than in Russia, the development of the capital market has not matched expectations. Most trading has taken place off the stock exchange, often in the form of swaps among voucher funds. Compared with the Russian voucher funds, the role of Czech funds as proactive buyers of new assets—not only as sellers of valuable assets—is notable. Czech funds have even mounted mergers and takeovers of several companies. But the market for corporate assets has suffered from insider dealings and a lack of transparency. These conditions may be side effects of the large stakes acquired by funds during privatization, which are not easy to liquidate on official markets without steep discounts in prices, but they also could be attributed to the lack of oversight and law enforcement in the capital market.

Funds as financial intermediaries

One indicator of a fund's credibility is its ability to raise additional capital on the market and channel it to productive uses. Czech funds have a mixed history in this regard. Privatization showed that fund managers were quite aware that funds lack credibility. Rather than asking investors to use their second-wave vouchers to invest in existing funds, many new funds were created in the hope that they would be more credible than those that had defaulted on earlier promises.

Of the 354 funds that participated in the second wave, only 133 had registered for the first wave. The rest were new creations. Many were created by investment companies that also managed funds that had participated in the first wave. This move did not escape the attention of coupon holders. The different ranking of investment groups at the end of the second wave relative to the first wave indicates that investors wanted to try alternative intermediaries rather than rely on the funds they had chosen previously (Coffee 1996). In April 1996 Czech securities and investment fund legislation was amended to improve investor protection and increase confidence in the market. Thus the legislature has recognized the need to improve the credibility of the emerging capital market.

Market for fund securities

The lack of confidence in the new financial intermediaries is also reflected in the fact that a secondary market for shares in funds has developed slowly. The overall picture is better than in Russia, however. By October 1995 funds accounted for seventy-four issues of shares and had contributed 33.9 million korona, or 8 percent, to the capitalization of the stock market. Still, many funds' shares have been trading at discounts, and overall demand for shares has been low (Coffee 1996).

Cross-ownership in the financial sector: Vice or virtue?

One of the most intriguing aspects of Czech funds has been their close relationship with the banking sector and the degree

of cross-ownership in the financial sector. The largest banks in the country are mostly owned by other banks and investment funds, including funds established by investment companies that in turn had been created by these banks. Regulations in the investment fund law that could have been used to counter these types of cross-shareholdings proved ineffective. Cross-ownership between banks and funds as well as between banks and funds and the companies they own offer the participants in these networks the opportunity to hedge against hostile takeovers and other market adversities. But evidence from the Czech Republic suggests that shareholders have been disadvantaged by such arrangements, with the shares of funds engaged in such cross-ownership trading at a heavy discount (Coffee 1996).

Moreover, many observers doubt that banks have managed to raise firewalls between themselves and the funds. In light of recent bank failures, this raises concerns about funds that are directly or indirectly controlled by these banks and that frequently also hold assets in them. The recent failure of Kreditnibanka, which is only a medium-size bank, highlights the potential effects of a crisis. The failure of Kreditnibanka triggered the crisis at Agrobanka, which has been placed under the temporary administration of the Czech government. Agrobanka is partly owned by Motoinvest and, with Motoinvest's help, took over several investment funds at the beginning of 1996. The funds created under the auspices of Agrobanka were also the most successful funds during the second wave of mass privatization.

Thus the crisis at Agrobanka shows how the close connections between banks and funds may turn out to be more a vice than a virtue. The bank-fund connection may have helped funds gain status during privatization by providing them with well-known trade names and presumably with liquidity. But funds sponsored by failing banks are now likely to face difficulties not only as the bearer of the failing banks' trade names, but also because the lack of bank liquidity may cut off a main source for their survival so far.

Transformation of funds

Since mid-1995 Czech funds have undergone a transformation. Several funds have been reorganized into holding companies, with Harvard Capital and Consulting taking the lead. As joint stock companies, funds are not subject to investment fund regulations. They can increase their stake in companies beyond the 20 percent ceiling imposed by investment fund regulations and can freely transfer capital abroad for foreign investment. These features created strong incentives for some funds to reorganize.

Other funds that had committed themselves to a portfolio investment strategy were taken over by financial institutions that saw greater potential in financial holding structures. The best example is the fate of the funds affiliated with Creditanstalt, which were sold to Agrobanka in 1996. The Creditanstalt funds had already been listed on the London Stock Exchange. Their commitment to the prudential standards and disclosure requirements imposed by that exchange attracted new portfolio investors in the Czech Republic and abroad. However, the future of this investment strategy had come increasingly into doubt as the transformation of many funds from portfolio management firms to holding structures received open political support. As a result Creditanstalt withdrew from the market.

Not all funds have been transformed into holding structures. The main exceptions are funds affiliated with large Czech banks that are still partly owned by the state. However, this lack of adjustment may be more the result of a general inertia that afflicts this largely state-controlled part of the financial sector than of a commitment to a portfolio management strategy based on market control.

Assessing Mass Privatization in Russia and the Czech Republic

Based on the two case studies, what conclusions can be drawn about the success or failure of mass privatization programs? In both countries mass privatization has succeeded in privatizing a large number of companies in a short period. Though mass privatization was often delayed for political reasons, once it gets off the ground it has a good chance of succeeding, at least in terms of speed. However, latecomers to mass privatization have had a harder time implementing similar programs as quickly. Although there is not enough evidence to draw more definite conclusions, it appears that voucher holders in other mass-privatizing countries have grown more cautious about the benefits of these programs. Some countries have responded to the credibility problem by increasing entry requirements and improving the supervision of investment funds.

Has mass privatization been fair and equitable? That is, has it provided returns to the public? In the Czech Republic and in Russia the results have been disappointing. Most former voucher holders who opted to invest in funds are now locked

in to their holdings or were squeezed out of more profitable assets by aggressive raiders. The discount at which shares in funds are being traded—if at all—reflects the market's perception that funds either have been unable to enhance the value of their holdings or have failed to pass on to their investors the benefits from any increase in value that may have occurred.

These findings are not intended to suggest that funds have been useless in privatization. Their main contribution has been to channel company assets to third parties to the extent that asset liquidity permitted these transactions. Although the funds' role in transferring assets to new owners may ultimately benefit the companies, the costs are borne by the voucher investors. In the absence of liquid markets for fund shares and without enforceable redemption rights, investors in funds have had no way to retrieve the current value of their investment. Dividends, if paid at all, have been extremely low. Thus most citizens of Russia and the Czech Republic have become owners of the least-performing assets in the economy, while the crown jewels have been reallocated to insiders. Small investors' lack of confidence in capital markets is therefore a rational response to their experience with mass privatization.

Has mass privatization created effective private property rights? For the most part it is too early to tell. Restructuring has been much slower than expected, which suggests that realizing property rights is a much more complicated and long-term process than the nominal allocation of title. Moreover, there are troubling signs—particularly in Russia—that the property rights created during mass privatization may have been too weak to provide a sustainable basis for property rights reform. Many new outside owners—including funds—were effectively frozen out by company insiders. Where they were unable to effect their rights, companies remained in a control vacuum.

Finally, the state, particularly regional governments, has continued to play an important role as a silent owner and company rescuer of last resort. Consider ZIL, the large motor vehicle manufacturer outside Moscow. ZIL's privatization in the spring of 1993 was hailed as a big success for mass privatization (Boycko, Shleifer, and Vishny 1993). In the summer of 1996, however, the Moscow city government acquired the shares that had been transferred to an outside investor in an attempt to prevent the bankruptcy of the ailing company (*OMRI Daily Digest*, 16 September 1996). This event also suggests that efforts to depoliticize property relations using a hasty privatization program do not come without risk (Boycko, Shleifer, and Vishny 1995), because they may provide too weak a basis for the development of effective property rights.

The influence of mass privatization on the creation of capital markets needs to be further examined. Although mass privatization generated a large supply of equity to fledgling capital markets, markets have remained undersupplied by (domestic) capital in both Russia and the Czech Republic. One explanation for the lack of capital market development seems to be the absence of an institutional framework. Funds were created to monitor enterprises, but no mechanism was developed to monitor the funds. Mass privatization offered enormous opportunities for wealth creation that were realized by the unscrupulous few who exploited the arbitrage opportunities of a nontransparent and unregulated market. Many funds that followed disclosure rules established in developed markets, though profitable and able to attract new investors, were eventually forced to surrender, as with the Creditanstalt funds in the Czech Republic.

The lack of capital market development has undermined the ability of funds to develop into viable financial intermediaries. Although funds were developed to engage in long-term corporate monitoring and investment, they had trouble maintaining the short-term cash flow they required to survive. Illiquid capital markets have made it difficult to issue new shares, to raise capital, or to trade many of the stocks in their portfolios. Moreover, the inability of funds to acquire enough cash to become large traders in the securities markets has been a major impediment to making the markets more liquid. It also has determined the structure and investment strategies of the remaining funds and their legal successors. In both Russia and the Czech Republic there are strong tendencies toward concentration of shareholdings in companies by financial intermediaries who, working alone or as part of a larger group, act as holding companies rather than as portfolio managers.

Lessons of Different Privatization Models

The free market model of mass privatization has succeeded in Russia and the Czech Republic in quickly transferring a large number of enterprises from public to private ownership. The ultimate success of mass privatization cannot, however, be determined solely by the speed at which privatization occurs. Instead, the effects of free market mass privatization on economic and political outcomes beyond privatization must be assessed.

The relationship between free market mass privatization and capital market development needs to be more fully examined. Investment funds were created to overcome a number of market imperfections in the creation of new financial markets by gathering and disseminating information about privatized firms and monitoring the property rights of new shareholders. However, few funds have evolved into financial intermediaries that provide these market-building services. Thus the initial design problems identified during the implementation of mass privatization—asymmetric information and imperfect property rights—remain in the capital markets of Russia and the Czech Republic. Moreover, the negative experiences of a large part of the population with financial intermediaries appear to have worsened these problems by destroying confidence in the emerging financial markets.

Where and how are privatized firms going to raise the capital needed to engage in required restructuring? Although foreign investors provide some funds, research has demonstrated that domestic savings and domestic investment are essential for sustained growth (World Bank 1989 and 1991). Thus the relationship between mass privatization and the development of domestic capital markets should be further investigated based on a comparative analysis of country experiences with the free market and regulated market models of mass privatization.

The experience with the free market model suggests that the regulated market model may have several important advantages. Rather than trying to create the market first and provide the institutional underpinning for the market later, market regulations and institutions are created before the market expands through privatization. Speed is sacrificed in this model, however. Depending on a country's political conditions, developing these regulations and institutions may in fact endanger the entire privatization process. But where political conditions allow for a choice among different strategies, a slower, institutionally sound strategy may pay off in the long term.

Note

1. Investment privatization funds are financial intermediaries that are allowed to accept vouchers (coupons or similar privatization options) as payment for the rights they issue and to use those vouchers to acquire shares in enterprises during privatization. In some countries funds are explicitly designated as voucher funds or privatization funds; in others all properly licensed funds may participate in privatization by acquiring investment capital from small investors in the form of vouchers and using this capital to invest in companies during priva tization. In countries where funds were specifically designed as voucher funds and operate under this label, we use the term voucher funds.

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Regulating Post-Privatization Securities Markets in Transition Economies

Marko Simoneti

Securities markets in transition economies are developing on the heels of large-scale privatization. Because privatization in the primary market used many innovative methods, secondary transactions involving privatized shares also have unique characteristics. And because market players in transition economies have different objectives than their counterparts in industrial countries, their behavior is different. Regulators in transition economies must take these differences into account, since applying standard rules from industrial countries might prove counterproductive. Transition economies also differ from one another, so regulation must be country specific.

The degree of difference between transition and developed markets depends on the importance of these markets for the financing needs of privatized companies. The more important are these new sources of finance in transition economies, the more similar is the behavior of market participants to those in industrial countries. Two basic models of regulation have emerged in transition economies: regulation of the market after case-by-case privatization (as in Hungary and Poland) and regulation of the market after mass privatization. In the context of mass privatization regulation must take into account differences between mass privatization to the public (as in the Czech Republic) and mass privatization dominated by insiders (as in Russia and Slovenia).

Developing Securities Market Regulation in Transition Economies

The main functions of secondary trading in the shares of privatized companies after case-by-case privatization are the same as in industrial countries: to provide liquidity to investors, to provide opportunities for companies to raise money by issuing new shares, to generate information for investors on investment opportunities, and to monitor management performance (corporate governance). Regulatory priorities under case-by-case privatization are also similar to those in industrial countries: protecting small investors trading privatized company shares sold for cash through public offerings.

The main function of secondary trading in the shares of privatized companies after mass privatization is to consolidate ownership, which is essential for improving corporate governance and supporting enterprise restructuring. Given their size and difficult economic situation, these privatized companies should have active owners—not passive individual or institutional investors with limited ability and desire to restructure the company. The regulatory priorities (in order of importance) for developing a transparent and fair market under mass privatization are:

- Protecting shareholder rights in privatized companies—particularly where mass privatization has been dominated by insiders who want to prevent outsiders from exercising their rights.
- Protecting small investors in privatization funds.
- Protecting small shareholders in the ownership consolidation process following mass privatization.
- Protecting investors trading shares of public companies on public markets.

In case-by-case privatization, capital market development starts at the high end of the market. The first candidates for public offering are carefully selected, and trading usually starts

in the official stock exchange. Only later are less attractive companies introduced to the market and less structured trading facilities established. This top-down approach is quite conservative compared with the approach used in mass privatization.

Two approaches are used to regulate transactions in privatized shares after mass privatization. The first approach treats all mass-privatized companies as public companies that are traded on public markets. Under this liberal, bottom-up approach regulatory standards initially are set at a minimum to accommodate all privatized companies (as in the Czech Republic). Securities market development starts at the low end of the market. Standards are gradually increased to the international level, and some companies and markets no longer qualify as public.

In the second approach a limited number of mass-privatized companies are treated as public companies that are traded on public markets. International regulatory standards are applied to these companies, while regulation of the remaining quasi-public companies is limited (as in Slovenia). Securities market development starts simultaneously at the low and high ends of the market. This dual approach to regulation uses conservative rules for the public segment and liberal rules for the quasi-public segment of the market.

The dual approach captures the benefits of the coexistence of public and quasi-public companies after mass privatization. Moreover, a separate, high-standard public market makes it easier to attract foreign investment and to select privatized companies capable of raising funds on the market. At the same time, the dual approach helps companies that could never be public remain a part of the quasi-public segment of the market for as long as is needed to consolidate ownership.

There is considerable risk of regulatory capture when regulating secondary transactions after mass privatization. The same interest groups that influenced the initial distribution of shares often demand restrictive regulation of secondary transactions to preserve this distribution—to the detriment of small investors. The dual approach can help avoid regulatory capture because standard rules for protecting small investors can be limited to the public segment of the market, while for most quasi-public companies only minimum standards for trading and corporate control transactions need be applied.

Protecting Shareholder Rights in Privatized Companies

A priority of securities regulation in transition economies should be to ensure that basic rights (voting rights, right to dividends, transfer of shares) are enjoyed by shareholders in privatized companies. These rights must be provided to all shareholders—majority and minority, small and large, insiders and outsiders—on equal terms. Protection of shareholders is a precondition for protection of investors trading on the market.

In industrial countries basic shareholder rights, defined by company law and company statutes, are taken for granted and are strictly enforced. However, investors can choose not to invest in a public company if they find some statutory rules unacceptable. Because attracting investors is a primary objective of public companies in industrial countries, company managers have little incentive to violate basic shareholder rights.

In transition economies the main objective of managers in privatizing companies is often to retain control of the company. Dissatisfied investors are not a big problem because they do not represent a serious threat to management. Companies privatized through public offerings in transition economies often do not want to be traded on organized markets and to report to investors, share transactions often are not possible because share registers are controlled by managers, and shareholder meetings are often organized in ways that discriminate against certain groups of shareholders. The problem is not simply one of enforcing rules but of completely changing the incentives of key players. The approach to enforcement used in industrial countries would be counterproductive in this context. For example, delisting of shares for nonreporting would reward rather than punish misconduct by the managers of these companies.

The problem becomes even more complicated in countries where mass privatization is dominated by insiders, who are in a much better position then outsiders to exercise shareholder rights. Although laws provide the same rights to all shareholders, de facto shareholders are in a very different position. Laws from industrial countries do not take into account the reality of these quasi-public companies: many are controlled by insiders, many are not interested in outside investors, and outside investors—who often are legally obliged to be shareholders in such companies—may want to exit but cannot without the cooperation of insiders.

The only long-term solution to these problems is to transform quasi-public companies into private or public companies in which the motives of companies, managers, and investor-owners are the same as in industrial countries. During the transition, however, several steps can be taken to protect shareholder rights in privatized companies.

Providing a fair corporate legal framework

Initial conditions for shareholders in privatized companies are determined by the company law, privatization law, and company statutes. These rules—which define shareholder rights and powers, rights of minority shareholders, board structure, and disclosure of information—are often much more important for outsiders than the percentage of shares they hold. To protect outsiders, these rules should establish cumulative voting on board representation, supermajority voting on major issues (including sale of large assets), two-tier boards, and high quorum rules, and should not combine employee participation with insider ownership, since such arrangements increase the decisionmaking rights of insiders.

To protect outsiders after mass privatization, it is important to limit the possibilities for statute amendments that are not in the interests of outsiders and that allow major corporate decisions to be made without their consent. Potential problem areas include changes in voting rules favoring insiders, anti-takeover amendments, asset stripping by insiders, and introduction of profit distribution schemes for employees.

Establishing proxy rules

Because most outside investors are not active in company matters, they should be represented by proxy at shareholder meetings. In the German system banks that are themselves owners of companies usually act as a proxy for small investors. In the U.S. system small shareholders who are not represented at shareholder meetings grant de facto support to management proposals. In transition economies the managers of companies dominated by insiders often are able to control the votes of small inside and outside investors. It would be more logical for investment funds, as the largest outside shareholders, to represent small outside investors in shareholder meetings.

If the abuse of proxy arrangements by insiders becomes a serious problem, simple proxy rules should be established to protect outsiders:

- All shareholders should have equal access to the list of shareholders;
- Proxy solicitations should be equally financed for insiders and outsiders;
- Managers should be restricted from serving as a proxy;
- There should be no proxy arrangements without instructions for voting and no long-term proxy arrangements.

Ensuring equitable shareholder agreements

Shareholder agreements among insiders are used to control votes and to prevent the transfer of shares to outsiders. Such agreements can substantially limit the ability of outside shareholders to promote their common interests. To protect outsiders, managers should be restricted from organizing shareholder agreements, all shareholders should have equal access to information and financing when formulating shareholder agreements, and ex post restrictions on the transfer of shares in public companies that are traded on organized markets should be forbidden.

Setting technical requirements for the free transfer of shares

Insiders often have an incentive to block the free transfer of shares. In addition, registered shares from privatization often are not easy to transfer. Two basic principles should guide the transfer of shares after mass privatization: the share register should be operated by someone independent of the company and public companies should be listed at the request of investors without the consent of the company.

Dematerialization and central registration solve many problems in exercising shareholder rights after mass privatization. There are many possible arrangements, each with advantages and disadvantages:

- Immobilization of securities is less cost-efficient than complete dematerialization but is much easier to introduce in the current corporate legal framework.
- Dematerialization of securities can be obligatory or voluntary. For practical reasons it should be obligatory for privatized companies and public companies traded on organized markets.
- Central registries of dematerialized securities can hold accounts for brokers who act as intermediaries for individual shareholders or for shareholders directly. A two-tier structure provides more confidentiality to investors, while a single-tier structure is more efficient.

Different approaches are used in transition economies to reduce or eliminate the need for physical transfer of paper share certificates. The Czech Republic and Slovenia use centralized dematerialization, Russia uses decentralized dematerialization, and Poland uses gradual immobilization.

Regulating Ownership Consolidation

The widespread ownership emerging from mass privatization does not facilitate effective corporate governance or provide

the support needed to restructure privatized companies. More consolidated ownership—achieved through secondary transactions and privatization of many quasi-public companies—is needed to start post-privatization restructuring on a large scale. Postponing this consolidation limits privatization to the administrative distribution of shares, with modest effects on the efficiency of privatized companies. The more artificial was the initial distribution of shares, the more adjustments in ownership will have to be made through secondary transactions to improve company efficiency.

Market for shares and market for companies

During ownership consolidation many shares are bought in order to concentrate corporate control in the hands of a strategic buyer. Although it may appear that investors are trading shares, in reality some investors are accumulating shares to obtain control (Morgenstern 1994). From an economic perspective these two markets are difficult to separate, but the market for shares and the market for companies are very different. On the market for shares investors buy and sell shares with a mostly financial motive; on the market for companies many small shareholders sell shares to an active owner who wants to control the company.

The rules of the game in these two markets are well defined in industrial countries. Shares of public companies are traded in public markets, and such transactions are regulated by securities market regulation. Shares of private companies are traded off the market (in the market for companies), and there is no special regulation. When a public company is taken private through accumulation of shares—that is, taken off the public market for shares into the private market for companies—such transactions are governed by tender offer rules. When a private company wants to be traded on the public market for shares, such transactions are governed by initial public offering or going public rules.

In industrial countries these concepts are straightforward, and the only problems are in establishing operational definitions of various transactions so that standard regulation can be properly enforced. In transition economies these conceptual dilemmas are much more challenging. Most privatized companies are quasi-public or quasi-private with a mixed set of characteristics: they have many shareholders but shares are not actively traded on securities markets. In addition, they are transforming from quasi-public into public or private companies. Corporate transformation, unusual in industrial countries, is the rule after mass privatization. Regulators in transition economies must decide whether to regulate corporate transactions in countries that lack a well-developed secondary market for shares.

The liberal approach would be to treat privatized companies as such; the conservative approach would be to treat them like public companies. These extreme approaches are only theoretical, however. In practice a balance must be struck in which some—but not all—private rules apply to privatized companies during the ownership consolidation period.

Transforming quasi-public companies dominated by insiders

Companies dominated by insiders that also have many outside owners are the most difficult to regulate during ownership consolidation. The key question is whether insider ownership is a permanent or a temporary feature. The answer depends on who controls the company after privatization and whether there is a need and a way to finance the company by issuing new shares to the public.

Companies controlled by insiders who have no incentive to raise new financing on the market should be encouraged to transform into private companies. Two principles must be followed for this transformation to be fair for both inside and outside shareholders. First, outside shareholders should be able to exit from the company at a fair price. Since insiders cannot pay them out and it is hard to sell shares for cash, the simplest way to exit is to use equity-debt conversions or seller financing techniques. It is only logical that outside investors hold debt instruments in companies they cannot trade on the market and monitor effectively as owners.

Second, inside shareholders who want employee ownership to become a permanent feature of the company should organize themselves in an employee stock ownership plan (ESOP) with nontradable shares but with clearly defined rules for entry and exit, price determination, voting, and maximum and minimum ownership of shares by individuals. This scheme could be structured as an internal ESOP through statute amendments or as external trusts for employee shares.

In some countries (Russia, Slovenia) most quasi-public companies will have to be transformed into private companies using this approach. There is no real need for organized secondary trading of these shares or for tender offer rules. Buyers and sellers are already in the company because demand by outside investors is limited. Forcing these companies to follow the rules of public companies and insisting that their shares be traded for cash on public markets could even be counterproductive to market development and to the devel-

opment of ESOP-like structures. Thus such transactions should take place off the market. What is needed is a flexible corporate legal framework (German company law is often too restrictive) that allows for easy changes in corporate ownership when the majority of shareholders agrees to do so.

Companies that are not controlled by insiders or that hope to raise additional financing by issuing new shares should be encouraged to behave like real public companies, following international standards on accounting, auditing, reporting, disclosure, listing, and so on. Inside shareholders in such companies should be in the same position as outside shareholders. Any control by inside shareholders that reduces the rights of outside shareholders or affects the price and liquidity of shares should be forbidden.

Challenges in regulating private transactions

In regulating tender offers in transition economies, regulators should bear in mind that the purchase of a company can be structured in different ways: through statutory merger, as an assets purchase, or as a shares purchase. If the rules for tender offers are overly restrictive, buyers and sellers will use less costly and less transparent techniques. Overregulation does not prevent consolidation; it just makes it less transparent. In addition, too much protection of small shareholders might not benefit them. As a result the number of tender offers that benefit shareholders will decrease and the number of asset transactions that leave shareholders less protected will increase.

Although tender offers can be addressed directly to shareholders against the will of managers (hostile takeovers), all other transaction techniques require considerable cooperation from the managers of a targeted company. Because poor managers are a key problem in many privatized companies, it would not make sense to protect them with restrictive tender rules at the expense of shareholders. Hostile takeovers can be quite friendly for shareholders and for the company itself.

Some privatized companies in transition economies have attempted to use takeover rules to regulate foreign direct investment and to protect against hostile takeovers by foreign investors. In case-by-case privatization, government institutions negotiate directly with foreign investors, and broader national interests can be addressed in the sales contracts. In mass privatization, newly created shareholders willing to sell at a low price become the counterparts of foreign investors who were not allowed to participate in voucher privatization. No ex post government regulation can reverse this situation, which is an economic consequence of mass privatization. Restrictive regulations requiring government approval for transactions with foreigners cannot improve the negotiating position of domestic sellers, and encourage foreign investors to structure transactions in a less transparent way.

Regulating Privatization Funds

Privatization funds in transition economies and investment funds in industrial countries have similar legal structures but very different economic rationales. Regulation during transition must take this into account. Privatization funds are essential to the development of securities markets after mass privatization because they are the largest institutional investors in the market and the largest issuers of securities to small investors.

Fund characteristics

Funds are created during mass privatization to ensure efficient and quick distribution of property, diversify participants in mass privatization, and concentrate ownership and improve corporate governance in privatized companies. From a corporate governance perspective funds are designed to be active in companies to varying degrees:

- Passive funds limit their activities to managing their portfolios.
- Active funds seek board representation in the companies they own shares of.
- Restructuring funds are involved in the daily operation of their companies.

The use of funds in mass privatization is in line with general trends in industrial countries, where institutional investors are becoming larger and more active owners. Fund portfolios and shareholders, however, are completely different from those in the investment funds of industrial countries. Fund portfolios are mostly shares that will never be actively traded in public markets. Among fund shareholders are many temporary shareholders looking for the first good opportunity to sell (Simoneti and Tříska 1995).

Regulatory issues in setting up funds

Funds can be set up using a bottom-up (as in the Czech Republic) or top-down approach (as in Poland). In the bottom-up approach licensed management companies compete to collect vouchers from citizens in the first phase and to buy company shares in the second phase. An advantage of this

scheme is that the process is market driven. In the top-down approach management companies are selected by the government, which also sets up funds and their portfolios. Under this approach funds initially are owned by the government; only in the second phase are shares distributed to citizens participating in the scheme. Advocates of the top-down approach claim that it allows funds to be set up with a focus on restructuring, while in the bottom-up approach restructuring will occur only if the management company is motivated to do so. The government's continuous and active involvement is a great danger of the top-down approach, however.

The regulatory framework for funds can be standard investment funds regulation with some modifications (as in Slovenia) or special regulation (as in Poland). Local conditions must be taken into account, since simply adopting the rules for investment funds from industrial countries can have unexpected results. Given the structure of fund portfolios and the motives of investors, funds should be closed end and grant voting rights to investors, like in public joint stock companies. Unit trusts with no voting rights for investors should be forbidden.

To avoid problems in regulating funds, some institutions and individuals should not be allowed to set up a management company to run funds:

- Companies and financial institutions to be privatized during mass privatization, to avoid cross-ownership and self-privatization;
- Managers of companies and financial institutions to be privatized, to avoid conflicts of interest;
- State-owned companies and financial institutions, to avoid government influence on privatized companies.

All mass privatizations violate these common-sense rules to at least some degree. In most countries there is strong interest and political pressure to include state-owned banks and other financial institutions in the scheme. There is also the problem of enforcement, since people who are forbidden from running funds can set up bypass management companies. Finally, there is pressure to get mass privatization off the ground as quickly as possible. The people who are most interested in starting funds are often the least desirable from a corporate governance perspective. In most countries the preoccupation with short-term objectives and the absence of a long-term vision for future ownership links between companies and financial institutions will have a lasting effect on financial sector development after mass privatization.

As funds are being set up, policymakers must decide how much advertising and promotion should be allowed. Although it is important that small investors not be misled by aggressive promotion, restrictive policies on advertising and promotion might lead potential investors to invest not in funds but directly in privatizing companies. More liberal policies than those in industrial countries should be adopted, with the proviso that funds can always sue one another for unfair competition practices.

Competition among funds is also important. Transparent competition among funds can be facilitated with standardized management contracts, fund statutes, and prospectuses (Simoneti and Tříska 1995). Minimum quality standards enforced through the licensing of management companies can also be used to limit the market share of individual management companies. Standards on market concentration similar to those used for other financial services could be used, although various aspects of competition should be addressed differently. Strong competition among funds when they are collecting vouchers and selecting companies is clearly desirable, but later there are good reasons to encourage cooperation among funds involved in corporate governance.

Regulatory issues in the operation of funds

Most of the standard portfolio restrictions applied to investment funds in industrial countries are simply not realistic for funds in transition economies, while some are counterproductive. For example, there should be no limit on the percentage of company shares a fund can hold if active funds or restructuring funds are being encouraged (Coffee 1994; Anderson 1994). Standard diversification rules should be applied immediately, but rules requiring that a certain percentage of fund portfolios be in listed securities do not make much sense initially. It is a paradox of transition that the liquidity of funds might improve if they hold investments in real estate instead of shares listed on quasi-public markets.

Given the types of companies owned by funds, funds cannot act only as diversified portfolio funds trading shares on the market. If they want to increase the value of their portfolios, funds will have to be much more active owners. If funds are allowed to become controlling shareholders in a company and to operate as active funds or restructuring funds, the focus of regulation should move from portfolio regulation to regulation of potential conflicts of interest:

- Conflicts arising from the commercial activities of funds' sponsors in the portfolio companies;
- Conflicts due to cross-ownership in funds managed by the same management company;

- Problems of interlocking board membership structures in the group;
- Enforcement of arm's-length transactions in the group.

These issues are complicated to regulate but must be addressed, since most of the abuses in fund business develop from these conflicts. The least that should be done is to clearly define behavior that is not allowed and develop procedures for shareholders to use in self-enforcing these rules. Focusing the attention of regulators on portfolio issues is misguided.

Management companies must have proper incentives to engage in active ownership (as well as limited restrictions on fund portfolios). The extra costs of active ownership must be covered and additional efforts rewarded. A management fee structure that reflects a fund's current income (based on realized capital gains and dividends from portfolio companies) rather than its size (based on net asset value) provides much stronger incentives for active ownership. Linking the management fee to the fund's net asset value encourages passive ownership and active trading, often to manipulate share prices on the secondary market and to create accounting capital gains (unrealized capital gains). Refining the net asset value methodology can only partly improve the situation because the problem is more fundamental: net asset value is simply the wrong target when most companies in the portfolio are not actively traded and their true value could be better increased through active ownership.

Funds are created in mass privatization to improve corporate governance of privatized companies. Once funds are a major owner of the corporate sector, the relevant issue becomes corporate governance of funds: Who guards the guardians? In industrial countries the pressure for investment funds to act in the best interests of investors comes from investors, competitors, and regulators. Most funds are open-end funds in which voting rights for investors are not really important. The ability of investors to exit the fund at any time is the most important monitoring mechanism since management fees are directly linked to the size of the fund. In this setup competition among funds and the reputation of management companies also play an important role in corporate governance of funds. In addition, there is strong regulation and supervision of funds as well as of trading on the organized securities markets where funds operate.

These corporate governance mechanisms would not work in transition economies because most funds are closed-end. Thus alternative mechanisms are needed to protect the interests of small investors; otherwise the credibility of mass privatization might be undermined by the abuses of fund managers. The most important requirement is that the voting rights of investors be respected and reinforced during the transition. Investors with voting rights can protect themselves against abuses and self-enforce rules if and when necessary. Practical solutions include:

- Organizing closed-end funds as joint stock companies with voting rights for investors and independent supervisory boards.
- Ensuring that supervisory board members are held responsible for their actions and can be sued by investors for negligence.
- If funds are not legal persons, setting up an internal decisionmaking structure similar to that in joint stock companies, with an assembly of investors and a supervisory board.
- Allowing for the management contract to be terminated or renegotiated by investors.
- Establishing short-term management contracts and open competition for each new contract.
- Trading closed-end funds on organized securities markets.
- Encouraging mergers of small funds and takeovers of poorly managed funds by competitors.
- Allocating a portion of the shares in the funds they manage to management companies to align their interests with those of investors. These should be nonvoting shares because giving management companies a controlling package of shares in funds would create opportunities for self-dealings.

Regulatory issues in transforming funds

Standard regulation of investment funds provides procedures for dealing with situations in which a management company does not wish or is not allowed to manage an investment fund any more: the management contract can be transferred to another management company or the fund is liquidated by selling the portfolio on the market and paying out the investors.

Funds are temporary institutions created to support and expedite mass privatization. In the long run they will have to be transformed into standard institutions (along the lines of those in industrial countries) and regulated according to international standards. Liquidating funds is one way of transforming them, but additional transformation rules are needed given that all funds will have to adjust their operation in the long run. Other possible exit routes for funds include transforming into closed-end funds (with portfolios adapted to international standards), open-end funds (with limited voting

rights but with investors allowed to exit or enter at any time), holding companies, venture capital funds, real estate funds, or an investment banking arm of a commercial bank.

This transformation is already under way in some transition economies, although investors and regulators might not be fully aware of the new directions taken by management companies. Several regulatory issues need to be addressed. First, rules are needed to define investors' role in these transformation decisions, how their interests are protected, and the rights of investors who disagree. Second, what alternatives are available, and are some more desirable for policymakers and regulators? Specifically, will a market-based or a bank-based financial system be encouraged?

In most countries this strategic decision has not been made intentionally. Although mass privatization and the development of funds as major institutional owners would appear to be a decisive step toward a market-based financial system—with securities markets playing an important role—there is strong evidence to the contrary. When commercial banks control most large funds indirectly (through management companies) or directly (by owning funds), these banks start to operate as universal banks, providing credit to companies while representing the interests of other shareholders in the companies. By controlling funds' business, commercial banks have become the winners in privatization, while institutional investors, small shareholders, and securities markets are not playing as large a role as expected.

Internal consistency among various financial institutions, markets, and instruments is essential for both market-based and bank-based financial systems to work properly. Regulators cannot provide a consistent framework if they are only reacting to events; some strategic choices must be made in advance. If regulators have a clear concept of how the financial system should look in the long run, some exit routes for funds might not be desirable or allowed. Management companies and investors in funds should be made aware of these restrictions in advance.

Regulating Public Markets

The financing needs of public companies provide the economic rationale for the public market for securities (organized markets). Active and orderly trading on the secondary market is a precondition for issuing new shares on the primary market. At the same time, the secondary market supports self-financing of public companies through retained earnings because investors in need of liquidity can always sell shares on the market.

The same economic rationale applies in the public segment of the market in transition economies. All market participants basically have the same objectives as those in industrial countries; thus standard Western regulation is appropriate for this segment of the market. Questions remain about the best approach to this type of regulation, but they are not unique to markets in transition. Only aspects specific to transition are discussed below.

Why regulate?

Channeling private savings into productive investments is important for economic development. Regulation must create an environment conducive to this activity. Various measures are used to protect small investors, including requirements for public offerings, trading, professional conduct of intermediaries, transfer, clearing, and settlement, and accounting, auditing, and disclosure.

Regulators in transition economies must be careful not to overregulate market development. In addition, they should maintain public confidence, but investment risks should remain with investors. Regulators should not be concerned with the prices of individual securities because doing so would send the wrong signal to investors entering securities markets for the first time. Maintaining the stability of the financial system and reducing systemic risk in the financial sector are important objectives for regulators in industrial countries (OECD 1988). During mass privatization, however, it may be impossible to avoid initial instability on the market. Regulators that attempt to do so risk losing credibility before they even start operating. On the positive side, securities markets after mass privatization are not fully integrated with the financial system, which helps limit potential negative spillovers.

Legal framework

Several laws provide the legal framework for securities market regulation: company laws, banking laws, contract laws, investment fund laws, tax laws, and securities market laws. The main problems in supervising securities markets often originate not in securities market law but in other laws. A common problem in transition economies is that these laws, adapted from the legal systems of various countries, are inconsistent, making the enforcement of regulation difficult.

A fundamental legal difficulty in regulating and supervising securities markets in civil law countries is the traditionally

narrow reading of the law. In transition economies changes have been dramatic, and many situations could not be foreseen at the time the laws are written. Pragmatic interpretation of a law's purpose, as practiced by U.S. courts, would be a better approach.

Regulatory challenges

The main regulatory challenge facing transition economies is not to prepare regulations but to enforce them. When regulations are being prepared, the ability of institutions to implement them should be taken fully into account. Markets develop better when there are no rules than when there are restrictive rules that everybody violates and nobody enforces.

Overregulation problems include the creation of monopolies, excessive regulatory costs, limited innovation, and constrained market development. These problems occur in transition economies that choose a conservative approach to regulating the public segment of the market.

In an environment where the enforcement capabilities of government institutions are limited, self-regulation might seem appealing. But self-regulation requires reputable and professional market participants who are motivated and capable of enforcing professional standards while maintaining competition and free entry—unlikely conditions at the beginning of securities market development in transition economies. Basic rules developed and enforced by government institutions are the only realistic option during the initial period of transition.

Institutional framework

Before a decision is made on who should regulate what, important conceptual issues must be resolved and several relationships clearly defined: the relationship between banking business and securities business, capital markets and money markets, government securities and corporate securities, spot markets and futures markets, and regulation and self-regulation.

Possible regulatory authorities include the ministry of finance, central bank, securities and exchange commission, and self-regulating organizations like the stock exchange and the association of brokers or other market participants. Different countries use different institutional frameworks; the two most prominent are the continental (U.K.) approach, which relies on self-regulation, and the Anglo-Saxon (U.S.) model, which relies on government regulation. Country requirements and local institutional capacity should be taken into account when adapting these imperfect frameworks. Initially, transition economies should:

- Separate banking from securities business.
- Establish an independent securities and exchange commission.
- Focus regulation and supervision on corporate securities and spot markets.
- Gradually move from regulation to self-regulation.

Market architecture

Trading systems in public markets differ, and some approaches clearly are not appropriate for transition economies. Each approach has its advantages and disadvantages, however, and final decisions should take into account country conditions (Pagano and Roell 1990).

Transparency. Transparency—meaning that information about trading is timely, accurate, complete, and publicly available—is essential for fair and efficient markets. But even if public markets are transparent, many transactions are done off the market with little or no reporting. How can regulators reduce the volume and number of off-market transactions? By making it cheaper and easier to use public markets when trading shares. Still, it cannot realistically be expected that corporate control transactions involving large block of shares will ever take place on the market for shares.

Market access. The large number of small shareholders after mass privatization should encourage transition economies to provide a low-cost and easy-access market (such as the RMS stock exchange in the Czech Republic) in which individual investors can place their orders directly. The alternative is to have even more off-market transactions and door-to-door accumulation of shares by interested buyers. Counterparty risk is high in such direct-access markets and pre-trade verification and advance payments might be required, which slows down clearing and settlement. In the long run most trading by professional investors will take place on markets where orders can be placed only through brokers.

Market consolidation. A single market might be more operationally efficient because of economies of scale and the better price discovery due to concentration of demand and supply. Competition between markets and cross-listing of securities, however, might lower transactions costs and encourage innovation and the development of services adapted to different types of investors.

Role of intermediaries. Market stability requires that the market include, in addition to long-term investors, short-term speculators who buy securities when the price is low and sell securities when the price is high. Brokers act as speculators when they are trading on their own account or when they act as official market makers (dealers) for a security. The capital and skills required for dealers are much higher than those required for traditional brokers, and thus dealers simply do not exist in most transition economies. On the other hand, brokers trading simultaneously for themselves and on behalf of clients have a strong conflict of interest (Pohl, Jedrzejczak, and Anderson 1994).

Price discovery mechanism. Price-driven markets (dealers' markets) require market makers who are always willing to buy and sell certain securities on the market at a spread. Price-driven markets also improve market liquidity, which is a major problem after mass privatization. Again, however, transition economies have few capable market makers. Thus order-driven (auction) markets will dominate in transition economies for years to come.

Trading period. In a call market there is one price per trading. Supply and demand are concentrated at a point in time, and the resulting price for securities that are not heavily traded is more realistic. Simplicity is another advantage of a call market. In a continuous market there is more than one price per trading, which is important for speculators but less so for long-term investors. Trading must be computerized for an efficient continuous market. The main problem with continuous trading is that it can easily be abused and manipulated when market liquidity is low. Moreover, as call markets are replaced by computerized continuous trading systems, transparency, fairness, and the quality of information received from the market may suffer. To avoid this outcome, regulators should ensure that thinly traded securities are traded only on the call market or through dealers, and that heavily traded securities are traded only on the continuous market.

Clearing and settlement. Transition economies should try to follow international standards and recommendations for clearing and settlement, at least on public markets. Given the number of shares issued in transition economies, physical transfer of shares is not practical even for off-market transactions. Dematerialization of securities is recommended to improve the security of investors, reduce the cost of issuing securities, reduce transactions costs, improve the tradability of registered shares from privatization, and facilitate the supervision of secondary transactions. The main problem with dematerialization is that it should be introduced before large-scale secondary trading fully develops, a complex undertaking from a legal point of view. Although the final goal for clearing and settlement on public markets is clear, emerging systems generally have a long way to go, and various ad hoc solutions will have to be used during the transition. For example, many countries do not have a quick and reliable payments system that can be used by market participants.

Problem areas for supervision

The lack of experienced staff in supervising institutions is the main obstacle to effective supervision in transition economies. Supervisors and market participants are learning on the job, and new technical solutions and new practices are introduced in the markets every day. Supervisors often do not have adequate resources to keep pace with market participants. In addition, supervising institutions are losing their most experienced staff to the private sector. The main problem areas for supervision in transition economies include:

- Separation of clients' accounts from brokers' accounts to limit conflicts of interest.
- Activities of unauthorized intermediaries and markets.
- Price manipulations and artificial market transactions among related parties.
- Abuse of insider information.
- Unreported off-market transactions.
- Off-market block trading.
- Pyramid schemes in the mutual funds business.
- Net asset value calculations for investment funds.
- Information disclosure on concentration of shares.
- Abuse of shareholder agreements to restrict transferability of shares.
- Separation of primary and secondary markets (intended to prevent price manipulation on the secondary market) can be used to promote the primary market for a particular security and to build up pyramid schemes.

Conclusion

The regulatory solutions discussed here can support securities market development in transition economies—but they cannot be a driving force in this development. The key factor for success is the market's ability to support the financing

needs of privatized companies. Primary and secondary markets must complement each other for securities markets to develop. Privatized companies will not be drawn to the market if there is only a secondary market for privatized shares with limited possibilities for issuing new shares. Government has a decisive role to play in making the primary market accessible to companies—a role that requires a long-term commitment to completing the economic transition in key areas.

Long-term macroeconomic stability is the most pressing need, since investors will not risk buying shares in an unstable and chaotic economic environment. Related to macroeconomic stability is long-term fiscal discipline of governments in transition. Many countries finance their huge budget deficits by offering attractive financial instruments to the public, crowding out privatized companies. Thus many newly established financial institutions are not supporting private sector development, but instead are continuing irresponsible macroeconomic policies.

The next big task for government is to complete privatization. When the primary market is oversupplied with shares from privatization, new issues of companies that have already been privatized are crowded out. The situation is no better if privatization is carried out for vouchers. Investors with cash are taking advantage of opportunities on the secondary market created by the large-scale exit of temporary shareholders. With mass privatization the primary market for cash is being crowded out by the secondary market for cash.

The most difficult and most important task in market development is to increase private savings and channel them into the securities market. Privatization vouchers initially solve the problem of limited purchasing power, but when secondary trading starts the problem of limited private savings reemerges. Privatization creates only the supply side of the market; normal market development requires a demand side as well.

Transforming national pension schemes from pay-as-you-go systems to partially funded systems would help build up the demand side of the market. This important link between privatization and social security reform has not yet been established in transition economies. Social security reform might be even more complex than privatization, since all citizens' interests will be even more directly affected. Transferring some of the responsibilities for social security from governments to citizens would be consistent with the objectives of economic transition. A large portion of savings in industrial countries comes from such sharing arrangements, with savings held by private and government-sponsored pension funds and insurance companies. There is no reason transition economies should be any different in the long run.

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Part 5

Corporate Governance and Corporate Finance

Orphans in the Storm: The Challenge of Corporate Governance in Transition Economies

Joseph Saba

This paper reviews the patterns of corporate governance that have emerged from mass privatization programs and recommends further steps to support the growth and efficiency of newly privatized companies. Mass privatization involved corporatizing a large number of state-owned enterprises and transferring a significant share of ownership into private hands. Once that was done, private ownership incentives, hard budget constraints, and market forces were expected to force corporate restructuring for efficient production. Meanwhile, the state's role was expected to change from owner and manager to regulator.

Transition, however, has been much more complex than was promised by the crisp economic models promising speedy adjustment. First, the transfer of ownership often has not resulted in corporate governance structures that respond to market incentives. Second, market forces such as product market competition and competitive financial intermediation, which shape corporate governance in a market economy, are still weak or missing. In addition, given the heavy arrears of enterprises, settlements by barter, poor infrastructure, and political uncertainty in these countries, prices and transaction outcomes are often uncertain. In this environment hard budget constraints are difficult for governments to maintain and financial intermediation barely exists. Thus mass-privatized corporations often have neither the internal structures nor the external forces sufficient to support transition and growth.

Mass-privatized corporations, still fragile and evolving, face two hurdles in their dash to market efficiency. First, they must strengthen their corporate structures and internal governance mechanisms. This is a major challenge. The corporate form was imposed on most enterprises, not a natural evolution as in market economies. Thus it is not surprising that pre-privatization management remains dominant. Second, facing an uncertain environment for production, exchange, and regulation, the new corporations must adapt to ever-changing external incentives.

New corporations do not have the luxury of jumping these two hurdles in sequence. Both must be faced simultaneously—and now. What should be done to strengthen corporate governance and external incentives and align them in ways that encourage coherence and efficiency?

Relying on corporate models drawn from international best practice, this paper compares the progress of mass-privatized corporations in establishing corporate structures and governance. It is hoped that this comparison will suggest options for policies, strategies, and means to realize the goals of transition.

Four Structural Attributes of the Modern Corporation

Internationally, corporate law and practice has converged in specifying four minimal, essential attributes of a commercial corporation:

- *Separate identity.* The corporation is an independent legal person, distinct from its shareholders, with its own property rights (liabilities as well as assets) clearly defined by a separate accounting.
- *Limited liability for shareholders.* Shareholders' risk of loss is limited to their contribution to the corporation's capital.
- *Centralized management.* The day-to-day affairs of the corporation are conducted by one or more persons chosen by the

shareholders. Where ownership and management are separate, centralized management is characterized by incentives and monitoring mechanisms that link management activities to the attainment of shareholders' goals.

- *Transferability of shares.* Shareholders' ownership interests are freely transferable. If transfer markets are deep and liquid, transferability affords owners flexibility in allocating their capital and encourages corporate management to respond to market variables that interpret performance. Transferability also creates a market for corporate control that in turn disciplines corporate management to satisfy shareholders' goals.

The weakness or absence of one or more of these four pillars significantly impairs any corporation's efficiency. And while most mass-privatized corporations have formally adopted all four attributes, weaknesses or gaps remain.

Regarding separate identity, corporatization has not always resulted in a clear definition of responsibility, residual risk, and allocation of costs and benefits, particularly for liabilities. Creating owners has not resolved the property rights claims of other parties.[1] Crisp lines between public and private shareholders, creditors, debtors, and owners have not yet emerged. The corporation's property rights are often diffused, held or disposed of by different actors with different agendas. There are problems, too, with the definition and allocation of responsibility for liabilities, including not only debt but also social liabilities such as schooling, medical care, unemployment benefits, and pensions. In many cases social liabilities are shared with local governments, but with undefined accountability. Land occupied by a privatized enterprise is also a subject of uncertainty in many countries, although great improvements have been made, especially in Russia and Kazakhstan. Accounting standards and methods within and among corporations are not always consistent. Nor is valuation. Other improvements, such as registration for land, shares, and security interests, are also needed to facilitate easy transfer and leverage.

Limited liability has come under attack in recent drafts of the civil codes and bankruptcy codes of many of the newly independent states. The model seems to be Russia's civil code which states, in part,

> If the insolvency (bankruptcy) of a legal person has been brought about by the founders (participants) or the owner of the property of the legal person or by other persons who are entitled to issue binding instructions for this legal person or otherwise have the possibility to determine its acts, subsidiary liability for its obligations may be imposed upon such persons where the property of the legal person is insufficient.

Such provisions invite enforcement and judicial authorities to pierce the corporate veil to hold accountable those shareholders who "cause" their corporations to become bankrupt. Note the discretionary "may be imposed." By whom and on what basis?

The concept of centralized management is well established. In the classic corporate formation model, shareholders come first and they choose directors and, indirectly, managers. In most mass-privatized corporations, however, central management existed before there were shareholders and remain in place. Thus in transition economies the sequence was reversed, with consequently different dynamics (Blasi 1996).

Transferability of shares is more a theoretical than a practical possibility for shareholders of most mass-privatized corporations, investment privatization funds, and investment companies. Even Russia's securities markets remain shallow and illiquid. In Kazakhstan there is little public trading of either enterprise shares or shares in investment funds. In many transition economies transferability is hampered by inadequate share registration, clearing, and depository facilities.

Corporate Governance Structures

What factors determine corporate performance? Essentially there are two incentive structures, and the dynamic between them determines performance. *Governance incentives* include the internal structures and arrangements under which corporate managers (the agents) act on behalf of and for the goals set by the owner or shareholders (the principal). *External incentives* are primarily market factors. While not under the direct control of owners, these factors discipline mangers as well as owners.

Models of governance

The classic problem of governance, identified in Berle and Means (1932), is: How do corporate owners structure an organization and regulate its operations to ensure that their corporate goals are met? The key issue is how shareholders can achieve efficiency, profitability, and accountability while permitting managers the necessary degree of autonomy to run the business and produce and exchange goods and services.

Internationally, there has been a convergence of the laws

and forms of corporate organization. Generic models—the Anglo-American, German, and Japanese—are representative of the universe of arrangements for internal governance. Each model represents each society's response to concerns about the principal-agent problem as well as efficient organization for production, exchange, and performance monitoring (figures 1, 2, and 3).

Figure 1. Anglo-American model of corporate governance

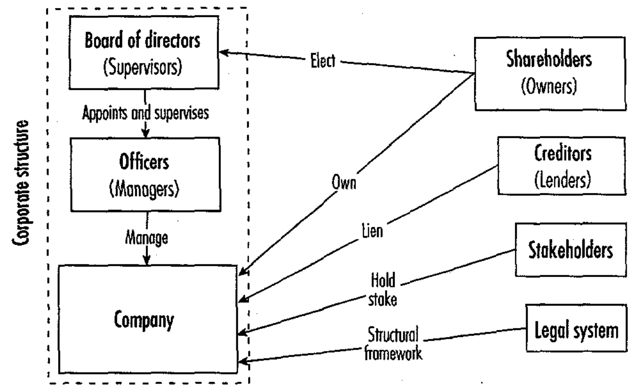


Figure 2. German model of corporate governance

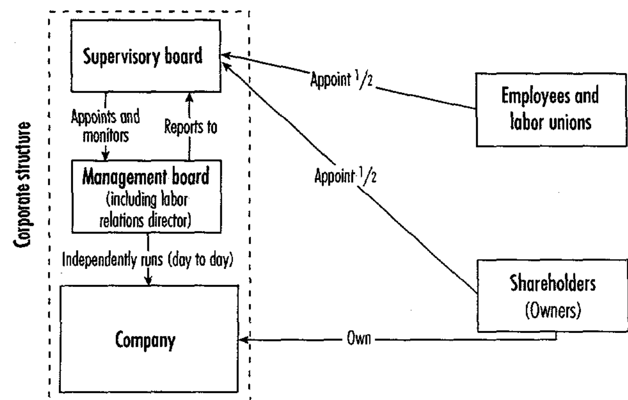
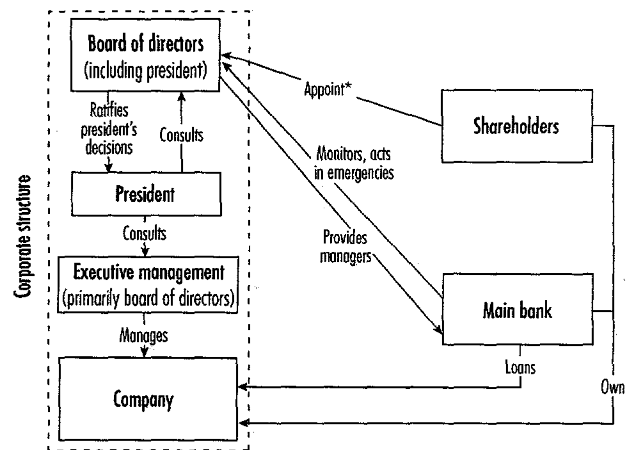


Figure 3. Japanese model of corporate governance



* This appointment is generally considered to be a ratification of nominees for the board chosen from within the company.

Shareholders. In most mass privatizations the initial transfer of shares was to insiders (employees and managers) and to a state agency charged with managing further transfers to voucher holders, cash purchasers, and often a state agency that managed the state's residual shares. Typically, those residual shares were to be sold for cash at auctions or sold to a strategic investor (Lieberman and others 1995; Blasi 1996; Commander, Fan, and Schaffer 1996).

The main concern with voucher transfers was whether they would produce shareholders who would pressure managers to use corporate assets efficiently. Mass privatization relied on investment funds to solve this problem by creating active agents for the widely disbursed voucher holders and shareholders.[2] It was also hoped that these agents would mobilize capital for restructuring.[3]

The mass privatization programs have produced a wide range of ownership patterns. Shareholders of mass-privatized corporations include combinations of insiders (managers and employees), voucher holders, investment funds, and state shareholders acting directly through state agencies or indirectly (as in the Czech Republic) through state ownership of the controlling interest in an investment fund.[4]

Regulations limiting each investment fund to a minority shareholding, combined with limitations on portfolio concentration, cross-ownership, and common control, often have constrained funds from acquiring enough shares to gain insider status. In many cases they are prevented from gaining a seat on the board of directors. In most cases investment funds are constrained from acquiring a shareholding sufficiently large to enable them to veto major corporate decisions. These restrictions are being revisited, however. Ukraine now allows funds to acquire up to 25 percent of a firm. In April 1995 Kazakhstan recognized the importance for governance that a veto block can offer and raised from 20 percent to 31 percent the shareholding an investment fund can own in any single firm and hiked the limit on portfolio concentration from 5 percent to 10 percent. The 31 percent share gives Kazakhstan funds a potential veto vote of 34 percent of the voting stock because the 10 percent stock granted to employees is nonvoting. Normally, major corporate decisions require a two-thirds vote in Kazakhstan.

Cross-ownership in Russia, Kazakhstan, and the Czech

Republic has revealed new and complex property rights relationships in which some mass-privatized corporations are the nodes at which investment fund interests intersect. These patterns link customers, suppliers, and providers of finance in corporate management structures. Recent studies suggest that such cross-ownership patterns may be a prelude to restructuring. But it is not always clear that this is the case.

