MATJAŽ NAHTIGAL

A DECADE OF TRANSITION AND BEYOND

INSTITUTIONAL TRANSFORMATION OF THE COUNTRIES IN CENTRAL AND EASTERN EUROPE

Ljubljana, 2004

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PREFACE

Ten years after the first reforms were introduced in former socialist countries of Eastern and Central Europe, we have the opportunity not only to gauge the relative success of transition, but also the opportunity to tinker with new solutions in the areas where such solutions might be desirable. Despite many successful attempts in different socio-economic areas, post-socialist countries still have not reached their main goal – of becoming fully integrated members of the developed part of the world.

The assessment of institutional transformation is not a goal in itself; instead, it should serve as a medium for reflexive thinking about future opportunities. Institutional transformation was not a one-time historical act upon which future generations could subsequently build 'normal' social activities. Rather, it was an attempt in building new pathways to exit from economic, social and political periphery. In my thesis it is not my intention to retroactively gain more knowledge and insight into the logic of institutional transition, but rather to evaluate the current stage of institutional reforms.

In the first part of the thesis I analyze various methods of mass privatization in the transition economies, especially in the Czech Republic, Poland and Hungary. Regardless of the methods chosen, in the first stage of mass privatization, all the countries in the region experienced immediate industrial decline, and overall fall in GDP which significantly exceeded experts' expectations. Comparative analysis shows that in the first stage of reforms more important than the method of mass privatization – a central point of reformers' focus – were external factors, such as trade shock after collapse of common market, liquidity crisis due to macroeconomic stabilization, institutional vacuum after old coordinating mechanisms were abolished whereas new, market mechanisms were still not in place. In the first stage of reforms, more important than the efforts to privatize rapidly were other policy measures, such as establishment of rules of competition, anti-trust measures, bankruptcy laws and integration into the trade regimes under GATT, WTO and EU trade rules.

In the second phase of reforms, when transition economies regained it is a growing momentum, most of industry was privatized. It was a unique experience, not tested in any other region before. Many innovative approaches were applied, among the most interesting was the method of free distribution of vouchers to the citizens. The process of privatization was far from ideally executed. In the absence of regulatory and supervisory institutions, mass privatization was poorly executed in most of the countries. Many questions remain unanswered, for example, what is the ideal model of mass privatization, what are the best owners of the privatized companies, what is the best mixture of external and internal owners of the newly privatized companies. Empirical comparative studies available to date suggest that we do not have the best possible formula for the most efficient, responsive and accountable owners of the newly privatized firms. A major problem was to establish an effective corporate governance system for the privatized firms due to undeveloped capital markets, undeveloped legislation and lack of managerial experience and knowledge. Weak accountability of the managers and poorly regulated capital markets do not secure efficient control over the management of the firms, lack of access to capital, lack of access to new technologies to new markets do not guarantee rapid development of the privatized firms. Still, many privatized firms were able to successfully enter international markets and to start competing with other international companies. New rules on merger and takeover policies and strong regulatory framework are necessary to further integrate firms in transition with the developed international markets.

The road of privatization brought many surprises. One of them was that state-owned enterprises became competitive, once the market was freed, contrary to initial expectations. On the other hand, firms where employees became main owners, did not become less efficient or started to disinvest in order to secure additional payments to the employees – owners.

Among many interesting lessons from the mass privatization it is worth mentioning that strong regulatory framework with regard to competition, capital markets and basic company rules on average yield better results than weak regulatory approaches. Furthermore, a weak regulatory approach toward complex operations, such as mass privatization, might further distort the market activities of the firms. Finally, it is important to understand that mass privatization is not a goal in itself, but a method to secure more competitive and more efficient private sector. Therefore, other measures, such as competition rules, rules on mergers and acquisitions, bankruptcy rules are necessary to accompany a successful process of mass privatization. Simultaneously, ignoring efficiency of the public sector, such as energy sector, or other infrastructure, might turn out to be a strategic mistake.

In the second part of my thesis I analyze the social welfare reform with particular emphasis on the pension reform. The discussion on the necessity of the pension reform occurred during the "second fiscal crisis", when the question about the (un)sustainability of the existing pension reforms emerged. Traditionally, countries in transition relied on relatively generous universal insurance for the retirees. Typically, the systems based on the "pay-as-you-go" approach, were similar to those familiar in most of EU countries. The debate on the sustainability occurred in the same period when the sustainability of the pension system in most of the EU countries was questioned and many countries started with partial reforms in this area. The demographic changes, growing unemployment and fiscal problems are the main "culprits" for the debate on the necessity of the pension reform. In this debate, many "trade-offs" are involved.

In this part of the thesis I argue that many risks are involved, if the radical pension reform is introduced in the countries in transition, whereas the declared benefits are less certain and less visible. Experience from other developing countries, such as Chile, shows that the introduction of the "fully-funded system" based on the private pension funds, and financed through mandatory individual contributions, carries with it many risks. First, introduction of the second pillar requires massive transfers of funds from the public to the private sector in order to facilitate the establishment of the private pension funds. It typically takes a long period (at least a decade or two) before such funds are strong enough to return invested means, based on actuarial projections. If poorly regulated and managed, these funds cannot return even the promised obligations. The major issue therefore becomes, how to finance the transition period from one system to another, and the problem of the double burden for the present generation appears unavoidable.

Of course, many different forms of pension reform can take place, some of them are more gradual with the greater role of the public sector than others. The debate is still going on, in the developed part of the world as well as in the developing countries.

Finally, the role of legal institutions in the process of reforms is of major interest to my thesis. The question to what extent certain legal institutions might help reform certain area cannot be answered on the abstract level. It can be answered only within the actual social, political and legal environment of any given country.

Despite the fact that the manuscript was finished in Spring of 2001, many of the lessons from transition are still valid and should encourage the next generation of reformers to facilitate real economic and social development of the countries in Central and Eastern Europe.

INTRODUCTION

INSTITUTIONAL ANALYSIS AS A METHOD OF RESEARCH

The institutional analysis of legal reforms in Central and Eastern Europe is offering us a significant amount of methodological, conceptual, intellectual and moral issues. Until recently, such analysis has been primarily reserved for international institutions with access to governmental data, that have the support of an impressive number of available researchers who possess the necessary skills to collect and evaluate statistical data. International institutions not only have by far the most developed research apparatus, but they also have many financial, normative and personal stakes in the process of transition.

The mentioned observations would probably suggest that there is only little room for comprehensive institutional analysis of the process of transition outside the network of national governments in the post-socialist countries and international financial institutions. It would be easy to subscribe to this belief if the process of transition itself were a rather smooth, technical and bureaucratic routine that would not radically change the everyday life of almost every citizen. The necessity to conduct independent research seems obvious. The institutions and individuals, which themselves have large stakes in the process of transition, hardly account for an independent and unbiased assessment of the process of transition.

However, at the beginning of this thesis, I would like to emphasize that it is not my intention to retroactively gain more knowledge and insight into the logic of institutional transition, but rather to evaluate the current stage of institutional reforms. Again, assessment of institutional transformation is not a goal in itself; instead, it should serve as a medium for reflexive thinking about future opportunities. Institutional transformation was not a one-time historical act upon which future generations could subsequently build ‘normal’ social activities. Rather, it was an attempt in building new pathways to exit from economic, social and political periphery. The ultimate goal of post-socialist countries is to successfully integrate with the developed part of the world, in particular, with the EU. European integration was the goal of the first generation of post-socialist reformers when they embarked upon the protracted path of reforms. As it turned out, the original expectations fueled by domestic reformers were far too ambitious. Therefore, the economic and social downturn following the first stage of transition was not only the sobering moment for the first generation of reformers and international financial institutions, it also offered new opportunities for a more realistic approach toward the institutional restructuring of post-socialist societies.

Ten years after the first reforms were introduced we have the opportunity not only to gauge the relative success of transition, but also the opportunity to tinker with new solutions in the areas where such solutions might be desirable. Despite many successful attempts in different socio-economic areas, post-socialist countries still have not reached their main goal – of becoming fully integrated members of the developed part of the world, which is usually identified with rich and developed Western democracies. There are many uncertainties about the future development of the countries in transition. According to the most optimistic expectations, it will take another decade or two for only a few of the successful countries in transition to reach the present average of the EU countries.

I do not intend to compete with either optimistic or pessimistic views about the future development of the countries in transition, nor do I wish to determine which of the countries in transition have done best or worst. It is also not my aim to declare the ultimate success or failure of reforming efforts or of the conceptual model of transition. The reason for not entering such a discussion is obvious: in a conceptual analysis of such an abstract and broad model of transition, one would, by definition, have to neglect a multitude of concrete issues that are posed in front of the actual reformers. Rather, the aim of this discussion is to focus on concrete and empirical examples of the reforming process. Lessons from the transition and the implemented reforms should serve as an insight into the real nature of reforms and as an understanding of the logic of transition itself. The process of transition as a one-time historical act remains an attractive intellectual challenge; however, it should also serve as a useful base of how to proceed from the present stage to the next stage of legal development.[1]

In pursuing the institutional analysis of the transition period, the most important and difficult question is how to actually establish a firm link between a certain institutional change and the actual change for society at large. In other words, the introduction of certain new institutions in the post-socialist societies may or may not give similar results to those known in the developed parts of the world. Additionally, gauging the outcome of the change might already appear to be problematic, because

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1 Methodologically, my legal analysis of importing institutions to the countries in transition, draws extensively from Duncan Kennedy's major statement in A CRITIQUE OF ADJUDICATION (*fin de siécle*), Harvard 1997 and his subsequent work in law and development.

we do not know whether to apply the metrics used in the developed countries or the metrics adjusted to the transition countries. In the absence of more objective criteria it is also possible to argue that certain changes have failed according to the criteria of the developed countries, while certain changes have succeeded according to the criteria of the transition countries. Room for manipulation and rhetorical victories or defeats cannot be exhausted and might ultimately depend more on the forcefulness of the arguments rather than their content. Still, we should not forget what the new school of institutionalism teaches us: institutions do matter, but it is up to careful and thoughtful analysis to show the actual chain of causation inherent to particular decisions. Here, applying Hegelian wisdom about the Minerva's awl that spreads its wings with the fall of the dusk looks more an act of basic scientific prudence than an act of unnecessary caution.

It is a demanding analytical task to understand the interaction between the legal aspects of reforms and their associated economic and social activities. For example, it is difficult to establish the economic and social effects of new legislation in business, banking or labor regulation. The difficulty in this analysis is partly due to the preceding assumptions about the neutrality of legal institutions, but is largely due to the most important and simultaneous aspects of reforms, such as: macroeconomic stabilization as a form of collective shock therapy, external pressures for immediate trade liberalization, constitutional reforms and the presence of democratically elected governments.[2] Yet searching for the firm links between legal reforms and social change is like peeling the layers of an onion. After removing the superficial levels of institutional analysis, one should be able to establish a more transparent picture of the link between legal activities and the social outcome of the reforms. Unlike many legal scholars in Central and Eastern Europe, I believe that we could and should establish such a connection. If this would not be possible, we would have to accept the notion that there is such a thing as legal disengagement and a legally autonomous world that is safely detached from the rest of the society. Obviously, this cannot be the case,[3] yet the prevailing notions shape our beliefs and activities in everyday life of individuals and society.

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2 A comprehensive survey of the mentioned set of reforms that largely determined outcome of transition in Jon Elster, INSTITUTIONAL DESIGN IN POST-COMMUNIST SOCIETIES, *Rebuilding the Ship at Sea,* Cambridge 1998.

3 Enjoying the privilege of being partly educated in one of the transition countries, I was constantly told by many legal scholars that lawyers themselves should not interfere with the process of transition, because the less law interferes with the process of transition, the less harm could be done.
Important theoretical discussion on the historical roots of the atemporal, abstract and speculative approach toward jurisprudence in Morton Horwitz, *Why is Anglo-American Jurisprudence Unhistorical?,* OXFORD JOURNAL OF LEGAL STUDIES, vol. 17, pp. 551–586.

While a firm, transparent link between certain legal institutions and social activities in Western society is presupposed and not questioned or explored as part of actual social life, the link for countries in transition is more precarious and less tenuous. This is probably the origin of the blueprint approach that was used to reform the post-socialist countries. Under the blueprint approach the process of implementing certain institutional solutions and their outcomes are not questioned or uncertain, but rather presupposed. Therefore, it is believed that the introduction of certain institutions through legislation and regulation will automatically lead towards an expected outcome. Another deeper dimension of the blueprint approach is a common belief that the existing institutional arrangement, which was created by the developed part of the world in the transition countries, could work equally well and in the same way, if implemented properly by their respective legislative and regulatory agencies. Thus, the process of reform is believed to be a merely technocratic enterprise of introducing institutional solutions that guarantee a practical outcome. After a broad consensus was reached regarding the introduction of market reforms in the post-socialist countries, the process itself was carried in the strict Weberian means-end sense. The autopoetic reforms process did not address any other circumstances, such as the lack of expertise, lack of capital, and largely unfavorable economic conditions in domestic and international markets. Above all, these institutional reforms were implemented in countries that were dealing with major economic crisis. All the aforementioned aspects were brushed aside, as if institutional transformation itself presented a major part of the healing process for post-socialist countries.[4]

From the transition countries perspective, the Western legal institutions themselves were perceived as the outcome of natural historical developments toward a modern democratic society and a free market economy. The historical development of the Western legal institutions, accompanied by theoretical debates in the formative period of institution-building, were largely deemed as unimportant. Furthermore, the competing historical views about several plausible institutional arrangements were also disregarded. Views with explanations are regularly presented as dissociated from their actual historical, political and intellectual struggles. In addition, the institutional differences among the most developed industrial countries and their different understandings of basic market functions were also largely neglected.[5]

Thus, the Western institutional framework was transferred to the first generation of East European reformers as a ready-made answer to their

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4 *See* a comprehensive critique in Gregory Alexander and G. Skapska, (eds.): A FOURTH WAY? PRIVATIZATION, PROPERTY AND THE EMERGENCE OF THE NEW MARKET ECONOMIES, Routledge 1994.

5 I owe this observation to David Kennedy, *Turning to Market Democracy: A Tale of Two Architectures,* 32 HARVARD INTERNATIONAL LAW JOURNAL 373 (1991).

problems, without considering flaws of each post-socialist society. Simultaneously, the mixture of anxieties combined with high expectations placed an overwhelming amount of pressure on the socialist governments. The loss of confidence in the last socialist governments to improve the economic and democratic situation was offset by the enthusiasm of the first post-socialist governments when they rapidly improved economic conditions and implemented modern democratic standards in one big swing of reforms. The loss of confidence of the former stemmed from their repeated unsuccessful attempts to improve socialist market economies, while the enthusiasm of the latter was fueled by their determination to finally "getting things right," that, is to introduce a market economy without any adjectives or compromises. Gradually, however, the first generation of post-socialist reformers encountered so many obstacles that their initial enthusiasm quickly became replaced by moderate realism.

Ultimately, the discussion regarding the introduction of institutional reforms to the countries of Central and Eastern Europe will also offer an analysis of the characteristics of Western legal institutions. The transfer of Western institutional solutions to the post-socialist economies should also be taken as a test of these institutions and the current conceptual beliefs that accompany them. Thus far, surprisingly few academics have taken this direction, which gives an impression that the reluctance of Western scholars to test their own beliefs and existing institutional solutions equals the reluctance of East European legal scholars in contemplating their role in the process of transition. We should not forget, however, that the ready-made package of reforms invoked by the historic chain of causation has deep theoretical premises and beliefs that are built into the everyday governance of most developed countries. The institutional analysis of the reforms in Central and Eastern Europe will reexamine some of the dominant theoretical premises and give new insights into the character of existing institutional solutions. Some of the prevailing ideas will inevitably be challenged as the price of being involved in such a broad and comprehensive set of reforms.

It is my view that the lessons from the process of reforms in Central and Eastern Europe should benefit the next generation of reformers in transition economies. However, I also believe that scholars in developed countries could benefit from the process of reforms by using the reasons to enrich and revise the accepted axioms accepted in their countries. Though the baldness of reforms represents the reverse picture of minimal attempts at domestic improvements in the first world, my main focus will remain in the countries in transition.

Probably the biggest surprise of the whole process of transition was that there was little to export and subsequently transplant into post-socialist societies.[6] The approach toward reform was carried on a firm

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[6] An overview of the set of legal institutions has been presented in The World Bank

belief that there were a few basic principles and clear rules that would successfully lead the process. The most important of these rules can be summarized as follows: the introduction of clearly defined property rights and the enforcement of contracts should guarantee a dynamic market economy; government interference should be minimized if not abolished altogether. Apart from providing a stable macroeconomic framework through a balanced budget, low inflation, positive interest rates and an open economy, the basic principles advise governments to refrain from doing anything else. Furthermore, the post-socialist governments believed that minimal government interference would lead to a minimum of market distortions, while private sector initiative would successfully guide the market. As we shall see through the analysis of transition, the process of reforms is too complex for a few basic principles to guarantee its success.

However, before I begin a more detailed discussion on privatization, I would like to point out that this will not primarily be a discussion on the advantages or deficiencies of private versus public ownership. Equally, this will not be a discussion on the extent to which the means of production in post-socialist economies should be owned or controlled by the government. Instead of discussing the alleged superiority of the private sphere over the public sphere, my main concern in this thesis will be the theoretical and practical interaction of the two relatively autonomous spheres. For this purpose I will rely on extensive empirical materials from the period of transition as well as theoretical literature on the role of government in transition and its role in developing the private sector. Bearing in mind that the command-style economy in the socialist period was largely characterized by both the dominant role of the public sector and the central role of the government, the transition period itself was largely a process of dismantling and minimizing the central role of the government.

Should the development of the private sector have been a smooth, unproblematic and highly successful process, my thesis could easily end here. However, the mounting problems concerning the process of transition, some of them expected and most of them unexpected, raise legitimate questions about the nature and logic of the transition period, and the conceptual approach toward reforms. When the first generation of reformers in Eastern Europe desperately needed suggestions, ideas or criticisms, they received only a few basic recommendations, well tested only in abstract orthodoxy. While most of the orthodox predicaments before the beginning of transition were not tested outside the classroom,

Development Report 1996, FROM PLAN TO MARKET, pp. 87–97. More detailed overview of introduction of legal framework in Cheryl Gray, *Evolving Legal Frameworks for Private Sector Development in Central and Eastern Europe,* WORLD BANK DISCUSSION PAPER NO. 209, Washington, D. C, 1993.

the idea of mass privatization was not even theoretically elaborated before the demise of socialist countries.

If mass privatization became a carrying flag of transition and all other reforms were aimed at facilitating privatization, than the conceptual, legal and economic reasons for pushing through mass privatization should be the main focus of my analysis. I do not intend to offer yet another retrospective account of the irreversible process of mass privatization, but to understand the meaning and outcome of privatization in order to start thinking about how to proceed from here. The first generation of reformers appear exhausted and disillusioned, the leading advisers are engaged in other projects on other continents. Ten years after major reforms were implemented in Central and Eastern Europe, we now have the opportunity to assess the current efforts and to consider our options for the future. Any productive discussion on the legal, economic and social aspects of reforms should, therefore, be capable of sharp criticism of reforms whenever persuasive, but also be capable of focusing on solutions and recognizing the many valuable and successful aspects of transition.

Only by discerning successful reforming attempts from their failures, will it be possible to provide a useful blueprint for the future development of the post-socialist countries. Likewise, the discussion itself will not primarily aim at making distinctions between analytical and normative arguments. Since most discussion did not hesitate to offer highly authoritative arguments in barely examined areas, the only way to stand on equal footage with the existing literature is to carefully revise its theoretical assumptions and practical expectations and then compare it with empirical data. The main difference in the blueprint approach will be my counter-assumption that there are no best possible solutions given in advance. Rather, my thesis will be an exercise in presenting several competing institutional solutions without insisting that one of them be automatically accepted as the best possible solution. Furthermore, my effort will focus on comparing several different options and weighing arguments for certain options. The analysis will be based on concrete empirical findings, comparative analyses and normative conceptual beliefs.

As the following discussion will show, the blueprint approach stems from a conviction that structural adjustment and structural reforms should suffice for the success of reforms. In other words, it should be enough for the countries in transition to create an institutional structure that resembles the institutional structure of the advanced countries. The more a country in transition resembles the advanced countries – or perhaps even better: the more it resembles the ideal perception of the advanced countries – the more successful the transition was expected to be. The success of transition was measured according to their structural proximity to Western societies, without paying attention to the actual contents of the reforms. For example, the rapid adoption of formal laws on establishing corporations, incorporating former state firms, enacting laws on securities, and adopting privatization legislation counted as good examples of reform commitment. The support and interest in mass privatization was measured by the number of people participating in mass privatization, that is, by the number of people who received vouchers. In the context of mass privatization, this meant practically all of the citizens. However, what most people actually did with their vouchers was much less carefully examined.

Additionally, immediate price and trade liberalization, the rapid withdrawal of state subsidization and the non-selective wave of bankruptcies served as the most important signs of a serious commitment to radical market reform. The associated economic recession, mass unemployment, drop in industrial output and the deterioration of human development indices throughout Central and East Europe were for a long time perceived only as the unpleasant by-products of transition. This was the so-called "necessary price" for the structural adjustment of the countries in transition. Yet, little by little, it became clear that even if the countries in transition were able to structurally adjust (and none have completely reached this stage of development), the reforms would not necessarily lead these countries to the same level of development as achieved by the developed countries.

The preliminary findings and insights into the logic of transition suggest that there was not a comprehensive theory on how to execute transition properly. The aforementioned blueprint approach does not qualify as a fully-fledged theory of institutional reform, but rather as an arm's length manual to the policy makers, whom shall be examined in the following sections and chapters. Despite the mounting number of policy recommendations, empirical studies and evaluations of the transition period, we still have not developed a solid theory on how to transform former socialist economic, legal and social institutions into the capitalist system. As succinctly stated by Dewatripont and Roland, the theory of large-scale institutional changes beyond macroeconomic stabilization remains very poorly developed.[7] Dewatripont and Roland realize that economists have rarely had such a great role in public policy as in the transition economies, although their efforts and activities were not supported by theory. In fact, the number of ratio of theory to policy papers about transition economics has been surprisingly low.[8] This finding does not only apply to economists, but to social scientists in general. In the early stages of transition lawyers, political scientists, sociologists, even philosophers and writers were regularly perceived by the public as originating from a higher knowledge of transition. However, this knowledge

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7 Mathias Dewanport and Gerard Roland, *Transition as a Process* in THE ECONOMICS OF TRANSITION, vol. 4, no. 1, 1996, pp. 1–3.

8 *Id*, p. 1.

did not exist and still does not exist to a satisfactory level. Finally, the experience gained from the transition did not channel into a solid theory and explanation of the process of transition.

As a methodological point of departure, I would like to propose some of the theoretical underpinnings and working hypotheses of the analysis. First and foremost, I would like to expand in the theory of development economics to the level of an institutional developmental science. One could argue that development economics as a tool for government to facilitate economic growth and social welfare has disappeared with the demise of Keynesianism. Keynesianism produced the fastest period of growth in developed and developing countries during the fifties and sixties of the post-war era. Some of the most important authors in development economics have linked Keynesianism with development economics and declared the decline of development economics together with the demise of Keynesianism.[9] On the other hand, there are many contemporary scholars who see future prospects in the field of institutional analysis and do not accept the premature obituary for development economics.[10] These scholars believe that there is still room for improvement in some of the theoretical aspects of institutional analysis and that many complex relations on a structural, institutional and relational level have not been satisfactorily explained or understood. Comprehensive empirical studies on economic and social development were not successfully captured and incorporated by most of the theoretical literature on institutional transformation. Meanwhile, the rapid and successful development of East Asian countries produced many valuable studies and attracted worldwide attention. I also believe that many important findings from the experiences of the Latin American countries can facilitate our understanding of the institutional transformation of Central and Eastern Europe.[11] The fact that the East Asian model has lost its aura in recent years[12] does not change the developmental accomplishments of these countries.

Thus, the institutional transformation of Central and Eastern Europe should be understood as a historical example of large-scale institutional transformation within a broader theoretical and conceptual discussion on the logic and characteristics of institutional transformation. Instead of focusing on the process of structural adjustment as most of the studies of transition do, I would like to focus on the dynamic and developmental aspects of the transition. In doing so, it is my goal to achieve two things:

9 Albert O. Hirschmann, *The Rise and Decline of Development Economics* in ESSAYS IN TRESPASSING, Cambridge University Press 1981.

10 Douglas North, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE, Cambridge University Press, esp. pp. 131–140.

11 Douglas North, *id,* p. 137.

12 CAMBRIDGE JOURNAL OF ECONOMICS, November 1998 (special issue on Assian financial crisis).

to emphasize the importance of the development moment in the process of transition on both a theoretical and practical level; and to enhance our theoretical knowledge about large-scale institutional transformations. This endeavor should serve as a useful resource for both the countries in transition, and the advanced countries that attempt to reform the segments of their own institutional arrangement.

Before concluding the introductory section, I would like to address the question of borrowing and emulating legal and economic institutions. In principle, borrowing foreign institutions is a reasonable, acceptable and often a highly recommended activity. However, the activity of borrowing legal and economic institutions carries several caveats. Most importantly, it is not sufficient to merely transplant legal institutions from one country to another, as the activity of emulation requires several additional steps before it can become a valuable activity. To transplant legal institutions from one system to another, reformers should first carefully study the historical development and actual impact of a chosen legal institution in the legal system. The next step is to be able to properly implement a certain institutional solution in one's own legal system. The process of implementation should be perceived as an act of creative reconstruction that makes practical use of institutional innovation. Instead of allowing institutions to govern reformers, reformers should be capable of using institutional innovations strategically to achieve full economic and social development. Of course, such an enterprise must be fully and overtly disclosed in advance, as the process of implementing institutional innovation must be completed under close auspices of the broad public.[13]

Many comparative studies show that such a borrowing and emulating activity can be successful for the reformers and societies at large. For example, empirical studies of the rapid development in East Asia show a great degree of transformative capacity. Of course, there are no guarantees in a large-scale institutional transformation. Many attempts have failed in the past and most likely will continue to fail in the future. My discussion will focus on the successes and failures of institutional transformation in Central and Eastern Europe.

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[13] Roberto Unger emphasizes Piaget's maxim, "emulating is innovating" in DEMOCRACY REALIZED, Verso 1998, p. 96. Alan Watson, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW, Edinburgh 1974, Bojan Bugaric, ONE WAY OR MANY, doctoral dissertation, Wisconsin 1998, Kerry Rittich, RECHARATERIZING RESTRUCTURING: GENDER AND DISTRIBUTION IN THE LEGAL STRUCTURE OF MARKET REFORM, Harvard Law School, 1998.

MACROECONOMIC STABILIZATION AS A BASIS FOR INSTITUTIONAL REFORM

Throughout the 1990s, the efforts to achieve macroeconomic stabilization have produced mixed results. As we shall see in this part of the study, attempts at macroeconomic stabilization produced different assessments, ranging from those who see this period as a lost decade to those who see this as the time necessary to build macroeconomic conditions for sustainable development.

To present a broader perspective and the background of institutional reforms, we should begin by analyzing the process of macroeconomic stabilization. The aim of this section is not a detailed analysis of the macroeconomic policies of the countries in transition, but to highlight the basic characteristics and the problems of reformers in the early phases of transition. Of course, it is useful to take into account some of the important figures pertaining to the economic and social changes that have occurred in the past decade.

Before taking a closer look at the process of macroeconomic stabilization, I would like to set forth the basic framework and policies in which macroeconomic stabilization was conducted. The package of reforms, usually referred to as "the Washington consensus,"[14] aimed to secure macroeconomic stabilization and produce a free market economy in the transition countries. The four basic requirements of the package were to achieve: (1) macroeconomic stabilization through strict monetary and fiscal policy, (2) price and trade liberalization, (3) mass privatization as an attempt to create a private sector, (4) and the creation of a social safety net. With respect to the last requirement, it has not been explicitly stated whether the social safety net should be created as a residuum of the former social welfare system or as an overall new social welfare system. Although this dilemma has not been resolved, the policy measures to date suggest the transition countries are heading toward the social welfare residuum. There will be further discussion on the dilemmas regarding the proper design of the welfare policy in the last chapter of the thesis.

The results of the macroeconomic stabilization package reforms have been well-documented over the past ten years. Two to three years after the policy measures were in place, all of the countries in transition, without a single exception, experienced a heavy decline in industrial output and decline in GDP. Furthermore, the countries in transition, which used to be largely egalitarian societies,[15] all experienced a significant increase

[14] The term coined by the World Bank's economist John Williamson, *The Emergent Development Policy Consensus,* presented at the conference "Sustainable Development with Equity in the 1990's: Policies and Alternatives" at Madison University, Wisconsin, May 13–16, 1993.

[15] World Bank Development Report FROM PLAN TO MARKET estimates that "output has

in social inequality. The sharp decline in industrial output and GDP occurred irrespective of the initial conditions of the countries in transition, even though recent studies showed significant divergencies in some of the key indicators before the transition took place.[16] Important divergencies existed in the composition of the economy, its (de)centralization, the size of firms, the tax system, the depth of fiscal crises, and the level of internal and external indebtedness. The economic slump, however, was an unambiguous and common phenomenon for all the countries in transition.[17]

Heavy economic decline was neither planned nor announced by the national governments. The decline immediately invoked concerns and produced new social tensions that replaced the high expectations at the beginning of radical reforms. Broad social consensus, which was a necessary precondition for radical reforms, rapidly melted away in the face of economic downturn and increasing social stratification. As a result, each of the countries in transition tried several different measures to achieve basic macroeconomic and broader social stability.[18]

The so-called transformational depression, no matter how unavoidable and logical it seems to be retroactively, came as a surprise for the first generation of reformers. Contraction of production, waves of bankruptcies, mass unemployment and contraction of credits caused insurmountable problems. There was little time for comprehensive analyses and

fallen dramatically in European and Central Asian transition economies. Some of the official estimates overstate the decline because of statistical weaknesses, not least, in many countries, the exclusion of a large and growing unofficial economy. But the data show a substantial decline even after adjusting for these biases; in Russia, for example, output fell by about 40 percent during 1990–95. Estimates based on electricity demand are also problematic but provide perhaps a lower bound to the output decline; they suggest that GDP fell, on average, by around 16 percent in all CEE countries between 1989 and 1994, and by around 30 percent in eleven NIS. Because of sharp falls in investment, consumption has declined less than output, but there is little doubt that living standards fell in the early stages of reform in most countries, notwithstanding improvements in product quality and the elimination of queues (footnotes omitted)." P. 25, *supra* at 6.

