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

Socialism’s defining characteristic was state ownership of all productive assets. Moving from state to private ownership and creating the conditions to improve the performance of medium-size and large enterprises are the main tasks of the transition from socialism. But privatization goes beyond a change in ownership. Programs to privatize enterprises in transition economies should be evaluated in terms of three broad dimensions: the corporate governance mechanisms they create, the supporting institutions they foster, and the extent to which they create a self-sustaining economic and political reform process. Although some governments judge revenues to be an important goal of privatization, they are at best a secondary objective.

The initial patterns of ownership resulting from any program of enterprise privatization are unlikely to be optimal. They may be too dispersed, or they may be concentrated in the hands of entities unable or unwilling to use such resources efficiently. The long-run success of any privatization program therefore depends on the capacity for ownership patterns to change and evolve...
to more efficient forms. Programs that spur institutional development, particularly the growth of capital and asset markets, will have a distinct advantage in this regard.

Goals of Privatization

Creating “Real” Owners

The primary economic goal of enterprise privatization is to create true representatives of capital—individuals or groups of individuals who clearly reap the gains from improved performance. Transferring property rights to new owners is just the first step, however, and on its own is not sufficient to guarantee changes in the behavior of managers. The new owners must also have the power, incentive, and ability to monitor managers and ensure that they act in the owners’ best interests. Typically, in small firms the owners and managers are one and the same; in large firms, however, ownership and management are usually separate, creating the need for monitoring.

Shareholder monitoring is only one of numerous constraints on managerial behavior in market economies, but it is likely to be more important in the early stages of reform in Central and Eastern European economies where markets for products, capital, and managerial talent are underdeveloped and may not exert strong competitive pressures on managers. Shareholder monitoring can be passive or active. Passive shareholders simply sell their shares to discipline managers, while active shareholders exert their views and vote their shares. In countries where stock markets are still in their infancy, passive monitoring is unlikely to be efficient, and thus active shareholder monitoring is likely to be a critical mode of corporate governance in the near term. Furthermore, under socialism, production was so inefficient that major improvements in efficiency are likely to depend more on restructuring than on marginal changes in managerial behavior. Alternative patterns of corporate governance should therefore be judged on how they affect not only day-to-day decisionmaking, but also a firm’s capacity for radical change and restructuring.

Changes in corporate governance are not the only potential benefits that come with real owners. Privatization can also stimulate an infusion of capital, technology, ideas, and skills, complementing changes in incentives and boosting the productivity of enterprises. Whether these benefits arise depends to a large extent on the technique that is used to privatize and the distribution of ownership that results. Different types of private owners—whether “insiders” or “outsiders,” individuals or institutions, residents or foreigners—all bring different mixtures of goals and capabilities to the firms they own. In some cases, the move from public to private may involve intermediate forms of property—neither wholly public nor wholly private—with their own rationality in the particular setting and their own distinct incentive characteristics (Stark 1996).

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Developing Supporting Institutions

Although many market economies have pursued privatization since the early 1980s, the formerly socialist economies face an especially formidable task. They must not only change ownership, but also establish the institutions of a private market economy. Socialism either crippled or reoriented these institutions to reflect the goals of central planners. Legal frameworks defining property rights, private contract regimes, fiduciary liability, dispute resolution mechanisms, and rules of entry and exit for private firms atrophied. Courts lost much, if not all, of their independence as well as their role as adjudicators of commercial disputes and enforcers of commercial laws. Banks lost their independent monitoring role over firms and became instead passive funnels for channeling state funds. “Watchdog” institutions that provide critical information for markets to function, such as credit-rating and consumer protection services, accounting and legal professions, and independent journalism, had neither reason nor permission to exist. Finally, socialism inhibited (indeed, often classified as illegal) the development of basic norms and ethics of market conduct and fiduciary responsibility on which so much behavior in advanced market economies implicitly rests. These laws, organizations, professions, and commercial norms must now be rebuilt, sometimes from scratch.

Creating a Sustainable Reform Process

Transforming property rights and building the institutions of a private market economy necessarily take time. These reforms must therefore be politically and economically sustainable and mutually reinforcing. Yet the often-profound tension between preexisting patterns of state enterprise control and reformers’ desire to ensure a positive economic outcome can complicate privatization.