To illustrate, consider the Czech Republic. Banks, investment funds, and investment companies are interlocked in dense networks of cross-holdings. The relationship of the state to the financial sector and to the companies is not clear, however, since investment companies, founded by banks, acquired shares of banks through voucher privatization. Thus it is difficult to say who owns what. In Kazakhstan some entrepreneurs have formed groups that have substantial holdings in banks and investment funds and direct stakes in corporations. There is evidence that these groups are engaged in share trading and regrouping. In each case the result is a complex web of shareholdings through which a multiplicity of investors are trying to resolve and reform property rights claims, production, and exchange.

Although data are limited, the impact of employee shareholding on corporate governance appears negligible (Blasi 1996). Insiders, essentially managers, have won the (first) day in Russia. Elsewhere, employees hold varying percentages of equity, with and without voting rights. (Lieberman and others 1995; Blasi 1996; Lorch and Karlova in this volume).

Shareholder rights remain problematic, especially access to information that managers should readily make available. Coupled with disbursed shareholding, minimal enforceable legal recourse, and a strong cultural and historical bias favoring secrecy, these arrangements cripple shareholders' ability to know about—let alone influence—the manner in which corporate property is deployed by management.

Boards of directors. Shareholders generally exercise their control over a privatized corporation through a board of directors. The board has three functions—representation, direction, and oversight. In many respects the boards of mass-privatized corporations seem closer to the Japanese model than to the German or Anglo-American models.[5] In Japan the board is hardly representative of shareholders, and is generally an extension of management. Through extensive cross-shareholdings, veto power, and oversight functions, however, shareholders, stakeholders, and insiders (such as suppliers, customers, and the corporation's bank) have considerable influence on directing and monitoring management. In Japan the board of each corporation is drawn from a variety of investors whose incentives are not always to maximize their own financial return from their shares (Gilson and Roe 1993).

Although empirical data are limited for mass-privatizing countries (other than Russia and the Czech Republic), such information indicates that managers are firmly in charge of their boards. Shareholder challenge is rare, and replacement of management even rarer (Blasi 1996). Devices such as cumulative voting (30 percent of the firms in Russia are said to use this device) seem to be having some impact, however. In Russia medium-size and large corporations generally have seven board members, including five top managers, one state representative, and one outsider (Blasi 1996).

Initially it was hoped that the boards of mass-privatized corporations would include members appointed by investment funds and other large (but generally passive) institutional investors. A model is the large California Employees Pension Fund. Although its shareholders are numerous and have little or no interest in the governance of the fund's portfolio corporations, the fund itself has been effective, on a selective basis, in influencing the actions of poorly performing firms in which it holds shares.

In transition economies, however, such models are rare. Where shares are widely disbursed and where funds are passive or portfolio investors, a mechanism to appoint an "outside" director to the board is considered crucial to resolving the agency problem. In the Anglo-American corporate model, factors that do not yet exist in the mass-privatizing countries address the agent-principal issue: accepted and enforced disclosure rules, concepts of fiduciary duty, and the presence on boards of knowledgeable, reputable executives acting on behalf of otherwise passive outside shareholders.

Banks play no direct role in the Anglo-American model but, along with other outside financial firms, they have substantial property rights claims on corporations, supported by a strong web of contract, banking, insurance, securities and bankruptcy laws, and enforcement institutions. Banks play a direct and crucial role in the Japanese and German models of corporate governance. Banks' participation in corporate shareholding is permissible in most mass-privatizing countries. Generally, however, prudential regulations limit shareholdings to a percentage of a bank's capital (10 percent in the Czech Republic and 25 percent in Poland, but up to 60 percent in Hungary). The case for and against bank participation in corporate governance in transition economies is well doc-

umented (see, for instance, Dittus and Prowse 1996). But where banks are owned by the state, are not yet on a sound financial footing, and lack capacity for market-based credit appraisal, the balance of argument tips in favor of nonparticipation or limited exposure.

What is the best internal organization? The corporate model on which mass privatization was built assumed a hybrid of the Anglo-American and German models. This model's functioning depends heavily on the strength of the fundamental corporate characteristics and on the dynamics of checks and balances among the corporate components. Available evidence shows that in all mass-privatizing countries most fundamental elements are still weak (separate identity, limited liability, share transferability), while only one, centralized management, might be considered strong. The weak internal arrangements are not a good basis for restructuring since the only strong element, central management, is the factor most likely to oppose change. In this case the dynamics of checks and balances do not come into play.

Cross-shareholdings between firms and between investment funds suggest that there are strong possibilities for policies and strategies that encourage a more effective governance structure composed of shareholders, customers, suppliers, and others with contractual links involving production, exchange, and finance. Lessons from Japan and the Republic of Korea could prove useful. (Issues of continued state participation as one or more of these interested parties will have to be addressed, as will difficult issues of competition and finance.) To some extent financial-industrial groups are efforts in this direction.

External incentives

While internal incentives are necessary to achieve efficiency, experience shows that they are insufficient. External incentives—those outside the direct control of the corporation—play a critical role in monitoring, directing, and disciplining management.

Product market competition. Product market competition forces managers to adopt the most efficient methods to maximize profits through market share and competition. Where shareholders are dispersed or do not have the capacity to monitor managers closely, a company's market power is a clear indicator of its performance. Managers have a strong incentive to protect their positions by maintaining market power.

In the immediate post-privatization period there were many attempts to preserve monopolies and create vertically integrated organizations. Thus associations, holding companies, financial-industrial groups, and contractual arrangements for trust management used state shares (including residuals shares from the mass privatizations) to form combinations. Whether these are more efficient producers or exclusionary and anticompetitive (or both) is still unclear. But these groups—in Russia, the Czech Republic, and elsewhere—seek protection and market dominance. It is clear, however, that product market competition is not well established and new industrial groupings, led by strong managers, are trying to recreate the vertically integrated noncompetitive world they understand and avoid the discipline of competition.

In the Czech Republic, Hungary, Poland, and Slovakia, however, procompetition statutes have addressed abuses of market dominance, restrictive contracts and combinations, and anticompetitive mergers (Fox 1996). Most other transition economies have adopted procompetition or antimonopoly legislation, although there is little evidence that these efforts are encouraging product markets or discouraging anticompetitive behavior.

Economic legality. Certainty and security of commercial transactions are essential for a well-functioning management. This condition requires well-known and easily understood rules that are enforced predictably and broadly, not selectively. For commercial transactions these rules are not limited to definition of property rights and ownership, but include rules for the allocation of property rights (priorities, gains, and losses) in contracts between creditors and debtors, customers and suppliers, lessors and lessees, and more complex combinations of all of these.

In the mass-privatizing countries, however, managers and owners are immersed in uncertainty and insecurity. There is not yet a degree of economic legality sufficient for efficient medium- and long-term transactions. The old command economy (with its order and institutional underpinnings) is gone. But no new structure has taken its place. In market economies the rights and obligations (and the distribution of gains and losses) in the contractual processes for production and exchange are set by a widely accepted and used property rights regime. Enforcement efficiency may vary, but it is effective, since the costs and results are generally predictable.

Economic legality in transition requires clarity for the property rights of third parties—employees, suppliers,

customers, creditors, debtors, and lessors. Most mass-privatizing corporations are indebted to suppliers, employees, and banks. Yet many are themselves substantial creditors. There is no certainty for owners or mangers as to the relative rights of different parties to commercial transactions. Debtor-creditor relations are still nascent. It is difficult for third parties to establish their claims and priorities and harder still to enforce them.

This ambiguity makes liability management and resolution difficult, if not impossible, by the conventional means used in a market economy. Yet failure to resolve these matters perpetuates uncertainty and impedes the emergence of the market environment in which the new corporations are supposed to flourish.

Competitive capital markets. Equity and debt markets impose substantial constraints on managers. But in transition economies competitive capital markets, for all but a few mass-privatized corporations, do not yet exist. Capital market development has been foiled by an absence of means for asset securitization, lack of reliable corporate share registries, and information asymmetries. While these issues are being addressed in some countries, for most enterprises in many transition economies (particularly Azerbaijan, Georgia, the Kyrgyz Republic, Lithuania, Mongolia, and Slovenia) it is unlikely that capital markets will have much effect on corporate governance.

Market for corporate control. Stock markets provide effective discipline mechanisms for managers. This discipline is dependent on share transferability—at the extreme, manifest in tender offers, takeovers, or other actions triggered by management failure to maximize profits (Manne 1965). This mechanism creates the possibility of acquiring shares at a discount, installing a more efficient management, and taking other steps to maximize value and profits. In the United States these tools are often characterized as elements of hostile takeovers. In Europe and East Asia, however, they are more often accomplished by negotiated agreement among related shareholders.

Formal capital markets are shallow in transition economies. However, informal markets are emerging in Kazakhstan, Russia, and other mass-privatizing countries where moribund investment funds are searching for buyers for their own shares or for the shares that they hold. For a few corporations with value, these markets may emerge as an effective tool for management discipline and restructuring.

Labor markets. Not only do managers compete with each other to reach the top positions in modern corporations, in market economies there is also an active market outside companies for managers to improve corporate performance. Moreover, managers at all levels can (and often do) leave a company if they believe that it is poorly managed. Thus managers are disciplined from inside and outside by well-developed labor markets. In countries where labor is represented on the board, labor organizations (in and outside the company) also exert influence and thus constrain management.

But in the transition economies where information is available (primarily Russia and Central Europe), labor mobility (whether for managers or employees) has been modest. Employee shareholders have yet to acquire and exert significant influence. In times of severe underemployment and redundancies in enterprises, however, labor markets for managers may emerge.

Legal obligations. In most market economies laws directly affecting corporate governance, such as company and securities laws, set minimum norms and standards for managers aimed at protecting shareholders' rights. Such legislation normally requires a high degree of disclosure, permitting easy monitoring by shareholders. Other laws on antimonopoly, fair trade, and competition are all designed to make managers answerable to shareholders and the general public. The net effect of these laws is to force managers to adhere to competitive and fiduciary norms. In the Anglo-American case there is heavy reliance on the legal system, an approach that is gaining currency in Europe as well. In East Asia and Japan long-established social constraints, reinforced by legal measures, provide the normative environment.

To be effective, laws, administrative practices, and enforcement must be reasonably predictable and well known. Dissemination of laws, regulations, and enforcement results is poor in the transition economies. Many laws are not harmonized, so there are significant inconsistencies between corporate law, civil codes, land law, foreign investment laws, and others. More recent efforts, however, may have hit the target.

Prospects for the development and regulation of the securities market improved substantially in Russia with the Law on the Securities Market (effective 25 April 1996), which provides for regulation, disclosure, and enforcement. Disclosure requirements, in particular, are detailed and extensive. Registration of a prospectus for a public offering may be denied if disclosure is deemed inadequate. A major improvement in transparency permits a holder of at least 1 percent of the voting stock to examine the share register. The

Commission on Securities and Exchange has been beefed up to prosecute violators of the law. Perhaps more significantly, private companies and individuals may initiate enforcement action.

In many countries mass-privatized corporations are second generation entities. The first generation were the children of *perestroika*. The third generation is emerging from the latest round of code and joint stock company law. In Russia, for example, the Law on Joint Stock Companies that took effect on 1 January 1996 requires earlier generation companies to rationalize and conform to the new law. In Kazakhstan the law on economic partnerships of 2 May 1995 took effect long after the initial corporatization of 1993–94. Conforming can be a bureaucratic challenge. Similar situations prevail in the Kyrgyz Republic and Lithuania. Such changes, however, create uncertainty that in turn diminishes respect for the law. Thus legal measures, even when well drafted, may have little impact. Their stability and enforcement over time, with predictable results, will determine their effectiveness as factors shaping corporate governance.

Bankruptcy. The threat of surrendering day-to-day control to a trustee in bankruptcy or to a liquidator is a powerful incentive for managers to achieve profitability through financial discipline. Conversely, a lack of credible bankruptcy laws facilitates asset stripping and rent seeking, since there is no predictable end or exit for a poorly performing enterprise. Bankruptcy legislation has been strongly advocated as a necessary basis for restructuring and for sound governance.

In many cases the focus in bankruptcy has been on liquidation. Such a focus is too narrow. The debate on bankruptcy should instead be centered on and have as its goal the establishment of clear, market-based rules for relationships between creditors, debtors, owners, and third parties. Liquidation should be the last resort. The credible threat of liquidation and the rules by which it takes place establish creditor-debtor relations that in turn should provide confidence, equity, and predictability for commercial lenders. These factors, largely absent in transition economies, encourage the use of market-based credit analysis by bankers and the more extensive use of collateral for lending. The result should be differentiated interest rates and longer-term lending.

Drafts of bankruptcy laws in some mass-privatizing countries—Bulgaria, Kazakhstan, the Kyrgyz Republic, Romania, Russia, Ukraine, Uzbekistan—reveal deficiencies that arise mainly from fears of liquidation of large enterprises with thousands of employees. Some drafts create exceptions and a separate bankruptcy regime for state-owned enterprises. This approach limits the application of the law while creating circumstances whereby the state remains the risk bearer. At the same time, the emerging private sector receives less favorable treatment in bankruptcy. Some drafts set out stringent conditions for involuntary bankruptcy, in effect discouraging creditors from using the law. In most cases the approach to creditors' rights is overly rigid, while the approach to secured lenders is disadvantageous. Finally, even in those codes that are the most market oriented (Bulgaria and Romania) there is extensive reliance on administrative procedures and administrative discretion for oversight and enforcement.

A financial press. The press provides a critically important source of information on the performance, value, and market position of firms. Its role in disciplining corporate managers as well as owners, while not well researched, is understood to be a critical element in the success of the most robust financial markets.

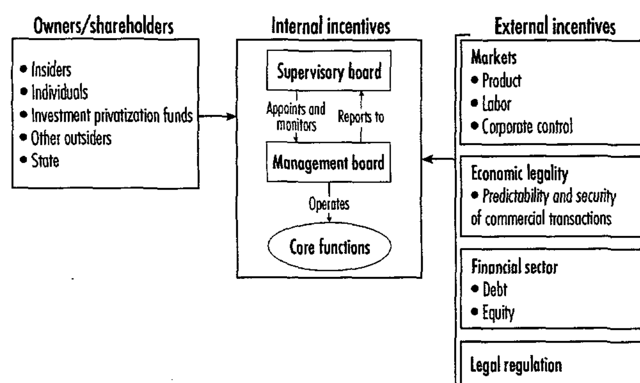
Looking Forward

It is easier to build a model for corporate governance in transition economies then to realize its execution (figure 4). Hardly any of the model's elements are sound in transition economies. Some barely exist. Of the four essential elements of a corporation, only central management, a carryover from the command economy, is strong. Not yet clear are the internal structures and the nature of the dynamics between shareholders, managers, employees, and third parties with claims on property rights. And the external incentives and actors are still too undeveloped to measure. Although mass privatization cannot (and should not) be abandoned, much work remains to be done to achieve its goals.

Reforming governments could benefit from programs targeted to strengthen the four fundamentals, internal governance and structures, and external incentives. In particular, there are practical programs that emphasize the rules of the game and provide self-enforcing mechanisms. These programs, some of which have begun in some mass-privatizing countries, include:

- Shareholder registration, shareholder rights legislation, and easy access to corporate information;
- Registration means for both immovable and movable property to facilitate their use as collateral in finance;

Figure 4. Modern corporations are disciplined by internal and external incentives



- Rules for limited liability and for "piercing the corporate veil" to prosecute fraud;
- Shareholder protection measures;
- Clarification of rights of owners, creditors, debtors, and managers;
- Clarification and dissemination of rules and easy means of enforcement for commercial transactions, including legal and administrative means for expanded use of leasing and immovable property (including intangible property and inventory) in finance;
- Procompetition measures;
- Harmonization, rationalization, and wide dissemination of all the rules for production and exchange;
- Introduction of international accounting standards;
- Liberalization of government procurement to ease entry and leverage in contracts;
- Rationalization of bankruptcy laws as a means of restructuring, not just for liquidation; and
- Assistance in building public debt and equity markets.

Notes

1. The term *owner* in the context of transition has often been oversimplified and too much reliance placed on centralization of property rights. Property can be disaggregated in ways such that different actors can legitimately claim and use rights to different aspects and capacities of the same thing. Thus a share confers certain rights on its holder or registered owner. But those rights, or some of them, might be claimed or limited by many other actors (Comisso 1991; Walder 1995). Defining the rights of the owners does not necessarily exclude the rights of all others, such as suppliers, customers, and creditors. In the absence of state orders and a reasonably certain contract regime, managers often have had difficulty reestablishing stable relationships with third parties who acquire claims on the property of their corporation. In establishing the corporate balance sheet and the rights of third parties, the difference between debt and equity is not well appreciated. Thus many managers continue to argue that customers, suppliers, and creditors should be "owners" in their enterprise. Otherwise they have difficulty understanding the means by which the corporation can regulate its transactions with them.

2. In all mass privatizations except those in Kazakhstan, Poland, and Uzbekistan voucher holders have been free to acquire investment fund shares or corporation shares directly. In the three exceptions voucher holders could acquire only investment fund interests. In all cases there are limits on investment funds with respect to the interest they can acquire in any one corporation and the portfolio risk allotment among acquired corporations. In addition, most countries have restrictions on cross-ownership and owner control (Lieberman and others 1995; Lorch and Karlova in this volume).

3. The debate for and against voucher methods is summarized in Lieberman and others (1995) and Pistor and Spicer (in this volume).

4. Pistor and Turkewicz (1996) document the extensive, persistent state ownership in mass-privatizing countries.

5. To date, corporate boards have had little effect on restructuring (Pistor and Spicer in this volume).

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Financial Institutions and Corporate Governance: A Survey of Six Transition Economies

Raj M. Desai and Katharina Pistor

Enterprise reforms and financial reforms are closely linked in transition economies. In the absence of central planning, it is the financial system that allocates resources to their most productive uses, and it is the financial system that ultimately determines the instruments enterprise owners can use to control management. Moreover, enterprise losses will continue to be absorbed by the financial sector—in particular, commercial banks—until a sufficiently active financial sector is put in place, capable of "hardening" the flow of money to formerly state-owned enterprises. Countries that have chosen to privatize state enterprises through government-issued vouchers face an additional problem. The distribution of vouchers to the public for free or for a nominal charge formally endows a segment of enterprises with private owners but creates neither purchasing power nor adequate resources to finance investments. Thus these countries face a greater prospect of severe investment capital shortages than countries that have relied on cash-based enterprise sales.

Financial intermediation is the primary responsibility of the banking sector in economies that have used voucher distributions to privatize enterprises. Although the formation of secondary equity markets is no less significant, their persistent thinness and illiquidity mean that the burden of financial discipline will fall mainly on credit markets, and particularly banks, as sources of external finance. We focus, therefore, on the capacity of credit markets to impose hard budget constraints on formerly state-owned enterprises. Without hard budget constraints, property rights will not be strictly exclusive, since income from enterprise activity will be claimed but losses will be left in the public domain.[1] Moreover, without hard budget constraints, privatization will not solve the problem of financial misallocation, since a large share of credit will be used to refinance the loans of insolvent state-owned enterprises and formerly state-owned enterprises, *crowding out* the private sector.

This paper considers three related policies and institutional arrangements that comprise the basic framework for credit allocation and credit enforcement: elimination of implicit subsidies to enterprises passed through commercial banks, resolution of bad enterprise debts held in the banking sector, and development of a credible threat of bankruptcy. Drawing on evidence from six Eastern European countries and newly independent states—Bulgaria, the Czech Republic, Poland, Romania, Russia, and Ukraine—that have implemented or are implementing mass privatization programs, we argue that credit allocation and enforcement institutions are shaped by the broader dynamics of institutional choice. Specifically, we suggest that the institutions of public and private finance are inevitably linked during post-communist financial reform, and demonstrate that aggregate fiscal looseness is a severe impediment to the development of an effective credit allocation regime.

Our argument rests on three claims. First, given the peculiar financial lineages of the socialist state, public and private finance must be distinguished early on in the transition. Second, where the fiscal responsibilities of the state—"fiscal" property rights—are poorly defined or enforced, they are subject to excessive manipulation by politicians, who may divert public resources to enterprises outside the supervision of a central budget office. Third, under these circumstances

former state enterprises can receive implicit subsidies through a variety of off-budget funds and soft credits, enterprises and commercial banks have few incentives to reduce their debt burdens, and government intervention on behalf of insolvent enterprises increases, making liquidation proceedings against the worst offenders impossible to initiate. By contrast, where political distortions in fiscal and monetary policy are contained or quickly resolved, authority over the public purse can be more clearly delineated and enforced and tighter fiscal and monetary policies are more sustainable. In the latter case, subsidies are more transparent, better debt resolution mechanisms are implemented, and bankruptcy legislation is more likely to be enforceable.

Money and Credit in Transition

In post-communist economies the lines dividing public and private finance initially tend to be blurry. The development of efficient credit market institutions and the enforcement of hard budget constraints require that responsibilities for public finance be clearly delineated and that all other investment be left to the private financial system, especially banks. Transition economies face two legacies of socialism that make these adjustments problematic: the dispersion of control over the public purse and the structural weaknesses of the banking system. Transition ultimately requires the simultaneous creation of public and private finance from scratch.

Transition's effect on the public purse

Under the classic socialist system the concept of public finance had little meaning because there was no real private sector, and thus no private finance (Tanzi 1993). The monobank system was responsible for public investment, disbursing credits to state-owned enterprises according to the dictates of the central plan. These enterprises, in turn, provided their workers with housing, medical care, pensions, employment assistance, and so on and typically owned a variety of social assets to assist in this regard—including elementary and vocational schools, recreation facilities, clinics, and shops. Economic reforms aimed at enhancing the economic efficiency of public enterprises have forced governments to assume spending responsibilities that were either unnecessary under central planning or were the province of public enterprises or the monobank.

But just as the need to restructure public finances became the greatest, governments in transition faced severe budgetary pressures (Barbone and Polačková 1996; Barbone and Marchetti 1995). Unprecedented recessions, worsened by the collapse of trade among members of the Council for Mutual Economic Assistance, put pressure on governments to bankroll failing state-owned enterprises. Meanwhile, the sharp drop in state-owned enterprise output, together with the structural limits of fledgling tax administrations, curtailed countries' capacity to raise revenue (IMF Staff 1995). Under socialism revenue collection was facilitated by the unitary organization of the party-state and was secured by turnover, profit, and payroll taxes. Thus most revenue was collected from a small number of large state-owned enterprises, whose outputs, wages, and prices were set through the plan and whose operations were supervised by branch directorates and ministries. Monobank branches settled state-owned enterprise accounts and acted as the government's treasurer, assuring that taxes were paid.

In addition, many revenues were collected implicitly, through overvalued exchange rates (a tax on exporters), low or negative interest rates (a tax on depositors), price controls, and low wages. With the dismantling of the socialist revenue apparatus, tax evasion became endemic: privatization and the breakup of large state-owned enterprises multiplied the number of taxpayers while sharply reducing the amount of information available to tax authorities. The drop in state-owned enterprises' profits further shrunk the tax base. In many countries, moreover, agriculture and certain other sectors were either exempted from profit taxes or were exceedingly difficult to tax. Thus revenues fell in all transition economies—in some cases precipitously.

Banking and the legacies of socialism

The financial sector and the enterprise sector are closely linked in all economies for three reasons. First, financial intermediation provides the chief means of mobilizing resources for the most efficient uses. Second, the financial system determines, to a large extent, the mechanisms of corporate governance. Finally, the financial system proscribes the ability of governments to provide selective assistance to specific enterprises (Zysman 1983).

Under socialism, financial intermediation accommodated the needs of the plan. Banks served as conduits for public funds to enterprises, made available through revolving credits, through the financing of inventories, and through low- or negative-interest loans. Unlike market-based credit transactions, credits were not tied to enforceable control

rights: the decision to liquidate enterprises was made by administrative agencies, not by banks, and thus risk and enterprise performance did not affect lending. Thus the monobank performed both monetary and fiscal functions. Monetary policy was exercised through the control of credit to state enterprises; as a quasi central bank the monobank was responsible for issuing currency, ensuring that financial resources were passed to enterprises for particular investments, and seeing that these loans and the enterprises' deposits were used for the planned transaction. In addition, the state bank acted as the treasurer for the government's public finances, facilitating immediate finance for fiscal deficits (Kornai 1991; Garvy 1977).

Toward the end of the 1980s several countries in the Eastern bloc introduced limited reforms in the banking sector, generally breaking up the monobank system and establishing a formal two-tiered banking system consisting of a central bank and one or more commercial or savings banks. In 1987 the Polish Savings Bank was hived off the state bank, Bulgaria created a system of regional banks, and the Soviet Gosbank was split into a central bank and nominally separate agricultural, industrial, and savings banks. In 1989 Poland carved an additional nine commercial banks off the monobank system. In Bulgaria, Czechoslovakia, and Romania the formal dismantling of the monobank system coincided with the collapse of the Communist party's monopoly on political authority (although the decision to break up the monobank had been made in 1988 in Czechoslovakia). In Russia and Ukraine, on the other hand, a two-tiered banking system was not fully in place until after the breakup of the Soviet Union.

Central planning weakened these reformed banking systems in several ways. First, in all these countries the payments system was inefficient, rudimentary, and characterized by a sizable float, potentially shrinking the banking sector as it became less attractive to use banks to make payments (Baliño, Dhawan, and Sundarajan 1994; Marquardt 1994). Second, no effective banking supervision institutions were in place. Central banks were generally subordinate to commercial lenders, absorbing commercial bank losses directly (through the central bank's own finances) or indirectly (by printing money). Third, commercial banks lacked the experience, institutional memory, and technical skills to properly assess credit risk. Fourth, loan portfolios were dominated by risky or bad loans to single regions or industries. Undiversified loan portfolios exacerbated the bad loan problem, which crowded out good borrowers as long as governments were willing to accommodate insolvent enterprises. Not having been governed by loan loss or capital adequacy provisions for most of their lives, banks were severely undercapitalized.

Transitional Frameworks for Credit Allocation and Enforcement

The provision of financial discipline requires both the ability to monitor enterprise performance and to punish enterprises by withholding funds. There has been much discussion on the role of equity in disciplining enterprises—through changes in equity prices, proxy fights, and takeovers in capital markets.[2] Our main concern, however, is with the role that debt plays.[3]

We ask three related questions to gauge a country's level of institutional development. Does the government directly (through state spending) or indirectly (through below-market interest rates) subsidize enterprises? Do financiers and enterprises have any incentive to reduce debt burdens? And how easily can financiers, as a last resort, initiate liquidation proceedings against their defaulting borrowers? In short, we are interested in the sets of rules that permit credit to play a disciplinary role—or, alternatively, to perpetuate soft budget constraints—in former public enterprises.

Implicit subsidies

Subsidy data in Eastern Europe are difficult to use for cross-country comparisons. The lack of standard national accounting methods and the distortionary effects of inflation also make the data unreliable. Finally, clear distinctions are rarely made between budgetary expenditures and those made outside the state budget in consolidated government balance sheets. Despite these deficiencies, there is evidence that the long-standing tradition of easy credit supplied by banks to loss-making enterprises has been broken, though to varying degrees.

Fiscal (nominal) subsidies and estimates of implicit subsidies to enterprises for the six countries are listed in table 1. Fiscal subsidies are explicit transfers to enterprises from the government budget. Implicit subsidies consist of three other types of subsidies: directed credits channeled through commercial banks, credits to enterprises at preferential rates financed by commercial bank borrowing from the central bank through refinance facilities, and, in the special case of

Table 1. Fiscal and implicit subsidies, 1989–94
(percentage of GDP)

Country	1989	1990	1991	1992	1993	1994
Bulgaria	15.6	14.9	4.1	2.9	3.8	1.5
				(1.3)	(0.8)	(0.7)
Czech Republic	25.0	15.7	7.6	5.2	3.4	3.5
				(0.3)	(0.8)	(0.1)
Poland	12.7	7.3	4.6	3.3	2.3	2.2
			(0.8)	(0.5)	(0.0)	(0.0)
Romania	5.7	8.0	9.2	13.0	6.8	3.8
				(9.4)	(9.5)	(10.5)
Russian Federation	n.a.	n.a.	15.0	19.0	12.0	9.0
				(30.5)	(7.8)	(1.7)
Ukraine	14.0	14.5	13.0	9.1	11.2	17.0
			(4.1)	(15.7)	(7.7)	(18.9)

Note: Fiscal subsidies are calculated by subtracting nonsubsidy fiscal expenditures from total fiscal expenditures. Implicit subsidies (in parentheses) are estimated from directed credits, extrabudgetary funds, and other forms of nonbudgetary transfer to enterprises and households.
Source: International Monetary Fund data; De Melo, Denizer, and Gelb 1996.

Table 2. Directed credit programs and central bank real refinance rates

Country	Directed credits	Average annual central bank real refinance rate, 1992–94 (percent)
Bulgaria	Agricultural loans directed through banking system until 1995	–11
Czech Republic	Not used	–4
Poland	Limited use after 1991	3
Romania	Special credit lines for long-term lending to agriculture and various sectors at preferential rates	–23
Russian Federation	Used until 1994	–41
Ukraine	Used extensively until 1995	–59

Note: Real refinance rates are average weighted monthly refinance rate minus average monthly inflation rate multiplied by twelve.
Source: Central bank annual reports; De Melo and Denizer 1997.

Russia, import subsidies. After 1990 all the countries made efforts to slash producer subsidies. The most rapid declines in subsidies have occurred in Poland and the Czech Republic. In both countries, moreover, implicit subsidies have fallen to zero.

In contrast, as subsidies from the official state budget fell in Ukraine, and to a lesser extent in Bulgaria, Romania, and Russia, these countries struggled to reign in off-budget transfers. In 1992 directed credits through the Central Bank of Russia and import subsidies totaled more that 30 percent of GDP. In 1993 Russia lowered both subsidies, but fiscal and off-budget subsidies still accounted for about 20 percent of GDP. After 1993, however, Russia made substantial progress toward drastically reducing both types of subsidies while essentially eliminating hidden subsidies. Ukraine, however, has made little progress. In 1994 subsidies were equal to 35 percent of GDP—twice the 1991 percentage. Directed credits mandated by Parliament still account for most off-budget transfers (IMF 1996b).

Real central bank refinancing rates are one proxy that can be used to examine subsidization rates (Hinds 1991). Credit allocated from the central bank to selected commercial banks at highly negative interest rates has typically been used to maintain employment levels in agriculture and industry.[4] Average year-on-year real central bank refinance rates are listed in table 2. Again, in Poland and the Czech Republic real refinance rates have remained mostly positive since 1993, and central bank credits have been restricted. In Bulgaria and Romania refinance rates turned positive in 1995, at about the same time that central bank credits were tightened. Finally, in Russia and Ukraine generous central bank credits, coupled with negative refinancing rates, persisted through 1995 (although there is evidence of tightening since 1995).

Inflation is another proxy for aggregate subsidization. Average annual inflation in the six countries during 1989–95, together with changes in broad money, is shown in table 3. Together tables 1–3 reveal three facts about post-communist reform. First, the increase in inflation can be reviewed as an indicator of the timing of economic reform. Thus in countries with mixed economies, such as Poland, inflation accompanied reform because monetary policy expanded to cover enterprise and bank losses. In late reformers, such as Bulgaria and Romania, open inflation did not begin until 1991. Only in the Czech Republic was inflation kept low in the first year of liberalization. In Russia and Ukraine, on the other hand, reform began with price hikes in 1992.

Second, the increase in inflation rates and the money supply indicates how generous the central banks were during that period. In Russia and Ukraine huge amounts of central bank credits in 1992–93 led to hyperinflation (exceeding 100 percent a month). Third, the length of inflationary periods reflects the government's ability to gain control of and restructure public finances. Russia, Ukraine, and to a lesser extent Bulgaria and Romania experienced inflationary periods lasting more than five years. Poland, on the other hand, controlled runaway inflation after 1990. Only the Czech Republic has lowered inflation to single digits. What do these macroeconomic indicators reveal?

Among the fast reformers, banks now aggressively seek loan repayment from clients, do not relend automatically to pre-reform debtors, and carefully monitor their clients using hands-on evaluations of investment projects or sufficient

Table 3. Inflation and money supply growth, 1989–96
(percent)

Country	1989	1990	1991	1992	1993	1994	1995	1996[a]
Bulgaria								
Inflation	6.4	26.3	333.5	82.0	73.0	96.3	62.0	123.0
Money supply growth	10.6	16.6	122.0	43.5	52.9	78.6	39.6	111.4
Czech Republic[b]								
Inflation	2.3	10.8	56.7	11.1	20.8	10.0	9.1	8.8
Money supply growth	3.5	0.5	26.8	22.8	20.3	20.8	19.4	13.5
Poland								
Inflation	251.1	585.8	70.3	43.0	35.3	32.2	27.8	20.0
Money supply growth	236.0	121.9	47.4	57.5	36.0	38.2	35.0	29.0
Romania								
Inflation	1.1	5.1	174.5	210.9	256.1	131.0	32.3	45.0
Money supply growth	5.3	22.0	101.2	79.6	143.2	138.1	71.0	66.7
Russian Federation								
Inflation	2.0	5.6	92.7	1,354.0	896.0	302.0	190.0	48.0
Money supply growth	14.6	17.6	126.0	643.0	416.0	190.0	126.0	34.0
Ukraine								
Inflation	2.2	4.2	91.0	1,210.0	4,700.0	891.0	376.0	80.0
Money supply growth	n.a.	n.a.	n.a.	859.0	1,778.0	573.0	117.0	35.0

Note: Inflation rate is average annual change in the consumer price index; money supply growth is year-on-year increase in broad money.
a. Estimates.
b. 1989–90 inflation figures and 1989–92 money supply figures are for Czechoslovakia.
Source: EBRD 1996 and 1997.

securitization. Any subsidies to enterprises are not provided by the banks but through the state budget, thereby revealing their full costs to the government. By making the provision of subsidies as transparent as possible, governments will also be able to differentiate between cases where subsidies may be needed only temporarily and cases where long-term public support is required (Kopits 1992; Cheasty 1992). In the slow reformers, by contrast, banks act like credit unions to large (mostly unprofitable) enterprises, supplying them with cheap loans financed by the central bank or other government agencies. These subsidies are not provided through explicit fiscal transfers, but rather are hidden in the form of cheap or directed credits channeled through the banks.

Resolving bad loans

All formerly state-owned banks were saddled with nonperforming loans inherited from their public enterprise clients.[5] In countries where commercial banks still hold bad loans as "phantom" assets, the continuing losses from these loans must be absorbed elsewhere in the economy. In addition, in many countries banks accumulated new portfolios of bad loans during the early years of transition. The relevant issue for post-communist financial systems, then, is the extent to which the rules for dealing with nonperforming firms actually limit new loans to these borrowers or provide other incentives for banks and firms to reduce debt burdens.

Instilling financial discipline while dealing with bad loans has proven particularly problematic in Eastern Europe. Most transition governments have infused state banks with capital to keep borrowing firms alive (table 4). Recapitalizations were aimed at compensating the state banks for the writeoff of nonperforming loans incurred as a result of central planning, and to raise capital adequacy by exchanging bad debt for good (in the form of government bonds or equity in commercialized enterprises). Bulgaria, the Czech Republic, Poland, and Romania all recapitalized their banking systems to varying degrees. In Poland bank recapitalization was a once-off event totaling 11 trillion zloty (6.5 percent of banking assets) and was linked to an assertive bank restructuring program—the Polish Financial Restructuring Law of 1993—that prohibited banks from lending to problem enterprises. In addition, the privatization of banks was actively promoted (Belka 1994; Gomulka 1994). The Czech Republic also limited debt writeoff (to about 8 percent of outstanding bank credits), and an additional 110 billion koruna of perpetually revolving credits were set aside in a hospital bank. State-owned commercial banks in the former Czechoslovakia were part of the mass privatization program (Desai 1996; Čapek 1995). In both Poland and the Czech Republic, then, recapitalization was closely linked to larger programs designed to change the incentives faced by state-owned commercial banks.

Table 4. Bank recapitalizations in selected transition economies

Country	Year bank recapitalization began	Recapitalization procedures	Extent of recapitalization (percentage of GDP in first year)	Share of enterprises in total outstanding commercial bank credits (percent)
Bulgaria	1993	All nonperforming loans made before December 1990 exchanged for state bonds	37	79
Czech Republic	1992	National Property Fund financed recapitalization with state bonds amounting to 8% of all enterprise credits; Consolidation Bank purchased nonperforming inventory loans to enterprises (20% of enterprise credits)	10.9 through Consolidation Bank; 7.0 through National Property Fund	36
Poland	1993	Seven state-owned commercial banks, the Agricultural Bank, and the Polish Savings Bank issued state bonds	1.5	34
Romania	1991	90% of nonperforming claims on banks' balance sheets purchased by the government, then canceled	20	n.a.
Russian Federation	None	—	—	30[a]
Ukraine	None	—	—	n.a.

a. Primarily loans made to enterprises after 1992.
Source: EBRD 1994, 1995, and 1996; Borish, Ding, and Noël 1996.

In Bulgaria and Romania, on the other hand, recapitalization was far more extensive, and bank restructuring was never part of these schemes. The Bulgarian strategy involved the writeoff of all bank loans granted through the end of 1991—an amount equivalent to 37 percent of GDP. A bank consolidation company was established to hold all shares in banks held by the state or enterprises (Hunter 1993; Thorne 1992). The Romanian government provided a guarantee on all outstanding bad loans, estimated at 20 percent of GDP (Demekas and Khan 1991; Thorne 1993). But neither recapitalization scheme was linked to a credible program for debt conciliation or bank privatization. Indeed, progress on both fronts has been tentative and halting in Bulgaria and Romania (Angarski 1994; Engerer 1995; "Coming Out of the Shadows," *Central European*, February 1995; "Recapitalizing Romania's Banks," *Central European*, April 1993).

In most of the newly independent states long periods of inflation shrank the value of nonperforming loans, making recapitalizations unnecessary. In addition, several of these countries embarked on a different strategy for banking reform—namely, creating a new banking sector rather than reforming the old one. The foundation for this approach had already been laid during perestroika, when cooperative banks were allowed to be established (World Bank 1996a). Although new banking sectors in Russia and Ukraine had the benefit of a fresh start without an inherited bad loan portfolio, they did not solve the problem of bank incentives, and thus did not prevent the accumulation of new, bad loans by the new banks. A significant amount of bad debt was accumulated by new and old banks alike during transition. Thus a few poorly capitalized banks simply multiplied into hundreds (Ukraine) or thousands (Russia) of poorly capitalized banks. Ukrainian banks, especially, are characterized by extreme passivity in allocating credit and seeking debt repayment.

The efficacy of the Russian banking sector has been the focus of some debate. But while some analysts have argued that the new banking sector is a model for radical banking reform (Pohl and Claessens 1994), it is beginning to show signs of increasing politicization as a result of the arbitrage opportunities offered by the ad hoc privatization of Russia's most valuable assets[6] and by the liquidity crises brought about by attempts to stabilize the economy in 1995.[7]

Bankruptcy

The ability to force the closure of firms that are unable to pay their debts is most important instrument of financial discipline in market economies. Liquidation is the last resort in the debt collection chain, but it is from the credible threat of liquidation that creditors derive their power, since debt holders are the ultimate claimants of a firm's assets when it is in distress. Under standard rules of bankruptcy management, shareholders lose their rights over firm management and property.

In all the countries studied the enactment and enforcement of bankruptcy legislation was characterized by struggles over the potential effects of liquidating a large number of enterprises. Compromises were reached by, among others, enacting temporary moratoriums on the enforcement of bankruptcy laws, weakening the law with the help of vague definitions of insolvency, or allocating extensive compensation rights to workers over private creditors in settlement proceedings. The six countries studied here have all enacted laws that allow debtors to initiate bankruptcy proceedings. For

these laws to be effective, however, bankruptcy must be feasible in terms of duration, cost (court and attorney fees), prospective recoverables at the end of the proceedings, and the assorted institutional obstacles debt holders may face in initiating liquidation proceedings.

Of all the countries studied, enterprises in Poland face the most credible threat of bankruptcy. Though not as aggressive as, for example, Hungary in pushing insolvent enterprises toward liquidation,[8] Poland has nonetheless built an effective bankruptcy regime not as a result of the bankruptcy law itself—which has several deficiencies—but as a side effect of the 1993 Financial Restructuring Law. That law empowered banks to negotiate agreements on behalf of all creditors. In addition, the law imposed a concrete deadline: by April 1994 loans had to be recovered in their entirety, the debtor had to have regained its creditworthiness (proven by a record of debt service), or some alternative form of conciliation with the bad debtor had to have been reached. Otherwise, the debtor would be liquidated under the Law on State Enterprises (for state-owned enterprises) or the privatization law (for formerly state-owned enterprises; Kawalec, Sikora, and Rymaszewski 1994). This rule boosted the number of in-court liquidations after 1993 (Borish, Long, and Noël 1995).

In the Czech Republic, by contrast, a 1991 bankruptcy law similarly granting creditors wide powers to enforce loan contracts was delayed twice because it was considered an obstacle to mass privatization. The Czech Bankruptcy Act was passed in 1993, but it ceded little power to junior creditors. As a result the power to initiate bankruptcies was left in the hands of the former state banks (Hayri and McDermott 1995; Charap and Zemplinerová 1993).

Despite their drawbacks and ambiguities, however, formal and informal bankruptcy regimes in Poland and the Czech Republic remain more credible than those in Bulgaria, Romania, Russia, and Ukraine. Russia and Ukraine passed bankruptcy laws in 1992. These laws, however, did little to establish a credible threat of bankruptcy despite mounting interenterprise arrears and widespread de facto insolvencies in both countries. In Russia the State Privatization Committee set up a special agency charged with selecting enterprises and initiating their bankruptcy proceedings. The agency, however, was really an impromptu response to the absence of rules enabling private parties to enforce debt contracts. As a result the liquidation of companies remains a contentious issue, plagued by infighting and corruption. Similarly, in Ukraine it is probably a mistake to speak of bankruptcy "rules," despite bankruptcy laws, because much of the responsibility for bankruptcy is in the hands of a poorly defined agglomeration of state agencies with overlapping responsibilities and extensive discretion.

Bulgaria and Romania passed bankruptcy laws relatively late: July 1994 in Bulgaria and March 1995 in Romania. Thus it is premature to draw substantive conclusions about the credibility of bankruptcy laws in these two countries. Some observers believe that the formal design of Romanian and Bulgarian laws represents the state of the art in modern bankruptcy legislation; enforcement, however, is still pending (World Bank 1996b). Preliminary evidence also reveals two factors that are bound to be problematic. First, as with Russia and Ukraine, Bulgaria and Romania rely heavily on state privatization agencies—and therefore administrative discretion rather than uniform rules—for bankruptcy oversight. Second, the configuration of ownership relations following partial privatization in the financial sector is such that several banks in each country are now owned by large enterprises (as in Ukraine), making the liquidation of those enterprises problematic.

How "Fiscal" Property Rights Shape Credit Markets

As noted, post-communist transition involves the financial disengagement of the state from the provision and allocation of credit. All governments include multiple claimants to the powers of the public purse—legislators, executive agencies, local politicians, and so on. But in new democracies the distribution of authority is ambiguous and fluid, and thus different parts of government struggle to define the rules and institutions of the state. Lacking precedents, conventions, or informal agreements delineating the responsibilities of branches and levels of government, conflicts over the content and form of financial policies are inevitable. It is this dual transformation—in the system of government and in the institutions of the economy—that allows room for certain political distortions in financial markets.

Above all, the ambiguities of intra- and intergovernmental relations, by affecting the distribution of fiscal property rights across parts of the state, influences the institutional capacity of countries to establish hard budget constraints at the enterprise level. Evidence from the six countries indicates that politicians have responded to the unpredictability of parliamentary approval or of intergovernmental transfers by sequestering revenues in discretionary funds and by ex post

bargaining with the finance ministry and, more important, the central bank to increase deficits.

For politicians discretionary spending has three advantages over explicit budgetary rules. First, discretion allows flexibility that rules do not, since funds are not limited to ex ante specifications. This flexibility is valuable to fragmented states in which branches or levels of government are motivated by different incentives (Tirole 1994; Laffont and Tirole 1993; Holmström and Milgrom 1991).

Second, discretionary spending allows opacity where budgetary rules do not. Arms-length control is subject to oversight by other parts of government, including (but not limited to) legislatures and courts. Discretionary spending obviates the need for executive-legislative bargaining or center-periphery negotiation and thus is especially advantageous when branches of government or ministries are split over policies and laws. Finally, discretionary spending reduces the vulnerability of state-owned enterprises to collapse. With discretionary funds, politicians can shelter favored industries or enterprises.

This last possibility is also invaluable to parties or factions whose political futures are in doubt, and who seek ways to shield the groups on which they rely for concentrated electoral support (Moe 1989 and 1990). All governments face a potential "tragedy of the commons" with respect to public finances, as constituents of public spending come to see public funds as a common pool into which they can dip at will (Pradhan 1996). In transition economies where spending outcomes are rarely fixed by rules, there is an additional problem: it is in the interest of every claimant to the budget to expand their control over discretionary spending. If one party ties its hands while the other does not, then the restricted party inevitably loses because it is unable to engage in the kind of intervention necessary to assist or shelter current or former state enterprises.

Budgetary institutions

Under the system of cash management inherited from the Soviet Union, finance ministries, following the approved budget, authorized expenditures among line ministries, which distributed funds to smaller units. These disbursements were set out in a detailed spending plan, or *smeta*. Russian and Ukrainian budget offices continue to rely on the smeta in several ways. Finance ministries collect budget requests from spending agencies and various functional units—including subnational governments—that, on the basis of the smeta, prepare payment orders so that funds can be transferred from the budget to individual distributors (LeHouerou and others 1994).

The lengthy budget delays created by this sluggish administrative preparation are compounded by overlapping responsibilities between executive departments and parliament, along with the problems of intergovernmental revenue sharing. In addition, there are few checks on divergences between appropriations and actual spending. In Ukraine budgetary delays are still commonplace. In the absence of a treasury, Ukraine relies on a daily system of cash rationing. This approach has resulted in the buildup of large deposits in the banking system, held by local and other government agencies outside the control of the finance ministry (IMF 1996b). Since 1994 Russia has shortened budget delays, but despite efforts to control the execution of the budget—including the creation of an independent treasury—monitoring and control over budgeting remains fragmented.

Romania and Bulgaria have made some progress in improving budgetary oversight and in restricting ad hoc expenditures. Romania has established a treasury directorate within the finance ministry to enhance the quality of the ministry's financial decisionmaking but has had trouble making the ministry autonomous. Bulgariahas been slower in building effective fiscal institutions. Budgets submitted by the cabinet to Parliament have consistently underestimated expenditure requirements, forcing parliament and line ministries to bridge the gap with offsetting reductions in investment and by borrowing (Bristow 1996). As in Ukraine and Russia, budgetary uncertainties are responsible for the short-term horizon of Bulgarian fiscal policy, sacrificing long-term adjustment to deal with immediate pressures.

Problems of fiscal management in Poland and the Czech Republic, by contrast, were tackled early in the transition. In Czechoslovakia the first reform government budget, adopted in 1991, put in place mechanisms that are still lacking in Ukraine and Russia, including restrictions on ad hoc increases to the budget by Parliament, simplification of the tax system, limitations on line ministry participation in the preparation of the budget, and improvements in financial reporting by the Ministry of Finance (Kameníčková, Horčicová, and Vašková 1992; Prust 1992).

Similarly, Poland redesigned its budget office in 1991 in accordance with a new budget law. The new budget law also allowed for intervention against current appropriations in order to maintain budgetary stability; in the event that the planned fiscal balance were threatened, the law gave the

Council of Ministers authority to block budgeted expenditures for a specified period. Finally, both Poland and Czechoslovakia set up audit offices within their finance ministries to oversee the use of budgeted funds. Unlike similar offices in Russia and Ukraine, where statutes gave audit offices powers to issue mandatory orders and to suspend funding to audited institutions, Polish and Czech audit offices were limited to an advisory role (World Bank 1996a). Partly as a result, the audit offices in Russia and Ukraine have become progressively politicized, since they are squarely in the middle of disputes between the executive and legislative branches. The audit offices in the Czech Republic and Poland, by contrast, have served the more traditional role as a final check on the proper use of public resources.

Parliamentary and executive initiative in fiscal matters reflects the ambiguity of states' constitutions. Although tight fiscal policy was a goal of individual finance ministers—Klaus in Czechoslovakia, Balcerowicz in Poland—the concentration of budgetary powers in central ministries and the statutory independence of audit offices were achieved in these countries because different branches of government had clearly delineated responsibilities and veto powers. In Romania significant steps were taken after 1993 to improve fiscal management, but efforts have been frustrated by constitutional stalemates. Iliescu attempted to strengthen the role of the finance ministry in a 1995 budget law that was held up by Parliament through early 1996. Part of the foot dragging is attributable to a stalemated bicameralism: two legislatively equal houses of Parliament have generally canceled each other out on sensitive matters such as budget and taxes, focusing instead on more popular issues such as security, employment, and so on (*East European Constitutional Review* 5, 1, 1996).

In Russia and Ukraine, on the other hand, the pre-1993 and pre-1996 constitutions, respectively, gave extensive powers to parliament to approve, amend, or veto the budget. Budgetary laws in both countries also repeated traditional provisions of Soviet law, that parliamentary budget amendments proposing additional expenditures should identify corresponding revenue sources. In both countries, however, parliamentary control over the budgetary process was at odds with the growing concentration of presidential power. In both cases parliaments simply failed to implement these restrictions on supplementary expenditures, and raised the deficit above and beyond the amounts set in the executives' proposed budgets. In both countries parliamentary participation in budgeting has since been restricted. Budgets are passed through a series of parliamentary "readings," yet in neither case do explicit provisions restrict parliament from exceeding spending limits voted on in previous readings. Moreover, contradictions between legislative powers and executive prerogative have allowed line ministries to usurp budgetary responsibilities and compromised the independence of the audit offices.

At the intragovernmental level, ambiguous separation of powers limited the capacity of the main central bodies—the finance ministry and the central bank—to manage the public purse. In the absence of approved budgets, ministry allocations were made on the basis of the previous year's allotments. These expenditures—set by line ministries without overall coordination and with little emphasis on any encompassing public welfare criteria—tended to benefit special sectors of the economy (agriculture, defense, mining) at the expense of others (households, pensioners, and so on).[9] More important, they were usually based on overly optimistic revenue forecasts, and thus were inadequate to cover current requirements. In the absence of clear and transparent intergovernmental revenue transfer mechanisms, central governments simply reduced transfers to local governments in order to offset the direct payments needed to close the gap between allotted and available funds.

Consequently, although in principle the amount of transfer from the central budget to local governments was fixed, in practice it was subject to negotiation (Shleifer 1996). At the intergovernmental level the instability of revenue sources, along with the excessive dependence of the periphery on the center, encouraged local politicians to bargain with the central government, and in some cases with local companies. According to Russian legislation, for example, the social assets of privatized enterprises were to be transferred to municipalities to relieve enterprises of these liabilities. As a result companies and municipalities typically bargained to share these responsibilities (Pistor 1995). In the more unitary states of Ukraine, Romania, and Bulgaria the system of revenue sharing evolved toward a quasi centrally planned system in which local governments became enmeshed in a sort of "vertical" bargaining with the ministry of finance.

The off-budget economy

These problems of ad hoc, fragmentary budgeting led to the expansion of off-budget fiscal and quasi-fiscal flows. In Ukraine, Russia, Romania, and Bulgaria the proliferation of extrabudgetary funds made expenditure management in-

creasingly complex and unsupervised. Systematic and comparable data on extrabudgetary expenditures are unavailable for most of these countries, yet the number of these funds and the proportion of total public expenditure they accounted for grew rapidly after 1991. In Ukraine and Russia line ministries established extrabudgetary industrial funds to perform a variety of functions—to promote research and development, make certain capital investments, and assist financially distressed enterprises. The bulk of the resources given to enterprises may or may not have been used for specific purposes—that is, they may have simply been kept as deposits in banks.

In Bulgaria and Romania extrabudgetary funds were encouraged as a means of gaining budgetary autonomy. In Bulgaria the activities of extrabudgetary funds have increased, while Romanian authorities have made some extrabudgetary funds parts of the budget law, thus requiring full reporting to Parliament (IMF 1996a). As in the former Soviet Union, local governments in both countries are responsible for a significant portion of extrabudgetary funds.

In Poland and the Czech Republic, on the other hand, the size and activity of unbudgeted funding has been reduced since 1990. In Poland the number of funds was cut in half between 1991 and 1993 (IMF 1994). In the Czech Republic extrabudgetary funds have been limited to managing privatization transactions and health care. More important, in both Poland and the Czech Republic estimates of extrabudgetary funds show that their portion of total expenditures has declined by between one-half and two-thirds since 1991.

In addition to extrabudgetary funds, the other main sources of off-budget funding are the refinance credits of the central bank. In Ukraine (and Russia until 1994) parliament directed the central bank to provide targeted sectors, through the commercial banking system, with low-interest refinance credits. These off-budget financial flows simply worsened the problem of cash and fiscal management, since these transactions occurred through the banking system, and outside the supervision of central budgeting offices.

The growth of the off-budget economy had three effects on enterprise finance in transition economies. First, those in charge of money creation were able to perpetuate a system of extensive patronage and hidden, open-ended subsidies to enterprises. Although extrabudgetary funds were often defended as an effective means of insulation from budgetary delays and other uncertainties, they were also used to prop up loss-making firms. Similarly, while directed credits were usually used as a source of government deficit financing, they were also a source of cheap credit to insolvent enterprises. In the worst cases the system of directed credits constituted a de facto industrial policy for ailing firms and a source of liquidity for the banking system.

Second, because a large portion of these quasi-fiscal activities involved the banking system, banks had little incentive to develop sound commercial practices (van Wijnbergen 1993; Begg and Portes 1993). As noted, extrabudgetary funds often served as a source of cash reserves for local governments or line ministries, which kept large portions of these funds in bank accounts. Moreover, where banks were used primarily to channel directed credits, their ability to allocate credit according to risk was restricted. As a result they were unwilling to invest in acquiring the kind of information about clients needed to monitor debt. Many banks that held loans to state-owned enterprises began to anticipate bailouts from the state. The privatization of these enterprises, consequently, did not automatically create incentives for banks and insolvent former state-owned enterprises to reduce their debt burdens. With a passive central bank, commercial banks continued to behave as quasi-fiscal agents of the state.

Third, large off-budget financial flows to enterprises from the state meant that the costs of initiating bankruptcy against the most problematic borrowers far exceeded the expected benefits (Mitchell 1993). Initiating foreclosures would have signaled the extent of the banks' own insolvency. Where credit allocation by banks was passive or coordinated by government directive, banks had few incentives to foreclose on their borrowers. Not only would the salvage value of the enterprises be highly uncertain, but bankruptcy would have been an exceedingly complicated, time-consuming, and mutually destructive affair, particularly in countries lacking the necessary judicial institutions and regulatory oversight.

Conclusion

Where conflicts over public finance were affected by battles between different parts of the government over broader constitutional powers, the fiscal roles of governmental agencies were typically left ambiguous because it was simply too difficult politically to clarify or delineate fiscal boundaries. In sum, these constitutional dilemmas, by affecting the distribution of fiscal property rights, influenced the institutional capacity of the six countries studied to establish hard budget constraints at the enterprise level.

Three institutional reforms are required if credit markets are to serve as an instrument of corporate governance. First, banks should play a limited role as transmitters of soft loans and subsidies from the state budget, or as institutions that are forced to implement credit directives on their own account. Second, structural reforms in the banking sector must ease the burden of bad loans accumulated under central planning and provide incentives for credit transactions based on relative cost rather than administrative directive. Third, the threat of bankruptcy must be credible.