16 Grzegorz Ekiert, *Do Legacies Matter? Patterns of Postcommunist Transitions in Eastern Europe*, Center for European Studies, Harvard University, working draft – October 1998 in which he shows a great diversity in party systems, electoral systems, the role of civil society in the first year of transition. Similar findings in a comprehensive study on the consolidation of democracy in Juan Linz & Alfred Stepan, PROBLEMS OF DEMOCRATIC TRANSITION AND CONSOLIDATION (Southern Europe, South Europe, and Post-Communist Europe,) John Hopkins 1996, esp. pp. 434–457. *See* also Jon Elster et al., *supra* at 2.

17 *See supra* at 6, pp. 25–28.

18 These studies aim retroactively at explaining some of the crucial and most difficult moments in the process of transition while also giving a more theoretical explanation for the overall process of transition. For one of the most helpful studies with many important insights *see*, Fabrizio Coricelli, MACROECONOMIC POLICIES AND THE DEVELOPMENT OF MARKETS IN TRANSITION ECONOMIES, CEU Press, 1998. *See* p. 9.

there was even less time for any corrections in the program of macroeconomic stabilization.[19] Further deterioration of the economic situation was inescapable. This is evident in macroeconomic and human development indicators, but is much less evident compared to the EU countries at the level of microeconomic indicators, such as value added per worker, labor productivity or competitiveness in individual branches. Even today we are capable of only very limited insight into the improvement of individual branches of industry. Likewise, we possess an even less comprehensive survey on the competitiveness of individual firms in the CEE countries. Lack of a comprehensive survey of firms and the individual industrial branches further weakens the analysis and assessment of the transition period.[20]

The first period of macroeconomic stabilization was marked by the 'fiscal trap' as noticed and described by Janos Kornai.[21] The 'fiscal trap' is a situation in which a decline in production inevitably brings about a decline in state revenues, which prevented a government from injecting necessary financial stimuli into the economy. The deficit is exacerbated by the increasing number of unemployed people who almost exclusively depend on unemployment compensation. Such a trap leads to weak economic growth that cannot offset the early economic decline. As recognized by the World Bank economists, no one expected tax revenues to fall quite so dramatically during transition.[22]

There are many theories explaining which factors contributed to the swift and unexpected economic decline. One strong argument suggests that the main cause of the rapid economic downturn was the external shock caused by the collapse of trade with the former Soviet Union. The estimates made by Dani Rodrik suggest that the sudden interruption of trade amongst the former members of the common market – CMEA or COMECON – had a severe impact on the economies in Central Europe,

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[19] For the discussion on the avoidability of the economic decline in the countries of transition *see* Michael Bruno, *Stabilization and reform in Eastern Europe: preliminary evaluation,* WORLD BANK DISCUSSION PAPERS 196, ed. By Mario I. Blejer, Guillermo A. Calvo, Fabrizio Coricelli, Alan H. Gelb, Washington 1993, pp. 22–24.

[20] The first econometric analysis of the response to reforms on enterprise level was made by Saul Estrin, Mark E. Schaffer, and Inderjit Singh, *supra* at 19, pp. 111–136.

[21] Janos Kornai, *Transformational recession,* in HIGHWAYS AND BYWAYS, MIT 1993, pp. 193–194.

[22] World Bank Report FROM PLAN TO MARKET, *supra* at 6, p. 119. World Bank economists estimate that in the Visegrad group and Slovenia, although at one-half of GDP, it was still high for middle-income countries, the ratio of revenues to GDP fell on average by 4 percentage points during the period between 1989 and 1994. By contrast, the share of revenues in GDP dropped by an average of 16 percentage points in most of the other CEE countries and NIS, p. 118.
Although I accept these findings, I have a further comment with respect to theVisegrad group. There was still a high proportion of state revenues in the overall GDP, the drop itself did not occur because an increase in the private sector, but because of overall economic decline.

Hungary, the Czech Republic (former Czechoslovakia) and Poland.[23] The collapse of a payment system, the deterioration of the terms of trade, suspended economic and political ties and the dissolution of CMEA abruptly ended trade amongst these countries. In fact, as Rodrik's analysis suggests, the deterioration of the terms of trade and the dissolution of CMEA accounted for virtually the entire estimated decline in GDP in Hungary during 1990–91, and for most of the decline in GDP in (former) Czechoslovakia. Although to a lesser extent, the trade shock also explains the decline in Poland.[24]

There are a few other important determinants which contributed to the rapid economic decline of the countries in transition. All these determinants suggest that the rapid decline of the transition economies was not a 'natural and inevitable' phenomenon, but rather a mixture of exogenous shocks and endogenous factors. On one hand, the decline was a result of the inevitable consequences of macroeconomic stabilization. On the other hand, however, the decline resulted from bad policy decisions, such as overshooting monetary and fiscal targets, an insufficient understanding of the different initial conditions in the post-socialist countries, and the deliberate dissolution of common trade. As Kornai discovered, the production of every firm and product in a mature capitalist economy does not decline during recession.[25]

Another, perhaps even more important phenomenon I would like to discuss is the occurrence of the 'credit crunch' in relation to the economic decline. The role of credit as a major determinant in the output collapse in Eastern Europe has been analyzed by the IMF economist Guillermo Calvo and by the World Bank economist Fabrizzio Coricelli.[26] Their study stretches beyond the discussion on macroeconomic stabilization and focuses on the direct impact that credit had on the direction and practical implementation of mass privatization. The authors claim that negative output effects in the period of monetary contraction were greater due to underdeveloped credit markets.[27] In the East European context, the underdeveloped credit markets prompted many state-owned

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[23] Dani Rodrik, *Making sense of the Soviet trade shock in Eastern Europe: a framework and some estimates,* WORLD BANK DISCUSSION PAPERS 196, *supra* 19, pp. 64–85. Rodrik estimates that the cumulative trade shock in the period between 1990 and 91 amounted to around 2 billion USD in Poland and Hungary, and 3.4 billion USD in Czechoslovakia, which represented between 7 and 8 percent of GDP in Hungary and 3.5 percent in Poland. P. 77.

[24] *Id,* p. 81.

[25] *Supra* at 21, p. 167. Kornai compared the experience of Hungary with the Great Depression period of the early 1930s and discovered that the fall in Hungarian production, which followed a long period of stagnation, was deeper than the one that took place during the Great Depression. *Id,* p. 166.

[26] Guillermo A. Calvo and Fabrizzio Coricelli, *Output collapse in Eastern Europe: The Role of Credit*, IMF WORKING PAPER WP/92/64, August 1992.

[27] *Id,* p. 2.

banks to significantly raise interest rates during the monetary contraction. Furthermore, banks frequently ceased lending to the state-owned firms. Credit contraction was simultaneously accompanied by the removal of state subsidies. In the situation of a general liquidity crisis and the absence of developed capital markets, the post-socialist firms[28] were unable to develop alternative methods of financing.

As a result of the general liquidity crisis, firms had to respond in one of four possible ways: (1) deplete inventories; (2) fall into arrears; (3) lower wages; or (4) borrow more from the banking sector or international lenders.[29] Clearly, option four was out of the question, as firms did not have access to international financial markets. According to the authors, options one and three were widely practiced during the period of transition.[30] Since one cannot infinitely invest in inventory or constantly fall into wage arrears, massive layoffs and inter-enterprise arrears occurred in the long run. The occurrence of inter-enterprise indebtedness, as I will argue later, significantly determined the implementation and results of mass privatization. Inter-enterprise indebtedness obfuscated the distinction between good, potentially viable and non-viable firms and distorted the attempts to realistically determine the book- and market values of individual firms before privatization took place.[31] Roman Frydman and Andrzej Rapazcynski, among the leading scholars of transition, estimated that "around 40 percent of the book value of some of the companies being prepared for privatization in Poland is in the form of outstanding liabilities from other enterprises, much of it of very long standing."[32]

The liquidity crisis, caused by monetary measures and state bank reluctance escaped the attention of the first generation of post-socialist reformers. This is most likely due to the conviction of the reformers who believe that the only real market economy is a market economy with a developed capital market. Reformers did not attempt to use the banking sector for the purpose of economic development; rather, they separated

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28 The authors refer to post-socialist firms as *previously centrally-planned economies* (PCPEs) with most of the characteristics retained from the centrally planned economy (control of the state over management and workers, automatic grants of credits, prohibition of bankruptcies). *Id.,* pp. 2–3.

29 *Id,* p. 5.

30 *Id.*

31 Empirical studies of transition provide, however, sufficient evidence that managers did not deliberately use the liquidity crisis for perverse behavior, such as moral hazard: "We find very little evidence of purely perverse behavior. Polish state-owned firms may be characterized by weak management and powerful workers, but that does not appear to have led to Ward-type income maximizing behavior. Output responses in the short run are not perverse...". *Supra* at 17, p. 134.

32 Roman Frydman, Andrzey Rapazcynski, PRIVATIZATION IN EASTERN EUROPE: IS THE STATE WITHERING AWAY?, CEU Press 1994, p. 18. Authors recognize that "...the chain of mutual indebtedness among the companies along the production process, introduce a further element of uncertainty into the already clouded company books..." *Id.*

bank restructuring from the restructuring and privatization process. While banks went through the restructuring process, which involved breaking-up the former monobank system and creating commercial banks, the rest of the economy was being prepared for the protracted process of mass privatization. Left alone, firms simultaneously lost government subsidies and lost access to bank credits due to high interest rates or the reluctance of banks to continue lending. Banks that suddenly tried to adopt commercial criteria ceased lending to firms with past bad loans and to firms that could not offer collateral. In the period preceding mass privatization, the general uncertainty regarding firm ownership, bankruptcy or survival created a risk too high for the commercial banks to continue lending.

According to this line of reasoning, the credit crunch and the general liquidity crisis were not only a result of monetary measures, but probably more the result of an institutional vacuum and a lack of coordinating mechanisms. When the old mechanisms of the command-style economy were dismantled, they were not simultaneously replaced with market coordinating mechanisms and a well-regulated and transparent capital markets. It is certainly not a surprise that reformers were unable to introduce all the necessary market institutions immediately. Thus, the remaining question to be answered is why reformers did not rely on state banks to a larger extent in order to sustain the necessary level of liquidity and credit expansion. One of the best explanation are offered by Jenny Corbett and Colin Mayer. These authors believe that East European reformers have mistaken the concept of capitalism for the concept of capital markets. They never defined the role of banks in transition, as they were focused on the creation of capital market.[33] Liquidity issues, credit constraints and the role of banks were set aside in favor of mass privatization, the creation of capital markets and the struggle against inflation. It might well be that the order of reforms and the list of priorities in the process of transition were wrong, but the final results and the bulk of literature remain inconclusive on that issue. We might never get the definitive answer on what the right order of reforms should look like. What is certain, however, is that the first generation of reformers did not follow the recommendations made by some prominent scholars, such as Joseph Stiglitz, who was arguing that "LDSc should not imitate the capital markets of the most developed countries."[34] Other scholars argued in favor of alternative forms of financing, a subject I will return to later.

My presentation of the process of macroeconomic stabilization attempts to display that the overall economic decline in the first phase of

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[33] For an early assessment and critique of such an approach *see* Jenny Corbett and Colin Mayer, *Financial Reform in Eastern Europe: Progress with the Wrong Model,* OXFORD REVIEW OF ECONOMIC POLICY, vol. 7, no. 4 (1991), pp. 57–75.

[34] Joseph E. Stiglitz, *Financial Markets and Development,* OXFORD REVIEW OF ECONOMIC POLICY, vol. 5. no. 4 (1989), p. 56 and *ff.* (55–68).

reforms was a combination of exogenous factors and bad policy decisions, while the question whether it was possible to avoid such a slump, remains unresolved. Findings suggest that the economic decline did not cause only severe macroeconomic imbalances, but also significantly changed the microeconomic landscape of the economies in transition. Furthermore, findings show that there were no serious attempts to create mechanisms of coordination between the macroeconomic stabilization policies and the microeconomic restructuring efforts in the first period of reforms. It is important to bear these facts in mind, as I continue analyzing the second phase of reforms. The second period is marked by the resumption of economic growth in most of the countries in transition, which practically brought an end to the period of radical reforms in Central and Eastern Europe.

After the 1993–1994 period all of the countries in Central Europe and most of the countries in Eastern Europe resumed growth. Russia, a notable exception, has resumed growth only recently after almost a decade of negative growth rates, and it will be discussed separately. Poland and Slovenia, on average, experienced the least severe decline on average experienced, each about 15 percent of GDP.[35] In the following years, most of the countries in Central and some of the countries in Eastern Europe grew between three and four percent per year on average. The highest and most sustainable economic growth was achieved in Poland, where the average annual growth rate between 1994 and 1997 amounted to 6.3 percent. Stronger growth rates were also achieved in the Czech Republic (which fell into recession again in 1998 and lasted until the second half of 2000), Slovenia and Slovakia, whereas Hungary achieved modest growth of 2.5 percent of GDP.[36]

Comparing the recession in the first period of reforms and the growth in the second period of reforms, we can see that only Poland outgrew its initial 1989 GDP in real terms (before the reforms started). To date, none of other countries outgrew their own GDP, although Slovenia, the Czech Republic and Slovakia are at an index around 100 (comparing the years 1989 and 1997), and Hungary is producing about 90 percent of its 1989 GDP.[37] In his comprehensive study on transition, Grzegorz Kolodko, the former Polish finance minister between 1994–97 observed that the economies in transition have reached a level of macroeconomic equilibrium that will allow them to expect solid economic growth in the near future. The advanced transition countries that are currently negotiating

35 Martha de Melo and Alan Gelb, *Transition to Date: Comparative Overview* in Salvatore Zecchini (ed.), LESSONS FROM THE ECONOMIC TRANSITION, Kluwer Academic Publisher, 1997, p. 59.

36 The data were pulled together by the World Bank researcher Grzegorz Kolodko, *Transition to a Market Economy and Sustained Growth, Implications for the Post-Washington Consensus* (manuscript, December 1998).

37 *Id.*

to enter the EU have also managed to meet most of the Maastricht criteria.[38]

In retrospect, it seems that the many unanswered questions will remain unanswered. One of the most obvious questions is why so much suffering and pain was necessary for the countries to achieve their pre-reform levels of economic development? True, no one can deny that many of the most important achievements and benefits of the reforms were for the people at large. Such benefits include the introduction of constitutional rights and liberties, democratic elections, free enterprise and initiative, business development rights, international competition and relaxed import of foreign goods. However, there were many hardships during the process of transition, such as the emergence of mass unemployment, sharp increase in inequality, and increased poverty.[39] The disparate impact of reforms on different social groups is well measured and well documented. Would it be possible to achieve the beneficial effects while avoiding or alleviating the negative effects of reforms? This question should move beyond the realm of academics and rather serve as a guideline for future policy responses in order to minimize the negative effects of the process of transition.

A brief overview of the macroeconomic stabilization effects in Central and Eastern Europe should give us some basic insights into the process and problems of transition. The above presentation did not aim at giving a final account of the successes or failures of structural adjustment, although it stemmed from the belief that structural adjustment can not automatically bring about greater economic and social prosperity.[40] Given the true nature of macroeconomic structural reforms, there should be a heavy burden of persuasion on those who claim that structural adjustment automatically leads to fast economic development and social prosperity. It is equally important that the critics of structural reforms get a fair opportunity to present their critique, propose alternative measures and offer concrete successful examples. If the critics had such an opportunity, they would have to take the same level of responsibility and burden of persuasion as the proponents of alternative measures. Since this was not the case, the whole responsibility for the disparate outcome of reforms must be assumed by the main proponents of structural adjustment.

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[38] *Id.*

[39] For a study on rapid increase of inequality, *see* World Bank Report FROM PLAN TO MARKET, *supra* at 6, pp. 66–84 and Branko Milanovic, *Income, Inequality and Poverty during the Transition from Planned to Market Economy*, World Bank Regional and Sectoral Studies, manuscript 1998.

[40] In Poland, in fact, being the only country that at least partially excelled during the second phase of transition, government and public officials combining many of the prescribed orthodox measures with less orthodox measures in order to achieve high growth rates. The policies and instruments are presented in Grezgorz Kolodko, *The Polish Alternative* (manuscript 1998).

Recognizing that the "Washington consensus" did not automatically solve the existing economic inefficiencies and did not automatically lead to rapid economic growth, came, perhaps somewhat surprisingly, from the former Chief Economist of the World Bank, Joseph Stiglitz. In his analysis of the requirements and policies that are known as the "Washington consensus," he showed that the policies were not complete and were sometimes misguided.[41] According to Stiglitz, "...making markets work requires more than just low inflation; it requires sound financial regulation, competition policy, and policies to facilitate the transfer of technology and to encourage transparency, to cite some fundamental issues neglected by the Washington consensus."[42] Stiglitz's critique of the "Washington consensus" is based on theoretical, practical and contextual reasons. He argues that the whole "Washington consensus" policy was developed in the context of Latin America's struggle against inflation in the eighties. The doctrines and policies of the "Washington consensus" came as a result of the ongoing disappointments with Latin American countries and their persistent problems with inflation. Therefore, strict monetary and fiscal measures were aimed primarily at stopping inflation and achieving macroeconomic stability. Yet, as Stiglitz argues, "the focus on inflation [...] has led to macroeconomic policies that may not be the most conducive for long-term economic growth, and it has detracted attention from other major sources of macro-instability, namely, weak financial sectors."[43]

In a different institutional context, the approach based on the "Washington consensus" might have perverse effects on macroeconomic (in)stability. For example, freeing up markets by weakening the financial sector may contribute to macroeconomic instability.[44] This is not to say that macroeconomic stability is not vital for economic progress, but it is necessary to discuss the real content of macroeconomic stabilization in more detail while trying not to confuse means and ends of macroeconomic policy.[45] An attempt to control inflation is another such example.

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41 Joseph Stiglitz, *More Instruments and Broader Goals: Moving toward the Post-Washington Consensus, speech in Helsinki,* Finland, January 7, 1998, available on: *www.worldbank.org/html/extdr/js-010798/wider.htm*

42 *Id.*

43 *Id.*

44 "More broadly, in focusing on trade liberalization, deregulation, and privatization, policymakers ignored other important ingredients, most notably competition, that are required to make an effective market economy and that may be at least as important as the standard economic prescriptions in determining long-term economic success" (*footnotes omitted*). *Id.*

45 "While macro-stability is important, for example, inflation is not always its most essential component. Trade liberalization and privatization are key parts of sound macro-economic policies, but they are not ends in themselves. They are means to the end of a less distorted, more competitive, more efficient marketplace and must be complemented by effective regulation and competition policies. " *Id.*

While it is necessary to struggle against high- and medium-rate inflation, it might be too costly to fight low levels of inflation at the expense of other segments of macroeconomic policy, such as interest rates or unemployment. Japan, for example, through many decades of the post-war era successfully combined relatively high rates of inflation with low unemployment rates, while simultaneously achieving high rates of economic growth.[46] With respect to low inflation rates, there is little agreement in economic theory about the acceptable rate of inflation, even if we leave the problem of wrong signals on the markets with long-term persistent inflation aside.[47]

The issue of an acceptable level of budget deficit is even more controversial. Stiglitz believes that "the optimum deficit – or the range of sustainable deficits – depends on circumstances, including the cylical state of the economy, prospects for future growth, the uses of government spending, the depth of financial markets, and the levels of national savings and national investment."[48] Thus, determining the level of acceptable deficit depends on many other macroeconomic factors, including complementary public policies. The question of a sustainable deficit level does not come from mathematical premises, but rather from the context of macroeconomic policies in a given moment. Of course, there is an upper limit to the budget deficit which should not be exceeded, in order not to undermine one's own governmental policy.[49] How the deficit is financed and for what purposes it is used – long term productive investments or short term spending – also plays a significant role in determining the optimal level of budget deficit. It is certainly risky for a government to maintain a proper macroeconomic policy due to domestic inflationary pressures on increasingly volatile international financial market. The dynamic international financial markets, including international financial speculators, can punish governments with current fiscal imbalances through orchestrated speculative attacks on their national currencies at any moment. Our recent experience with the Asian financial crisis convincingly displayed the power of international speculators

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[46] For study on how Japan managed to control inflation, while pursuing other policies, *see* Ronald Dore, FLEXIBLE RIGIDITIES, Stanford 1986, esp. pp. 22–26 and TAKING JAPAN SERIOUSLY, Stanford 1987, esp. pp. 81–84.

[47] "In my view, the conclusion to be drawn from this research is that controlling high and medium-rate inflation should be a fundamental policy priority, but pushing low inflation even lower is not likely to significantly improve the functioning of markets." *Id.*

[48] *Id.*

[49] According to Michael Bruno, budget deficit in the countries in transition should "endorse a pre-committed budget framework trajectory for each of the coming years with full budget balance to be regained within, at most, three years and the deficit in no year exceeding a certain percentage GDP, say, 4 or 5 percent, as a safety margin." *See supra* at 19, p. 26.

and to a lesser extent also exposed domestic financial problems.[50] Another set of constraints, deriving from the EU Stability Pact, certainly further narrows the room for maneuver with regard to running a budget deficit policy.

Similar is true for other aspects of macroeconomic stability, for example, the current account deficit: current account deficits are neither inherently good nor inherently bad – it depends on the circumstances and especially on the uses to which the funds are put.[51] If the rate of return exceeds the cost of international capital, running current account deficits is acceptable from theoretical and practical aspects.[52] The discussion on alternative possibilities to achieve macroeconomic stability can be summarized in this way: "While macro-stability is important, for example, inflation is not always its most essential component. Trade liberalization and privatization are key parts of sound macro-economic policies, but they are not ends in themselves. They are means to the end of a less distorted, more competitive, more efficient marketplace and must be complemented by effective regulation and competition policies.[53]

This important and useful critique by the Chief Economist of the World Bank gives us insight into the limited reach of the Washington consensus policy and argues that broader instruments and goals are needed to make the blueprint approach toward reforms truly workable and ultimately successful. The necessity to design a broader framework of instruments and policies that can adequately respond to the real developmental issues of the countries in transition is evident. It is, therefore, up to the next generation of reformers to build a satisfactory developmental model – or, according to our introductory observations, a number of developmental models, because it is highly unlikely that one developmental model would fit for all. Thus, Russian reformers need to produce their own model of development, which should be based on some of the above described premises, but will offer guidance on their own strategic and developmental issues. The same is true for Poland, the Czech Republic, Slovenia as well as for the emerging economies in Latin America, East Asia and other developing regions. Paradoxically, it might turn out that the "Washington consensus" unwittingly prompted the sec-

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50 For perhaps the best overview of the mounting speculative attacks against the individual Asian currencies, *see* the special issue of CAMBRIDGE JOURNAL OF ECONOMICS, November 1998. As Robert Wade has discovered, no national economies could sustain the short term-inflows and outflows in the amount between 8 and 10 percent as was the case in South Korea. Even much stronger economies than South Korea at the moment of speculative attacks would not be able to survive such attacks. *See supra* 12.

51 *See supra* at 41.

52 *Id.*

53 *Id.*

ond generation of reformers towards much more divergent approaches toward reforms. There is hope that World Bank and IMF officials will work together with governments and people around the world to address developmental issues while preserving the local and institutional content of each country and refraining from giving directly applicable universal or seemingly universal answers. New developmental models should be built on past experience and lessons, while simultaneously combining new insight into the logic of institutional development.

Before finishing the section on macroeconomic stabilization, I would like to mention a dimension that is surprisingly and persistently missing in the discussions on institutional transformation. This is the question of national savings, either public or private. Lessons from successful East Asian models show that one of the key components of rapid economic development is the fact that these countries succeeded in creating high saving rates that were being channeled into productive investment.[54] No other region ever came close to the performance of the East Asian countries (including China with saving rates close to 40 percent of GDP), but no other rapidly developing region has ever tried to promote the policy of high saving and investment rates so consistently over a long period of time. In theory, the causal link between high savings and high growth was never satisfactorily resolved,[55] but it still safe to claim that the chances to achieve rapid economic development are very low without the capacity of governments in transition to create and subsequently channel higher savings into productive investments. The almost exclusive reliance on domestic capital markets, still very much in the process of development and still lacking necessary regulatory framework, appears to be one of the major strategic flaws along the course of reforms in the transition countries.

In fact, the World Bank Development Report *From Plan to Market* strongly recommends to governments in transition economies to take fiscal and tax measures to raise saving rates and to increase productive investments.[56] However, the problem with this very important insight was that it came at a rather late stage of reforms, not at the beginning of

[54] High performing Asian economies enjoyed savings and investment rates well over 30 percent during the period of rapid economic development. *See* World Bank Research Policy Report, THE EAST ASIAN MIRACLE, Oxford 1993, pp. 40–43. For empirical research on deliberative policies intended to promote high saving and investment rates, *see id*, pp. 212–242.

[55] For a theoretical debate on causal link between savings and growth, *see* Zhiyuan Cui, appendix to Robero Unger, *Democracy Realized,* Verso 1998, pp. 279–286.

[56] "However, sustained rapid growth has been associated with exceptionally high saving and investment rates worldwide. Saving generally averages at least 25 percent of GDP and investment at least 30 percent in fast-growth periods. In CEE and the NIS both the rate of capital accumulation and the efficiency of investment are presently inadequate to sustain rapid long-run growth. In CEE in 1994, saving averaged about 15 percent of GDP and investment 17 to 18 percent; average saving and investment rates in the NIS were close to 20 percent. Capital productivity, historically very low

reforms. The macroeconomic aspect of reforms was based on cutting the size of the state budget in the GDP. Removal of subsidies to state-owned firms and liberalization of foreign trade in the early stage of reforms, which was followed by a rapid decline in production, caused negative effects on long-term fiscal stability. While the macroeconomic stabilization policy consolidated the budgets of the countries in transition for a moment, the 'secondary fiscal crisis' followed soon afterwards due to a fall in revenues from the state-owned firms, a rise of unemployment compensations and a rapid increase of early retirements.[57]

The program of macroeconomic stabilization was clearly focused on the reduction of government spending in the overall GDP. This was done primarily by reducing expenditures, such as state subsidies. However, the social problems caused by increasing unemployment demanded a raise in social expenditures again. Such a fiscal development was not possible to defend, because the tax base shrank due to output contraction. As a result, current policies are all oriented toward the reduction of social expenditures, primarily toward cuts in unemployment benefits and in pensions. These policies are all based on the premise that an existing level of social benefits is not affordable at a given level of economic development.

An interesting issue in the debate on macroeconomic stabilization is the neglected element of public and private savings in the countries in transition. It seems that there is a common belief that a balanced budget, low public debt, low inflation and a balanced current account should suffice for sound economic policy, while the 'invisible hand' of private markets takes care of the rest. As it appears retroactively, the original reduction in public expenditures was not used to increase public savings. Such an increase in public savings could have been used for public investments in infrastructure, education, research and development. Yet the "Washington consensus" focused primarily on the creation of private market institutions, whereas the role of the public sphere was neglected and never properly defined.[58] The important lesson from the East Asian countries about the necessary role of public sector in raising savings and creating new investment opportunities for the private sector[59] was for-

in both regions, has recently begun to recover in the leading reformers, but continued improvements will be critical for sustaining growth." *Id.*, p. 41.

[57] On the development of 'secondary fiscal crisis' *see* Marek Dabrowski, *Dynamics of Fiscal Developments during Transition* in Lorand Ambrus-Lakatos and Mark E. Schaffer (eds.), FISCAL POLICY IN TRANSITION, Economic Policy Initiative 1997, pp. 9–15. *See* also Grzegorz Kolodko, *Perverse Effect in Fiscal Adjustment in Transition Economies,* ECONOMICS OF TRANSITION, vol. 1(3), 1993, pp. 345–355.

[58] *See* also Stiglitz, *supra* at 41: "Without a robust financial system – which government plays a huge role in creating and maintaining – it is difficult to mobilize savings or allocate capital efficiently."

[59] *See supra* at 54, pp. 207–210.

gotten by both the first generation of reformers and the international financial institutions. Instead, Central and Eastern European countries became more similar to Latin American Countries through a distinct economic pattern of low growth cum low savings, while experiencing increasing difficulty in advancing a sustainable fiscal policy.[60]

This section on macroeconomic stabilization should allow us to increase our understanding about the logic of transition, the policy of the "Washington consensus," and the actual outcome of the transition. Even today, it is difficult to declare that the countries in transition have structurally adjusted and laid down solid macroeconomic fundamentals in order to pursue rapid economic development based on shared growth. It is still more likely that the countries in transition will experience further fiscal crises, partly as a result of globalizing capital pressures and the inherited fiscal burdens that are still increasing due to long-term unemployment and early retirements throughout Central and Eastern Europe. Further attempts to reduce the level of public expenditure, especially in the form of pension and unemployment compensation, will inevitably raise social tensions. The previously broad public consensus for radical economic and social reforms disappeared amidst the political and economic struggle for control over the remaining industrial and financial enterprises and for the (re)distribution of the remaining social wealth.[61] The creation of a new public consensus is thus necessary to proceed with reforms, although it is clear that this will be extremely difficult to achieve after the many endured hardships during the early stages of transition.[62]

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[60] Important insights and lessons from pursuing the Washington consensus policy were drawn by the leading Latin American scholars in the eighties, but were overlooked by the Eastern European reformers: "The assumption that it is enough to stabilize and reduce state intervention for growth to follow is false. While liberalizing reforms do foster market coordination and improve resource allocation, making the economic system more efficient is not enough for growth. If growth is to resume, it is necessary to combat the fiscal crisis, to recover a capacity for public savings, and to define a new strategic role for the state, so that total savings are increased and technological progress can be promoted," Luiz Carlos Bresser Pereira, *Economic Policy and Economic Growth: Efficiency and Politics in Latin America* in Luiz Carlos Bresser Pereira, Jose Maria Maravall, Adam Przeworski (eds.), ECONOMIC REFORMS IN NEW DEMOCRACIES, Cambridge 1993, p. 20.