On the one hand, experience shows that the design of a privatization program must take into account the interests of and distribution of power among existing stakeholders—that is, anyone who has an interest in the enterprise, whether economic or political, including managers, employees, and government bureaucrats. Incentive and efficiency problems were pervasive in all socialist economies, but the distribution of power among stakeholders varied from country to country. Earlier reforms toward “market socialism” in Poland, the former Yugoslavia, and to some extent Hungary gave rank-and-file employees extensive powers to influence decisionmaking. In contrast, employees had very little power in East Germany or the Czech and Slovak Federal Republic (the former Czechoslovakia), where control remained firmly in the hands of management, government ministries, and the party bureaucracy until the demise of socialism, after which it shifted to the new democratic leadership. The situations in Bulgaria and the former Soviet Union were somewhere between these two extremes; some influence had devolved to workers, but bureaucrats and managers retained strong powers. Thus the Czech and Slovak Federal Republic and East Germany...
could design and effectively implement top-down privatization programs; Poland, Russia, and Slovenia had no such option.

On the other hand, accommodating stakeholder interests clearly has its risks. Compromises that are made to co-opt stakeholders or overcome informational or institutional weaknesses may have negative economic or political repercussions down the road and may undermine long-term economic and political stability. That may occur, for example, if newly privatized firms fail to restructure because new owners lack the incentives or skills for effective corporate governance, if the public perceives privatization as corrupt or highly inequitable, or if privatization concentrates economic and political power in the hands of a small domestic or foreign elite rather than an expanding, independent middle class.

Recent events illustrate this conflict between what is “doable” and what is optimal. In Russia, for instance, the preferences initially given to managers to garner political support for the program are proving costly. Not only is there limited evidence that managers are restructuring existing (largely insider-owned) firms, but resentment is growing over the concentrated wealth and power that has resulted from privatization. In the Czech Republic, the large state banks were encouraged to set up investment funds as a way to solidify public support for privatization (in part because they, particularly the savings banks, were among the more trusted institutions at the time). Yet this decision may prove counterproductive in the longer run because extensive economic and political power has come to rest in the hands of a few banks and funds, themselves linked to the government through both formal and informal ties.

In adapting privatization strategies, certain early steps appear to increase the sustainability of reform in any setting. Countries with legacies of strong bureaucratic control over domestic industry should move quickly to sever the old links between firms and line ministries—to cut pervasive subsidies, to weaken the ministries’ control, and perhaps to abolish branch or sector ministries altogether. Old political links can be cut as well by barring former Communists from government service for a period of time, as was done in the Czech and Slovak Federal Republic. This first step should be accompanied by the quick adoption of a privatization strategy and systematic efforts to prevent the wholesale looting of the newly freed state firms before they are privatized. This is likely to require a combination of “carrots” (linking the future well-being of managers to the quality of the assets they deliver to the eventual private owners) and “sticks” (imposing strong penalties on managers who divert state assets). These actions may be easier to take in the period of “extraordinary politics” immediately following a political break with the past regime (Balcerowicz 1994). After these steps are taken, each stage of the process should ideally create the momentum and incentives for further progress. That occurs, for example, if the new owners lobby politicians to design and implement laws (such as corporate and securities regulations) that further refine and protect their new rights.

Although steady progress is important for momentum, sustainability is not necessarily correlated with speed. Very rapid privatization was pushed
in the former Czech and Slovak Federal Republic and Russia, in large part on the theory that breaking the links with the state was the primary hurdle and that the political window of opportunity had to be seized quickly. Many aspects of these programs are impressive, and they may yet prove to be major success stories, but the initial design decisions taken to ensure speedy implementation have also produced serious problems, particularly in Russia. Their eventual economic and political impacts are far from clear. In contrast, slower privatization programs, such as those in Poland and, to a lesser extent, Hungary, run the risk of barely getting off the ground when political receptivity is greatest and thus of stagnating before major progress can be achieved. They could nevertheless prove successful if steady progress continues. The slowest movers, such as Belarus, Bulgaria, Romania, and Ukraine, run the greatest risk. Because transition governments are weak, the failure to commit to a formal privatization program leaves the door open for managers to strip assets or direct income flows. The economic injustice of such spontaneous privatization may eventually lead to a political backlash that will undermine further reform.

Finally, reforms in property rights must be complemented by supportive reforms in other areas. Fiscal and monetary policies should be refined to foster a stable price system and impose hard budget constraints on firms. One important policy lesson is that any privatization strategy is likely to be fairer and work better where government subsidies are limited, inflation is controlled, and markets exert hard budget constraints on firms. If governments continue to soften budget constraints even for private firms, as they do in many transition economies, the purported benefits of privatization (particularly with regard to incentives) may disappear. On the microeconomic side, the strategy calls for reforms in product markets, more competitive labor markets, and institutional reforms to build effective financial markets. All three are needed to complement shareholder efforts to discipline managers.