In Poland and the Czech Republic a basic but workable framework for enforcing financial discipline was put in place early in the transition. Positive interest rates were established quickly, and governments cut off subsidies to all but a few industries. Recapitalizations were narrow in scope and linked to bank privatization and debt conciliation programs. Both countries also made progress in formulating and enacting bankruptcy laws, although in the Czech Republic the volume of liquidation proceedings has been limited by the institutional capacity of the courts.

In Romania, Bulgaria, and perhaps Russia of late financial discipline has been compromised as governments have struggled to eliminate directed credits and subsidies, work out bad loans, and enforce bankruptcy laws. Some directed subsidies persist in these countries, along with negative-interest loans, although progress has been made in reducing both. Attempts at banking reform, however, were not accompanied by incentives for banks to reduce the debt burden of their most problematic borrowers or to develop skills in assessing credit risks. Bankruptcy laws in these countries are limited in scope, and thus restrict the ability of banks to initiate liquidation proceedings against enterprises.

In Ukraine and Russia until recently governments have forced banks to play a subordinate role to ailing state enterprises and former state enterprises, providing cheap loans and financing budget deficits. Banks continue to finance loss-making state enterprises and former state enterprises. Debt burdens have not been reduced, and little enforcement of bankruptcy legislation has occurred.

Analyses of economic reform in transition economies have paid considerable but separate attention to stabilization and institutional reform. The few attempts to link these issues have been limited to arguments about sequencing or to explanations of enterprise behavior in response to stabilization programs (McKinnon 1993). This debate sought to define the "correct" order of macroeconomic and microeconomic reforms—that is, whether stabilization should precede or follow privatization or whether legal institutions to enforce private property rights should be established before privatization. One lesson from this discussion is that the institutions that efficiently allocate financial resources and enforce credit contracts are weakened if intragovernmental conflicts and power struggles are not managed or resolved. In countries that have suffered prolonged constitutional crises—and where, consequently, more gradual approaches to stabilization were pursued—no government proved capable of committing itself to creating effective institutions to enforce financial discipline.

From this perspective, the crucial challenge for newly democratic countries of Eastern Europe is not so much to quickly set themselves on a course of irreversible economic reforms but rather to lock in constitutional reforms that delimit the scope and instruments of authority available to branches and levels of government. Transition governments are generally inclined to put off these constitutional reforms in order to devote more attention to economic liberalization. Such priorities are misguided. Radical economic reforms can be initiated by all kinds of governments; they are sustained, however, by the clear and unambiguous allocation of political power.

Notes

1. Overlapping or ambiguous control and income rights mean that surpluses deriving from an asset's use will not be clearly divisible; thus the incentives of parties to invest in a relationship are weakened, as is the power of owners to enforce their will (Hart and Moore 1990; Grossman and Hart 1986).
2. In most countries banks were universal banks that had the potential to hold equity. The extent to which they have actually acquired equity in companies—during privatization, on the secondary market, or by financing new startups—is uncertain. It appears that (direct) bank ownership is concentrated in a few industry sectors or even companies. Because of the value of these companies, bank ownership may actually play a much larger role than surveys of average privatized companies suggest (Dittus 1996).
3. Long-term debt has not played a role in most transition economies because of inflation and the incompleteness of risk markets. These problems are exacerbated by the lack of an appropriate institutional framework. For the role of long-term and short-term credits in Hungary and Poland, see Baer and Gray (1996). In Russia short-term credits accounted for 31 percent of credits extended by one-third of Russian banks in 1994; long-term credits amounted to just 0.3 percent (Dimitriev 1996).
4. In Ukraine, for example, all credit resources were allocated administratively by the National Bank of the Ukraine during 1992–93. Some 98 percent of credits were lent to two commercial banks—Agrobanka

Ukraina and Prominvestbank—at interest rates several times lower than the official discount rate of 240 percent. In November 1993 credits were extended at 28 percent, and in December at 132 percent (Pynzenyk 1994).

5. In 1989 credit to public enterprises accounted for more than 100 percent of GDP in Bulgaria, 70 percent in Czechoslovakia, 65 percent in Romania, and 40 percent in Poland.

6. Most valuable assets, including the oil and gas sectors, have been excluded from standard privatization and were privatized according to presidential decrees, heavily influenced by special interests. The most egregious examples are the privatization of Gazprom and the loans-for-shares program launched in 1995.

7. The new government-bank link was finalized in August 1996 with the appointment of Vladimir Potanin, chairman of Oneximbank, as the new deputy prime minister in charge of economics. Potanin is the mastermind behind the loans-for-shares program put in place before the December 1995 parliamentary elections. At the core of this program is a credit contract between the government and a bank. Under the contract the bank lends money to the government and acquires the right to control blocks of shares in some of the country's most valuable companies as well as the right to sell these shares and cash in on the difference between the (nominal) amount lent to the government and the market price at which shares are sold. This arrangement reallocated control over Russia's most valuable companies to a few hand-picked banks and provided strong incentives for the government to keep those banks afloat, since the government's loans will be recalled should a bank be liquidated (see Karlova in this volume).

The government-bank link is affecting central bank policies toward illiquid banks. Faced with large numbers of insolvent banks, the Russian Central Bank recently designed a special scheme in which twenty-seven banks have been deemed too big to fail, ensuring their survival. Not coincidentally, the main banks involved in the loans-for-shares deal are among those selected (*Kommersant weekly,* 11 July 1996, pp. 20–21).

8. While pursuing a more gradual approach to economic reform, Hungary's government has been considerably more stable than Poland's—and perhaps more effective. In 1991 Hungary adopted a law that provided clear and strict rules on insolvency. Companies that were unable to meet their obligations for ninety days were obliged to file for bankruptcy. As a result, ninety days after the law went into effect, about 3,500 companies filed for bankruptcy. Some 25,000 companies have initiated bankruptcy proceedings since the law was enacted. Mizsei (1993) explicitly relates the better performance of Hungary's bankruptcy law (relative to Poland's) to the greater stability of the Hungarian government.

9. Most commonly, previous-year expenditure assignments fell short of the amounts needed to maintain controlled energy prices.

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Financial-Industrial Groups, Industrial Policy, and Competition in the Russian Federation

Enna E. Karlova

Financial-industrial groups, which combine industrial, banking, insurance, and trade capital, are a phenomenon of post-privatization Russia, and have become a major tool of Russian industrial policy (Starodubrovskaya 1995). Those in favor of such groups argue that an economy with many single-plant joint stock companies controlled by workers and managers and without an effective financial system is unlikely to result in efficient firms or effective corporate governance. With widely dispersed ownership, the argument continues, no economic agent can exercise sufficient control to ensure the appointment of competent managers and the needed organizational restructuring of enterprises. The Russian government sees financial-industrial groups as engines of economic growth and expects them to reverse the severe decline in the country's industrial production, improve increasingly difficult financial conditions, and make Russia competitive in world markets.

This idea is not new. Many Russian policymakers cite the financial-industrial groups of Germany, Japan, and the Republic of Korea as models. Japan has its integrated bank-finance *keiretsu*. Under Germany's universal banking system, financial firms have been allowed to take both debt and significant equity stakes in nonfinancial firms. Even the United States may adopt a more universal banking system.

Supporters of financial-industrial groups argue that the success of the German and Japanese economies is partly attributable to the direct equity links and "main bank" relationships between financial intermediaries and industrial firms. Financial institutions have board representation and exercise significant control over corporate decisionmaking, which limits the riskiness of projects chosen by firms and ensures that management is looking in profit-maximizing directions. Moreover, industrial firms with strong ties to banks are better able to survive periods of financial distress by continuing their investment projects. This benefit might prove especially important in Russia, where many enterprises would not survive the uncertain and turbulent transition to a market economy.

Besides the government, three main forces have driven the creation of financial-industrial groups in Russia—regional administrations, industrial (branch) ministries, and banks. Most groups were created during privatization and formation of a securities market, including recent shares-for-loans deals (where banks extended loans to the government and in turn received shares in large state-owned enterprises as collateral; Artemiev and others 1996). Broadly, there are four ways to form a group. Large industrial enterprises can establish their own banks, with other "independent" legal entities engaged in trading, research and development, and other activities—for example, AO AvtoVAZ formed its own bank, AvtoVAZbank. Other groups have been established on the basis of former state management structures (such as branch ministries) with further diversification of their activities—for example, RAO Gazprom was established on the basis of the Ministry of Gas. In some cases large regional industrial holding companies have been formed—for example, Krasnoyarsk Wood-Chemical complex. Finally, banks and investment funds have acquired shares of industrial enterprises, forming bank holding companies and alliances—for example, Menatep bank and other integrated structures such as Russkaya Nedvizhimost, Olbi-Group, and Alfa Group.

Because of Russia's unique industrial and institutional legacy, however, financial-industrial groups have several disadvantages. First, establishing several large conglomerates will exacerbate the economy's propensity toward inefficient allocation of resources. These groups will make the creation of efficient competitive markets in Russia even more difficult. Second, some groups could resuscitate industrial ministries and lead to the resurrection of Soviet-style economic organizations and control structures. Third, groups that are hastily thrown together under administrative direction are likely to be inefficient. Multi-industry enterprises have worked well only when there has been an evolutionary market process that seeks to exploit synergies, production complementarities, and other sources of economies of scope. Fourth, in Russia such conglomerates could lead to cross-subsidization, which would distort competition, perpetuate production inefficiencies, and inevitably run counter to the public interest. Finally, there is a risk that Russian banks will be burdened with capital of doubtful value, further weakening their already precarious state. Moreover, groups that were created through administrative direction and have received favorable tax treatment and subsidies might be pressured by the state to pursue employment and investment policies that do not meet the criteria of a free market.

Despite the possible consequences for the Russian economy, the creation of financial-industrial groups has been routinely excluded from prior review by the antitrust and competition authorities, even though there are substantial risks of anticompetitive structure and behavior. Russia's Antimonopoly Committee carries little weight; its rules exist only on paper.

The Russian government has developed a regulatory framework for establishing financial-industrial groups and has started registering existing groups and setting up new ones. The rules of the game, however, are not yet clear. Only some forty groups have been registered, and the rest do not seem in a hurry to do so. It is not known how many groups there are, or how many enterprises they represent. Many issues need to be resolved, such as how to ensure that groups do not become monopolies, stifling competition in the domestic market.

Nor is the organizational structure of these groups transparent, universal, or uniform. There are some similarities, however. All are based on cross-shareholdings. As a rule the groups have several key members—one or a couple large manufacturers, a bank, an investment fund, an insurance company, and a trading company. Some players, but especially financial institutions, can belong to or head different groups (or both). Cross-ownership among different groups is widespread.

So what should be done? The most urgently needed changes are for the Russian government to take a hands-off approach toward financial-industrial groups, withdraw any explicit support to them, and limit its role to regulator. Four specific moves are essential.

First, the government should stop using financial-industrial groups as a primary tool of its industrial policy. Any explicit privileges and concessions offered to these groups should be withdrawn. Such support creates barriers to entry for other firms in the domestic market, smothering competition and further destabilizing the financial system.

Second, the market economy should serve as a natural catalyst for voluntary financial-industrial integration. Market forces will determine the best means for economic efficiency, which may or may not be achieved through these groups. Industrial (branch) ministries and regional administrations left without any government support will have to be guided by the same efficiency yardsticks as the rest of the market. That will prevent a return to the branch ministry system that was so disastrously inefficient in the Soviet past, and make local regional monopolies unlikely if not impossible.

Third, market-driven and voluntary financial-industrial integration should be properly screened for antimonopoly violations. But first the government needs to devise an appropriate antimonopoly policy, taking into account Western countries' experience and Russian specifics, supported by clear and straightforward legislation and strong supervision. The Antimonopoly Committee should be strengthened, possibly with targeted technical assistance from the World Bank that addresses Russia's overall competition policy. Finally, existing financial-industrial groups should be reviewed for violations of antimonopoly legislation and be brought in line.

Other Countries' Experience with Financial-Industrial Integration

Financial-industrial integration provides a competitive advantage to firms engaged in international trade and encourages faster technological innovation. In Germany, Japan, and the United States the trend is toward greater financial-industrial integration, but none has placed such an emphasis on financial-industrial groups as has Russia, which has explicitly made them the focus of industrial policy.

One defining feature of any financial-industrial group is its inclusion of a bank or a giant manufacturer—or both—so that

it is regulated by banking and antitrust legislation. In Germany, where financial-industrial groups are firmly embedded in the law, the government plays a regulatory role and rarely intervenes in group activities. Banks form a core of these groups and provide them with cheap long-term financing. The groups are doing remarkably well in world export markets. In Japan financial-industrial holdings are legally banned, but banks and industrial companies have found a way for non-cross-shareholding integration. The resulting keiretsu, based on "spiritual" ties and contractual obligations, are powerful and successful. In the United States financial-industrial groups are prohibited by the Glass-Steagall Act of 1933. However, globalization and fierce international competition might force the United States to relax its restrictions on universal banking.

The ideal model for development of Russia's financial-industrial groups would probably include elements from all three countries—powerful banks and a hands-off government approach from Germany, parts of the antitrust legislation from the United States, and antimonopoly safeguards and traditional operating practices from Japan.

Germany

In Germany financial-industrial integration (known as "universal" banking) has often been regarded as a cornerstone of the country's postwar economic success. This integration, however, was never an explicit goal of the government's industrial policy. Instead, government involvement has been limited to a regulatory role. Financial-industrial cross-holdings are regulated by banking and antimonopoly laws, and the government intervenes only if there are clear anticompetitive practices.

Universal banking means that German banks have big equity stakes in industrial companies, representatives on the boards of these companies, and equity stakes in one another. Three major banks—Deutsche Bank, Dresdner Bank, and Kommerz Bank—have close relationships with Germany's big industrial firms. In 1990 Deutsche Bank alone had large equity stakes in Daimler-Benz (28 percent), Philipp Holzmann (30 percent), and Sudzucker (23 percent), among others. Collectively, the three banks also had two dozen seats on the supervisory boards of Germany's ten biggest firms.

There are certain advantages when banks hold equity in industrial companies. Turning lenders into shareholders can help minimize conflicts between debt holders and equity holders. Allowing banks' representatives in the boardroom can encourage them to take a long-term view of their allocation of credit. Moreover, giving banks voting rights can help promote good corporate governance by putting constraints on a company's managers. Industrial companies may also get easy and reliable access to low-cost long-term financing, which can translate into increased exports.

Although universal banks have fueled Germany's economic growth, this model of financial-industrial integration may not be suitable or best for Russia. Germany's banking system is mature, and banks are trusted to behave rationally. Russia, however, is still making a painful transition to a market economy, and its banking system is far from stable. Few banks have gained depositors' trust, as recent runs illustrate. Giving Russian banks an opportunity to make credit allocation decisions that often do not reflect market conditions may further destabilize the banking system.

The German model, however, offers one definite advantage for Russia. The participation of banks on the supervisory boards of companies leads to improved corporate governance. In Russia better corporate governance could encourage rapid restructuring of hugely inefficient industries. Thus if Russia follows the German model, it should do so with extreme care, balancing its pros and cons.

Japan

In Japan, *zaibatsu*—huge industrial groups united by holding companies that existed solely to hold interests in other firms—were the skeleton of the pre–World War II Japanese economy. In 1947, however, U.S. General Douglas MacArthur, driven by antitrust considerations and, most important, determined to prevent the revival of a strong industrial base in Japan, banned zaibatsu. Later, zaibatsu were revived as keiretsu, but this time without a formal legal holding structure.

Keiretsu have been formed around six major Japanese banks and are kept together by spiritual and contractual ties, with little cross-shareholdings. The ties are further strengthened by regular meetings of presidents' clubs. Under current rules no bank can hold more than 5 percent of the shares of any one industrial company (Flath 1994).

The recent financial crisis in Japan was expected to result in massive mergers and acquisitions. This prompted the coalition government, led by the Liberal Democratic Party, to suggest removing the ban on holding companies. The more powerful Social Democratic Party was less enthusiastic, however, wishing to ensure strong safeguards against the possibility of anticompetitive practices. Business strongly favors lifting the ban, arguing that the holding companies would enable firms to restructure operations more efficiently, move into new activities more

easily, and increase their international competitiveness. In anticipation of passage of the bill, several large stockbrokers and banks are studying ways to set up holding companies.

For now, however, financial-industrial integration in Japan is on hold. In February 1996 the coalition government failed to reach agreement on revisions to antimonopoly legislation, and the lifting of the ban on holding companies was postponed indefinitely.

The United States

Ever since the stock market crash of 1929 and the Great Depression that followed, the United States has been averse to integration of banking and industrial capital. Congress identified the securities operations of commercial banks as one of the main causes of the Depression, and in 1933 passed the Glass-Steagall Act. This act prohibited commercial banks from investing in corporate equity and other securities, thus banning trusts and universal banks. Although later substantially relaxed, this act remains a solid barrier between commercial banks and industry, with only a small window of commercial lending and borrowing. With fierce competition from Japan, Germany, and more recently the Republic of Korea, however, the United States has been forced to reconsider its position. There are concerns that the United States stands to lose out unless its banks become universal, engage in financial-industrial integration, and provide industry with cheap and easy financing.

Those in favor of repealing the Glass-Steagall Act argue that financial-industrial groups will:

- Lower financing costs for industry;
- Overcome the agency problem;
- Overcome information problems—which exist when banks are reluctant to lend to industrial companies because the banks lack complete information on the companies' internal dealings, corporate governance, and so on;
- Give banks more confidence by allowing them a say on borrowers' boards; and
- Allow U.S. banks to compete on equal terms with German and Japanese banks.

Financial-Industrial Groups: The Core of Russia's Industrial Policy

Financial-industrial groups are at the heart of Russia's industrial policy. Other countries have been more careful in their approach to such groups. In Germany, Japan, and the United States individual companies, not governments, set up the groups. Governments in those countries play the role of regulator, not of founder and promoter, of the groups. And only in Germany are financial-industrial groups recognized by law.

Financial-industrial integration offers two main advantages in market economies. First, group members are better able to compete internationally than they would on their own. The group's costs are lowered because of economies of scale and scope and vertical and horizontal (financial) integration. These advantages translate into higher exports and GDP growth. Second, group members are able to achieve more rapid technological innovation. Companies that have access to low-cost, long-term financing and reliable banks are more active in research and development than companies that do not. U.S. successes in research and development can be explained by the role that venture capital funds play.

These advantages do not, however, provide a rationale for an explicit industrial policy for financial-industrial groups. Such a policy may be dangerous for several reasons. First, when the government provides groups with subsidies, preferential treatment, and guarantees, it may be substituting for the economies of scale and scope and vertical and horizontal integration the groups are supposed to achieve. Second, by interfering with the operations of the groups, the government distorts competition in domestic markets. Entry into the market for small firms becomes limited, and large groups dominate the market and stifle competition.

An industrial policy favoring financial-industrial groups might be justified during the early stages of their formation, but later the state should adopt a hands-off approach, intervening only in clear breaches of antimonopoly regulation. The excessively strict antimonopoly policy pursued by the United States is an extreme, although it is being relaxed. Japan is following suit. Germany seems to provide a reasonable model for government intervention, although in recent years its antitrust policy has become more stringent in accordance with European Union (EU) norms. Thus the right policy mix for Russia is somewhere between Germany and Japan, but farther from the United States.

From chaos to order?

In 1993 the Russian government made its first attempt to define the legal framework for financial-industrial groups (Presidential Decree 2096, dated 5 December 1993) and established a registry with the State Committee on Industrial Policy (Goskomprom). After much debate, government industrial policy strongly advocated these groups, and a new

law was passed on 30 November 1995.[1] The law covers only those groups registered with Goskomprom.

According to the law, the groups are formed voluntarily by legal corporations that want to integrate their technological, economic, and other resources for investment or other projects. Group members congregate under the umbrella of a full or limited liability holding company, which is officially registered as a financial-industrial group and is referred to as a parent or central company. In practice, three methods are used to form a group: a new joint stock company is established as a parent company in which all member companies hold shares, one group member holds in trust the shares of other members, or one member acquires the shares of others (provided that most of the member companies are privately owned).

The parent company is usually an investment company that provides day-to-day operational management of the group. Each group also has a management board, which enables group members to effect corporate governance over the group. Any company can become part of a group—commercial and noncommercial, including foreign companies. When a group includes companies under the jurisdiction of other countries of the Commonwealth of Independent States (CIS), that group is registered as a transnational financial-industrial group. All groups must include manufacturing and services firms as well as banks or other credit institutions, and may include investment institutions, non-state pension and other funds, insurance companies, and fully municipally or state-owned enterprises.

The government used the law on financial-industrial groups to proclaim itself as a proactive creator of the groups. As such it has the power to establish groups when potential group members are state-owned enterprises and entities supported by the federal budget and when it decides to establish transnational groups with other CIS countries, which are called international financial-industrial groups.

Does direct government participation change the voluntary basis of group formation? In the first case, probably not. The government may be seen as merely delegating corporate governance over state-owned enterprises. The second case is more worrisome, however, because it does not explicitly specify whether the companies that form the group are entirely state-owned or include private companies as well. If the group includes private companies, the government will be seen as directly intervening in the market economy. In both cases the creation of state-owned groups creates a big responsibility on the part of the government to support them and has strong implications for the health of the federal budget and the economy as a whole.[2]

Implications of state support and privileges

Although the privileges granted to financial-industrial groups are designed to encourage formation of groups and ensure their successful operation, they can impede the development of a level playing field. They could also hinder internal market competition in Russia by creating artificial barriers to entry and thus undermining the ability of other companies to compete. The list of privileges is long.[3]

First, industrial firms becoming members of a group can convert their debt into the equity of the parent company. This is done through an investment tender, where the investment is set at a level sufficient to clear any outstanding debts or arrears of the firm. Since the parent company is usually an investment institution (or simply a bank), the government in essence uses political pressure to convert the debt of big ailing firms into equity of the banks. This approach could easily backfire: it could put banks in a vulnerable position and weaken their already fragile capital bases, and it could stop hopelessly inefficient companies from being liquidated, making the banks responsible for their turnaround.

Second, group members enjoy flexibility in financial management. They are given the right to determine the method of depreciation and to reinvest the cash flow sheltered by accumulated depreciation into activities of the group.

Third, group members can significantly reduce their tax liabilities if the group is given the status of a consolidated taxpayer. As if that were not enough, advocates of groups are lobbying for tax breaks on reinvested profits and hope to exempt group members from tax on securities issued to finance projects that are in the interests of the state industrial policy.

Fourth, the government guarantees foreign and domestic investment in the groups. By doing so, it intervenes in the allocation of credit in the economy and undermines its functioning according to market forces. Many of the groups' supporters are also lobbying for state insurance of group projects against noncommercial risks.

Fifth, the Central Bank of Russia is allowed to lower capital adequacy requirements and change other (unspecified) requirements of banks that are members of a group. As it is, few banks have adequate capital, and such practices will only further erode their capital bases.

Sixth, the government offers direct financial support to groups in the form of investment credits and other financial

assistance to help implement projects. This situation is dangerous because:

- It represents a return, on a grander scale, to the system of state subsidies and targeted credits that existed for state-owned enterprises. It is even driven by the same justification—priorities in the government's industrial and economic policy.
- It places a tremendous burden on the state budget. In 1997 Goskomprom is expected to receive more than $550 million from the budget to support groups with guarantees, investment credits, and direct subsidies. Defense and aviation industry groups have already been identified as first recipients.
- It creates expectations that if groups prove nonviable, they will always be rescued by the government. The costs of such unconditional bailouts could be tremendous.

Finally, the government can entrust its residual ownership stake in privatized enterprises to the parent company of a group. The current regulatory framework fails to define the mechanism of such a transfer, its conditions, and the responsibilities and accountability of those entrusted with the management of assets. However, being partly owned by the government, these companies could easily serve as a conduit for additional financial transfers from the government to the group, and, most important, can in effect become renationalized.

Existing financial-industrial groups have tried to take advantage of these privileges, but in a surprising way. Instead of becoming registered, they create (or become part of) newly registered groups. For example, RAO Gasprom is one of the founders of the group Nosta-Troubi-Gaz. The existing group preserves its freedom of operations while enjoying all the privileges and concessions offered by the state to registered groups. Alternatively, many existing groups are developing significant lobbying powers to obtain the above-mentioned benefits and other concessions.

State support to and privileges of groups require strict monitoring by the government. This is a delicate matter. On the one hand the government has the right to require and pay for an annual audit of groups' financial statements. It is not certain, however, that such audits are an effective monitor. Moreover, should the state be "clawing back" into the ownership and governance of enterprises, a move that seems inconsistent with its commitment to privatization?

Objectives of groups and first results

The objectives the Russian government set for financial-industrial groups are not only ambitious, but contradictory. Groups are expected to increase their production efficiency, broaden their markets for goods and services, and increase their competitiveness. On a much broader scale, groups are also expected to create new workplaces. Is it possible to meet these objectives? Consider how they are being met by the registered groups.

By July 1996 thirty-nine groups were registered (compared with twenty-seven six months before).[4] These groups represented more than 500 enterprises and 87 credit institutions, including 37 banks, with the number of members in a group ranging from three to forty (see appendix 1). Group members employed a total of 3 million people, or nearly 17 percent of the total industrial workforce. Their combined capitalization amounted to nearly $400 million. Their annual production exceeded $19.7 billion, and they accounted for more than 10 percent of GDP (up from 2 percent in 1995). The investment portfolio of these groups included more than 200 projects for a total of $12.8 billion. The fifteen largest groups saw a 5 percent annual increase in production, 31 percent increase in sales, 28 percent increase in exports, and 250 percent increase in investments (Makarevich 1996).

The first four registered groups—Uralskie Zavody, Sibir, Dragotsennosti Urala, and Ob'edinennaya Gorno-Metallurgicheskaya Company—are often cited as success stories. In 1994, when industrial production was in a slump, they increased production by 4 percent over 1993 while maintaining an essentially unchanged work force. In addition, the four groups more than doubled their industrial investments thanks to retained earnings and borrowed capital, and their export volume was 139 percent of the 1993 level. The financial position of these groups was helped partly by a 13 percent reduction in overdue intercompany payables.

Those in favor of entrusting groups with residual state shares of privatized enterprises often cite Ruskhim as a successful example of this move. In 1995 this group was given a three-year trust agreement covering the state shares of five large enterprises of the Russian chemical complex. Between November 1995 and the first half of 1996 the sales revenues of these enterprises increased by 10–12 percent. Enterprise debts incurred before 1994 were reduced by 4–5 percent. Sales volume, adjusted for inflation, increased by 10 percent. There was an increase in exports for some products. At JSC Korund, for example, export sales volume rose by 250–300 percent compared with 1994, while prices increased by only 30 percent, and $10 million was raised for project financing. Instead of offsetting transactions, enterprises began to see more cash payments, and the ratio of offsets to cash payments

dropped from 90:10 to 70:30 (Kuzina 1996). Although these results are impressive, it is too early to say if they are sustainable. In addition, it is necessary to compare these results with the costs that were necessary to achieve them.

The birth of financial-industrial groups is painful, and plagued with problems. First is the lack of proper legislation. Further clarification is needed for trust arrangements, tax breaks and guarantees made by federal and regional governments to investors, and mechanisms for creating transnational and intergovernmental financial-industrial groups. Poor legislation means problems are dealt with on a case-by-case basis (as, for example, the loans-for-shares transactions), groups continue in a de facto existence, and groups face financing difficulties, lacking both internal and external investors.

Another issue is taxation. In theory, financial-industrial groups should be consolidated taxpayers. In practice, however, the authorized capital of many groups does not yet include the assets of its members because of problems with consolidation of property. And there are still many cases of double and triple taxation, where local administrations cannot agree on the tax treatment of groups—for example, until November 1995 JSC Norilsk Nickel, part of the Interros financial-industrial group, had to pay federal tax and two local taxes—to Taimir okrug and to Krasnodar krai. A bilateral agreement between local administrations was needed to resolve the situation.

Groups are growing in strength and size, and are trying to solve their problems. For instance, in what was perceived as a remarkable development, groups were the subject of the meeting of the governmental commission on operations, which took place immediately after the first round of the June 1996 presidential election.

Problems of Anticompetitive Structure and Behavior

The most striking difference between the centrally planned Russian economy and Western market economies was the size of firms and the degree of industrial concentration within each industry.[5] In market economies the size distribution of firms is generally highly dispersed; in Russia most manufacturing industries were (and remain) highly concentrated. In most industries more than a third of subindustries are highly concentrated. Seller concentration has been preserved and enhanced in ways that thwart the natural tendencies of firm size dispersion. Entry has been inhibited by the scarcity of independent sources of finance. Furthermore, state-owned enterprises have no incentive to fragment into competing units (even if it were allowed) because competition in the same product market would inevitably reveal the sources of productive inefficiency.

If Russian enterprises are to be more efficient in their use of resources and in their choice of investment, they must face competition in markets with rational prices and hard budget constraints. Industrial concentration reduces competitive pressures for cost minimization and allows firms to set prices at distorted levels. Unfortunately, the emergence of financial-industrial groups and their multienterprise structures will exacerbate Russia's historical tendency toward monopolization, and is likely to create significant competitive problems by slowing—even halting—further restructuring.

Industrial concentration and market monopolization levels are officially calculated on a national scale. Regionally, industrial concentration might be even higher. There are well-known instances of:

- Local monopolism (monopsonism) of regional markets—for example, in agroprocessing enterprises, in enterprises engaged in trade and services in remote villages, in sewerage services and storage, and in the distribution and retailing of refined oil and gasoline.
- Oligopolies—where several large enterprises dominate production and sales in one industry—for example, in the production of cars. The Volzhsko-Kamskaya financial-industrial group transformed this oligopoly into a monopoly by uniting the two largest car and truck manufacturing companies, Avtovaz and Kamaz, and the distribution and sales company Logovaz.
- Industrial production and sales dominated by one enterprise that coexists with small outsiders—for example, Gazprom.

Mutual forbearance

The rapid emergence of multi-industry financial-industrial groups raises fundamental questions about the market system in Russia—a system in which interfirm competition should be the regulator and the guarantor of social welfare. The trend toward conglomeration and interlocking financial ties could eventually result in a Russian industry dominated by a few groups.

The behavior of conglomerates that face each other in a web of markets differs from that of single-product firms competing in a single market. Profit maximization among multiproduct competitors requires knowledge of rivals and their interactions across markets. Behavior in any market is likely to be conditioned by both the firm's internal structure and interdependence from intermarket contacts—that is, any action taken by one multiproduct competitor against another could generate reactions in other jointly contested markets.

This potential interdependence among financial-industrial groups means that mutual forbearance can emerge. That is, their multimarket contacts could blunt the edge of their competition. Groups that compete against each other in many product or geographic markets may hesitate to fight vigorously because the prospects of local gain are not worth the risk of general warfare. As a result competing groups may adopt a live-and-let-live policy in order to stabilize the structure of the competitive relationship.

Distortions of dynamic competition

Undistorted and effective competition leads to economic efficiency, and markets can further many important aspects of the public interest. Competition ensures that prices are no higher than is necessary to cover pertinent costs, because higher prices would attract additional and alternative supply. Prices lower than costs cannot be sustained in competitive markets because insufficiently compensated supply will not be forthcoming from firms that are free to make their own business decisions.

By offering the full and necessary rewards from investment, marketing initiatives, and relative efficiency, competitive markets provide full incentives for entrepreneurs. By presenting no impediments to firms vying to meet customers' needs and thereby create business, competitive markets ensure that customers will be served by suppliers best able to innovate and to satisfy demands at the lowest possible cost.

Competition can only work if the playing field is level. A level playing field will be conspicuously absent in Russia, however, if financial-industrial groups are given preferential treatment and receive subsidies not available to smaller, less-integrated competitors. Government policy that increases the incentives for the formation of these groups will inevitably distort the forces that would otherwise shape efficient and competitive markets, and might create inefficiencies of supply as well as other serious impediments to the goals of the public interest.

How can monopolies be avoided?

Russia clearly needs strong antimonopoly legislation. Instead of sponsoring more financial-industrial groups, the government should concentrate on regulations that ensure that existing and future groups do not become virtual monopolies and stifle domestic competition. At present, however, any attempt at effective antimonopoly regulation is bound to fail. The government often influences the decisions of the Antimonopoly Committee, whose regulations exist only on paper.

A 1993 decree made a widely criticized and failed attempt to prevent voluntarily created groups from becoming monopolies—cross-shareholdings were prohibited (Bolotin 1995); the state could not hold more than 25 percent of the shares of a group; and financial, credit-financial, and investment institutions could not own more than 10 percent of the shares of group members, and such shareholdings could not exceed 10 percent of the institutions' assets. At present cross-ownership is widespread, the state can create and fully own groups, and ownership restrictions for financial institutions are not observed.

Another attempt to thwart monopolies was made when the government required approval from different federal agencies to establish groups—Goskomprom, the State Property Committee, the Antimonopoly Committee, and regional administrations. A group was considered a monopoly if total employment exceeded 25,000 people and the group had a dominant position in the national or local market; if the group included more than twenty companies and employed more than 100,000 people; or if one group acquired shares of enterprises that were part of another group. In addition, the approval of the ministries of defense and economy was required for group members whose defense orders accounted for a significant part of their production. Finally, the participation of state enterprises and other organizations financed from the federal budget required state approval.

Of the thirty-nine registered groups, at least twenty employed more than 25,000 people and at least four had more than twenty companies with a combined workforce of more than 100,000. Would the outcome have been different if the approval of federal agencies had not been required? These created giants exceed the thresholds of the antimonopoly legislation, which means that only they will have preferential entry and receive state privileges. But their mere size will give them exclusive unmatched powers, since no other company will be able to grow to a similar size.

Recent experience shows that groups are becoming smarter, and are successfully avoiding antitrust obstacles on the path to their creation. Menatep-Group recently succeeded in creating one of the largest textile groups through its holding company, Rosprom. Moreover, it is a member of another group, Exsokhim. And although the law says that no bank can be a member of more than one group, nothing prevents a financial group from engaging in multiple holdings.

Antimonopoly legislation, no matter how progressive and advanced, means nothing if not applied and enforced strictly

and consistently. The Antimonopoly Committee does not carry much weight in implementing and enforcing the law and has limited capacity. And being a federal agency, it is influenced by the government.

There is a delicate balance between the costs of developing antimonopoly regulations (and enforcing them) and their benefits. Western economies recognize two enforcement systems—judicial and administrative. In Australia, Canada, France, Germany, Japan, and the United States the enforcement system centers on judicial decisions. Spain, Sweden, and the United Kingdom use an administrative body whose senior staff is appointed by a member of the executive branch. The two systems differ in their costs and the working style of the antimonopoly entities. The administrative system is more informal, but is less appropriate if antitrust penalties are to be levied.

Behind the Scenes—Stakeholders and Shareholders

Not surprisingly, the government is not the only stakeholder and shareholder in financial-industrial groups. Regional administrations, industrial (branch) ministries, and banks are three other powerful forces. The interests of these three groups will shape the groups that will soon be competing in world markets. Industrial ministries are pure stakeholders, government and regional administrations are stakeholders and sometimes shareholders, and banks are always both. The first three push toward a return to the command economy, while banks push toward a free market economy.

Interests of regional administrations

In mid-1993, at the start of privatization, the administration of Primorsky Krai region helped create one of the first regional financial-industrial groups—the Primorsky Manufacturers Shareholders Corporation. The 213 founders (people, not enterprises) of the corporation represented thirty-six leading industrial enterprises, including six defense plants (among others, Varyag and Radiopribor), four fishing and fish processing companies, and producers of chemicals and electronic circuits. The corporation inevitably raised questions about whether regional groups should be allowed. In August 1993 the corporation employed 90,000 people, or 9 percent of the krai's work force. It soon became a vehicle for its founders' interests, however. The corporation's publicity brochure described the structural reorganization of the Primorsky Krai economy; development of competitive technologies and services, possibly with foreign participation; interregional cooperation and development of small and medium-size enterprises; creation of an economically efficient financial investment system; transfer of capital from nonprofitable to profitable branches of the industry; and creation of a socially stable and economically protected structure for voucher investment by krai citizens and Russian voucher funds (Vacroux 1995). Regional administrators, on the other hand, saw the corporation as their personal generator of wealth and a means to achieve control over virtually any industry of the krai. In practice, this meant that the corporation's members could enjoy lower taxes, obtain export licenses, and distribute regional quotas for member companies in preference to other companies in the region (Kirkow 1995).

Four of the first registered financial-industrial groups—Uralskie Zavody (Izhevsk; box 1), Sokol (Voronezh), Dragotsennosti Urala (Yekaterinburg), and Sibir (Novossibirsk)—were also regional (see appendix 1). Of the twenty-seven groups registered by December 1995, eleven were Moscow-based, three were Voronezh-based, and the rest were spread among thirteen different cities. Many regions are trying to take advantage of their large, technologically linked enterprises. Karelia, for example, is setting up groups in the pulp and paper industry, which includes forest-industrial holding Karellesprom—consisting of twenty-seven enterprises in forest, wood processing, and pulp-paper industries. Other holdings are being created from Onezhskii Tractor Plant, Seghezhskii, and Kondopozhskii Pulp-Paper Combinats.

Interests of industrial (branch) ministries

Industrial (or branch) ministries, which had a monopoly over industrial production in the Soviet Union, saw their powers cut back greatly with the fall of communism and the transition to a market economy. Many ministries were dismantled, but those that remain see financial-industrial groups as a path to their former glory. As a result groups initiated by branch ministries tend to include enterprises of a single industry—for example, Ruskhim in chemicals and Nosta-Troubi-Gaz in metallurgy. These groups are especially attractive for branch ministries because they allow them to reestablish control over enterprises located in the territory of other CIS countries. The international group Interros, which includes the Kazak nuclear energy state holding company Ulba, was registered in September 1995. The participation of Ukranian companies in this group is being discussed. There are also plans to create Electrometpribor in the machine-building industry, with Russian and Kazak electronics enterprises. In addition, Sokol

Box 1. Case study—The Uralskie Zavody financial-industrial group

History
November 1992—Udmurtia Republic administration, wishing to preserve the scientific-industrial potential of the region's industry at the time of drastic economic reforms, decides to establish Uralskie Zavody, a financial-industrial group.

December 1993—Uralskie Zavody became the first registered group in Russia.

Profile
Parent company—open-type joint stock company.

Members—Twenty companies with different ownership structures and activities: ten equipment and electronic components manufacturers, two joint stock commercial banks, a voucher investment fund, an insurance company, a scientific research institute, two construction companies, two large commercial trading companies, and Udmurtia property fund.

Activities—Coordination and implementation of programs deemed of high priority to the Russian government, in four main areas:

- *Equipment for the fuel-energy complex.* Six companies are in charge of ten programs, solving major problems of oil and gas extracting enterprises, including substituting imported equipment.
- *Telecommunications equipment and communication systems.* Four companies participate in five programs together with leading foreign firms—Simens, Alkatel-Sel, Phillips.
- *Medical equipment and medical services provision.* Three companies.
- *Equipment for the agroindustrial complex and for the development of social infrastructure of villages.* Five companies manufacture more than seventy products.

Structure—Group members are mutually interested in working together. The parent company provides startup capital and has invested 80 percent of its assets in its subsidiaries. The parent company allows the group to concentrate on new business instead of having to deal with problems of individual members.

Management—Highest body: general meeting of shareholders; day-to-day organization: supervisory board (elected at the general meeting of shareholders from among the member-company managers), committees (elected at a general shareholders meeting from among shareholders to develop programs; committee chairman is usually a member of the supervisory board), and expert commissions (from among professional staff of group members; develop implementation mechanisms for programs).

Source: Botkin and Kozlov 1995.

might be transformed into an international group with Kazak and Kyrgyz companies.

One branch ministry that has been especially aggressive in setting up financial-industrial groups is the Committee of the Russian Federation on Metallurgy (Roscommet). Roscommet considers the creation of these groups crucial to restructuring Russia's metallurgical complex. The first group in this industry, Magnitogorsk Steel, was formed in 1994. It included thirty-nine Russian and foreign enterprises headed by AO (JSC) Magnitogorsk Metallurgical Kombinat. The founding capital of the group was 100 billion rubles. The founders included auto plants (AO AvtoVAZ, URALAZ), banks (Tveruniversalbank Promstroibank, AvtoVAZbank), and foreign companies from Germany, Poland, and elsewhere. The main task of this group was to complete in 1996 the construction of a complex to produce 5 million tons of steel, 5 million tons of hot-rolled steel, and 2 million tons of cold-rolled steel each year.

Another group, Nosta-Troubi-Gaz, was the catalyst for upgrading steel sheet manufacturing at the Orsko-Halilovskii kombinat. As a result Russian pipe manufacturers will be able to produce large-diameter gas pipes that RAO Gazprom currently has to purchase abroad. By 1998 import substitution is expected to lower hard currency expenses by $3 billion and gas costs by $1 billion.

Roscommet is keen on reactivating and developing links with enterprises and suppliers located in Kazakhstan, Tadjikistan, and Ukraine, and has plans to set up eleven international groups; five are being discussed with Kazakhstan's Ministry of Industry and Trade. These groups will produce chromium ore and chromium ferro-alloys, nonferrous metals and rolls, titanium and titanium rolls, aluminum and aluminum rolls, and rare and rare-earth metals.

Russia, more than any other country, is the driving force behind international financial-industrial groups because the once-powerful headquarters of industrial ministries are still located there. International groups are a partial return to production cooperation with CIS countries and also form the basis for renewal of trade among former members of the

Council for Mutual Economic Assistance (CMEA). For now, however, rapid creation of international groups is unlikely because many issues have not been resolved. These include taxation, customs duties, payments system and interbank and financial-credit institutions relations, property rights, and national independence of CIS countries. Still, it is clear that many Russian ministries hope to establish transnational and international groups in neighboring countries.

Recent developments, however, indicate that enterprises no longer listen to their respective ministries and instead take initiative on their own. For example, at the end of July 1996 directors of the companies proposed for the aluminium group mentioned above decided to merge without the involvement of their ministries, and signed an agreement to establish what may be the most powerful association of aluminium manufacturers in the world—Sibir Aluminium. This group not only unites the profitable Sayansk and Bratsk aluminium plants (with total production capacity estimated at 1.1 million tons of aluminium a year and net income of 1.5 trillion rubles in 1995), but also Kazakhstan's Pavlodar aluminium plant and the United Kingdom's Trans World (aluminium). Reynolds International, the U.S.-based world leader in the production of aluminium foil and packaging, is said to be considering joining the group. If that happens, the group's production capacity will be 3.1 million tons of metal a year.

Interests of banks

Banking capital plays a crucial role in Russian financial-industrial groups. Of the eighty-seven credit-financial institutions that are part of the thirty-nine registered groups, forty-nine are banks. These banks hold equity stakes in the companies of the group and provide them with long-term investment credits. The landscape is dominated by ONEXIMbank, Incombank, Rossiiskii Credit, Promstroibank, Avtobank, and Menatep, which are among Russia's biggest banks. Other active banks include the International Financial (Mezhdunarodnaya Finansovaya) Company, Germes-Soyuz, and AvtoVAZbank.

During the early stages of transition, banks were isolated from industry and unable to make large industrial investments. Nowadays, however, banks are on a constant hunt for enterprises, and since there is a limited number of enterprises worth investing in, competition among financial institutions is intense. Some banks are even investing in other companies in CIS countries—ONEXIMbank, for example, created the international group Interros. At least six banks—Rossiiskii Credit, Avtobank, Promstroibank, AvtoVAZbank, Voronezhbank, and Tveruniversalbank—have equity stakes in two to three registered groups (tables 1 and 2). Given the recent law prohibiting any entity from maintaining holdings in more than one financial-industrial group, it will be interesting to see how these banks reconfigure their stakes.

The emphasis on the role of banks in financial-industrial groups and, therefore, the very idea of these groups as a focus of industrial policy might be dangerous for two reasons. First, groups may attract the wrong banks. The government assumes that banks in Russia are solid and sound and, like Western private financial institutions, are interested in maximizing profits. Few banks, however, are ready to accept the responsibility for groups envisaged for them by the government. As recent bank failures illustrate, including those of Olbi-Group and Tveruniversalbank, some banks are interested only in short-term gains and are short-sighted when it comes to long-term survival. Moreover, banks often lack the credit assessment skills required to make sound decisions to extend short- and long-term loans, let alone equity investments. Such opportunistic banks might undermine the future of financial-industrial groups. The government's policy of encouraging banks to participate in the groups worsens the situation by allowing the Central Bank of Russia to lower capital adequacy requirements for banks that become group members. Hopefully, the government's recent decision to designate the Federal Commission on Securities and the Capital Market as a supervisory and control body for commercial banks engaged in securities operations will protect industrial companies from being exploited by opportunistic banks.

Second, financial-industrial groups might further destabilize Russia's banking system. Even if the banks that become group members are sound, the political pressure from the government for them to support industry might eventually weaken their position. Government involvement will undermine the market's ability to allocate credit and hinder proper corporate governance of the companies the banks could offer. One of the advantages of banks holding equity positions in industrial companies is that the banks are able to vote on the supervisory boards of these companies and to ensure their market-oriented development. Under political pressure, however, banks will be obliged to finance all members of the group, regardless of whether they are profitable. In many cases these companies will be loss-makers that the government wants to save from bankruptcy. That was the case with the first twelve financial-industrial groups established by presidential decree in December 1993.

Table 1. Existing banking groups

Group	*Banks*	*Investment banks*	*Trading and other companies*	*Industries*	*Part of registered groups?*
Alfa Group	Alfa Bank	Alfa Capital	Alfa Eco (trading), Alfa Art, Raiffeisen-Alfa, Alfa Real Estate	Food processing (Lyubyatov), cement (Alfa Cement, comprising Volsk Cement, Nizhny Tagil, and Spassk), chemicals, pharmaceuticals, glass, power supply, oil production, retail distribution (crossroads supermarkets)	No
Olbi-Group	National Credit Bank, Industrial Service Bank	None	Olbi Trading House, Olbi-Tours, Olbi Fund Management	Retail distribution (Olbi Diplomat supermarket, Olbi Store)	No
Menatep-Group	Menatep, SKB Samara	Alliance-Menatep	Menatep Trading Company, Menatep Impex (trading), Menatep Real Estate	Aluminium, copper (Orenburg), food processing (Koloss), timber (Irkutsk, Syktyvkar), pulp and paper (Ust-Ilimsk), textile holding company Rosprom	Yes—Exsokhim; Consortium Russian Textile
Incombank	Incombank	Incom Capital	None	Aluminium (Samara Aluminium Plant), food processing (Babayev), steel production (Magnitogorsk), pipe production (Nosta), aircraft production (Sokol)	Yes—Nosta Pipes and Gas
AvtoVAZbank	AvtoVAZbank	None	None	Steel production (Magnitogorsk), car and truck manufacturing (AvtoVAZ and Kamaz), car sales and distribution (Logovaz)	Yes—Magnitogorsk Steel; Volga-Kama
Rossiiskii Credit	Rossiiskii Credit	In-house brokerage	None	Mining (United Mining Company, Lebedinsk), gold mining (Urals Gold)	Yes—Urals Jewelry; Ruskhim; Svyatogor

Source: Blishen 1995.

Notes

The author is indebted to Ioannis Kessides and Ira Lieberman for reviews of earlier drafts.

1. All groups created before the adoption of the 1995 law were required to reregister within six months.
2. The draft 1996–97 privatization program proposes to allocate the government's residual shareholdings to existing groups or to create new ones from these shareholdings through trust management agreements.
3. Different state bodies may also extend additional benefits and guarantees to groups within the area of their competence. Members of international groups may, in addition, be granted customs tariffs privileges, as envisaged in Russia's Law On Customs Tariffs.
4. By November 1996 two more groups had been registered, bringing the total number to forty-one.
5. This section was drafted with the assistance of Ioannis Kessides.

Table 2. Banks with stakes in more than one registered financial-industrial group

Bank	*Financial-industrial groups in which bank holds a stake*
Avtobank	Nizhegorodskie Avtomobili; Svyatogor
Promstroibank	Primorie; Magnitogorsk Steel; Rossiiskii Aviatsionnii Consortium
Voronezhbank	Sokol; Soyuzagroprom
Tveruniversalbank	Urals Jewelry; Magnitogorsk Steel

Source: Economica I Zhizn (December 1995).

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Appendix 1. Financial-industrial groups registered in the Russian Federation, July 1996

Group	*City, registration date*	*Number of companies*	*Number of employees*	*Financial and credit institutions*
Uralskie Zavody	Izhevsk, Udmurtia, 12.21.93	20	46,000	*Izhevsk* KB Aksion; AO Evroasiatskaya Strakhovaya Companiya (Eurasian insurance company); Evroasiatskii bank; AO Tsentralnyi Investitsionnii Fond (Central Investment Fund)
Sokol	Voronezh, 3.31.94	22	81,000	*Kursk* APB Kurskprombank *Voronezh* KB Energia (Energy); AKB Voronezh
Dragotsennosti Urala (Urals Jewelry)	Yekaterinburg, 5.20.94	9	3,200	*Yekaterinburg* APB Zoloto-Platina Bank (Gold-Platinum Bank); AOZT investment company Standart-Invest *Moscow* AKB Lanta-Bank; AK Rossiiskii Credit; Tveruniversalbank
Ruskhim	Moscow, 6.02.94	21	86,000	*Moscow* AK Rossiiskii Credit; AO Russkii Strakhovoi Centre (Russian Insurance Center) *Unknown* AO Komintek LTD
Sibir (Siberia)	Novossibirsk, 8.23.94	18	48,100	*Novossibirsk* KB ST Bank; AO Sibirskaya trust investment company; AOZT KRAMDS-Novinvest; AOZT Insurance company Simaz *Unknown* Promradtekhbank
Ob'edinennaya Gorno-Metallurgicheskaya Company (United Mining)	Moscow, 11.21.94	9	97,900	*Chelyabinsk* AKB Bank Sodeistviya Privatizatsii
Skorostnoy Flot	Moscow, 12.30.94	18	25,000	*Moscow* AO TNK Germes-Soyuz; MAB Germes-Centre *St. Petersburg* AO investment company Germes-Neva
Ob'edinennaya Promyshlenno-Stroitelnaya Company (United Industrial Construction)	Ryazan, 3.01.95	21	10,600	*Ryazan* KB Stankobank; AO Chekovii Investitsionnyi Fond (Check Investment Fund) Course-E; TOO Strakhovaya Companyia SIF
Nosta-Troubi-Gaz (Nosta Pipes and Gas)	Novotroitsk, Orenburg oblast, 3.01.95	6	59,100	*Moscow* AKB Incombank *Novotroitsk* AKB Nosta
Vostochno-Sibirskaya Grouppa	Irkutsk, 3.23.95	26	107,800	*Irkutsk* AO Finansovo-Promyshlennaya Companiya (Financial-Industrial Company); AO Vostochno-Sibirskii Commercheskii Bank

Number of enterprises by industry	*Activities by industry*
10: defense 1: construction 1: metallurgy 1: machine building 2: trade	Telecommunications equipment, communications systems, medical equipment, equipment for fuel and energy complex and agroindustrial complex, construction materials
5: defense 4: chemical 3: electronics 2: cars 4: other	Equipment for auto building, fuel and energy complex, agroindustrial complex, construction industry, radio electronics, agro-products, home video equipment
5: precious metals	Gold ore concentrate, extraction and processing of precious metals and stones, jewelry manufacturing
14: chemical and oil-chemical 4: other	Chemicals, fertilizers, agriculture, machine-building, food and light industry, consumer goods
3: agriculture 2: electronics 2: construction 1: defense 2: pharmaceuticals 1: trade	Manufacturing of electronics products, electro-technical equipment, medicine and agro products, mini-plants processing consumer waste, construction industry
4: metallurgy 1: transport 3: other	Steel production and export, production and sale of products of nonferrous metallurgy, mining and production of tradable ferrous ore, production, processing, and sale of metal products
13: defense 1: other	Design, building, and export of speed ships and vessels; establishment of repair facilities and ship ownership companies abroad
10: construction 2: fish 1: forestry 1: trade 2: transport 1- light	Construction and repair of non-industrial objects, house construction, construction materials, leather consumer goods, fish products, transportation services
3: metallurgy	Production of different kinds of steel, steel pipes for oil and gas pipelines for Gazprom, consumer goods
4: mining 5: chemical and petrochemical 2: food 2: trade 1: defense 1: light 7: other	Development of oil and gas fields, generation of electro- and heat energy, chemical and petrochemical production, packing materials, consumer chemical products and consumer goods

Appendix 1. Financial-industrial groups registered in the Russian Federation, July 1996 (continued)

Group	City, registration date	Number of companies	Number of employees	Financial and credit institutions
Nizhegorodskie Avtomobili	Nizhny Novgorod, 4.04.95	40	241,200	*Nizhny Novgorod* AKB Avto-GAZ-Bank; AKB NBD; AO Rosgosstrah-Polis *Moscow* AKB Avtobank; MAB ASM-Clearing-Bank; joint stock insurance company Continent-Polis *Zhukovskii, Moscow oblast* TOO insurance company KALLISTO
Svyatogor	Chelyabinsk, 6.02.95	14	49,800	*Moscow* Bank Rossiiskii Credit; KB Avtobank; Investitsionno-Finansovaya Grouppa (Investment Financial Group)
Primorie	Vladivostok, 6.07.95	21	19,700	*Moscow* AIKB Promstroibank *Vladivostok* AKB Agroprombank; AKB Evrobank; TOO Insurance Company PrimASTRO-VAZ
Magnitogorsk Steel	Magnitogorsk, 6.07.95	27	264,000	*Moscow* AIKB Promstroibank; AKB Tveruniversalbank *Tolyatti* PK AvtoVAZbank *Magnitogorsk* TOO Insurance company SKM
Exsokhim	Moscow	22	54,800	*Moscow* Bank Menatep
AtomRudMet	Moscow, 7.14.95	13	90,500	*Moscow* Commercial bank Style-bank; Insurance company Trig
Volzhsko-Kamskaya (Volga-Kama)	Moscow, 7.27.95	3	231,000	AvtoVAZbank
Evrozoloto	Moscow, 8.11.95	7	3,000	*Moscow* AKB Impex-Bank; AOZT Mosexpo; AOZT Lymos-Invest; AOZT Centre-Uvelir; Moscow plant of special melts AO Chemical plant Voikova (AOOT Aurat)
Tulskii Promyshlennik (Tula Industrialist)	Tula, 8.30.95	18	39,000	KIBP Tulskii promyshlennik; AKB Evrocosmos; ASK Garant
Edinstvo (Unity)	Perm, 8.30.95	18	30,000	AKB YUVENTA; Industrial non-governmental pension fund Sozidanie
Doninvest	Rostov-on-Don, 8.30.95	6	10,000	KB Doninvest
TFIG Interros	Moscow, 9.01.95	24	306,000	*Moscow* AKB Mezhdunarodnaya Finansovaya Company; AKB ONEXIMbank; NPF Interros-Dostoinstvo; Interros Leasing Company; IB Renaissance Capital *St. Petersburg* Balt-Onexim bank

Number of enterprises by industry	*Activities by industry*
16: auto building 5: chemical and petrochemical 1: trade 1: other	Production of trucks and cars, diesel and petrol engines, refrigeration vans, rubber-technical goods, glass goods, and consumer goods
6: machine building 2: defense 2: other	Production of tractors, pipeline-placement equipment, equipment for oil exploration, geology research, drilling devices, construction equipment
12: construction 2: trade 1: agriculture 1- ferrous metallurgy	Industrial-civil construction, manufacturing of construction structures, goods, and materials, housing and social/cultural construction, irrigation, ore mining, wood processing, agroprocessing
7: metallurgy 3: construction 2: auto-building 3: other	Steel production, manufacturing of metal products and pipes, mining of ferrous ore, preparation and processing of scrap, construction works, production of cars, metallurgical, drilling, and excavation equipment
	Manufacturing and sale of chemical materials and consumer goods
2: nuclear energy 2: metallurgy 1: defense 1: ore mining 1- energy machine-building 3: other	Production of electro-energy, mining of metal ore, metallurgical production, construction materials, steel pipes, heat-energy equipment
2: auto-building	Car and truck manufacturing, car distribution and sales
1: chemical 2- defense 2: trade 2: other	Processing of mineral and secondary resources and scrap that contains precious metals, precious metals and jewelry production
8: machine building and metallurgy 2: food 2 -construction 3: other	Ferroalloys production and exports, machine building, agriculture, local trading companies
2: machine building 10: food 3: trade	Equipment for fuel-energy and agro-industrial complex, production and processing of agro-products and consumer goods
2: defense 1: machine building 1: metallurgy	Production of cars, agro-machinery, defense production
3: metallurgy 2: transport 10: trade 2: chemical 4: other	Production and export of nickel, aluminium, copper, steel, chemical fertilizers, food and other products, nuclear fuels, railways, optics, shipping

Appendix 1. Financial-industrial groups registered in the Russian Federation, July 1996 (continued)

Group	*City, registration date*	*Number of companies*	*Number of employees*	*Financial and credit institutions*
Zhilitshe	Moscow, 9.08.95	13	21,600	*Moscow* AKB Kontakt; Fund for development of Middle-Russia region *Syktivkar* Republican fund for development of housing construction
Rossiiskii Aviatsionnii Consortium	Moscow, 10.12.95	8	71,400	*Moscow* Promstroibank of Russia
Prompribor	Moscow, 11.15.95	22	25,400	*Moscow* AKB Business
Metalloindustria	Voronezh, 11.24.95	13	206,700	*Moscow* KB Interbank
Soyuzagroprom	Voronezh, 11.24.95	40	24,800	*Voronezh* Voronezh regional branch of Agroprombank; AKB Voronezh; Voronezh bank of Sberbank of RF *Moscow* Joint-stock bank for development of agro-industries and processing industry Rospishinvest
Gormash-invest	St.Petersburg, 12.14.95	6	7,300	*Moscow* AKB Crossinvestbank; Rossiiskaya Finansovaya Corporatsia
TFIG Sibir Aluminium	Agreement signed July 1996	5		Zalogbank
Consortium Russian Textile				Doveritelnii and investment bank
Trehgornaya Manufactura				
TaNaKo (Transnational Aluminium Company)	September 1996	11		Bank Metalex

Note: KB: commercial bank; AO: joint stock company; AB: joint stock bank; APB: joint stock industrial bank; AKB: joint stock commercial bank; AOZT: joint stock closed-ended company; AK: joint stock company; TNK: transnational company; MAB: Moscow joint stock bank; TOO: limited liability partnership; AIKB: joint stock industrial commercial bank; PK: industrial bank; ASK: joint stock insurance company; KIBP: commercial industrial investment bank; IB: investment bank; NPF: National Pension Fund.