[61] The initial broad social consensus, which was necessary for radical economic reforms, has disappeared due to output collapse, upward redistribution of wealth, increased inequality and mass unemployment. About the necessity of having a broad social consensus to pursue radical economic reforms, *see* Michael Bruno, CRISIS, STABILIZATION, AND ECONOMIC REFORM – THERAPY BY CONSENSUS, Oxford 1993, esp. pp. 231–232.

[62] *See* Stiglitz, *supra* at 41.

METHODOLOGICAL REMARKS AND ISSUE MAPPING

Macroeconomic stabilization revealed some of the problems, successes and failures of the first stage of radical reforms. There are, of course, many achievements from the first period of reforms: inflation was significantly reduced, the countries in transition have returned to a path of growth, they enjoy, on average, relative fiscal stability and for the first time after the war they are opened toward Western markets and are increasing their volume of trade.[63] The goal that was not achieved in the first period of transition was to link macroeconomic reforms with successful microeconomic reforms. While it was still possible to achieve macroeconomic equilibrium at a lower level, macroeconomic stabilization has not translated into rapid economic development on the microeconomic level.[64] The omission of active microeconomic restructuring and the lack of coordination of macro- and microeconomic activities certainly further deteriorated the competitiveness of Central and Eastern European economies. Thus, the relative success of macroeconomic stabilization was not followed by a substantial improvement in the micro-level competitiveness of the respective economies. The introduction of new technologies, creation of new markets, and manufacturing of new products still remains more an exception than a general rule for the countries in transition.

To make an assessment of the large-scale institutional changes, the following analysis will attempt to link institutional transformation with the efforts of macroeconomic stabilization and microeconomic restructuring. The goal of this analysis is to show the further development opportunities for policy-makers in the countries in transition. A "bias for hope" is a *motto* that will accompany me through the following institutional analysis. Throughout the thesis I shall not pretend to be neutral in choosing or favoring one or another policy option. My main critique will be oriented against a rigid policy of structural adjustment that neglects the institutional surrounding. In other words, I am of the opinion that the policy of structural adjustment must not be the only and exclusive policy of the reformers, but must also be accompanied by a broad set of developmental policies. It would be in vain to make structural adjustments that impoverish society and economy at large. Perhaps built-in stabilizers can work successfully for highly advanced societies at the cutting edge of development, but not for rapidly developing countries.

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63 *See* Stanley Fischer, Ratna Sahay and Carlos A. Vegh, *From Transition to Market: Evidence and Growth Prospects* in Salvatore Zecchini, *supra* at 35, pp. 79–101. *See* also Grzegorz Kolodko, *supra* at 36.

64 "...these [macroeconomic] policies are certainly necessary, but a growing literature, both theoretical and empirical, has emphasized the important microeconomic underpinnings of macroeconomic stability." Stiglitz, *supra* at 41.

Proposals for new models of development should not come only from the top international institutions and their leading experts, but also from the new generations of reformers in the developing countries themselves. Learning from the past experience of institutional reforms, drawing heavily on the broad knowledge of the leading international experts and relying on our own insights, knowledge and imagination should be the proper approach toward the next wave of reforms. Likewise, reformers should remember that there is not a 'one size fits all' structural or developmental model. It is also not possible to merely emulate experiences of other countries without adjusting those experiences to the present needs and capacities of a particular transition country. Finally, the regained status-quo in the transition countries must be thoroughly questioned in order not to diminish the developmental potential.

The following institutional analysis will focus on two major aspects of legal reforms: mass privatization and social welfare reform. Mass privatization as a major legal event in the process of transition will be analyzed from a conceptual, theoretical and practical point of view. The topic itself is so broad that no single paper or analysis can completely embrace the concept and process of mass privatization, so I will inevitably have to focus on more specific moments within the process of mass privatization and try to emphasize some of the most distinctive characteristics of the process. The analysis should broaden the reader's understanding of the logic of transition, explain some of the most common patterns in the process of transformation, and enrich the theoretical understanding of property relations, legal institutions, and broad social conceptions of social efficiency and justice in modern societies. Additionally, the analysis should give us more insight into the future developmental potential of the Central and Eastern European societies under a newly established institutional framework. As Joseph Stiglitz pointed out in his well-known speech on broader means and goals in a post-Washington consensus era,[65] these insights should try to add some of the fragments to the emerging new development model. It is my strong belief that there cannot be one single and abstract development model towards which all of the emerging economies should aspire, but that we should rather prepare ourselves to live and cooperate under different institutional frameworks and substantive contexts.[66]

The reform of the social welfare system will follow as the second part of my analysis. Under economic and political arrangement of authoritarian socialist countries, the system of social welfare was perhaps the most distinctive positive achievement of these countries. It presented a relatively successful part of the whole social and political arrangement with-

[65] *See supra* at 41.

[66] One of the few studies on the possibility of alternative approach toward reforms in Gregory Alexander, G. Skapska, *supra* at 4.

in the old framework.[67] The steps toward dismantling the existing welfare systems are seen by some experts as necessary measures to avoid the "premature welfare societies" due to the low level of economic development[68] whereas they are seen by the others as a further deterioration of basic social and living conditions.[69]

In the analysis of social welfare reform I will primarily focus on pension reform, which is currently the most debated and most important segment of social welfare. The analysis of pension reform will try to show how inextricably welfare reform is connected to the broad economic, social and political reforms in a particular country. The decision for a certain path of reforms always depends also on a broader understanding of the logic of institutional transformation and the general development policy. As we shall see, the current process of pension reform inevitably takes a similar path in different transition countries. As such, very predictable and almost immediately visible changes are taking place in the pension policy and social welfare, as well as the expected behavior of firm, individuals and the private sector.

Finally, I would like to finish the analysis of institutional changes in Central and Eastern Europe by discussing some of the future possibilities and prospects for the countries in transition. Certainly, one of the main prospects for some of the countries is entering the EU and becoming a full member of the Union. Obtaining full membership in the EU presents the single most important international commitment for the countries in accession negotiations. Poland, the Czech Republic, Hungary, Cyprus, Estonia and Slovenia are in the first round of negotiations and the rest of the Central European countries are in the second or third round of negotiation. Upon entering the EU, the countries in accession must adopt the body of European law – known as the *acquis communitaire.* The adoption of the *acquis* represents an enormous task for the governments of these countries, and upon successful implementation, almost completely re-regulates some of the most important areas of public and private activities in these countries. For example, public administration, instruments of industrial policy, competition policy, state aid policy, regulation of capital markets, company laws, accounting rules, regulation of the energy and telecommunications sector, regulation of

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67 The old system of social welfare was praised in particular because it created largely egalitarian societies where the level of inequality was comparatively low. The low level of inequality was praised by some Western experts as an important comparative advantage at the beginning of comprehensive reforms, but for some others it was from economic and ideological perspective less worthy of praise. *See* Alice Amsden *et al.*, MARKET MEETS ITS MATCH, Harvard 1994, p. 15 for the first view, and Janos Kornai, THE SOCIALIST SYSTEM, Princeton 1992, pp. 311–332 for the second view.

68 Janos Kornai, STRUGGLE AND HOPE, Edgar Elgar 1998.

69 Guy Standing, *Social Protection in Central and Eastern Europe: a Tale of Slipping Anchors and Torn Safety Nets* in Gøsta Esping-Andersen (ed.), WELFARE STATES IN TRANSITION, UNRISD 1996, pp. 225–255.

banking and the insurance market, trade law and many other areas will need to be substantially reformed.

Institutional analysis of transition will, therefore, not only have to examine the process of transition itself, but will also have to bear in mind the ultimate goal of all of the countries in transition – to become full and equal members of the EU. Rapid globalization also has a large effect on the countries in transition. Particularly, foreign direct investment policies and policies of increased international competitiveness substantially and rapidly change the existing economic and social landscape of the countries that were only ten years ago known as socialist economies. Thus, successful integration with the developed part of the world will depend not only on the abilities to dismantle the past command-style economic and social order, but more so on the ability to rapidly adjust to the new international regulatory framework. New rules, coming formally from the WTO or EU and informally from many other important international institutions (the World Bank and IMF in particular, but also from OECD, Basel Group and the like), are more strict and demanding and require closer scrutiny than ever before.

For the reasons mentioned here, the pathways from periphery are more difficult for the countries of Central and Eastern Europe than they were a few decades earlier when some of the East Asian countries succeeded in joining the developed part of the world. Increased international competitiveness, a stricter international regulatory framework and the rapid development of new technologies prevent the countries in transition from copying the success stories from the past within the new international regulatory framework and the new international economic landscape. In order to become equal partners in globalized markets, the present countries in transition must be able to complete their own domestic reforms while adjusting to the new international, legal, economic, political and social requirements.

MASS PRIVATIZATION AS THE CENTRAL PART OF INSTITUTIONAL REFORM

INTRODUCTION

Mass privatization throughout the former socialist world was the most distinctive and unique experience for the governments of the countries in transition, the reformers within these countries and their advisers. The grand project of massive redistribution of property entitlements, wealth and governance has, however, still left many unresolved questions. Therefore, it is appropriate to analyze the process of mass privatization on a comparative basis in order to find out the level to which this process lived up to its early promises and expectations and to establish the existing constraints upon firms. It is my belief that it is not possible to understand the present constraints that firms are subjected to without having an in-depth and comprehensive overview of the actual process of mass privatization in the countries in transition. As we shall see, some aspects of privatization are already well elaborated and documented, whereas some other aspects are still unexplained and obfuscated.

At the point of departure, the establishment of property entitlements through mass privatization was perceived by policy-makers and most scholars as "the most built-in stabilizer" for the former socialist economies. The dominant belief was that once you privatize the state firms, they will immediately start behaving as private profit-maximizing actors instead of relying on continuous support from the government. As such, it was believed that newly privatized firms will be able to restructure themselves and enter international markets as real competitors.

At a superficial level, this logic of enterprise and market reforms seems plausible. In practice, however, such logic proved significantly difficult to materialize. Of course, practical experience varies from one country to another – and it is not the aim of this thesis to search for commonalities for its own purpose – but there are certain issues within the actual process of privatization that seem to apply to all of the countries in transition. One such commonality has already been mentioned and described: the economic decline in the first years of transition, which was a universal and well studied phenomenon in the countries in transition.

Another important commonality among the countries in transition was the occurrence of an institutional vacuum due to the state withdrawing from running businesses. The institutional vacuum had many causes, some of them were more superficial and therefore more predictable, while some were conceptual and therefore probably less predictable. In many cases, the institutional vacuum certainly contributed to a very idiosyncratic process of transition with a very particular outcome of privatization. On a superficial level, the institutional vacuum lacked transparent rules of privatization at the beginning of reforms and even weaker monitoring institutions to enforce these rules. On a conceptual level, it presented an immediate and unconditional withdrawal of the state from running businesses which should have made a symbolic and practical turn towards market economy. As the following analysis will show in detail, many governments have forgotten that they do play an important role in organizing markets and businesses even in the most advanced economies. By analogy, the same is true for transition countries which started to establish market driven economies.

In the early stage of privatization, many important elements of legal framework were not in place or were underdeveloped and had poor chances of being implemented in practice due to the substantial legal infrastructure inherited from the past. For example, competition rules, financial market and securities laws, bankruptcy procedure rules, rules on improving payment discipline and rules on avoiding the chain of arrears were all underdeveloped or poorly executed in practice. Since the transition countries had to go through the process of privatization in such an underdeveloped legal environment, it does not come as a surprise that many opportunities for the rapid development and successful integration were missed. The free distribution of vouchers – a unique historic act – was overshadowed by massive fraud in too many cases to be perceived as a successful operation. In terms of economic efficiency on the firm level, many issues remained opened and overall improvement of industries despite many successful individual firms.

Many detailed studies on the economic efficiency of firms, the improvement of corporate governance, as well as corporate finance and industrial relations show that there are still many obstacles on the road of firm restructuring. Investment level, the introduction of new technologies and products and even setting up new industries show that institutional transformation still did not create an environment conducive to the rapid development of different industries. In the following analysis, I will argue that the partial success of some industries and some individual firms in the countries in transition did not primarily originate from successful and deliberate institutional reforms, but rather from the individual efforts of firms and industries that also enjoyed at least relative comparative advantages over other firms and industries at the beginning of reforms. To experience successful overall performance in the transition economies, further reforms in many important areas of law are needed. In order to complete the process of transition, however, the next wave of reforms must be based on careful studies and empirical analyses of the current results of the reforms. One important lesson that we have already learned, and that I will try to underscore in more detail, is that legal institutions imported from the developed part of the world do not behave in the same way in the transition countries as they do in the Western countries where they were developed. The ways to meaningfully adjust imported institutions from the West is perhaps the single most important challenge for the second generation of reformers in the countries in transition.

Privatization became the central most important task for the first generation of reformers, leaving many other important issues practically ignored. In doing so, privatization became a goal in itself. Clearly defined property rights were expected to solve the rest of the problems as long as government ceased interfering with business. Likewise, it was believed that a self-contained and self-regulated market should replace the former command-style economy. Such a model was expected to bring economic growth and overall successful economic performance. Yet the link between mass privatization and economic growth was not studied in detail, rather it was presupposed. Whereas there is no doubt that the link between mass privatization and economic growth was negative in the early stages of transition, the link between the two became more complicated and less certain along the course of reforms. It is true that neoclassical economic theory never questioned private property as a condition of economic development, but the positive link between the two remained less studied during the reform period.

An interesting observation in the first phase of reforms is that the economic decline afflicted practically all industries and firms regardless of their ownership structure. Government retreat from the control of state-owned enterprises did not contribute to their immediate recovery, rather it further deteriorated their situation in the markets. There are many causes for the deterioration in the first phase of privatization: legal uncertainties regarding the future owners of firms, financial uncertainties due to the lack of bank loans, payment problems, the hardening of the state budget (which meant the end of soft subsidies for firms), unclear signals and incentives from the market (which were not yet fully established) and the absence of new coordinating mechanisms to replace the abandoned mechanisms of the planning economy. In retrospect, the overall decline was unavoidable in such an institutional vacuum and in the described conditions of multiple uncertainties.[70]

[70] Comprehensive comparative study of the overall impact of economic decline in the first period of transition, *see* in Robert Holzmann, Janos Gacs and Georg Winckler (eds), OUTPUT DECLINE IN EASTERN EUROPE, *Unavoidable, External Influence or Home-made?,* Kluwer 1995.

The overall decline, measured by firms as the decline of industrial output, the level of new investments and wages, as well as the rapid growth of unemployment, certainly surpassed initial expectations. The following analysis will try to reveal which additional requirements and which policy measures would have to be in place in order to avoid the aforementioned decline and in order to secure long term competitiveness in the Central and East European economies. I do not wish to argue that the chosen path of transition was wrong in itself, but I wish to search for those policy measures and institutional solutions that might have contributed to a more efficient path of transition.

While searching for the improved policy and institutional measures, it is important to recognize the initial differences among the Central and Eastern European countries in transition. Some policy measures and some segments of institutional transformations significantly varied from country to country due to the different socio-economic and political settings under the socialist regimes and due to the efforts to reform and improve socialist economies in the past decades. For example, Poland started its early reforms at the beginning of 1980 due to its economic and political hardships, whereas reforms in the Czech Republic (former Czechoslovakia) started only after "the velvet revolution," which means that the first generation of post-socialist reformers inherited an almost intact socialist planning economy. The role of the initial conditions played an important role along the pathways of transition and should not be neglected, especially in the cases where similar policies led to substantially different outcomes. This does not, however, change the initial proposition that the countries in transition followed a similar trajectory of reforms, whereby mass privatization was the central element of the process of transition.

OVERVIEW OF MASS PRIVATIZATION

On the most basic level, undertaking the process of mass privatization means two main things: (1) the withdrawal of governments from running businesses, (2) establishment of a property rights regime, defined by the existing civil codes, such as the German or French civil code. The goals to be achieved by mass privatization were several, but the most important were: (1) the establishment of an autonomous business sector that operates firms according to market principles, not current political interests, (2) ending the practice of arbitrary subsidization of state-owned enterprises based on political criteria, (3) the establishment of accountability for managers to owners whose property entitlements are clearly defined and consolidated. On the macroeconomic level, mass privatization would contribute to the reduction of budgetary burdens and also raise revenues after selling firms to new owners according to privatizing schemes. On the microeconomic level, the establishment of property rights would solve the well-known agent – principal problem and would raise the investment level and profit rates to the privatized firms. As a result, mass privatization should contribute to the international competitiveness of the firms, while governments would not have to waste scarce resources on loss-making firms. Finally, legal institutions should secure the autonomy of the firms vis-á-vis governments while also guaranteeing the inalienability of the newly created property rights.

To achieve the described goals of mass privatization, the major question was how to design a privatizing scheme for such a unique operation in economic and social history. Above all, the transfer of property entitlements should enjoy broad popular support, or else the whole process of transition would lose its most important aspect: legitimacy in the eyes of the citizenry. Thus, the stated economic goals of mass privatization were mixed with political goals of securing broad popular support for such a large-scale and historically irreversible operation. The potential danger that mass privatization could prompt the contest betweeen old and new political elites for the (re)distribution of political power should have been prevented from the start.[71] It is still not possible to say which goal was more important at the beginning of mass privatization: whether to achieve greater efficiency for the privatized firms or to secure the necessary level of legitimacy so that the architects of reforms could enjoy the necessary level of trust and support to proceed with reforms.[72] Ideally, the reformers would have been able to achieve both sets of goals, efficiency and legitimacy, through securing the principal equity of privatization. As it turned out, in practice the obstacles and economic hardships along the path of reforms made the process of mass privatization more difficult and protracted then previously expected.

Several different ways of privatizing former socialist economies have been considered.[73] One possibility would be a direct sale of the firms, or

71 The contest among political elites for the (re)distribution of political power through privatization was not a novelty from the comparative perspective. In fact, it has been carefully studied and analyzed well before any attempts at privatizing former socialist firms took place. *See*, for example, Luiz Carlos Bresser Pereira, José Maria Maravall, Adam Przeworski (eds.), ECONOMIC REFORMS IN NEW DEMOCRACIES, Cambridge 1993, esp. pp. 1–76.

72 Adam Przeworski maintains that there is an intrinsic link between explosion of expectations and reality not only in the terms of political rights, but also in the terms of social transformation (*id,* p. 90), which certainly makes the task of the first generation of reformers so much more difficult. In this situation even the temporary sacrifices cannot be justified, which makes some of the tough policy measures virtually impossible, even though the potential benefits of such measures are likely to materialize in the foreseeable future.

73 For a discussion on the different possible approaches toward privatization *see* Jeffrey Sachs, *Accelerating Privatization in Eastern Europe: The Case of Poland,* PROCEEDINGS OF THE WORLD BANK ANNUAL CONFERENCE ON DEVELOPMENT ECONOMICS 1991, pp. 15–30.

even a giveaway, but such actions were impossible due to underdeveloped markets, especially in the case of larger firms. Another possibility would be to sell the firms through initial public offerings (IPOs), where large international investment banks would facilitate the offerings. However, underdeveloped capital markets, hampered by poor regulation and low level of household savings, made this method of privatization difficult to realize. Additionally, the method of privatization through IPOs would inevitably delay the process of privatization in circumstances where large number of state-owned enterprises needed to be privatized. Finally, there were many technical problems involved in the privatization. One of the major problems reformers had to face was finding a reliable method to establish the value of enterprise.[74] The simplest method of privatization would have been to declare the employees of the former state-owned enterprises as owners of the firms and to delegate property entitlements directly and freely into the hands of managers and workers. Yet such a method was unacceptable for several reasons: first, it would have contradicted the idea of economic efficiency, which dictates that outside owners are necessary,[75] second and most importantly, the free assignment of property rights to employers contradicted the declared goal of fairness.[76]

There were few other possible approaches, such as bank-led privatization, or privatization through pension funds, but they did not prevail. In the described situation, governments in the countries in transition opted mainly for privatization through distribution of voucher coupons, which became one of the most important characteristics of the process of transition. These vouchers could be used to buy either individual shares or shares in an investment fund. The primary innovations of mass privatization were thus the distribution of vouchers to citizens and the investment funds created and regulated by the newly adopted privatization legislation. Although the schemes of mass privatization varied from country to country, some of the most important characteristics of the process of mass privatization were similar in all of the countries which opted for the so-called voucher privatization.

The most unique and peculiar innovation of mass privatization was the free distribution of vouchers to citizens, which allowed them to participate in buying shares of firms or bidding in public auctions.[77]

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74 *Id.,* p. 19.

75 The debate about internal versus external owners of the firms is discussed *infra,* pp. 161–189.

76 "Although insiders should receive some explicit property rights in their enterprise as compensation for their implicit property rights, transferring whole firms to insiders at low prices is unfair to the rest of society. The [Polish] work force in state enterprises is about 3.6 million (in a labor force of 18 million) and of course, some workers are in profitable companies whereas others are in bankrupt firms." Sachs, *supra* at 73, p. 20.

77 The attempt at creating "popular capitalism" through the free distribution of vouch-

Reformers opted for the vouchers primarily to achieve fairness and to attract the citizenry into the process of privatization. In the eyes of reformers, citizens stakes in the process of privatization should secure broad support for mass privatization as well as contribute to an overall beneficiary outcome. The individual stakes were expected to raise the general interest of the citizens to promote the successful operation of the firms and, perhaps most importantly, guarantee the legitimacy of the process of ownership reorganization. Without legitimacy and without broad public support it was deemed impossible to implement and successfully complete the planned ownership transformation of the countries in transition.[78] Equally important to the fairness of mass privatization was the speed of the process. It was widely believed among reformers that any delay in the course of privatization could jeopardize the whole process and perhaps even reverse it.[79]

Voucher privatization was therefore a result of two basic assumptions: (1) such privatization would be easier and faster to implement than any other scheme of mass privatization, (2) such privatization should achieve a higher degree of fairness than any other form of privatization. The underlying idea was that once the government reassigned legal entitlements to the hands of citizens, the government would no longer play any role in the management of firms. Consequently, firms were required to become competitive in the (international) markets or else face the possibility of being shut down. Instead of competing for government subsidies and other forms of rents, which in turn required firms to fulfill political goals such as full employment or low consumer prices, firms would finally start behaving according to the market forces. Political obedience and dependency from the government would be replaced by laws and forces of the market. The firms which could not compete would go bankrupt immediately after the introduction of the bankruptcy laws that previously did not exist or were not implemented.

Czech example of voucher privatization

The prime example of the described scheme of mass privatization is the Czech Republic, which was the first of the countries in transition to

ers to citizens in Central and Eastern Europe, as a unique andinnovative characteristic of mass privatization, was described and analyzed by Zhiyuan Cui in Adam Przeworski (ed.), SUSTAINABLE DEMOCRACY, Cambridge 1995, pp. 91–106.

[78] The reasons for the introduction of vouchers are extensively analyzed. *See*, for example, The World Bank Development Report, *supra* at 6, pp. 44–56 (esp. p. 56**)**.

[79] "The need to accelerate privatization is the paramount economic policy issue facing Eastern Europe. If there is no breakthrough in the privatization of large enterprises in the near future, the entire process could be stalled for years to come." Sachs, *supra* at 73, p. 15.

undertake voucher privatization. It is worth taking a closer look at the Czech voucher privatization scheme, because as Coffee succintly stated, "the natural experiment in ownership structure transcends the East European context and with all the issues and unanswered questions it immerses itself with the broader international academic, especially in the field of monitoring the firms, incentives, conflicts of interests..."[80] The Czech example of voucher privatization was carefully studied for a longer period than any other example of voucher privatization. Before starting the survey, however, I need to mention that comparative literature still has not reached definitive conclusions on many of the posed questions and issues.

What made Czech voucher privatization especially attractive for reformers, advisors and researchers alike, was the two-wave issuance of millions of vouchers to citizens. As already discussed and observed by the main scholars of Czech voucher privatization, the rationale[81] for the chosen path was manifold. The proposed model was expected to overcome some of the most important deficiencies of the inherited conditions. Among these deficiencies were, for example, the large state industrial sector,[82] small domestic savings, and a lack of proper methods and market knowledge to evaluate the state owned assets. The most important anticipated advantages of voucher privatization were: (1) its ability to quickly perform the task of large scale privatization, (2) its designed fairness due to the distribution of vouchers to the citizens, (3) political acceptability, as voucher privatization did not present a sell-off to foreigners (who would, according to the popular perception, buy the prized national industry), (4) finally, fear that widely dispersed ownership would not seriously endanger the existing managers of the firms.[83]

The described rationale and the underlying premises of voucher privatization already show the complexity of the transition period. Above all, they present the complicated and delicate mixture of economic and political goals, where some goals stood clearly in opposition with others. For

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[80] On the lessons from the Czech experience *see* John C. Coffee, *Institutional Investors in transitional economies* in Roman Frydman, Cheryl W. Gray, Andrzej Rapaczynski, CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, The International Bank for Reconstruction and Development/The World Bank and Central European University Privatization Project 1996 (2 vol.), pp. 111–112 (vol. 1).

[81] The rationale for voucher privatization was analyzed by John C. Coffee, *supra* at 80, pp. 119–121. Political analysis and broader political context for the described rationale presented in Karla Brom and Mitchell Orenstein, *The Privatised Sector in the Czech Republic: Government and Bank Control in a Transitional Economy,* EUROPE-ASIA STUDIES, vol. 46, no. 6, 1994, pp. 893–928.

[82] 86 percent of gross national product was produced in the state sector, whereas only 4 percent in the private and 10 percent in the cooperative sector. As such, former Czechoslovakia stood among the former socialist countries as having the highest proportion of the GDP produced by the state sector. Coffee, *id.*

[83] *Id.*

example, withdrawal of the government from running the firms required substantial presence of government in the form of designing and regulating privatization, whereby the stated neutrality of government was impossible to achieve. One such 'non-neutral' decision was the creation of widely dispersed ownership – even though the establishment of the investment privatizing funds should have reduced the extreme dispersion – which could not threaten the existing position of the managers.[84] Choosing among different possibilities in the course of transition was always a blend of various goals, assumptions and desires, where a careful balancing had to take place before actual measures were adopted.

In technical terms,[85] two waves of vouchers were issued to citizens to materialize the idea of mass privatization. After the adoption of privatization laws in 1991, the first wave of privatization started in May 1992. Each adult citizen was eligible to purchase a book of vouchers for the nominal price of 35 USD. The idea behind selling books of vouchers for a symbolic price was that they should not be obtained entirely for free.[86] After subscribing for vouchers, citizens could decide whether to convert vouchers into shares through auctions or to place vouchers into invest-

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[84] This is not to argue that existing managers should or should not have been replaced, but only to show some of the many dilemmas of transition. In fact, as I try to claim throughout the thesis, more important than the unselective replacement of people in leading positions, based not on established market criteria, but on the beliefs and prejudices of the first generation of reformers, the countries in transition could not bring about immediate and substantial improvement. Such an approach based primarily on the assumption that managers are created rather than trained. Therefore, more important than unselectively replacing people is to create an institutional structure that provides proper incentives for managers, workers and their firms. The organization that is focused on work, cost reduction, quality of production and products, the search for new markets, as well as technological progress and rapid development, is not a result of the spontaneous emergence of new managers, but the result of trained managers and workers based on the broad set of institutional incentives given to them. For more about the critique of naturalistic approach toward market development and the spontaneous emergence of new managers *see* Cui, *supra 77*, pp. 94–95.

[85] Presenting the two waves of voucher privatization in the Czech republic (originally started in the former Czechoslovakia), I rely on the following literature and studies: Nemat Shafik, *Making a Market: Coupon Privatization in the Czech and Slovak Republics,* Policy Research Working Paper 1231, 1993, World Bank, Washington, D.C., Karla Brom and Mitchell Orenstein, *The Privatised Sector in the Czech Republic: Government and Bank Control in a Transitional Economy,* EUROPE-ASIA STUDIES, Vol. 46, No. 6, 1994, pp. 893–928, Ira W. Lieberman, Andrew Ewing, Michal Mejstrik, Joysita Mukherjee and Peter Fidler, MASS PRIVATIZATION IN CENTRAL AND EASTERN EUROPE AND THE FORMER SOVIET UNION, *A Comparative Analysis,* The International Bank for Reconstruction and Development/The World Bank 1995, David S. Young, *The Demand Side of Voucher Privatization in Central and Eastern Europe,* in Ira W. Lieberman, Stilpon S. Nestor, Raj M. Desai (eds.), BETWEEN STATES AND MARKETS, *Mass Privatization in Transition Economies,* The International Bank for Reconstruction and Development/The World Bank 1997, John C. Coffee, *supra 80*.