Methods of Privatization

Privatizing large enterprises has proven more difficult than most observers originally envisioned. Not only are the goals complex and sometimes at odds with each other, but the firms are often ill-suited to the needs of a market economy. Many are overstaffed and inefficient. Reflecting socialism's efforts to make enterprises the providers of social assets as well as income, many are vast conglomerates with housing, medical services, and child care facilities. Because central planners wanted to economize on transaction costs, many are monopolies. Table 1 summarizes the various methods used to privatize medium and large firms and estimates the extent of privatization in seven countries under each method. What lessons have emerged to date?
Table 1. Privatization Techniques for Medium-Size and Large Enterprises, 1995

<table>
<thead>
<tr>
<th>Country</th>
<th>Sale to outside owners</th>
<th>Management-employee buyout</th>
<th>Equal-access voucher privatization</th>
<th>Restitution</th>
<th>Other*</th>
<th>Still in state hands</th>
</tr>
</thead>
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<tr>
<td>Czech Republic</td>
<td>By number</td>
<td>32</td>
<td>0</td>
<td>22</td>
<td>9</td>
<td>28</td>
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<tr>
<td></td>
<td>By value</td>
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<td>0</td>
<td>50</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Estonia*</td>
<td>By number</td>
<td>64</td>
<td>30</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>By value</td>
<td>60</td>
<td>12</td>
<td>3</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Hungary</td>
<td>By number</td>
<td>38</td>
<td>7</td>
<td>0</td>
<td>0</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>By value</td>
<td>40</td>
<td>2</td>
<td>0</td>
<td>4</td>
<td>12</td>
</tr>
<tr>
<td>Lithuania</td>
<td>By number</td>
<td>&lt;1</td>
<td>5</td>
<td>70</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>By value</td>
<td>&lt;1</td>
<td>5</td>
<td>60</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mongolia†</td>
<td>By number</td>
<td>0</td>
<td>0</td>
<td>70</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>By value</td>
<td>0</td>
<td>0</td>
<td>55</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Poland</td>
<td>By number</td>
<td>3</td>
<td>14</td>
<td>6</td>
<td>0</td>
<td>23</td>
</tr>
<tr>
<td>Russia*</td>
<td>By number</td>
<td>0</td>
<td>55</td>
<td>11</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Note: Boldface numbers show the dominant method in each country. Data are as of the end of 1995.

a. Includes transfers to municipalities or social insurance organizations, debt-equity swaps, and sales through insolvency proceedings.
b. Percentage shares of the number of all formerly state-owned firms, including parts of firms restructured before privatization.
c. Includes assets sold for cash as part of the voucher privatization program through June 1994.
d. Percentage shares of the value of all formerly state-owned firms. Data for Poland and Russia are unavailable.
e. Does not include some infrastructure firms. All management buyouts were part of competitive, open tenders. In thirteen cases citizens could exchange vouchers for minority shares in firms sold to a core investor.
f. Mongolia has used only voucher privatization to privatize medium and large enterprises. Every enterprise was sold for vouchers, first in a limited closed subscription to insiders and subsequently to outsiders via the stock exchange (Korsun and Murrell 1994).

Source: Blasi (1994); Korsun and Murrell (1994); Kotrba and Svejnar (1994); World Bank data.

Sales to Outside Investors

Before the transition process got under way in earnest, most countries of Central and Eastern Europe that wanted to privatize state enterprises sought to sell them as going concerns. They were following the only known experience at the time, most notably Great Britain and Chile, where privatization through individual sales had been successful. Because capital markets were undeveloped in the transition economies, most countries hoped to sell the bulk of state enterprises directly to large outside investors, generally strategic investors with special-
ized knowledge of the industry. Such trade sales were perceived to have three advantages: they would bring in revenue; they would result in real owners who had the knowledge and incentives to govern companies efficiently and the capital to restructure them; and the conditions of the sale could theoretically be manipulated to take special needs into account.

Although these advantages have indeed been evident in some cases, sales to outside investors have proven far more difficult than originally anticipated. Such sales can work when market institutions are in place, but they are problematic when such institutions are in their infancy. East Germany successfully privatized virtually all of its state enterprises through sales to outside investors, but only with massive amounts of political will and technical and financial assistance from West Germany. Among the transition countries, only Estonia and Hungary have managed to privatize the bulk of their state enterprises through direct sales. Poland and Romania pursued sales vigorously in their early efforts at privatization but with limited success.