Source: Blishen 1995; *Economica I Zhizn (Economy and Life)*, December 1995; *Kommersant Daily*, 23 July 1996; *Kommersant Daily*, 20 July 1996.

Number of enterprises by industry	*Activities by industry*
4: construction 2: electronics 1: defense 1: chemical 2: other	Housing construction, manufacturing of industrial-technological products
4: defense 1: transport 2: other	Production and exploitation of aero-equipment
20: equipment	Design and manufacturing of equipment for industrial control and monitoring of technological processes
3: ore mining 2: metallurgy 4: energy 1: railroad 2: other	Mining of metal ore, nonferrous metallurgy, machine building, electro-energy, consumer goods, agro-products
33: food and meat/milk 3: other	Production, processing, purchasing, and supply of agro-products
2: metallurgy 2: other	Manufacturing of excavation equipment
4: metallurgy	Largest producer of aluminium in the world
2: textiles	Textiles
	Textiles
4: metallurgy 2: energy 1: railroad 1: property fund 2: other	Aluminium

Corporate Ownership and Corporate Governance in the Russian Federation

Joseph Blasi

This paper is based on two surveys of general directors and deputy general directors of large and medium-size privatized companies in the Russian Federation. The first survey was conducted in the fourth quarter of 1994 and the first and second quarters of 1995. Executives of 322 companies in forty-four of the federation's eighty-nine regions responded to this survey. The second survey was conducted in the fourth quarter of 1995. Executives of 185 companies in thirty of the eighty-nine regions responded to this survey. The conclusions in this paper draw primarily on the findings of the second survey. Data from this survey are labeled "1995Q4." Data from the first survey are labeled "1995Q1."

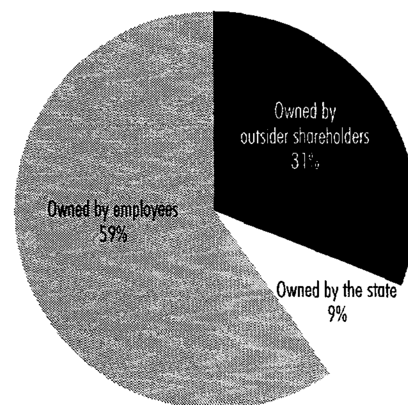
All the surveys were conducted in person by a Russian research team from Rutgers University hosted by the Russian Federal Commission on the Capital Market. The samples in both surveys are representative in that the distribution of employment across industry groups in both samples approximates the distribution of employment across industry groups throughout the Russian economy. In the first survey companies had an average of 1,966 employees, and half the firms employed more than 961 employees. In the second survey companies had an average of 2,444 employees, and half the firms had more than 958 employees.

The survey results illustrate the development of ownership patterns in Russia's medium-size and large companies. It should be noted, however, that the fifty largest Russian companies—those that are most actively traded in the Russian capital market—probably differ systematically from the larger sample described in this paper. For example, they tend to have less employee ownership and a larger share of state ownership. The accuracy of these data, like all survey data, depends on the answers provided by respondents. It is possible that some results may be distorted by systematically inaccurate answers from respondents.

Ownership of Corporate Stock

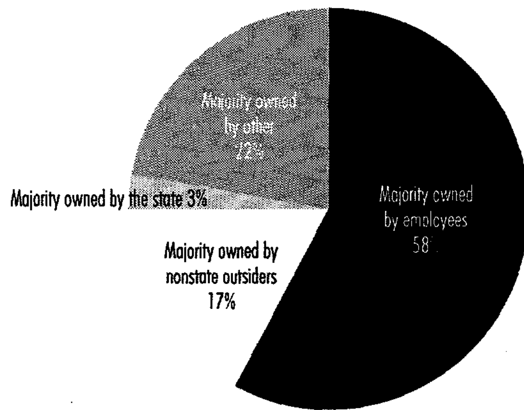
The study found that most Russian companies are largely owned by insiders, with the largest stakes held by company employees—that is, workers and managers (figure 1). However, employees are often passive shareholders who do not participate in corporate decisionmaking. Ownership by managers—especially top managers—is increasing and has reached a high level in some companies (figures 2 and 3).

Figure 1. Ownership of Russian companies, 1995Q4
(average percentage of outstanding stock)



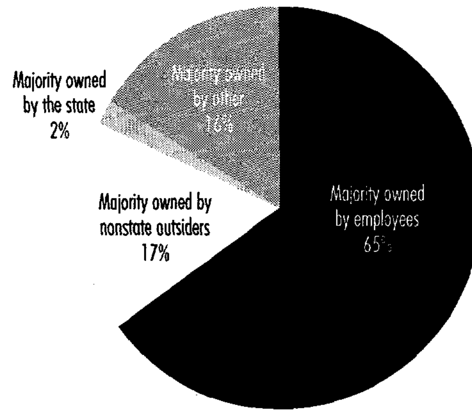
Note: Percentages do not add to 100% because of rounding.
Source: Rutgers University.

Figure 2. Majority ownership of Russian companies, 1995Q1
(percentage of companies)



Source: Rutgers University.

Figure 3. Majority ownership of Russian companies, 1995Q4
(percentage of companies)



Source: Rutgers University.

Outsider ownership has increased since the end of voucher privatization, but seems to have leveled off over the past year.

Insider ownership

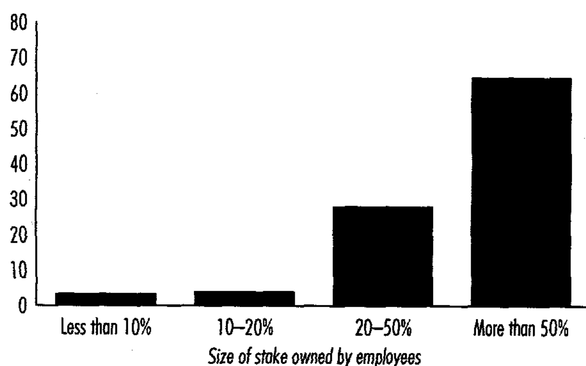
Employees owned 59.2 percent of the outstanding stock of the companies surveyed. Few companies have no significant employee ownership. Although the first survey found that the number of companies with majority employee ownership declined by about one-third between the end of 1993 and the end of 1994, this downward trend has stabilized and probably reversed itself in 1995.

In most cases the managers reported that rank-and-file workers, rather than managers, own the largest stakes in Russian companies. At the end of 1995, 65 percent of the companies surveyed were majority owned by employees—61 percent by rank-and-file employees, 2 percent by managers, and 1 percent each by top managers and the general director (figures 4 and 5). Employee ownership is highest in the consumer cyclicals (67.7 percent) and consumer noncyclicals (62.8 percent) sectors.[1]

However, workers are exerting little if any influence on company management. This is due partly to a lack of representation. In most Russian companies rank-and-file workers, despite their large holdings, have no representatives on the boards of directors. The survey suggests that few workers and their trade unions are interested in corporate governance, and many do not even monitor their shareholdings.

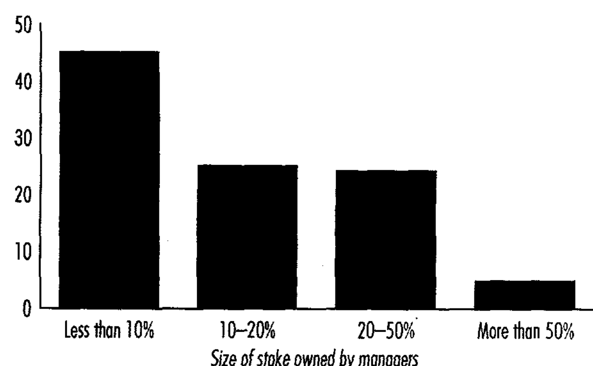
Ownership of Russian companies is becoming increasingly concentrated in the hands of management, especially top company executives.[2] Company managers, including top executives and lower-level managers, reported that they own 17 percent of their company's stock, on average.[3] Although managers hold less than a 12 percent stake in almost half the companies surveyed, they own more than 50 percent in one of every twenty companies.

Figure 4. Ownership of Russian companies by employees, 1995Q4
(percentage of companies)



Source: Rutgers University.

Figure 5. Ownership of Russian companies by managers, 1995Q4
(percentage of companies)



Source: Rutgers University.

Management ownership is especially concentrated among top company executives. Few companies were found to be majority owned by top management, however. In the typical company, seven to eleven top executives own about 10 percent of the company's stock.

In addition, the survey found that a few individuals, usually top executives, own large stakes in some companies. In one of every five companies a single employee owns more than 5 percent of the outstanding stock. In 86 percent of these cases this employee is a top manager, typically owning a 12 percent stake.

Average management ownership was highest in consumer noncyclicals (24.8 percent) and consumer cyclicals (18.9 percent). Management ownership in industrial and technological companies was only 13.5 percent on average, and in utilities, 11.8 percent. This pattern disappears, however, in the case of top management. Ownership by top management is very similar, on average, across these four sectors (10.8 percent in noncyclicals, 11.3 percent in cyclicals, 10.0 percent in industrial and technological companies, and 6.4 percent in utilities).

The increasing concentration of stock in the hands of management and top management is being achieved through several mechanisms. In many companies managers are one of the main groups buying stock from employees. In some cases company insiders have purchased shares through investment tenders or cash auctions. However, stock buybacks and dilutive share issues were also used to increase insider stakes at the expense of outsiders. These mechanisms are discussed in more detail below.

State ownership

The state no longer plays a significant role as a shareholder in most Russian companies. The average state-owned stake has decreased steadily since the beginning of the reform period. At the end of 1995 more than half of the companies surveyed reported having no state ownership. The average state-owned stake was 9.4 percent of outstanding stock.

However, the study also found that the pace of privatization slowed considerably over the past year. For example, 91 percent of the companies surveyed had not conducted an investment tender for shares since mid-1994, and 76 percent had not held a cash auction for their shares. Those companies that did conduct investment tenders or cash auctions generally sold off small amounts of shares (averaging 13.0 percent and 8.4 percent, respectively).

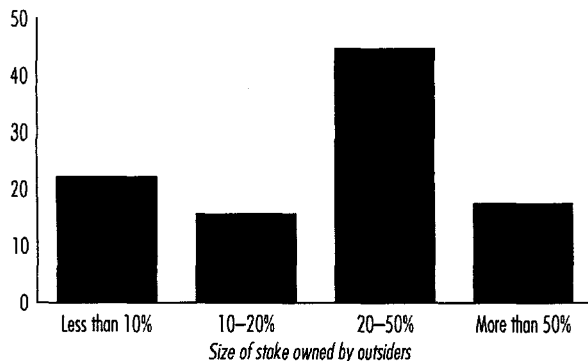
Outsider ownership

Outsider share ownership has grown since the end of voucher privatization, but this trend seems to have slowed dramatically over the past year and may even have reversed somewhat. The average stake held by outsiders in the companies surveyed increased from 22.0 percent at the end of 1993 to 31.2 percent at the end of 1995 (figures 6 and 7). This end-1995 figure is slightly less than the 32.2 percent that the survey found at the beginning of 1995. This difference may not be statistically significant, however. Furthermore, the portion of companies surveyed with no outsider share ownership increased from 8.0 percent at the beginning of 1995 to 10.5 percent at the end of 1995.

The pattern of outsider ownership is quite uneven, with outsiders heavily concentrated in a few companies. For example, at the end of 1995 Russian commercial firms held more than 10 percent of the outstanding stock of one of every three companies surveyed (figure 8). But in half of the companies

Figure 6. Ownership of Russian companies by outsiders, 1995Q4

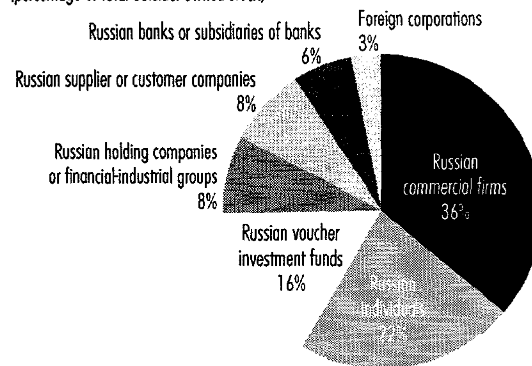
(percentage of companies)



Source: Rutgers University.

Figure 7. Outsider ownership by type of owner, 1995Q4

(percentage of total outsider-owned stock)

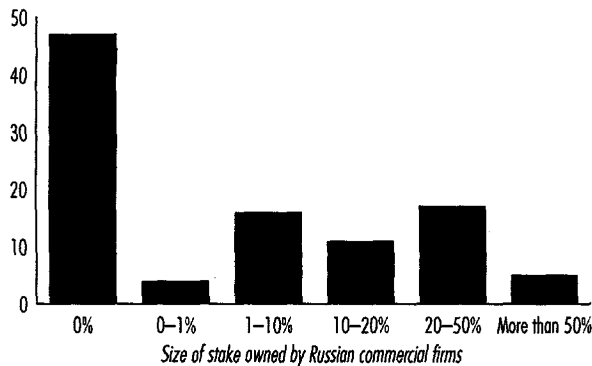


Note: Outsider-owned stock accounts for 31.2% of total outstanding stock. Percentages do not add to 100% because of rounding.

Source: Rutgers University.

Figure 8. Ownership of Russian companies by Russian commercial firms, 1995Q4

(percentage of companies)



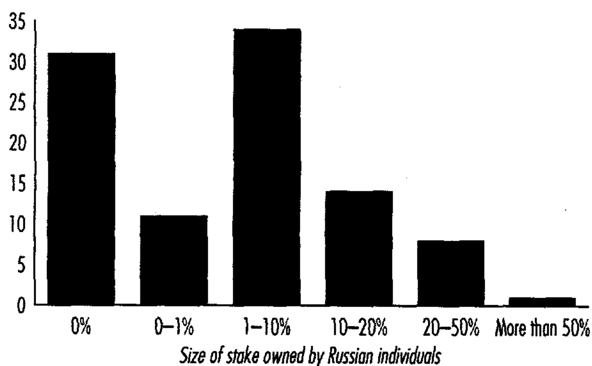
Source: Rutgers University.

surveyed, they hold less than 1 percent or no stock at all. Similarly, voucher funds hold 10–50 percent stakes in about 20 percent of the companies surveyed (figure 9). But in half of the companies surveyed, voucher investment funds have no holdings at all. The most substantial outsider shareholders are Russian commercial firms, Russian individuals, and Russian voucher investment funds. Individual Russian shareholders typically hold 1–10 percent in aggregate (figure 10).

Contrary to popular wisdom, Russian financial-industrial groups and Russian banks have a small average ownership in Russian companies. Financial-industrial groups own shares in only 11 percent of the companies surveyed (figure 11). This finding may be misleading, however, since the survey also found that financial-industrial groups and banks have concentrated large holdings in a small number of companies. Russian financial-industrial groups own more than 10 percent of 10 percent of Russian companies. They own more than 20

Figure 10. Ownership of Russian companies by Russian individuals, 1995Q4

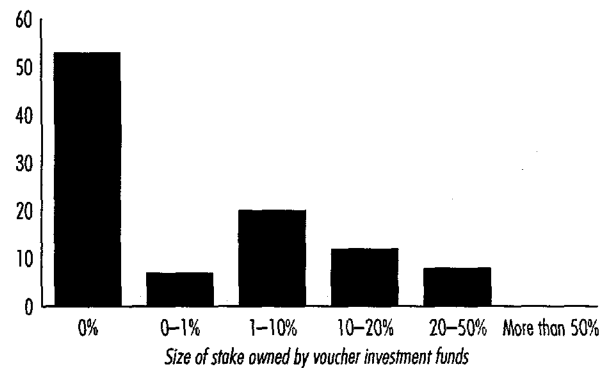
(percentage of companies)



Source: Rutgers University.

Figure 9. Ownership of Russian companies by voucher investment funds, 1995Q4

(percentage of companies)



Note: There are voucher funds that own majority stakes in Russian companies; however, none were found in this survey sample.
Source: Rutgers University.

percent of 5 percent of companies, and more than 47 percent of 1 percent of companies. Russian banks and their investment arms own more than 28 percent of 1 percent of companies, and more than 14 percent of 5 percent of companies (figure 12). The survey also suggests that share ownership by financial-industrial groups and banks is increasing.

Foreigners' holdings in Russian companies remain small. Foreign commercial firms hold an average of 0.87 percent of the outstanding stock of the companies surveyed (figure 13). However, some foreign commercial firms have significant holdings in some Russian companies. They own more than 34 percent of 1 percent of Russian companies. Foreign individuals hold an average of 0.03 percent (figure 14) and foreign financial institutions (such as investment funds) hold an average of 0.01 percent (figure 15).

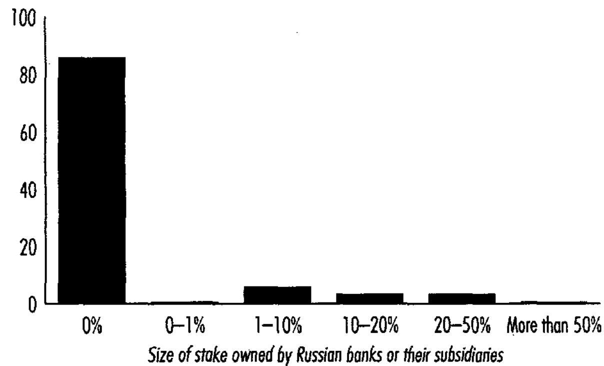
Figure 11. Ownership of Russian companies by Russian holding companies or financial-industrial groups, 1995Q4

(percentage of companies)

Source: Rutgers University.

Figure 12. Ownership of Russian companies by Russian banks or subsidiaries of banks, 1995Q4

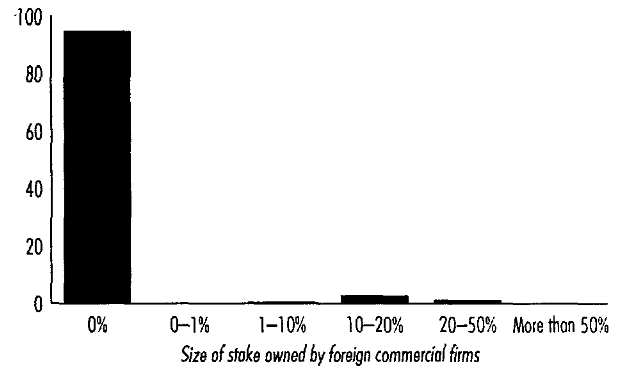
(percentage of companies)



Source: Rutgers University.

Figure 13. Ownership of Russian companies by foreign commercial firms, 1995Q4

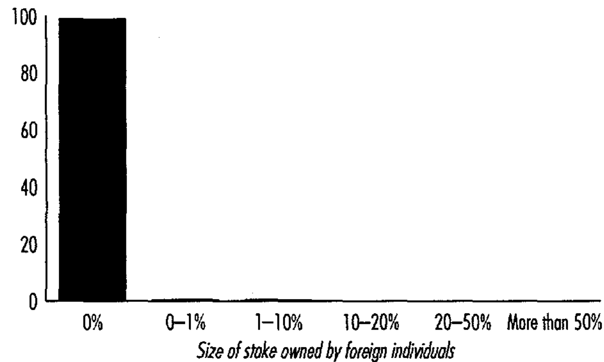
(percentage of companies)



Source: Rutgers University.

Figure 14. Ownership of Russian companies by foreign individuals, 1995Q4

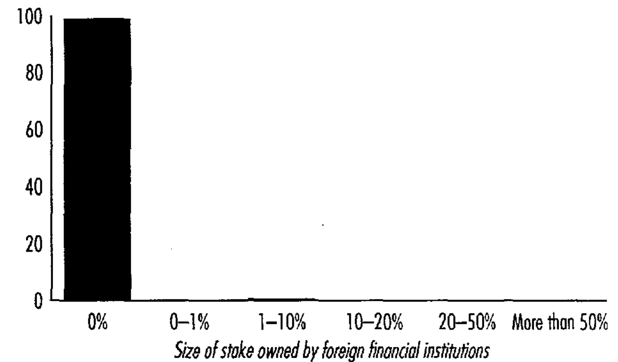
(percentage of companies)



Source: Rutgers University.

Figure 15. Ownership of Russian companies by foreign financial institutions, 1995Q4

(percentage of companies)



Note: Of the companies that answered this question, only one reported having a foreign financial institution among its shareholders.

Source: Rutgers University.

There is no evidence that foreign banks, pension funds, and individuals have significant holdings in even a small group of Russian companies. Their average ownership is very small, and the survey did not find any meaningful concentrated holdings. While there may be some such cases that were not included in the survey sample, the influence of these investors is quite small.

Ownership by concentrated outsider shareholders

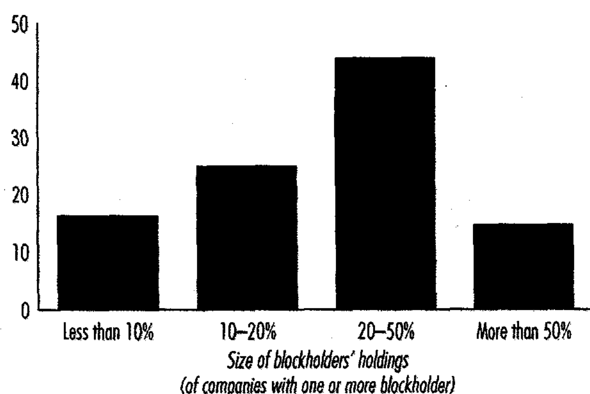
Increasing numbers of outsider shareholders with substantial holdings are appearing in Russia. This study focused on blockholders, defined as shareholders owning at least 5 percent of a company's outstanding stock. Among the companies surveyed, 71 percent have at least one outsider blockholder, who typically owns 15 percent of a company's stock (figure 16). About 39 percent of companies have more than one blockholder. About 11 percent are majority owned by one or more blockholders.

Most blockholders are Russian commercial firms, followed by voucher investment funds. The largest private blockholder stakes are held by Russian commercial firms and Russian holding companies or financial-industrial groups (figure 17). The state also holds a large average stake (24 percent), but because the state constitutes only 1 percent of all blockholders, this phenomenon is relatively insignificant. Only 3 percent of blockholders are foreign entities, who hold an average stake of 15 percent.

Shareholder Rights and Corporate Governance

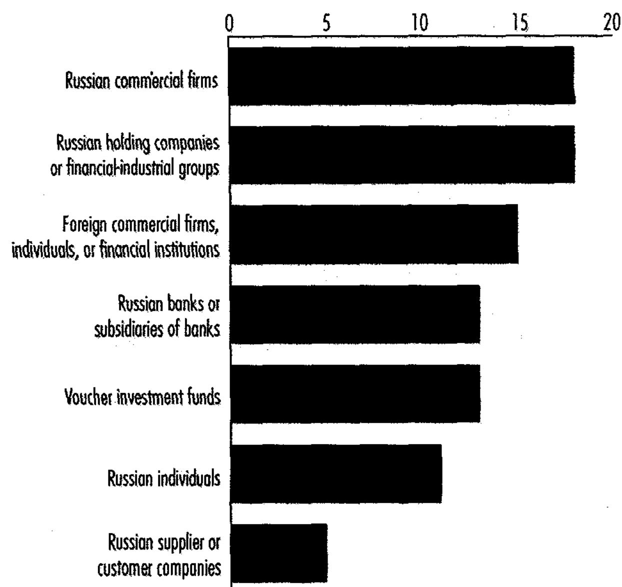
At the end of 1993 the president of the Russian Federation issued a decree on shareholder rights mandating that all elections for boards of directors use cumulative voting. The Russian government has continued to support cumulative voting as a

Figure 16. Blockholder ownership of Russian companies, 1995Q4
(percentage of companies)



Source: Rutgers University.

Figure 17. Private blockholder ownership by type of blockholder
(size of stake)



Source: Rutgers University.

way to enhance the influence of minority shareholders. In January 1996 the Federal Law on Joint Stock Companies went into effect. This law requires all companies with more than 1,000 shareholders to use cumulative voting. The following discussion reviews practices in these areas as of the end of 1995.

Board representation and cumulative voting

The study found that outsider shareholders have been gradually added to boards of directors since the spring of 1994. At the end of 1995, 75 percent of companies surveyed had at least one outsider director, up from 40 percent in 1993. Outsiders currently occupy 31 percent of board seats among the companies surveyed, up from 14 percent in the first quarter of 1995. Outsiders have a clear majority of board seats in one of every four companies surveyed. This is partly a consequence of cumulative voting, use of which has increased since 1994 (figure 18).

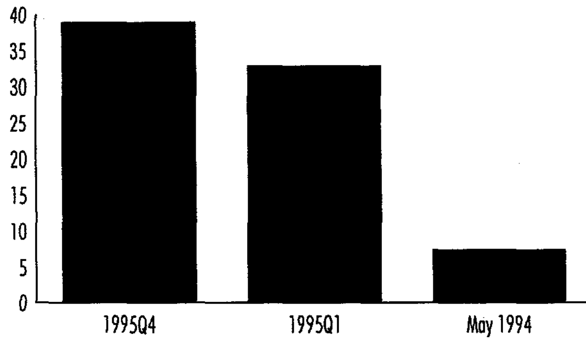
Despite gains for outsiders on company boards, the study found that outsiders, especially diffuse outsiders, remain underrepresented. To test this, the percentage of stock held by outsider shareholders was compared with the percentage of board seats occupied by outsider representatives in each company surveyed (figure 19). Overall, only about 1 percent of nonstate outsider stock ownership is not reflected in board representation. But representation is much poorer in some companies. In one of every four companies, 13 percent or more of stock ownership by outsider shareholders is not represented on the company board of directors. In one of every ten companies, a huge amount—25 percent or more—of outsider stock ownership is not represented. Furthermore, companies with board underrepresentation tend to be companies with relatively high outsider ownership.

The presence of a blockholder outsider shareholder significantly increases the chances of achieving strong outsider representation on a board of directors. In companies without blockholders, 11 percent of board members are outsiders on average. But in companies with blockholders this figure is 39 percent. Regression analysis shows that a 1 percent increase in blockholder ownership is associated with a 0.70 percentage point increase in the percentage of board members who are outsiders. This correlation is highly statistically significant and is independent of company size, sales volume, or industry group.

Still, the study found that some outsider blockholders face barriers to achieving board representation. Outsider blockholders are achieving a disproportionately high level of board representation—averaging 8 percentage points higher than their equity stake. But in many companies blockholder representation is still inadequate. In one of every ten companies surveyed, blockholders have achieved about 20 percent less board representation than their equity stake would suggest.

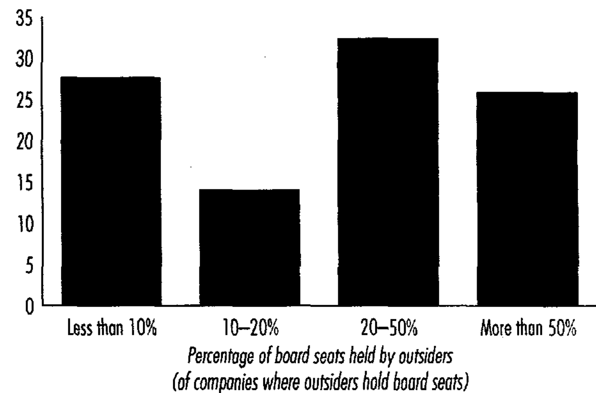
Furthermore, not all blockholders have equal rights in the area of corporate governance. Blockholders that are Russian commercial firms, Russian supplier or customer companies, or Russian financial-industrial groups or holding companies are the most successful at gaining board seats (table 1). Russian individual investors and foreign investors are the least successful.

Figure 18. Companies using cumulative voting to elect boards of directors
(percentage of companies)



Source: Rutgers University.

Figure 19. Outsider representation on boards of directors, 1995Q4
(percentage of companies)



Source: Rutgers University.

Table 1. Blockholder ownership and board seats
(percent)

Type of blockholder	Average stock ownership	Share of blockholders with no board seats
State-owned companies	24	25
Russian commercial firms	18	17
Russian holding companies or financial-industrial groups	18	19
Foreign commercial firms, individuals, and financial institutions	15	50
Russian voucher investment funds	13	27
Russian banks or subsidiaries of banks	13	26
Russian individuals	11	55
Russian supplier or customer companies	5	18

Source: Rutgers University.

As a result of inadequate board representation, many outsider shareholders are unable to exert much influence over corporate decisionmaking. The typical board of directors of a Russian company is composed of four managers, two representatives of outsider shareholders, and one representative of state-owned shares. Since a quorum usually requires five votes, most corporate boards can still transact business without the presence or support of the outsider board members.

Furthermore, some of the outsiders sitting on company boards are not "real" outsider representatives. Most of the company managers who responded to the survey reported that outsider board members were unknown to them personally before joining the board. But the survey also found that in 1995 about one-third of outsider directors were added as a result of private negotiations with company management. This raises doubts about the stability of even the current level of outsider board representation. It is possible that, under different circumstances, managers and shareholders would no longer be willing to accept the agreed allocation of seats. In other words, some of the outsider representation that exists in Russia today is secured by private arrangements rather than by formal legal procedures such as cumulative voting.

Share purchases, share buybacks, and dilutive share issues

As noted above, company managers are using a variety of mechanisms to increase their control over companies. Some managers and employees have bought shares at cash auctions or investment tenders. But a more common practice is buying shares from workers. The survey found that Russian workers sold 6.2 percent of their equity holdings in 1995. In 10 percent of companies the enterprise managers report that employees sold 20 percent or more of their shares, in 5 percent employees sold 30 percent or more of their shares, and in 1 percent employees sold 41 percent or more of their shares. Top managers were the main buyers of these shares. The survey found evidence that this trend continued into 1996.

Managers have also increased insider holdings (and perhaps their own holdings) through stock buybacks. Of the companies surveyed, 41 percent reported doing stock buybacks in 1995. Almost two-thirds of these companies (62 percent) reported that the shares were resold to managers and employees.

Dilutive share issues are another mechanism that is increasing insider control. Seventeen percent of companies surveyed reported issuing new shares in 1995, and about one-third of these reported that the share issues diluted outsider shareholders. In most cases this was accomplished by giving the new shares for free or for a nominal price to insiders. Fifteen percent of the companies surveyed reported that they plan to issue new shares in 1996–97.

Information disclosure

A large portion of Russian company directors are failing to comply with their obligations to disclose information to shareholders. Of the general directors surveyed, most oppose disclosure of financial information and ownership information (table 2). More than one-third oppose disclosure of general business information, including information about their product lines. Clearly, this widespread reluctance to release information also undermines shareholder efforts to participate meaningfully in company management.

Conclusion: Corporate Governance Ratings

All the companies surveyed were assigned a corporate governance rating. This rating is based on an evaluation of the company's performance in several areas (all factors were equally weighted):

- Percentage of outsiders on the board of directors.
- Proportion of outsider or blockholder stock ownership reflected in board seats.
- Use of cumulative voting to elect boards of directors.
- Use of secret voting in electing boards of directors.
- Use of dilutive stock buybacks or new share issues to increase insider control.
- Use of independent shareholder registrars.

About one in ten companies received the lowest possible rating, indicating that in 1994–95 they systematically engaged in poor corporate governance practices (table 3). Half of the companies received a poor rating, indicating that they participated in half as many poor practices as those with a very poor rating. Thirty-nine percent of the companies received a good rating, meaning that they generally engaged in positive corporate governance practices. But these companies also engaged in some bad practices—just one of which might be enough to deter investors. None of the companies surveyed received an excellent rating, which would have indicated a perfect record on these issues.

In summary, outsider ownership of Russian companies has increased since privatization, and some companies are improving their corporate governance practices. The use of cumulative voting, in particular, has become more widespread. But insiders, especially company managers, are still attempting to retain and strengthen their control over companies. To the extent that outsider ownership is no longer increasing while management ownership is rising, managers seem to be succeeding.

Insiders in many companies have prevented outsider shareholders—especially diffuse outsiders—from achieving board representation proportional to their holdings. Furthermore, poor corporate governance practices, including practices that violate shareholder rights under Russian law, remain common. Many companies systematically engage in a number of such practices. These practices unquestionably have a damaging effect on both domestic and foreign investment.

Table 2. Views of company executives toward information disclosure

View	Share of company executives (percent)
Opposed to the disclosure of financial information	68
Opposed to the disclosure of ownership information	57
Opposed to the disclosure of general business information	37

Source: Rutgers University.

Table 3. Corporate governance ratings

Rating	Share of companies (percent)
Excellent	0
Good	39
Poor	49
Very poor	11

Source: Rutgers University.

Notes

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1. It is difficult to draw firm conclusions about patterns of ownership across sectors. Although the distribution of companies in the second survey reflects the distribution of employment across Russian industrial sectors, this means that some sectors are represented by only a few companies. Of the companies surveyed, there were 75 in industry and technology, 58 in consumer cyclicals, 28 in consumer noncyclicals, 13 in utilities, 10 in basic materials, and 1 in energy, for a total of 185 companies. Thus although sector comparisons are provided in this paper, they should be treated with caution.

Dow Jones industry groups sectors were used. Consumer cyclicals are consumer industries that respond to economic cycles, such as advertising, airlines, apparel, and home construction. Consumer noncyclicals

are consumer industries that do not respond to economic cycles, such as food and beverages, consumer services, health care products, and household products.

2. For the purposes of this study, management refers to all the managers in a company, including the general director and deputies of the general director. Top management refers only to the general director and deputies of the general director.

3. Some managers informally told our researchers that they were reporting as rank-and-file employee ownership and as outsider ownership some ownership that is actually in the hands of management.

Part 6

Country Studies

A Taxonomy of Mass Privatization

Saul Estrin and Robert Stone

The concept of mass privatization has been popularized by the dramatic economic transformation taking place in Central and Eastern Europe. Conceived early in the reform process by two Polish academics, Janusz Lewandowski and Jan Szomburg, there were also references to mass privatization in the earliest Western academic work on the microeconomics of reform (Blanchard and others 1991; Lipton and Sachs 1990; and Estrin 1991). By 1992 the first program was being undertaken in Czechoslovakia, and by 1996 almost every transition economy had either introduced such a program or was considering doing so.

Mass privatization was invented to solve a problem specific to transition: how to quickly privatize a large number of firms in a situation where few potential buyers had enough funds to purchase company shares, where capital markets were so underdeveloped that potential buyers could not expect to borrow such funds, and where valuation of companies was extremely difficult. Mass privatization injects sufficient liquidity into the system to transfer ownership from the state to private individuals, while limiting the inflationary impact by ensuring that the credits cannot be used to finance consumption directly.

In designing such schemes, the authorities needed to consider how and to whom these transfers would take place, as well as how the credits should be used to purchase enterprise ownership rights. A further question concerns the nature of the capital markets created by voucher privatization, particularly the potential for outsider involvement and for the evolution of the ownership structure as the needs of firms change (Aghion, Blanchard, and Burgess 1994; Estrin 1994; and Aghion and Blanchard 1996).

The literature already contains a number of studies describing mass privatization in various countries (Frydman, Rapaczynski, and Earle 1993; Boycko, Shleifer, and Vishny 1995; and Estrin 1994) and evaluating alternative forms of ownership (Aghion and Blanchard 1996; McMillan 1996; and World Bank 1996). But these studies tend to concentrate on the early mass privatizations, do not adequately reflect the variety of country experiences, and do not focus on the differences between alternative approaches. We seek to fill this gap by offering a taxonomy of mass privatization. This paper is not intended to analyze the effects of different privatization methods. Rather, we identify the key elements of mass privatization programs and categorize schemes according to the decisions made about those elements. We also speculate about the ways that different mass privatization methods might affect ownership structures and the development of capital markets.

Key Elements of Mass Privatization

Mass privatization schemes are complex and difficult to compare. The focus here is on the legal structure and mechanics of privatization. Six common elements are used to define the fundamental characteristics of each scheme (table 1). The initial question must be whether a country has introduced or is about to introduce mass privatization. If not, it is not included in table 1. Hungary is the most conspicuous absence; other countries without schemes include Azerbaijan, Croatia, Macedonia, Serbia, Turkmenistan, and Uzbekistan, though some of these countries are considering such schemes.

Table 1. Mass privatization programs in transition economies

Country	Year voucher distribution began	Are shares issued in waves or continuously?	Are vouchers bearer, tradable, or nontradable?	Is investment in funds allowed, encouraged, or compulsory?	Is fund management independent or self-managed?
Albania	1995	Continuously	Bearer	Encouraged[a]	Independent
Armenia	1994	Continuously	Bearer	Allowed[b]	Independent
Belarus	1995	Continuously	Bearer	Encouraged[c]	Self-managed
Bulgaria	1995	Waves	Nontradable	Encouraged	Self-managed
Czech Republic	1992	Waves	Nontradable	Encouraged	Independent
Estonia	1993	Continuously	Tradable[d]	Allowed[e]	Independent
Georgia	1995	Continuously	Tradable	Allowed[b]	Self-managed
Kazakhstan	1994	Waves	Nontradable	Compulsory	Independent
Kyrgyz Republic	1994	Continuously	Bearer	Allowed[f]	Independent
Latvia	1994	Continuously	Tradable	Allowed[e]	
Lithuania	1993	Continuously	Nontradable	Allowed[e]	Independent
Moldova	1994	Waves[g]	Nontradable	Encouraged	Independent
Poland	1995	Waves	Nontradable	Compulsory	Independent
Romania[h]	1992	Waves	Nontradable	Compulsory[i]	Self-managed
Romania	1995	Waves	Nontradable[j]	Encouraged	To be determined
Russia	1992	Continuously	Bearer	Encouraged	Self-managed
Slovak Republic	1992	Waves	Nontradable	Encouraged	Self-managed
Slovenia	1994	Continuously	Nontradable	Allowed	Independent
Ukraine	1995	Continuously	Nontradable	Allowed	Self-managed

a. By July 1996 only one or two funds had applied to receive vouchers.
b. Although a legal entitlement exists to invest vouchers in funds, in practice this option was limited.
c. The results of the first voucher auction were canceled in March 1995, and fund licenses were suspended from then until August 1996.
d. *Vouchers were nontradable at the outset of the program, but cash trading was legalized in the spring of 1994.*
e. Citizens could also exchange vouchers for other things such as apartments or land.
f. Citizens could invest their vouchers in housing as well as shares. They can sell their vouchers to funds, but no formal mechanism exists for them to subscribe to funds.
g. *Although the design of the Moldovan program was based on the offer of companies in waves, the waves were small in the early stages and thus had many of the characteristics of a continuous issue.*
h. In 1991 Romania introduced a scheme based on the distribution of certificates of ownership in five private ownership funds. In 1995 a supplementary mass privatization program was introduced involving the distribution of coupons that could be exchanged for company shares or fund shares, after which the funds are to be transformed into financial investment companies.
i. Under certain circumstances certificates of ownership in funds could be exchanged for company shares.
j. Certificates of ownership were bearer, coupons were registered and nontradable.

Designers of mass privatization schemes must make three main decisions:

- In what form should vouchers to be issued?[1]
- Once enough vouchers are in private hands, how should firms be sold?
- What kind of capital market institutions, if any, should be built into the process?

A supplementary question concerns the independence of privatization investment funds, if these are created. Designers also face a number of other issues, but these are the most significant in defining a program.

The issuance of vouchers raises two separate issues: whether they are bearer or registered and whether they are tradable. Bearer vouchers are always tradable; registered vouchers may or may not be. Countries have taken very different approaches to this issue (see table 1).

Turning to the supply side of the newly formed market in enterprise ownership rights, shares in firms could be brought to the market either continuously—that is, as and when enterprises and the privatization bureaucracy were ready—or in waves. Waves usually involve the simultaneous offer of 25 percent or more of the companies eligible for privatization. This approach allows buyers to compare alternative options directly but is administratively much more demanding. Most mass-privatizing countries sold shares continuously, but some of the best-known schemes used the wave approach.

Mass privatization transfers ownership rights but leaves the character of future capital markets open. In some schemes, however, capital market intermediaries—privatization investment funds—are an integral part of the program. We categorized mass privatization according to whether these funds are merely allowed, actively encouraged, or central to the process. Early schemes tended to encourage funds, while many later schemes merely allowed them (funds could also be set up by the government, as in Poland). Funds were always closed ended (except perhaps in Romania in 1995) and the shares were registered (except in Romania in 1992, where fund shares were bearer). Finally, fund management could be either independent (in separate management companies) or self-managed. Most transition economies have chosen the independent approach.

The significant variations identified in table 1—in terms of both the demand side and supply side of the voucher market and the capital market institutions being developed—follow no geographical or time pattern. This finding suggests that there are several competing models of mass privatization, identified below.

Models of Mass Privatization

A suggested taxonomy of mass privatization is shown in table 2. The Russian and Armenian models differ only in whether funds are encouraged or merely allowed—not a significant difference. The Polish model is distinguished by the fact that citizens received participations, or entitlements to shares, in funds rather than in commercial companies. The three models from the Commonwealth of Independent States and the Baltics differ from the two models from Central Europe primarily in their use of continuous sales rather than waves of shares. There were also differences in funds' holding limits in a single company, from a minimum of 33 percent in Poland to a maximum of 20 percent in the Czech scheme.

More recent mass privatization in the Balkans as well as in Kazakhstan have opted for the Central European approach. The Lithuanian model, with nontradable vouchers, merely allowing funds, and continuous sales of shares, has attracted imitators not only in the other Baltic states but also in Slovenia and Ukraine.

Applying the Taxonomy

Taxonomies are particularly useful when they generate empirically valid categories. This section considers whether our classification yields insights into two issues: the ownership structures generated by mass privatization and the effects of mass privatization on capital market development.

Economic theory ascribes great significance to the role of outsiders in corporate governance, particularly in transition economies (Aoki and Kim 1995 and Aghion and Blanchard 1996). The evidence suggests that in many transition economies privatization has led predominantly to insider control (Earle and Estrin 1996). Do the models that we have defined also imply differences in ownership structures?

Evidence indicates that the combination of features in the Czech-Slovak and Polish mass privatization models result in greater outsider ownership (World Bank 1996 and EBRD 1995). These features include wide distributions to the public, nontradable shares, and perhaps the role of privatization waves in helping to disperse ownership. But the most important feature is the central role played by funds, which were compulsory in Poland and, though only encouraged in the Czech Republic and Slovakia, given potency by the effective advertising spearheaded by Harvard Capital and Consulting. It remains to be seen whether outsiders will play a significant role in more recent applications of the Czech-Slovak and Polish models—in Bulgaria, Kazakhstan, Moldova, and Romania.

Despite the strong role ascribed to funds, mass privatization resulted in insider ownership of most Russian firms (Commander, Fan, and Schaffer 1996). According to Boycko, Shleifer, and Vishny (1995), however, the Russian scheme has put in place fundamentals of private ownership that will allow adjustment to outsider control as capital markets develop. Insider control developed from the discounts offered to employees in obtaining bearer vouchers and the continuous privatization process—common features of most mass privatization programs. If anything, the Armenian program seems even more likely to favor insiders. The Lithuanian model relies on nontradable vouchers and grants fewer discounts to insiders during the auction process. However, some countries adopting the Lithuanian model—especially Lithuania and Slovenia—allowed insiders to acquire shares on favorable

Table 2. Models of mass privatization

	Russian	Armenian	Lithuanian	Czech-Slovak	Polish
Characteristics	Shares issued continuously, bearer vouchers, funds encouraged	Shares issued continuously, bearer vouchers, funds allowed	Shares issued continuously, nontradable vouchers, funds allowed	Shares issued in waves, nontradable vouchers, funds encouraged	Shares issued in waves, nontradable vouchers, funds compulsory
Other countries following this model	Belarus	Georgia[a] Kyrgyz Republic	Estonia[b] Latvia[b] Slovenia Ukraine	Bulgaria Moldova Romania (1995)	Kazakhstan Romania (1992)[c]

a. It is not clear whether vouchers are bearer or registered.
b. Vouchers were tradable for all or part of their period of validity.
c. Certificates of ownership in the funds were distributed in one wave, but the exchange of the certificates for company shares was undertaken on a continuous basis.

terms through other mechanisms, so the effects on ownership distribution in this model are less clear. In any case, all three models establish a larger initial role for insiders than in the Czech-Slovak and Polish models.

In terms of capital market development, one expects countries that use registered and tradable vouchers and that (at a minimum) encourage funds to see the deepest capital market growth. Again, the Czech-Slovak and Polish models have clear advantages in this regard. By contrast, the Lithuanian model does not encourage funds, and the Russian model does not have registered vouchers. One should expect the least capital market development under the Armenian model, which neither encourages funds nor has registered vouchers. Although the evidence is spotty, capital market developments appear to be following this ranking, at least in terms of market depth (EBRD 1995 and 1996).

Notes

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1. The term *voucher* refers to entitlements to ownership of former state property that are given away for free or for a nominal registration fee. These entitlements have a variety of names, including coupons, bonds, and certificates.

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Albania

Igor Artemiev and Gary J. Fine

Albania, the poorest country in Europe, remained centrally planned longer than other transition economies, many of which spent years and even decades experimenting with combinations of plan and market. The others showed that when less time and effort had been spent "perfecting" central planning, the transition to market could be more compressed—if a comprehensive policy framework was in place from the start. In many countries the long transition from central planning was prone to spontaneous privatization (that is, appropriation of state assets by managers) or the appearance of de facto owners of (usually small) public enterprises. In Albania these pernicious developments did not reach a scale comparable to that in other countries. Albanian privatization also benefited from rapid economic growth and financial stability (low price increases and a stable exchange rate).

The Law on Privatization, approved 10 August 1991, proclaimed certain key tenets of divestiture of state property and envisaged further regulatory support in the form of government decrees. The National Agency for Privatization was founded in accordance with this law as the central institution responsible for privatizing state property. The agency has developed rules that enable its offices to hold public auctions. The Law on Commercial Companies, adopted on 19 November 1992, together with the Law on Privatization, became the cornerstones for private sector development. The company law defines the types of legal entities that may be established.

The adoption of the mass privatization program by law on 22 May 1995 opened a new door in the transfer of ownership from the state to the private sector. The program, like mass privatizations in other countries, provided a framework for the achievement of a broadly based distribution of shares for many medium-size and large enterprises.

Early progress in privatization, 1991–94

Privatization was high on the agenda of the government from the beginning of Albanian reforms, and four institutions have played key roles in it.

- The Ministry of Finance had overall responsibility for designing, implementing, and funding the small-scale and mass privatization programs—and specific responsibility for preparing enterprises for privatization. Under the small-scale privatization program the ministry's offices in thirty-seven districts conducted property valuations and reviewed financial statements in cooperation with local authorities. Under the mass privatization (of medium-size and large enterprises) program the ministry was responsible for transforming enterprises into open joint-stock companies.
- The National Agency for Privatization, the government's sales agent, uses its regional network of offices to organize public auctions of assets and small enterprises. For mass privatization the agency developed a network of voucher bid collection points nationwide to enable citizens to bid for shares of enterprises participating in the program. Vouchers and executed subscription forms are forwarded from voucher bid collection points to Tirana, the capital, where they are processed and results of the bidding are determined.
- The Bank of Albania and the Savings Bank of Albania facilitated the development of demand for divested assets in

both small-scale and mass privatization. Special noncash payment instruments were introduced to enable eligible citizens to participate in the process. The Bank of Albania designed the voucher and privatization account schemes. The Savings Bank managed the establishment of privatization accounts and the distribution of vouchers among the eligible population.

Albania's early progress in privatization included the divestiture of agricultural land, small enterprises, and individual assets. An effort to restructure large enterprises to prepare them for privatization had mixed results; if the enterprises were liquidated, the remaining assets were sold separately. The effort to privatize large enterprises as going concerns had been largely unsuccessful until the mass privatization program was launched in 1995.

Small-scale privatization of shops, warehouses, and consumer service facilities and sales of movable assets were carried out rapidly during the initial stage of privatization through public auctions. Starting with the sale of inexpensive assets in large numbers—in 1991–92 the average value was $200—the trend shifted over the years to the privatization of fewer but more expensive units. In 1995 the average value reached $11,800. During 1991 more than 35,000 units were sold for a total of 7.8 billion leks.

Mass privatization, 1995–96

The government adopted the mass privatization program to privatize medium-size and large enterprises and achieve widespread public participation. To speed up reform, the program aimed to quickly create a critical mass of privately owned enterprises and foster the emergence of numerous shareholders. The program was coordinated by a special commission chaired by the deputy prime minister and minister of finance.

Supply side

The program envisaged transforming state enterprises into open joint-stock companies before privatizing them. The government limited the universe of enterprises to those demonstrating technical insolvency, regardless of their prospects in a transformed economy and with new management incentives. Starting with 800 medium-size and large enterprises, the privatization commission selected about 350 for transformation, with the balance supposedly earmarked for liquidation. A handful of the largest enterprises, generally involving infrastructure or natural resources, were considered most attractive for and most in need of investment by a strategic foreign investor. These were assigned for case-by-case privatization, although in most cases a small percentage of shares was reserved for public participation through auction.

Demand side

All adult Albanians (including those abroad) who did not participate in the privatization of agricultural land were allowed to receive vouchers exchangeable for shares. Vouchers were denominated in leks, and the value of each citizen's voucher was based on his or her age (table 1). Vouchers were to be issued in three tranches, the first tranche having been printed and distributed starting in June 1995. Because the number of enterprises to be included in mass privatization has been reduced, the government has decided to eliminate the third voucher tranche, distributing the remaining values with the second tranche.

Form of sale

Enterprise shares are sold at voucher auctions in exchange for either immaterial privatization leks (through a bank transfer from the bidder's privatization lek account) or through privatization vouchers, which are submitted at the time of bidding. (Cash is not accepted at this type of auction.) The voucher auction is open for thirty to forty-five days for bid collection. An announcement informing the public about the start of bid collection must be made at least thirty days in advance. Twenty to thirty enterprises are offered at each auction. All enterprises are sold nationally in thirty-seven districts, without the regional or local auctions that are common in small-scale privatization. Since October 1995 five voucher auctions have been completed, with shares in ninety-seven enterprises sold.

Voucher auctions are cleared pro rata—that is, all bidders receive shares of the company in proportion to the amount of privatization leks (from accounts or in vouchers) they invest. Simply put, the total number of shares offered is divided by the value of privatization leks bid, and a price per share is

Table 1. Age groups and voucher values
(face value in privatization leks)

Age group	Tranche 1	Tranche 2	Tranche 3	Total
18–35 years	10,000	20,000	20,000	50,000
36–55 years	15,000	30,000	30,000	75,000
More than 55 years	20,000	40,000	40,000	100,000

Source: National Agency for Privatization.

determined. The calculation determines the number of shares to be received for each privatization lek bid.

Because no fractional shares are awarded, a formula is used to reallocate fractions among the bidders. The pro rata system guarantees that every bidder receives at least one share of the enterprise he or she wants. If demand outstrips supply, so that each lek would receive less than one share, a share split takes place in which the number of shares offered is increased and the book value of each share is proportionally reduced, so that each bidder receives at least one share. Only nonpriced bids (that is, those in which the bidder has not limited the price he is willing to pay) are accepted, and no minimum clearing price is established.

Public information

Openness and transparency is important for successful mass privatization. Public education and wide dissemination of information on enterprises, vouchers, auction procedures, and results, as well as summary financial and operational data of enterprises, are an indispensable part of the program. Investors at Albania's voucher auctions, however, are given only minimal information on the enterprises offered. Information is generally limited to the name and location of the enterprise, size of the plot of land it sits on, and the share of the charter capital to be privatized. No financial data are offered. Despite encouragement from the World Bank and others to offer more information, the government has refused, citing concerns about releasing financial data that it considers to be of poor quality. Press conferences, interviews with privatization officials, and company documents have been used instead. Moreover, little has been spent on outfitting auction bidding centers, which are often located in hard-to-find places.

Financial intermediaries

To reduce investor risk and to offer an alternative investment vehicle—particularly vital given the difficulties of enterprise analysis in the absence of appropriate information—the privatization program envisaged the creation of closed-end investment funds. These would accept vouchers or privatization leks from citizens in exchange for shares in the funds, which would invest vouchers and privatization leks in a portfolio of enterprise shares offered at auction. An investment fund law was only recently adopted, and only one fund has been licensed. This slow progress may reflect the public's reluctance to turn its money over to intermediaries, as well as the government's hesitance in approving licenses.

Implementation Issues

Several issues have impeded effective implementation of the privatization program.