[86] This presented about 25 percent of the average monthly wage. *See* Coffee, *supra 80*, p. 123.

ment privatization funds (IPFs), which would bid for blocks of enterprise shares on the same auctions.[87] In the first wave of privatization, five rounds of bidding procedures were organized. The original lack of interest of the citizens to participate in bidding rounds was overcome the moment one of the newly created investment privatization funds – Harvard Capital and Consulting (HC&C) – made its famous, albeit vague, promise that it would redeem shares in its IPFs after one year at a price equal to 10 times the cost of a voucher booklet.[88]

While the government issued voucher booklets for citizens to participate in the process of privatization, large firms issued shares to meet the newly created demand. All shares were assigned a nominal value of 1,000 CSK (the same amount as a voucher booklet had points). The number of shares reflected the book value of the firms to be privatized. In the eyes of the citizens and the IPFs, some of the firms were better than others, some were bargained for their nominal value, and some others seemed overpriced.[89] As Coffee describes, when demand exceeded the supply of shares by 25 percent or more, no sales were affected in the first round and prices would be raised in the second round. However, when supply exceeded demand, all bids were accepted and the remaining shares were offered at a reduced price in the next bidding round.[90]

From the description of the bidding rounds it becomes obvious that skillful investors would choose the optimal round for a successful placement. Investing too soon could mean that the price was too low and waiting for too long could mean that the shares were oversubscribed. During the bidding rounds, regulators did everything to avoid the situation where voucher points could be wasted if particular stock remained oversubscribed until the last round. Such a situation could potentially lead to the dissatisfaction of investors, whereas the inverse situation of an excess supply of shares was acceptable.[91]

Success in bidding rounds was measured by investors as the net asset value per voucher book. Not surprisingly, investment privatization funds were successful in gathering vouchers from the citizens due to the promises funds made to them. IPFs were also successful in subscribing for shares, whereas some of the citizens wasted their vouchers. Ultimately, both ways of privatization were dominated by a few large investment privatization funds – IPFs, that attracted most of the trust of citizens and were capable of broadly diversifing their portfolios through the bidding

[87] Ira W. Lieberman, Andrew Ewing, Michal Mejstrik, Joysita Mukherjee and Peter Fidler, MASS PRIVATIZATION IN CENTRAL AND EASTERN EUROPE AND THE FORMER SOVIET UNION, *A Comparative Analysis,* The International Bank for Reconstruction and Development/The World Bank 1995, pp. 6–8.

[88] Coffee, *supra 80*, at 124.

[89] *Id,* at 131.

[90] *Id.*

[91] *Id,* p. 132.

rounds. The level of risk differed amongst the IPFs, as some invested heavily in the early rounds of the bidding process and some took the risk waiting until the end.[92]

After two waves of privatization through a rather complex bidding process, the large-scale privatization had come to an end in 1994. As a result of the two waves of privatization (Slovakia participated only in the first wave, whereas the program stalled after gaining independence shortly after privatization started), more than half of the former state-owned assets had been transferred into private hands.[93] To put that in figures, 1,849 firms – 56 percent of the 3,278 Czech companies selected for joint stock conversion – were completely or partly privatized in the period between 1991 and 1995.[94] The newly created private sector started to produce between 65 and 70 percent of share in GDP in the years 1994 and 1995,[95] almost equal to the share of privatized medium and large enterprises.[96] The number of citizens that participated in the bidding process either directly (through auctions) or indirectly (through IPFs) was 8,54 million.[97]

The book value of the 1,849 privatized companies in the two waves of privatization was 12.3 billion USD.[98] The assets of the newly privatized firms went primarily into the hands of IPFs, which were able to obtain more than 70 percent of all vouchers from the citizens.[99] IPFs duly diversified their portfolios, partly due to regulatory requirements, partly due to their strategic decisions. At the beginning of privatization, firm managers had to submit a detailed plan of privatization to the Ministry of Industry and Trade for initial approval and the Ministry of Privatization

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92 Coffee reports that particularly successful tactic was a YSE private fund, which deliberately withheld most of its vouchers for the last two rounds in which the price of shares had already been drastically reduced. Some others were less successful in these tactics and wasted up to 20 percent of their vouchers. Still, some others, less prone to risk, invested heavily in the early rounds of the bidding process at higher prices. *See* Coffee, *supra 80*, p. 133.

93 WORLD BANK DEVELOPMENT REPORT 1996 – FROM PLAN TO MARKET – describes the Czech Republic's mass privatization as "the most successful to date," p. 56. As we shall *see* later, an equal or even more ambitious privatization plan took place in Russia.

94 Raj M. Desai and Vladena Plockova in the case study *The Czech Republic,* in BETWEEN STATE AND MARKET, *Mass Privatization in Transition Economies, supra* 85, p. 191.

95 Statistical data on the development of private sector in the Czech Republic from THE EBRD TRANSITION REPORT 1998, London 1998, p. 162–163.

96 *Id.*

97 As Coffee reports, 8.54 million citizens bought and registered voucher books (out of an estimated 11 million eligible citizens, or 77 percent of population in the Czech Republic), of which 5,8 million chose to invest with one or more IPFs, while another 4 percent split their investment, contributing some voucher points to an IPF, but also retaining some points for individual investment. *Supra 80*, at 123 and 127.

98 Coffee, p. 129.

99 *Id*, p. 127.

for final approval. What was especially interesting was the commitment of the Ministry of Privatization to secure competition at the privatization plan stage.[100] According to Coffee, the speed of privatization was compromised with the introduction of competitive privatization plans, where not only managers, but also prospective buyers of firms could present their privatization plans to the Ministry of Privatization. Thus, individual firms in the first wave were on average the object of four privatization proposals, whereby managers preferred voucher privatization over other options, such as direct sale to third buyers.[101] As Coffee concludes, managers were unwilling to risk because of the fear of being removed from their offices immediately upon sale. This does not mean, however, in many cases of direct competition that the Ministry of Privatization did not hesitate to approve the buyer's proposal over the managerial one.[102] Finally, after approval was granted, the firms were commercialized, and ownership was transferred to the National Property Fund (NPF) for the execution of the program.[103]

The incorporatization of firms, the preparations of privatization plans, the listing of firms for auctions, the auction bidding process and firm privatization would not be possible without another important institutional innovation in transition, called the National Property Fund (NPF).[104] Although the principal objective of the reformers in the Czech Republic was to create as few regulatory bodies as possible and to promote market initiative as much as possible, the complex process of privatization without the support, supervision and regulation of public institutions was not possible. The government remained a residual shareholder directly or indirectly through the NPF, a quasi-governmental agency. The reasons for remaining a shareholder were several. One part of reasons stems from the government's desire to retain control over the selected industries of firms that were deemed of strategic importance or required regulatory presence and control. Another part of the reasons stem from the government's interest to either continue benefiting fiscally or from tactically waiting for higher prices of the firms in the future. Two other possi-

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[100] About the preparations for privatization at the firm level *see* Coffee, *id,* pp. 121–123.

[101] *Id,* p. 122.

[102] *Id.*

[103] Katharina Pistor, Joel Turkewitz, *Coping with Hydra – State Ownership after Privatization, A Comparative Study of the Czech Republic, Hungary and Russia* in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA (vol. 2), *supra 80*, pp. 195–197. As the authors point out, state ownership after first wave of privatization remained particularly high in the financial and heavy industry sectors.

[104] NPF was the institution perceived as subsidiary of the main privatization institution. As such, a privatization minister headed the supervisory body and the deputy minister was its chief executive. *See* Stilpon S. Nestor, *Insitutional Aspects of Mass Privatization: A Comparative Overview* in BETWEEN STATES AND MARKETS, *Mass Privatization in Transition Economies, supra* 85, p. 23.

ble reasons were that the government wanted to restructure designated firms before selling them, and finally, a large number of firms and industries remained in the government's hands because it was not possible to sell shares on the market. Whereas the majority of the previously described reasons stemmed from *ex ante* deliberate decisions of the government, the last one came as an unexpected result of privatization.[105]

Thus, after two waves of privatization, the NPF retained holdings in 945 enterprises, although it held less than 19 percent in most (653 enterprises), and it also held more than 34 percent in 182.[106] Although the NPF became the state's main agent in share management during the process of mass privatization, the role was assigned to the Ministry of Industry.[107] The demand for clear strategy in strategic enterprises was understandable, but due to various trajectories of becoming a strategic national enterprise and due to several different ministries involved in continuous control of these enterprises, the strategy was conducted. According to analysts, the involuntary retained assets did not present a major problem, because of the government's principal commitment not to retain or dispose with any of the firms' assets outside the financial sector.[108] Despite the strong commitment of reformers to avoid any bureaucratic obstacles in spinning off the remaining state shares, in April 1996, the NPF still owned shares in 968 enterprises, of which a large residual share portfolio resulted from unintended consequences related to the Czech approach to privatization.[109]

Not only did the NPF retain a vast residual portfolio, it also retained majority ownership in some of the largest enterprises in the country. On the basis of available data from 1996, Schwartz reported that in fourteen out of the twenty largest Czech enterprises the state owned at least 46 percent of stakes.[110] The vast residual portfolio in the hands of the central government (and to a lesser extent in the hands of the local governments) raised the issue of the management and governance of the residual state shares. The issue is even more interesting because the government had a clear and strong commitment to leave the economy to the market and to reduce the role of government to a minimum. Instead, after two waves of privatization efforts, the Czech government had to

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105 For a theoretical discussion and practical reasons regarding the government remaining a residual shareholder, *see* Karla Brom, *On the Management and Sale of Residual State Shareholdings* in BETWEEN STATE AND MARKET, *Mass Privatization in Transition Economies, supra* 85, pp. 65–66.

106 *Id*, p. 66.

107 *Id.*

108 Pistor and Turkewitz, *supra* 103, at 223.

109 The unintended and surprising outcome of privatization analyzed by Andrew Scwhartz, *The Czech Approach to Residual Share Management,* in BETWEEN STATE AND MARKET, *Mass Privatization in Transition Economies, supra* 85, p. 70.

110 *Id.*

deal with yet another quasi-state institution that became an important player in transition.[111]

The NPF's organization, regulatory powers and governance of the firms show that the institution became at odds with many of the proclaimed goals of the reformers. Although it was founded to play "a passive role as the midwife of the privatization process," (Coffee, p. 121) and its officials showed strong commitment to avoid bureaucratic obstacles (Coffee, *id.*), the NPF had to assume a more active role in the course of transition. The unexpected and unintended role of the NPF was even more difficult to perform due to the previously described mixed trajectory of the firms that found themselves under the government umbrella. Additionally, in many large and important firms, not only the NPF, but several other ministries (usually the Ministry of Industry and the Ministry of Finance) participated in controlling and governing the state-owned enterprises.[112] From different trajectories and different reasons of remaining under the state umbrella also different and often contradictory approaches toward governance were originating, where clear objectives of how to proceed with the firms usually were not specified. Needless to say, this created additional problems for the NPF officials that were designated to monitor the firms, for the managers and for the prospective buyers of those firms.[113]

There were two main groups of firms assigned to the NPF: (1) a large group of 'non-strategic' firms, and (2) a small group of firms with strategic importance.[114] In dealing with these firms, the plan was to sell the first group of firms in the near future without interfering with the governance of firms. The plan for the second group of firms was to prepare them for privatization when they were in high demand on the market. Therefore, question for the NPF officials was what to do with the firms in the meantime, especially if the market would not absorb the whole group of fully or partly owned state enterprises at once. Since the NPF was created primarily to secure approved privatization projects and its officials were not instructed or trained to be corporate managers,[115] officials had to confront new challenges.

[111] Of course, Coffee is right in saying that in contrast to German Treuhand, who was playing the role of a policymaker, auctioneer, and amateur investment banker, the Czech NPF did not play such a prominent role. This does not mean, however, that the NPF did not play an important role in the Czech transition; and as Coffee concludes, the NPF continued to hold a potentially pivotal role in many major Czech corporations even after privatization. *See* Coffee, *supra* 80, p. 121.

[112] Karla Brom, *supra* 105, p. 66.

[113] *See more* about the difficulties encountered by NPF officials in Karla Brom, *supra* 105, pp. 65–69 and Andrew Schwartz, *supra* 109.

[114] Schwartz reports the total number of firms in the NPF share portfolio, as of April 1996, was as follows: out of 968 enterprises in full or partial ownership of NPF, 909 were deemed 'non-strategic' and 59 strategic. The portfolio share in those enterprises ranged from 100 % (23 enterprises) to 0–19 % of the shares in 653 enterprises. *Id,* p. 71.

The decision for a large number of 'non-strategic' firms was rather easy: officials were instructed to play a limited role in enterprise management, that is, their activities could not impede the planned privatization of the firm. They were instructed to pay special attention to the changes in ownership structure, significant property sales, issues of convertible debt, shifts in basic capital, and negative auditor reports.[116] Outside this limited scope, officials did not interfere with the management of firms. In practice, however, this limited and passive approach toward firm governance produced some serious difficulties. Commentators pointed out some of the most important deficiencies of the passive approach: weak monitoring of management did not contribute to corporate governance improvement, incentives for the monitors were not clear due to the temporary character of ownership, and perhaps most importantly, the temporary character of unsettled ownership created uncertainties for management to the extent that it prevented long-term investments in the firms.[117]

A different approach was attempted with enterprises of strategic importance. The strategically important enterprises were mostly from the financial, steel, mining, petrochemical and refinery, manufacturing, telecommunication, utility and transportation industries.[118] In strategic enterprises, the government carried on with a range of traditional interventionist policies. Not all of the measures were appreciated internationally. However, some of the measures were appreciated internationally, for example, selected interventions in the form of subsidies, credit access and protection from bankruptcy.[119] Despite some of the obvious difficulties in performing these measures, such as the fact that NPF officials were not prepared or trained to become the managers of the state-owned enterprises, the surprising and forgotten fact is that the Czech government was successful in financially restructuring many of the strategic enterprises. As reported by Schwartz, the Czech government succeeded in reorganizing and restructuring many of the enterprises before they faced the market for the first time. This was especially important during the accumulated inter-enterprise debt, which in 1992 caused 43 percent of all firms to become insolvent.[120] The selective removal of debt from enterprises' books through the Consolidation Bank or the NPF and the re-capitalization of creditor banks allowed strategic firms to weather and

115 For a discussion on the elemental task of NPF *see* in Schwartz, p. 71.

116 *See* Scwhartz, p. 72.

117 About the difficulties of the passive monitoring *see* more in Brom, *supra* 105 and Scwhartz, *supra* 109.

118 For a precise breakdown of the strategic enterprises and the government's share *see* Scwhartz, p. 72.

119 *See* Schwartz p. 74 and Brom p. 66.

120 Schwartz p. 75.

restructure in difficult times.[121] Incentives to creditors and managers to carry out the debt-equity swaps were also provided by the government.[122]

Within the strategic enterprises, these and other measures of selective intervention played an important role in restructuring the important parts of the national economy. The success of intervention was mixed; in some cases it was convincingly positive while in some other cases it was negative. For instance, the restructuring of the coal-mining industry was considered a successful example of state intervention based on state aid[123] on one hand, and gradual downsizing on the other hand. Some other cases, such as the restructuring of the steel industry, were considered a failure, apparently due to the deep politicization of the approach toward restructuring.[124] Schwartz believes that consistent government policy toward the restructuring of the certain strategically important sectors played a crucial and determining role. Similar was the experience with foreign direct investments, where the state remained a minority shareholder and in the cases of joint venture with foreign investors, where the state could offer a collateral to foreign investors. Learning from the experience of negotiation and concluding contracts with foreign investors, some of the arrangements turned out to be more successful than others.[125] Governments that gained the capacity to impose tough sanctions on the investors who would not meet contractual obligations significantly improved their bargaining position.

The overview of the role of the NPF in the process of privatization shows the significance and importance of transparent and coherent government policy through the NPF and the line ministries. They proved that it is possible to successfully restructure and run state-owned enterprises without necessarily falling under the pressure of interest groups and lobbies. The better the policy and goals were articulated, the greater the chance of successful restructuring.

This is not to say, however, that the policies of the NPF or the line ministries were flawless and that they did not fail in some cases. The importance of the state and quasi-state institutions lies within the fact they were capable of restructuring and running an important part of the national economy. Bearing in mind that NPF officials had to confront severe macroeconomic conditions and an environment disinclined

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121 *Id.*

122 *Id.*

123 State aid included subsidies in the purchase of machinery and equipment, in ecological clean-up, and within the coal industry in included protection from foreign competition (Polish mines), while the workforce declined from 90,000 workers in 1990 to about 34,000 in 1994, Schwartz, pp. 75–76.

124 *Id.*

125 The arrangement between Skoda and Volkswagen was well-known internationally, whereas some other arrangements were less successful. *Id.*

toward government intervention, the role and importance of the NPF is such that it deserves serious attention of the analysts of transition and the scholars of institutional transformation. Being designed originally as a purely technical institution to facilitate mass privatization and despite having ill-prepared staff to actively run and restructure firms, the NPF, as a by-product of transition, became one of the crucial players in the process of transition. Having dissolved the old coordinating mechanisms of the command economy, the NPF assumed an analogous role on the path toward a private market economy with its own regulatory framework.

The regulatory framework of IPFs

Another important innovation of voucher-privatization was the creation of the IPFs. Unlike the NPF, whose poorly regulated role developed as an unintended consequence of unfinished privatization, the IPFs were envisaged from the beginning to secure the smooth path towards market economy. Furthermore, reformers strongly relied on them to achieve this goal. Consistent with the views of the Czech government regarding how the process of transition should look like, reformers relied on private initiative. Government allowed the free entrance of newly created private investment funds, while providing only a rudimentary regulatory system.[126] A rudimentary regulatory system and a generally permissive environment accompanied by liberal licensing from the Ministry of Finance brought about the rapid evolution of privatization investment funds. Since substantive regulation to found IPFs was minimal,[127] in theory, anyone could establish an IPF. These 'bottom-up' developments of the market for IPFs produced 420 IPFs that participated in the first wave of privatization (at that time the Czech Republic and Slovakia were still the same country) and an additional 221 IPFs participated in the second wave of privatization.[128]

The underlying reasons for such a permissive approach toward IPFs are mainly twofold: (1) in the eyes of the Czech reformers, granting con-

[126] On rudimentary regulatory system *see* Stilpon S. Nestor, *supra* 104, p. 22. For the inclination of the Czech government toward *ex post* regulatory approach *see* David Stark and Laszlo Bruzst, POSTSOCIALIST PATHWAYS, *Transforming Politics and Property in East Central Europe,* Cambridge 1998, p. 157.

[127] to have a minimal basic capital of 100.000 (which was later raised to 1.000.000 CSK or 33.000 USD), professional qualification requirements for supervisory board members and their officials (which was not specified or controlled), and that the IPF had a contract with a bank to act as its depository. *See* Coffee, *supra* 80, pp. 124–125.

[128] Coffee, *id,* p. 127. *See* also Brom and Orenstein, *supra* 128, pp. 904–909 and Katharina Pistor and Andrew Spicer, *Investment Funds in Mass Privatization and Beyond,* in BETWEEN STATE AND MARKET, *Mass Privatization in Transition Economies, supra* 85, p. 101.

cessions to employers would lead to the prolongation of the old economic system, which was based on hierarchy and party loyalty, (2) and the extreme dispersion of vouchers among millions of citizens without intermediaries would create insurmountable problems for the governance of the newly privatized firms. The first of the aforementioned reasons was clearly ideological and stemmed from the belief of the reformers that concessions to employers would create insider control of the firms, which would, in consequence, prevent them from restructuring. The ideological conflict of insiders *versus* outsiders was resolved in a decision not to grant any concessions to the insiders. Concessions to the insiders would support the former socialist regime, while support for the outside control of the firms would benefit the reformers and new owners of the firms, whose free-market orientation was preferred over political loyalty to a Party.[129] On the other hand, extreme fragmentation of the ownership of the firms due to distribution of vouchers to the citizens would cause the governance of the firms to be anything but efficient. Through the establishment of intermediaries by creating the IPFs, the problem of extreme fragmentation should have been overcome. It is important to bear in mind, however, that the government did not play any role in the creation of the IPFs and that it adopted highly permissive legislation for creation of the IPFs.[130]

The described approach toward the establishment of the IPFs and their envisaged role partly explains the outcome of the two waves of voucher privatization. In the bidding process the two most important limitations for the IPFs were that each IPF could only buy up to 20 percent of the stock in a single company and that the IPFs were required to diversify their assets so that they did not invest more than 10 percent of their capital in any one security.[131] After an aggressive advertisement campaign before and during the first wave of the privatization, and many promises to attract citizens vouchers were made, the IPFs turned out as the holders of more than 70 percent of all the voucher points. The subscribed voucher points were duly diversified in more than 1,800 firms that were listed for privatization. Despite the fact that a few hundred newly created IPFs participated in the privatization, the bulk of the voucher points and equity shares went to ten or fifteen biggest IPFs. The success in obtaining voucher points from the citizens depended mostly on advertising, marketing and on the backing of the existing banking sector.[132]

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[129] *See* more about the debate on grantging concessions to employees in Coffee, *supra* 80, pp. 144–145.

[130] Coffee, *supra* 80, pp. 124–125.

[131] Coffee, *supra* 80, p. 125.

[132] These are the findings from the field study and analysis made by Brom and Orenstein. Authors reported about the part-time agent that was hired by the IPFs to can-

When analyzing the structure and origin of the IPFs, two main groups of funds can be distinguished: (1) bank affiliated and (2) independent funds. The distinction is the ones that were founded or managed by the existing banks or insurance companies and IPFs, which were founded by other physical or legal persons. Although it was initially expected that the bank sponsored IPFs would gather most of the voucher points, the outcome after two waves of privatization was that some of the independent funds did equally well or even better than the bank sponsored IPFs. Still, only a handful of IPFs gathered a substantive number of voucher points, which allowed them to exert influence on the future development of firms and markets.[133]

What made the Czech voucher privatization effort and its outcome differ significantly from any other mass privatization efforts in Central and Eastern Europe is that the proportion of shares and assets transferred to the external owners were mainly in the form of IPFs. To illustrate better the newly gained leverage of the external owners over the owners, one must look at the employee shares after privatization. Earle and Estrin report that after the first wave of privatization the average employee shares across all firms in the program was 4.4 percent.[134] Additionally, only 3 firms in the first wave of privatization were given the concession that employees could hold more than 50 percent of its shares.[135] The only more important concession to the insiders was that the privatization plans proposed by management were almost always approved over the competing plans proposed by others.[136]

An analysis of the development and structure of the IPFs, and the constraints and opportunities given to them, becomes even more important because funds became crucial market players in the restructuring of firms. The emphasis in the following sections of this study will therefore be in assessing the capabilities of the IPFs to actively participate and

vass voucher holders to register for them. Other IPFs used school children to do the same for them. Brom and Orenstein, *supra 85*, 906. *See* also Coffee, *supra* 80, p. 127.

133 *See* Coffee, p. 117, pp. 137–139 and the note 23 on p. 127: "Ralf Egerer estimates that the 10 largest bank-sponsored funds held 61 % of all points acquired by all IPFs (or about 43 % of all voucher points) (footnotes ommited)." *See* also Brom and Orenstein, *supra 85,* pp. 905–910.
According to Desai and Plockova, the five largest Czech financial institutions – the "big four" (Ceska Sporitelna, Komercni banka, Investicni banka, and CSOB) plus the state insurance company Ceska pojistovna – acquired 42 percent of fund-held points in the first wave, falling to 19 percent in the second. Overall, these five institutions acquired 32 percent of fund-held voucher points over the course of the privatization waves. Desai and Plockova, *supra* 94, p. 192.

134 John S. Earle and Saul Estrin, *Employee Ownership in Transition,* in Roman Frydman, Cheryl W. Gray, Andrzej Rapaczynski, CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, *supra* 80, p. 38.

135 *Id.*

136 *Id.*

secure the process of restructuring, which was urgently needed to improve the market positions and international competitiveness of the firms.

Preliminary findings and conclusions

Before continuing with the survey of privatization in Central and Eastern Europe, it is worth dwelling on the preliminary findings about the process of privatization in the Czech Republic. To date, it has been the most documented and analyzed process of privatization, despite the fact that even a decade after the beginning of reforms, many of the important data are still inconclusive. But the existing findings should suffice to provide us with more insight into the logic of institutional reform in Central and Eastern Europe.

A measure of transition success can be of two different origins. One is to compare the original expectations and plans with the final outcome of the reforms, while another perhaps most important measure is to be able to make plausible assessment on the overall improvement of efficiency and fairness of privatization. In this section I will make preliminary estimates on the basis of the first measurement and I will conclude with some preliminary estimates on the basis of the second measurement.

If the key goal of mass privatization was the withdrawal of government from running businesses, then it is difficult to give a completely positive mark on this issue. There is no doubt that the government stood firmly behind and remained deeply committed to the stated goals throughout the privatization process. The fact that within a period of five years the private sector grew practically *ex nihilo* and that it started to contribute between 65 and 70 percent to GDP, show not only strong government commitment but also that it succeeded in materializing its proclaimed goals. In the process of privatization, millions of citizens could become small owners of shares of the firms they chose. Alternatively, citizens could place their vouchers in the investment privatization funds, which were converting vouchers into shares of the firms through competitive bidding proces.

A closer look at the process of privatization and its ownership structure at the outcome of privatization show, however, a much more complex picture, which in many ways deviates from the classical theoretical premises of consolidated property rights. There are many remaining aspects which do not confirm that Czech voucher privatization was the "genuine" one in the sense that it provideed – at least theoretically – what consolidated property rights should provide: proper incentives for those with assigned property entitlements, strengthened accountability and the optimal solution of the 'principal/agent problem.' Only consolidated property rights in this sense could consequently bring about wealth maximization. As opposed to the classical theory on the consolidated property rights, the Czech privatization experiment could not satisfy all the theoretical presuppositions of private property rights.

The most peculiar characteristic of voucher privatization was the cross-ownership between the new investment funds, IPFs and their founders – banks, which underwent a similar path of privatization.[137] David Stark, one of the most distinguished scholars of transition, concluded on the basis of the described dense cross-ownership relations in the financial sector, "voucher privatization did not sever the ties between the state and economic institutions; it reorganized them."[138] He came to this conclusion on the basis of ownership analysis, which showed the interlocking ties between the network of relating holdings with an ambiguous ownership character. As such, Stark believes that the density of networks and crisscrossed relations surpasses even that of the Japanese *keiretsu* groups.[139]

Despite becoming main owners of the privatized firms,[140] IPFs by and large did not play an active owner role. A high level of cross-ownership between banks and funds developed not as a result of deliberate legislative action, but primarily as a result of regulatory failures during the process of privatization. Namely, the Czech law on investment funds expressly prohibited that IPFs could buy shares of their founders or of banks. IPFs, however, simply bypassed the law by founding other investment companies as wholly owned subsidiaries, which in turn founded various IPFs that started buying shares of founders.[141] As a result of the mutual buying of shares, the lack of incentives to maximize the wealth of a fund's shareholders became traceable and empirically confirmed.[142] Rudimentary original legislation accompanied by *ex post* regulatory failures and weak institutions to monitor the implementation of legislation without determined sanctions did not contribute to the governance capabilities of the IPFs. In this regulatory environment, IPFs had two differ-

137 On incestuous relationship in the Czech financial sector at the outcome of voucher privatization *see* Coffee, *supra* 80, pp. 145–149.

138 Stark, *supra* 126, p. 159.

139 *Id.*

140 Due to the highly fragmented ownership for *de facto* control over the firms, it sufficed for the IPFs to acquire far less than 50 percent of ownership, regardless of the IPFs acting collectively or if other IPFs acquired only a small percentage share in the same firm. *See* Coffee, *supra* 80, p. 141. Due to similar interests – preventing managerial or employee diversions of assets and securing competitive assets – IPFs in the early stage did not have problems acting collectively on the supervisory boards. In the latter stages, this cooperation gradually disappeared due to the inherent conflict of choosing which bank should become the primary lender to the firm. *See* Coffee, *supra* 80, pp. 153–154.

141 For an anlysis of the regulatory failure and the practice of bypassing the existing laws analyzed, *see* Coffee, *supra* 80, p. 148.

142 Coffee, *supra* 80, p. 147.

ent types of substantive problems: one had to do with finding qualified and educated staff, and the other had to deal with the issue of financing and capital markets.

IPFs used different method to solve the problem of finding qualified people with the necessary skills and experience to make strategic decisions on the boards. Some smaller and less developed funds simply decided to send their representatives to gather information about the firms and to notify the fund managers without actively interfering with business decisions. Bigger and better organized IPFs were able to draw people from the small pool of existing qualified people and send them to vote on the boards of various firms.[143] There are serious doubts that the limited number of people could actively engage themselves with running the highly diverse set of firms. Finally, some of the IPFs solved the problem by simply hiring people from the banks that founded them.[144] It does not come as a surprise that most studies show that IPFs representatives did not contribute much to improve the governance of the firms, as they were unable to offer any advice to the managers since they lacked business plans and coherent strategies for the firms.[145]

Another set of substantive IPF functioning problems related to the issue of financing and capital markets. The obvious and very important consequence of voucher privatization is that newly created investment privatization funds did not bring fresh capital to the firms upon the transfer of formal ownership. Apart from the fiscal consequence in raising only small proceeds from mass privatization,[146] this created a major obstacle toward the establishment of fully consolidated property rights.[147] A lack of qualified people to participate in strategic decisions, the inability to raise capital on the illiquid capital market, and weak institutional incentives to actively engage in the restructuring of firms did not make IPFs strategic partners to the firms. Despite large equities, outside owners of the firms proved similarly unable to substantially improve the

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[143] Since the typical *bank-affiliated* IPF would diversify its portfolio without any deliberate selection, those IPFs had to monitor the portfolio between 200 and 500 firms. Independent funds were more careful in portfolio selection, and the portfolio of the HC&C – one of the biggest private IPFs – consisted of around 50 firms. *See* Coffee, *supra* 80, p. 133–134.

[144] Coffee, *supra* 80, p. 150–152.