THE DISADVANTAGES—LESSONS OF EXPERIENCE. What are the disadvantages of this approach? First, the process is hampered by the limited amount of private capital (particularly domestic capital) available and by the poor quality of information about the condition of the enterprises. One option, which was followed widely in Hungary, is to sell to foreign investors who have sufficient capital and are willing to incur risks or to invest in information-gathering that might decrease such risks. This somewhat controversial strategy may nonetheless be necessary if trade sales are to succeed, and even then, of course, there will be many state enterprises that overseas investors have no interest in buying. Foreign interests have tended to concentrate in certain sectors, such as automobiles, food processing, tobacco, and certain consumer products, whose international market structure tends to be dominated by large, oligopolistic firms (Kogut 1996). A second option is to require less capital up front, so that owners can pay in installments, perhaps out of the future earnings of the firm. Variants of this approach have been tried, for example, in Estonia, Hungary, and Poland. Enforcing future payments is often difficult, however, and renationalizing firms if such payments are not made is equally problematic.

A second disadvantage is that both the process and the resulting distribution of ownership rights may be perceived as unfair. Not only are ordinary citizens unable to participate, but individual deals often look arbitrary, if not corrupt. This perception has been most notable in dealings with foreign investors, with whom packages of incentives and legal regulations have often been negotiated case by case.

Third, the approach tends to be costly and slow, due to the sheer magnitude of the job of evaluating and negotiating deals for each company one-by-one and of providing follow-up monitoring to ensure that the buyers fulfill contract provisions. Sales have also been slowed by other uncertainties, such as who is responsible for cleaning up past environmental damage and how to compensate
those who owned the property before the socialist government came to power (Rutledge 1995).

Fourth, the process is complicated and often stymied completely by the difficulty of placing a value on firms to be offered for sale. Accounting standards inherited from socialism were inadequate to determine the historical value of a firm—much less net present value, on which sales price should theoretically be based. Furthermore, price and trade reforms quickly reduce—if not eliminate—the relevance of previous experience. Potential buyers face profound uncertainty about what these companies will look like in the future. What products will they produce, and for what markets? In what quantities and at what costs? What financing will be available? At what interest rate? Given these uncertainties, calculating even the rough value of an investment is virtually impossible in many cases, even with reforms in accounting techniques.

Finally, insiders have used either explicit or implicit power to block sales to outsiders, particularly in countries such as Poland and Russia in which decisionmaking power had been decentralized. Furthermore, the strength of the insiders' incentives to block a sale is likely to be correlated with the potential profitability of the firm itself, and thus it may be harder to sell the better firms—exactly those for which there is likely to be greater demand from outside investors.

These disadvantages have been more debilitating than initially expected. The Treuhandanstalt in East Germany was able to privatize (or liquidate) its 8,500 state enterprises relatively quickly but at an enormous cost in terms of both skilled manpower and explicit or implicit subsidies to buyers (von Thadden 1994). Other countries, which lacked a benefactor of West Germany's economic strength, could move only slowly—or adopt radically different divestiture techniques. In five years (1990–94) Hungary was able to transfer only about one-third of its state-owned assets to private hands through formal sales programs (Pistor and Turkewitz 1996); large sales in infrastructure and energy firms late in 1995 pushed this total somewhat higher. With extensive assistance from former Treuhandanstalt officials, Estonia sold most of its 350 enterprises in three years (1992–95). These are the "successful" cases. None of the other countries of Central and Eastern Europe or the former Soviet Union have even come close to these achievements (in part because foreign investors have shown less interest). Overall experience in the region has led observers to conclude that sales, while a useful pillar in the privatization process, cannot be the sole or even the primary instrument in transition economies.

**Privatizing through equity offerings.** Firms can also be sold to the public by floating shares on public stock exchanges, but this approach is limited by the capacity of the infant stock exchanges in transition economies. Furthermore, it tends to work only for the very best firms with good financial prospects and strong reputations. It is not an avenue for restructuring, not only because poorly performing firms are unlikely to be listed successfully, but also because the dis-
persed ownership structure that results is unlikely to create incentives for owners to make the necessary changes. Poland has perhaps had the most success with this approach but still has privatized only about two dozen firms in this manner. Initial public offerings are clearly not the answer to the need for rapid and large-scale privatization, but on the margin they can help develop capital markets.

Management-Employee Buyouts

A second important method of privatization is the sale or giveaway of all or part of the company to its managers and employees. Croatia, Georgia, Poland, Romania, Russia, and Slovenia have all relied primarily on management-employee buyouts, sometimes using government-issued vouchers to provide the liquidity for insiders (and a few outsiders) to purchase shares. To speed up privatization, Hungary implemented a similar small program in 1993 to supplement its emphasis on trade sales. Although the governments of Lithuania and Mongolia did not originally set out in this direction, many firms divested through voucher privatization programs became, in effect, management-employee buyouts (Korsun and Murrell 1994).

An important advantage of this approach is its feasibility and political popularity. In countries in which insiders already had extensive power, those insiders have generally been able to retain their influence during the transition period and effectively maintain a veto power over privatization decisions. In some countries this veto power is explicit; in Poland, for example, employee approval is required for a privatization plan to go forward. In most countries, however, such veto power is implicit. To garner political support, governments have often offered generous benefits to insiders.