Restitution

Under Albanian restitution law the former owners of land on which an enterprise sits are entitled to compensation when the return of the land is not feasible. Potential forms of compensation include either shares in the enterprise located on the land (assuming it is an open joint-stock company), land elsewhere, or payment of a cash sum. The government's preference is to award shares in the enterprise located at the site. In the case of a voucher auction, where all available shares of an enterprise are supposed to be offered to the public, the number of shares to be awarded to the former landowner must first be determined and then subtracted from the amount to be offered to the public. This approach often delays auctions, given the difficulties in approving land claims, determining their value, and separating competing or overlapping claims on the same property. Complicating the process are the overlapping and often redundant responsibilities of the government entities involved.

The government's inability to determine the exact number of shares to be offered at auction has repeatedly delayed the calculation and public announcement of auction results. Furthermore, new shareholders have not been properly registered, raising the possibility of subsequent house sales not being properly recorded.

Notification of shareholdings

The government has not adopted a consistent, transparent method of notifying bidders of the price resulting from an auction and the number of shares they own as a result. Since shares are nonmaterial, once an auction is completed shareholders are expected to go to the enterprise to see that their name has been included in the shareholders register and to verify the number of shares they own. This requirement is difficult for shareholders living in other cities and is open to abuse.

Market price of vouchers

Although vouchers are denominated in leks, they bear little relationship to the value of the lek, trading on variables that are mostly unrelated to the national currency. Nevertheless, the voucher price is typically quoted as a percentage of its lek face value. For most of 1996 vouchers traded at only 11 percent of their face value—considerably less than at the end of 1995,

when they traded at 25–30 percent of their face value. As in most mass privatizations that use a tradable voucher, the price of the voucher typically reflects public confidence in the credibility of the program. Thus it is reasonable to assume that delays in announcing auction results and the recent hiatus in auctions are partly responsible for the drop in voucher prices.

Overhang of vouchers

Vouchers initially were to be made available to citizens in three or four tranches to smooth voucher investment over the life of the program. At the beginning of 1996 about one-third of privatization accounts and distributed vouchers had been invested. Unlike the privatization lek accounts, which do not have an expiration date, the first tranche of vouchers originally was deemed to be valid until 30 June 1996. The government later decided to have only two tranches of vouchers, both with the same expiration date.

Special benefits to enterprise employees

The distribution of vouchers in tranches gave rise to special bidding arrangements for employees of enterprises offered at auctions. In the belief that enterprise employees would be particularly interested in purchasing shares of their companies, they were given the opportunity to bid all their vouchers (those received plus those they would receive in the future) for these companies. Apart from the difficulty in processing applications for these shares (since they were accompanied by only a portion of the required privatization payment), there is good reason to believe that enterprises have a greater portion of their shares held by their employees than would otherwise have been the case.

Shrinking enterprise pipeline

It has become increasingly evident that privatization is facing considerable resistance from enterprise managers and local authorities. To maintain control, managers and local authorities would prefer to conduct privatization through direct sales, where they could exert more influence, possibly in a nontransparent way, on the selection of winning investors. They also have an interest in blocking the process entirely to preserve state ownership and, of course, protect their own positions. As a result the government has considered privatizing many more enterprises by simply liquidating them.

Results

Ninety-seven companies were auctioned in five rounds from October 1995 through July 1996. Given the complications that have arisen from the allocation of shares to former landowners, however, only the first two auctions have been completed. For the sixty-nine enterprises sold in the first three auctions, privatization payments of around 2.8 million leks were collected, roughly 2.3 million in vouchers and 500,000 in privatization lek accounts. These auctions resulted in more than half the enterprises having up to 200 shareholders—with one company having more than 700 shareholders, one other with more than 500, and ten others with more than 400.

The amount bid in the second auction increased relative to the book value of the enterprises offered. In the first auction about 768 million leks were bid for shares having a book value of roughly 2 billion leks, for a bid to capital ratio of almost 0.39. In the second auction the bid to capital ratio rose to 0.65, with about 1.2 billion leks bid for shares having a book value of roughly 1.9 billion leks. Food processing (eleven enterprises) and machine building and repair (eight enterprises) dominated the first three auctions, with printing and publishing (six enterprises) and construction-related companies (six enterprises) close behind. Well-known companies appear to be the most popular.

Despite recent disturbances relating to collapsed financial schemes, Albania has slowly moved forward with a modified auction scheme. Recognizing the lack of ownership concentration, with all or most shares having been sold to individuals through voucher auctions, the authorities have introduced a list of the first fifteen companies to be privatized using a combination of coupon and cash auctions. Cash auction shares are expected to be sold in a single share parcel to bidders who will take an active management role. An unusual feature of these sales is that vouchers can be used as currency at cash auctions at their face value, which is far higher than current voucher market prices.

Armenia

Melinda Roth-Alexandrowicz

Armenia's mass privatization, now under way, is expected to be substantially completed by early 1998. Unlike programs in other transition economies, Armenia's program has been implemented without massive amounts of donor assistance. The main lesson from Armenia's experience is that it is possible to achieve mass privatization in a simple, transparent, and popular way.

The Setting

After independence in September 1991, Armenia achieved early success with agricultural and small-scale privatization. It was the first newly independent state to privatize land following the dissolution of the collective farm system. By mid-1992 more than 300 small enterprises had been auctioned. This process stopped almost as quickly as it started, however, since the legal framework for privatization had not been fully developed.

As part of the conflict over Nagorno-Karabakh, Azerbaijan imposed a trade and transport blockade on Armenia, and the Turkish border was closed. Compounded with civil strife in neighboring Georgia, Armenia became isolated, and structural reforms took a backseat to managing an economy under siege. Thus, in addition to the usual problems inherited from central planning and the exigencies of transition, Armenian enterprises faced difficulties created by the blockade. Given the small domestic market (slightly more than 3 million people) and lack of natural resources, many enterprises simply stood idle, waiting for a resolution of the Karabakh problem while exploring alternative trade routes and new markets.

Yet despite these difficulties, the government initiated mass privatization. Some Armenians argued that mass privatization should wait until it was clear which enterprises would survive—the blockade created unfair hardships and would, hopefully, be lifted. Until the Caucasus became more stable, foreign investment was unlikely. And the many Armenians living outside of the country, obvious candidates to invest in the new economy, were providing only humanitarian support. Nevertheless, the government adopted the voucher concept developed in other countries to begin rapidly privatizing enterprises.

The state owned about 5,000 small enterprises and 2,000 medium-size and large enterprises, all of which, including infrastructure companies, were to be privatized. The most interesting feature of the Armenian case is not the quantity of privatizations but the quality of the process. The Armenian program is similar to others in the region: it uses vouchers as the main privatization currency, employees have some privileges in the process, and public auctions are held regularly to sell enterprises. But the auction method—specifically, valuation and pricing issues—make the Armenian program notably different. As detailed below, the program uses a pro rata approach, in which the number of shares received depends on the number of vouchers bid. By June 1997 about 4,500 small enterprises had been privatized and nearly 1,200 medium-size and large enterprises had been offered for sale.

Institutions

Two separate bodies, the Privatization Commission and the Privatization Board, originally supervised privatization in

Armenia, although the Ministry of Economy eventually assumed supervisory responsibility. The commission, created to deal with privatization strategy, comprised ten members appointed by Parliament and ten appointed by the president—a guaranteed way to politicize privatization. The board, created to deal with valuation and sale, reported to the minister of economy.

Divisions between the government, the commission, and the board led to delays and frequent stalemates. In March 1996 the commission lost its independence, was reorganized, and eventually was folded into the government. It currently functions as an advisory body, staffed with deputy ministers representing economy, finance, and line ministries. In November 1996 the Ministry of Privatization was established, and the Privatization Board was moved under it. This move helped centralize and facilitate decisionmaking.

Enterprise Sales and Voucher Distribution

All medium-size and large industrial enterprises were transformed into joint stock companies before privatization. Twenty percent of the shares of corporatized enterprises were given to employees free of charge. The law also gave employees the right to purchase 20 percent of the shares earmarked for the general public, or another 16 percent of total shares (20 percent of the remaining 80 percent). Employees could also participate freely in the sale of the remaining 64 percent.

Initially there was a debate over the use of cash in privatization. Some analysts believed that some shares should be bought only for cash. The government believed that the Privatization Law made cash and vouchers interchangeable. Cash could be used to purchase shares. But who would use cash when vouchers could be bought at a discount? In most countries vouchers traded below their face value. If shares were to be sold for cash only, it would require amending the law. The government believed that allowing cash and vouchers to be interchangeable would help support the market for vouchers. Moreover, it thought that citizens had the right to use their voucher to invest in any enterprise to be privatized. If shares were reserved for cash-only purchase, this right would be denied. The government eventually won, and the mass privatization program accepted vouchers or cash for all shares offered for sale.

Vouchers were materialized, tradable, and initially valued at 10,000 dram (about $25). All citizens were eligible for one voucher at the cost of one dram (a fraction of one cent). Distribution began in October 1994 and was carried out through the Savings Bank. The stated value of the voucher was then increased to 20,000 dram. An informal market was created and anybody (including foreigners) could buy vouchers in many marketplaces. The Yerevan Stock Exchange now trades vouchers and quotes a daily price.

Pro Rata Approach

In the early stages of developing privatization policy, the government considered a first-come, first-served approach to the pricing and sale of shares. Enterprises were to be valued and share prices set according to these valuations. Shares would then be offered for sale in the same way that airplane or theater tickets are sold, that is, specific numbers of shares were to be sold at a designated price until there were no more shares to sell.

The government recognized the difficulty involved with this sort of administrative price-setting. In addition to the incompleteness of markets, the blockade made accurate valuation of Armenian enterprises problematic. Thus the program ran a risk of extreme underpricing or overpricing of shares that could not be corrected in subsequent rounds. Consequently, Armenia looked at other countries' experiences with mass privatization. The Russian program was of interest due to the market-clearing mechanism (modified from the Czech and Slovak program). But Armenia—a small country with limited resources—wanted a simpler solution and thus developed the pro rata approach.

In this approach the valuation of the enterprise is only a starting point. For example, suppose the value of an enterprise is set at 100 million dram. Initially, 1 million shares would be offered at 100 dram each. Either the price of the shares or the number of shares could be altered, depending on the demand. The Armenians chose to change the number of shares. In the example, if there were demand for 2 million shares, then 2 million shares would be sold at 100 dram each (as stated, the price could have changed so that 1 million shares were sold at 200 dram each). Thus the value of the enterprise has changed because it is worth twice as much as the initial valuation. Alternately, if there were demand for only 100,000 shares, then 100,000 shares would be sold at 100 dram each. In this case 100 percent of the shares are still sold, but the enterprise's value has fallen to a tenth of its initial value.

The Armenians realized, however, that under this method one person could come with one voucher and get all of an enterprise's shares. Collusion could not be entirely prevented. Thus the authorities required that 25 percent of the shares offered needed to be subscribed for an auction to be consid-

ered valid. In the earlier example, at least 250,000 of the 1 million shares for sale had to be subscribed. If only 200,000 shares were subscribed when the auction closed, the enterprise was not privatized and all bids were canceled.

The pro rata approach has several advantages: everyone is a winner, everything gets sold, and implementation is easy. First, the pro rata system is open and equitable. Any citizen that participates is free to choose where to invest and will always receive shares in the company they want. The pro rata system also avoids favoritism because all participants are treated equally in accordance with the number of vouchers they bid. This is a tremendous political advantage because the approach is popular with the public. Second, as long as the 25 percent minimum threshold is met, all shares of a given enterprise are sold. There are no residual government shareholdings, as there are in other mass-privatizing countries. Finally, unlike schemes in other countries, the Armenian approach does not have different rounds or waves, obviating the need for sophisticated, computerized auctioning systems.

Auctions

The main auction center, located in central Yerevan, was generally well staffed and well equipped. Potential investors were required to bring a receipt from the Savings Bank specifying how many vouchers were in their possession. The Privatization Board's ten regional offices were also used as regional auction centers, but bids were not accepted on the last day of an auction; investors had to go to the Yerevan auction center.

Auctions initially were supposed to last two months. This was cut back to one month because most potential investors waited until the last minute so that they could estimate how many vouchers would be collected for a given enterprise and therefore how many shares could be bought with a given number of vouchers. This approach was possible because of open access to the auction center. Results (how many vouchers had been bid for each enterprise open for subscription) were posted daily, and on the last few days of an offering, results were posted every two hours.

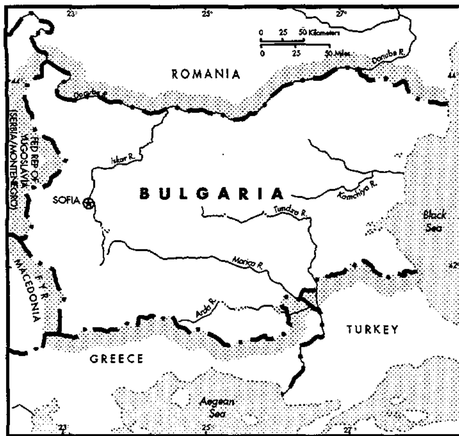
Note on Investment Funds

An Investment Fund Law was developed to regulate financial intermediaries. The authorities were concerned because pyramid schemes had already surfaced in Armenia, and the MMM scandal in Russia was happening at the same time. In developing the law, external advisers borrowed heavily from similar laws in the region. Licensing procedures were also developed. Nevertheless, investment funds have played no role in mass privatization so far, and by June 1997 only two investment funds had been licensed. Neither has been very active. Onerous licensing requirements, along with high minimum capital requirements, may have contributed to the lack of investment funds in the mass privatization program.

Lessons

The Armenian program provides several useful lessons:

- Quality is more important than quantity. The government's privatization program had ambitious targets—based not on experience with implementation, but on bureaucratic objectives. These targets were not met, but they helped keep privatization moving forward.
- Valuation of enterprises should be used only as a starting point. In Armenia's program, the pro rata approach seems to make everybody happy. It provides the semblance of a market valuation, although demand is not necessarily an indicator of price. However, demand may be the best alternative until a mature and liquid secondary market develops.
- Capital market development is critical to the long-term success of mass privatization. Armenia's mass privatization is seen as the first step toward the creation of an equity market as well as a market for corporate control. In the first stage, shares have been sold (for vouchers) to the public. But secondary trading will help to establish better owners—those who want to cash out will and those who want control will buy in. Thus mass privatization must establish the legal framework and institutions needed for a capital market. The Armenians have realized this, and are developing this infrastructure.



Bulgaria

Kalin Mitrev

Bulgaria's mass privatization program will create about 3 million shareholders, possibly bringing to the market shares of about 80 privatization funds and 1,050 enterprises. This enormous increase in the potential volume of tradable securities should provide the biggest boost to Bulgaria's capital markets to date. As in other countries that have launched mass privatizations, Bulgaria will face the dual challenge of ensuring that the market remains ordered and regulated while allowing enough flexibility to encourage liquidity and corporate governance.

Recent History of Bulgaria's Capital Markets

Today's coordinated government effort stands in sharp contrast to the events of the past six years, when market reforms and capital market development proceeded independently. This separation of activities was partly a result of the government's preoccupation with the country's faltering economy. In the summer of 1990 Bulgaria began its transition from a command economy to a free market system—heavily in debt and restricted from international lending markets. In addition, during 1990–95 the country's main trading partners (Yugoslavia, Iraq, and the former members of the Council for Mutual Economic Assistance) were either isolated by United Nations sanctions or unable to maintain high levels of trade because of severe economic restructuring. Together with the slow pace of market reforms, this difficult economic environment impeded capital market development and resulted in a protracted period of underinvestment, with cumulative foreign investment inflows from 1990 to mid-1996 totaling less than $400 million (during the same period the Czech Republic received twelve times as much).

Early progress, later difficulties

Despite these challenges, Bulgaria's capital markets developed as part of the emerging private sector, expanding to two national and twelve regional stock exchanges by the end of 1994. Such expansion was unusual among transition economies because the development of capital markets infrastructure was independent of ongoing state and municipal privatization programs. Neither the government nor the national bank was responsible for monitoring capital market development, and until 1995 the only legislation governing market activities was the 1991 Commercial Code and a licensing requirement under the banking law.

With few official policies regulating capital market development, the securities markets began experiencing a number of difficulties, including arbitrary trading and listing rules, conflicting regulations, and limited shareholder protection. In April 1995 this weak regulatory framework became evident when a few prominent investment funds were exposed as pyramid schemes. The emergence of these schemes undermined confidence in equity markets and, combined with increased interest rates offered by banks, contributed to a 40 percent drop in equity prices. By the end of 1995 both the trading and market values of the two largest exchanges had declined, and trading in the regional exchanges was eliminated altogether.

A revised legal framework

In the second half of 1995 the impending mass privatization program prompted the government to alleviate these regulatory problems. As a result a regulatory framework for capital

markets was signed into law and the long-awaited mass privatization program was launched. This framework included the introduction or revision of four major laws that vastly improved the regulation of Bulgaria's capital markets:

- The Commercial Code, adopted by Parliament in 1991 and revised in June 1995, provides the legal basis for transforming limited liability companies into joint stock companies and regulates their operations. Specifically, it outlines a joint stock company's organization, management, board of directors, shareholder rights, and procedures for holding annual general meetings.
- The Privatization Law, adopted in 1992, was amended in October 1995 along with the mass privatization program and the list of enterprises to be auctioned. The Privatization Law outlines the legal infrastructure for all of Bulgaria's privatization programs.
- The Securities and Stock Exchanges and Investment Companies Act, approved in July 1995, regulates securities transactions, investment brokers, investment companies, the issuing of securities, and the establishment and operation of the Securities and Stock Exchange Commission and the national stock exchange.
- The Privatization Funds Act, adopted in December 1995, provides the framework for establishing, operating, monitoring, and controlling privatization funds in mass privatization.

Mass Privatization Program

The amendments and new laws passed in 1995 set the stage for launching mass privatization. The program will give Bulgarians the chance to purchase, either directly or indirectly through privatization funds, shares in 1,050 state-owned firms (about 50 percent more than were privatized for cash from 1993 to mid-1996). About 77 percent of these companies will offer more than two-thirds of their capital for vouchers, while many of the other companies will be offered in both the mass and cash privatization programs. As a result the state will no longer retain a blocking minority vote in most of the companies being mass privatized and will lose its controlling block in many companies being sold through a combination of the mass and cash programs.

The final list of enterprises was approved by Parliament on 4 June 1996. However, the shares of many firms being offered for mass privatization have since been revised to allow cash investors to make further offers on these companies. For example, in July 1996 the share of the Sheraton Hotel offered in the mass privatization auctions was lowered from 25 percent to 15 percent following the cash sale of 67 percent of its shares to Daewoo. In mid-August 1996 all shares over 50 percent were lowered because of successful cash privatizations, resulting in a 5 billion leva decrease in offered capital relative to early June 1996. The most recent breakdown of registered capital on offer is shown in table 1.

Registration

Like other mass privatizers in the region, Bulgaria launched its program with a registration period, which began on 8 January 1996. All permanent Bulgarian citizens over the age of 18 were eligible to participate for a 500 leva registration fee; special discounts were given to the elderly and orphans (orphans were the only group under the age of 18 allowed to participate in the program). Registration originally was supposed to take place over a three-month period, but to ensure broader participation it was extended until 8 May 1996. About half the eligible population took part in the program. A second extension was made to the first week of June, but the leva crisis (when the currency depreciated 50 percent against the U.S. dollar) diminished its impact. By the final registration deadline about 3 million people had collected their voucher booklets to participate in the first wave of auctions, for a total of about 75 billion investment bonds.

Transfer period

The next phase of the program, the transfer period, took place during the summer of 1996. During this time people who had registered and received a voucher booklet could exchange their investment bonds for shares in privatization funds, buy shares directly, or transfer ownership to relatives. The transfer period ended on 15 August 1996 (table 2).

Table 1. Companies offered for privatization in Bulgaria, September 1996

			Registered capital		
Share of company capital offered	Number of companies	Share of total (percent)	Millions of leva	Share of total (percent)	Amount offered during mass privatization (millions of leva)
More than two-thirds	812	77	87.0	40	60.5
One-third to two-thirds	60	6	11.9	5	5.0
Less than one-third	178	17	118.6	55	29.1
Total	1,050	100	217.6	100	94.6

Source: Center for Mass Privatization, Bulgaria.

About 80 percent of investment bonds were invested in privatization funds—a rather high share given the negative publicity that funds received in 1995. Aside from people who did not feel comfortable investing directly, a possible reason for this outcome is that the government's regulatory push helped restore the public's confidence. The Securities and Stock Exchange Commission, supported by the Center for Mass Privatization, thoroughly screened fund applicants, and only two-thirds of applicants received provisional licenses.

Centralized auction

The program is nearing its third and final stage, the centralized auction (made up of three sessions). Once the start date for the first auction is announced (scheduled for 7 October 1996), individuals and privatization funds will start preparing their bids for shares of the enterprises subject to mass privatization. Participants can submit bids during any or all of the auctions, which are expected to conclude in 1997.

Capital Market Institutions

Development of the institutions responsible for administering and overseeing Bulgaria's secondary markets recently intensified in response to the imminent completion of the mass privatization auctions. The auctions will create more than 3 million new shareholders, significantly increasing the size of the market. This essentially new capital market will be supported by the Securities and Stock Exchange Commission, the (new) Bulgarian Stock Exchange, the Central Securities Depository, and one or two self-regulating organizations that are now being designed. These institutions will need to be fully operational by the middle of 1997, when trading is expected to commence.

Securities and Stock Exchange Commission

The Securities and Stock Exchange Commission was established in July 1995 as part of the Securities and Stock Exchanges and Investment Companies Act. However, its members were not appointed until January 1996, when it became necessary to regulate the parties involved in mass privatization. The commission has been in operation since April 1996 and comprises a chairman, a vice chairman, and five members appointed by the Council of Ministers.

In theory, the commission performs a wide range of functions. To date, however, it has primarily monitored the activities of privatization funds by approving fund prospectuses, granting provisional licenses, and reviewing advertising campaigns. The commission's initial responsibility was to review the prospectuses of the funds applying to collect investment bonds during the transfer period. Between 19 April and 19 July 1996 the commission received 141 applications from prospective privatization funds. Of these, 92 were approved and received provisional licenses.

During the transfer period the commission demonstrated its commitment to enforcing regulations by levying fifty-six fines. Most of the fines were levied because funds failed to state in their promotional materials and publications that the price of shares may fall and that no profits are guaranteed. The other fines were levied for misleading advertising. Both offenses violate article 26 of the Privatization Funds Act. The swift, severe, and early fines imposed on funds such as the Nadezchda privatization fund set a precedent, resulting in honest and transparent advertising campaigns by the rest of the funds.

In addition to monitoring funds, the commission has helped improve their administration. After holding informal meetings with fund managers, the commission was able to suggest legislative improvements to Parliament. In July 1996 the combined lobbying efforts of the funds, the Center for Mass Privatization, and the commission were realized when Parliament:

- Lifted the quorum restrictions on shareholder meetings. Previously funds had to have at least half their capital represented by person or by proxy in order to hold a valid shareholder meeting.
- Lifted the requirement that proxies for the first shareholder meeting be notarized. Procedures for shareholders are now easier because proxies only need to be in written form.
- Allowed legal persons (that is, company representatives) to sit on boards of directors. Previously only natural persons were permitted to hold seats on boards.

As mass privatization comes to an end, the commission will assume its general responsibilities, implementing and enforcing

Table 2. Results of the transfer period

Transfer option	Share of investment bonds transferred (percent)	Billions of investment bonds transferred
Privatization funds[a]	79.8	59.8
Direct use[a]	20.2	15.2
Transfer to relatives	16.0	12.2

Note: As of 16 September 1996. About 500,000 investment bonds have not yet been counted. Only funds with a provisional license were allowed to collect vouchers during the transfer period.
a. Includes transfer to relatives.
Source: Center for the Mass Privatization, Bulgaria.

the laws governing the securities market and resolving investor disputes. In addition, the commission will continue offering seminars to representatives of financial service organizations and will likely begin training brokers and market makers.

Bulgarian Stock Exchange

Activity on the stock exchanges is minimal, with a shortage of both listings and investors. Mass privatization, however, is expected to greatly increase the number of tradable securities and shareholders. To manage the increase in volumes, a national stock exchange was recently formed by consolidating Bulgaria's five main stock exchanges.

The framework for this exchange provides for an auction market operated by brokers and dealers. Once the exchange is operational, the trading system will manage two trading processes: continuous trading for the most active issues and single-price auctions for less liquid issues. A call market will be used for thinly traded shares and for orders that have accumulated overnight, while a continuous market will be used for heavy trading of small and medium-size orders that take place during operating hours. Orders will be executed through registered brokers or dealers who will either intermediate between buyers and sellers (for a commission) or buy and sell shares from their own account.

The Czech Republic's experience suggests that shares of privatization funds and shares of the largest companies will be traded most often. Other companies will be thinly traded or not traded at all. Despite the probability that most companies will be inactive, Bulgaria's capital markets might benefit if venture capital groups change them from publicly listed companies to privately held firms. Should that occur, company shares that would not normally have been listed would be eliminated and the market should become more efficient.

Some trading is expected to take place off the market, where buyers and sellers deal with each other directly. As in other Central and Eastern European countries, such trading creates difficult reporting issues that have yet to be resolved. In the Czech Republic, for example, significant changes in ownership are often made without the knowledge of small shareholders, and the disclosed price may be incorrect. Bulgaria is drafting legislation to address some of these issues, especially those affecting small shareholders. Once the rules governing off-market trading are enacted, the Securities and Stock Exchange Commission will ensure fairness and transparency. Off-market trading should diminish once organized markets mature.

Central Securities Depository

A charter for the Central Securities Depository was signed on 13 August 1996. Together the Center for Mass Privatization, the Ministry of Finance, and the Bulgarian National Bank own 26 percent of the depository. The remaining 74 percent is reserved for private players such as commercial banks and investment houses. An executive director has been appointed and the decree guiding the operations of the depository is expected to be passed in September 1996. In addition, an agreement was recently signed between the Center for Mass Privatization and the U.S. Agency for International Development outlining U.S. assistance.

The Center for Mass Privatization will play a leading role during the early stages of the depository by temporarily carrying out registry and depository functions for the 1,050 privatized enterprises. Once the depository is operational, the center's computerized database will be transferred to the depository to form the basis of its system. The depository will be responsible for clearing and settlement on the stock exchange and will provide reports to its members detailing all securities transactions. In addition to administrative details, three other issues are being addressed:

- *Legal form of the securities.* New securities from mass privatization will likely be dematerialized. In that case the depository will be electronically linked to the stock exchange to ensure that transactions are executed in an expedient manner.
- *Payment systems.* Initially all transactions will be made through commercial banks or the Bulgarian National Bank. Once the country's banking system is reformed, clearing and settlement will be more integrated with private banks.
- *Counterparty risk.* Either the brokers acting as intermediaries between buyers and sellers will be liable and ensure that transactions are completed, or a collective of registered brokers and market makers will organize a mutual guarantee system to ensure that transactions are executed properly.

Self-regulating organizations

Self-regulating organizations will more than likely include the Bulgarian Stock Exchange and professional organizations formed by the firms providing financial services. These organizations are expected to develop and enforce industry rules, train and test members, adopt minimum financial entrance standards, develop a code of ethics for members, and offer self-insurance mechanisms. Self-regulating organizations will strengthen the regulatory framework and increase transparency and fairness in the market.

Market Participants

Bulgaria's capital market initially will be dominated by large privatization funds. The funds' presence will allow individual investors to own a lower-risk, diversified portfolio of shares and will help attract foreign investors by increasing efficiency and transparency in the market.

Privatization funds

Privatization funds were established to support mass privatization and to improve corporate governance by actively monitoring the companies in their portfolios. The funds are sure to play a significant role in both, having collected more than 80 percent of investment bonds. This high level of ownership should lead to combinations of funds taking a controlling interest in many firms offered for mass privatization. The Privatization Funds Act allows each fund to own up to 34 percent of a company, which gives the funds the right to veto any company decision requiring a qualified majority. The Commercial Code requires companies to obtain a qualified majority to amend articles of association, increase or decrease capital, transform or terminate the company, and make decisions in accordance with company statutes.

All Bulgarian funds are closed-end joint stock companies, and by law the funds must remain closed-end for five years. After five years the funds will have the option of becoming open-end, which will allow them to redeem (buy back) their shares. The closed-end period will give the funds time to establish and improve their portfolios without facing redemption demands from shareholders, and should strengthen secondary markets because all funds are expected to list their shares on the national exchange. In addition, once mass privatization auctions have ended, funds will be instrumental in raising capital for further restructuring—a process that is expected to benefit companies individually and improve the capital market as a whole.

Foreign investors

Foreign investors are already participating in mass privatization through privatization funds. Fifteen funds have founders that include foreigners. In addition, the country's third-largest fund was cofounded by the Netherlands's ING Bank, which has been operating a commercial branch in Bulgaria since 1993. The early participation of these companies in the program suggests that international financial organizations will continue to play a role in mass privatization.

Once trading is permitted, efforts will be made to attract institutional portfolio investors, who can add much-needed liquidity to the market. Mass privatization should increase foreign investment in Bulgaria because it is easier for foreign investors to purchase shares from private owners than from the government—the sale of an enterprise from one private owner to another is less political and is subject to less criticism and scrutiny from the public. With a well-regulated and nonpolitical market, foreign investment should begin flowing into Bulgaria.

Institutional Funds

In addition to the main capital market institutions and participants, there are plans to establish a post-privatization fund and a custodian fund.

Post-privatization fund

The Center for Mass Privatization, with assistance from the European Bank for Reconstruction and Development, plans to establish a post-privatization fund that will take equity stakes in newly privatized enterprises. The fund is expected to help fill the gap left by the weakened banking system and by low levels of domestic investment by giving enterprises access to financial and technical support. A total of 30 million ECU is slated for minority stakes in the enterprises, and an additional 15 million ECU will be used to provide equity and management assistance. The fund is expected to be operational by spring 1997.

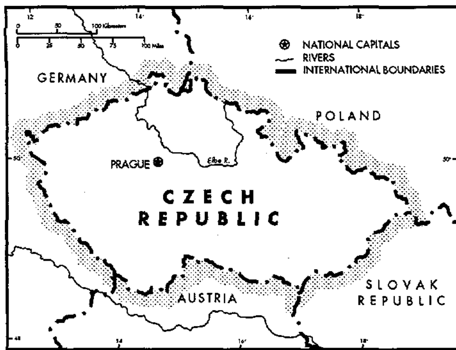
Custodian fund

Once the first wave of privatization ends, the government might establish one or more custodian funds to hold and possibly manage the sale of residual shares of companies that have gone through coupon auctions. These shares will include those that have not yet been offered to the public as well as shares that went unallocated at the auctions. The fund is being planned, and a broad framework should be in place by the middle of 1997.

Conclusion

The renewed development of Bulgaria's capital markets will be shaped by the first wave of mass privatization. A large num-

ber of companies will be offered to the public in exchange for vouchers, significantly boosting the number of publicly held shares. Then about half the adult population will become investors directly or indirectly through privatization funds, creating more than 3 million new shareholders. Finally, the institutions responsible for overseeing and administering capital markets will expand their operations, accommodating the needs of the new investors and shareholders.



The Czech Republic

Raj M. Desai and Vladěna Plocková

In June 1996 the Czech Republic's Ministry for State Property Administration and Privatization closed its doors after five years of operation. Although the Czech mass privatization program had ended a year earlier, when shares acquired during the second wave of voucher distributions became tradable on the Prague Stock Exchange, the dissolution of the privatization ministry signaled the formal end of the critical "asset transfer" phase of mass privatization. While the speed, scope, and fairness with which the Czech Republic implemented mass privatization have been envied (and emulated) by other transition economies, the Czech experience highlights the challenges of creating effective ownership following rapid, broad privatization of large state enterprises.

Two defining features of the post-privatization landscape have influenced recent events in the Czech Republic: the concentration of enterprise ownership rights in a few investment funds with ties to large, partly state-owned banks and the absence of a sufficiently sophisticated market infrastructure in which to trade and enforce those rights. Former state banks have used their control over Czech companies to extract rents in the form of unprofitable banking relationships—typically inducing companies in their funds' portfolios to borrow exclusively from the parent bank—and to obstruct liquidation proceedings for insolvent enterprises. Meanwhile, since early 1995 several aggressive "entrepreneurial" groups have taken advantage of a poorly regulated stock market to acquire significant financial and industrial holdings through direct purchases or through raids on bank-run funds.

Mass privatization was completed in four years, and the Czech Republic now boasts the most private economy, the lowest unemployment, and among the lowest inflation in Eastern Europe, as well as the highest share of gross foreign investment in GDP of all the economies that have implemented mass privatization. Still, the recent problems in the financial sector underscore the difficulties privatized corporations face in raising long-term capital to finance modernization and restructuring.

Privatization in the Czech Lands: An Overview

The mechanics and results of privatization in the Czech Republic are well-known and require little summary. In brief: Czechoslovakia launched mass privatization with the passage of the 1991 Large-Scale Privatization Law, the centerpiece of a broader economic reform program adopted in 1990. Defining features of mass privatization included centralized administration of the program, with institutional control concentrated in the privatization ministry and the autonomous National Property Fund; limited foreign participation; a laissez-faire approach to investment funds; avoidance of preferences for insiders (as well as a limited role for management-employee buyout schemes); and early and widespread public involvement in the program—both to generate a critical mass of support for reforms and to mobilize domestic capital. The innovative use of coupons, or privatization vouchers, in Czechoslovakia influenced the design of mass privatization programs in most transition economies that have attempted them. After the federation was split into constituent states, the Czech Republic, unlike the Slovak Republic, continued to rely on competitive bidding for vouchers in sales of state enterprises.

Privatization proposals ("projects") could be submitted by any citizen or group of citizens for any firm, and were quite varied in intent and result. Projects could select a single method or some combination to privatize enterprises and convert them into joint stock companies. Projects could propose that firms be privatized in whole or in part, could recommend breaking up large firms, and could outline different methods or different combinations of methods for different parts of an enterprise. Competing projects were submitted to the sectoral or "founding" ministry, which had some discretion in choosing final projects. Final decisions, however, were in the hands of the Czech and Slovak privatization ministries. After being selected, a project was delivered to the republic-level National Property Fund, which would implement the project and act as sole overseer of state's shares in privatizing firms.

Thus no firm was required to sell shares for vouchers. Instead, vouchers were used alongside several other privatization methods—including direct acquisitions, public offerings, auctions, management-employee buyouts, and free transfers. Still, approved privatization projects reserved an average of 62 percent of a company's shares for distribution through vouchers, or about half the nominal value of all the joint stock companies included in the program. Voucher privatization was then carried out in two waves, with 1,849 firms—56 percent of the 3,278 Czech companies selected for joint stock conversion—wholly or partly privatized through vouchers during 1991–95 (table 1).

As originally conceived, the Czechoslovak voucher privatization assumed that only individual citizens would invest in the program. But fearing the dilution of ownership across small shareholders, and thus the danger of excessive de facto control by enterprise insiders, the government allowed privatization investment funds to participate in voucher privatization as investment vehicles, pooling vouchers to concentrate ownership. In addition to improving enterprise governance, as institutional owners investment funds would reduce the risk of expropriation faced by individual shareholders by offering shares in diversified investment portfolios. Each investment fund was legally required to invest in at least ten enterprises.

Consistent with the economic liberalism built into the Czechoslovak reform program, investment funds were set up privately without any government support. The Large-Scale Privatization Law only allowed investment funds to participate in voucher collection, prohibiting them from taking part in other privatization schemes. Taking advantage of minimal licensing requirements (with respect to base capital and disclosure of information about principals), 264 investment funds registered in the Czech Republic (165 in the Slovak Republic) for the first wave and 353 registered for the second wave of the voucher program. About 6 million of the nearly 8 million eligible Czech citizens bought voucher booklets. Investment funds collected 71 percent of available voucher points during the first wave and 64 percent during the second (table 2). Moreover, a disproportionate share of the investment points entrusted to investment funds was largely concentrated among a small number of funds.

At the end of the first wave, the fourteen largest investment companies had collected 78 percent of the investment points allocated to investment funds. The five largest investment companies took 69 percent of these points, with the largest taking 16 percent. Of the fourteen investment companies, nine were founded by Czech and Slovak financial institutions (eight of which were former state-owned banks). These nine companies acquired 40 percent of all voucher points and 56 percent of all voucher points given to investment funds—the equivalent of 30 percent of all shares and 48 percent of all

Table 1. Mass privatization in the Czech Republic, 1992–95: Basic indicators

Indicator	First wave (1992–93)	Second wave (1993–95)
Joint stock companies	988	861
Shares (millions)	973	867
Voucher points (millions)	6,980	6,170
Book value of shares (billions of crowns)	200	155
Eligible citizens registering voucher booklets (percent)	78	81
Registered investment funds	264	353
Voucher points invested with funds (percent)	71	64

Table 2. Cumulative ownership in the Czechoslovak/Czech voucher market
(percent)

	Total voucher points		Fund-held voucher points		Total shares[a]	Fund-held shares[a]
Owner	First wave	Second wave	First wave	Second wave	First wave	First wave
Individuals	29.0	36.5	—	—	37.0	—
Largest fund	11.1	5.2	15.6	8.2	7.7	12.2
Largest 5 funds	38.0	21.1	69.0	33.4	27.0	42.0
Largest 14 funds	55.4	36.7	77.6	60.1	43.0	67.5
All funds	71.4	63.5	100.0	100.0	63.0	100.0
Bank funds[b]	39.8	11.8	55.7	19.6	29.9	47.5
Total	100.0	100.0	—	—	100.0	—

a. Share information for investment funds following the second wave was not published

b. Funds managed by investment subsidiaries of large former state-owned financial institutions. Nine were involved in the first wave, five in the second.

shares held by investment funds. Although investment funds affiliated with former state-owned financial institutions were less successful in the second wave, the bank control built up by 1993 was only slightly diluted. The five largest Czech financial institutions—the "big four" (Česká spořitelna, Komerční banka, Investiční banka,[1] and ČSOB) plus the state insurance company Česká pojišťovna—acquired 42 percent of fund-held points in the first wave, falling to 19 percent in the second (table 3). Overall, these five institutions acquired 32 percent of fund-held voucher points over the course of two privatization waves.

During the first wave investment funds were set up exclusively as joint stock companies, subject to the legal provisions of the Large-Scale Privatization Law and the Commercial Code. During the second wave, however, these funds could also be established as open- or closed-end mutual funds, which gave shares to voucher holders in exchange for points, but no voting rights. As a result investment companies that may have managed single funds during the first wave set up a diverse set of funds along the lines of U.S. or British mutual funds (for example, growth funds, dividend funds, sector funds, and so on) during the second wave.[2]

Consolidating Ownership

Despite initial concerns that the search for strategic owners with a long-term interest in privatized enterprises would be slow, ownership concentration in the Czech Republic has proceeded rapidly. By the end of 1995 about 800 of the 1,849 enterprises privatized through the voucher program had found a non-state majority stakeholder. By the end of 1997 analysts forecast that the remaining enterprises will be in the hands of investors with majority stakes. Although uniform, comparable data on ownership of privatized enterprises are lacking, a recent survey of privatized Czech firms is consistent with anecdotal evidence of increased ownership concentration in many corporations.[3] Ownership stakes have shifted from investment funds and individual voucher holders to "real" investors, particularly enterprise insiders and strategic partners (table 4).

This shift in ownership is also reflected in significant turnover and structural changes in board membership. During 1994–95 more than half the members of boards of directors had been replaced in 25 percent of the enterprises surveyed. Similar turnover occurred among supervisory boards. Overall, changes in board membership were reported in 60 percent of the companies surveyed. In 1994 boards of directors were dominated by investment fund representatives (39 percent); by 1995 managers had become the predominant members (36 percent), and investment fund representatives accounted for 30 percent of board members. Investment funds saw their representation on supervisory boards fall as well, with the 30 percent share of supervisory board seats held by investment funds in 1994 falling to 20 percent in 1995. Strategic investors' representation on supervisory boards increased from 8 percent in 1994 to 15 percent in 1995, and their representation on boards of directors increased from 11 percent to 14 percent of total seats.

Toward Basic Securities Regulation

By 1994 the Czech Republic's stock market was by far the region's largest in terms of the number of companies listed and in terms of market capitalization as a share of GDP. Yet the stock market was also acquiring a reputation as a playground for privileged insiders, plagued by information asymmetries and price fixing. Indeed, to a large extent ownership consolidation was made possible by the general absence of capital market regulation. Commercial and securities legislation did not, for example, require investors acquiring a majority stake in a company to make buyout offers to other shareholders. As a result the market value of other shareholders'

Table 3. Voucher ownership by funds of the five largest Czech financial institutions, mid-1995

	First wave		Second wave		Cumulative	
Parent company	Total points acquired (millions)	Share of fund-held points (percent)	Total points acquired (millions)	Share of fund-held points (percent)	Total points acquired (millions)	Share of fund-held points (percent)
Česká spořitelna	950	15.6	124	3.2	1,074	10.7
Investiční a poštovní banka	724	11.9	98	2.5	822	8.2
Komerční banka	466	7.7	124	3.2	590	5.9
Česká pojišťovna	334	5.5	187	4.8	521	5.2
ČSOB	49	0.8	198	5.1	247	2.5
Total	2,523	41.5	731	18.8	3,254	32.4
All funds	6,112	100.0	3,920	100.0	10,032	100.0

Table 4. Ownership of privatized Czech corporations, 1994 and 1995
(percentage of share capital)

Owner	1994	1995
Investment privatization funds	38.0	31.5
Individual voucher holders	25.0	18.0
Strategic partners	11.5	17.0
Foreign partners	4.0	7.0
National Property Fund	14.0	13.0
Managers and employees	1.5	6.5
Other[a]	10.0	14.0

a. Includes shares held by municipality, public investment, restitution, and foundation funds and other nonvoting bodies, typically acquired by free transfer.

stock plummeted once a large investor gained a majority stake in a company, and minority shares often became untradable. Commercial statutes also did not require that shareholders be informed of capital increases, changes in the company's legal form, or even takeovers.

This period of mergers and acquisitions, sometimes referred to as the "third wave" of voucher privatization, typically involved takeovers without public announcement. By early 1996 more than 500 Czech corporations had quietly changed hands in this way. Between 1994 and mid-1995 Czech stock market prices fell steadily, recovering once second wave shares became tradable. But even though the market has climbed since mid-1995, it has done so at a slower pace than the neighboring bourses in Hungary and Poland.

Motivated by the Czech capital market's increasingly negative international reputation, the chairman of the Prague Stock Exchange began marshaling support for basic stock market regulation. Despite initial resistance from the Ministry of Finance—the principal regulator of Czech capital markets—in May 1996 Parliament adopted a package of amendments to the Commercial Code, the Securities Act, and the Stock Exchange Act. These amendments, which took effect in July 1996, fundamentally altered investment strategies in the Czech economy. The most important regulatory changes included:

- *Mandatory buyout offers.* Investors who acquire a majority interest in a publicly traded corporation must offer, within sixty days, to buy out all shareholders at the weighted six-month average price.
- *Supermajorities for altering corporate form.* Major changes in the legal status of a corporation (including investment companies and investment funds) must be approved by 75 percent of all shareholders at a general meeting (approval by a simple majority was required previously). If accepted, the corporation must buy out dissenting shareholders.
- *Ownership notification requirements.* Investors must announce the acquisition of more than a 10 percent stake in a company. Disclosure is also required if an ownership stake increases or decreases by more than 5 percent of the company's stock value.
- *Stricter disclosure rules for investment companies.* Investment funds and their management companies are obliged to publish quarterly reports on portfolio structure and performance and to pay any advertising and brokerage fees from the investment funds' management fees.

The Rise of Financial-Industrial Empires, Czech Style

Anticipating these changes in the post-privatization environment, investment companies that had actively built up stakes in financial and industrial concerns began converting themselves into holding companies. Because the cost of acquiring majority stakes would likely increase once the new laws took effect, companies faced strong incentives to speed up the pace of corporate takeovers. But investment funds, limited by the Investment Companies and Investment Funds Act to a 20 percent stake in companies, were likely to wind up as minority shareholders. By reregistering as holding companies, investment funds were liberated from the 20 percent ownership ceiling and from Ministry of Finance supervision.

This legal maneuver—relatively simple under the existing Commercial Code—would also become far more costly once the new legislation took effect. Even if approval by 75 percent of shareholders could be obtained, buyouts for dissenting shareholders would have to come from a fund's net asset value, not the steeply discounted prices at which fund shares traded on the market. Between the end of 1995 and June 1996 investment funds rushed to convert to holding company status and to acquire controlling stakes in certain companies before the amendments made both activities more difficult. By 24 July 1996 the Ministry of Finance had reregistered fifty-nine funds as holding companies.

Significantly, all the largest funds administered by investment companies established by private banks (Agrobanka's funds, for example) and nonbank owners (Harvard, YSE, PPF) were among the funds that transformed. Few of the funds established by state financial institutions transformed into holding companies. The only exceptions were funds managed by PIAS, an investment company controlled by Investiční a poštovní banka, the country's third-largest bank.

The most common acquisition strategy, typified by the private investment group Motoinvest, was to establish a web of secondary and tertiary investment subsidiaries that would subsequently acquire stakes in a particular company through coordinated raids on the investment funds owning the company. Motoinvest used this technique to expand its financial and industrial holdings over the course of a year. Through this network of holding companies, each acquiring relatively small nominal stakes in a targeted company, Motoinvest also coordinated the takeovers of several private banks—most notably Agrobanka, the largest private bank and the fifth largest bank in the Czech Republic—without informing other shareholders. This strategy was also used by the former Harvard funds, now incorporated as Harvard Holding. Both Harvard and Motoinvest targeted companies in specific sectors, and each held fairly limited portfolios of forty to fifty companies. The Harvard funds, the first to convert to holding company status, also entered a joint venture with Bahamas-based Stratton Investments in order to expand stakes in several large industrial concerns beginning in 1995.

In sum, many of the investment companies that struggled for two years to break the lock on corporate ownership held by major banks have slowly created their own financial-industrial empires, replicating those of the large banks in many ways. For the most part the major banks' investment funds did not transform into aggressive holding companies, but chose to act as portfolio investors, managing smaller shares of stock (less than the 20 percent ceiling) in a large number of enterprises.

In May 1996 Motoinvest revealed that—using its coordinated management strategy—it had acquired significant stakes in the largest Czech financial institution, the former state savings bank Česká spořitelna, and moved to place a Motoinvest representative on the executive board.[4] Meanwhile, Motoinvest had also acquired a reputation for "greenmail" operations against large commercial banks, including Komerční banka, the 67 percent state-owned foreign-trade bank ČSOB, Živnostenská Banka, and the Austrian bank Creditanstalt. Motoinvest typically would acquire shares in the investment funds run by these banks, then force the parent bank to buy back shares in their funds at a premium.

The main domestic banks responded to these indirect takeover attempts in one of three ways. First, they defended their investment funds by buying back stock or by issuing new shares. Second, in the case of Motoinvest they withdrew (or failed to renew) deposits held at the largest bank in Motoinvest's portfolio, Agrobanka, squeezing Motoinvest's main source of liquidity.[5] Third, they used debt contracts with former state-owned enterprises to finance acquisitions of scores of companies thought to be targeted for takeover by Motoinvest or other private investors. Two prominent examples are the financial-industrial alliance between the former chemicals trading monopoly Chemapol and ČSOB and between the engineering giant Škoda Plzeň and Komerční banka. Chemapol, a holding company since 1992, has continued to pursue a strategy that worked during the two waves of privatization: selected acquisition of companies with whom it had long-standing relationships.[6] In recent months, however, ČSOB—a shareholder in Chemapol—has loaned Chemapol money to buy companies (or bid for them in public tenders) in the trade, energy, and chemicals sectors. Similarly, Komerční banka has continued to finance the acquisitions of the engineering giant Škoda Plzeň in the machinery and defense sectors. While some of these acquisitions were commercially sound, many have been undertaken as a defensive strategy to prevent certain companies—often of dubious viability—from being acquired by multinational companies or by domestic investors like Motoinvest.

The prospective rise of financial-industrial groups in the Czech Republic suggests an interesting contrast to the Russian Federation, where such groups are best known. In Russia conglomerates are generally the result of a state-prompted effort to consolidate ownership rights—mainly in the hands of banks—that were dispersed among enterprise insiders following mass privatization. More recently, banks in Russia have acquired sizable blocks of state-held residual shares in large companies in exchange for loans to the government. In the Czech Republic, by contrast, ownership rights were already concentrated in the hands of former state-owned banks following mass privatization. Financial-industrial conglomerates have emerged as a result of competition between outside investors and the former state banks. As private investors try to dilute the ownership rights held by the large banks, the banks, together with large industrial concerns, resist these efforts through repurchases and stock dilutions.

What Kind of Governance?

What do these different ownership arrangements imply for industrial recovery in the Czech economy? As suggested above, disciplining companies through changes in share price

is unlikely as long as the securities market is plagued by illiquidity and a strong potential for collusion. Legislation improving investor protection—after several delays—signals recognition of these problems, as does a recent effort to build a U.S.-style securities regulation agency. But in the short term the burden of enterprise control will depend on shareholders who are willing to use "voice" over "exit."

During 1994–95 investment funds sold large blocks of shares in privatized enterprises to single investors, acting as catalysts in the search for strategic investors. In this regard it is useful to consider the incentives faced by two groups of owners—private investment companies and bank-controlled investment vehicles. In both cases the evidence for improved governance is mixed. Private investors reorganized as holding companies generally acquired controlling stakes in a large number of companies in their portfolios. Although some of the new holding companies seem to be committed to maximizing firms' long-term profitability, others are simply waiting for the first opportunity to sell their stakes to other investors at a premium. Worse, some converted funds are clearly more interested in stripping funds' assets to acquire cash for securities speculation than in investing in restructuring.

Acquisitions by the five holding companies controlled by Motoinvest, administering assets worth about $222 million, for example, have failed to add shareholder value to any of the acquired funds or companies; on average the funds Motoinvest controls have collapsed to one-third of their twelve-month high share price. YSE, PPF, and even Harvard Holding are trading shares at discounts on net asset value per share that average as much as 70 percent, by far the largest on the market. By contrast, shares of unconverted funds trade at discounts closer to 50 percent. The absence of disclosure requirements for holding companies, along with a fear that these companies' controlling stakes are mainly speculative, is a major reason shares of converted funds trade at higher discounts.[7]

Evidence on the activities of the investment funds and investment companies affiliated with the major banks is similarly mixed. Contrary to expectations that universal banks would form the crux of an efficient system of corporate governance, large Czech banks and their investment subsidiaries have performed poorly as corporate monitors. Czech banks do not directly hold large portions of share capital in corporations. Rather, equities are held by bank-sponsored investment funds, diluting banks' potential gains from monitoring.

Neither banks nor bank-sponsored funds have strong incentives to behave as active shareholders. Although banks have an interest in seeing their firms adjust—since only a well-performing enterprise will be able to repay its debt—most commercial bank revenue in the Czech Republic comes from interest income. According to the Investment Companies and Investment Funds Act, funds have only two sources of income: share appreciation of the stock owned by the fund and independent trading activities. An investment company owned by a bank can charge its funds an annual fee of up to 2 percent of the fund's average net asset value, or 20 percent of fund profits. Because the equity holdings of large Czech banks are small, the only real benefit banks receive is a portion of this fee. Since few investment funds receive significant dividends from their portfolios, most investment companies choose the 2 percent fee; this represents a negligible portion of investment company revenue and an even smaller portion of bank income.

Trading activities are far more lucrative. While all investment funds may have strong incentives to avoid costly monitoring, bank-sponsored investment funds may even be worse off because their portfolios typically are far more diverse (although they divested significantly after the second wave of privatization ended). Surveys of company managers and board members suggest that large banks use their dual role as creditors and shareholders to extract rents (in the form of forced lending), and in some cases force enterprises to buy from or sell to other companies in the bank's family. Bank-affiliated investment funds, consequently, often behave less in the interests of their shareholders than as agents of their parent bank, seeking to maximize the bank's commercial business.

The Struggle for Enterprise Control

Mass privatization was not intended to allocate property rights to strategic owners, but simply to create the mechanisms by which such owners could be found. Czech privatization authorities also emphasized that the restructuring of enterprises privatized for vouchers would ultimately depend on the initiative of private owners, but would not necessarily be undertaken by the first group of private owners. One of the basic questions for the Czech economy, then, is whether the main owners of privatized enterprises will now commit resources toward their reorganization.

The Czech Republic transferred ownership and privatized enterprise cash flows with admirable speed. Yet the neglect of

basic financial and securities regulation, once strategic owners were found, has enabled those owners to divert resources to themselves at the expense of other shareholders. If this is true, it implies an irony. Czech investment funds were encouraged to participate in large-scale privatization in order to ensure adequate portfolio diversification and reduce risk, and thereby boost public involvement in the voucher program. But with the conversion of some funds and the subsequent concentration of their portfolios, former voucher holders who are now shareholders in these converted funds face much larger risks and higher discounts on share price. As bank-sponsored investment funds and independent investors struggle for ownership rights in privatized Czech companies, the choice of risk is increasingly constricted by collusive financial-industrial arrangements and less related to rates of return. Until 1995 the main debates about corporate governance in the Czech Republic related to the limitations on investment fund activities created by artificial share-ownership limits. Such limits no longer affect investment funds that have transformed into holding companies. But these investors have still found numerous opportunities for self-dealing.

The main post-privatization challenge in the Czech Republic is to devise rules that encourage investors seeking to acquire a controlling block of shares in a company to do so out of expectations that they can increase future cash flows—not out of the possibility of channeling resources to themselves in ways that injure smaller shareholders. The question of "who governs the governors" arises in all economies. In the transition environment, given the lack of established norms governing property rights and the absence of public enforcement, the question is even more critical to matters of allocative efficiency. To reap the rewards of productive investment and economic growth, there must be competent policing against financial collusion and greater accountability of major investors, whether through new regulatory mechanisms or alternative investor protection regimes.

Notes

1. In early 1994 Investiční banka merged with the Czech Postal Bank to form Investiční a poštovní banka (Investment and Postal Bank).

2. Of the 353 investment funds competing for voucher investment points in the second wave, 158 were formed as mutual funds—120 closed-end and 38 open-end. (The remaining 195 funds registered as joint stock companies.) Unlike closed-end mutual funds, through which investors can redeem their fund certificates or shares only in secondary capital markets, open-end mutual funds give investors the right to redeem their certificates for cash paid directly by the fund. Moreover, open-end mutual funds are obliged to buy certificates from their investors at the market price of the fund's underlying assets per certificate (minus a fee stated in the fund's statutes), with the payment taking place within a month of the investor's request. To avoid the danger of a run on funds and consequent liquidity problems, however, open-end mutual fund managers were granted a two- to three-year grace period during which they were not obligated to honor direct redemptions. This measure may explain why most Czech mutual funds were formed as open-end. Not only did the exemption from direct redemption provide founders of open-end mutual funds with the same initial conditions as closed-end funds in terms of reserve requirements, but the well-defined exemption period was likely to generate higher demand from voucher holders given open-end mutual funds' guarantee that in the near future fund certificates would be bought back at the market price for cash. The open-end mutual fund form of investment fund also may have been preferred by founders because of the possibility of issuing additional fund certificates for cash once voucher privatization was completed. Closed-end mutual fund investment funds, by contrast, are prohibited from raising further capital by issuing additional fund certificates.

3. Coopers and Lybrand (Prague) surveyed 170 large and medium-size corporations between 1994 and 1995.

4. Although the Ministry of Finance has never been a fierce regulator, current laws require that any investor acquiring more than 10 percent of a former state-owned bank receive the approval of the ministry and the Czech National Bank. In the case of Česká spořitelna, Motoinvest's stake was estimated to be approximately 35 percent, distributed across five holding companies.