[145] *See* Coffee, *supra* 80, pp. 152–153 and Pistor and Spicer, *supra* 128, p. 102. Anecdotal findings showed that there were board representatives occupying 10 to 13 board seats and in extreme cases even 40 seats. *See* Coffe, *supra* 80, p. 153.

[146] EBRD TRANSITION REPORT 1999 states for the Czech Republic that by 1997 the cumulative revenues from privatization represented 3.3 percent of the GDP. P. 212–213.

[147] As noted by Pistor and Spicer, "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." *Supra* 128, p. 98.

governance of the firms than any other potential owners of the firms. From the perspective of the Czech reformers, any other potential owners were less capable and therefore less desirable. Instead of overcoming some of the problems of mass privatization, such as the extreme fragmentation of ownership, and becoming the key actors in transition, IPFs proved incapable of efficiently governing the firms. Researchers and experts of transition concluded on the basis of existing studies and available data that IPFs did not act as active owners of the firms and had only little impact on the restructuring efforts of the firms.[148] Some of the harshest critics even suggested that "the long term consequence of voucher privatization with investment funds is a *de facto* 'industrial policy' of real sector decapitalization in favor of short-term rent-seeking by fund managers through board sinecures and lucrative side deals with portfolio companies and through financial market manipulation and paper entrepreneurship in the "financial sector."[149]

Still, the difficulties with the performance of the IPFs as strategic owners of the firms does not necessarily mean that IPFs became completely marginal players in the process of ownership structure consolidation. The data show, for example, that until 1995 the change in ownership caused changes in board membership, in boards of directors and supervisory boards.[150] Despite poor commercial and securities regulation, which brought the "third wave" of privatization, and the period of unrestrained mergers and acquisitions without the protection of minority shareholders,[151] the available evidence suggests that corporate improvement in fact took place in the privatized sector of the economy. According to an empirical study made by Claessens, Djankov and Pohl, firm profitability, labor productivity, and the propensity to open a new marketing department are positively related to the ownership concentration of the firms.[152] The study, based on a survey of 706 Czech firms in the period between 1992 and 1997, showed that an increase in ownership

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148 Pistor and Spicer, p. 102. *See* also Coffee, pp. 154–156.

149 David Ellerman, *Voucher Privatization with Investment Funds – An Institutional Analysis,* THE WORLD BANK POLICY RESEARCH WORKING PAPER 1924, May 1998 (summary findings).

150 According to survey presented in Desai and Plockova, "during the 1994–95 more than half the members of boards of directors had been replaced, as was similarly the case with the supervisory boards." P. 192.

151 Before the Parliament in May 1996 adopted a new package of legislation regarding the Commercial Code, the Securities Act and the Stock Exchange Act, the takeovers of the firms did not require prior public announcement. This often meant that minority shares became non-tradable or that their prices plummeted. The absence of regulation also created the space for privileged insider trading. *See* Desai and Plockova, *id,* pp. 192–193.

152 Stijn Claessens, Simeon Djankov, Gerhard Pohl, *Ownership Structure and Corporate Performance: Evidence from the Czech Republic,* THE WORLD BANK POLICY RESEARCH WORKING PAPER 1737, Washington DC, 1998.

concentration leads to an increase in the measured variables (firm profitability, labor productivity, and the propensity to open a new marketing department). Thus, the study confirms the historical Berle and Means thesis, which indicates that diffused ownership leads to the inability of owners to monitor managers.[153]

The study did not, however, show there were any direct positive links between the activities of the investment funds or the "real" strategic owners and the performance of their firms. The authors could not establish the link between ownership structure and market valuation. They believe that this problem stems from the weak protection of minority shareholders. The absence of a correlation between ownership structure and market valuation could also be explained by an illiquid capital market. According to Coffee, the number of stocks traded in the Prague Stock Exchange was around 1,000 in 1994, and only 30 stocks were actively traded.[154] The unexplained problems of the study relate to the decline in labor productivity in 1996 and to the methodological problem that the remaining 1,000 plus firms were outside the evaluation. In the absence of more empirical work, spanning a longer time period, we need to rely on the existing efforts of researchers to evaluate the impact of privatization on the performance of the firms.[155]

After a decade of privatization efforts, less than impressive results were achieved in the relation between privatization, firm restructuring and the overall growth of the Czech economy. The unresolved relations between the state, investment privatization funds, banks and firms, accompanied by a weak and undeveloped regulatory framework, contributed not only to the decline of labor productivity in the privatized firms, but also to the negative growth rates in the late nineties.[156] Negative growth rates cannot be an exclusive result of the negative economic events in neighboring Germany or other exogenous factors. They are primarily a result of unresolved domestic issues, among which privatization

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[153] *Id.*

[154] Coffee, *supra* 80, p. 142.

[155] On the impact of privatization on the corporate performance *see* the comparative study by Roman Frydman, Cheryl Gray, Marek Hessel, Andrzej Rapazcynski, *Private Ownership and Corporate Performance: Some Lessons from Transition Economies,* WORLD BANK POLICY RESEARCH WORKING PAPER NO. 1830, Washington DC, 1997 (available at *www.worldbank.org*). The study shows that in the first year of transition revenue and employment losses occurred regardless of the ownership structure, while in the later period the firms with private owners outperformed the state-owned enterprises.

[156] The Czech economy recorded negative growth rates in 1995 and 1996, then a one percent growth rate in 1997, and again negative growth rates in 1998 and 1999. It is estimated that there will be a slight positive rate again in the year 2000. *See* John Nellis, *Time to Rethink Privatization in Transition Economies?,* INTERNATIONAL FINANCE CORPORATION, discussion paper number 38, The World Bank, Washington D.C, 1999.

certainly takes an important place.[157] What is interesting is that Nellis does not believe that the cause of negative growth rates are exclusively unresolved issues of privatization, but also a fact that the large sector of the economy remained in state hands.[158] From this trajectory, it is possible to conclude that the Czech government was less successful in privatizing its economy than it declared. The efforts to fully privatize the Czech national economy turned out to be far more vexing in terms of cost, time and efficiency than expected by the first generation of reformers.[159]

To summarize the preliminary findings and conclusions: the Czech government remained faithful to its program of rapid mass privatization, which should have simultaneously severed the ties between the government and its economy while bringing about the accelerated development of Czech industry under private owners' monitoring. As we have seen, the (per)severence of ties turned out to be much stronger than expected, whereas the search for new owners was much more difficult than expected. There are studies which show the improvement of productivity, profitability and governance at the privatized firms. The difficulty with these studies is their "selection bias," which is very difficult to control, because it is easy to estimate that the (potentially) best firms underwent the process of privatization first, and that the worst firms remained in the hands of the state. Still, there cannot be any doubt that the privatized firms experienced an increase in productivity and employment under the new market principles. What remains less clear is how far the investment privatization funds actually influenced the restructuring of the firms.[160] It may well be that the restructuring efforts have been driven by reasons other than IPF activities. For example, restructuring efforts could be a result of events external to the ownership relation, such as liberalization of trade, increased competition and the like. Another possible

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[157] *See* Nellis, *id,* pp. 10–11.

[158] To support his view, Nellis cites that at the end of 1998 three out of four major banks, parts or all of the country's infrastructure, and a number of large industrial concerns deemed as 'strategic' and minority stakes in more than 300 other firms remained in the hands of the state. The state's significant ownership interest remained in 9 out of the10 largest firms in the county. *Id,* note 33 on p. 10.

[159] According to the findings of the comprehensive empirical overview by Karla Brom and Mitchell Orenstein, after the two official waves of privatization, the large sectors of the economy, including most of the banking sector and 'strategic enterprises,' remained in the hands of the state. Their skepticism of the real outcome of privatization and of Coffe, Pistor and Spicer regarding the efficiency of investment privatization funds operating through capital markets, has become important one more time after a decade of transition efforts.

[160] Coffee believes that the issue of restructuring is central to the privatization process, but in his analysis he could not establish the causal link between IPFs and the restructuring efforts of the firms. Although some restructuring process coincided with the process of privatization, according to his findings, "it is still not clear that managing boards have either driven or directed this process." P. 155.

reason for restructuring could be a result of the sheer certainty that formal owners of the firms finally exist.[161] The analysis in the following sections of this chapter will attempt to focus on how to improve the links between IPFs and the firms and how to improve the efficiency of the IPFs themselves, given a belief that IPFs should play the crucial role in restructuring the economy. Above all, the quality of IPF governance will have to be taken into reconsideration. Alternative possibilities and measures regarding the strengthening and restructuring efforts of the firms will be discussed as well.

Until now we have seen the establishment of the privatization model, the underlying premises of mass privatization, the actual process of the privatization, the impact of privatization on the firms and their restructuring as well as the impact of privatization on the overall efficiency of the economy and its dynamics. The impact on the overall economic activities remains ambiguous until today, although signs of the problems were evident in the mid-nineties.[162] After finishing with the taxonomy of privatization in some other comparable countries, in order to provide more insight into the actual process of privatization, including the changes and missed opportunities, we should be able to explore the prospects and policy measures that strengthen the chances for successful development in the coming years. At this stage, lessons tell us convincingly that without a well established, strictly implemented and unambiguous regulatory system, the process of transition certainly does not increase the chances for a successful transformation.

Hungary and Poland

The Czech example of mass privatization showed us the initial theoretical and practical dilemmas, the modeling and implementation of the program, and the difficulties reformers faced during its implementation. Other countries tried to pave their own path toward a privatized economy and faced their own initial condition problems, macroeconomic difficulties and broader social and political issues. As we have learned, all these predicaments were relevant in the process of mass privatization. In

[161] The assigning of property entitlements as the possible cause of new investment and other restructuring activities has been discussed in Claessens, Djankov and Pohl, *supra* 152, p. 8 and ff.

[162] The analysis by Ales Capek of the output decline and the dynamics of privatization in the Czech Republic in the mid-nineties has shown that "private domestic firms, though growing rapidly, face some financial problems and thus may represent a less stabilizing force in the economy than expected." Capek attributed the actual and anticipated problems of the private firms to many factors, such as low financial discipline, lack of capital, lack of skills and limited access to markets that were still dominated by SOEs. *See* Ales Capek, *Output Decline and the Dynamics of Privatization in the Czech Republic,* in Holzmann, *supra* 70, p. 298.

Poland, for example, the period of transition started with the most rigorous program of macroeconomic stabilization in the region, largely due to inflation, which was highest in the region, and other macroeconomic imbalances. The program started in January 1990 under Prime Minister Balzcerowicz, and included the immediate removal of price controls; a restrictive income policy; a 40 percent currency devaluation; the liberalization of trade; the setting of realistic interest rates; and the removal of subsidies on all goods with the exception of coal.[163] The program of macroeconomic stabilization and its impact on the economy in terms of its rapid decline in industrial output, immediate price increases, and rising unemployment gave Polish reformers a different set of priorities before starting with the program of mass privatization.[164]

The Hungarian political and economic context was, again, somewhat different in the sense that a democratic transition did not occur that was similar to the Czech "velvet revolution", where the old and rigid regime collapsed overnight. In Hungary, the democratic transition occurred in the form of a political contest between authority and the emerging opposition. The two political groups, both internally diverse, negotiated democratic elections after months of talks.[165] In terms of economic development, two other factors determined the approach toward reforms: one was the history of small-scale attempts at reforming a Hungarian economy under the old socialist regime, which primarily aimed at relaxing the planned economy and allowed greater freedom to the small property holders.[166] Another important factor was the fact that Hungary was *per capita* significantly more indebted than the other countries in transition.

The interaction of initial conditions, a democratic environment and the dominant ideas certainly played an important role in the design of the program.[167] The lessons thus far suggest that large-scale institutional

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[163] The transition program described in Jeffrey Sachs, POLAND'S JUMP TO THE MARKET ECONOMY, MIT 1993, pp. 44–48. A good summary presentation of the program and its impact may be found in Carol Graham, *The Political Economy of Safety Nets During Market Transitions: "The Case of Poland,"* TRANSITION RESEARCH PAPER SERIES NUMBER 3, The World Bank, Washington D.C., 1993, pp. 4–11. For a discussion on macroeconomic stabilization *see* the introductory chapter.

[164] For the political context before mass privatization took place in Poland, *see* Janusz Lewandowski, *the Political Context of Mass Privatization in Poland,* in BETWEEN STATE AND MARKET, *Mass Privatization in Transition Economies, supra* 85, pp. 35–39.

[165] The political context of the democratic transition in the countries of Central Europe is analyzed in various literature. *See*, for example, Jon Elster et al., *supra* 2, pp. 46–62; Juan Linz & Alfred Stepan, *supra* 16, pp. 255–343 and David Stark and Laszlo Bruszt, *supra* 126, pp. 15–48.

[166] On the history of small-scale economic reforms and the critical assessments of these attempts in Janos Kornai, THE ROAD TO A FREE ECONOMY, *Shifting from a Socialist System: The Example of Hungary,* Norton 1990, pp. 14–20.

[167] The political context in which the most important economic questions were discussed and decisions adopted are presented in Janos Kornai, THE ROAD TO A FREE ECONOMY, W. W Norton 1990.

reforms, such as mass privatization, can be implemented only as long as there exists broad public support and legitimacy for such reforms. Once the government loses public legitimacy for large-scale reforms, it cannot proceed regardless of how genuinely committed the government officials remain toward reforms. An electoral defeat becomes imminent, and the next government, despite a strong rhetoric of commitment towards reforms becomes less genuine in practice to exercise the proclaimed reforms. Hence, delays and all sorts of unexpected bureaucratic obstacles serve as excuses.

Having in mind a different set of political, economic and reformist experience, Hungary took a different path in privatizing its economy compared to the Czech Republic. This does not mean that the goal of Hungarian reformers was anyhow different from their Czech colleagues, but it explains why the model and outcome of privatization somewhat differed from the Czech experience. One of the early characteristics of the Hungarian move toward privatizing its economy is that the actual privatization started before formal laws were adopted. A loosened political environment, accompanied by the belief that a private market economy must develop from grassroots and without much government interference or bureaucratic obstacles, created space for a "spontaneous" level of privatization, where managers were buying cheaply or simply seizing assets.[168] The formal part of privatization started with the adoption of the first privatization laws in 1991. The company law, which was adopted in 1988, gave the managers of state firms significant powers to reorganize state firms and their parts as limited liability companies or joint stock companies.[169] The incorporation of the former state-owned enterprises presented the first step toward privatization, if not privatization itself. The gradual slipping away of state control occurred in the form of concessions toward firms and especially toward their management. An increase in managers autonomy and hardening the state budget introduced the proper incentives that increased the entrepreneurial spirit in the firms.[170] Managers of large state firms took advantage of the new legislation which allowed state firms to establish joint stock companies and limited liability companies.[171]

David Stark describes the process of the increasing autonomy of the managers in running formally state-owned firms (either heavily indebted

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[168] THE WORLD BANK DEVELOPMENT REPORT 1996, *supra* 6, p. 50.

[169] Pistor and Turkewitz, *Copying with Hydra – State Ownership after Privatization, A Comparative Study of the Czech Republic, Hungary and Russia, supra* 103, p. 200.

[170] "In the 1980s, managers in Hungary (and workers in Poland) exercised *de facto* property rights. Although they enjoyed no rights over disposal of property, they did exercise rights of residual control as well as rights over residual income streams." David Stark, *Networks of Assets, Chains of Debt, Recombinant Property in Hungary,* in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA (vol. 2), *supra 80*, p. 118.

[171] *Id*, p. 121.

or prosperous), accompanied by the opportunity to freely establish joint stock companies or limited companies, and through them to connect to other formally state-owned firms, as the "decentralized reorganization of assets." It was a process in which state-owned enterprises started to gradually disappear (from statistics) and incorporated companies, either in the form of joint stock companies or limited liability companies, started to emerge.[172] Outside the state as a shareholder, the new shareholders of the joint stock companies became other joint stock companies, which created a complex and dense network of cross-ownership relations amongst the firms.

The state remained the main owner of shares in the newly incorporated companies, and for this purpose the government established the State Property Agency (SPA) and the State Holding Agency (SHA) established to manage the utilities and property designated to remain in state hands.[173] The establishment of the SPA presented an attempt by the government to implement a central body to oversee the process of privatization. It started at the beginning of 1992, and its legislative mandate was to directly supervise and control the process of privatization.[174] With a strong bureaucratic apparatus, descending from the tradition of a well-educated and powerful central Hungarian bureaucracy, the goal of SPA was to sell the designated large firms to the buyers – domestic or foreign. The value of a firm was determined through bargaining with potential owners.[175] In practice, however, the SPA exuded a major effort to prepare a list of 20 enterprises for sale. The first round of privatization was organized as an invitation to investment and consulting firms whose bids included a method of evaluation, a plan for finding and contacting the potential strategic investors, the financial conditions of the transaction, and a restructuring plan. The payment of investment and consulting firms was based primarily on success fees, many of the leading international investment banks bid for the tenures. The SPA decided within only few weeks and awarded the tenures for selling the 20 designated state enterprises to 20 different investment banks. According to analysts, such a decision showed that attracting as many financial institutions as

[172] "While there was a 60 percent recorded decline of state enterprises in the period between 1988–1994, the number of shareholding companies increased more than 20 fold (from 116 to 2,679), and increase of limited liability companies from 450 in 1988 to 79,000 in 1994." Stark, *id*, p. 117.

[173] The Hungarian law on management and entrepreneurial assets permanently remaining uder the state ownership included assets of economic-strategic, national economy or other important interest. On the basis of this law, the portfolio of energy and infrastructure, industry, agriculture and forestry, research and development, culture and financial institutions were assigned for management. *See* Pistor and Turkewitz, *supra* 103, p. 228.

[174] *See* Stark, *supra* 126, p. 97.

[175] *Id.*

possible to participate in the first round of privatization was more important than offering quality proposals and bids.[176]

As the number of firms designated for privatization in the first round suggests, the process of privatization started slowly and significantly differed from the ambitious Czech first wave of privatization.[177] The method of privatization differed as well. The SPA was to prepare the large state enterprises one by one for a sale through tenure bids. The intention to find foreign strategic buyers for the firms was also clear from the beginning – and the attraction of foreign investment banks to participate in the tenure process helped realize that goal. In fact, Hungary was able to attract far more foreign investments – in proportion of GDP – than any other country in transition.[178] As far as the management activities of the SPA (and, by analogy and before merging the two agencies in 1995 – SHC) are concerned, the management of the state portfolio was complicated by the fact that the sale of state owned enterprises became a slow process with few interested buyers. This fact not only further lowered the bargaining position of the SPA vis-á-vis prospective buyers, but also vis-á-vis the managers and workers of the firms.[179] The SPA did not have a clear and transparent strategy to determine which firms should be privatized first and which firms should undergo a process of restructuring before privatization. As it appears, the approach toward individual firms depended more on factors which did not relate directly to the initial purposes of having the SPA; for example, to slate the state-owned firms and find prospective strategic buyers for them.[180]

Despite becoming an important state institution designed to monitor and control the process of privatization, the SPA had to face the problem of staffing to a much higher extent than, for example, the Czech NPF. By 1994, only 15 SPA case officers were responsible for over 250 firms;[181] furthermore, the SPA had to contract outside representatives for active monitoring.[182] The roles and tasks of SPA representatives on the supervi-

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[176] For the process of the first round of privatization and the selection of financial advisors *see* Stark, *id,* pp. 97–98.

[177] The new government after the 1990 elections announced that it was necessary to slow down the process of privatization and to put it under central control. Stark, *id,* p. 100.

[178] THE WORLD BANK DEVELOPMENT REPORT 1996, *supra* 6, pp. 63–65, esp. Figure 3.2. *See* also Bruce Kogut, *Direct Investment, Experimentation, and Corporate Governance in Transition Economies,*in Roman Frydman, Cheryl Gray and Andrzej Rapazcynski, CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA (vol. I), *supra* 80, pp. 293–332.

[179] The broader context and obstacles for the activities of the SPA described in Pistor and Turkewitz, *supra* 103, pp. 230–233.

[180] Other factors were, for example, the level of existing regional (un)employment, the access of managers to the state institutions and decision-makers to obtain credits from the state-owned banks... *See* Pistor and Turkewitz, *id,* 231.

[181] *Id,* note 89 on p. 230.

[182] *Id,* p. 230.

sory boards were limited to the most egregious asset stripping or management failures.[183] The limited role of SPA officials in managing the portfolio of firms in formally state hands does not, however, entirely exhaust the importance of the agency. The close ties between state officials and firm managers, gradually (re)built through the interaction on supervisory boards, created a dense network through which managers often sought access to powerful central authorities and state-owned banks.[184]

The channels toward central authorities and state-owned banks were particularly important, because banking reform took place during the process of privatization. In the period between 1991 and 1994, Hungarian banks were recapitalized four times with a state injection which in total represented 9 percent of the Hungarian GDP.[185] The effort of the government to revive and reinvigorate the banking sector, which inherited losses and bad past loans, stopped however, at this point. According to Baer and Gray, no other efforts were made at that period to restructure the banks or to create appropriate incentives. Furthermore, most observers agreed that the banking supervision remained weak.[186] In the first few years of privatization in Hungary, not only had the government concessions to the existing management and the creation of the SPA to monitor the process of privatization played a role, but also a complex process of interwoven relations among firms, banks and state bureaucracy, which in practice determined the future development or bankruptcy of the firms. The studies of Gray and others show that liquidations, financial reorganizations and bankruptcies significantly reorganized and changed the economic landscape of the country in the first years of transition.[187]

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[183] *Id,* p. 231. Anecdotal evidence from Pistor and Turkewitz suggests that sometimes even these violations were first reported by newspapers and attracted the attention of the officials only afterwards (n. 90).

[184] "As we have documented, private parties in Hungary have been able to intertwine themselves with state firms in a dizzying array of organizational relationships...the interwoven nature of the Hungarian economy not only diminishes the ability to find buyers for state property, but also increases the risk for the government of parting with ownership." Pistor and Turkewitz, p. 232.

[185] To put in figures, the size of the capital injections on the basis of four different bank recapitalization and loan consolidation programs was 3.4 billion USD. *See* Herbert L. Baer and Cheryl W. Gray, *Debt as a Control Device in Transitional Economies: the Experience of Hungary and Poland,* in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA (vol. 1), *supra 80*, pp. 81–82.

[186] *Id.*

[187] "Over 22,000 cases were filed in the two-year period from January 1992 through 1993, including over 5,000 bankruptcy cases and over 17,000 liquidation cases. Resolving the bankruptcy cases, however, has been speedy, with more than 90 percent completed during that period. Liquidation cases take much longer, and most cases filed during the 1992–93 period were still pending." *Id,* p. 95.

The described process of privatization in Hungary created a complicated network of assets that were formally still in state hands through direct or indirect control, but with little interference in business decisions. This left certain room for maneuver to the managers to connect with other firms, establish new companies (formally still indirectly belonging to the state, but in practice acting as autonomous firms or joint ventures), or network with state officials and negotiate with state banks. Katharina Pistor described these property relations as "a shell for a host of private activities, and their founding organs, regional governments, or other parts of the state administration."[188] For the same set of reasons we need to follow Stark, who came to the conclusion that analyzing the privatization process through the SPA activities would be misleading if we were to understand the nature of asset reorganization in Hungary, where the more important underlying processes took place.[189] Once the government decided to allow state firms to freely establish joint stock companies and limited liabilities companies, the decentralized, 'spontaneous' activities toward the reorganization of property relations took place. It is not of least importance that the greatest concessions were not given to employees at large, but almost exclusively to firm management. Earle and Estrin estimate that the autonomy of directors in decision-making, which included decisions regarding the use of assets and profits, gave those directors the decisive leverage to determine the nature of transactions, their links with outsiders[190] and the outcome of ownership reorganization.[191] Despite the efforts of the government to put the process of privatization under SPA control and their legislative

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[188] Pistor and Turkewitz, *supra* 103, p. 227.

[189] Stark believes that the new property relations should be named "property recombinants" to capture the characteristics of the new relations. Apart from the above described characteristics it is necessary to add that in the process of privatization, in many cases, the arbitrary removal of liabilities (written off, left behind to the firms filing bankruptcies or to the banks, suppliers, and other creditors) and assets took place. This so-called asset privatization fits well with other characteristics of the property reorganization: "The basic process of this property transformation is one of decentralized reorganization: under the pressure of enormous debt, declining sales, and threats of bankruptcy, or in the cases of more prosperous enterprises, to forestall takeovers as well as attempt to increase autonomy from state ministries, directors of many large public enterprises took advantage of several important pieces of legislation that allowed state enterprises to establish joint stock companies and limited liability companies. In the typical cases, the managers of these enterprises were breaking up the organization into numerous corporations. It is not uncommon to find virtually all of the activities of a large public enterprise distributed among 15–20 such satellites orbiting around the corporate headquarters." Stark, *Networks of Assets, Chains of Debt: Hungary, supra* 170, p. 121.

[190] Stark's analysis shows that the most important outside owners became banks: "In many cases, the establishment of new corporate forms was triggered by enterpise debt, and in the reorganization the creditors, whether commercial or other credit institutions, exchange debt for equity." Stark and Bruzst, *supra* 126, p. 99.

[191] Earle and Estrin, *supra* 134, p. 39.

effort in 1992 to establish schemes on the Employee Stock Ownership Plan to extend the ownership base amongst all employees, the available data suggest that, once again, most of the buyouts went to managers or at least were in their control.[192]

Inter-enterprise ownership was the outcome of the Hungarian process of privatization, in which "the typical owners of large shareholding companies are other large shareholding companies."[193] The complex ownership relations put at the center of the network and the core enterprise (such as giants in steel industry), were circled by a number of smaller enterprises, with links to each other and to the core unit. The strength of the ties depended on the importance of the smaller units to the core unit (most important were held in 100 percent ownership, less important in lesser percentage), and on technological or financial dependence. Stark used the term "corporate satellites" to illustrate the character of reorganized ownership, which he calls "the network of recombinant property" and believes that this description better suits the actual process of privatization in Hungary than studying the process of privatization through SPA activities.[194]

An assessment of the impact of the process of privatization in Hungary is similarly difficult than in the Czech republic, as most of the findings remain inconclusive to date. It seems that large-scale institutional transformation, such as ownership reorganization on the scale of the national economy, takes more than a decade until all the actors (firms, managers and workers, financial institutions, government) adjust to the new institutional framework. Although the privatization plan in Hungary was more gradual compared to the Czech Republic, which had already started in the late 1980s, the economic decline in the early 1990s

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192 Earle and Estrin warn that there is a lack of data concerning the characteristics of employee-owned firms in Hungary (p. 45), but the almost unanimous view among observers is that despite possibilities for nonmanagerial ownership and influence, managerial ownership and control was predominant. P. 46.
An excellent study on some potential advantages of employee ownership in the transition economies in Milica Uvalic, Daniel Vaughan-Whitehead, PRIVATIZATION SURPRISES IN TRANSITION ECONOMIES, *Employee-Ownership in Central and Eastern Europe,* Edgar Elgar 1997. On potential advantages and risks of employee-ownership *see* esp. pp. 17–48.

193 Stark, *Networks of Assets, Chains of Debt: Hungary, supra* 170, p. 119.

194 It is interesting to note, however, that the networks of reorganized property relations were never fully accepted by the authorities due to their proclaimed individual asset-selling approach through the SPA: "Property is already being reorganized along such lines; but such networks are not acknowledged in public policy. So long as the policy of privatization is based on getting the highest price for a set of assets already bundled in a given enterprise, and so long as the policies of restructuring and debt consolidation operate on a strictly firm by firm basis, so long will the network properties of the Hungarian economy be continually underutilized. Networks will remain shady as long as they remain in the shadows of official policy." Stark, *id,* 125. For an analysis of the complex structure of inter-enterprise ownership *see* esp. pp. 119–125.

was of similar magnitude. Kornai was surprised to realize that "transformational recession" hit all the post-socialist countries without exception. Hungary, for example, suffered a 19 percent decline in total production and a 39 percent decline in industrial production, far beyond the expected 12 percent fall. The decline hit the economy after a lengthy stagnation, but Kornai believes that the recession in Hungary was still milder than in some other countries in the region.[195] Unlike other authors, who ascribed the decline to a single cause, he gave a multi-causal explanation of the "transformational recession." His analysis includes the change of balance between macro-supply and macro-demand, that emerged from the old "economy of shortage," the change in relative prices after liberalization of prices, the disinflationary efforts of the monetary authorities, the change of the size of the state and private sector accompanied by the new coordination system and the dissolution of the old one, the hardening of the former soft budget, the backwarded financial system, the "external schock" after the COMECON collapse and the gradual export orientation to the West.[196] To overcome these grave problems at the early stage of transition, Kornai recommend stabilizing the economy to regain confidence and raising the propensity to invest on a private-ownership basis when laws and institutions became stable.[197]

Eventually, Hungary resumed growth. After four years of decline, it recorded positive growth rates in 1994, and since then has experienced growth rates between 1.5 to 5 percent.[198] As seen from the empirical evidence and analyses, the causes of economic decline and growth can be attributed to many factors, including the role of initial conditions. The firms suffered a manifold external shock, whereby the internal efforts to reorganize the property relations contributed the share of uncertainty. In this environment, the level of output inevitably fell.[199] The question remains, however, to what extent and in which way the reorganized ownership and new legal entitlements contributed to the higher level of productivity, the increase in investments, and the improved governance of firms, all of which ultimately contributed to the growth and development of the whole economy. As already noted, the studies analyzing the actual impact of privatization on productivity improvement, new investments,

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[195] Janos Kornai, *Transformational Recession,* in HIGHWAY AND BYWAYS, MIT 1995, p. 165.

[196] *Id,* pp. 167–186. A comparative analysis is in THE WORLD BANK DEVELOPMENT REPORT 1996, *supra* 6, pp. 22–31.

[197] *Id,* pp. 197–206.