A second potential advantage is the one stressed by most proponents of employee share-owning plans in advanced market economies. Insider ownership can be both more equitable and, under certain conditions, more efficient (Hansmann 1990; Earle and Estrin 1996; Shleifer and Vasiliev 1996). It can be more equitable because it rewards those who do the work—ironically, the argument at the very heart of socialism. It can be more efficient because it aligns the incentives of owners and workers. Managers and employees may be willing to work harder, monitor each other more carefully, and push for greater productivity if they reap the residual gains.

THE DISADVANTAGES IN TRANSITION ENVIRONMENTS. These potential advantages are counterbalanced by serious disadvantages that are particularly acute in transition settings. First, the process may be inequitable, as employees, particularly those in good firms, reap most of the benefits. One study, for example, calculated that the 19 percent of Russians employed in privatized firms obtained 56 percent of equity sold through June 1994, while the 81 percent of Russians who had only vouchers ended up with only 15 percent of the equity (Blasi 1996).
Second, giving preferences to insiders inhibits—and may even eliminate—
competition in the privatization process. Insiders are generally unable to bring
new skills and new capital to the company, and socialist managers may have
few of the skills needed in a market economy. Because potential outsider owners
who may be more qualified are not given the chance to participate, the resulting
ownership pattern is likely to be suboptimal for the economy as a whole, at least
initially. Research in Central Europe confirms that firms privatized to insiders
are less likely to restructure and invest than firms sold to outsiders (Earle and
others 1994; Barberis and others 1995). Furthermore, changes in ownership
patterns may be blocked if managers try to stop employees from selling their
shares. Even if employees are free to sell, there may be few buyers. If corporate
law and disclosure rules are underdeveloped and thus provide little protection
for outside shareholders, as is true in virtually all transition countries (and in
some advanced market economies), outsiders may be unwilling to invest in firms
with significant insider ownership.

Russia's voucher privatization program, completed in mid-1994, resulted in
insider ownership of about two-thirds of the shares of privatized companies.
Some managers have tried, albeit illegally, to prohibit workers from selling their
shares to outsiders. Others have used less transparent means to block participa-
tion by employees or outsiders. For example, managers may attempt to change
the form of the company from joint stock to limited liability, because the latter
restrains sales of shares to outsiders. Alternatively, they may try to convince
employees to put their shares in a trust and assign their voting rights to the
managers of the firm. Even when the rights of workers to vote their shares are
not restricted, managers may—and do—convince workers that incumbent man-
agement is on their side but that outsiders will fire them if they are allowed in.
Finally, managers may try to get around employee ownership altogether by set-
ing up new firms and using their inside information and power to transfer valu-
able assets to these firms. If such a pattern is repeated on a wide scale, this form
of ownership may inhibit rather than reinforce the development of a private
market economy. It may also backfire politically, if the fruits of privatization
become more and more concentrated in the hands of the few, unleashing grow-
ing resentment among those ostensibly included at the beginning but ultimately
cheated of their expected gains.

Addressing the problems with buyouts. How can the advantages of man-
agement-employee buyouts be enhanced while their disadvantages are mitigated?
First, governments need to cut subsidies, liberalize prices, and institute trade
reforms to force insider-owned firms to abide by the rules of the marketplace.
These steps will help to ensure efficiency regardless of ownership.

Second, government should encourage the entry of new firms to increase com-
petition. Management-employee buyouts may work well for smaller manufac-
turing and service firms in sectors that are attracting new domestic entrepre-
neurs; product market competition will keep the insider-owned firms on their
toes. Foreign competition could potentially do the same for larger firms, but in such cases managers are more likely to turn to the state to block such competition or to obtain support of one kind or another.

Third, governments should adopt policies that encourage share trading and thereby develop markets for corporate control. In advanced market economies, insider (particularly worker) ownership has an inherent tendency to "degenerate" into investor ownership over time (Earle and Estrin 1996). Whether the same tendency exists in transition environments has yet to be seen. Ownership change requires both a supply of and a demand for shares. To create a supply, shares must be immediately tradable without limitation. To create a demand, outside investors must have not only sufficient capital, but also basic information and protection against fraud and abuse by insiders. These in turn require well-functioning corporate laws, securities regulations, and accounting systems. Such shareholder protections do not arise in a vacuum but go hand-in-hand with other economic reforms (Gray and Hendley 1995).