5. At the same time, the major banks froze Agrobanka out of the interbank market. This liquidity crunch ultimately led to the forced administration of Agrobanka by the central bank in September 1996.

6. By 1994 Chemapol, through direct acquisitions as well as through the voucher collections of its investment subsidiary Expandia, had acquired controlling stakes in most of its former clients (export suppliers or imported raw materials purchasers), including the four largest petrochemical producers, the main local gasoline distributor, and some of the largest plastic, rubber, and pharmaceutical producers. Most of these companies owned stock in Chemapol to begin with (Chemapol was incorporated as a joint stock company in 1968, with shares owned by its main clients), thus creating a complex network of cross-shareholdings.

7. Most shareholders in these holding companies did not oppose the funds' conversion because in some cases these decisions were made at extraordinary shareholders meetings that were deliberately organized to ensure limited participation (and hence approval) by a simple majority of present shareholders. For example, Harvard's investment funds, which were the first to merge and transform, held their meeting in a remote village in southern Moravia.

Georgia

Stuart Bell

The concept for Georgia's mass privatization program largely followed Russia's voucher program. The objectives, as in Russia and throughout most of Eastern Europe, were threefold: to quickly create a private sector through rapid and extensive privatization of state enterprises, to foster the conditions for distributive equity by distributing shares to citizens, and to involve and commit the populace to the process.

Mass privatization through voucher auctions was not the only method used to sell almost 1,100 medium-size and large state-owned enterprises in Georgia. Other methods included management-employee buyouts, free transfers to employees (limited to twenty times the minimum wage), discounted sales to employees, and debt-equity swaps, which came about as a result of state liabilities to enterprises that delivered goods to Turkmenistan in exchange for gas under the former state order system (table 1). In addition, a small group of larger, export-oriented enterprises has been set aside for case-by-case privatization. Finally, residual shares will be sold at cash auctions, organized along the same lines as the voucher auctions. In those cases where the state retains a majority after an unsuccessful cash auction attempt, the enterprise will be liquidated.

The primary accomplishments of the program were:

- The privatization of more than 500 medium-size and large enterprises in one year.
- The sale of more than 81 million shares (about 22 percent of the total charter capital of medium-size and large enterprises).
- The creation of hundreds of thousands of new shareholders.
- The establishment of an efficient nationwide auction system giving all people easy access to the privatization process and serving as the institutional framework for future privatization methods.
- The initial development of Georgia's capital markets.

The program's most serious shortcoming has been the failure to sell larger proportions of share offerings—due to low popular participation and the absence of a fully market-based clearing mechanism.

Legal Origins

The privatization program had its legal origins in the Privatization Law of 1991, which is a general empowering law and does not contain provision for the Georgian people to participate in privatization *en masse.* The law does, however, require the Cabinet to prepare and the Parliament to approve an annual privatization program identifying state enterprises subject to privatization. The legal origins of mass privatization are in Article 1 of the 1992–93 privatization program, which stated that the "social basis of privatization will be expanded by the free transfer of significant parts of the value of state property through the distribution of privatization cards

Table 1 Distribution of privatized shares by method in Georgia
(percent)

Method	Share
Management-employee buyouts	28.9
In lieu of gas debt	2.6
Free to employees	5.9
Discount (20 percent) to employees	2.8
Core investor voucher auctions	1.4
Small investor voucher auctions	58.6

Source: Ministry of State Property Management.

(vouchers) to the population." To avoid contentious parliamentary debate about the specifics of the program—and the possible delay of implementation—the government exercised its powers to establish the implementing regulations of the program through subsequent cabinet resolutions and presidential decrees to regulate corporatization, investment funds, the institutional framework, and voucher distribution, auctions, and tenders. This move allowed the government to fill legal gaps quickly as the program's preparation gathered pace.

Insider Buyout Option Eliminates a Political Constraint

In the three years after passage of the privatization law in 1991, the government encountered sustained resistance to privatization among enterprise managers. By the end of 1993 only twenty-three joint stock companies had been formed, and it was apparent that the program could not go forward without political compromise. After considerable debate, the government agreed to give managers and employees certain privileges, including the right of first refusal for purchase of their enterprises. Introduction of the buyout option in May 1994 significantly accelerated the rate of corporatization and provided a sufficient pipeline of enterprises to launch the voucher auctions (table 2). By the deadline more than 600 enterprises had applied for the buyout.

Applicants were allowed to purchase 51 percent of the enterprise's charter capital at the time of the first payment, but only enterprises that had paid 15 percent of the capital by 15 November 1995 retained rights to purchase the remaining 36 percent. The first payment could be made in vouchers, and 425 enterprises made at least a partial payment. Of these, 125 made the full first payment and thus retained rights to purchase the remaining shares in the package. Final payment for remaining shares, to be in cash, was due by 1 July 1996. However, many of the enterprises that took the buyout option ultimately succeeded in buying the remaining 36 percent at voucher auctions, as this was a significantly cheaper alternative to cash payments (given prevailing market prices for vouchers). As a result insiders own controlling blocks of equity (and in many cases, a majority) in about 40 percent of enterprises.

Table 2. Cumulative establishment of joint stock companies in Georgia

Date	Number of companies
End 1993	23
May 1994	50
May 1995[a]	675
May 1996	976

a. Voucher auctions launched in 1995.
Source: Ministry of State Property Management.

Although the buyout option helped accelerate privatization, it did not come without cost. Most insiders lack the capital, marketing skills, and understanding of restructuring that their enterprises need. Introduction of an interim national currency (the coupon) at an unfavorable exchange rate depleted the cash reserves of most enterprises, leaving them with idle factories short of working capital.

Building Institutions

One significant achievement of the Georgian privatization program has been the establishment in just six months of a comprehensive and efficient institutional framework for mass privatization. The Ministry for State Property Management is responsible for most aspects of the program's implementation. But, like Russia, Georgians developed a multilayered bureaucratic structure, including a cabinet-level steering commission, a coordinating council, and a territorial commission to provide oversight (particularly for identifying eligible voucher recipients and distributing vouchers).

To enable people to easily obtain their voucher, the ministry contracted with the former savings bank to distribute vouchers at its more than sixty branches. To carry out the auctions, the ministry established a central bid processing center in Tbilisi, three regional auction centers, and sixty-seven bid collection centers (one in each *raion*). And to reduce implementation costs and ensure that ministry staff concentrated on preparing a suitable pipeline of enterprises, the ministry contracted private operators to manage the central bid processing center and the regional centers and to handle voucher security, transport, and auditing.

The focus now is a privately operated share registration system. Having learned from Russia's bad experience with enterprise-managed share registries—where managers threatened by the influence of outside shareholders neglected to register new shareholders—the Georgians will allow only private share registries for enterprises with more than 100 shareholders. The private registries will be regulated initially by the Securities and Stock Exchange State Inspectorate of the Ministry of Finance and later by an independent securities commission. The World Bank is is helping to establish three pilot private registrars and regulations governing their operation.

Auctions for Small and Core Investors

Except for a small group designated as "strategic," all medium-size and large enterprises were required to participate in mass privatization (some strategic enterprises will be retained; others are expected to be privatized through international tenders). Encompassing almost 900 enterprises from the universe of 1,100 medium-size and large state-owned enterprises, the original program envisaged the sale of 35 percent of each enterprise through voucher auctions. But the government later decided to use the program to dispose of as many shares as possible in two rounds. In the first round at least 35 percent would be sold through "small investor" auctions targeted at the general public. In the second round the remaining shares in many enterprises would be offered through "core investor" auctions, with majority or minority packages of shares sold to the highest bidders.

Voucher distribution began in March 1995, with each of Georgia's 5 million citizens eligible to receive one voucher free of charge. The vouchers had a nominal value of $30 but no face value. The total nominal value of the vouchers ($150 million) was equivalent to 35 percent of the nominal value of all enterprises to be privatized ($429 million). Vouchers could be freely traded, used to bid for shares in individual enterprises, or surrendered to one of nine active voucher investment funds. They could also be used for the initial 15 percent payment of shares purchased through the management-employee buyout option.

Of the 5 million available vouchers, 4.3 million (86 percent) were distributed. Of those distributed, 4 million (93 percent) were actually surrendered—3.7 million (91 percent) at auctions and 350,000 (9 percent) for management-employee buyout payments. A total of 81 million shares were sold through the voucher auctions, or just over half of all shares offered.

Bids could be submitted at one of the sixty-seven bid collection centers, where they were checked to conform to established formats and their validity was verified. Bid forms were then sent to one of the three regional auction centers, where the bid data were computerized, rechecked, and passed on to the central bid processing center in Tbilisi, where the results of the auction were calculated and announced.

Small investor auctions

The small investor auctions began in July 1995, and the core investor auctions in January 1996. Targeted at the general population, the small investor auctions allowed conditional and unconditional bids. Conditional bids required bidders to state the minimum number of shares they would accept for the vouchers submitted. Unconditional bids accepted whatever rate of shares per voucher (the auction rate) resulted from a given auction. But because the government feared that some bidders might obtain all the offered shares for an enterprise for only a few vouchers, it imposed a share cap of forty-five shares per voucher.

The distribution of shares was determined by first dividing the total number of shares offered by the number of vouchers submitted under unconditional bids to establish the initial auction rate. This initial rate was then compared with the highest conditional bid to see if this bid could be satisfied (the required number of shares per voucher of the highest conditional bid had to be equal to or lower than the initial rate). If it could, the auction rate was recalculated considering the highest conditional bid and all unconditional bids. This new rate was then compared with the next highest conditional bid, and so on, until a conditional bid that could not be satisfied was reached. Shares were distributed to bidders according to this final rate (subject to the share cap). At the end of the mass privatization program, in July 1996, 3.2 million vouchers (89 percent of all vouchers bid at the auctions) were submitted through the small investor auctions.

Core investor auctions

Core investor auctions involved the sale of a majority package of shares or minority "packets" of shares (10 percent or 20 percent, for example) to the highest bidder. For many of these auctions more severe share caps were introduced (fifteen to twenty shares per voucher)—in some cases to the equivalent of nominal prices—which generally blunted demand. Targeted at core investors and investment funds, these auctions were intended to create owners with effective management control of the enterprise, avoiding the governance problems of widely disbursed majority ownership. A total of 391,000 vouchers (11 percent of all vouchers bid) were submitted through the core investor auctions, and only 6 percent of all shares offered were sold. Why did these auctions fail to attract more buyers? Mainly because few Georgians had the financial means to acquire such large blocks of shares, particularly since the imposition of more severe share caps further inflated prices.

Little Enthusiasm

The Georgian program suffered from low public enthusiasm for share ownership. According to nationwide surveys, most

Georgians (69 percent) supported privatization, but 53 percent did not intend to purchase shares with their voucher. Instead, most people who collected their voucher intended to sell it for cash. Two public information campaigns were organized to improve participation. Georgian television and radio were saturated with information about the program. Focus groups were organized and public opinion surveys were conducted. Moreover, the information campaign was modified to address gaps in the public's knowledge.

Still, these efforts had little effect on the public's willingness to become shareholders. Many Georgians were dissatisfied with the way privatization was carried out, with many seeing it mainly benefiting enterprise managers, foreigners, and well-connected individuals. And when this attitude dampened their enthusiasm to participate, it became a self-fulfilling prophecy. Most Georgians who did participate merely collected their voucher and immediately sold it. The result? Unofficial estimates indicate that about 90 percent of all shares purchased through the voucher auctions were bought by as few as 500 bidders—ironic, since one important objective was the equitable distribution of assets.

Perverse Cap

The most important constraint to the sale of shares through mass privatization was the imposition of the share cap. In theory the share cap would not distort the interface of supply and demand, provided that information on the entire pipeline of enterprises slated for auction was made available to bidders prior to launch of the auctions. The voucher market would simply adjust to the share cap through a reduction in the price of vouchers (reflecting low-value enterprises in the pipeline that would have cleared the auctions—in the absence of the cap—at more than forty-five shares per voucher), and the outcome would be the same.

This outcome did not happen, however, because the full range of enterprises that would pass through the auctions was not known in advance. Thus the share cap had a distortionary effect, and many shares remained unsold. Policymakers were aware of the possible negative effects of the cap and knew that some enterprises had low market values, but decided that the tradeoff was necessary to avoid exposing itself to accusations that it was giving away shares too cheaply. The government could not imagine how to explain selling entire enterprises for a handful of vouchers to a voting public unfamiliar with the forces (and logic) of a market economy.

Georgia's experience shows that attempts to regulate price discounts through share caps require careful planning and sufficient and timely provision of information, particularly with regard to the supply of assets over the entire course of auctions. Free voucher markets, in the absence of sufficient information on the total supply of assets prior to the start of auctions, cannot be counted on to adjust automatically to share caps to clear the market for shares. The perverse outcome—as in Georgia—might then be a failure to privatize more shares of marginal enterprises.

Investment Funds Shunned

Before the first mass privatization auction, twenty-one investment funds were licensed in Georgia. Aware of Russia's scandals over unscrupulous investment funds, the government passed more restrictive regulations, increasing the minimum capital requirement from $1,000 to $10,000 and requiring all investment funds to apply for new licenses. Only nine funds qualified.

Investment funds were not major players in the Georgia program because they could not attract enough vouchers. Public opinion surveys midway through the program revealed that fewer than 1 percent of the respondents invested their voucher with an investment fund. And of those who had not yet used their voucher, 29 percent said they would not entrust it to any investment fund and 47 percent were undecided. The Russian scandals just before the launching of the Georgian program undermined people's willingness to associate with local funds. By the end of the program, the nine active funds invested only 105,000 vouchers—just 4 percent of all vouchers submitted at the auctions (table 3). Most of the investors in Georgian funds are enterprise managers, Georgians living abroad, and a small number of foreign investors.

Table 3. Distribution of shares privatized at voucher auctions in Georgia
(percent)

Shareholder group	Share
Individuals	66.2
Investment	3.9
Foreign	19.8
Other	10.2

Source: Ministry of State Property Management.

Kazakhstan

Klaus Lorch and Enna E. Karlova

In the final years of the Soviet Union and the first few months after its dissolution, several thousand enterprises in Kazakhstan were transferred to private interests. But fewer than 300 of these were medium-size or large, and even in these the state often retained a majority shareholding. Without standardized privatization methods, few of the transfers were competitive and transparent. Most firms went to insiders for almost nothing because of long interest-free payment schedules in a process that supported neither the budget nor the equitable distribution of state property. Nor was the transfer to employees and managers conducive to improving the governance of large enterprises. These new owners lacked the deep pockets required to sustain losses or increase capital. They were reluctant to cut employment. And they continued to rely on their old connections in the state sector.

In mid-1992 the government started preparing a second phase of privatization for 1993–95 to privatize faster, to improve enterprise governance, to increase fairness and transparency, and to distribute state property equitably. The second phase consisted of four programs:

- Small-scale privatization of small enterprises, trucks, and warehouses through open cash-based auctions at the municipal level.
- Mass privatization of medium-size and large firms in coupon-based central auctions.
- Case-by-case privatization of large and natural resource–exploiting firms, mainly through international tender.
- Agricultural privatization, with farm employees' joint ownership of the farm but eventual individual ownership of its land.

The mass privatization program, the focus of this paper, was at the core of this second phase.

Responsibility for developing the program went to the State Committee for State Property (SCSP), which together with its *oblast*-level organs was the owner representative and privatization agent for all state enterprises. (In 1993 conduct of the auctions was spun off to a State Privatization Fund under SCSP's control and in 1995 to a separate State Committee for Privatization.) Initially advised by a joint team of experts from the World Bank, the European Bank for Reconstruction and Development, the U.S. Agency for International Development, and EU-TACIS, the SCSP had to manage a complex process of consensus building with line ministries, parliamentary commissions, and the president's and prime minister's offices before final decisions on the programs design were made by the cabinet and president. When finally published, the program document had gone through more than forty drafts.

Examples of coupon-based privatization were available from four countries:

- The new Russian program, with its predominance of insider ownership.
- The Mongolian program, with its emerging "orphaning" problems among privatized enterprises.
- The Polish program, with its technocratic allocation of firms to state-controlled but contractually managed investment funds.
- The well-known Czech and Slovak Republic program, with its complex infrastructure and communication flows.

Kazakhstan's program followed that of the Czech and Slovak Republic in many respects, but with several simplifications.

The most notable was that the investment of coupons in private investment funds was not optional—it was mandatory.

During April 1994–January 1996 Kazakhstan implemented and completed its mass privatization program for medium-size and large enterprises, achieving most of its main objectives. The program was fast and broad, with 1,712 companies, most of them with more than 200 employees, offered at coupon-based share auctions. In all the program covered companies employing 750,000 people, or about 35 percent of the nonagricultural state enterprise sector. The process was largely fair and transparent, and the initial distribution of state property was equitable. Kazak citizens used 61 percent of the coupons they were eligible for, and enterprise managers and other insiders got only limited privileges. Moreover, enterprise governance has started to improve, but at a pace slower than expected—due in part to excessive restrictions on the investment funds at the core of the program.

Enterprise Governance before Mass Privatization

It took eight months to design the program and build consensus for it. It took another nine months to prepare for implementation—to elaborate some fifty regulations, build up institutional capacity, install information and communication systems, establish citizen lists, develop and launch a public relations campaign, and so on. Coupons were issued at the end of 1993, and share sales started in April 1994. When the program was being designed, it was clear that building consensus, preparing for implementation, and selling 1,500–2,000 firms would take time. How should the firms be governed in the interim? How could the state identify the least viable firms and, at a minimum, prevent the further allocation of state resources to them? How could accountability be ensured to minimize excessive spending on welfare, the theft of assets, , and the encumbrance of insupportable liabilities and disadvantageous long-term contracts?

Foreign advisers reluctantly proposed that the SCSP temporarily delegate its enterprise governance responsibilities to a handful of state holding companies capable of exercising governance with financial prerogatives and in a business-oriented manner. The idea was that the state-owned enterprises in each subsector would be given in trust to several holding companies in order to nurture competition among firms, weaken the influence of the *nomenclatura,* and make each diversified holding company focus on financial control rather than operational interference.

Things did not work out that way, however. Instead, eighty-one state holding companies were established on a strictly subsectoral basis and had about 2,800 enterprises subordinated to them—including half of all mass privatization objects and many agroindustrial and small firms. Thus most holding companies were dominant, even monopolistic, in their subsector. Holding companies were often managed by former line ministry staff and overseen by the line ministries, not by the SCSP or the Ministry of Finance. Moreover, instead of holding state shares in trust, the holding companies became owners of some state shares. Just as bad, the authorities found it difficult to deny requests to issue shares in holding companies to some of their subsidiaries, managers, and other affiliated parties. This complicated the later release of holding companies' subsidiaries for privatization.

Recognizing these drawbacks, the government subsequently decided to dissolve all but a few holding companies. This was to be done through the sale of the majority shares of their subsidiaries through the mass privatization program, the sale of further subsidiary shares through other means, and the segmentation or dissolution of the holding companies with their few remaining assets. In all, seventy-seven of the eighty-one holding companies were to be dissolved or otherwise reorganized. The release of the majority share packages—with the encouragement of World Bank loan conditions in the face of resistance by the holding companies—succeeded to a fair degree. Sixty-five of the eighty-one holding companies were to discharge their 1,000 eligible firms into the program, 900 of which went on auction. Still, the holding companies remained the largest single shareholder in many mass-privatized firms, often with a controlling 44 percent minority of voting stock. The subsequent release of these shares for cash-based auctions and the segmentation or closure of the holding companies have been proceeding despite technical and political difficulties.

Coupons As the Currency

The first design decision for the mass privatization program was whether to sell shares for cash, make concessional transfers to employees, or give shares away to all citizens. Cash-based auctions were rejected for several reasons. Inflation had eroded people's savings. Concentrations of new wealth, after only a short period of *perestroika,* were seen as unfair gains from rent seeking and theft rather than as entrepreneurship. And foreign investors lacked interest in all but a few firms.

Simply turning ownership over to employees and waiting for subsequent secondary ownership changes to improve governance was rejected as well—mainly for reasons of inequity. Hence coupons were chosen.

Each citizen was eligible to receive the same number of privatization investment coupons, although rural inhabitants got 20 percent more coupons than urban dwellers in recognition of their disadvantaged living conditions. Since many citizens had migrated or lived in "closed cities," citizen lists needed to be recreated. Local housing management offices completed the lists within tight deadlines (but not without errors) and computerized and forwarded them to the state-owned savings bank and its dense branch network. People claimed their coupons by registering at these branches and receiving a coupon booklet as evidence of a coupon account. Since inflation had wiped out people's savings, coupons were distributed free of charge.

Individuals received a booklet of 100 coupons (120 in rural areas). They could invest them only in multiples of ten, so each person had a maximum of ten (or twelve) investment opportunities. This setup meant that many investments (in investment funds) would be as tiny as one-tenth of a citizen's coupon allocation. Although this approach was intended to facilitate risk diversification, it made it very difficult to register and trade such small holdings and to communicate with shareholders cost-effectively. The coupons were denominated not in currency but in points—advisable given the country's high inflation and poor accounting; nominal values could have misled citizens unaccustomed to shareholding. To avoid forgery and theft, the coupons were not securities but mere records of account entries. To simplify the coupon system and to prevent the selling of coupons for quick cash, coupons were not tradable.

Kazak citizens were eligible to receive 1.84 billion coupons: 100 each for the 9.6 million urban residents and 120 each for the 7.3 million rural citizens. According to the SCSP, more than 95 percent of citizens registered their coupons, so they had about 1.75 billion coupons to invest. Citizens quickly started allocating their coupons to investment funds. An intensive public campaign, built on frequent surveys, conveyed general information about market economies and privatization, specific information about the program, instructions for the use of coupons, and news of progress and results. After about six months (mid-1994), however, the coupon collection slowed for several reasons. The second SCSP chairman slowed the privatization process. The companies for sale started to be less valuable. Complaints arose about irregularities at the share auctions, mainly the last-minute withdrawal of some objects from the sale. And the failure of some fraudulent investment funds in neighboring Russia hit the news. With the resumption of vigorous program implementation in late 1994, interest in the program gradually recovered, and allocations to funds grew roughly in line with the volume of assets auctioned.

By early 1995 it had become clear that a large part of the program's expected assets were slow to enter the pipeline for auctions and that a large number of unallocated coupons faced a thin supply of objects. With the country's leaders increasingly concerned about a politically damaging coupon overhang, efforts were made to strengthen the enterprise pipeline. Quantitative targets were imposed on oblast authorities to force them to disclose eligible enterprises. An attempt was made to establish a comprehensive enterprise database. Efforts were redoubled to pry eligible firms out of state holding companies. And some shares were added to the program from firms that were not genuine objects—such as residual state minority shares in agroprocessing firms and small share packages in large enterprises otherwise subject to case-by-case privatization. As a result coupon allocations recovered in 1995, and when the allocation of coupons to investment funds formally closed in late 1995 citizens had used 61 percent of the coupons they were eligible for and 64 percent of the coupons they had registered.

Investment Funds As the Instrument

Citizens could invest their coupons in 169 specially licensed investment privatization funds, and only these funds were eligible to participate in auctions where enterprise shares were sold for coupons. This approach allowed major technical simplifications. It also allowed people to invest their coupons at any point in time, forced them to invest in vehicles with quite diversified portfolios, and reduced the risk of orphaning enterprises. The funds' founders and managers had to be private entities, and they had to undergo training and legal instructions prior to their licensing.

The investment funds fall into four broad categories:

- Those related to new business groups, which often have ties to commercial banks. These include groups like Butya, Raimbek, and Astana (all with ties to Kazkommerz Bank, and jointly known as the New Generation alliance), the Kramds group, and Alemsystem.

- Those that benefit from broad membership or retail networks in attracting coupons from citizens, such as the consumer cooperatives network.
- Those with a narrow regional or sectoral focus, some of which are rumored to be affiliated with state conglomerates.
- Many small yet often unfocused funds with little capital committed by their founders.

Regulations sought to prevent the predominance of any one fund by setting a 5 percent cap on the share of all coupons issued that one fund could accumulate, but this rule became difficult to enforce when the most popular investment fund, Butya, approached this limit just halfway through the program. Tight ceilings were imposed on the funds' investments for several reasons. Ceilings on the percentage of a fund's portfolio that one firm's shares could account for ensured risk diversification. The 5 percent cap on the coupons that one fund could accumulate ensured competition in the share auctions and avoided excessive concentration of control in the economy. Moreover, caps were placed on a firm's shares that one fund could buy (10 percent) or hold (20 percent, later raised to 31 percent).

The investment funds seem from the start to have had realistic expectations of the number of enterprises that would eventually be offered in auctions, and of how many coupons they would collect from citizens. For example, after the first five auctions the investment funds had bought 11 percent of the 1,712 companies eventually offered and used 11 percent of the coupons they eventually collected. When the final auction started, the investment funds held 17 percent of the coupons that they had collected from citizens, and the government offered about 18 percent of the program's assets (254 primary and 159 repeat offers). At that auction the government modified its procedures to clear the stock of coupons and companies. In the end only 0.2 percent of coupons that the funds had collected remained unused.

The 169 investment funds licensed before the first auction generally performed well in a difficult environment. No major fund collapsed. Some attracted the country's best young talent. And many demonstrated considerable business savvy. By the end of the program the more important funds were consolidating their equity stakes by trading with each other, and they were seeking outside strategic investors to bring in more capital and business know-how. Anecdotal evidence indicates that they also started forcing information requirements on enterprises, replacing enterprise managers, and elaborating strategies for restructuring their main firms.

Observing that the vast majority of Czech and Slovak citizens chose to give their coupons to investment funds, Kazak authorities decided to make this route mandatory to permit major simplifications. That Kazak citizens used almost two-thirds of the coupons they were eligible for indicates that they were not adverse to the funds. Giving the funds such an important role required careful licensing, regulation, and supervision. But some of the regulations hindered the funds in their governance of the firms they acquired. Moreover, the concentration of coupons and share ownership in a few leading funds was significant, and the control of funds by their investors still suffers from technical constraints.

Why make the use of investment funds mandatory? Citizens could limit their assessment of investment options to a small number of investment funds, leaving the assessment of the 1,712 enterprises to professional investors. Moreover, the share auctions and citizens' use of coupons were technically delinked. The share auctions took place at monthly intervals among representatives of investment funds. Citizens could invest their coupons in investment funds at any time at the 4,000 counters of the savings bank. In addition, with most enterprise shares in the hands of a few investment funds, the risk of orphaning these enterprises was reduced, and rapid governance improvements became possible. In this sense the program was a "one-stage approach" to governance improvements that would not require a second ownership transfer after privatization.

But enterprise governance by the funds was hindered by counterproductive investment restrictions. Despite a concurrent limit on a fund's portfolio concentration—a 5 percent single exposure limit, later raised to 10 percent—the authorities also restricted to 10 percent the shares of any one enterprise that a fund could buy, and to 20 percent the shares a fund could hold (after additional share purchases). As a result most investment funds found it very difficult to supervise, check irregularities, force restructurings, or even get access to meaningful company information. In April 1995 the ownership ceiling was finally raised to 31 percent. Given the 10 percent nonvoting stock allocated to employees (see below), this amounted to 34 percent of the voting stock, a controlling minority stake. Governance improvements were also impaired by a weak legal and business environment and by a general shortage of market-oriented skills in the economy. Today the most dynamic investment funds are monitoring their firms, replacing managers, identifying corporate strategies, and pursuing restructuring agendas.

They have also been consolidating their portfolios through share trading.

Investor governance of the funds remains a problem. The tiny size of many citizens' investments in a fund (as small as one-tenth of his or her coupon allocation) and the high transactions costs relative to investments affect the communication of fund managers with their investors, the trading of investment fund shares, and the interest that investors take in the oversight of the funds. Most funds are controlled by their managers and sponsors, their behavior checked only by weak regulatory supervision and by the concern of sponsors about the image of their business group.

Auctions As the Mechanism

Enterprises meeting the definition of the program were ordered to corporatize within a few months. The main purpose: to clarify their legal status, their assets, liabilities, and stock, and the roles of their managers and supervisory councils. There were model documents for corporatization but only limited site assistance, and the documents were reviewed in detail only when preparing a firm for sale. As an incentive, employees collectively received 10 percent of the share capital of their enterprise (in the form of nonvoting stock) on completion of corporatization. Employees were then expected to distribute these shares among themselves. In the final mass privatizations an additional 5 percent of shares was given for free to enterprise managers.

Any restructuring prior to the program was kept to a minimum. The government knew that it lacked the capacity and experience to control, let alone conduct, widespread restructurings prior to sale and that such restructurings might delay privatization by months or years. Enterprises generally were sold with all their financial and environmental liabilities, though this undermined a number of sale offers. Many social assets, though usually not housing, remained with the firms. Some small, commercially viable sections of firms, such as canteens or in-house shops, were split off from the firms, though not systematically or comprehensively. To avoid major delays, even firms considered monopolistic or dominant in their markets were sold without prior segmentation.

Enterprise shares were sold to the investment funds at auctions, which were held in Almaty (the capital) about once a month. Forty-five days before an auction, funds received a standard set of publicly available data on the financial conditions, assets, and production of enterprises, and they could request additional information directly from the enterprises. The list of firms for sale was finalized about a month before each auction, although a few firms were withdrawn as the auction neared. During the auction fund representatives assembled in one room for the biddings. Minimum prices (in coupons per share) were set artificially, based on the face value of the shares and the prices paid at the previous auctions. Shares unsold at these prices were offered a second time at a later auction, and sometimes a third time. A few firms that remained unsold entered liquidation proceedings. Only in the final few auctions did new legislation permit a reduction of the minimum price in a repeat offer, thus enhancing the chance of sale. Payment was made immediately by debiting the coupon accounts of the investment funds.

At least 51 percent of the shares of each company in the program were to be offered for sale for coupons. In the early auctions some companies had more than 51 percent of their shares offered, but in later auctions this share was rarely exceeded and often was not achieved. A 51percent stake was equivalent to 56 percent of voting stock because of the 10 percent of shares that went to employees as nonvoting stock. Due to the 20 percent ceiling on the stake a fund could hold in any one enterprise, this share majority was always split among several funds (although some funds were affiliated with the same business groups or with clusters of collaborating groups). The residual state shares (normally 39 percent) initially remained in the hands of state holding companies. In 1996 the state began selling these residual shares to the public through cash-based auctions (see below).

As noted earlier, during April 1994–January 1996 the shares of 1,712 companies were auctioned for coupons, for an average of seventy-eight primary offers a month. Together these companies employed about 750,000 people, or 35 percent of the workforce in nonagricultural state enterprises.

The auctions started at a good pace with about sixty-five primary offers a month. After a new SCSP chairman entered office four months into the program, that number dropped to fewer than thirty offers a month. With the second replacement of the SCSP chairman in late 1994, the initial pace recovered with fewer but larger auctions. An increasing portion of these offers, however, were firms with fewer than 200 employees and firms whose share majority was already private—a portion that eventually came to exceed half of the primary offers. In a major effort to find and sell larger firms, the composition of auctioned enterprises was then improved, and the program ended in January 1996 with a huge final auction of 254 primary offers.

In about 60 percent of the privatized companies the offerings were sufficient to convert them from majority state ownership to majority private ownership. For about 46 percent, more than 51 percent of the shares were offered for sale. Fewer shares were offered for 14 percent, but they were sufficient to achieve a private majority because other shares had already been in private hands. In 13 percent of the enterprises, often very large companies, not enough shares were offered to achieve a private majority. And in about 27 percent, the majority share was already private prior to the auction; these were often residual state shares in agroindustrial firms that had already been privatized in other ways.

For nearly 70 percent of the 1,712 companies, all shares offered were sold at once. For 25 percent the shares that remained unsold in their primary offer were subsequently sold in repeat auctions. The number of repeat offers was low initially, but from late 1994 onward there was an average of forty repeat offers a month. Only 5 percent of firms were left with unsold shares when the program ended.

Shifting Objectives Reflect a Turbulent Environment

Mass privatization was intended to satisfy some objectives directly and others indirectly, while certain potential objectives were intentionally omitted. Rapid privatization and a direct effect on enterprise governance were considered critical for accelerating Kazakhstan's transition, supporting its stabilization, and curtailing the widespread abuse of enterprise property. Fair process and equitable property distribution were key issues for the leadership of a new country with a difficult ethnic balance and a history, within the Soviet Union, of forced resettlement, prison camps, and secret cities.

Some objectives were expected to be supported by the program only indirectly: capital market development (through the eventual trading of privatized shares by investment funds), attraction of foreign investment (by the investment funds rather than government bureaucracies), and entrepreneur development (by new managers who would no longer be appointed by politicians). Other potential objectives were not pursued, such as maintaining traditional supply linkages and rewarding the industrial nomenclatura's past achievements. Generating budget revenue was also not a major objective in 1992–93.

The winners under the program were to be the citizens, as well as the dynamic new business groups that founded and managed investment funds. The losers were to be the industrial nomenclatura and the Treasury. Other losers were to be consultants with hopes for plenty of work on case-by-case deals, along with investors keen on gaining control of the most profitable of the privatized companies.

Once the program was under way, however, the political and economic environment changed—and with it, the program's objectives. First, drastic fiscal austerity, essential to stabilize the new national currency introduced in 1994, turned the government's eyes to the potential revenue from cash-based privatization. Second, a steep drop in industrial output in 1993–94 heightened concerns about maintaining domestic supply flows and averting a surge in unemployment. Both concerns played into the hands of the nomenclatura, who blamed rash reformers and brash young businessmen for the disturbances in production. Third, parliament was dissolved by the Constitutional Court in early 1995 and restored only in early 1996. In this changing environment the image of the program was further damaged by technical irregularities such as errors in coupon-holder lists, last-minute changes to auction lists, and delayed or incomplete releases of company information. News of scandals surrounding fraudulent investment funds in neighboring Russia also undermined confidence in the program.

The combined effect of shifting objectives, disgruntled insiders, and implementation mistakes challenged the government's commitment to the program. The SCSP chairman was replaced three times in 1993–94. Efforts to prevent spontaneous privatization (resulting from firms' issuance of new shares or transfer of enterprise assets to private entities) slackened. Smaller firms began entering the program, and the shares of their assets offered for sale were in many cases insufficient to lower the state's holdings below 50 percent. Moreover, an increasing number of firms were already majority private when they entered the auctions; only their residual state minority shares were sold off. Thus the program risked losing its relevance and integrity in the first half of 1995. Enthusiasm gave way to passivity and there were discussions about terminating the program prematurely.

In late 1995, however, the country's leaders reaffirmed their commitment to the program, as did major donors (through policy dialogue and technical assistance). State enterprise managers were promised 5 percent of shares (in addition to the 10 percent employee share) once their firms were sold under the program. A cash-based privatization program to sell the residual 39 percent state share packages started being designed, catering to the Treasury and to cash-rich

company insiders. The pipeline of firms for sale was strengthened by establishing a comprehensive database on enterprises, releasing firms from holding companies, and exerting pressure on regional property committees to reveal and submit candidates for privatization. Permission was given to waive minimum prices if a sale failed in the third auction effort.

As a result the volume of auction offers accelerated to 100 a month, the average size of privatized objects recovered somewhat, and program implementation continued until its completion in January 1996. However, the quantity of sales was raised in the second half of 1995 at the expense of the quality of sales. Put differently, a rather constant stream of proper sales was supplemented with additional sales of smaller share packages.

An Unexpectedly Narrow Scope

Almost all nonagricultural state enterprises with 200–5,000 employees, estimated at 2,500–3,000 firms in 1993, were supposed to be mass privatized. Exempt were natural monopolies, firms exploiting nonrenewable natural resources, and firms performing mainly noncommercial functions. A complete list of enterprises was not available because poor statistical and registration data did not keep pace with rapid changes in the enterprise sector and excluded some 2,000 firms that had been directly under Moscow's control. An effort to establish a comprehensive database on medium-size and large enterprises was carried out only in late 1995, toward the end of the program. In the end only 1,700 firms went through the coupon program. Why? Agroprocessing, trucking, wholesaling, and a few other firms were to be privatized through the other three privatization programs. Many firms dropped beneath the 200 employee floor because of layoffs or segmentation or were liquidated. And some firms may have found ways to privatize themselves spontaneously outside official channels.

The scope of the program was narrower than was initially intended, technically feasible, and economically desirable for three main reasons: excessive optimism about the speed of other privatization methods, efforts by stakeholders to escape a program that did not match their interests, and the shifting objectives of government.

Initially, mass privatization was seen as the main one of four programs in the second phase of privatization. Only small objects, farms, and sectors requiring major new regulations before privatization were to be excluded, so that they could be privatized in the three other programs or not be privatized for the time being. Eventually, however, these three exclusions widened to encompass trucking and wholesale firms, agroindustry, and very large enterprises.

The segmentation and privatization of trucking and wholesale structures were considered critical for local competition, and hence for the success of privatized firms. In addition to the sale of 11,000 individual trucks, domestic trucking and warehouse firms and their remaining fleets and stores were meant to be split up and privatized very rapidly—earlier than the expected start of the mass privatization program. To achieve this, these firms were earmarked for local small-scale auctions. In the end, however, this rapid privatization stalled in the face of influential vested interests. In mid-1996 many trucking and warehouse firms were still owned by the state.

Agricultural processing and distribution firms were excluded from mass privatization in the last months before signing of the program document for the second phase. Under the umbrella of agricultural privatization, most agroindustrial firms were then transferred without competitive procedures to their employees, managers, suppliers (that is, farms), and, occasionally, clients. Driven by a concern for rural stability, traditional vertical linkages were thus preserved beyond privatization through interlocking ownership and the continued influence of old managers with local political ties. After May 1995 the government did offer more than 450 agroindustrial enterprises in the program—but most of these offers were residual minority shares in firms that had, by that time, already been privatized.

Most very large firms (more than 5,000 employees) were also excluded from the program and instead included in the case-by-case privatization program. This move reflected concerns about the limited capabilities of the investment funds and the often dominant role of giant enterprises in the local economy and social sphere. It also reflected the judgment that the size of these firms made the time-consuming case-by-case sales effort worthwhile for both sellers and buyers. The optimistic sales targets for case-by-case privatization soon proved infeasible, however, because of the program's scarce institutional capacity and inadequate budget. Within three years only a half-dozen firms were sold in this manner. Frustration with the slow pace led to the noncompetitive award of more than thirty management contracts, sometimes poorly structured, for large mining and metallurgical firms—mostly to offshore or local management companies. Small shares (5–10 percent)

in about sixty-five very large firms were eventually sold through the program, but these sales merely compensated for the shortage of assets and allowed motivated citizens to use their remaining coupons. It did not change the program's scope.

Privatization of Residual State Shares

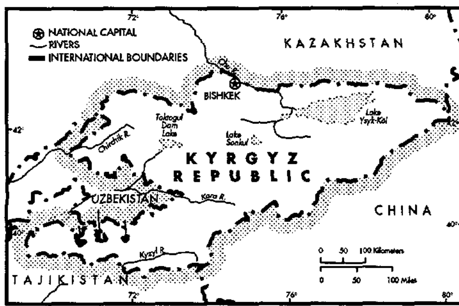
The program document for the second phase of privatization foresaw the mass privatization of 51–90 percent of firms' shares. Since 10 percent in nonvoting stock was usually given to the employees upon corporatization, this 51–90 percent range translated into 56–100 percent of the voting stock. Any shares retained by the state were to be minority shares, largely in firms with particularly good prospects for revenue generation.

As it happened, almost 95 percent of the firms still had some state shares left after the program, and in some the state maintained a majority shareholding. Of the first 1,000 firms offered, 10 percent still had a state share majority when the program closed: in 7 percent by design (few shares were offered for sale) and in 3 percent by default (shares remained unsold even after repeat offers). Moreover, with the program's objectives shifting toward revenue targets and the preservation of horizontal and vertical linkages (through the holding companies), offers of less than 51 percent were made with increasing frequency.

What, then, became of the residual state shares? In many cases they were purchased by insiders. Industrial managers saw the residual shares as an opportunity to acquire their firms in cash-based privatizations. In these open auctions, they would have an information advantage. And with some creativity, they could use the enterprises' resources to purchase the shares.

A cash-based auction program for residual minority shares was designed in 1995 using Dutch and English auction methods. Pilots for the cash-based auctions started in October 1995, and a first batch of 190 share packages was offered in January 1996. In all, the state expects to sell its residual shares in some 2,500 companies by the end of 1996—a very optimistic goal. The broad intention is to divest as rapidly as possible the residual state shares in nearly all the corporations that have undergone agroindustrial privatization, earlier spontaneous privatization, or mass privatization.

To stimulate capital market development, not all the auctions will be run by the state. Some will be organized by specially licensed private auction intermediaries who acquire through tender the right to conduct auctions for batches of firms. These intermediaries must sell the shares above state-set minimum prices and surrender all sale revenue (except their fees) to the authorities. How well these provisions capture value for the state, and how well the manipulation of the auction process is avoided, remain to be seen.



The Kyrgyz Republic

Gary J. Fine

The Kyrgyz Republic's mass privatization program has used privatization vouchers, known as "coupons," and cash privatizations to encourage participation by managers, employees, outside investors, and the general population in a massive redistribution of enterprise shares from the state to the private sector. Begun in 1994, the coupon auction was completed for 993 enterprises (typically for 25 percent of the shares) by January 1997. Of these, 804 enterprises (more than 80 percent) were fully or partly privatized through cash auctions or direct sales to managers or outside investors following coupon auction.

The coupon auction was essentially a mass giveaway, as the chronic shortage of available cash among the population would have made alternative forms of privatization unviable. Coupon auctions have offered the Kyrgyz public shares in medium-size and large enterprises in exchange for privatization coupons, issued to every citizen in early 1994. In order to allow holders to invest in several enterprises without purchasing additional coupons, coupons were issued in varying denominations and amounts depending on a citizen's age and years of employment. Coupons were issued in points that bore no relation to the Kyrgyz currency, the som. Rather, the distribution of points was based on an earlier account-based voucher system administered by the state Savings Bank. In that program citizens were meant to purchase only those shares in the enterprises where they were employed.

Mass privatization was modeled on Russia's voucher auction, which featured simple, transparent, and accessible bidding and provided citizens with choices for investing their vouchers (including outright sale). As in Russia, Kyrgyz citizens could invest coupons at regional auctions, where midsize enterprises of regional interest were offered, or at nationwide auctions, where the largest and best-known enterprises were sold.

Unlike the Russian program, however, large concessions to managers and workers, in the form of a significant portion of enterprise shares, were not needed to win program acceptance. Free distribution of shares to workers in the Kyrgyz Republic was limited to 5 percent, a considerable turnaround from the earlier unsuccessful privatization attempt that was limited to enterprise employees. Coupons could be invested at one of fifty or so bid collection centers located in Savings Bank branches, post offices, or at the primary auction center in each region. In addition, mobile collection points served rural locations, and auction center staff frequently set up bid collection points at enterprises being auctioned.

Less than 80 percent of the coupons printed were claimed by citizens. In part this low turnout was due to emigration to Russia and elsewhere. Some Kyrgyz analysts also believe that a popular perception that the best companies and the best managers were in Russia was at the heart of initial apathy toward the program. This may also explain why coupon holders, especially those in small towns, tended to invest in local firms.

Steady Progress

Despite the slow start to the auctions (only 14 percent of distributed coupon points had been invested by the end of 1994), public relations efforts to reach rural populations and

the offering of some of the most attractive enterprises resulted in a significant increase in coupon investment by mid-1995. By January 1996, the beginning of the final full year of the auction program, just over 50 percent of the total coupon points distributed had been invested, and by late 1996 that figure had grown to more than 62 percent. Since 1997 promises to bring to coupon auction the long-awaited share sales of the nation's largest enterprises, it is hoped that the auctions will soak up a good portion of the remaining coupons still in circulation.

Coupon holders unsure about how to select an enterprise for investment could invest indirectly through one of eighteen licensed coupon investment funds. Investment funds in the Kyrgyz Republic have never reached the level of acceptance or popularity of those in the Czech Republic and Russia; by the end of June 1996 only 20 percent of total coupons were invested in investment funds. This relative indifference toward investment funds can be explained in part because the public preferred to invest in enterprises with which they were familiar and in part because of a perceived risk of fund investment as a result of the well-publicized investment scandals in Russia.

Coupon investment funds have been particularly strapped for cash. They have not had the commodity and other asset exchange venues that were available to Russian businesses. In Russia these exchanges provided a market venue where unneeded assets could be sold by businesses to those who sought them. They also helped spur the rapid growth of voucher trading, which provided cash flow to Russian voucher investment funds that participated in trading.

Things did not evolve in the same way in the Kyrgyz Republic. Many investment funds have sold shares to enterprise managers in order to raise cash; some even borrowed to pay dividends to shareholders. To promote profitability among funds, new regulations permit them to engage in other businesses. Double taxation, which had reduced the attractiveness of these investment vehicles, also has been eliminated. Since 1996 coupon investment funds must be licensed and must follow new reporting and disclosure requirements and accounting standards.

The Kyrgyz mass privatization program has benefited from a steady supply of enterprises to feed the auction program, processing at the height of the program almost forty enterprises a month among regional and national auctions. This progress occurred despite the protracted enterprise preparation process, which requires a valuation, inventory taking, and the approval of an oversized corporatization commission developed to promote consensus among the various parties having an interest in the privatization of each enterprise. The process was also intended to speed the approval process, to deflect accusations of selling assets at low prices.

Since the State Property Fund is responsible for privatizing nearly all sectors of the economy and enterprise shares were transferred to the fund upon corporatization, it has had the luxury of determining its auction calendar as much as six months in advance. This is an unusual phenomenon, since in most mass privatizations enterprise availability is known only month-to-month. Thus Kyrgyz citizens have been able to make investment decisions well in advance.

The Kyrgyz program has also benefited from a strong, reform-oriented presidency and government, despite ethnic pressures that have tended to propel certain regions on their own course.

Obstacles and Modifications

One of the greatest difficulties facing the program is the belief among many legislators and the opposition that state assets are being sold too cheaply. At the same time, the economy suffers from a dearth of cash, constraining competitive bidding from realizing what some believe are appropriate values. This belief is compounded by the arbitrary and nonmarket-based methods used by the state to value its assets.

The preoccupation with valuation has delayed the sale of many enterprises. This is particularly true of enterprises at open-outcry cash auctions (the most common form of share sales following coupon auction), where sales frequently have not been realized because of the imposition of a nonmarket-based floor price. Many enterprises have been placed on auction several times, with no reduction in the floor price, and consequently many shares remain unsold. As a result the number of enterprises fully privatized initially fell short of expectations.

In late 1995 the State Property Fund adopted a regulation intended to ensure the sale of all shares offered at cash auction. This rule permits a maximum of two cash auctions per enterprise. If all shares are not sold at an initial open auction, where the starting price can be lowered by up to 25 percent, they are to be sold at a closed auction, without reference to a minimum price. Only a few enterprises were sold in 1995 under this rule, and other sales ignored the new rule altogether. By early 1996, however, thanks to the determination of the State Property Fund (now under new management and

elevated to the ministry level), implementation of the revised cash sales format was completed throughout the country, and the number of full divestitures increased substantially. By the end of June 1996, 640 of the 946 enterprises that had gone through coupon auction had been fully privatized.

Even in a number of cases where shares were offered without a minimum price, however, there were no bidders. No doubt the existence of debts, many of them to former state banks, meant there would be no takers, even if at first glance the purchase price appeared to be nil. Privatization officials have considered offering these shares at a second coupon auction that they hope will further absorb outstanding coupons. Officials also hope to begin offering more than the usual 25 percent of shares at coupon auction if they expect demand at a subsequent cash auction to be weak.

Another method for disposing of the balance of state shares, through the solicitation of price bids and investment proposals, has not been particularly successful. Known as the competitive bid program, it sold only fifty-four enterprises by the end of 1995. The program is targeted at encouraging investor groups, including managers, to compete for remaining state shares following the coupon auction, which in most cases would provide the investor group with control. In this regard these sales differed from cash auctions, where shares were packaged into lots and only the purchase of sufficient share lots could guarantee control. The program requires an automatic sale if the highest bid exceeds the next highest bid by at least 15 percent (assuming they both exceed the starting price or state valuation). In all other cases experts review the bidders' business and investment plans for the enterprise.

Although privatization officials have claimed that the competitive bid program was necessary to prevent inexperienced or poorly capitalized investor groups from gaining corporate control, the process is protracted, subjective, and opaque, with bidding procedures sometimes reduced to simple negotiations. A companion program focuses exclusively on enterprise sales to managers but is equally nontransparent: 213 enterprises were earmarked for these programs, although only 74 were announced. Citing the lack of cash, potential investors have petitioned the government to permit payment by installments; current rules require full payment within two months.

Finally, no category of stakeholder has emerged with sufficient concentration of ownership to have a positive effect on corporate governance and restructuring. The population's lack of interest in coupon investment through investment funds, compounded by an investment limit per enterprise of 25 percent of shares, has meant that investment funds have had a limited influence on enterprise corporate governance. Likewise, workers and managers have not emerged to perform this role because they receive a maximum of 5 percent of shares free of charge. Shares sold at cash auctions following coupon auction frequently have been sold to multiple buyers—when they have been sold at all—reflecting the general lack of monetary resources among individual buyers.

Capital Market Links

One measure of the success of a mass privatization program is the ease with which the investing public can trade privatized shares. Kyrgyz authorities moved early on to encourage private establishment of a stock exchange. During 1994–95 the government actively promoted the creation of a national stock exchange, related infrastructure, and a legal and regulatory framework to support the sale and trading of privatized shares. The result was the Kyrgyz Stock Exchange, the first privately owned exchange in Central Asia, founded by a group of brokers in early 1995. Although twenty-seven listed securities were being traded by the end of 1996, market capitalization was only about $5 million.

Despite the low capitalization, the broker community appears to have consolidated itself around the stock exchange and is poised to participate in further development of the capital markets. Eleven of the country's eighteen active brokers are members of the exchange. (Two of them are affiliated with commercial banks and nine are individuals.) Discussions with a key exchange broker revealed a client profile of local firms and individuals, with many foreign contacts waiting for additional signs of economic stability and increased liquidity before they consider investing. Brokers either manage clients' accounts on a discretionary basis or invest their funds as they require for particular transactions.[1] Clients typically invest in listed stocks, stocks of privatized banks, and Kyrgyz government bills.

The exchange, which recorded more than 300 trades a month by the end of 1995, has created a simple share clearing and settlement system that could be used in other emerging markets. Clearing and settlement are conducted by the exchange, which is unusual. The exchange works with the half-dozen or so shareholder registries throughout the country, so when a trade takes place the registry confirms ownership and freezes the shares from further trading until the buying broker's funds are confirmed and transferred by Maksat Bank (a local, privately held commercial bank at which all

broker-members have an account). Shares are reportedly always delivered against payment in three days.

The exchange has not been successful in encouraging the listing and trading of privatized shares. While a number of countries with mass privatization programs have allowed all privatized companies to trade on their exchanges, the Kyrgyz exchange's strict listing requirements demand a high level of corporate disclosure. Few of the many enterprises that have gone through coupon auction are able or willing to satisfy these requirements. And even if they could, enterprise managers have not been attracted to listing, fearing both increased disclosure and a loss of corporate control. Many are even concerned that sales proceeds would be taxed as income and seized by the tax authorities. A second-tier listing, begun in January 1996, does not permit companies to raise new capital through share sales, making it equally or even more unpopular.

Because Kyrgyz privatization officials had trouble selling residual state-held shares for high prices following coupon auctions, they attempted to distribute privatization shares, on a selective basis, through the Kyrgyz Stock Exchange. This effort has been less than successful, as in some cases an agreement on offering price could not be reached. Using the stock exchange for the mass privatization program could, however, supply new enterprises to the exchange and direct privatization demand—for the first time—through the securities markets.

Looking Forward

Among the objectives of the government's current (1996–97) privatization program is the inclusion of various infrastructure sectors, including telecommunications, power, natural resources, and aviation. In order to provide shares of these companies to coupon holders before the coupon auctions end in mid-1997, a small portion of shares—no more than 10 percent and in come cases less—is expected to be offered to the public at coupon auctions before the program ends. These enterprises, among the country's largest, are expected to be divided into a number of smaller entities before their divestitures are completed over the next year or two. The government estimates that nearly 1,200 enterprises will have gone through coupon auction by the time the program comes to an end.

Many other industrial sectors, such as the agroindustrial sector, have been fairly well represented in mass privatization. The large wheat-processing and bread-producing holding companies have been broken up and mostly privatized, and more than two-thirds of the enterprises of the chemical and fertilizer holding company and the agrotechnology holding company have gone through coupon auction, with half of these now fully divested. Tracking and transportation are also well represented in privatization, with the breakup of large enterprises, participation in mass privatization, and the sale of individual trucks and other enterprise assets. Breeding, farm construction, rural power distribution, irrigation, and fodder are still underrepresented, however. Privatization of these enterprises is not entirely within the realm of the State Property Fund because enterprises in this area not previously corporatized by the fund must do so through the Ministry of Agriculture.

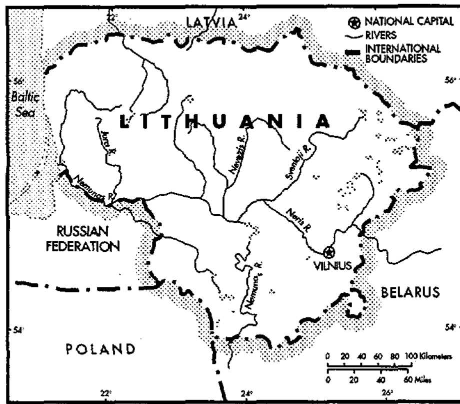
As the coupon auction program comes to a close, the State Property Fund is turning its attention to several dozen companies for which it hopes to attract foreign investors. These companies have all gone through coupon auction, but significant state holdings remain. Plans call for the sale of these enterprises to strategic investors, many anticipated to come from nearby countries. Although no firm figure has been projected, it is hoped that the shares of these enterprises can be sold through tender under a methodology now being developed.

Risks and Benefits

The Kyrgyz mass privatization program has demonstrated the ability to privatize fully—including residual state shares—a significant number of medium-size and large enterprises in a short time. Although it has managed to disseminate shares to a large portion of the population, it has done so in the absence of available investment capital, which has inhibited the development of ownership concentration and its expected positive effects on corporate governance and enterprise restructuring. The program has promoted linkages to capital markets development by supporting the development of a stock exchange, shareholder registries, and accounting reform and by attempting to use the stock exchange to privatize enterprises, again despite the absence of capital to broaden the market for privatized entities.

Note

1. Individuals are not permitted on the exchange floor; all trades must be made by member brokers only, and all trades in listed securities must be registered with the exchange.



Lithuania

Barbara Lee

Lithuania's mass privatization program, launched in 1991 as one of the earliest, gave vouchers to all Lithuanian citizens—vouchers that could be traded for housing, small businesses, shares in large enterprises, or shares in investment funds. The goal of the program—to privatize two-thirds of state property—was pretty much achieved by the time the program ended in June 1995. Some 5,700 enterprises, or 85 percent of the enterprises slated for privatization, were wholly or partly transferred to private hands—a tremendous success. More important, enterprises no longer controlled by the state function largely under a hard budget constraint, forcing some restructuring (particularly labor retrenchment and some market and product reorientation). But since there has been almost no foreign involvement, privatization rarely brought in new strategic owners. The outcomes: few major turnarounds and little new investment.

Key Features and Issues

The program's objective was to transfer assets to the private sector quickly while providing equitable compensation to all Lithuanian citizens. Two-thirds of state assets—some 6,700 enterprises and nearly all housing—were included in the program. All citizens received vouchers (entries in individual accounts held at the savings bank) with a cash value based on the age of the recipient and indexed several times over the course of the program. Expected to last one year after its launch in mid-1991, the program was extended to September 1994 and then again to June 1995. Vouchers could be traded for different kinds of assets (housing, enterprises, and later investment funds), and midway through the program the vouchers became tradable. Unused vouchers initially held a value (to be traded for government bonds) but this was later rescinded.