[198] More precisely, after years of decline (up to –11,9 in 1991), positive growth rates since 1994 to 1999 are as follows: 2.9, 1.5, 1.3, 4.6, 5.1, 3.0 (estimated), EBRD TRANSITION REPORT 1999, p. 229. Thus, it is estimated that the GDP growth index is somewhat higher than the one in 1989.

[199] Akos Valentinyi, *Output and Employment in Private and Non-Private Businesses in Hungary: 1990–1992,* in Robert Holzmann, Janos Gacs and Georg Winckler (eds), *supra* 70, pp. 279–283.

and the improvement of governance will remain inconclusive until additional empirical studies are completed within the coming years.

The existing studies and analyses show, however, a strong correlation between privatization and restructuring of the firms. This finding especially holds for the countries in which the institutional setting at large was strong, but holds less for the countries in which the institutional setting was weak. The study by Anderson, Djankov, Pohl and Claessans, based on performance indicators of more than 6,000 industrial firms in seven countries between 1992 and 1996, showed that "privatization was the single most important factor in restructuring, whereas the method of privatization has been less important."[200] The study, which measured the effect of policies, such as rapid privatization, concentrated outside ownership (for better governance), wage growth restraint, financial discipline, and maintaining debt obligations, concluded that privatization accounted for almost all the productivity gains in all of the factors of production.[201] The authors also concluded that the method of privatization is the fact that privatization took place and the new owners came in.

Similar results were found in another econometric study, prepared by Frydman, Gray, Hessel and Rapazcynski, in which they analyzed the effects of privatization on corporate performance in a sample of about 190 Czech, Polish and Hungarian firms (half privatized, half state-owned). The so-called synchronic study (as opposed to historical study in which the same pre- and post-privatization firms are followed) followed state and private companies in the same macro-environment. The authors tended to control the "selection bias" in a sense that better firms were chosen for privatization.[202] They claim they were successful in their effort, but the sample was small.[203] The research, which took place between 1990 and 1994 "provided strong empirical evidence that private ownership dramatically improved the most essential aspects of corporate performance in the countries undergoing post-communist transition."[204]

[200] Robert E. Anderson, Simeon Djankov, Gerhard Pohl, and Stijn Claessans, *Privatization and Restructuring in Central and Eastern Europe – Evidence and Policy Options,* WORLD BANK TECHNICAL PAPER NO. 368, 1997, Washington DC, introduction summary, V–VI.

[201] The authors found that "labor productivity growth across the seven countries averaged 7.3 percent a year for privatized firms during 1992–95, but 0.2 percent for state-owned firms." They also found similar results for other factors of production and authors even believe that the credible threat of the government to privatize the firms can already lead to improvement in profitability, *id.*

[202] Roman Frydman, Cheryl Gray, Marek Hessel, Andrzej Rapazcynski, *Private Ownership and Corporate Performance: Some Lessons from Transition Economies, supra* 155, on selection bias problem esp. ch. 5, pp. 40 and ff. (cited from the web pages).

[203] John Nellis praises the methodological rigor to avoid "selection bias" as exemplary, but must admit that "the sample size was small, the firms of medium in size (and not larger firms) and the data somewhat dated. *Time to Rethink Privatization in Transition Economies?, supra* 156, n. 53 on p. 20.

[204] Frydman *et al, supra* 155, pp. 44–45.

The authors even claimed that "privatization was the dominant employment strategy in transition,"[205] as the improvement was particularly traceable in terms of revenue generation and in terms of employment gains relative to state firms. Unlike Anderson *et al,* the authors in this study, whose findings almost coincided with the first one, came to the conclusion that the form of ownership in the privatized firms was important. According to Rapazcynski *et al,* "outsider-owned firms perform better than insider-owned firms on most performance measures."[206] As far as insider-owners are concerned, manager-owned firms perform better than employee-owned firms, which do not perform any better than the remaining state-owned enterprises, at least according to the aforementioned study. However, the study also shows that some of the collected data did not fit with the expected and theoretically elaborated assumptions of mass privatization. The authors were also surprised to realize that there were a significant number of successful firms that were partially owned by the state, where the state remained the largest owner.[207]

The many remaining unknowns make it difficult to wholly appreciate the effect of privatization on the dynamics of the economy. The time frame is certainly of great importance, as turning around large enterprises is a task that is different in magnitude compared to the (re)assigning of property entitlements. It is therefore legitimate to say that we need more time to see the positive effects of restructuring large enterprises. It is difficult, however, not to recognize many other approaches to restructuring, which were not envisaged at the beginning of reforms. For example, the Czech government remained an important actor even after two waves of privatization – and the successfully restructured firms were documented. Another such surprise is the remaining large state sector in Poland (as we shall see in the coming section) and the slow privatization process in Hungary, which did not prevent these countries from increasing and recording sustainable growth. The structure of the new property regime also presents a puzzle to some extent. The aforementioned study by Frydman *et al.* also showed that managerially-owned firms (after the managerial turnover throughout the region, which does not necessarily coincide with each particular firm) generated strong revenue growth. This salient finding made authors speculate that the cause for success was perhaps that managerially-owned firms were significantly better than others at the time of privatization.[208] Such findings return us, apparently, back to the problem of "selection bias" and to the speculation that the process of privatization was a kind of "natural selection"

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[205] Frydman *et al, supra* 155, p. 22.

[206] *Id.*

[207] To authors, this came as the "biggest surprise of them all," according to their own findings, p. 22.

[208] *Id,* p. 39.

between good and bad firms as well as a selection of owners and managers on the not-yet-established-market.

Up to this point, the causal link between mass privatization and restructuring, and overall economic development and growth, has not been clearly established in the countries in transition. Too many patterns deviated from the initial outline of mass privatization to allow us to claim that mass privatization unambiguously contributed to restructuring and growth across all the firms and industries. The fact that the state held an upper hand over a large part of the industries in the countries in transition might lead us to the conclusion that mass privatization was not the sole and perhaps not the key industrial policy that was superior to other types of industrial policies. Other factors might also have played an important role in the transition and contributed to the fact that many firms and industries regardless of ownership did follow the path of restructuring and development. Not only that the government has been successful in many cases of restructuring the "strategic enterprises," but also that managers of the 'managerial-owned' enterprises proved successful in restructuring the firms, without any outside control and monitoring of the new owners. Other factors, such as inflation reduction, stabilization of public finance, price and trade liberalization, reduction of state subsidies, and threat of bankruptcy, might have equally forced the firms to restructure and adjust to the new economic environment without the change of formal owners.

To be sure, the argument above is not against privatization, or any particular method of privatization. I agree with John Nellis, the question is not whether to privatize or not, but how to privatize.[209] More precisely, on the basis of the experience of mass privatization, reformers should determine the expected gains and potential costs of mass privatization within a given context before making further decisions. The lessons learned from the decade of privatization should suffice for precise balancing. The decision to privatize should be adopted within the larger context of a country's industrial policy and not as a political goal in itself. The decision to privatize can be a useful policy tool only in the context of broader institutional setting that is based on a more comprehensive policy goal.

In the absence of complete evaluation of the transition period, the available empirical studies to date unambiguously show that privatization helped restructure and improve governance of the firms. It is not clear whether this was the sole cause of the changed ownership or the result of other determinants. In the studies where the state remained the largest owner, the enterprises did equally well. Similar is the case with managerial-owned enterprises. Perhaps closest to the truth, thus far, is the thesis by Djankeov and Claessens, which states that formal owner-

[209] Nellis, *supra* 156, p. 18.

ship after privatization brings the necessary certainty to the firms that allow for further corporate activities.[210] As long as the ownership question is not resolved in the period of transition at the firm level, the uncertainty further deteriorates the organization of production and the future plans of the firms. Additionally, once formal ownership is assigned to the firms, the secondary market for buying shares or pursuing takeovers for domestic and foreign buyers can be activated. What exactly are the mechanisms and incentives after the firms are privatized and what is necessary to create a broader regulatory framework to secure the successful governance of the firms, will be discussed in the forthcoming sections of this chapter.

Poland serves as another example where firms and economy at large underwent a demanding phase of macroeconomic stabilization. The package of economic measures and the course of the program has been described in the previous sections.[211] Perhaps the comprehensive macroeconomic program was the main reason why Poland delayed more than any other Central European country in privatizing its economy. The program of mass privatization was not a part of initial macroeconomic program (the so called "shock therapy").[212] Since the privatization program was not a part of the initial macroeconomic program, it allowed policymakers to carefully design a program in which not only the distribution of vouchers was the goal, but several other goals were pursued. Other goals included restructuring the firms that were selected for privatization, strengthening managerial skills, filling the governance vacuum, and establishing links with foreign fund managers.[213] What made the Polish approach to privatization particularly interesting was the fact that the discussion on privatization was opened to the public. Initially, the political parties agreed on a proposed model that placed a 20 percent ceiling for workers shares. The political dispute arose before parliamentary elections in 1991, when the privatization program started to be heavily criticized. Some of the criticism before and after the elections in 1991 came from the Czech experience, which was labeled in Poland as "mass appropriation," but several other substantive issues were also at stake, notably the support for traditional privatization methods.[214]

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210 *See* the section on the Czech voucher privatization, pp. 54–82.

211 *See* the section on the Polish approach toward privatization, pp. 82–114.

212 An overview of the legislative history of the privatization laws in Poland and the political debates about mass privatization in Januzs Lewandovski (former Minister of privatization in Poland), *The Political Context of Mass Privatization in Poland,* in BETWEEN STATES AND MARKETS, *Mass Privatization in Transition Economies, supra* 85, pp. 35–39.

213 *Id,* p. 36.

214 *Id.* We should bear in mind, however, one another important fact from the Polish history in transition. As noticed by Sartori, the election system in Poland allowed 29 political groups to win seats in the Seym, with 8 parties within the range between 6

Finally, after lengthy discussion and years of delay, the privatization program in Poland was implemented in the summer of 1995, when all the controversies were removed and the supportive laws were adopted.[215] The delay in designing and implementing a privatization program in Poland[216] had, according to commentators, quite a few important, although somewhat unintended, positive effects. Unlike the Czech Republic, where regulators usually stepped in *ex post,* in Poland the relatively complete regulatory framework was ready before privatization took place.[217] The intermediaries in Poland were carefully designed and implemented "from top down," by the establishment of 15 investment funds, with each holding a controlling block of shares (33 percent) in about 35 enterprises while also holding minority stakes in other enterprises.[218] According to Nestor, the 15 investment funds in Poland had two main, but conflicting goals. One goal was to secure strong corporate governance, and the other was to protect the minority shareholder – citizens.[219] The top down approach in the regulated environment did not seek for auction rounds, but it determined that each citizen ("buyer") was entitled to one share in each of the 15 investment funds. The firms participating in the process of privatization (around 500 large enterprises) were selected by the funds before the vouchers were issued to the citizens.[220] More than 25 million participated in mass privatization through vouchers (95 percent of eligible citizens), which were selling at the Stock Exchange at ten times the fees to the authorized bank (state bank PKO, which distributed vouchers for the price at around 37 USD).[221]

In short time, the regulated centralized approach toward large enterprise privatization spurred the rapid development of the stock market. Commentators believe this was largely due to a transparent and well-reg-

and 17 percent. This fact alone hardly allowed Polish reformers to proceed with any kind of comprehensive reforms. *See* Giovanni Sartori, COMPARATIVE CONSTITUTIONAL ENGINEERING, New York University Press 1994, n. 7 on p. 77.

[215] Yves Duvier, *Poland* in BETWEEN STATES AND MARKETS, *Mass Privatization in Transition Economies, supra* 85, p. 219.

[216] According to Grzegorz Kolodko, finance minister of Poland between 1994 and 1997, four consecutive governments had failed to implement privatization until September 1993. The main causes of political and technical disputes, which delayed the privatization, were requirements for complex procedures in setting up National Investment Funds, selecting Fund managers, negotiating reward formulas, and allocating enterprises. *See*, p. 32.

[217] David S. Young, *The Demand Side of Voucher Privatization in Central and Eastern Europe, supra* 85, n. 8 at p. 47.

[218] Yves Duvier, *supra* 215, pp. 219–220.

[219] Stilpon S. Nestor, *Institutional Aspects of Mass Privatization, A Comparative Overview* in BETWEEN STATES AND MARKETS, *Mass Privatization in Transition Economies, supra* 85, p. 22.

[220] David S. Young, *supra* 217, n. 1 on p. 47.

[221] Grzegorz Kolodko, *supra* 216, p. 32.

ulated framework, which put the Warsaw Stock Exchange far ahead of the Prague Stock Exchange in terms of size and liquidity.[222] A centralized approach with a strong regulatory framework did not only allow for the rapid development of the stock market, but it also attempted to secure the stronger presence of fund managers in restructuring firms and in improving governance. For this purpose the regulators were careful in choosing fund managers, who had passed exams before obtaining the license for running funds.[223] Funds were composed of foreign and Polish experts based on fixed cash and performance fees in the form of fund shares. They adopted supervisory boards according to the German model.[224]

Investment funds attempted to function as the strategic owners of the firms and they had the incentives and capabilities to do so. The substantial stakes were assigned to each of the 15 investment funds, while their staff was partly chosen with the help of an international tender. Concentrated ownership, strict regulatory framework and careful selection of the fund managers gave investment funds sufficient capabilities and incentives to play strategic roles in firms. The transparency and disclosure rules gave NIFs important advantages over the Czech IPFs.[225] The stakes of privatized enterprises were assigned to individual NIFs and were chosen by lottery, and for each firm the "lead fund" was selected, whereas the rest of the funds became minority owners of the selected firm. The group of firms that were prepared for privatization represented 10 percent of industry and construction; the original group was composed of firms that volunteered and a group of a few pre-selected firms. Before the actual process of privatization started, a group of 30 valuable

[222] David S. Young, *supra* 217, p. 47: "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 Czech preferred to privatize first, hoping to plug regulatory gaps after privatization. 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 (footnotes ommited)."

[223] Evaluation and prequalification of the fund managers was monitored by the World Bank and EBRD, but the final appointment belonged to the prime minister, which in some cases drew political controversies and criticism. Yves Duvier, *supra* 215, p. 220.

[224] More on the basic characteristics of the National Investment Funds in Duvier, *supra* 215, p. 220.

[225] Comparisons and advantages of certain regulatory and institutional solutions are discussed in THE EBRD TRANSITION REPORT 1997, p. 197.

enterprises were removed from the list and hundred smaller firms with weak financial structures were added.[226] This clearly shows the political and arbitrary selection process of the firms to be privatized, although it still facilitated the process of restructuring in most of the privatized firms. Nevertheless, the most difficult initial task of the NIF was to discover the actual financial situation of the assigned firms and to create the relevant database for them.[227]

The NIFs, established as closed-end funds by the State Treasury, were incorporated as joint-stock companies according to the Polish Commercial Code. The State Treasury exercised shareholder power over the funds, and the Ministry of Privatization assigned the shares of over 500 companies to them.[228] The funds were run by the management firms, which provided the necessary personnel. The management firms that had contracts with funds represented a combination of domestic and foreign entities that were mostly foreign investment banks and domestic banks. They tried to bring together a successful mixture of experience, skills and expertise. In practice, only one of the contracts had to be cancelled due to disagreements.[229] The structure, as presented, posed some fear of collusion and interlocking effects among the funds. The aforementioned strict legislation attempted to prevent collusion in several ways. For example, sponsors were legally and organizationally separated from management, which, according to the analysts, did not completely prevent self-seeking interests.[230] The agreements on acquiring the shares of funds or between funds in third parties had to be notified to the Anti-Monopoly Office. The Office had many other important authorities with regard to enforcing the fair and transparent activities of the funds.[231]

The main source of conflict relating to the management of funds came from the differences between the supervisory boards and the managers of the funds. While the latter pursued the policy of increasing the value of the portfolio and quickly selling the firms, the supervisory boards supported the long-term strategy of restructuring the firms. The key issue in this dilemma was to what extent the NIFs were obliged to engage in restructuring the firms by using their own resources, since many of the firms they received were nearly bankrupt.[232] Although a completely efficient ownership structure had not been established, there

[226] Duvier, *supra* 215, p. 220.

[227] Janusz Lewandovski and Roman Szyszko, *The Governance of Privatization funds in Poland,* in Marko Simoneti, Saul Estrin, Andreja Bohm (eds), THE GOVERNANCE OF PRIVATIZATION FUNDS, *Experiences of the Czech Republic, Poland and Slovenia,* Edward Elgar 1999, p. 49.

[228] *Id,* p. 47.

[229] *Id,* pp. 50–51. *See* also the scheme with the complete structure of the NIFs on p. 50.

[230] *Id,* p. 51.

[231] *Id,* pp. 51–52.

[232] On this dilemma and the differences within the funds, *see id,* pp. 52–53.

is sufficient evidence that the NIFs held strong control over their portfolio companies.[233] Comparing the two different types of investment funds and different approaches toward privatization between Poland and the Czech Republic, it is obvious that the results are still inconclusive and that there is still a lot of space for improvement in the practical functioning of the funds in both countries. Nevertheless, to this moment, the Polish investment funds gained some important advantages over the Czech IPFs. Among the most important are: (1) a well-conceived regulatory framework that requires strict anti-collusive and transparent behavior of fund managers, (2) a small number of the funds with concentrated ownership; (3) the capacity and incentives of the fund managers to actively engage in the firm restructuring efforts; (4) a pre-established liquid stock market that allows fund managers to pursue all other important corporate activities, such as portfolio management, raising capital, and selling firms or minority stakes through the secondary market.

"Managed privatization" aimed at raising the sale revenues of firms and improving the governance of the firms through commercialization. The program was successful in creating a liquid secondary market for shares and facilitated in restructuring efforts.[234] The growth of private sector output continued to develop and many *de novo* firms joined the market.[235] It would be a mistake, however, to analyze the process of privatization in Poland only through its described legislative history and its "managed privatization." The delay in preparing the regulatory framework for privatization and in finding the political consensus for privatization proved not only to be beneficial, but also costly. In the wake of "shock therapy" and in the absence of privatization legislation, which was not yet fully in place, the state-owned firms found themselves in a deep crisis. The crisis was reflected in financial difficulties, growing inter-enterprise debts (through the chain of suppliers and customers), mounting debts to the banking sector and a decline of output.

In this situation, state-owned enterprises, the government and the banking sector needed other mechanisms to respond to the grave financial crisis. The response to this crisis was somewhat unique for the countries in transition, not as much in using certain policy measures, but rather in a sense of concerted activities and perhaps better coordination compared to some of the other countries in transition. The initial response of the state-owned enterprises entailed a reduction of the workforce and the shedding of unnecessary assets and the like, which was followed by a more coherent government program, called The Enterprise and Bank Restructuring Program (EBRP). The program was initiated in 1993 after the government recognized the growing debt problem.[236]

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[233] *Id*, p. 65.

[234] Kolodko, *supra* 216, p. 33.

[235] *Id*.

Until this program was launched, the banking sector kept lending indiscriminately to the firms, instead of forcing them in liquidation or bankruptcy. The program also tried to stop the practice of indiscriminate lending and tried to engage banks into facilitating the financial and operational restructuring of the firms. The short and long term goals were to be achieved through the bank conciliation processes, which empowered banks (and not, for example, the courts) to conclude agreements with the firms on how to restructure their debts. Again, detailed substantive and procedural rules were adopted and the Ministry of Finance adopted the final deadline on when it was possible to conclude agreements.

Apart from the fact that the conciliation processes were run by led-banks if the firm applied for a debt work-out, the process resembled the financial reorganization of U.S. Chapter 11 and Chapter 7 and other bankruptcy processes. If agreement was not reached or the firm objected to its content, the firm could file an appeal with the court. The work-out programs themselves were very flexible, because they assumed a range of possible solutions to the debt problems, and they gave led-banks the explicit power to monitor the implementation of the restructuring program.[237] Exemptions to the cases of conciliation led by the banks were cases where the state became the main creditor due to unpaid taxes and social contributions, and in these cases the government and not the banks or suppliers led the work-out plan.[238]

The conciliation procedures were in principal voluntary, but there were several reasons forcing creditors and firms to reach the work-out agreements. The mounting debts seriously threatened the banking system, so the opportunity to conclude the work-out agreements with the state-owned firms offered the opportunity to the banking sector. The deadline for implementing the restructuring program, imposed by the Ministry of Finance, showed its determination to strengthen financial discipline. Furthermore, if the firms did not meet their deadlines, they were forced into bankruptcy procedures. The growing inability of the firms to continue to raise working capital and the opportunity of the firms to achieve some debt reduction in the case of a concluded agreement were other important reasons for the introduction of conciliation procedures.[239]

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[236] A detailed study of the program is in Cheryl Gray and Arnold Holle, *Poland's Bank-Led Conciliation,* in Leszek Balcerovicz, Chery W. Gray, and Iraj Hoshi (eds.), ENTERPRISE EXIT PROCESSES IN TRANSITION ECONOMIES, Central European University 1998, pp. 249–275.

[237] *Id,* pp. 250–251.

[238] Taxes and social contribution payables doubled in the period between 1991 and 1993 due to arrears, and in 1993 represented a 30 percent share of the total assets in 1993. The government led the conciliation process in 13 cases. As the observers stressed at the same time, in Poland unlike in Russia, the debt to workers was negligible. *Id,* p. 254.

[239] An analysis of incentives to initiate procedures and reach agreements *id,* p. 255–256.

As it turned out, the program was relatively successful in achieving most of its proclaimed goals. The most common methods of conciliation were debt write-offs and deadline extension for payment obligations, whereas other methods were less common.[240] Financial restructuring gave firms room for maneuvering in major macroeconomic distress, which was considered to be one of the most important achievements of the program.[241] It helped firms consolidate their financial situation and stopped or significantly slowed down lay-offs, whereas wages started to grow again.[242] Additionally, the program further expanded basic market principles, because according to the analysis, better-off firms tended to conclude agreements whereas worse-off firms were forced into bankruptcy.[243] What the program did not achieve, however, was major operational and ownership restructuring. The major banks were not particularly interested in debt-for-equity swaps and therefore did not impose major operational restructuring requirements on the firms. In fact, the study shows that the major and stronger banks were less interested in deeper restructuring, including debt-for-equity swaps, compared to the weaker banks, thus indicating less of an inclination toward bearing risk. This shows that weaker banks also had worse clients and less options than the stronger banks.[244]

The EBRP was one of the important programs of the Polish government before privatization finally took place. Although studies show mixed success of the program, it provided some space for the firms to restructure financially and sometimes also operationally. The program was less successful, however, in pursuing privatization through debt-for-equity swaps, because banks generally found this approach too risky. There were other, less programmatic pathways toward creating a private sector in Poland. One of the most frequent methods of privatization before the adoption of formal privatization schemes was a process called "privatization through liquidation."[245]

The process of privatization through bankruptcies or liquidations was a result of deep financial crises and occurred without any formal framework. The main causes of the financial distress were similar to other

[240] According to the analyzed sample, the average write-off was 66 percent. *Id,* pp. 260–261.

[241] *Id,* p. 270.

[242] *Id,* p. 268.

[243] *Id,* p. 269.

[244] *Id,* p. 262.

[245] "Privatization to insiders has also dominated in Poland, where its primary vehicle of "privatization through liquidation" has been quantitatively much more important for trade sales or share flotations... Even the "mass" privatization program is planned to include many fewer companies than already privatized through liquidation and will bestow large minority stakes on employees. As of the end of 1993, enterprises that had completed or were in the process of privatization through liquidation numbered 1,999 (footnotes omitted)." Earle and Estrin, *supra* 134, p. 36.

countries in transition: the declining domestic consumption and inability to collect receivables.[246] Focusing on the program designed by the government, the banking-led conciliation process (EBRP), the government neglected other exit options. Other exit options, such as court conciliation, bankruptcies, and state liquidations, did not receive the attention of the government compared to the described process of bank conciliation. The inability of the government to properly regulate and monitor other exit options allowed for less organized and less efficient methods of financial and operational enterprise restructuring. For example, in the state liquidation processes, which were implemented according to the rules from 1981, the weak monitoring of creditors allowed appointed liquidators or managers to divert some assets to new owners while leaving state assets to enter bankruptcy procedures with debts and fewer assets.[247] The bankruptcy procedures were based on the old 1934 bankruptcy statute, which was rarely applied after the war, when courts lacked experts in leading bankruptcy procedures and had little support from outside professionals, such as trustees, accountants, and trained lawyers. With little funds, expertise, and experience, it does not come as a surprise that the bankruptcy courts were inefficient and plagued with frauds.[248] Other exit options were similarly weak in protecting secured loans and secured creditors, and weak institutional arrangements and undeveloped legislation did not contribute to a controlled and organized turnaround of the economy.

The reform of the banking sector in Poland, which took place simultaneously with other reform efforts, was, according to existing studies, relatively successful. Unlike in Hungary, where the recapitalization process was isolated and not embedded in a larger picture of economic reforms, the recapitalization of the commercial banks in Poland was embedded in a larger picture of privatization, restructuring and reorganization of control and incentives.[249] In total, the extent of recapitalization was much smaller compared to Hungary (650 million USD), and its goal was to pre-

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[246] "Total domestic consumption of the major product of the seventy-seven firms declined on average by more than 40 percent between 1989 and 1991. The second most commonly cited cause, which affected about one-half of all firms, was an inability to collect receivables." Cheryl W. Grey, Arnold Holle, *Classical Exit Process in Poland: Court Conciliation, Bankruptcy, and State Enterprise Liquidation* in ENTERPRISE EXIT PROCESSES IN TRANSITION ECONOMIES, *supra* 236, pp. 207–247. It perhaps does not come as a surprise that the decline in industrial output equaled 40 percent in the same period.

[247] *Id*, p. 228.

[248] "The study concluded that, while some of the cases were legitimate instances of economic downturn, many were fraudulent in nature. Most assets with any value had been sold or otherwise disappeared before the petition for bankruptcy was filed or considered by the court." *Id*, p. 224.

[249] Herbert L. Baer and Cheryl W. Gray, *Debt as a Control Device in Transitional Economies, the Experience of Hungary and Poland, supra* 185, p. 83.

vent the banks from continually lending to bad debtors. The government decided to subsidize the state-owned enterprises directly through its budget (and not indirectly via irretrievable loans from the state-owned banks), thus achieving a greater transparency level of the subsidizing policy and allowing banks to perform solely on a commercial basis. As a result, banks stopped lending to firms with non-performing loans, which forced them into major restructuring, such as cutting costs, selling assets, and reaching work-out agreements with banks.[250] Management of the banking sector received incentives to start carefully weighing the worthiness of debtors and assessing risk on market based criteria. The incentives to maximize the value of the banks became clear even before some of the commercial banks were privatized.[251] Other prudent decisions of the government, such as early diagnostic bank audits based on international accounting standards[252] or the recapitalization of banks in order not to penalize the more active banks that were trying to retrieve loans by themselves,[253] contributed to a relatively successful and efficient way of banking reform. In comparison with Hungary, the banking sector in Poland showed its strength and adjustment to market rules much earlier and to a greater extent. A comparative study shows that in Hungary the equity of five out of eight banks remained negative even after an enormous recapitalization, whereas in Poland the equity of the commercial banks (owned by the Treasury) remained steady and five of the banks showed significant improvements.[254]

To summarize the Polish example from the viewpoint of comparative institutional reforms, there are many interesting examples that deserve to be put henceforth. In the first place, we saw major government programs, such as mass privatization, the creation of capital market, and banking-led conciliation that were implemented successfully. The strength of these programs was a strong regulatory framework, prepared in advance, and carefully chosen institutional framework, responsible for the successful implementation of government programs. Outside the government-launched programs, there were many uncontrolled, spontaneous and unplanned processes in the reorganization of the existing eco-

[250] *Id.*

[251] *Id.*

[252] The early diagnostic audit gave Polish government good insight into the conditions and problems of the banking sector, including a year-to-year comparison about changes and improvements. *Id,* p. 88.

[253] The value of non-performing loans was taken from 1991, which determined the amount of capital injected into the banking sector. *Id,* p. 84.

[254] *Id,* pp. 84–85. The study had to deal with many methodological problems, including the somewhat different nature of the two banking sectors, but it was still able to trace the distinctively better and more organized market approach with clear incentives on the side of the Polish banks in comparison with Hungarian banks. This, however, does not mean that the Polish banking sector was anywhere close to the ideal. Pp. 84–89.

nomic links, although on balance it seems that the government was capable of managing the transition. It was capable of designing and implementing many complex and highly demanding programs, even though it had weak support from the parliament, especially in the early 1990s before the electoral reform took place. On the other hand, the government delayed with many of the announced and planned reforms. The most peculiar aspect of the reform efforts was the long delay in preparing and implementing the privatization program. It started only after the economy had already picked up and recorded high growth rates. As such, the case of Poland deviates slightly from the general understanding that privatization was the central part of the transition, without which any corporate restructuring and economic development could not have taken place.

In the early years of transition, it was more important to stabilize the macroeconomic environment than change firm ownership. In Poland, a stabilized macroeconomic environment appears to be a stronger determinant of enterprise activities than any other attempt in changing the ownership structure of the firms. The government's determination to stop indiscriminately subsidizing firms and to stop indirect subsidies with the help of commercial banks owned by the state was particularly successful.[255] The clearly defined goals of the prepared government programs, its regulatory framework, and ability to engage in restructuring large enterprises (both state-owned enterprises and enterprises in the process of privatization) were the virtues of the Polish transition. The virtues of the transition in many ways counterbalanced the negative aspects of the transition, such as the immediate decline in economic output, the uncontrolled wave of bankruptcies based on the obsolete prewar legislation and the spontaneous part of "privatization through liquidation." Some of the studies show that Poland, through the course of transition, lost some of its potentially viable and competitive firms due to the induced macroeconomic shock and the inability of the government(s) to cope with some of the viable and potentially competitive, large enterprises in economic hardship.[256] Nevertheless, in the same period, and despite a frag-

[255] "While there is limited evidence that privatized firms were responding slightly better to the improved economic environment in 1993, the Polish survey suggests that by then there was little to distinguish privatized, commercialized, and state-owned firms in terms of restructuring behavior. One explanation is that the primary determinant of enterprise behavior in the early years of reform was harder budget constraint, and this impacted the entire former state sector, whether privatized or not." Saul Estrin, *Privatization and Restructuring in Central and Eastern Europe,* in Peter Boone, Stanislaw Gomulka, and Richard Layard, EMERGING FROM COMMUNISM, *Lesson from Russia, China, and Eastern Europe*, MIT 1998, p. 92.