In sum, management-employee buyouts excel in their capacity to adapt to the implicit or explicit demands of existing stakeholders, but are less effective in creating corporate governance mechanisms or in attracting new capital and skills. For firms that cannot survive without restructuring, the conflicts of interest that confront insiders may prove particularly unwieldy. In such cases, insiders may look to the state for help and, given political pressures, the state may be willing to listen. This route may thus work better for viable firms that can generate internal funds for investment and may be suitable for small firms without political clout. Indeed, in the case of the latter, employees may be more willing to take painful wage cuts to preserve the company (Earle and Estrin 1996). In the case of large distressed firms with major capital needs, however, this strategy is unlikely to generate the resources, incentives, and capabilities necessary to undertake large-scale change.

These pros and cons are particularly apt for firms in which insiders have majority interest. There are, in contrast, strong advantages and relatively few disadvantages to giving insiders minority ownership rights. One clear advantage is that privatization is more likely to be perceived as fair if workers share in any upside gains. Another is that employee-owners can monitor managers or outside owners (such as investment funds or foreign owners with significant minority stakes) who may otherwise have an incentive to loot the firms or stifle competition with other firms under their ownership. These advantages are important, considering the political fragility and the general weakness of watchdog institutions in virtually all transition environments.

**Equal-Access Voucher Privatization**

A third approach used widely in transition countries is voucher, or "mass," privatization. The government gives away or sells low-priced vouchers that can then be used to purchase shares in companies, thereby eliminating the problem
at the core of the sales approach—the shortage of domestic capital. So-called equal-access voucher programs embrace outsiders as well as insiders. This form of privatization has been—or soon will be—implemented in Armenia, Bulgaria, the Czech Republic, Kazakhstan, Lithuania, Moldova, Poland, Romania, Slovakia, and Ukraine.

Well-designed voucher privatization can overcome many of the problems encountered with the various sales techniques, notably the perceived unfairness, the shortage of domestic capital, and the difficulty of placing a value on assets. Because the voucher approach can proceed rapidly, it can simultaneously stimulate the development of market institutions, create new owners, and reorient the interests of existing ones toward further reform. Furthermore, it can speedily cut the links between enterprises and the state that both inhibit restructuring and put fiscal pressures on the state.

The main concern when this method of privatization was first proposed, apart from the question of revenue, was its questionable capacity to develop real owners with proper incentives for effective corporate governance and with access to new capital and skills for restructuring. The concern over corporate governance arose in part from the very notion of vouchers, that is, that one did not value what one did not pay for. More fundamental, however, was the fear that the resulting distribution of ownership would be inefficient and would interfere with the development of strong ownership interests. Experience has shown, however, that a wide variety of ownership patterns can result from voucher privatization. Perhaps more important, such initiatives, if well-designed, can stimulate the development of capital markets and stock market trading, thus fostering further ownership change and speeding up the development of corporate control. It can, in effect, privatize the privatization process.

Combining Sales and Vouchers. All transition economies have chosen to follow several privatization routes simultaneously, albeit with different emphases. The earliest, biggest, and most successful equal-access voucher program to date has been that of the Czech Republic, which has transferred the bulk (in value) of its state enterprises through this route. Mongolia used vouchers to privatize 70 percent of its large enterprises. Romania’s 1991 privatization program was much smaller; only 30 percent of the shares of eligible firms were involved. The intention, unrealized and replaced in 1995 by a second and larger mass privatization attempt, was to transfer the remaining shares to strategic owners who could effectively govern and restructure the enterprise. Poland’s recent mass privatization plan is smaller still, covering only about 500 companies, or fewer than one-tenth of state-owned enterprises.

Larger programs have certain advantages, in that they can include both more firms and a greater diversity of firms. To ensure value to participants and thus gain more political support, while at the same time divesting firms that might not attract cash offers, some of the most profitable firms should be included in the program, along with some of the more marginal ones. Perhaps more impor-
DECIDING WHETHER AND HOW A FIRM WILL PARTICIPATE. When a voucher privatization program is announced, who decides whether and in what form a particular firm will participate? As with the size of the program more generally, this decision evolves in large part from the balance of political interests and powers in the particular country. The government of the former Czech and Slovak Federal Republic chose which firms would participate, and the Czech government continued to apply this principle after the country split up. In each case, the central government decided on the mix between voucher auctions and other forms of transfer (primarily sales to strategic investors and restitution to former owners) but based that decision on bids submitted by competing bidders and prepared by them with little government involvement. Thus, the process of designing privatization programs for individual firms was decentralized in a competitive framework, but the final decision process was controlled at the top. This approach, attractive both economically and practically, appears to have worked well in a politically centralized environment where there were no strong inside stakeholders.