Designed and carried out solely by the domestic authorities, the program's legal framework was developed early and well publicized, changing little over the course of the program. Institutional arrangements were pragmatic and generally transparent.

- A central committee provided the overall framework and approved privatization plans.
- Founding ministries and municipalities volunteered entities for privatization.
- Most sales were conducted by local privatization offices.
- The Ministry of Economy monitored the process.
- The Savings Bank handled some 2.6 million privatization accounts.
- Investment funds were permitted in 1992.
- A stock exchange was established the same year to handle post-privatization trading.

Still, several difficult issues arose during implementation. Logistical issues—such as how to arrive at a market clearing price for assets—were quickly and easily resolved. But many political issues remained problematic throughout, among them employee ownership, investment fund ownership, and cash-based privatization.

Employee ownership

At first employees (including managers) could purchase 10 percent of an enterprise's shares at concessional prices—a

ceiling raised to 30 percent shortly after the initial legislation was passed. And after the election of a populist government in 1993, the possibilities for acquiring shares were broadened further. Concessional purchases were raised to 50 percent of enterprise shares. The best business plan method was introduced, allowing twelve very large enterprises (with nearly 11 percent of all assets privatized) to be privatized through management-employment buyouts. The possibility of using retained earnings for management-employee stock purchases was legalized, and managers and employees were allowed to pool their vouchers in investment funds to acquire controlling shares (some 300 investment funds were purportedly created for this purpose). All this activity crowded out many would-be purchasers of the shares of large enterprise in the privatizations after 1993.

Investment fund ownership

Vouchers originally were nontradable and could be used only for the direct purchase of assets. But when illegal trading began early on, the government permitted the creation of "investment stock companies." In time 400 such funds held ownership stakes in about 600 enterprises.

Although the data are sketchy, about 300 funds are thought to have been formed to purchase single enterprises, with another 60–70 having some diversified ownership and the remaining 30–40 having sizable capital, shareholders (up to 25,000 shareholders), and portfolios (the largest owning shares in 140 enterprises). Because investment funds in Lithuania have no foreign involvement and the controlling interest is frequently held by a small number of founding members, there is little liquid capital. Recent legislation to regulate investment funds requires them to choose between the Western mutual fund model and the holding company model.

Other privatization efforts

The original program held the promise of significant foreign cash in parallel with the domestic vouchers. But cash-based privatization never took off. A list was drawn up for cash privatizations that could involve foreign purchasers, but only forty-eight enterprises (thirteen large and thirty-five small) were sold for cash over the five years.

This clear reflection of the government's inward focus was also evident in the development of other sales methods—such as the best business plan and the increased concessional purchases by employees of manufacturing or service enterprises and by farmers in agroindustry. Insider ownership was overwhelming.

Results

Of 10,504 million litas issued in vouchers, a full 93 percent were used by the end of the program—65 percent for enterprises (or investment funds), 19 percent for housing, and 9 percent for agroindustry and land plots. Only 7 percent remained unused. Of the 4,854 million litas worth of enterprises to be sold, the final value was 3,491 million litas (72 percent). Of the 6,700 enterprises slated for sale, 5,700 (85 percent) were sold, roughly half for large enterprises through share sales (2,928) and half for small businesses in auctions (2,729). The pace of sales was somewhat uneven (table 1).[1]

The demand for voucher purchases was initially high with the sale of housing, small businesses, and some large enterprises. But demand tapered off as large enterprise sales became less transparent. In the later years anecdotal evidence suggests considerable underpricing of assets, which led to asset stripping and enterprise closings by the new owners.

There has been little tracking of post-privatization ownership, but it seems that almost all enterprise assets ended up in the hands of employees, managers, and investment funds. There is almost no documentation of share trading (most of which does not go through the stock exchange), but managers seem to have acquired a significant amount of employee shares, and a small number of influential citizens have taken control of large chunks of specific industrial branches. This move has been assisted by investment funds, which may have ended up with some 30 percent of all privatized assets. The fifty largest funds are estimated to own 75 percent of all investment fund assets, and the twenty largest, 50 percent. If this assessment is correct, the program quickly turned an enterprise sector from complete state ownership to one with vastly dispersed ownership, and then to one with heavily concentrated control.

Assessment

The Lithuanian program was swift and effective at transferring assets out of state ownership, but Western know-how and capital were excluded.

Table 1 Strong initial demand tapers off, 1991–95
(annual percentage)

Indicator	1991	1992	1993	1994	1995
Share of enterprises sold	15	39	22	15	9
Share of value of assets sold	3	27	31	26	13

The program was most successful in:

- Quickly transferring the ownership of vast amounts of state property to private hands.
- Imposing a hard budget constraint on most enterprises, leading to significant labor retrenchment and some reorientation of production.
- Avoiding political backlash because the program was simple, well publicized, and favored domestic interest groups.

It was least successful in:

- Attracting (or even permitting) strategic investors with the means to use investment funds to their fullest, keeping the process fair and transparent over time, and avoiding insider purchases.
- Foreseeing the need for post-privatization technical assistance to enterprise management (given the lack of strategic investors).
- Identifying ways to divest or close down enterprises or parts of enterprises that were put up for sale but not privatized.

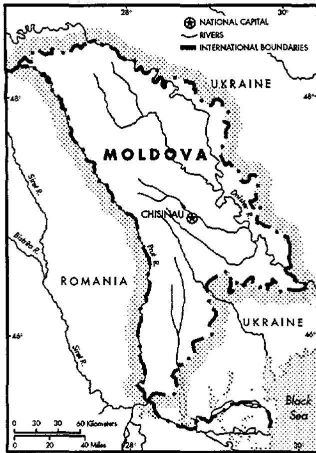
The Next Phase

The authorities are determining how many enterprises are to remain in public hands, which they wish to sell, and what methods they will use. A new privatization agency, set up in late 1995, has drawn up a list of some 200 entities for cash sales during 1996—for about 100 million litas of a reported 1 billion litas remaining in state-owned assets. This new cash-based program encountered three problems in 1996. First, there was no consensus at the highest political levels on what assets to privatize and what to retain as state or municipal property. For instance, nearly all energy, communications, and transport entities were considered strategic. Second, state ministries and local authorities have been unwilling to relinquish entities for privatization. Third, the objectives of the privatization program—such as job preservation—remain unclear or conflicting. So, the difficult political choices in the second, cash-based privatization in Lithuania remain the same as those in the first: who will be the new owners?

Notes

This paper was written in the spring of 1996.

1. Even though these data come from official sources, they are open to interpretation because of different definitions of "state assets," various indexations of assets over time, shifts in what was included in the program, and the changing character and number of assets through enterprise divisions. Thus they should be considered merely indicative.



Moldova

Theodor Stolojan

Moldova completed its mass privatization in November 1995, achieving its targets. Transparent, fast, and fair, the process was supported by almost all Moldovans, who invested patrimonial bonds (vouchers) in 1,139 medium-size and large joint stock companies and 1,096 shops, coffee houses, and other small business. Private investors hold a majority of shares in 772 of the joint stock companies, but the state still holds shares in 591 companies that were approved to be privatized only for the patrimonial bonds. Privatization for cash is expected to gain momentum. Privatization of land and the assets of agricultural firms is proceeding under a separate law, but the pace is slow, and 83 percent of the state's housing stock has been privatized.

Patrimonial Bonds

Moldova's Parliament approved the concept of mass privatization in July 1991 with the Privatization Law, but implementation slipped during 1992–93 due to a bloody conflict with Transnistria. Also slowing things down were conflicting legal provisions, weak coordination among different government institutions involved in the process, and the electoral campaign's focus on privatization issues. The first of two privatization programs approved in March 1993 for 1993 and 1994 focused mainly on privatization for bonds. Privatization for cash was limited by the absence of a national currency. The new government appointed in April 1994 decided to accelerate privatization and immediately established the Ministry for Privatization and State Property Administration as the implementing agency for the privatization programs, merging the State Department for Privatization and the State Property Fund.

For 1,139 medium-size and large joint stock companies to be privatized for patrimonial bonds, all without prior restructuring, Parliament approved the distribution of 100 percent of the shares for 784, 70 percent for 105 (with 30 percent staying with the state), 40 percent for 41 (with 60 percent for cash), and 40 percent for 209 (with 60 percent remaining with the state). The government included the shares remaining in state hands in the third privatization program, scheduled for 1997–98. The state-owned enterprises located in Transnistria were not available for privatization.

The bonds were issued to 3.5 million Moldovans (97 percent of those eligible), with September 1993 as the deadline for residents to declare their citizenship. Many Transnistrians could not apply for Moldovan citizenship and thus were not eligible for the bonds. To be used by November 1995, the bonds were nominal and nontradable, with their face value linked to work-years of employment. All citizens, including children, were credited with five work-years, to which was added the number of years adults actually had worked. Some categories of citizens, such as veterans, received extra work-years.

National Auctions

The shares of medium-size and large joint stock companies privatized for patrimonial bonds were allocated in competitive auctions open to all Moldovans. Employees had the right to buy up to 20 percent of the shares (at nominal value) of

their privatized enterprises with patrimonial bonds and suppliers of agricultural raw materials received free of charge 50 percent of the stock in agroprocessing enterprises.

For the privatization of small units, a classic open outcry auction was used. For medium-size and large enterprises, a national auction system was developed allowing interested bondholders to register their interest in purchasing shares of a certain company at 115 bid collection sites around the country. This approach allowed hundreds of enterprises to be privatized at one time. By the end of November 1995 forty-three investment funds and eleven trust companies were involved in the exchange of bonds for shares. Many citizens associations (voucher clubs) also had been set up.

The allocation of shares was to be pro rata if demand was within 40–300 percent of supply. For oversubscriptions (more than 300 percent) and undersubscriptions (less than 40 percent) shares were to be allocated in a second or third auction. At each round of auctions, a new set of joint stock companies was usually put up with oversubscribed or undersubscribed joint stock companies from previous rounds.

This pro rata criterion was applied in all oversubscriptions, but in only a limited number of joint stock companies where demand was less than 100 percent of the shares supplied. As a result the state still holds shares in 591 medium-size and large companies—shares that were to be privatized for the patrimonial bonds.

A controversy rose over how to privatize the rest of those shares. The investment funds and trust companies proposed that they be distributed free of charge to the new private investors in each firm. The government instead decided to sell the rest of the shares, mainly for cash, through the stock exchange.

Results of Mass Privatization

By the end of November 1995, 3.1 million Moldovans (90 percent of those who received bonds) had invested in 1,139 medium-size and large joint stock companies and 1,096 small businesses. The medium-size and large joint stock companies were auctioned through the national auction system, starting with one enterprise in June 1994 as a pilot case. Fifteen other national auctions were held over the next seventeen months. The distribution of shares of the joint stock companies is shown in table 1.

The national auction system proved very effective for the mass privatization of the medium-size and large firms. Investment funds and trust companies were the main players in those auctions, with 81 percent of Moldovans participating in the auctions doing so through such intermediaries. The investment funds and trust companies have controlling blocks of shares in many companies because workers and managers was generally limited to holding no more than 20 percent of the stock. A solid base has been created for capital market development and for corporate governance: the Moldovan Stock Exchange opened in June 1995, and 1,000 privatized companies had already registered their shares and shareholders with independent registrars.

A nationwide public information and education program supported the program well—more than 60 percent of citizens surveyed rated their role in the program as satisfactory. Two processes were critical for the program's fast pace: the transformation of state enterprises into joint stock companies and the evaluation of worker stakes in those companies.

The privatization of small businesses for bonds has proceeded slowly because of the resistance of the enterprises and the local authorities (which had to give their approval). Bonds proved inappropriate for the privatization of small units because they would have brought in too many owners.

Not Much Privatization for Cash

For the program's second round in 1995–96, Parliament approved the privatization for cash of 190 small enterprises, 99 unfinished construction sites, 100 medium-size and large enterprises (including some in infrastructure) and some land. The small enterprises and unfinished construction sites are to be sold at cash auctions, with the starting prices adjusted according to supply and demand—flexible pricing to partly compensate for the lack of capital.

Of the medium-size and large enterprises, forty-one are to be privatized through the sale of controlling blocks of shares (60 percent) in competitive bidding. The idea is to encourage

Table 1. Distribution of privatized shares among joint stock companies

Percentage of shares privatized	Number of joint stock companies
95–100	502
90–95	48
80–90	63
70–80	46
50–70	113
30–50	191[a]
0–30	176[a]

a. For 250 companies Parliament approved broad privatizations for only 40 percent of the shares.

bidders to compete, to avoid subjective evaluations and negotiations, and to make the process transparent. If no investor is found, the shares will be sold through cash auctions. The other fifty-nine ("unique") enterprises are to be privatized through individual trade sales approved by Parliament. These enterprises include one company in communications, three in banking, nine in tobacco, and more than forty in gas.

By December 1996, 184 small businesses and 42 unfinished construction sites had been advertised for auctions, but because of unrealistic high starting prices only 82 of the businesses and 25 of the sites were sold. The controlling block of shares of only three out of forty-one medium-size and large enterprises had been advertised because the government could not agree on starting prices. No block of shares has been sold. Another ten were included in special restructuring and privatization programs supported by the European Bank for Reconstruction and Development and the Moldovan Restructuring Agency.

No individual privatization based on trade sales has been implemented. Individual privatizations for the tobacco sector have been in the works for two years. Two foreign investors competed for the tobacco sector through an international tender. After the winner was announced, the deal could not be concluded because the winner requested new facilities from the government. A new international tender will be organized for the tobacco sector.

To avoid delays resulting from setting the right starting price for auction, the government should adhere to its principle of letting competitive auctions determine the market price. It should also reconsider its retention of controlling blocks of shares in some enterprises included in the second program and privatize other strategic enterprises.

Poland

Yves Duvivier

Poland, among the first socialist countries to pursue market reforms, has been among the last to implement a mass privatization program. After one of the longest gestation periods (almost three years) of all formerly socialist economies, Poland's program—also called the National Investment Funds program—finally began in 1995. Unlike many other countries, Poland did not adopt mass privatization as the main method for privatizing its state-owned enterprises and other state-owned property. Mass privatization was not an essential element of the "shock therapy" program developed under the Balcerowicz plan in late 1989 and launched in January 1990, the first objective of which was to stop hyperinflation. Mass privatization was envisaged only as one of several methods of a multitrack privatization program.

Program Design

The August 1991 privatization law provided for capital privatization (sale of shares through trade deals and initial public offerings after commercialization), direct privatization (or liquidation) of small and medium-size enterprises (allowing employees and outside investors to purchase or lease with the option to purchase entire enterprises or parts of enterprises), and liquidation of distressed enterprises (with the sale or contribution of their assets to new enterprises). It also envisaged a later program of voucher privatization to be adopted under separate legislation. In essence, Polish privatization was primarily "bottom up," with the employees of state-owned enterprises at least agreeing to the privatization of their enterprise. This approach resulted from a principle of strong employee participation in the management and ownership of enterprises—a principle deeply ingrained as a result of the unions formed by the Solidarity movement during the 1980s. The main consequence of this approach was the slow pace of privatization, aggravated by the reluctance of successive governments (six since 1989) to adopt a more forceful approach to enterprise reform. Some political parties, even when they became part of government coalitions, remained hostile to privatization and opposed or derailed enactment of badly needed amendments to the original privatization law.

Political interference particularly affected mass privatization. Although the basic principles of the program were set out in early 1992, details of the scheme were not agreed and the supportive law (the Law on National Investment Funds) was not enacted until June 1994—effectively delaying the program until 1995. Meanwhile, privatization dragged on through other, less controversial methods. By December 1995, of 8,440 state-owned enterprises existing at the beginning of privatization, 2,667 had been effectively privatized—160 through capital privatization and 2,507 through liquidation and direct privatization (1,100 of them through employee buyouts). Another 1,045 enterprises had gone bankrupt.

Poland's mass privatization was conceived as a heavily "engineered" program, rigidly organized by the state. Instead of acquiring shares in enterprises of their choice, citizens receive shares in national investment funds that hold shares of selected enterprises. The idea is to spread citizens' ownership (and thus risk) over a wide range of good enterprises, the ownership of which is effectively exercised by the funds. These

"top down" created funds (instead of private, spontaneously created funds, as in the Czech Republic) are closed-end hybrids of holding companies and mutual funds, with each holding as "lead fund" a controlling block of shares (33 percent) in about thirty-five enterprises plus minority stakes (about 2 percent) in other enterprises.

In all, 60 percent of the shares of privatized enterprises are allocated to the funds, up to 15 percent is given free of charge to the employees of the enterprises, and 25 percent remains in the hands of the state treasury for further use—possibly for capitalizing a modernized pension scheme. Participating enterprises were preselected by the state but could refuse to participate (which many chose to do). Each fund was to be managed by a professional group (referred to as the fund manager), ideally composed of foreign and Polish experts, under a ten-year management contract with a fixed fee in cash and a performance fee in the form of shares of the fund. This fee is attractive—1 percent of the funds' shares each year over ten years and another 5 percent at the end. Following the German model, the funds have a supervisory board (made up of Poles) and a management board. Under the management contract, however, the decisive powers are spelled out in the fund and enterprise bylaws, with the fund manager controlling the boards of the enterprises.

Each adult Pole is entitled to receive for a nominal fee a "universal certificate," a bearer instrument that is immediately tradable but that can be exchanged for one share of each of the funds when these are listed on the Warsaw Stock Exchange (essentially after the funds have been in operation for a year and have published their audited statements). Thus the government-appointed boards play a significant role, at least until participating citizens have received their shares in the funds and possibly decide at the first general shareholders meetings to elect new supervisory boards.

Progress

Implementation of mass privatization started in 1995, when the fifteen funds were incorporated, their boards appointed, the fund managers matched with the funds, and the management contracts signed. The selection of the board members (some 3,000 Polish candidates passed special tests) and of the fund managers (through a detailed prequalification and evaluation process closely monitored by the World Bank and the European Bank for Reconstruction and Development) was complex. The final selection and appointment of board members by the prime minister drew some criticism. Some members were perceived as being selected for political reasons. One fund eventually decided not to sign a management contract with a preselected fund manager; the Ministry of Privatization did not object.

A critical element of the program was the final selection of participating enterprises in 1994–95. From the original group of volunteers and additional preselected enterprises, some eventually dropped out of the scheme, and the prime minister cut another thirty valuable enterprises (deemed of national interest) from the list. Anxious to keep a critical mass of underlying assets, the Ministry of Privatization convinced more enterprises to volunteer. To the original batch of 412 enterprises another 101 were added, but the small size and weak finances of many of these proved more of a burden than a boon. These episodes and delays in implementation had a strongly negative impact on the program through:

- The deterioration of many companies in the original group, which were left for a long time without an owner and with managers refraining from making urgently needed business decisions;
- The removal, under political pressure, of valuable and large enterprises from the scheme; and
- The belated addition of enterprises of lower quality.

By the second half of 1995 enterprises were allocated to the fund portfolios, with the funds selecting controlling blocks (as lead funds) of shares through an elaborate "football pool" process. Although some funds concentrated on specific sectors when building their portfolios, most did not. Participating enterprises are mostly in manufacturing, food, and construction, with a few in transport and commerce. These enterprises represent about 10 percent of total industry and construction (in terms of sales) in Poland, and their book value was about $2.8 billion—or about $1.6 billion for the funds (about $100 million for each fund). With the 15 percent being reserved for the performance fees of fund managers, the effective interest of participating citizens is 85 percent, or about $1.4 billion. With the deterioration in some companies, however, underlying book values may be lower.

One of the most important phases of the program got under way on 22 November 1995, when Polish adults could start buying their certificate for about $8. If popularity is a measure of success, the results are impressive. By June 1996, 14.8 million people (of 27 million) had bought their certificates, and the Ministry of Privatization expects 85–90 percent of eligible citizens to collect their certificates by the November 1996

deadline. The secondary market has rapidly become active, with trading by brokers and some banks organizing auctions for bigger investors interested in blocks of certificates. The certificates started trading at 50 zlotys, climbed to 120 zlotys, and eventually stabilized at about 90 zlotys ($36). Institutional investors have started to accumulate sizable packages, and some 40 percent of secondary market purchases are believed to be by foreigners.

Official listing of the certificates on the Warsaw Stock Exchange started in July 1996, and preparations are under way for listing the funds on the exchange. Although officially targeted for the end of 1996, their listing is more likely to take place by mid-1997. Nonpublic trading of company shares has also started among employees and the funds. Public trading of the most promising companies on the new Polish over-the-counter market is expected to start in the fall of 1996.

Problems

Three interrelated aspects of mass privatization raise concern:

- The poor situation of some participating enterprises;
- The role of the fund managers and compliance of the funds' boards and fund managers with the spirit of the program and with the terms of management contracts;
- The public and political perception of the program and risks of more damaging political interference.

The financial situation of some enterprises attracted attention when one fund declared the first company bankrupt. It is now anticipated that another seven will soon go under, with perhaps some twenty more following. On average, 20–30 percent of the funds' portfolios are estimated to be good or very good companies likely to attract strategic or institutional investors or to be successfully floated on the stock exchange. By May 1996 the funds were planning to float 64 companies (with preparation well advanced for another three), and an additional 128 were set to be listed on the new over-the-counter market. Strategic investors had been found for about 15 other companies, and the Ministry of Privatization was hopeful that talks under way would bring strategic or financial investors for another 143. Trading has been particularly active in the cement sector, where strategic investors have acquired controlling stakes in four plants through hectic purchase from the funds. Also with the help of the funds, 115 companies have secured commercial loans and another 48 are actively seeking such credits in zlotys as well as in foreign currency.

The role of the funds and particularly of fund managers relative to troubled companies is the subject of controversy. Some fund managers have set up a strong team of foreign and local experts for a hands-on approach. Other have taken a more passive approach, and a third group simply failed to build up a strong team for tackling problem enterprises. The second group can argue that the original underlying principle—that the underlying asset base would be of good quality—has not been adhered to since in 1995 the prime minister withdrew valuable companies and the Ministry of Privatization added weak companies. Among the third group, some fund managers lost part of their teams of professionals; because the start-up of the program was continuously delayed, these experts found other assignments.

The debate on the role of the fund managers centers around two concepts. One is that funds and fund managers should adopt a long-term strategy and focus on restructuring their companies. The other is that the funds' priority should be to boost the value of their portfolios (particularly in view of their impending stock exchange listing), so they should focus their limited supervisory and advisory capabilities on promising companies and sell off other companies quickly. Differences of perception have caused serious tensions between some fund managers and supervisory boards, which often have their own preference for restructuring. In some cases supervisory boards object to severe restructuring measures that fund managers recommend. In addition, supervisory boards often want to play a managing role that conflicts with the boards' attributes and the management contracts. These problems have caused major disputes in three recent cases. Two ended with the cancellation of the management contract. In the third case the minister of privatization dismissed most members of the supervisory board.

With press reports concentrating as much on these disputes as on the successes, the program is still in the political spotlight. These disputes provide ammunition to politicians opposed to privatization and to Poles hostile to foreign involvement in ownership and management of companies. Another criticism is the apparent high costs of the scheme. Fixed management costs (about 1.5 percent of the book value of underlying assets) are not high by industry standards, yet there is a political perception that fund managers are overpaid. As part of the campaign for the coming parliamentary elections, one political party has hinted that it will request a full review of the fund managers' performance and management arrangements, with the intention of revising or abolishing them.

Assessment

Supporters of mass privatization should be pleased with the public's strong interest in vouchers and with the generally satisfactory way that fund managers are handling their portfolios. However, the scheme's ultimate success cannot be gauged until:

- Trading of enterprise shares starts on the over-the-counter market and (a few) enterprises are listed on the stock exchange.
- Fund managers have demonstrated that they can play a positive role in distressed enterprises, and have mobilized more equity funding for enterprises in general.
- The population replaces the state as the effective owner of the funds, possibly changing their governance.
- Fund shares are actively traded.

So what are the lessons? The scheme's complexity was also its weakness—and this weakness proved serious in the continuously changing Polish political environment. Constant political interference resulted in major delays, creating problems for potential fund managers in keeping the necessary staff available until mass privatization actually started. Moreover, the government failed to address the worsening asset base, adding more companies of poor quality. The government could have dispelled some misguided perceptions by better explaining how the requirements of the scheme had evolved.

Besides additional political interference, in the short to medium term there is still the potential danger of a significant drop in market price of the certificates and of fund shares. On the political front, much will depend in the short term on the Ministry of Privatization's (or its successor in the Ministry of the Treasury) capability to advise supervisory boards, handle disputes between fund managers and supervisory boards (while still pressing hard on poorly performing fund managers), and especially fend off political attacks, partly through strong public relations efforts.

The success of mass privatization will be measured by its final scope. An expansion of the program from the current 512 enterprises is not being actively pursued because of constant political interference. By mid-1996 about 3,600 Polish enterprises were still in state hands, although many are small or in poor condition. The currently planned program of trade sales and flotations of large enterprises and of improvements in privatization and liquidation procedures (provided in the new law approved in July 1996) will contribute to further progress in privatization. These alone, however, will not suffice to accelerate privatization. Thus a follow-up mass privatization phase is essential. The new law provides for an additional voucher program, with more flexible terms, but has yet to be adopted by Parliament. Action is needed now.

Romania

Patrick Tardy

Mass privatization in Romania was a rather convoluted two-step process, its awkward design the product of political and technical compromise. As a result the approaches used were often second-best solutions likely to appear unduly complicated to observers unfamiliar with the country's political and institutional background. The first round of privatization started in late 1992 and within four years led to the divestiture of 2,871 state-owned enterprises, or about 46 percent of the number available for privatization and 21 percent of employment (table 1).

A full-fledged mass privatization program, launched in mid-1995, involved 3,905 state-owned enterprises—more than half the number of those remaining under state control. The mass privatization program was successfully completed in mid-1996, with a remarkable 93 percent of vouchers distributed to the public.

Institutional and Legal Arrangements

By mid-1990 the commercialization of state-owned enterprises had largely been completed under two main categories. Commercial companies are joint stock corporations, about 6,300 of which were incorporated in 1990. More are constantly being created, either as spinoffs of *regies autonomes* or other commercial companies. By law all commercial companies must be privatized by the end of 1998. Regies autonomes, entirely owned by state or local authorities, represent about 45 percent of the original capital stock. They are

Table 1. Cash privatization in Romania, 1992–96

	Original number	Year privatized 1992	1993	1994	1995	1996	Total	As a share of original stock (percent)
Commercial companies	6,291	1	264	595	623	708	2,871	46
Small	3,124	1	247	500	342	1,068	2,158	69
Medium-size	2,459	0	15	87	237	279	618	25
Large	708	0	2	8	44	41	95	13
Capital (billions of lei)	9,060	0	46	330	1,759	1,421	4,145	
Small	240	0	26	73	195	558	959	
Medium-size	1,824	0	13	228	910	547	1,882	
Large	6,996	0	8	28	654	316	1,304	
Employment (units)	4,040,757	72	76,843	181,438	316,195	282,432	856,980	21
Small	497,069	72	51,624	82,571	43,890	65,690	243,847	49
Medium-size	1,753,828	0	11,984	68,118	162,235	161,499	403,836	23
Large	1,789,833	0	13,235	30,749	110,070	55,243	209,297	12

Note: As of 19 June 1996. The capital stock privatized in 1994, 1995, and 1996 is overstated relative to the original stock because the assets and equity of commercial companies were revalued by an average factor of four to five in 1994.

mostly national and local utilities, mining enterprises deemed of public interest, or enterprises essential for defense and security. Although regies autonomes were initially excluded from privatization, this will change as a result of a recent government decision to transform them into commercial companies.

The National Agency for Privatization was created in early 1991 to develop privatization strategy and to monitor and control its implementation. It was responsible for implementation of the mass privatization program.

The State Ownership Fund started operating in late 1992 and initially was the majority shareholder of all commercial companies, with a 70 percent stake in each of them. Those stakes gave the fund a major role in the mass privatization program. Its board of directors comprises the president of the National Agency for Privatization and members appointed by the president of the republic (five), the Parliament (six), and the government (five). The fund has proved fairly independent of and often at odds with the government. Under supervision of Parliament, it has been plagued by constant changes in management and various organizational problems. The fund was recently subordinated to the government.

Five private ownership funds were established in 1992 as private organizations. Each one was allocated 30 percent of commercial companies' shares, either sectorally or regionally, on behalf of the public. Performing essentially as closed-end funds, the funds were converted into investment funds in late 1996. Although the members of their boards of directors were proposed by the government and approved by Parliament, the funds behaved quite independently and considered themselves private. Initially the most dynamic organizations in the privatization setup, they have been sidelined in the mass privatization program, for they have been allowed to participate only after the subscription by individuals was completed.

The First Mass Privatization, 1992

The Privatization Law (Law 58/1991), passed in August 1991, remains the cornerstone of the privatization process. Under this law all commercial companies are open to privatization through a wide range of market methods, including trade sales, open auctions, open and limited tenders, initial public offering, and management-employee buyouts. Two of the law's original features deserve mention:

- More than 15 million certificates of ownership were distributed free of charge to all Romanian adults, as the counterpart of the 30 percent stakes held by the five private ownership funds in each commercial company. The certificates were freely tradable among individuals and could be converted into shares of commercial companies belonging to the funds, retained as ownership interests in the funds, or later converted into shares of successor investment funds. The shares belonging to the State Ownership Fund could only be sold for cash.
- Simple management-employee buyouts were offered for the speedy privatization of small enterprises (fewer than 500 employees), with the sale price based on the adjusted net worth derived from commercial companies' balance sheets. The shares of the private ownership funds typically were exchanged against certificates collected by employees, 15–20 percent of the State Ownership Fund's shares were paid in cash, and the balance was payable in installments over two to six years, bearing an annual interest rate of about 25 percent at a time of much higher inflation. This simplified process proved fast, easy to implement, and popular with employees, managers, and trade unions, and in late 1994 was extended to larger enterprises.

The initial program was a partial failure because the supply of enterprises and the organization of the process were not properly provided for. The certificates had already been distributed, but the State Ownership Fund and the private ownership funds (the shareholders) did not start operating until the first quarter of 1993, and there was no mechanism for distributing and trading shares in large quantities. As a result very little happened until 1993 (only twenty-two enterprises were sold at a pilot privatization program).

Moreover, there was an inherent conflict of interest in the mechanism. The private ownership funds' managers, bent on maximizing the value of their portfolios, were not keen on exchanging worthless certificates for shares in their best enterprises, but they were less inhibited about getting rid of shares of nonperforming firms. The public took the opposite view but could do little to influence the funds. The State Ownership Fund also had conflicting mandates: one, to privatize, and two, to restructure enterprises in its portfolio. Finally, the State Ownership Fund and the private funds were often at odds, with the State Ownership Fund more inclined to restructure poorly performing enterprises and sell good ones, and the private funds preferring the opposite approach.

As a result things moved slowly:

- With few exceptions, certificates could be exchanged for the private funds' shares in an enterprise only when the State Ownership Fund agreed to sell its shares in the same enterprise.
- Trade sales went poorly, with foreign investors providing only $2.2 billion over seven years for some greenfield investments and some joint ventures with state-owned enterprises. This capital could privatize no more than a small number of medium-size and large commercial companies.
- The first initial public offering for four enterprises was a failure. By contrast, management-employee buyouts for small commercial companies were a great success. By mid-1994, when the State Ownership Fund and the private ownership funds went into full gear, more than 100 commercial companies were being sold every month.

Except for the management-employee buyouts, however, the certificates could not be readily exchanged for shares. As a result an unknown (but allegedly large) portion of certificates was traded at a price below the initial par value of 25,000 lei, far below the adjusted value (upwards of 300,000 lei) calculated by the private ownership funds. Many of these certificates were purchased by a small number of wealthy Romanian investors who later could have acquired large stakes in commercial companies with these discounted certificates. The government did not want to encourage such market forces, and by mid-1994 it decided to revalue state-owned assets and raised the asking price of the shares by an average factor of four to five. This move was intended to compensate for inflation over the previous three years and to neutralize the certificates purchased by the wealthy investors. This development is essential to understanding why the government introduced a second and more confusing type of voucher when it could have used the certificates already distributed to develop a proper mass privatization program.

The reevaluation immediately priced the shares of commercial companies out of the market, and privatization ground to a halt. Only in late 1994 and in 1995 and 1996 did the speed of privatization recover, in part because of agreements between the government and international organizations—including the World Bank, which extended a $280 million financial and enterprise sector adjustment loan.

The Second Program, 1995–96

The full-scale Romanian mass privatization program was launched in mid-1995, following passage of the Law for Acceleration of Privatization (Law 55/95). Under this law and a string of subsequent regulations and norms, new free vouchers were issued to all adult Romanians who did not use up their certificates in buying shares during previous privatizations. Each voucher was given a face value of 975,000 lei, and each certificate still outstanding, a face value of 25,000 lei. The government argued that the street price for the certificate purchases had been close to 25,000 lei, making it fair to restore their par value of 25,000 lei. In the meantime, the revaluation of assets and of the capital stock of enterprises, and the introduction of new vouchers worth 975,000 lei, considerably reduced the purchasing power of the original certificates, hurting those wealthy investors who had (legally) purchased them at a discount.

The new vouchers were nominative and could not be transferred or sold. This is where things start getting complicated. The aggregate value of the vouchers and certificates distributed was calculated to be equal to the stock still owned by the private ownership funds—that is, 30 percent of the capital stock of commercial companies not yet privatized. Then all shares of commercial companies were given a face value of 25,000 lei. The estimated value of a commercial company's net worth was to be reflected not in the par value, but by the number of the shares it issued. In most cases eligible citizens owned one voucher and one certificate worth 1 million lei (then about $500), which allowed them to acquire forty shares of any commercial companies for free. Under the Law for Acceleration of Privatization, shares are simply exchanged for vouchers or certificates at par. There is no bidding for shares with vouchers and certificates. Nor were any voucher investment funds authorized to take part.

Citizens had only three alternatives: to exchange personally their vouchers and certificates against shares in one enterprise on the mass privatization list; to entrust their vouchers and certificates to one of the five private ownership funds, which are the only organizations allowed to participate in the mass privatization program; or under special circumstances, to acquire shares in enterprises that are not on the mass privatization list. Associations of employees and managers could acquire shares in enterprises in which they worked. Farmers and employees in the the agroindustrial sector could acquire shares in enterprises supplying services to agriculture or involved in processing food products. And in initial public offerings organized by the private ownership funds, they could exchange them for the private ownership funds' 30 percent stock in 737 enterprises.

If, on aggregate, only 30 percent of shares could be exchanged for vouchers and certificates, the proportion may reach 60 percent in any one enterprise, depending on demand. In such a case, shares of the State Ownership Fund could be exchanged for vouchers and certificates, with the proviso that the private ownership funds would later compensate the State Ownership Fund for these shares. For a limited group of 312 enterprises deemed of special interest to strategic investors, up to 51 percent of the shares could be offered for cash. For oversubscription in any enterprise, the shares would be distributed pro rata among subscribers. Under the Law for Acceleration of Privatization, unused vouchers and certificates were to be canceled on 1 April 1996, a deadline later extended to 1 May 1996.

The 40 percent of shares that could not be exchanged for vouchers and certificates had to be paid in cash, with the offered prices perhaps different from the par value of 25,000 lei. Calculated for each enterprise on the basis of the net asset value on 31 December 1994, combined with the discounted net income for 1994 and 1995, the offered price is also adjusted by sector. Buyers have to bid for these shares either at open auction and tender or at closed tender. If there is no taker at the offered price, it can automatically be discounted by 5 percent at subsequent rounds, up to a maximum of 15 percent in three successive auctions held after an interval of one hour. If there is still no taker at the final offered price, the shares are taken off the market. The enterprise is then reevaluated by experts, who may advise further discounting. If the discount exceeds 30 percent of the initial offered price, specific conditions for sale (such as maintaining jobs and activities) may be included to the contract. Attractive payment facilities offered to offset the government's reluctance to lower the (inflated) minimum asking price of shares are also offered for the cash sale of shares. Depending on the sector and condition of the firm, down payments range from 20–35 percent, payments from six to ten years, and interest payable on outstanding balances from 2–10 percent. In addition, 40–60 percent of the cash proceeds of the sale are plowed back into the enterprise to pay off debt and finance new investment.

A list of 3,905 commercial companies targeted for mass privatization was published in August 1995. Enterprises of all size, sector, and financial health were included, and only banks and state farms were excluded. Some of these enterprises were subsequently split and offered separately. As a result more than 5,500 commercial companies were offered for mass privatization. The companies were subdivided into four categories, for different approaches:

- 50 enterprises to be sold by initial public offering;
- 621 enterprises specializing in services to agriculture and 320 enterprises in agroindustry, reserved for farmers and employees of the sector. These were later split into 1,518 enterprises;
- 829 enterprises deemed of special interest to foreign investors, which have the first option on 51 percent of the offered shares;
- About 2,300 other enterprises to be sold at open auction.

Within this rather complicated framework, the National Agency for Privatization was in charge of implementation, in cooperation with the State Ownership Fund and the private ownership funds. The Council for Coordination, Strategy, and Economic Reform supervised. The National Agency for Privatization was directly responsible for the distribution of vouchers, the exchange of vouchers and certificates for shares, the public relation campaign, and the creation of the initial share registry. The State Ownership Fund was responsible for the cash sale of shares. The distribution of new vouchers in the summer of 1995 was done mostly through the postal service, while the subscription was handled by the private ownership funds, post offices, state-owned banks, and mobile units. The processing of share allocations was shared between the computer center of the Ministry of Industry and the National Agency for Privatization.

Starting on 1 October 1995, the free subscription of shares was done in three steps:

- First, individuals were given three months to exchange their vouchers and certificates against shares or to entrust the private ownership funds to do so on their behalf.
- Second, the private ownership funds were then allowed, over one month, to collect vouchers and certificates left unused.
- Third, the private ownership funds bid for the remaining mass privatization shares with the vouchers and certificates collected over the four previous months. But as a result of a poorly organized public promotion campaign, the paucity of information provided on enterprises, and public apathy and skepticism, the subscription period for individuals had to be extended by three months, up to 31 March 1996.

The subscription accelerated markedly in its final days, and 15.4 million Romanians (93 percent of the voucher holders) exchanged their vouchers and certificates for shares by the time it was completed. Of the subscribers, 14.5 percent

entrusted their vouchers and certificates to the private ownership funds and 85.5 percent bid directly for shares in enterprises. In April 1996 the private ownership funds collected unused vouchers and certificates and did their own bidding for shares left over after individual subscriptions. The deadline for the redemption of vouchers and certificates was 30 April 1996, and the subscription process ended on 30 June 1996.

During the fourth quarter of 1996 the private ownership funds were transformed into fully private closed-end investment funds, owned by those who decided to entrust to them their vouchers and certificates. These funds are regulated under a legal and regulatory framework designed and supervised by the National Securities Commission.

While the free subscription of shares was under way, the cash sale of shares at auction for the 2,300 commercial companies proceeded for the 40 percent of shares that could not be exchanged for vouchers and certificates. By 31 December 1996, 823 commercial companies had been offered for sale at auctions. Of these, 445 sold, induced by attractive payment facilities.

Associations of employees and managers purchased a majority of the shares, though a significant number of Romanian investors also successfully bid for shares. Foreign investors stayed away—deterred by the lack of information on enterprises, the inadequate protection for portfolio investments, and the unavailability of deferred payment facilities.

It is too early to tell whether the second attempt at mass privatization will achieve its objectives. It hinges on the ongoing cash sale of shares, the ability of the private ownership funds to acquire significant blocks of shares, secondary trading to further concentrate ownership, and the stronger governance that can come from the transfer of ownership to individual investors, private investment funds, and the transformed private ownership funds.

Things to Do—Which Romania Neglected

Keep the institutional setup simple and have one authority fully in charge. The Romanian program has been hampered by an excessively complicated institutional setup. There is no single authority in charge of strategy, preparation, and implementation. Instead, three organizations, at times with divergent views and interests, share responsibility. The government does not control the State Ownership Fund or the private ownership funds, and the National Agency for Privatization lacks clout and resources to impose its leadership.

Develop a proper legal and regulatory framework for capital markets at least six months before launching that program. Romania's legal and regulatory environment remains inadequate even now. Some key pieces of legislation and regulation have not yet been passed:

- *The Law on Transformation of the Private Ownership Funds.* As a result millions of citizens have been entrusting their vouchers and certificates to the private ownership funds without knowing what their future legal status will be or what companies they will be allowed to invest in. At the time of subscription of shares by the private ownership funds it was still unclear what percentage each could acquire in any enterprise. It was also unclear whether and how the private ownership funds would be allowed to select the shares.
- *Amendments to the Securities Law.* Under the law in force, the only authorized share registries were within enterprises, and only they could record transactions with these registries. The Securities Law had to be amended to allow for independently managed share registries.
- *The regulations applied to foreign portfolio investors.* Under the current framework, foreign portfolio investors are de facto restricted from acquiring shares on the Bucharest Stock Exchange and on the over-the-counter market because of regulations imposed on repatriation of profits. They also have little protection because regulations on the management of the share registry and depository have not been issued.

Detailed planning and strict adherence to work schedules are essential. The design and implementation of a mass privatization program is a massive endeavor requiring experienced technical assistance at the outset and adequate financing to acquire the necessary staff, equipment, and software. The Romanian program's design and implementation have been plagued by haphazard planning and by delays in requesting technical assistance and in receiving effective support. Lacking a comprehensive "war plan," the National Agency for Privatization faced difficulties coordinating the work of various groups of consultants that were financed by different donors. Moreover, regulations and norms for the cash sale of shares were published well after the beginning of the share allocation.

Offer enough shares in enterprises to ensure that the state relinquishes control. The Romanian program's allocation mechanism is flawed. In both the initial and the second attempt at mass privatization, only 30 percent of the shares offered in the program were exchangeable, in aggregate, against free vouchers and certificates. As a result there is a risk that too many enterprises will remain under the control of the State

Ownership Fund at the end of the process. A larger percentage of shares should have been offered for exchange against vouchers and certificates—say, 60 percent or more—to ensure that the State Ownership Fund relinquishes control in mass privatized enterprises.

Provide ways to indicate the market price of shares. The Romanian program did not. Because the new vouchers were not tradable and could be exchanged only at par for shares, there was no indication of the market value of vouchers and shares. The exchange of shares against vouchers and certificates at par value—rather than through bidding—may have been simple, but it failed to indicate the estimated worth of each enterprise. The rate of subscription of shares against vouchers and certificates was the only indicator of the worth of an enterprise in the eyes of the public, and it was communicated by the authorities only in March 1996. The bidding price of shares at the cash auctions was a better indicator. But these auctions took off at the end of the subscription process, and the public did not receive this information in time to make its choices. As a result there are three different prices for the same shares: one is the par value of 25,000 lei at which shares were exchanged for vouchers and certificates, the second is the price at which those shares were sold for cash, and the third is the market price that will be discovered when secondary trading of these shares starts. To avoid this confusion, the vouchers should have been tradable, and the shares should have been bid for vouchers as well as for cash. There should have been no limit on the number of shares exchangeable for vouchers and certificates. And if a floor price of shares at auction was ever necessary, it should have been set close to the liquidation value of the enterprise.

Allow investment funds to participate in the mass privatization process. The most serious flaw of the program has been the absence of voucher investment funds. Because the private ownership funds could not participate until the completion of the subscriptions by individuals, there were no market makers. Most individuals were at a loss to decide which enterprise to subscribe in for lack of information and market signals. Nor was there an initial concentration of ownership. Instead there is very diffused ownership with a large number of individual shareholders. Except for the commercial companies whose shares not exchanged for vouchers were sold at the cash auction, ownership will begin to be concentrated only after the shares are traded on the secondary market. Until then the State Ownership Fund is likely to remain the dominant owner in many enterprises.

Provide information on the performance, financial health, and potential of each enterprise. With no performance history and no evaluation of potential and development plans, the public was so confused that the subscription rate remained very low (26 percent after two and a half months) and the subscription period had to be extended by three months. This approach raised many questions about the fairness and equity of the process. First, it gave an undue advantage to insiders. Second, most people only had access to the fourth category of other enterprises (not the best), and those who have entrusted their vouchers and certificates to the private ownership funds may end up owning leftovers from the subscriptions. This lack of information and transparency has bred widespread public suspicion.

Secondary Trading, the Key to Success

The Romanian program, built on an uneasy compromise of speed, volume, and revenues to the state, has many flaws and leaves key issues unresolved. But it also has several positive features:

- The government has shown a strong commitment to accelerating privatization, demonstrated by its January 1996 agreement with the World Bank to fully privatize 3,600 state-owned enterprises over the next two years. Under the agreement an enterprise will be considered private when the State Ownership Fund retains less than 10 percent of the shares or when a single private shareholder owns more than 51 percent of the stock and has full managerial control of the firm. A new, reform-minded government that came to power in December 1996 has reinforced this commitment to accelerated privatization.
- The management-employee buyout privatization of small enterprises means that almost all small state-owned enterprises should have been transferred to the private sector by the end of the program.
- The cash sale of shares at auction appears to be surprisingly successful, thanks to the attractive payment facilities offered. With, on average, half the cash proceeds being plowed into the enterprise, the scheme may do much to improve the financial situation of these enterprises.

The key to success now is the secondary trading of shares. The Bucharest Stock Exchange is still in its infancy. However, the over-the-counter market has been organized, and broker coverage of the country is developing fast. More than 2,500 enterprises are registered with an independently managed

registry. By April 1997 the volume of trade had increased to more than 1.5 million shares a day. Creating a market from scratch involved major risks:

- A large percentage of the new shareholders will want to cash in their shares. How this infant market will handle millions of small selling orders is anyone's guess.
- Massive selling, in a market with few buyers, initially caused the price of shares to collapse. In April 1997 these shares cost less than 10 percent of the inflated and artificial value set by the authorities.
- The remarkable development of the over-the-counter market requires urgent strengthening of the Securities Exchange Commission's disciplinary and supervisory capabilities.

Note

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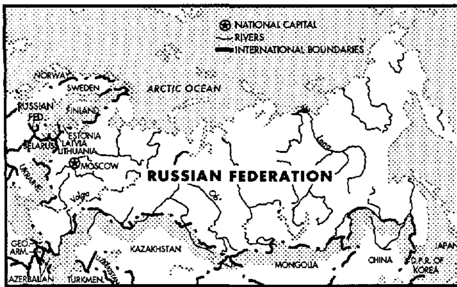

The Russian Federation

Ira W. Lieberman and Oleg Petrov

Russia completed its mass privatization program in June 1994. Since then the privatization program has focused on selling residual shareholdings from the mass privatization program through cash auctions and tenders, as well as on quasi-privatization through the "loans for shares" scheme. Under this scheme the government has received loans from four major Russian banks; in exchange each bank holds shares of major state-owned companies (in trust) as collateral. The government implemented twelve such transactions during the fourth quarter of 1995.[1] For the most part the 1995 privatization program represented a substantial step backward from the transparency of the mass privatization program.[2] It was generally closed to foreign investors and yielded little of value to the government.

The Initial Phase

Russia passed through two phases of privatization. The first phase, from 1992 to September 1994, was dedicated to small-scale privatization, the sale of service establishments such as retail stores and restaurants, and mass privatization (sale of medium-size and large companies, primarily in the tradables sector). Also during this period, a few thousand enterprises were privatized as a result of lease purchase agreements negotiated by the government and enterprise managers during perestroika (1988–89).

Small-scale privatization was carried out at the municipal level with relatively little intervention from the federal State Property Committee. Some 75,000 small-scale establishments were privatized. However, the process was not as successful as in the Czech Republic, Hungary, and Poland because of the tendency in Russia to hand control over to worker cooperatives rather than to auction small-scale enterprises to the highest bidder.

Mass privatization involved the sale of some 16,500 medium-size and large enterprises, including about 300 of Russia's largest enterprises, although they were theoretically excluded from the program. The program involved a massive distribution of vouchers to the Russian people and the creation of voucher investment funds as intermediaries. A closed share subscription went first to employees and was followed by open auctions of shares to the public, mostly at the regional (*oblast*) level. Some of the largest companies were sold through national interregional auctions ("all-Russian auctions") in which bidders in up to sixty oblasts participated. The state held on to a residual block of up to 20 percent of shares in many federally controlled enterprises. This practice has been common in mass privatization programs throughout the newly independent states (Lieberman and Nellis 1995 and Lieberman and others 1995).

The main accomplishment of mass privatization was its rapid ownership transformation of thousands of state-owned enterprises, creating a critical mass of private enterprises as a prelude to a market economy. Mass privatization also laid the foundation for capital market development. The main weakness of mass privatization was that its incentive structure left the majority of shares—some 65 percent, on average—in the hands of employees, creating substantial corporate governance problems. Another problem is that enterprises' real estate holdings, although under the control of the newly privatized enterprises, were not privatized along with their other assets, leaving property rights ambiguous. Finally, the vouch-

er investment funds, initially constrained from acquiring more than 10 percent of the shares in any enterprise, were left with some 30 percent of the public's vouchers and widely dispersed share ownership, but without a clear role in corporate governance or capital market development. These funds remain a substantial problem for the government, especially the Securities and Exchange Commission, although not on the scale or to the degree of unlicensed funds.

Mass privatization was a complex logistical and institutional undertaking. The State Property Committee (GKI) established policies for the program and designed and implemented it nationwide. Anatoly Chubais, chairman of the GKI, surrounded himself with a team of talented reformers. The GKI also used an extensive network of regional institutions to implement the program: oblast-level branch offices approved enterprises' corporatization, privatization programs, and closed share subscriptions. The Federal Property Fund, established by the Duma, was in charge of actual share sales, assisted by local property funds that worked closely at the oblast level to supervise the auctions. Auction centers were set up in every oblast to facilitate bidding. There was also an "all-Russia" auction center in Moscow that coordinated bids for the largest companies from throughout Russia, while Moscow and St. Petersburg maintained independent privatization programs throughout this period (Boycko, Shleifer, and Vishny 1995).

The GKI was also supported by expert external advisers financed by donors. These advisers brought to Chubais's team substantial Western know-how and expertise, as well as knowledge of what was happening in the leading reformers in Central and Eastern Europe. In short, the GKI and its affiliated institutions and advisers built substantial institutional capacity quickly, and Chubais's core team was able to effectively utilize this capacity.

During 1992–94 no large enterprises were privatized in a "classical" way—that is, using case-by-case privatization methods such as negotiated or trade sales or through international public offerings. Moreover, no large deals were concluded with foreign investors, despite the fact that from the start Russian officials expressed interest in receiving substantial foreign direct investment.

Mass privatization remained the exclusive privatization route for medium-size and large enterprises. Although the program was open to foreign investors, there was little direct participation (except for a French cement company that purchased 20 percent of the shares of Perm Cement Factory). Major investment banks purchased shares for their clients' portfolios toward the end of the program, when the most attractive enterprises sold small percentages of their shares to the public. This outcome is in sharp contrast to, for example, Hungary, which focused almost exclusively on joint ventures with foreign participation; the Czech Republic, which sold almost half its enterprises during mass privatization through trade sales and is now using large case-by-case transactions; and Poland, which delayed its mass privatization program but privatized its first five medium-size and large enterprises using capital market flotations (initial public offerings) on the Warsaw Stock Exchange.

The Move to Cash Sales and the Loans-for-Shares Scheme

The next phase of privatization, involving cash sales of residual shares from mass privatization and tenders for blocks of residual shares, started in the middle of 1995. The government viewed this process largely as a revenue-generating exercise. For federal enterprises, presidential decree N474 of 11 May 1995 ("On measures to guarantee the federal budget revenues from privatization") mandated that 55 percent of revenues go to the federal government. This decree reversed a 1994 decree that guaranteed that the majority of revenues would be reinvested in privatized firms. The Federal Property Fund was in charge of the program, although it was again implemented at the municipal and oblast levels by local property funds.

Little consideration was given to the strategic sale of large controlling blocks of shares or to the potential use of the capital market for sales or as a means of attracting foreign investment. In fact, just the opposite occurred. Residual share sales were largely nontransparent, particularly the tender process, which was based on commitments by buyers to invest in the companies whose shares they acquired. The process increased the control of enterprise managers and allowed major banks to acquire large blocks of shares in several important companies. Moreover, the process generated little cash for the government, leading in the last part of 1995 to the loans-for-shares program. Some analysts have suggested that the outcome of mass privatization doomed cash privatization. That is, outsiders were loath to purchase blocks of shares for cash in enterprises owned by insiders.

The loans-for-shares scheme was an outgrowth of the failure of cash privatization and residual share sales to generate revenue for the government. First proposed by a consortium of Moscow banks in March 1995, the program (with modifications) was adopted in September. Between September and

December 1995 shares in some of the largest companies in Russia—Norilsk Nickel, YUKOS, LUKoil, Surgutneftegas, Novolipetsk Iron and Steel, and Novorossyisk Shipping, among others—were handed to a consortium of banks—ONEXIM, Menatep, Stolichny, and Bank Imperial—in a form of trust arrangement. In return the banks provided loans and in some cases paid off the companies' tax arrears. The loans represented a fraction of the market value of these companies. Although the scheme was presented as reversible, nobody expects the loans to be paid back or the transactions to be reversed. A number of other companies were included in the loans-for-shares scheme, but the government excluded some because they were strategic and others (primarily pulp and paper enterprises) challenged the scheme in the courts. Finally, widespread criticism of the scheme's approach and lack of transparency led to its demise in December 1995.

The third feature of the 1995 privatization program, the sale of real estate and the sale of plots of land, never got off the ground. The 1995 revenue target from privatization was set by the Duma at 8.7 trillion rubles, of which 6.85 trillion was to come from residual share sales. In reality, 3.6 trillion rubles were generated by the loans-for-shares transactions, 1.5 trillion by debt repayments tied mostly to loans for shares, 1.1 trillion by auctions of federal and municipal shares for cash, 1.0 trillion by the LUKoil debenture flotation, and 200 billion by state property leasing and dividend payments, for a total of 7.5 trillion rubles (Artemiev and Lieberman forthcoming).

The Case of Svyazinvest

In September 1995, as an exception to the loans-for-shares scheme, the government approved the partial divestiture of 49 percent of the shares of Svyazinvest, a holding company for eighty-five regional telephone networks in Russia. The transaction was to occur in two tranches. The first tranche was the proposed sale of 25 percent of the shares to a strategic investor group that would take operating control of the company. The second tranche, of 24 percent of the shares, was proposed as an initial public offering in international capital markets. The objective was to raise $500 million for the federal budget and $1 billion for investment in Svyazinvest and its subsidiary companies.

Transactions as large and complex as the one proposed for Svyasinvest can take up to two years to complete because of the need to resolve within government (and often through the legislature) complex policy issues such as the future structure of the industry and the necessary regulatory framework. But because of pressure to generate fiscal revenues and to meet its budgeted revenue target, the GKI insisted that the first tranche of the transaction be completed by 31 December 1995.

The outcome of the Svyazinvest transaction is well known. The GKI, with W.M. Rothschild's advisory assistance, sought to complete a negotiated trade sale during the fourth quarter of 1995. Two major bidding groups emerged, with Italy's STET eventually winning the bid for $630 million plus an investment commitment of $600 million. The other bidder, a consortium of France Telecom, Deutsche Telecom, and the Russian Subsidiary of US West, did not submit a final bid. Eventually the deal failed to close, with STET claiming that it had little confidence that the proposed structural arrangements for the industry—with Svyazinvest sharing in the lucrative international market with Rostelecom—would be consummated. Other regulatory issues were also of concern. The government walked away from the deal because the loans-for-shares scheme resolved its fiscal targets for privatization.