[256] Enterprise level empirical studies showed the inability of many of the firms to restructure autonomously, despite having comparatively highly skilled management and relatively new equipment of good technology. Some empirical studies of the relatively good firms, unable to restructure before and during the process of privatization, analyzed by Amsden *et al, supra* 67.

mented political arena, the consecutive government launched few successful programs that created room for rapid economic development. The fact that a large number of enterprises remained in state hands even after a decade of transition [257] shows that the government in Poland succeeded not only in laying down an effective regulatory framework for the private sector, but was also able to force state-owned enterprises to start competing on highly competitive domestic and international markets without giving the latter unnecessary favors or concessions. Successful macroeconomic stabilization aside, the ability of the government to create an environment and the incentives conducive to private and state-owned firm restructuring counts as the most important achievement in the period of transition.

The Russian example

Due to its incomparable economic, social and political difficulties, Russia is in many ways the most difficult and complicated example of all the countries in transition. I do not intend to outline the Russian experiment of transition in this section. In this section I would like to point to some of the interesting instances of the Russian transition which are relevant to our discussion and are well documented and analyzed. The sheer size of its country, its economy, and the complexity of its inherited institutional structure do not permit rapid and general conclusions without taking into account the diversity and complexity of the Russian society and its economy.

A discussion on the Russian transition usually starts with an account of the unfavorable initial conditions, the magnitude of economic distortion rooted in the Soviet era, the inefficient and corrupt bureaucracy, and the highly centralized power that was in the hands of the old nomenklatura. Most of these facts are accurate and appropriate, especially in hindsight. A decade ago, however, the economic situation and the overall initial conditions in Russia were such that practically no one expected the disastrous failure of economic reforms. In fact, despite the magnitude of macroeconomic distortions, Russia enjoyed some comparative advantages over other countries in transition.[258] The country, which is

[257] EBRD TRANSITION REPORT 1999, country assessments, pp. 180–288.

[258] For example, Anders Aslund in his historical account of the Russian transition found that Russian industry was unusually competitive on the international level, and refuted the myth of Russian economy as uniquely monopolized: "The statistical study offers overwhelming evidence to refute this myth. At the national level, there was little aggregate or industry concentration. Monopolies and oligopolies accounted for an unusually small share of national employment and production in Russia... Russia's largest enterprises were actually smaller than those in many countries in the OECD. The total number of employees in the top twenty enterprises in Russia was less than in twenty biggest enterprises in the Unites States, Japan western Ger-

rich in natural resources, was to become an important exporter of strategic raw materials and energy, particularly gas and oil.[259] Unlike China, however, Russia opted, or was forced due to economic hardship, to choose the shock therapy approach instead of gradualism.[260] Russia did not start with land reform; rather, the large subsidies to the agricultural sector were immediately abolished.[261] As realized by Aslund, the government was pro-market oriented, but the underlying thinking was still stuck in the old command economy,[262] which led to further distortions and a return to cheap credits, before the agricultural market finally stabilized (without any further attempts in the reorganization of agricultural production). While Russia's output fell by 40 percent, China recorded the highest growth rates in the world. While the savings rate in China was around 40 percent and among the highest in the world, the savings in Russia were virtually wiped out due to the inflation and banking cri-

many, the United Kingdom, and France, even in absolute numbers. The average enterprise size was large only because there were so few small enterprises... In short, by any international standard, apart from the important absence of small manufacturing enterprises, the Russian industrial structure was unusually competitive..." Anders Aslund, HOW RUSSIA BECAME A MARKET ECONOMY, Brookings 1995, pp. 153–154.

[259] Alan Gelb, The role of initial conditions.

[260] The Chinese utilized a dual-track approach in almost every important policy-making segment, secured successful reforms in the agricultural sector by allowing the lease of land to peasants and a two-track pricing system (up to certain ceiling the prices of agricultural goods were fixed and liberalized beyond the ceiling) that spurred rapid agricultural development in the first years of reforms, from 1978 to 1982. Industrial liberalization followed in 1983, which gave enterprises greater autonomy in terms of profit retention, but created a contract responsibility system. External liberalization in 1984 created 'special economic zones' with a free tax regime for foreign investors, where some foreign currency could be retained. Gradual and incremental reforms in other sectors followed, such as by establishing a system of township-village enterprises (as opposed to state-owned enterprises), restructuring of the state-owned enterprises, and other reforms within the last two decades include, but are not limited to, regional development policies, trade promotion, foreign exchange management. In the last two decades, China recorded impressive growth rates, incomparable with any other country. For a discussion on Chinese gradual, incremental, and piecemeal approach toward reforms and the extent to which the Chinese experiment can be repeated in other developing countries, *see* Jeffrey D. Sachs and Wing Thye Woo, *Understanding China's Economic Performance (manuscript)* 1997, and Lawrence Lau, Yingyi Quian, Gerard Roland, *Reform without Losers: An Interpretation of China's Dual-Track Approach to Transition (manuscript)* 1997.

[261] "With the beginning of reform, the manifold large budget subsidies to agriculture were simply abolished in an attempt to balance the budget. This was an impressive show of political will by Yegor Gaidar, but it went almost unnoticed. However, without any actual policy, and with the old communist structures still in place, agriculture soon fell into a conservative trap. The regulative drive took shape in a decree on January 4, 1992, regarding compulsory deliveries of food to the state. It stated that a volume of grain corresponding to 35 percent of the average harvest between 1986 and 1990 should be delivered to the state." Aslund, *supra* 258, p. 162.

[262] *Id.*

sis. While China attracted around 40 billion of foreign investments per year, Russia managed to attract only around 2 billion of foreign investments and experienced massive capital flight in tens of billions of dollars. The crucial differences between these two countries certainly raise many questions about the proper handling of reforms despite their initial macroeconomic and social differences.[263]

Mass privatization in Russia was another key element in the transition process. The initial goals and underlying premises of the privatization scheme did not differ much from the other countries in transition. The most salient difference was that Russian reformers ran reforming attempts through presidential decrees and outside the parliamentary debates, which were consistently hostile and suspicious against reforms.[264] The number of medium and large enterprises to be privatized, which were spread throughout Russia's vast regions and were controlled by regional governments, while being situated in an increasingly unfavorable macroeconomic framework, presented some of the largest problems to reformers. The food shortages, especially in the winter of 1992 and the rapid deterioration of the social conditions added to the mounting problems. As such, Russian reformers were forced to choose between delaying reforms in the midst of growing difficulties or continuing the reforms despite the growing economic and social difficulties. Above all, they were hoping to make the reforms irreversible and to sever the links between politicians and firms through mass privatization. Only the severance of political ties and the establishment of clearly defined property rights could bring about the reversal of the economic decline, according to the architects of reforms in Russia.[265] Slow or delayed privatization would cause further economic stagnation despite the fact that 25,000 large and medium size enterprises had to be privatized.[266]

In this broader setting mass privatization could not start and gain its support without making some crucial concessions to workers and managers, which was clearly recognized from the beginning of the privatization program.[267] The main architect of privatization in Russia, Chubais,

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[263] For further comparisons in approach between reforms in these two countries *see* THE WORLD BANK DEVELOPMENT REPORT 1996, *supra* 6, pp. 19 and ff.

[264] The conflict culminated, as is well known, when Russian President ordered a military attack against the Duma and rebellions inside the parliament in 1994.

[265] "The most important objective of privatization is depoliticization of firms, or freeing them from politicians' control. The strategy for doing that is concentration of control and cash flow rights in the hands of enterprise managers and outside investors." Maxim Boycko, Andrei Shleifer, Robert Vishny, PRIVATIZING RUSSIA, MIT 1995, p. 69.

[266] "If these firms were properly valued, prepared for auctions, or, as some investment bankers wanted, restructured prior to sale, odds are privatization would have never gotten off the ground. Even if it did, at the rate of 200 per year, Russian privatization would have taken over a century! In the meantime, the economy would continue to stagnate." *Id*, p. 71.

[267] Concessions to the workers and managers were given in two main ways, despite the

fought against Option 2, but finally accepted it under the conditions that workers own their shares as individuals rather than as collectives and be free to sell their shares any time they want.[268] As it turned out, the privatization process in Russia was largely dominated by insiders, although at first glance it resembled the Czech-style voucher privatization through auctions. Like in the Czech Republic, the reformers opted for vouchers which could be used at auctions through investment funds or could be directly placed into the enterprises. The process of incorporatization prior to mass privatization required the large manufacturing enterprises to register as joint-stock companies with 100 percent equity owned by the government. Additionally, they had to have their own charter and a board of directors, which consisted of government representation, the firm's general manager (with two votes), the workers, and the local government, but with no representation of outside investors.[269] The process of incorporatization – for the first time in Russian history[270] – was of great importance, because ministries started to loose control over "their" enterprises and new powers and importance was given to the managers. It was the task of the managers to value the firm's capital to determine their charter capital.[271]

The process of incorporatization, the important first step toward mass privatization, was deeply politicized. The cabinet had to negotiate a list of large enterprises to be privatized as opposed to the enterprises that would not undergo the process of mass privatization. As a result, the firms in strategic industries, such as natural resources and defense, could be privatized only upon approval of the whole cabinet, whereas firms in railroad transportation, space exploration, health and education

skepticism of the reformers about the possibility of successful partnership between workers and managers (due to theoretical problems in raising capital and resolving between shareholders which claimed to be insurmountable in Russia, p. 78): "Option 1 offered workers 25 percent of the shares in their firm for free, but made these shares nonvoting to prevent worker control. Workers could buy an additional 10 percent of the shares at a 30 percent discount from the book value... Top managers received 5 percent of the shares at a nominal price... Option 2 as a compromise between Chubais and the Parliament allowed managers and workers together to buy 51 percent of the voting equity at a nominal price of 1.7 times the July 1992 book value of assets... These benefits to the workers and managers far exceeded those offered in any other privatization ever attempted in the world." *Id,* p. 78.

[268] *Id,* p. 78.

[269] *Id,* p. 74.

[270] *See* Owen C. Thomas, *Autocracy, Corporate Law, and the Dilemma of Cultural Decay* in THE CORPORATION UNDER RUSSIAN LAW, 1800–1917, Cambridge 1991, ch. 8, pp. 198–219.

[271] Boycko *et al, supra* 265, p. 75. According to reformers, the valuation of the firms was one of the hardest fought battles in privatization. Bureaucrats tried to hold a grip on valuation criteria and adjustments of the book values, but failed. Ultimately, the privatization program did not rely on valuations. *Id.*

were excluded from privatization at the outset.[272] The distribution of vouchers to citizens (including children for a nominal payment of 25 rubles) was the next major step in privatization. Vouchers could be invested in privatization funds, or they could be used to buy shares personally or at auctions. Vouchers, denominated in currency, could also be traded freely. The alleged advantages of auctions (for example, the allocation of shares to those who value them most and firm valuation based on market standards, not bureaucratic pressures or influences)[273] were taken into account when the auctions were organized. Unlike the centralized auction bidding process in the Czech Republic, the auction process in Russia had to be decentralized and the roles of managers in preparing the auctions were emphasized again to retain their support for privatization.[274] Auctions themselves were simply organized in a way to include all the placed vouchers and shares that were inversely proportional to the number of vouchers. Potential buyers thus could not speculate about the price of shares, but all investors were certain to receive some shares.[275]

The investment privatization funds also somewhat differed from those in the Czech Republic. The regulatory framework was similarly open with only few restrictions regarding the founders of the privatization funds. Because reformers did not want any state participation in the process of privatization, the state-controlled institutions could not participate as founders of the funds. The prohibition was generally observed, as the empirical study shows.[276] Outside a few distinct prohibitions, entering the market of newly established privatization funds was open with very minimal charter capital and the licenses to the funds and managers were easily granted.[277] The main founders of the funds were private banks, insurance companies and other financial institutions outside the state financial sector, but the foreign financial institutions, unlike in other countries in transition, showed practically no interest in setting up their own privatization funds in Russia.[278] The simple system of auctions

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[272] *Id*, p. 74.

[273] *Id*, p. 88.

[274] The reasons were partly in the geography of the country and partly in seeking further support from managers and local governments. *Id*, p. 88.

[275] P. 91.

[276] "The architects of Russian privatization were very thorough, much more so than their Czech counterparts, in trying to prevent both direct and indirect state ownership of the privatized companies... The funds were prohibited from acting as banks or insurance companies, and the prohibition on the ownership by state-controlled entities naturally worked to restrict the role of old-style banks in the creation of the funds – perhaps the most important difference with respect to the Czech funds." Roman Frydman, Katharina Pistor, and Andrzej Rapazcynski, *Investing in Insider-Dominated Firms,* in Roman Frydman, Cheryl W. Gray, Andrzej Rapaczynski, CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, *supra* 80, pp. 202–203.

[277] *Id*, p. 192–193.

allowed for the rapid process of mass privatization in which privatizing firms sold on average 29 percent of their shares at auction, whereas the strategic enterprises sold less while more was retained in government hands.[279] The interesting peculiarity of the auctions was that funds and other outside investors could not know the volume of privatized shares and the share of firms actually undergoing privatization in advance. Namely, the auctions, organized by the regional property funds, turned out to have much higher share prices than the insiders at the closed subscription.[280] Thus, on the basis of empirical studies, outside investors received only 5.7 percent of the shares of the privatized firms, despite investing in about 20 percent of all the vouchers.[281]

Despite the comparatively weaker role of the Russian investment funds, the funds played a role in some elements of firm restructuring. Funds still managed to obtain a portfolio in about 7,000 firms around the country, pursuing primarily the goal of achieving dividends in the firms. In the absence of the necessary information about the firms, funds sometimes obtained large stakes in advance because they could not know how many shares they were bidding for.[282] In such instances funds became more active players in running the firms, but in a large majority of the firms the role of outside investors was small and proportional to the typically small percentage of their stakes, which were acquired through the auctions.[283] Having obtained only a minority of stakes in the firms, funds had to choose a different strategy to participate in the corporate governance of the firms. In the firms, where they were minority holders, they had to ally with the management of the firms and with other large stakeholders, which was primarily the state.[284]

Among the other, more important elements of the activist approach toward running the firms by the funds, were providing the expertise for investment and firm restructuring, helping to arrange links with suppliers and customers, and helping to arrange access to credits and providing other forms of expertise.[285] Despite largely illiquid capital markets, weak regulation and a low level of transparency, the trading on the capi-

[278] Only two funds reported to have foreigners participate in their management companies. *Id,* p. 203.

[279] Boycko *et al,* p. 84.

[280] *See supra* 276, pp. 195–196.

[281] *Id,* p. 196.

[282] *Id,* p. 200.

[283] The empirical evidence shows that only in 125 firms the funds own more than 25 percent of the shares, whereas in more than half of the privatized firms the average stake of the funs is less than 5 percent. *See* pp. 199–200 and Table 5.6 on p. 199.

[284] This was true in general, but even more so in cases where the privatized companies were among the founders of the funds, which led to the 'managerial friendliness' of the funds. *Id,* pp. 232–233.

[285] Empirical data about the various forms of funds activism *id,* pp. 218–219.

tal market was surprisingly active and the investment funds frequently engaged in trading on the secondary market.[286] The investment funds outside the few biggest funds could not, however, overcome two major obstacles on the road toward creating efficient capital markets and an efficient market for corporate control: (1) to solve the cash-flow problems without selling the best shares in their portfolio, (2) and to acquire large stakes in potentially viable companies. The inability of the funds to overcome these two obstacles further undermined the prospect of the development of a viable capital market. Meanwhile, the trust of the citizens in the funds had plummeted. The limited impact of the funds on reorganization and firm restructuring led many scholars to the conclusion that investment funds in Russia did not contribute to the efficient distribution of property rights and to the rapid development of the efficient capital markets.[287] Weak regulations without disclosure requirements and a lack of auditing requirements did not help, either.

The main characteristic of the ownership structure in Russia after mass privatization is the dominance of the inside owners of the firms. Existing surveys of the ownership patterns in medium and large enterprises in Russia show us that employees owned 59.2 percent of the outstanding stock of the companies surveyed.[288] Strong insider ownership in Russia does not, however, mean that workers can exert some influence over the privatized companies. In Russia, unlike in some other Western countries, no legislation requires workers' representation on the boards of directors.[289] Another important factor about the distribution of property entitlements of insiders was the gradual concentration of ownership primarily in the hands of senior and top management of the firms. Contrary to the initial expectations of the architects of reforms, workers did not start selling their vouchers to the funds as the outside owners of the firms.[290] Most of the vouchers they decided to sell ended up in the hands

[286] 57 percent of the funds reported active trading on the secondary market, using this primarily as the opportunity to make profits by selling extremely undervalued shares of the firms in the early stages of privatization. *Id,* pp. 224–225.

[287] For more on the inefficient role of investment funds in Russia *see* in Pistor and Spicer *Investment Funds in Mass Privatization and Beyond, supra* 128, pp. 98–101.

[288] Data provided by Joseph Blasi, *Corporate Ownership and Corporate Governance in the Russian Federation* in BETWEEN STATES AND MARKETS, *Mass Privatization in Transition Economies, supra* 85, p. 163. For a comprehensive empirical survey of the Russian transition and mass privatization *see* Joseph R. Blasi, Maya Kroumova, Douglas Kruse, KREMLIN CAPITALISM, *Privatizing the Russian Economy,* Cornell University 1997.

[289] "The survey suggests that few workers and their trade unions are interested in corporate governance, and many do not even monitor their shareholdings." *Id,* p. 163.

[290] Frydman *et al.* noticed that initial discounts to the workers were designed to achieve the quick sell of the vouchers, which were acquired easily and almost for free. A large amount of anecdotal evidence suggests, however, that managers were the first and most skillful in using this opportunity to persuade or sometimes coerce workers to sell vouchers to management or subsequently not to sell them to anyone. *Supra* 276, pp. 226–228.

of the management of the privatized firms. Promises to keep jobs, the urge to receive some cash, weak legislative protection of the minority holders and sometimes even coercion from management were among the main reasons for the sale of vouchers to management.[291]

It cannot come as a surprise that surveys show the importance and strength of top management in acquiring the large stakes in privatized firms.[292] On average, company managers reported that they own 17 percent of their companies and that they own more than 50 percent in one of every 20 companies.[293] Ownership concentration varied somewhat across different sectors, but the concentration of ownership among top managers remained almost the same regardless of sector.[294] Furthermore, due to the Russian understanding that the owner of the firms must be a physical person (and not, for example, an institutional owner),[295] the concentration of ownership in the hands of top executives is even more telling: in one of every 5 companies a single employee owns more than 5 percent of the outstanding stock and in 86 percent of these cases this employee is a top manager, typically owning a 12 percent stake.[296]

The restructuring efforts of the Russian privatized firms did not differ significantly from other countries in transition except for the fact that Russia had even worse macroeconomic conditions. A barter economy, inter-enterprise arrears, the omission of payments of wages to workers for months and the overall rapid decline of production were among the most visible signs of the overall deterioration of the economy. Contrary to conventional expectations, the majority of the employee-owned firms

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291 "To the extent this story is correct, one could expect perhaps that because protection of minority rights, especially enforcement of basic rules concerning voting and share registration, might "emancipate" the workers, who are collectively the largest shareholders in nearly every Russian firm, and put them in a better position to sell their shares. To be sure, such enfranchisement might also bring greater worker participation in the government of privatized enterprises – which most observers do not find an attractive prospect – but the level of worker organization required for an effective exercise of worker control might not be present." Frydman *et al, supra* 276, p. 228.

292 We should not forget the traditionally important role of top management, because they were responsible not only for the enterprises, but also for the well-being of the their employees. Consequently, managers had strong opinions on what should be done with the firms. Their support for employee ownership came primarily as a defense against the potential outside owners of the firms, or, as Blasi noticed: "as a kind of Trojan horse that would carry them through the gates of privatization." Blasi *et al, supra* 288, pp. 52–53.

293 Blasi, *Corporate Ownership and Corporate Governance in the Russian Federation, supra* 288, p. 163.

294 "Ownership by top management is very similar, on average, across the four sectors (10.8 percent in consumer noncylicals, 11.3 percent in consumer cyclicals, 10 percent in industrial and technological companies, and 6.4 percent in utilities)." *Id.*

295 *See* more about this mentality in Blasi *et al, supra* 288, pp. 56–57.

296 Blasi, *Corporate Ownership and Corporate Governance in the Russian Federation, supra* 288, p. 163.

did not behave differently than other types of firms in Russia. For example, the available data suggest that employee-owned firms did not spend significantly more on either wages or social services.[297] On a comparative basis, the historical battle for control over the firms did not leave the employee-owned firms in financially worse situation than other firms. The empirical analysis even suggests that firms which remained in the hands of management as majority owners fought harder to stay afloat.[298] It seems therefore that the process of mass privatization played the role of natural selection, where potentially prospective firms typically ended up in the hands of top management or the state bureaucrats turned into businessmen. In the absence of an efficient capital market and any bankruptcies or other similar market criteria, it is practically impossible to claim that "natural selection" reflects the true and successful selection of the firms.

Restructuring on a deeper level to raise labor productivity, to employ investment capital, and adopt new technologies or introduce new products on the market was a much more complicated issue. There were certainly serious attempts to deeply restructure production in some firms in the aforementioned way.[299] The overall survey regarding the restructuring efforts of the firms in the post-privatization period suggests, however, that there were few attempts to profoundly restructure privatized firms. The analysis based on the National Survey from 1996 came to the conclusion that most of the companies did not seriously engage in restructuring activities.[300] Apparently, this was true for the privatized firms regardless of the ownership structure.

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[297] Blasi *et al, supra* 288, pp. 58.

[298] "There is some evidence that insiders fought harder because they secured majority ownership in the more valuable firms. A close look at employee majority ownership indicates that majority is large in very few Russian firms. With 10 to 20 percent of these firms' shares still in the state's hands, ultimate control probably depends on who wins out at the auctions of those shares. A fifth to a third of majority employee-owned firms are within one auction or one modest stock transaction of losing majority insider control. This is one reason why the privatization of those state shares became so politically controversial in 1995 and 1996." Blasi *et al, supra* 288, p. 60.

[299] In Blasi *et al.* there is a detailed analysis of the largest Russian truck producer – KamAZ from the Tatar Republic, which produced 120,000 vehicles per year and employed 117,000 people. During restructuring efforts, the company worked in close cooperation with Kohlberg Kravis & Roberts, which helped KamAZ enter international financial markets to raise necessary capital for investment. The American company further helped revise its product line to increase customer demand and advise with regard to developing and selling products. Other advising firms, such as Deloitte & Touche helped KamAz to restructure their banking debts. Cooperation with EBRD to issue additional shares was also among the efforts. The final results of restructuring are not available. *See* pp. 124–125.

[300] A completely restructured company could score 69 points if it implemented all 69 specific restructuring actions (which included, for example, changes in management and control, changes in organization, capital, social services, etc.): "The average score for all firms was 20, an indication that most companies were not seriously

There are other empirical studies, however, which show the ability of the privatized firms and the other regions that were able to reorganize and successfully adjust their production. One such example of the transformation is the Sverdlovsk region in Northern and Middle Ural, which concentrated on mining and metallurgy since Peter the Great's drive to industrialize Russia until 1990, when one third of the labor force was working in the defense relating companies.[301] Being far away from the capital and left to themselves, the region as a whole had to decide whether to reorganize and restructure or go bankrupt altogether. The industry of the region was forced to emancipate itself from the old system of vertical integration that placed the state ministries on top of the hierarchy.[302] After becoming autonomous, and having at their disposal not only wide range of manufacturing technologies, but also skilled labor and competent management, they had to make decisions about the future selection of projects. Companies saw potential niche for rebuilding the industrial infrastructure of the country (including the pipelines, the power transmission and switching equipment), which might produce a large market for components and installments compatible with Russian and international standards. Firms in the region were capable of using their stock of capital equipment for multiple, but matching purposes.[303]

The change in ownership of the firms in the region was not a major distress for the firms, which mainly used the Option 2 model of privatization. More important than the process of privatization itself was the possibility for the firms in the region to reorganize on their own. Firms slowly started to select investment projects and to set up new, flexible production processes that were based on the quick adaptability of the

engaging in two-thirds of the restructuring activities. No company scored above 42, and only a tenth of the companies achieved a score above 30. The combined percentage of either outside or blockholder ownership made a significant difference, but the impact was very small. A 10 percent increase in outside ownership increased the restructuring score about half a point, and a 10 percent increase in total ownership by blockholders raised it only slightly more." Blasi *et al, supra* 288, pp. 139–140. *See* also Table 10 on pp. 203–205.

[301] The study of the transformation of the Sverdlovsk region was prepared by Charles F. Sabel and Jane E. Prokop, *Stabilization through Reorganization?* in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, *supra* 80, pp. 151–191.

[302] To be sure, first experiments toward converting military industry into civilian industry already started in the mid-eighties. There were state-sponsored efforts and even some joint ventures were established with foreign companies in the Ekaterinburg. Still, military production was the main source of production and employment even until mid-nineties. See p. 179.

[303] For example, Urals Heavy Machinery, which was producing artillery pieces, was capable of producing pumps for oil industry. The adjustment could preserve the firm as a whole, especially if pump production could be further diversified into consumer goods and transportation equipment and preferably allied with foreign joint-venture partners. *Id,* p. 180.

available technologies.[304] New profit centers, small enterprises and joint ventures emerged in proximity to the main industry. Their new autonomy, their ability to employ the available industrial technology and to adopt a flexible organization and production processes present a pattern of reconstruction that is comparable to other great innovative approaches toward institutional and organizational innovations, such as the examples of Volkswagen, IBM or GM. Their innovation lies not as much in the issue of residual ownership, instead it depends on the issues of autonomy, cooperation and teamwork, and maintaining constant adaptability in the organization of production, which enables firms to successfully compete on the international markets.[305]

Outside some regional attempts to reorganize and restructure the privatized firms and the regional industry, few other centralized attempts are known. In the midst of the crisis and economic slump the central government launched a plan to establish financial-industrial groups through legislation, which was passed in 1995. According to the law, the groups are to be formed voluntarily by legal corporations that want to integrate their technological, economic, and other resources for investment or other projects.[306] The government tried to play a proactive role and financially supporting such groups. In practice there were many objections against such a program for several reasons based on ordinary market criteria. Among the important objections were that government had no antitrust policy, so the creation of such a group could lead again to monopolistic production in the industries. Because the government provides guarantees for credits to such groups, they could easily become a prey to lobbies and organized interests at the expense of less organized parts of the industry, which might again suppress the market forces. The issue of taxation, which is easier to hide behind the consolidated financial results of such groups was also among the important objections.[307]

On the other hand, the government had to do something during the economic slump, and this program was one such initiative. An analysis

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[304] "This was particularly true in the case of a firm like Urals Heavy Machinery, whose military customers were extremely reliable and well financed and whose products require constantly changing combinations of a wide range of manufacturing technologies. Thus, guided by the motto "Vse sdelai sam" (Do everything yourself), the firm became a microcosm of the metalworking industry as a whole, building up a huge machine park in which tools were grouped by type: lathes in one shop, milling machines in another. This guaranteed the company maximum flexibility so long as there was an assured market for complex mechanical products that could be made with the entire ensemble of machines." *Id,* p. 180.

[305] *Id,* esp. pp. 174–187. *See* also Mark Best, THE NEW COMPETITION, Harvard 1990, esp. pp. 1–26.

[306] Overview and analysis of the financial-industrial groups made by Enna E. Karlova, *Financial-Industrial Groups, Industrial Policy, and Competition in the Russian Federation,* in BETWEEN STATES AND MARKETS, *Mass Privatization in Transition Economies, supra* 85, p. 148.

[307] For the extensive list of objections *see id,* p. 148–149.

of the actual operation of the groups suggests that many of them were in fact successful. As reported, the first 4 registered groups increased production by 4 percent in the midst of an industrial slump in 1993 while preserving an unchanged work force.[308] Other groups or conglomerates, such as the large chemical complex, or the metallurgical complex, which included auto plants, banks and foreign companies, also emerged as powerful industrial groups. The administration of the Central and regional governments were among the shareholders of the established conglomerates, but the banks were getting more and more linked with the conglomerates, too. To some extent, the established conglomerates with regained links to the government and administration are reminiscent of an old style of command economy. On the other hand, the groups of firms, closely connected to one another, while maintaining links to the government and the banks, had to operate on market criteria in order to pursue profits, which might delineate them from the old style economy. Again, weak legislation and weak supervision of the government might offer opportunities for bypassing the market principles. Thus, the established conglomerates presented a double-edged sword for the Russian economy: if the basic market principles, including antimonopoly policy, state aid policy, disclosure requirements and other basic rules were observed, then conglomerates might play a productive role; if not, then they might further dampen the market development in Russia.

The architects of reforms in Russia believe that mass privatization was a success.[309] In a very short period, about two thirds of the large and medium sized enterprises were transferred into the hands of new owners and the implementation of privatization went mainly according to the original design of the reformers. Yet many of the problems obviously remained, and serious new problems emerged. The problems with the efficient distribution of property rights have not been resolved, and the struggle for corporate control and the improvement of corporate governance continue. In macroeconomic terms, the size of the Russian economy has decreased by 40 percent within a decade,[310] barter trade has spread, while the privatization revenues were miniscule.[311] Mass privati-

[308] Those groups were: Uralske Zavody, Sibir, Dragotsennosti Urala, and Ob'edinennaya Gorno-Metallurgicheskaya Company, *id.*

[309] "All the principal elements of the Russian privatization program worked largely as planned, and the program turned into a rare success story of Russian economic reform." Boycko *et al, supra* 265, p. 98.