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

POOLING OWNERSHIP INTERESTS. If the ownership of shares in a particular enterprise were as widely disbursed as the ownership of vouchers, there would be little corporate governance and probably little progress in reforming enterprises. For this reason many mass privatization programs have encouraged the creation of intermediary institutions to pool ownership interests in particular enterprises. The former Czech and Slovak Federal Republic allowed free entry of private mutual funds, and more than 420 participated in the first wave of privatization. These funds competed with each other to acquire vouchers from the public in exchange for shares in the fund. The funds then invested the acquired vouchers in shares of firms being privatized at auctions. This approach, based on free entry and competition, had the advantage of reducing the state's direct control over the process.

In contrast, the Romanian (1991) and Polish plans called for the government to establish a set number of investment intermediaries, staffed by managers chosen by the supervisory boards appointed by the government. The shares of the intermediaries were then distributed to citizens. No auctions were held. The governments hoped that the intermediaries would actively restructure the firms in their
portfolios and then sell their interests to core investors. That objective has merit, but the danger is that the intermediaries may not be subject to direct market pressures and could end up essentially as government-protected state holding companies. In 1991 Romania’s state ownership fund was allocated 70 percent of the shares of each commercial company to be privatized and was directed to divest 10 percent of its holdings a year. After four years it had divested almost nothing and had barely begun the necessary restructuring. Poland’s approach did not get off the ground until 1995 (after a delay of three years), and it is too early to judge results.

Although the free entry and competition among funds in the Czech Republic may be arguably preferable to the more bureaucratic approach used in Romania and Poland, creating truly private funds with market-based incentives is proving extremely difficult in any transition setting. The perennial question “who monitors the monitors?” looms over every experiment. This challenge is difficult enough in advanced market economies. It is even more problematic in transition environments, where norms of disclosure and fiduciary responsibility are weak, and watchdog institutions and oversight mechanisms are in their infancy. Breaking the links with the state, although desirable to stimulate entrepreneurship and risk taking, also may mean weakening the capacity to monitor the monitors.

In the Czech Republic, as noted, most of the largest funds were founded by, and are still connected with, the large banks through asset management contracts. These banks in turn continue to be closely connected with the government, both through the sizable stake owned by the state-run National Property Fund and through the government’s regulatory powers. Although some non-bank funds quickly established their independence and their potential influence over managers, the bank-affiliated funds appear to be less independent and entrepreneurial. The latter may also face a conflict of interest because the banks lend to the same firms that their funds own. On the other hand, these larger funds may be more secure investments than the more entrepreneurial funds, which might have an incentive to loot an enterprise or take other actions at the expense of fund or enterprise shareholders. To the extent that several funds own shares in a firm, they have an incentive to monitor each other (barring collusion among the funds themselves). Although limits on ownership by individual funds tend to discourage active involvement by these owners, the potential for cross-monitoring is one advantage of such limits.

The Russian privatization program favored insiders but also allowed the free entry of private investment funds. Although some 600 funds were formed, they were kept much smaller than the Czech funds, and thus they have far less power and influence. In the Russian environment, with no legal safeguards, less macro-economic discipline, and strong insider control, the goals of the funds are far from clear. Their small size may lead to complex coalitions among or between them and other actors in the economy. Some funds appear to have been established primarily for trading vouchers, while others are allied with the managers of individual firms, and still others seem to be involved in seeking subsidies from
government. Only a minority appear interested in owning and improving the performance of enterprises in the economy (Frydman, Pistor, and Rapaczynski 1996).

Intermediary institutions bring several advantages to voucher privatization programs. At a minimum they aggregate the power of individual vouchers and thereby exercise some monitoring functions associated with ownership. In addition, the free entry of independent intermediaries increases private participation and stimulates competition in the market for corporate control. Finally, observers hope that the funds will become the cornerstones (together with banks or even in place of them) for developing the financial infrastructure that is essential in market economies. But achieving these goals is not easy or automatic. Governments need to consider how they might regulate funds to prevent self-dealing and encourage responsible fiduciary behavior. The involvement of foreign financial experts as fund managers and advisors—one advantage of Poland’s approach—can help to strengthen the expertise and norms of conduct within funds.

**How do citizens use vouchers?** In the Czech and Slovak Federal Republic, vouchers could be invested either in specific companies or in investment funds. In the Romanian (1991) and Polish programs, in contrast, investing directly in firms was not an option. (In Mongolia and in Romania’s newer program, investing in funds is not an option!) In Estonia citizens could use their vouchers to acquire shares in firms or to purchase their homes or land (although relatively few shares were in the end offered for vouchers).

There seem to be no obvious costs—and significant benefits—to allowing wide latitude to investors. Options create competition that can spur funds to greater effectiveness, and they force citizens to become actively involved in voucher investments. In addition, options allow investors to tailor their choices to their own personal risk preferences. Although some people prefer direct investments, funds have proven to be more popular investment vehicles than first expected. When the Czech and Slovak Federal Republic program was set up, most vouchers were expected to be invested directly in firms, but 72 percent of vouchers were ultimately invested in funds.