The main lesson learned from the Svyazinvest transaction was that deals of such complexity need time to mature—the parties simply did not have enough time to negotiate a transaction. The government also lacked knowledge of what was required to put together an adequate regulatory and structural framework for the industry that would protect its future interest as well as that of investors and the public. Svyazinvest was meaningful because it was the government's first attempt to carry out an individual privatization transaction that involved sophisticated international investors. It should have been an important demonstration case and could have been because it was carried out professionally, with the important exception of the artificial time constraint imposed on the transaction. It is also important because of the importance of the telecom industry in the overall economy.

Institutional capacity

During the second phase of the privatization program (including during the Svyazinvest transaction), after Chubais was promoted to first deputy prime minister for economic affairs, a series of weak and ineffectual chairmen led the GKI. One chairman even sought to renationalize industry. All of Chubais's core team quickly moved to other reform agencies, leaving a vacuum in terms of privatization policy and strategy.

The only apparent strategy was to raise revenue for the budget. No external advisers were assisting either the GKI or the Federal Property Fund. Moreover, neither agency had had

much exposure to international best practice. In short, institutional capacity, privatization strategy, and an adequate policy framework to implement the next phases of privatization were simply not in place during 1995–96.

Toward a New Privatization Strategy, 1996–97

According to various statements issued by the GKI and government officials, during 1996–97 the government will move toward case-by-case privatization. In addition, the government has started to transfer blocks of residual shares to municipalities and regions to compensate them in lieu of shared revenue. The government also plans to improve management of state property by placing residual share blocks and state-owned enterprises under trust management for future privatization.

Divestiture methods will include:

- Selling shares through commercial and investment tenders, auctions, and specialized cash auctions.
- Issuing derivative securities such as global depository receipts (GDRs) and American depository receipts (ADRs) through financial intermediaries.
- Encouraging buyouts of leased property by lessees.
- Selling assets of enterprises in liquidation and unfinished construction sites.

Nondivestiture methods will include:

- Selling convertible debentures.
- Transferring shares under trust management to private companies, private individuals (trust agents), and financial-industrial groups, and contracting government officials to manage state shares.
- Transferring federal shares to the regions through debt-equity swaps.

Main elements

The GKI has compiled a list of enterprises not subject to privatization in 1996–97, including most military-industrial enterprises. Other large enterprises will be privatized on a case-by-case basis. The GKI also plans to strengthen control over the fulfillment of contractual obligations by the winners of investment and commercial tenders.

The government realizes that effective management of state property is a problem, and plans to "privatize" management rights through trust agents, trust management companies, and contractual agreements with state officials authorized to manage the state-owned shares on corporate boards. Existing and newly created financial-industrial groups will also receive transfers of these assets.

The government plans to reduce its debt to regional authorities by transferring titles to federally owned blocks of shares of privatized enterprises located in the regions. The GKI has prepared a list of companies whose federally owned blocks of shares will be transferred to the regions and has established a procedure for determining the value of these shares.

Generation of revenues for the budget appeared to be the overriding objective of the program's targets for 1996 (12 trillion rubles). As a result, by the end of the year another round of loans-for-shares transactions took place because privatization had virtually stopped prior to the June presidential elections and little occurred thereafter. And in November 1996 the government abandoned a second effort to sell 25 percent of Svyazinvest to strategic investors, mostly because of resistance from the Ministry of Telecommunications.

Legal framework

The GKI has worked out a draft law (not yet passed by the Duma) on the new privatization program that incorporates comments and proposals received from sixty-eight ministries and agencies as well as from seventy-eight regions based on an analysis of the flaws of the previous privatization policy. However, some concerns raised by top GKI and government officials are not reflected in the draft law.

The draft law contains the following changes:

- The mandatory annual submission by 1 December to the Federal Assembly of a report containing the preliminary results of privatization for the expired period.
- Compulsory privatization, with specific quantitative targets, has been abandoned.
- New privileges to insiders (managers and employees) have been scuttled, which will increase the number of shares offered at auctions and increase their attractiveness to investors (including foreign investors) and increase budget revenues from privatization.
- The list of industries and enterprises barred from privatization has been extended.
- The rights of the subjects of the Federation and bodies of local government in the implementation of privatization have been strengthened.
- A valuation of the assets of enterprises to be privatized (according to the latest official balance sheet data) is now required. Minimum authorized capital requirements are to be

set for public companies, equaling at least 1,000 times the minimum wage.

- New ways of privatization are to be developed, such as competitive tendering of securities convertible into ordinary shares or the sale of derivative securities certifying the right of their owner to buy Russian equities (ADRs and GDRs, for example).

New Proposals and Potential Problems

The draft law on the new privatization program is a vast improvement over the 1992 privatization law. However, it unduly emphasizes issues that are relatively unimportant or that can be dealt with at the operational level. At the same time, it does not cover or mentions only in passing several important areas, such as public flotation, the case-by-case approach, and the process for preparing enterprises for sale and regulating privatized monopolies.

The proposed law lags far behind privatization programs and best practice in many other countries. Thus the draft program is far behind where Russia should be in this stage of its privatization program. It badly needs more depth—such as the introduction of new privatization methods (for example, initial public offerings), valuation techniques based on market considerations (not as a function of book value), the possible inclusion of debt-equity swaps, new broadly based ownership schemes giving small investors preference in initial public offerings, and a more sophisticated approach to privatizing natural monopolies, including the development of regulatory frameworks and institutions.

It could be inferred from reading the draft law that its authors still do not want foreign participation on a full scale and do not want to privatize the bulk of residual state ownership for the foreseeable future. This inference is supported by the various prohibitions and restrictions that adversely affect potential investors and therefore can greatly detract from the value of new privatizations, even before they are announced. There is a serious risk that the program will transfer important enterprises, blocks of shares, and state assets from the general public to a narrow circle of new owners, just as the loans-for-shares schemes have. The recent privatizations of the remaining shares in several oil companies to "court" banks seems to confirm these fears.

Trust management

The draft presidential decree on trust management has been the subject of substantial disagreement between the GKI, line ministries, and Parliament. The decree provides for transferring to private companies, through trust agreements, the rights to manage residual federal shareholdings. Companies will be selected on the basis of competitive tenders (auctions). The winner of a tender will be required to conclude a fiduciary contract and (much like in the loans-for-shares schemes) to transfer to the federal budget a bonus fee and regular guaranteed income resulting from the trust management of the federally owned shares (70 percent of the dividends accrued on the shares in trust). The opposing plan would make line ministries responsible for trust management, thus perpetuating state control.

The list of enterprises whose state-owned shares are transferred in trust will be determined by the government, which will not make decisions on the sale of these shares until the trust management contract expires. The trust management company is entitled to the rights of an owner (including the rights of a shareholder) in accordance with the statutes of the company whose shares are put in trust (except the right to sell these shares). Remuneration to the trust management company and reimbursement of the necessary expenses incurred during trust management is paid out of the dividends accrued on these shares in the amount stipulated in the trust management contract.

The subject of the contract is the transfer for three years of common shares retained in federal property and the obligation of the trustee (the trust management company) to manage these shares in the interests of the state. The trustor (the GKI) transfers the federal shares free of mortgage and other liabilities and promises not to pass these shares to the statutory capitals of other companies or alienate these shares through other means (such as outright sale) during the period of the contract.

This process is an attempt to modify the loans-for-shares schemes, which inefficiently transferred majority ownership rights over the crown jewels of Russian industry to an exclusive group of state-favored banks. The rights of the banks have been curbed relative to the loans-for-shares schemes, which allow almost unconditional ownership of shares after expiration of the loan repayment period. The trust management contract only gives the right to manage the shares, not to own them (the sale of shares under the trust management agreement is prohibited without an explicit order by the government). On the other hand, the trust management company is given significant rights and privileges that can easily be abused if proper safeguards are not included in the trust management contract.

Trust management contracts represent a hybrid of a short-term concession and a proper management contract, and the

danger is that investors will inherit little state control from the concession and have little incentive to improve the company's long-term performance. Since they are not as scrupulously monitored as "classical" management contracts and do not create the conditions for long-term success fostered by classical concessions, the contracts create incentives for short-term profit taking through quick and wasteful exploitation of depleting resources.[3] The draft decree provides no guarantee that the mistakes made in other countries will not be repeated on a larger scale in Russia.

Tendering, negotiation, and monitoring of trust management contracts require greater resources and skills than outright privatization and therefore will demand extensive institutional capacity within the GKI or the Federal Property Fund. At present these resources and skills simply do not exist. The draft model contract does not contain objective criteria for gauging the quality of trust management services. Instead, there is a vague reference to the obligation of the trustee "to carry out the management of these shares in the interest of the trustor and for the purposes defined in the trust management contract." To be effective such deals must be based on mutual trust and developed business ethics—still nascent conditions in Russia. This is a major hindrance to successful implementation of trust management contracts, since they depend on trustees always acting in good faith. Outside of the coal sector (which has attributes that appear to justify trust management), trust management has not played a major role in Russia's privatization program. The government should not try to adopt trust management agreements in any universal form. Direct privatization would be simpler and more effective.

Debt-equity swaps

Another feature of the proposed privatization program is a form of debt (revenue) for equity swap in which the government swaps residual share ownership with the regions and municipalities in lieu of sharing revenues. It is unclear how extensive the swap program will be and what the obligations and rights of the regions and municipalities are under the program. But this proposal also appears to be a step backward from real private ownership and has not been welcomed by regional authorities.

Notes

1. An exception to the loans-for-shares transactions was the government's attempt to divest 25 percent of Svyazinvest, a telecom holding company for eighty-five regional telephone companies, to a strategic foreign investor in the fourth quarter of 1995, with a view toward divesting another 24 percent through an initial public offering during 1996. The Svyazinvest transaction failed to materialize, however.

2. The laws, decrees, and regulations governing mass privatization were clearly delineated, widely circulated, and well respected. All auctions were advertised in advance, and bids were processed and shares allocated according to a preestablished algorithm or formula. By contrast, the loans-for-shares transactions failed to respect the rules of the game, creating a non-level playing field in favor of four major Moscow-based banks.

3. Unlike long-term concessions or production-sharing agreements, the short duration of management contracts provides few incentives for capital improvements, maintenance, marketing, training, and licensing of technology that depress profits in the short term but increase them in the long term.

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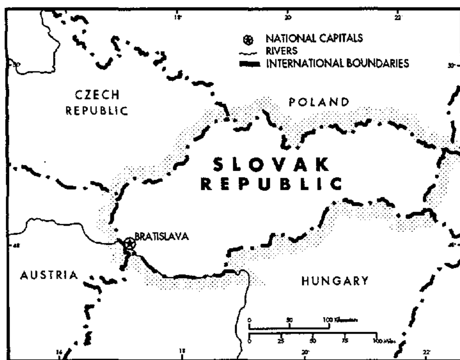

The Slovak Republic

Marinela E. Dado

After gaining independence in early 1993, the Slovak Republic continued the rapid privatization program initiated when it was still part of Czechoslovakia. Dissatisfied with the enterprise restructuring that had resulted from the first wave of mass privatization—started in mid-1992 and completed by mid-1993—and concerned that the economy would be controlled by foreign investors, the government abandoned mass privatization in favor of direct sales and tenders. During the process enterprise managers were given strong preference for acquiring controlling equity at favorable financing terms. About two-thirds of large industrial assets are now in private hands, but it is unclear how fast modernization and technological upgrading can proceed because domestic owners often lack capital and expertise. Privatization has suffered from excessive politicization and lack of transparency, resulting in limited participation of foreign capital. In the four years since independence foreign direct investment inflows have averaged just $150 million a year.

Stable Macroeconomic Environment

Contrary to the economic collapse predicted by many observers at the time of independence, the Slovak Republic has completed its third year of impressive economic recovery, and the outlook for continued growth is good. Following a 23 percent decline in output during 1990–93, the economy grew by more than 6 percent a year during 1994–96, making it the fastest-growing economy in the region. Inflation, at 6 percent, is lower than in any other transition economy. Unemployment has fallen to 12 percent. After weathering the loss of fiscal transfers from the Federation, fiscal accounts were quickly brought under control, with a deficit of 1.3 percent of GDP in 1996 (compared with the official target of 2.3 percent).

As in other small countries, economic recovery was driven by exports—particularly in 1994, when domestic demand remained stagnant. The reorientation of trade from the Council for Mutual Economic Assistance (CMEA) to the Organization for Economic Cooperation and Development (OECD) proceeded quickly, with exports to the OECD rising by 30 percent (in dollar terms) in 1995. In 1996, however, the current account deteriorated because strong import growth, fueled by a sharp expansion in domestic demand, considerably outpaced exports.

Strong macroeconomic performance is the result of a well-designed stabilization program focused on a stable exchange rate and prudent fiscal, monetary, and incomes policies. It is within this stable framework that privatization could proceed despite political changes and tensions among young constitutional bodies.

From Mass Privatization...

The Slovak Republic began privatizing its economy in 1991 as part of Czechoslovakia's bold and comprehensive transformation program, which combined massive devaluation of the koruna, almost complete trade and price liberalization, and prudent fiscal, monetary, and incomes policies. Privatization of large state enterprises, designed to take place in two waves because of the large number of firms being privatized, involved an innovative coupon scheme as well as more standard meth-

ods (direct sales, public auctions, tenders, restitution, and transfer of property to municipalities). The enterprises included in the coupon scheme were to be "sold" to individuals who had bought coupons that entitled them to bid in five successive rounds for shares in enterprises in both the Slovak and Czech Republics. In addition, the Slovak Republic privatized some 9,300 small shops and enterprises through auctions, direct sales, restitution, and leasing during 1991–93.

Policymakers chose the coupon method for speed, transparency, and fairness. The need for a rapid transfer of ownership stakes in a large number of enterprises called for a scheme that required minimal government intervention. Restructuring of enterprises prior to privatization was deemed not only unnecessary but also inappropriate in the new environment, where market forces were expected to reallocate resources. The opportunity for all citizens to own enterprises allayed fears that privatization would unfairly benefit certain segments of the population or groups with access to international capital markets. The pricing of enterprises and equity, which would have been a long and difficult task, was bypassed through competitive bidding.

Preparation of the first coupon wave began in late 1991, bidding for enterprises started in mid-1992, and the issuance of shares to new owners ended in mid-1993 (box 1). Some Sk 430 billion (book value) of large enterprises were initially slated to be privatized during the first and second waves (table 1). During the first wave Sk 170 billion of about 700 enterprises were to be transferred to private owners. Of this, some Sk 90 billion was to be privatized using coupons; the rest was to be privatized using standard methods or kept by the National Property Fund (the agency established to implement privatization).

Enthusiastic participation

After a slow start, 2.6 million Slovak citizens—nearly three-quarters of the eligible population—bid for equity in the 487 enterprises offered in the first coupon wave. At the beginning of the first round of bidding the price of a share was the same for all enterprises: 100 coupon points for three shares, or thirty shares for one booklet (worth 1,000 points). Subsequent bidding (in five rounds) then revealed different prices for different enterprises.

Table 1. Property offered for privatization in the Slovak Republic, 1992–96
(billions of koruna)

Stage/method	Book value
First wave	170
Coupon	91
Standard	79
Second wave	260
Canceled coupon	70
Standard	190
Total	430
Memo item: "Essential" enterprises	100

Box 1. Privatization events in the Slovak Republic, 1991–96

Mid-1991–mid-1992	Enterprises transformed into joint stock companies and privatization projects prepared
July 1991–April 1992	Individuals register for coupon books for the first wave of privatization
February–April 1992	"Zero" round: Coupon points transferred from individuals to investment funds
May–December 1992	Five bidding rounds of coupon privatization
Early 1993	Second wave of privatization prepared and privatization strategy adjusted
May 1993	Coupon privatization shares distributed to successful bidders
March–September 1994	Interim coalition government enters office
September 1994	Coupon books for second wave sold
September 30–October 1, 1994	National elections
December 12, 1994	New government formed
December 14, 1994	Second wave of coupon privatization postponed
July 1995	Second coupon wave canceled and replaced by bond privatization; law on essential and strategic enterprises enacted
January 1, 1996	Privatization bonds distributed to coupon holders
August 5, 1996	Privatization bonds begin trading
October 22, 1996	Preliminary list of companies announced whose shares are to be sold in exchange for bonds

Privatization investment funds

In the "zero round" that preceded bidding, individual coupon holders were allowed to turn over management of all or part of their 1,000 bidding points to privatization investment funds. The 165 funds in the Slovak Republic were formed by entrepreneurs, enterprises, and institutions (including commercial banks and insurance companies) to provide a large, diversified portfolio of shares to coupon holders. The funds were founded without government support or encouragement. In keeping with the government's philosophy of not regulating market developments, few rules governed the funds initially. Not until one month before the first bidding round was legislation passed to regulate the funds; these regulations limited to 20 percent the shares a fund could hold in a company and to 10 percent the amount of its capital a fund could invest in an enterprise.

The funds emerged as key players in privatization. Aggressive advertising by the funds, with promises of enormous returns to individual coupon holders, caused interest in the coupon scheme to grow dramatically. In the end more than two-thirds of coupon holders entrusted the funds with all or part of their coupons. The twenty largest Czech and Slovak funds controlled more than half of all coupons.

Bidding results

The coupon scheme privatized 47 percent of the equity of enterprises included in the first wave; standard methods privatized 24 percent. In making their bids, investors used official enterprise data (for example, 1989–91 employment, profits, and so on) published prior to bidding, but other factors (such as the enterprise's reputation or familiarity with the enterprise) also influenced demand for companies. Although bids covered the entire range of enterprises, investors preferred companies in light manufacturing, banking, insurance, and other service sectors.

Investment funds participated in all five bidding rounds, while individual investors generally participated only in the last two rounds. At the end of bidding only 8 percent of the equity of enterprises included in the coupon scheme remained unsold. Individual coupon holders acquired, on average, 55 percent of the equity of Slovak enterprises, resulting in rather diffuse ownership. Thus, while investment funds acquired large shares of many enterprises relative to individual investors, as a group the funds owned less than half of enterprises' shares.

Technical administration

The success of the coupon scheme was due in large part to the remarkable organization, skills, and technical infrastructure involved from the preparation of coupon books to the distribution of shares. A computer network was set up to handle both the registration of millions of citizens in thousands of registration offices and the bidding by participants all over the country. Moreover, officials skillfully designed pricing rules and a complex algorithm to clear the market. To ensure a speedy process that would result in the sale of nearly all available enterprises, officials encouraged investors to place bids as soon as possible. In fact, officials gave no indications either before or during bidding as to how many rounds ultimately would take place.

. . . To Standard Methods

The Slovak Republic's policymakers had believed that coupon privatization would play a dual role: quickly creating effective governance and equitably compensating Slovak citizens for the "mistakes of the past." The first wave of coupon privatization, however, caused the authorities to worry that:

- Dispersed ownership was not conducive to developing good enterprise governance.
- Investment funds would wield too much power over industrial assets.
- Funds' behavior as short-term profit-takers would come at the expense of the long-run interests of enterprises and society.
- Fund managers had too little experience with enterprise governance.
- Funds would sell Slovak companies to foreign investors who would reap most of the benefits of coupon privatization.

After the first wave of privatization was completed in mid-1993, the government announced that the second wave would rely more on standard methods in the hopes that it would lead to more concentrated ownership (and thus better governance), attract strategic investors (and thus provide capital needed for restructuring), and develop domestic entrepreneurial expertise (through sales of enterprises to enterprise managers and employees, who would then have a strong equity interest in pursuing strategic decisions related to the long-term development of the firm).

Favorable financial terms were provided to potential buyers to enhance the privatization program. Buyers were required to make a down payment of just 20–30 percent of the sales price, with the rest to be paid in installments. In

many cases the sales price was less than the book value of the enterprise—in part because of pledges of future investments to be undertaken by the new owners.

In 1994 an interim government announced that it would return to coupon privatization as the dominant privatization method. About 3.3 million Slovaks, considerably more than in the first wave, acquired coupon books in eager anticipation of the second wave. The government did not succeed in carrying out its coupon privatization plans, however, because it had only six months of preparation time (compared with a year in the first wave) and because the wide-ranging political views of the coalition government delayed decisions on which enterprises should be included in the second wave.

When a new government came to power in late 1994, it was accompanied by a decisive return to standard privatization methods. Although coupon privatization was to be given a supportive role if standard methods delayed privatization, no concrete plan or book values were announced for coupon privatization. In early 1995 the government announced that Sk 260 billion of enterprise book value would be privatized in the second wave, largely through standard methods. However, the procedures for selecting enterprises and for agreeing on financing became even more politicized and less transparent.

Privatization accelerated from late 1995 throughout 1996, and by the end of 1996 Sk 226 billion of book value—68 percent of the amount slated for privatization in both waves—had been privatized (table 2). Of this, Sk 146 billion went largely to managers and employees in the second wave and Sk 80 billion went to individual investors and investment funds in the first wave. However, it took three times as long to privatize roughly the same amounts through standard methods as through the coupon method.

Unpopular Bond Scheme

After the second wave of coupon privatization was officially canceled in mid-1995, the coupon books held by 3.3 million

Table 2. Completed privatizations in the Slovak Republic, 1992–96
(book value, in billions of koruna)

Method	1992	1993	1994	1995	1996	Total
Coupon	80	0	0	0	0	80
Standard[a]	40	7	17	47	35	146
Total	120	7	17	47	35	226

a. Includes the creation of reserve and other equity funds for joint stock companies.

Slovaks were exchanged for privatization bonds with a total value of Sk 33 billion, or 6 percent of GDP. The bonds, issued on 1 January 1996, have a face value of Sk 10,000 each, with a maturity of five years and an interest rate equal to the discount rate. Bond holders have several options for using the bonds:

- Holding on to them until maturity to receive the full principal and interest.
- Selling them before maturity for a state-guaranteed price of at least 75 percent (Sk 7,500) of their nominal value.
- Buying complementary health and pension insurance or apartments from municipalities.
- Bidding for shares in enterprises to be offered by the National Property Fund.
- Repaying debts owed by companies and individuals to the National Property Fund by buying bonds from citizens at their market price, in exchange for cash or equity. In turn, companies can use the bonds, at full face value, to settle their obligations to the National Property Fund. Companies and individuals with debts to the fund are expected to be the biggest group of buyers since the fund will accept the repayment of privatization debts at the bonds' face value.

The government felt that investment funds had taken advantage of Slovak citizens during the first coupon wave and believed that the bond scheme would be more transparent than the coupon scheme because bond holders would be fully aware of what they were entitled to (unlike in mass privatization through coupons, where individuals were faced with the uncertain outcomes of the bidding process). Thus, it reasoned, only investors with financial expertise would participate in the auctions for enterprise shares.

But unlike the coupon method, which was very popular with citizens, the bond scheme has met with skepticism and apathy. Most Slovaks find it too complicated and too removed from the objective of transferring state-owned assets into private hands. Many also doubt the government's promise to pay off the bonds upon maturity, mainly because they believe that the favorable terms extended by the National Property Fund to the new owners of enterprises and the risk of their default on installment payments could limit the fund's capacity to honor its future obligations.

Moreover, the National Property Fund has made it widely known that it would prefer to redeem bonds at a steady pace over the next few years in order to reduce the demands on its liquidity in five years' time. To that end the government has encouraged secondary trading of privatization

bonds in the RMS system, which began in early August 1996. Not surprisingly, many bond holders have been willing to sell for cash at a price lower than the government's guaranteed minimum price rather than wait several months (or even indefinitely) to find a buyer through the RMS system at the guaranteed price. Most bond holders do not see themselves as enterprise owners with long-term interests in the growth of their investments (as they would under the coupon scheme), and thus prefer to cash in their bonds immediately. Many bonds were sold in private deals at one-third of the minimum guaranteed price (one-fourth of their face value).

The government recently intervened to boost official bond trading by strictly enforcing the minimum price. As of October 1996 all direct deals have to be settled through a special account on the RMS system. By the end of November, four months after trading began, the National Property Fund had redeemed about Sk 2 billion in bonds (nominal value). To further encourage bond privatization, the fund offered to exchange bonds for shares totaling Sk 8 billion in 155 companies in which it holds equity.

Essential and Strategic Enterprises

After the second coupon wave was canceled, twenty-nine enterprises with a combined book value of more than Sk 100 billion were earmarked as "essential" and excluded from privatization. These include energy and water utilities, armaments and machinery firms, post and telecommunications services, pharmaceutical firms, agroindustrial enterprises, and railways.[1] The state also gave itself the right to retain (or regain) veto power over decisions in forty-five "strategic" enterprises with a total book value of Sk 110 billion—even though some of these enterprises have already been privatized.[2] The state can exercise veto power over such important decisions as the distribution of dividends and representation on management and supervisory boards. In addition, ownership rights for all enterprises considered essential or strategic were shifted back from the National Property Fund to the founding ministries.

Restrictions on foreign participation could adversely affect investor interest in these enterprises were they to be offered for privatization. The move to return ownership rights to ministries largely reflects the struggle for control over these enterprises within Parliament. This politicization was most evident in the recent disagreement among members of the coalition government on privatization of the largest insurance company (still partly owned by the National Property Fund), which resulted in the replacement of the entire management board.

Capital Market Development

As in other transition economies, the domestic capital market in the Slovak Republic remains a marginal source of financing for firms. Households are not yet familiar with the concept of investing in financial products as alternative savings instruments. At the end of 1996 stock market capitalization was about Sk 120 billion; with development the market could provide an alternative investment instrument for household savings deposits totaling Sk 180 billion. The most successful Slovak companies have been able to tap the eurobond markets because the country's international debt rating has been raised to investment grade.

The limited availability of information on companies issuing securities and on the operations of investment funds has hampered capital market development. Recognizing the need to boost investor confidence, legislation passed in July 1995 sought to enhance transparency in the capital market and to strengthen the regulatory framework for investment funds. An amendment to the Securities Act introduced stricter monitoring procedures and disclosure requirements by enforcing the registration of all shares in the central registry and the trading of all securities on the Bratislava stock exchange and through registered brokers.

The authorities believed that investment funds often interfered unnecessarily in enterprise management, engaged in anticompetitive actions through their participation in the management boards of many enterprises, used insider information in trading shares, and made unrealistic promises to uninformed investors. The July 1995 amendment to the investment funds act restricted the voting rights of the investment funds, requiring a larger number of funds to combine forces in order to exercise effective control over an enterprise. Specifically, the maximum equity stake of funds in any joint stock company was lowered from 20 percent to 10 percent. In addition, the amendment imposed limits on fees charged by the investment companies managing the funds. Though well intentioned, the legislation limited the role of the funds in enterprise governance. Moreover, it could adversely affect small, less-informed investors who rely on the funds.

Assessment

By the end of 1996 the Slovak Republic had privatized 68 percent of the industrial assets slated for privatization in mid-1995. However, privatization excluded "essential" enterprises with a combined book value equal to nearly one-quarter the book value of the enterprises originally earmarked for privatization. By contrast, the Czech Republic's National Property Fund has maintained sizable holdings in fifty-five enterprises with a combined book value of Sk 300 billion, about 40 percent of the assets originally slated for privatization.

The popular perception that most direct sales during 1995–96 favored certain interest groups (mainly enterprise managers and employees) has undermined privatization. Moreover, the lack of transparency has discouraged foreign investors and often limited them to minority shareholdings. The preference for domestic ownership could delay essential restructuring since entry of foreign capital and technological know-how will be slow. Although this approach encourages domestic entrepreneurship, limiting ownership to insiders discourages the development of other groups of managers with newer skills who could adapt more easily to rapidly changing markets.

Although the Slovak Republic's impressive record on stabilization stands in sharp contrast to the results achieved in enterprise restructuring, there is evidence that restructuring is taking place. But the methodical and time-consuming nature of restructuring may have led the government to quickly blame the seemingly slow results on the diffuse ownership resulting from the first wave of coupon privatization. In fact, a cross-country analysis of large enterprises in the region during 1992–94 shows that the 370 largest enterprises in the Slovak Republic have restructured more—as measured in terms of export growth, improvements in variable factor productivity, and changes in profitability—than similar enterprises in Bulgaria, Hungary, and Poland (Pohl, Djankov, and Anderson 1996). Only in the Czech Republic have large enterprises performed better.

Notes

1. An amendment to the "essential" and "strategic" enterprises act passed in mid-1996 added the three major banks and the largest insurance company, all of which were partly privatized in the first wave of coupon privatization, to the "essential" enterprise list.
2. The policy allows the government to block important decisions in the strategic companies even if the state's shareholding is a minority one. In April 1996 the Slovak Republic's Constitutional Court declared this policy unconstitutional and nullified the application of the law for companies that have already been privatized.

Reference

Pohl, Gerhard, Simeon Djankov, and Robert E. Anderson. 1996. *Restructuring Large Industrial Enterprises in Central and Eastern Europe: Empirical Analysis.* World Bank Technical Paper 322. Washington, D.C.

Ukraine

Bernard Drum

Ukraine was one of the last newly independent states to embark on privatization. Until mid-1994 progress was painfully slow, with a few false starts. Privatization was paralyzed by an absence of leadership, a lack of consensus among policymakers, an ambiguous legal and institutional framework, an unworkably complex methodology, and weak implementation capacity. In early 1994 initiatives sponsored by donors—working with leading reformers—helped identify the problems. These initiatives produced an action plan that would have streamlined and jump-started privatization and brought the promise of full financial backing from the international community. However, parliamentary elections in the spring of 1994 followed by presidential elections in the summer delayed any serious consideration of the issues raised.

Economic performance was abysmal between independence (in August 1991) and mid-1994. Output dropped by about 50 percent, inflation surged to more than 10,000 percent in 1993, and the stock of external debt increased from zero to around $7 billion. At independence there were 18,000 medium-size and large and 45,000 small state enterprises. Because of poor reporting, it is hard to determine the number of enterprises privatized through mid-1994. Some estimates put the figure at 3,000 medium-size and large enterprises and 7,000 small enterprises, but many so-called privatizations of medium-size and large enterprises consisted only of corporatization, with no transfer of the majority of shares to private owners. Moreover, many of these privatized enterprises were closed joint-stock companies, with shares owned by worker collectives. In the absence of legal privatization, spontaneous privatization accelerated. Although in theory most medium-size and large enterprises reported to central ministries, in reality managers and employees assumed strong de facto ownership and control.

Leasing arrangements also drew off state enterprises from the privatization program. A 1992 Ukrainian law—based on a 1989 Soviet law—allowed leased enterprises to continue operations and vested workers with full control over leased firms. These leases were rarely awarded on a competitive basis; rather, they were characterized by fixed rents and gave workers the option to purchase their enterprise for the value fixed at the beginning of the lease. Given that inflation was 20–30 percent a month at the time, this approach effectively amounted to appropriation by insiders. In addition, if workers voted in favor of leasing, the state could not refuse them the property in question, nor could it prevent the workers from redeeming the enterprise once leased. Some 1,600 enterprises were leased to employees on these favorable terms. During 1992–94 leasing, followed by employee buyouts, was the predominant privatization method. Almost 80 percent of the enterprises privatized during that period were bought by their employee collectives.

President Kuchma's election in mid-1994 marked a turning point both for economic recovery and for privatization. In October 1994 Kuchma announced a program aimed at reducing inflation, improving living standards, and promoting sustainable recovery. He also appointed a new chairman of the privatization agency, the State Property Fund. The International Monetary Fund, the World Bank, and other donors responded by giving Ukraine their full backing, with balance of payments support and technical assistance.

Although there have been some problems and slippage in implementation, the government has taken action to keep the program on course.

In 1995 privatization started to gather momentum, and since the second half of the year about 1,500 small-scale enterprises have been privatized each month. Mass privatization of medium-size and large enterprises is being managed by the State Property Fund and implemented by an independent certificate auction center network funded by the U.S. Agency for International Development (USAID), with help from other donors. There is an auction center in each of the twenty-seven oblasts and a network of more than 1,000 bid collection sites. Privatization certificates are being distributed to every Ukrainian citizen, and by late 1996 more than 80 percent of the population had collected their certificates. Although these certificates are not tradable between individuals, they can be traded for shares in, and sold to, financial intermediaries.

Packets of shares in corporatized state-owned enterprises are auctioned each month, at which time bids can be received from individuals and financial intermediaries. Ukrainian law grants employees and managers of enterprises first call on the sale of shares at book value. Employees can use their own certificates plus 50 percent of their face value in cash to buy shares before the public auctions begin. Managers can buy an additional 5 percent for cash and certificates and, since early 1996, another 5 percent if they cooperate with the process and deadlines. Other methods of privatization are proceeding in parallel, including offerings of shares on the Ukrainian stock exchange and public offerings and private placements to foreign and local investors.

Key Issues

Ukraine has privatized 36,000 small enterprises, or more than 80 percent of the total. This is remarkable progress, and barring unforeseen problems small enterprise privatization should be largely complete by the end of 1996. Since early 1995 at least 70 percent of the shares of more than 3,500 medium-size and large enterprises have been transferred to private hands through preferential sales to employees, certificate and other public auctions, and private placements. Medium-size and large enterprise privatization is gathering momentum and has reached about 400 enterprises a month. The current target is to privatize 5,000 enterprises by early 1997. The main issues affecting these efforts are described below.

Legal framework

Ukrainian privatization is governed by three laws passed by Parliament in 1992: the Law on Privatization of Property of State Enterprises, which controls medium-size and large enterprise privatization; the Law on Privatization of Small Enterprises; and the Law on Privatization Certificates. Privatization programs for 1992 and 1994 outlined enterprise groupings, targets, and methodologies. The basic legal framework is adequate for rapid privatization.

Many presidential and Cabinet of Minister decrees and State Property Fund regulations also govern privatization. In particular, a presidential decree signed in November 1994 streamlined mass privatization along the lines agreed with donors and required the preparation of a list of 8,000 medium-size and large enterprises to be privatized by certificate auctions (45 percent of these enterprises are in the agroindustrial sector). A similar decree mandated rapid small-scale enterprise privatization. Both decrees reaffirmed the State Property Fund as the central agency responsible for implementing privatization, allowing it to take control from sometimes hostile local authorities.

Still, the legal framework for privatization has been a constant battleground between Parliament, the president, the government, and local authorities. In mid-1994 Parliament issued a resolution requiring a moratorium on privatization until it approved a list of enterprises not to be privatized. The list of about 6,000 enterprises was later approved, and the moratorium was lifted in early 1995. Opponents of privatization are constantly trying to use the law to block the process, and in the leadership vacuum of 1992 to mid-1994 they were often successful. Parliament has repeatedly tried to slow down, complicate, or reverse privatization, although the president recently vetoed some of the worst parliamentary excesses and issued enabling decrees. The result has been a complex web of changing and often contradictory legislation.

One big problem has been the agroindustrial privatization law, vetoed three times by the president since December 1995 and finally enacted in July 1996. Earlier versions of this law would have effectively halted privatization of all agroindustrial enterprises (just under half of the 8,000 enterprises in the pipeline), requiring lengthy preparation procedures, granting a controlling interest in these enterprises to collective farms and other agricultural suppliers, and even retroactively canceling completed privatization deals. One unexpected benefit of the earlier drafts of the law was that agroindustrial enterprise managers rushed to get their firms privatized before the

law came into effect. Other draft legislation being considered would complicate and probably stop mass privatization if approved. There is even a draft renationalization law under preparation. President Kuchma has promised to continue resisting such obstructive maneuvers.

Institution building

Despite its large size (about 6,000 employees), lack of capacity in the State Property Fund has slowed privatization. First, the chairman of the fund, although a leading reformer and having the rank of cabinet minister, is appointed by Parliament—and can be fired by Parliament. Also, unlike heads of privatization agencies in other countries, he is not higher in rank than branch ministers, many of whom are opposed to privatization and can sometimes prevail in cabinet discussions. Not all fund employees appear fully committed to rapid privatization. The fund also has had great difficulty exercising control over local privatization bodies, even though legally they report to the fund. Local politicians and administrators sometimes have more power over local fund staff than do the central headquarters.

President Kuchma has periodically tried to boost the fund's power in public pronouncements, as well as in decrees and orders, but local political reality does not always reflect central policy. Hence the wide difference in the speed of privatization between different oblasts and cities. Largely because of the fund's institutional weaknesses, mass privatization is being implemented (with USAID and other donor support) by an autonomous certificate auction center network that appears to be doing the job effectively, if slowly. One consequence of the fund's institutional weakness has been inadequate reporting, particularly on privatization by methods other than certificate auctions. With donor support, however, steps are being taken to improve information flows, and the quality and detail of information is steadily improving.

Voucher auctions

Every Ukrainian citizen is entitled to a privatization certificate, which originally were dematerialized as privatization deposit accounts in the Savings Bank. After two indexations, these certificates now have a face value of 50 million karbovanets, or about $250. The certificates are not tradable. They must be exchanged for shares in enterprises or in licensed investment funds that can invest in shares of enterprises. A loophole, however, allows citizens to sell for cash the shares to be bought later by the financial intermediary that handles their certificate.

In early 1996 the State Property Fund set a deadline of 30 June 1996 for collecting certificates and 31 December 1996 for their redemption for shares. Since 30 percent of the certificates had not been collected by 30 June, however, the collection deadline was extended to 1 October. A new voucher, known as a compensation certificate, was introduced in March 1996. These certificates will compensate the holders of deposit accounts held in the Savings Bank on 1 January 1992 by index-linking their deposits by 2,200 times. These certificates are tradable between individuals and have been used in the auctions since May 1996. The intention is to reserve packets of shares totaling about 30 percent of total enterprise shareholdings for sale for compensation certificates.

Despite breakthroughs since the early design, problems remain that unnecessarily complicate auctions and therefore slow down mass privatization. First, not all the shares of enterprises remaining after preferential sale to employees and managers are being offered at auction. Thus, even when auctions fully clear, a percentage (reportedly about 30 percent) of enterprise shares remains in state hands. Second, separate auctions will be held for shares to be offered for compensation certificates, making the auction process longer and more expensive.

A third issue that has been partly resolved is that enterprises, which were capital intensive enough to ensure that their book value greatly exceeded the preferential purchase capacity of managers and employees, were likely to pass out of the control of employees during privatization. Unlike Russia's mass privatization, there is no mechanism in Ukraine for managers to elect to purchase majority control over their enterprise on preferential terms. This has led to insiders blocking privatization. Steps were taken to resolve the problem in January 1996, when managers' preferential access was raised from 5 percent to 10 percent if they cooperate with privatization. It remains to be seen whether this move will prove sufficient or whether additional incentives will be needed.

Valuation and pricing

Until 1995 every enterprise had to be valued individually by a specially created committee before it could be corporatized and privatized. This arrangement was one of the main causes of slow progress with mass privatization. A presidential decree in November 1994 simplified the valuation process and required that the most recent book value of the enterprise be taken as its privatization value. Attempts have also been made to introduce the concept of future profitability into the valu-

ation, but so far this move has been resisted. Enterprise asset book values have been revalued across the board twice since 1993 to account for inflation. Although privatization certificates were also revalued to compensate for inflation, this adjustment effectively reduced the purchasing power of cash contributions from employees during initial preferential sales. A planned 1996 revaluation will not apply to enterprises subject to privatization.

Shares of enterprises offered in the privatization certificate auctions currently have a floor price equivalent to the book value of the enterprises. In 1995 only 30 percent of the shares initially offered cleared the auctions at the floor price; the rest were held back for repeat auctions or retained in state hands for sale by another method. Repeat auctions were stopped in January 1996, but the question of what to do with the unsold shares remains. This issue will be partly resolved as public interest in the auctions grows and the auctions of compensation certificates proceeds, since these are allowed to clear all the shares offered without a floor price. It is still not clear, however, whether the State Property Fund will offer all previously unsold shares for compensation certificates or whether blocks of unsold shares will remain in state hands after mass privatization is over.

Other methods of selling blocks of shares in enterprises include public offerings at cash auctions through the Ukrainian stock exchange (where book value is also used as a floor price) and competitive (price-based) and noncompetitive (quality-based) tenders to local or foreign investors. At first foreign investors could participate only at a highly disadvantageous exchange rate that penalized them for the perceived undervaluation of the Ukrainian currency. This approach was discontinued in early 1995 and, except for being excluded from participating in preferential sales to employees, foreign investors are given the same rights as local investors.

Privatization perceptions

The program designers attempted to trade off the competing claims of different stakeholders—employees, managers, the general population, and the national budget—while taking into account the need for good post-privatization corporate governance. They also tried to make the process as transparent as possible. But the first result of their efforts was a program that was far too complex, that few people could understand, and that took too long to implement. After failing to take off, it eventually had to be dramatically simplified. Because of the historically complex nature of privatization in Ukraine and the repeated unfulfilled promises and missed targets, the public has responded to mass privatization with incomprehension, mistrust, and a wait-and-see attitude, despite public information campaigns.

A more aggressive campaign and public pronouncements by leading political figures in support of the new streamlined program may have contributed to recent increases in the pick-up rate for certificates. The improved auction clearing mechanisms and new deadlines for certificate pick-up and redemption are likely to have an even greater effect on public participation in the coming months. Enterprise managers, many of whom were initially hostile, are taking a more positive view of privatization and, where they believe they can maintain effective control, are pushing to be included in the program. Further incentives for managers would produce even quicker results but at a possible cost in post-privatization enterprise governance. President Kuchma recently announced that privatization is high on his policy agenda and has threatened punitive action against civil servants and others who impede it. Small-scale privatization is now almost complete in many large cities, and has probably gained a critical mass of public support. Parliament continues its hostility, however, and some branch ministries and local officials still oppose privatization. The battle is far from over, but as every month goes by the process that took so long to build up is getting more difficult to stop.

Corporate governance

Since Ukrainian privatization certificates are not tradable and each citizen has one certificate, there is a risk of fragmented ownership during primary mass privatization. This risk is somewhat reduced, however, by the ability of employees and managers to maintain control through preferential share purchase. This control, however, brings its own risk of employee owners who may have interests other than maximizing company profitability. It is too early to judge the impact of fragmentation or extensive insider buyouts on post-privatization corporate governance.

Several of the program's design features could mitigate adverse effects and lead to improved corporate governance. First, licensed investment funds are allowed to buy certificates and to use them to buy shares at auctions. As a result investment funds already have block ownership of shares in some enterprises. Second, the new compensation certificates are tradable, and holders of blocks of these will be able to bid at

auctions. Third, the State Property Fund has been willing to withhold blocks of shares for sale to strategic investors and is doing so through competitive and noncompetitive tenders.

To avoid the problems experienced in neighboring countries of enterprises running their own share registries and abusing control over information, temporary share registries have been created at the auction centers. At the same time attempts are being made, with donor support, to stimulate the growth of independent private share registries. Much work remains to be done in informing the rapidly growing number of new shareholders of their rights and responsibilities. Finally, steps are being taken to develop capital market infrastructure and supervision, which should stimulate further ownership change in the secondary markets that will result in, among other things, improved corporate governance.

Role of investment funds

The State Property Fund has licensed more than 350 private investment funds, companies, and trusts to invest in privatization certificates; 60 percent of these operate in five cities, with Kiev accounting for 25 percent of them. Some 30–40 percent of intermediaries are said to control 80 percent of the certificates obtained from individuals. In the first year of mass privatization financial intermediaries accounted for about 85 percent of all shares purchased at auctions. This percentage is falling steadily, however, because the certificates they obtained from citizens before the program was launched are being used up and citizens are becoming more interested in privatization.

Investment funds can hold up to 25 percent of the shares in an enterprise if the shares are purchased with privatization certificates or up to 10 percent if they are purchased through other means. The shares of a single enterprise cannot account for more than 5 percent of a fund's total investment portfolio. Regulation and enforcement have so far been poor, although in 1995 the State Property Fund began revoking the licenses of intermediaries guilty of the worst abuses.

Capital market links

The slow start to privatization in Ukraine allowed for preparatory work to be done on capital markets infrastructure and supervision before the market could be deluged by a large volume of unregulated share trading. A 1995 presidential decree created a Securities and Stock Markets Commission that eventually will be fully responsible for supervising markets. At present, however, the law provides for fragmented supervision of the markets by the National Bank of Ukraine, the Ministry of Finance, and the State Property Fund. Until new enabling parliamentary legislation gives the Securities and Stock Markets Commission a full mandate, it will have to work under a series of enabling decrees and regulations.

More than 500 brokers and dealers have been granted licenses by the Ministry of Finance, and of these about 50 are actively trading in securities. Ukrainian banks are allowed to apply to the National Bank for a license to purchase nongovernment securities up to a value of 10 percent of their capital. About 20 percent of banks have started buying securities, and there is little separation of their commercial and investment banking activities. Secondary trading is done mostly through a largely unregulated over-the-counter market in Kiev, but there are also two privately owned and operated centralized trading systems, the Ukrainian stock exchange and the so-called Central Depository system. Regional stock exchanges are planned for Lviv, Dnipropetrovsk, and Kharkiv, and USAID has sponsored the development of a recently opened NASDAQ-style market where shares are traded outside the established stock exchange.

Issues still unresolved are the inadequate arrangements for implementing and registering transfer of share ownership, the need to develop adequate clearing and settlement organizations, the need to strengthen the mandate of the new securities commission, and the need for the commission to delegate day-to-day responsibility for monitoring the markets to self-regulating organizations. Work is being financed by donors in the creation and strengthening of all these types of institutions, but this work needs to be accelerated as mass privatization delivers more shares to the market.

Shortcomings and Successes

The Ukrainian program has had four shortcomings:

- The main shortcoming is its lateness. As a result opportunities for developing and harnessing private initiative have been missed. Why? Largely because of the lack of early political commitment to reform in general and privatization in particular. Political commitment is essential for successful privatization in any country.
- Another shortcoming, an overly complex design, also impeded acceleration of the program. It eventually required more political will to overturn the previous (unworkable) program and replace it with a new one than it would have to design a good one from the outset. This second lesson—the need for simplicity in design—is an important one.

- A third shortcoming was the absence of incentives for key stakeholders. In particular, enterprise managers have strongly resisted privatization wherever it reduces their influence. It remains to be seen whether this problem has been fully resolved.
- A fourth shortcoming, still to be overcome, is the absence of market clearing mechanisms in the auctions. There has been strong opposition in Ukraine to allowing shares to be distributed in the voucher auctions for less than nominal value, even though the auctions are essentially a giveaway. The fear was, and remains, that a large enterprise could end up in the hands of a few shareholders for the price of a few certificates and that this would discredit the process politically. The use of the new compensation certificates in upcoming auctions (without applying the nominal value rule) may resolve this issue.

On the positive side, Ukraine has taken advantage of the delay in privatization to develop its capital markets infrastructure and regulatory environment. In the absence of widespread share trading, initiatives to develop capital markets have not been controversial—and have not yet attracted the attention of the opponents of reform in Parliament or elsewhere. Another advantage of being a late starter is the luxury of being able to assess the efforts of other countries as a guide to redesigning and simplifying the program. An added benefit is the availability of advisers from these other countries, who are now helping Ukraine resolve design and implementation problems.

Note

This paper was written in the spring of 1996.

Uzbekistan

Loup Brefort and Itzhak Goldberg

In 1992 the Uzbek government began privatization by selling enterprise shares for cash to its employees and the public. This approach was successful for small enterprises (almost 10,000 of which have been privatized through management-employee buyouts) and for a few companies that attracted foreign buyers (table 1). But the privatization of medium-size and large enterprises proceeded slowly—mainly because of the lack of capital in the hands of the public. Since cash sales to people whose GDP per capita averages $950 a year could not bring about widespread privatization, an alternative model was needed.

Table 1. Uzbekistan's privatization program

	Number	Share of total (percent)
The privatization program	18,716	83
Cooperatives	3,175	17
Small enterprises	11,910	64
Medium-size and large enterprises	3,631	19
Agroindustrial	11,772	63
Industry	1,024	5
Construction, transport, and communications	2,867	15
Consumer services and trade	3,053	16
Fully or partly privatized	13,726	73
Cooperatives	3,175	
Small enterprises (mostly full privatization)	9,547	
Medium-size and large enterprises (mostly partial privatization)	1,004	
Agroindustrial	8,736	
Industry	754	
Construction, transport, and communications	1,558	
Consumer services and trade	2,678	
Fully state-owned, to be privatized	4,990	27
Small enterprises	3,384	
Medium-size and large enterprises	1,606	
Agroindustrial	3,036	
Industry	270	
Construction, transport, and communications	1,309	
Consumer services and trade	375	

A group of Uzbek officials and a World Bank privatization team were asked to design a new program responsive to the government's aversion to vouchers.[1] V. Chjen, chairman of the Uzbek State Property Commission, has said that voucher privatization is unacceptable for Uzbekistan because "gratuitous distribution of vouchers or coupons does not allow additional funds for production development to be attracted, thus wasting capital....Under a voucher system, an aimlessly received voucher cannot make people active participants in market reform." Other countries have expressed similar opposition to vouchers, and the Uzbek design described here may provide a model for those countries.

The new program's main objective is to foster widespread public participation in privatization and broad distribution of ownership, not limited to insiders. Another objective is capital market development, including creating independent privatization investment funds to put pressure on companies to improve performance. Instead of using a voucher system the government is relying on low-priced public participation shares, a special credit to allow investment funds to purchase enterprise shares, and downward flexibility in the price of enterprise shares.

Privatization Investment Fund Scheme

The program is built on privatization investment funds that will buy shares in privatized enterprises and issue their own

shares, called public participation shares. Separate management companies will establish the funds and manage their portfolios on behalf of shareholders. Management companies will be formed by private interests and licensed and supervised by the Securities and Exchange Commission.

Public participation shares

To ensure broad public participation, the funds are being capitalized by issuing citizens a special category of shares, public participation shares. The price of each share is 100 sums (about $3)—equal to 5–10 percent of the average monthly wage, or 20 percent of the minimum wage. This is about the same as the fee paid for a voucher in the Czech program. Each citizen can buy no more than 100 shares in a single fund.

This ceiling is required to prevent a windfall for rich individuals since the shares are offered at a much lower price than the value of the underlying assets. Practical considerations, however, require a high limit to ensure that enough equity is raised to leverage the purchase of enterprise shares. During secondary trading everybody except state entities is allowed to buy shares freely.

Sale of enterprise shares to the funds

Funds are being offered shares in 300 medium-size and large companies. During the program's first wave the government is committed to privatizing 74 percent of enterprise shares—with at least 30 percent for the funds, 21 percent be sold through the stock exchange, and no more than 23 percent to employees. The government is willing to offer the enterprise shares reserved for the funds at substantial discounts. Funds also may buy shares offered to the public through the stock exchange and buy from employees during secondary trading. Thus the funds can acquire up to 74 percent of a company's shares.

A fund's influence on enterprise management depends largely on its share of ownership in that enterprise. As in other countries, the percentage of shares that a fund may own in a company is limited (35 percent), but it is higher than the limits imposed in the Czech Republic (20 percent), Russia (25 percent), and Poland (33 percent).

How is the 30 percent of shares earmarked for the funds priced? The shares are first offered at nominal book value. In the event of oversubscription, they are allocated pro rata. If the offer is undersubscribed, the price goes down—that is, unsold shares are sold to the highest bidder among the funds. Unlike some other countries, it is a major achievement that the program allows share prices to drop below book value.

Enterprise shares are offered to the funds but the funds are not obliged to buy any shares at any price. In this respect the program differs significantly from the Polish program, in which all companies slated for privatization are allocated to the funds. The Uzbek approach makes for a more commercial program—but for less privatization, since funds will not buy into companies that they consider to have poor prospects for profitability.

Deferred payment funds

Licensed funds will be eligible to significantly leverage their equity in the purchase of enterprise shares. For each share purchased for public participation shares, funds will be eligible to buy five more on credit. To ensure the long-term viability of the funds, they have seven years to repay the credit, with a four-year grace period during which no interest will accrue on their debt to the State Property Commission. The grace period will allow enterprises to build up liquidity and allow the funds to restructure the enterprises in their portfolios.

Who starts the funds?

Calculations by experienced Western investment fund managers demonstrate that business can be profitable under the Uzbek mass privatization scheme because shares are purchased at a low value and the leverage of the loan is considerable.

For example, assuming that the annual operating costs of a fund are $90,000 and the management fee is 5 percent of the net asset value of the portfolio, a management company would break even if 200,000 people bought three shares each (about $8 a person) in its privatization investment fund. Because the privatization program allows funds to take credit from the government at a rate of 5 sums for each sum invested, the potential leverage is considerable. Indeed, investors are expected to start funds to take advantage of this potential.

Who will buy public participation shares?

Public participation shares are the least predictable element of the program. As noted, funds will need to attract 200,000 investors (with three shares each) in a population of 22 million to break even in the first year. Uzbeks are not wealthy—the average monthly wage in 1995 was 1,500 sums—and they will take persuading to invest 300 of those sums in shares. An honest and effective public information campaign is essential. A user-friendly network for selling shares also must be created. Finally, the government should create the proper regulatory conditions for the promotion and sale of

shares by individual funds—leaving it to fund managers to decide on the most appropriate network and marketing activities (advertising, commission fees, and so on).

Timing and phasing

Mass privatization programs in other countries have stalled or even failed because they inadequately coordinated the various elements in the launching process. In some countries investment funds were ready but companies were not; in others, companies were ready but vouchers and funds were delayed. Coordination may be even more critical for the Uzbek scheme because the establishment of funds and the sale of participation shares will take time. To overcome the timing and phasing problem, the process should be simultaneous and continuous.

- Funds should start being licensed as soon as the legislation and regulation is in place, irrespective of the startup date for mass auctions, and they should be permitted to buy on the stock exchange, where it is proposed that the mass auctions be held. Requiring that all subscriptions be gathered before the fund can start buying at auction could delay privatization.
- Funds should be permitted to market their shares at the offer price (100 sums) throughout the six-month life of a prospectus. Given that all shareholders pay the same price and the fund closes after the offer is complete or after six months (the maximum period under Uzbek law during which an offer may remain open), all shareholders will be exposed to an equitable proportion of assets and liabilities relative to their shareholdings.
- Funds should be allowed to buy at auctions while simultaneously marketing new shares on the basis of the prospectus, since the publicity given to auctions of good companies and the active participation of funds will generate public enthusiasm.
- If the sale of participation shares is more limited than anticipated or is delayed, the sale of enterprise shares will still take place but will be limited to the scope of equity raised, leveraged by the special credit at the ratio of 1:5. As more companies are auctioned, publicity will encourage more share sales, making more company auctions possible.

Conclusion

The Uzbek program differs from the model developed in other transition economies in several important ways. Instead of free vouchers, the participation shares have a positive, albeit low price—hopefully leading to a more commercially oriented program. Moreover, while vouchers are distributed equally to citizens, each citizen can buy up to 100 shares in each fund. Thus if ten funds emerge, each person will be able to buy up to 1,000 shares—that is, invest 10,000 sums. Although the program is expected to ensure wider distribution than is possible with cash sales, it is less equitable in the primary issue than is a voucher program. In secondary trading, however, the two approaches are similar.

This scheme may be appropriate for other countries that do not want to follow the voucher privatization model but that are interested in a privatization scheme that fosters a broader distribution of ownership than is possible with cash sales of enterprise shares. And it is especially appropriate for encouraging outside ownership rather than significant employee ownership. Thus it provides for the emergence of market intermediaries and ensures the concentration of company shares in funds.

Note

1. The World Bank team included Bahtier Abdullaev, Loup Brefort, Itzhak Goldberg, Gregory Jedrzejczak, and Theodor Stolojan, with help from Michael Fuchs, Matthew Hagopian, and Mark St. Giles.

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