Furthermore, citizens need not be limited to investing their vouchers. Trading them is also a viable option, and such trading may encourage the emergence of strong, interested owners. If trading is not permitted, immediate rights to trade the shares that are acquired with vouchers is a close substitute. Most of the voucher schemes to date have given some latitude to citizens to sell their interests, whether vouchers or acquired shares. Russia allowed trading in vouchers from the beginning. The former Czech and Slovak Federal Republic forbade secondary trading by citizens in vouchers (although the prohibition was not strictly enforced) but encouraged trading in acquired shares. Such trading has developed rapidly through the Prague and other stock exchanges in the country and through off-exchange transactions.

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A somewhat surprising development has been the concentrated ownership and cross-ownership that has emerged from voucher privatization in the Czech Republic. Not only is ownership concentrated in a few funds, but individual funds often own shares of directly competing firms. Furthermore, the funds, together with affiliated banks, are locked in an intricate web of cross-ownership (or sometimes self-ownership) as a result of the privatization of the banks through vouchers (Coffee 1996). Thus banks are insulated from competitive pressures, and the government continues to influence the economy through its 40 percent (or greater) residual holdings of shares in privatized banks.

Organizing Auctions. Most voucher schemes rely on auctions to allocate enterprise shares. Voucher auctions can be organized either simultaneously or sequentially (Boycko, Shleifer, and Vishny 1994). The Czech and Slovak Federal Republic (in the first wave) and the Czech Republic (in the second wave) followed a simultaneous approach. The Bulgarian scheme proposed for 1996 is also simultaneous. Other countries, including Georgia and Russia, have generally followed a sequential approach. From an economic perspective the Czech model is more efficient, because all options are known to all bidders at the time of the auction, and the value of a voucher (in terms of purchasing power) does not vary over time, as it does in the sequential model. The simultaneous model, however, is also more complex and costly and may be infeasible in a larger country.

Shares in an auction can also be allocated two ways. One is simply to divide the shares on a pro-rata basis among bidders, based on the number of vouchers issued. The second is to match the bids against some independent measure of value and distribute the shares only when bids and offers match. The Czech approach, which was a modified version of the latter, required several rounds of bidding to equate demand and supply. The result was arguably fairer but perhaps feasible only because of the relatively small size of the country, the relatively strong central control of the government, and the relatively sophisticated level of understanding in the government and the citizenry. The sale was also facilitated by the country's more stable macroeconomic situation, which meant that inflation was moderate and thus the valuations of firms were more meaningful.

Residual State Ownership. Finally, voucher privatization schemes vary in the degree of residual ownership maintained by the state. Romania, for example, privatized only a 30 percent share in each enterprise (in 1991); indeed, some observers question whether this was really privatization at all. The Czech Republic and Poland left significant minority stakes in the hands of government property funds, with a view to using these stakes later to attract strategic investors (or otherwise influence events). The Polish government also had the initial power to appoint the managers and supervisory boards of the funds.

If the state is to maintain a stake in firms after privatization, its share should be small and temporary, and its stance relatively passive, although it should con-
Conclusions

Experiments in privatization abound, from extensive efforts to sell to strategic owners to programs based primarily on insider buyouts to innovative programs of mass privatization. These efforts are often complemented by extensive restitution to the former owners of the nationalized property and by smaller programs of bank-led debt-equity conversions or public offerings of shares on newly emerging stock markets. Each of these approaches has inherent advantages and risks, and in essence the jury is still out as to which will prove best in the longer run. At present, however, if the objectives are to sever the links between the state and the enterprise, to school the population in market basics, and to foster a perception of fairness, the weight of initial evidence appears to favor equal-access voucher privatization, particularly given the difficulty most countries face in finding willing cash investors. Competing and well-monitored intermediary funds are an essential component of this approach.

Experience shows that formal privatization programs are only part of the picture—and often only a small part, although they have received most of the attention. Firms are breaking apart and consolidating again from state to private ownership or from one private firm to another (Bogetic and Hillman 1995; Stark 1996). As one Hungarian observer noted, this is the period of “primitive capital accumulation” in the post-socialist world. Although formal programs may lay important ground rules, the tremendous economic, legal, political, and even moral uncertainty profoundly affect—and may even overwhelm—most formal efforts at privatization, and it is beyond our ability or insight to know what the final results will be. Both the economic outcomes of these various paths and the efforts to assess them are just beginning to yield insights, and it will be years, if not generations, before a definitive story can be told.

Notes

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References

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