[310] "Except for 1997, GDP has decreased every year for the past decade, with an accumulated decline since 1991 of 40 percent." Anders Aslund, *Russia's Collapse,* FOREIGN AFFAIRS, September/October 1999, vol. 78, no. 5, p. 64. *See* also statistical indicators in EBRD TRANSITION REPORT 1999: Russia reached zero growth rate in 1999 and will record positive growth rate in 2000; in 1997 positive growth rate was 0.8. *See* pp. 260–261.

[311] "Over the 20 months of privatization, the price of the voucher fluctuated between \$4 in the winter of 1993 and around \$20 in June of 1994. For most privatized firms, the

zation was accompanied by a massive capital flight in the size of tens of billions of USD, which further undermined the chances of the Russian economy to recover. Some of the privatization programs were tainted with corruption,[312] which culminated in the "loan-for-share" program.[313] The most valuable assets, including the oil and gas sectors, were excluded from standard privatization and were privatized according to presidential decrees, heavily influenced by special interests.[314]

voucher price was not higher than $20. Under this assumption, the implied aggregate value of the Russian industry was under $ 12 billion. That is, the equity of all of the Russian industry, including oil, gas, some transportation and most of manufacturing, was worth less than that of Kellog or Anheuser-Busch." Boycko *et al, supra* 265, p. 117.

312 "For example, the winner of the investment tender for Lada car maker VAS was AVVA, the dubious financial group controlled by VAZ itself. Not surprisingly, AVVA received the stake for the reserve price, and there were no competitors." Boycko *et al, supra* 265, p. 116.

313 The infamous loan-for-share program as described by Aslund: "The loans-for-shares deals at the end of 1995 were a scandal which blemished First Deputy Prime Minister Chubais and damaged the reputation of large-scale privatization. A few large banks were allowed to privatize some large enterprises in auctions they themselves controlled. In fact, only 15 large enterprises were involved and in some cases sold only a small share of their stock. But a few huge cash cows did change hands, most notably three big oil companies, Yukos, Sibneft, and Sidanko. No qualitative change accompanied these takeovers. The new majority owners did not behave like self-interested proprietors but just continued the management theft, primarily by selling the products below market prices to their own trading companies, letting the old state companies deteriorate. After a short-lived boom, these companies' values fell below their low purchase prices. For instance, Norilsk Nickel, the large metal company, was long worth less than what Oneximbank paid for it in a 1995 noncompetitive deal. In 1998, the big new "capitalists" showed yet again that they could not care less for the market value of their enterprises. Many minority shareholders responded by selling off their holdings. The Russian stock index consequently dove 94 percent from its peak in 1997. After the financial crash, these businessmen attempted to extract more money from the state – fortunately, there was little left to take." Aslund, *supra* 310, p. 69.

314 "The most egregious examples are the privatization of Gazprom and the loans-for-shares program launched in 1995". *See* Pistor and Desai, *Financial Institutions and Corporate Governance: A Survey of Six Transition Economies* in BETWEEN STATE AND MARKET, *Mass Privatization in Transition Economies, supra* 85, fts. 6 and 7 on p. 141. The authors also provide the more detail mechanisms of "loan-for-shares" program: "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."

Many laws were not in place when they were needed, while most and some others were not implemented due to a largely disorganized and incompetent bureaucracy. For example, bankruptcy law, anti-monopoly laws, and laws protecting investors on the stock market were either not in place or were poorly (if at all) executed.[315] The efforts of the reformers to break the backs of the ministries[316] might have also proven costly. Before bureaucracy became too corrupt, some type of workable relation between the central bureaucracy and the firms throughout the country was probably more advisable than trying to exclude bureaucracy at the beginning of reforms.[317] Loss of confidence in the institutional framework led to larger distrust against reforms.[318] The chosen order of reforms also played an important role. The persistent hostility of Duma against private land ownership did not allow agricultural or land reform. The negotiation to enter the WTO would certainly require a more transparent picture of the government's fiscal and industrial policy, and would force economy to rapidly adjust to international standards, while also creating an unambiguous and transparent institutional framework. The new economy that emerged within the last decade apparently tends to rewrite many of the rules that were only a decade ago taken as iron rules. Rapid changes and the development of international finance, information technology, telecommunication and many other sectors (energy, transportation) influence the domestic policies of the developed and developing part of the world. As such, globalization is a given fact, for which both developed and developing countries must find adequate answers to successfully pursue their policy goals.

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[315] A snapshot of historical legislative development in Russia in EBRD TRANSITION REPORT 1999, p. 259. An analysis of the development of corporate laws and about the missing puzzles in the legislative history of commercial laws in Russia by is completed by Katharina Pistor, *Company Law and Corporate Governance in Russia,* in Jeffrey D. Sachs and Katharina Pistor (eds.), THE RULE OF LAW AND ECONOMIC REFORM IN RUSSIA, Harvard University Russian Research Center 1997, pp. 165–187.

[316] "They [ministries] were given no role on boards of directors, in the preparation or approval of privatization plans (except in a few strategic companies), or in voucher auctions. Their great ideas about financial-industrial groups directed by former ministries never came to pass. With the help of the stakeholders, reformers broke the backs on the Russian ministries. Since the program's main objective was depoliticization, this was a vital accomplishment." Boycko *et al, supra* 265, p. 94.

[317] For the post-communist struggle between reforms and rent-seeking *see* Anders Aslund, *Why Has Russia's Economic Transformation Been so Arduous?*, paper prepared for the Annual World Bank Conference on Development Economics, Washington, D.C., April 28–30, 1999.

[318] Some of the observers noticed that public dissatisfaction with mass privatization was primarily a lightening rod of dissatisfaction with other less visible processes, such as hidden transfers through price transfers and cross subsidization in import subsidies, export subsidies, energy sector etc. Namely, mass privatization was among the most transparent and highly advocated processes when compared to some other, equally important reforms. *See* Blasi *et al, supra* 288, pp. 172–173.

Being interrupted half way through reforms is a nightmare for any reformer. Loosing public faith and support for reforms while vested interests are capable of unrestrained rent extraction is probably the worst possible outcome of large-scale institutional transformation. Yet building new consensus and a coalition for further reforms became a challenge for the second generation of reformers. Learning on past failures and successes should present a new point of departure. Providing transparent future steps in reforming and stabilizing ownership relations, promoting the developmental and entreprenurial potential of people around the country, and securing implementing the regulation of capital markets are among the next steps in reforming the country. A strong and democratic state, based on decentralization and market dynamics, should be capable of raising the necessary revenues to offset social insecurity for the disadvantaged. Instead of the transition process producing a prey of lobbies and handful of winners, the government should provide a fair chance to all of its citizens in terms of education, access to initial capital investments, and basic social security. To give up on reforms at this moment would only mean to secure the privileges of the few at the expense of the majority within the economy and society. The lessons from the past decade certainly present enough know-how and insight to successfully continue with reforms, while rejecting fear from future reform failures. It is therefore up to the courage and democratic accountability of the second generation of reformers in Russia to continue and complete this demanding task.

CONCLUDING REMARKS ON MASS PRIVATIZATION, RESTRUCTURING AND LEGAL INSTITUTIONS

The empirical material on mass privatization, restructuring and legal frameworks suggests that only a weak and often precarious causal link exists between institutional reforms and the overall restructuring and improvement of the economy and society for the countries in transition. Many of the initial expectations based on conventional textbook knowledge did not materialize in practice, whereas some others did. Therefore, for practical and theoretical purposes, the following question should be raised: in what conditions and what circumstances are institutional reforms likely to work, and what are the potential impediments, gains and costs of large-scale institutional reforms? While seeking some general findings about the large-scale institutional reforms with particular respect to mass privatization, one needs to emphasize two important caveats. One caveat is that implementing large-scale institutional reforms in a less than ideal economic and social environment is certainly far more difficult than performing reforms and structural changes in a wellarranged and organized society with accumulated know-how and potential. Another caveat is when analyzing the path of reforms in the countries in transition, one needs to liberate himself from many of the popular dogmas and myths about the reform efforts and results, both positive and negative. Sometimes the gathered empirical material, based on comparative studies and analyses is richer and more descriptive than any general theoretical conclusions on their own.

Everything is contextual and the large-scale institutional reforms in the countries in transition occurred in a specific context. An institutional solution, which might work in principle and in a certain larger context, might not work in another context. We saw that institutional details are decisive and take the course of reforms in other ways than initially hoped and expected by the reformers. At other times, the hidden agenda of reformers led toward sophisticated strategic behavior when one set of declared structural changes were supposed to lead to another set of tacitly implied goals. Of course, such an approach necessarily raises the issue of democratic accountability and legitimacy, which even in the case of a successful outcome cannot be advocated on a large scale.[319] More comprehensively, the actual context always requires particular set of institutional solutions to achieve the desired goals. Responsiveness and flexibility during structural changes are essential elements, without which reforms could easily collapse. But the lesson seems to be that it is not possible to carry out reforms successfully without a strong regulatory framework in place before the actual reforms are implemented. Perhaps the weakest part at the beginning of reforms was adopting and believing that there exists only one coherent and valid path of institutional solutions that would automatically trigger rapid development. Little by little reformers realized, however, that the an available set of institutional solutions does not automatically guarantee the achievement of the expected and desired results and does not necessarily present an answer to all of the concrete problems they had to confront in social reality. Along the path of reforms they discovered not only that there was a much larger set of institutional possibilities, but also that only a successful mixture of the best available institutional solutions applied cum practical innovations in their concrete situations might yield the desired results. If there are any winners among the first generation of reformers in the countries in transition, they are those who successfully combined the best available practices from around the world with their own solutions for the concrete problems within their context. However, successful reformers are not necessarily the most appreciated reformers in the eyes of observers or citizens.

Furthermore, the preoccupation with reforms in the countries in transition does not mean that time had stopped in the other parts of the

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[319] Joan Nelson.

world. In fact, we saw dynamic developments in many other parts of the world, especially in the US, but less so in the EU. Among the developing parts of the world, Brazil suffered from a financial crisis and is recovering again, but China recorded high growth rates throughout the whole decade. The international framework and international rules of fair trade changed substantially, while the monitoring system of fair trade practices strengthened. Regional integrations, most notably EU and accession agreements of some of the countries in Central Europe laid down new, stricter rules in the fields, such as competition policy, financial regulation, intellectual property laws, state aid, and standards of products and services. Such rules made their own significant impact upon domestic policies pursuing designed reforms.

Both domestic and international institutional frameworks as well as the rapid domestic and international development in the last decade influenced the course of the reforms. Inversely, domestic institutional development simultaneously influenced reforms. In the last section of this chapter I would therefore like to explore some of the specific institutional solutions and some specific theoretical premises upon which the reforms were built and determined. A comparative approach should facilitate the analysis. The institutional differences in designing a system of corporate governance, the incentives to restructure along the process of privatization and the creation of an efficient capital market will be the focus of my analysis. In addition, the role of government in designing proper legal framework will be analyzed.

Designing an efficient model of corporate governance for the countries in transition

One of the surprises of mass privatization was that the privatized firms in many countries did not behave significantly different than those which remained in the hands of the government or those which were partially privatized – at least in the first years after privatization. According to everything we learned from the decade of reforms, focusing primarily on mass privatization and neglecting the other important parts of institutional reforms, such as financial regulation or competition, was certainly a mistake. Mixing means and goals in privatization was another mistake, because we saw that privatization could not solve the many other deficiencies of the post-socialist economies.

To be sure, this is not a debate questioning the rationale of privatization in post-socialist economies; it is a debate about the additional necessary measures to secure the proper incentives for restructuring, technology and organization improvement, and increasing productivity and competitiveness. The point of departure for this debate is recognizing that, speaking comparatively, on average the privatized firms did not solve the corporate governance problem to an extent that made the majority of the privatized firms internationally competitive. Comparative studies available to date show that weak arrangements of corporate governance do not allow for a clear one-way approach toward strategic corporate actions, such as restructuring of the firms. Opposition sometimes comes from the inside due to a lack of interest from the existing management, sometimes from the outside due to a lack of interest or incentives from the outside owners and sometimes from the inability of the owners – inside or outside – to raise enough capital to finance the restructuring.

While recognizing the immense complexity of multiple relations inside and outside the corporation that trigger the efficient behavior of the firms in transition, the forthcoming discussion is based on the belief that there is still room for improving the legal institutions to refine corporate governance in the countries in transition. The fundamental elements of corporate governance remain weak.[320] The discussion on improving corporate governance in transition countries should not be completely mixed with the growing literature on corporate governance issues that emerged within the last decade. Although there are important similarities and analogies in the general discussion on corporate governance, I would like to delineate the concrete discussion on corporate governance of the firms in transition from the general discussion about corporate governance.

Although the discussion on corporate governance for the newly privatized firms resembles partly the discussion on corporate governance of *de novo* firms in the developed markets, it must also take into account several additional factors. For example, the method of privatization, the peculiar relation between the inside and outside owners of the newly privatized firms, the largely illiquid and underdeveloped capital markets, the regulatory framework and existing (dis)incentives of the investment funds to engage actively in corporate governance, and the broader macroeconomic environment that adds its own important dimension for the behavior of private firms.

As already mentioned several times, it is extremely difficult to determine the causality and independent variables along the chain of legal origin, corporate arrangement, corporate behavior and economic development. We had little difficulties in finding the negative causality between economic decline, mass privatization and macroeconomic stabi-

[320] "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." Joseph Saba, *Orphans in the Storm: The Challenge of Corporate Governance in Transition Economies,* in BETWEEN STATE AND MARKET, *Mass Privatization in Transition Economies, supra* 85, p. 125.

lization in the first years of reforms. Establishing a positive causal link between new legal institutions, privatized firms and restructuring is a separate endeavor. The issue of corporate governance for the firms in transition economies could be taken as a focal point for some of the most crucial institutional issues and policy recommendations. Policy recommendations, however, can only be successful if they are country specific and take into account the transitional path and outcomes of mass privatization while bearing in mind the important, but limited scope of abstract theoretical presupposition. Borrowing institutional solutions from other countries is only as good as our own understanding of those institutions and as good as our ability to adjust the borrowed solutions to the existing domestic environment.

The growing literature on corporate governance primarily discusses the relationship between and among shareholders, the board of directors and senior management.[321] The issue on how to protect small investors seems predominant in the literature on corporate governance. Unlike the existing debate in well-ordered societies with developed capital markets, a legal system and corporate culture, authors Berglof and von Thadden propose a different, broader conceptual model of corporate governance for the countries in transition. They believe we should take into account the important factors that determined the path of reforms in the countries in transition. The determining factors of corporate governance for the countries in transition are: (1) the undeveloped capital markets, (2) the lack of judicial decisions and judicial practice with regard to corporate governance, (3) the particular ownership structure with inside owners including workers and largely disinterested owners, such as privatization funds or government. Therefore, they advocate broader conceptual approach, which would include other stakeholders and mechanisms of governance for the purpose of analytical understanding and normative recommendations.[322]

Repairing or improving existing institutional structures after stakes and interests become entrenched, from the comparative perspective, is an inherently difficult task. This is also true after property entitlements have been reassigned to new owners in the countries in transition. Despite the many obvious deficiencies and flaws of corporate governance for the firms in transition, it is equally difficult to improve or change the basic corporate laws in any developed country. Only after careful examination, empirical studies and the ability to prepare a new set of goals can the changes take place.

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[321] Mark Roe, *Comparative Corporate Governance,* THE NEW PALGRAVE DICTIONARY ON LAW AND ECONOMICS, ed. by Peter Newman, Macmillan Reference Limited 1998 (3 vol.).

[322] Erik Berglof and Ernst-Ludwig von Thadden, *The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries,* The World Bank Annual Conference on Development Economics – ABCDE Conference, April 28–30, 1999, Washington D.C (available on the website: *www.worldbank.or/research/abcde*).

Authors Berglof and von Thadden maintain that protecting only minority shareholders while neglecting other classes of shareholders in the firms in transition cannot suffice. The reason for such a belief is the finding that "widely held firms are extremely rare outside the United States and United Kingdom, even in the countries in transition that opted for mass-privatization through vouchers."[323] If so, authors believe that the focus of analysis should not be as much on the inherent conflicts between management and owners, but rather on the conflicts between owner/manager or blockholders and minority investors.[324] Additionally, and as proposed already by Coffee, the issues of investor identity and who is monitoring them, of cross-ownership, and of capital markets should be taken into account.[325]

To analyze the intricate relations and behaviors of the firms and how the (in)efficient model of corporate governance of the firms contributed to economic development, an understanding of the broader institutional context is necessary. Unlike the early studies in efficient corporate governance as the function of the protection of minority shareholders,[326] recent literature emphasizes other important elements of corporate governance. One of them is the complementarity and substitutability of existing institutions. Berglof and van Thadden noticed that in the national legal arrangements lacking sufficient capital market regulation, this deficiency could be substituted with the presence of stronger competition in product markets.[327] Other factors determining the behavior of the privatized firms, but largely neglected in the literature on corporate governance, are suppliers, employees, outside creditors and government (central and local). The reason for a broader view on the behavior of privatized companies lies within the fact that the transition enterprises did not emerge *de novo,* but developed as a result of the chosen pathway of privatization. Employees are important, for example, because in most countries they received significant percentage of shares either with discounts or for free, and if organized as an individual blockholder, they can exert an important influence on the strategic decisions of the firms. Government is important because it was traditionally perceived as a provider of credits and subsidies through the soft budget mechanism and also a protector against bankruptcies. The transition turned the gov-

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323 *Id,* p. 4.

324 *Id.*

325 *Id. See* also Coffee, *Institutional Investors in transitional economies, supra 80*, esp. pp. 171–184.

326 Rafael La Porta, Florencio-Lopez-de-Silanes, Andrei Shleifer, *Corporate Ownership Around the World,* JOURNAL OF FINANCE, no. 54, 1999, pp. 471–517.

327 The authors were unable, however, to find empirical evidence for the thesis in the Russian experience. Making an effort to interpret the case, authors believe that competition requires at least a minimum of corporate governance to have an impact on firm behavior. *Supra* 322.

ernment into a tax collector, but in many cases also a large or partial owner of the firms. Suppliers and creditors do play an important role for the firms in transition in their particular way due to the inter-enterprise arrears and the dissolution of old coordinating mechanisms.

The protection of minority shareholders is certainly important for the countries in transition, but it would probably be a mistake for the second generation of reformers to focus solely on minority protection to improve corporate governance. Not only that it still remains uncertain whether the concentration of ownership is good or bad for performance, as Berglof and van Thadden remind us,[328] they also subscribe to Roe's point that better legal protection might, if anything, lead toward more large blocks than less.[329] Improved legal protection of all shareholders, especially in the sense of providing shareholders with more information and transparent accounting, is only one important step toward the improvement of corporate governance for the firms in transition. Other bottlenecks are the owners of the firms themselves, most notably privatization funds with their own lack of accountability and corporate governance problems due to their poorly designed ownership structure. Citizens, as voucher holders, do not have any monitoring power over privatization funds, nor does anybody else, except for the banks, as in the case of the Czech Republic and some other countries.[330]

Speaking comparatively, external financing through financial intermediaries is not functioning well, either. Successful private firms do not want to raise external funds, because this might threaten their internal consolidated structure in case of secure loan defaults. Financial intermediaries on the other hand are not prepared for taking a risk to lend funds to the firms which are in their eyes perceived as of having low quality and high risk. That said, it does not take much to conclude that for the firms in transition, alternative approaches toward corporate governance should be pursued. Instead of merely protecting shareholders (often one class of shareholders at the expense of another) through legal instruments, such as class actions, derivative suits or mandatory dividends, broader stakes in the firms need to be protected. In doing so, the protection of stakeholders in the firms cannot be a goal in itself, but rather a mean to achieve further restructuring, organizational improvement and firm productivity.[331]

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[328] *Id,* p. 14.

[329] *Id.*

[330] Overview of the fund structure and governance problems in Marko Simoneti, Saul Estrin, Andreja Bohm (eds), THE GOVERNANCE OF PRIVATIZATION FUNDS, *supra* 227, esp. pp. 137–162.

[331] For more on the insight that of shareholder protection as an instrument, not as a goals, *see* Alexander Dyck, *Ownership Structure, Legal Protection and Corporate Governance,* World Bank ABCDE Conference, 2000, Washington, D.C. (available on ABCDE homepage).

An alternative set of theories should be able to embrace the peculiarities of the firms in transition when discussing corporate governance and its efficiency. Some authors call such theories "multiple principal agent theory" or "stakeholder theory."[332] Regardless the definitions and metaphors, the goal of such alternative, comprehensive theories is to take into account several additional institutional determinants and factors to improve and strengthen corporate governance for the firms in transition. If an institutional system does not provide enough incentives for the actors (investment funds, owners, managers, employees, creditors, government) to engage in restructuring, new investment and higher productivity, the institutional transformation did not assign property entitlements and other rights effectively. Of course, the school of private legal thought teaches us that the initial assignment is not relevant as long as there is efficient market, which will *ex post* correct the ineffectively assigned entitlements through market mechanisms. Yet the entrenched interests and vested rights in the transitional context do not allow for the rapid correction of the misallocation of entitlements and rights.

Once the transformed institutional structure takes its place, the corrections and improvements of the given outcome cannot be a matter of the new large-scale institutional reforms. If nothing else, the popular support for broad institutional reform is gone. This does not mean, however, that future steps and proclaimed goals are necessarily less ambitious; rather, the practical decisions are more technical and less attractive for a general audience. Sometimes well thought-out technical solutions might lead to larger structural changes without making any large-scale institutional changes. *Ex post* institutional corrections either in the form of technical improvements or larger institutional changes will take more time and bargaining skills for the actors with stakes in question primarily for two reasons. First, for further changes and improvements, good insight and analysis of the transition is necessary. Second, the entrenched and vested interests after transition do not allow for rapid improvement or fast changes. In the context of the countries in transition it seems that the post-reform phase inevitably took some time to adjust and reflect upon the new institutional structure before it is ready for further change and adjustment. The fact that the outside world is changing quickly makes the second generation of reformers even more perplexed because it is increasingly difficult for them to attempt imitating the leading examples and role models. As was the case many times in the last decade, the developed part of the world has discarded many institutional solutions that were thought to be worth emulating for the countries in transition only a decade ago.[333]

[332] Joseph Stiglitz, *Quis Custodiet Ipsos Custodes? Corporate Governance Failures in the Transition,* ANNUAL BANK CONFERENCE ON DEVELOPMENT ECONOMICS-EUROPE, keynote address, Paris, June 21–23, 1999.

[333] Charles Sabel made an important warning for the second generation of reformers by

The starting point for the further improvement of corporate governance for the countries in transition should be the existing, post-reform structure of ownership, not the comparative models, as they really exist or are merely idealized in the eyes of the first generation of reformers. Along the path of adopting the new, improved rules and solutions, consultations with comparative models and solutions are useful and important, but only to the extent the nation-specific, historical or institutional context is understood. Finally, specific solutions for a concrete context should be adopted.

There are many authors and scholars who ultimately doubt in the usefulness and effects of any changes in corporate governance that would have some positive effect on restructuring and development. The link between the arrangement of corporate governance and the organization of production seems to be tenuous and precarious. So, the argument follows, any attempts in changing the corporate governance arrangement will have only a limited, if any, impact on the organization of production, on new investment decisions, and on higher productivity and future development.[334] On the other hand, if any of the existing corporate governance arrangements do not guarantee certain behavior of the firms and their responsiveness to market conditions, then there is no reason to believe that certain models of corporate governance are superior and more adept to the current needs of corporate development than others.

claiming that all the corporate arrangements in the most developed countries, including United States and Japan, are in flux. He believes that substantial changes in organization of production with close collaboration between suppliers and main producers will force the existing corporate governance, dominated either by the main bank (Japan) or by the shareholders (US) to improve the system of monitoring or costly errors at critical moments whenever they occur. *See* Charles Sabel, *Ungoverned Production: An American view of the Novel Universalism of Japanese Production Methods and their Awkward Fit with Current Forms of Corporate Governance,* THE SLOAN PROJECT ON CORPORATE GOVERNANCE AT COLUMBIA LAW SCHOOL, May 1998, pp. 211–222.

334 For the debate about the limited impact of corporate governance changes on economic activities, *see* for example, Mark Roe, *Political Preconditions to Separating Ownership and Control, mimeo,* 1999. The author is claiming that in some crucial historical instances institutional solutions were merely the sum of existing best available practices already in place. As an example he gives the American securities laws from 1933 and 1934, which came after the rise of the public firm and diffused ownership. He also believes that: "Building corporate law institutions, even if rarely rocket-science, costs somebody something. If the players who would build them – public policy-makers, investors, and managers – cannot profit from them, they will not invest in building them. Hence, the current literature over-emphasized law as a driving force in determining corporate governance structure. A minimum must be reached of, say, good contract enforcement or minimally satisfactory corporate law (via outright bans or fiduciary principles). Once the minimums are reached ... it is then the nation's means of settling social conflict, of building a financial system, and of affecting loyalties inside the firm that will determine which structures fit best. From there, the remaining needed law, if any more is needed, will come. Law then becomes more result than primary force."

Not many scholars believe that certain models of corporate governance are better than others, and most of them have their own preferred models of corporate governance. As Professor Sabel teaches us, if there is not a positive link between corporate governance and the organization of production, then surely a negative link would be in the form of constraints when trying to adopt advanced methods of production. Therefore, it is becoming urgent to invent and adopt new institutional forms through "learning by monitoring" to secure rapid economic development.[335]

POTENTIAL INSTITUTIONAL PILLARS AS ENGINES FOR FUTURE DEVELOPMENT

The approach toward future institutional structure improvements depends largely on which part of the institutional structure is viewed as potentially the strongest pillar of development. Among the candidates are privatization investment funds, capital markets, banks (state and privatized), large privatized firms under the domination of insiders/managers, foreign direct investments, *de novo* firms, or cross-ownership among the chain of suppliers and producers creating a network of multiple stakeholders. Some of the candidates can be combined once the development strategy is adopted and others are temporarily exclusive. Alternative to the adoption of a development strategy is the 'do nothing policy,' but this second best option should be postponed at least until the reforms are completed and the incentives for development are clearly assigned to the key actors. Without clearly assigned incentives throughout the spectrum of key actors, the current rent seekers that consolidated monopoly powers through privatization will most likely prevail and repress the developmental potential of the rest of the economy and society.[336]

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[335] *See* Sabel, *supra* 333, esp. pp. 219–221.

[336] An extreme, but not unique example is Russia after privatization: "Good arguments have been made to demonopolize before privatization: when the monopolies are privatized, resistance to demonopolization can become more intense than if demonopolization takes place before privatization. This is a sequencing mistake. Russia has made the sequencing mistake of privatizing before demonopolizing and is today paying the consequences. The task of demonopolization is partly orthogonal to privatization and corporate governance." Gerard Roland, *Corporate Governance Systems and Restructuring: the Lessons from the Transition Experience,* paper prepared for the 2000 ABCDE Conference, Washington, D.C.

Privatization Investment Funds

The first among the candidates whose role could be strengthened are privatization investment funds, an innovation of voucher privatization, which were created in the Czech Republic, Russia, Poland and some other countries in transition. Although the initial expectations regarding the contribution of privatization investment funds were high, those expectations were not met along the course of privatization.[337] The obvious initial deficiencies, such as maintaining a necessary level of cash flow or lacking the skilled portfolio managers, were expected to be offset through the course of privatization. The funds were designed primarily to overcome the problem of extreme ownership fragmentation and to start acting as the real outside owners of the firms, exerting pressure on the management of the firms. Their task was to start gathering sufficient information about the privatized firms and to develop portfolio management expertise to make informed investment decisions.[338] As it turned out, however, the newly created investment funds were until recently unable to develop sufficient capacities to monitor the day to day activities of the privatized firms, to help them in the evaluation and selection of investment projects, to raise funds on capital markets to help finance the selected projects or to promote such portfolio management to advance the market for corporate control. In short, privatization funds by and large failed to become active owners of the firms by not restructuring and improving the governance and organization of production in the privatized firms.

The reasons for the unsuccessful role of privatization funds are manifold and to some extent vary from country to country. One of the most important reasons for the unfulfilled expectation was that privatization funds did not bring any new capital to privatized firms.[339] Therefore, investment funds benefited from the initial distribution of vouchers and auction procedures without raising much of their own stakes.

The question remains, however, why privatization funds – even after obtaining shares in privatized firms – did not develop more active attitude toward governing the firms. One answer to this question is that governance is a costly enterprise, particularly for an inexperienced staff and a highly diversified portfolio that represents a cross-section of the industries. Closely monitoring the firms, participating in the evaluation and selection of investment projects and other business decisions requires a

[337] Critical analysis of the failed attempt to achieve goals by the privatization investment funds in Katharina Pistor and Andrew Spicer, *Investment Funds in Mass Privatization and Beyond, supra* 128.

[338] *Id*, p. 96.

[339] *See* Coffee, *supra* at 80, p. 120.

lot of time and knowledge from the outside managers – none of which was abundant in the countries in transition. There were additional disincentives for the investment funds to engage in active monitoring of the firms. For the Czech fund managers, payments did not depend upon successful participation in restructuring or increased value of the fund's assets.[340]

Weak regulation and weak incentives for the investment funds did not help to substantively change the governance structure and activities of the firms. Investment funds in most of the countries in transition were unable to develop close monitoring mechanisms and to offer the firms the necessary financial assistance, managerial expertise or new technologies. Perhaps the first generation of reformers did not pay much attention to the original distribution of entitlements, because they thought the trading on the secondary markets would ultimately provide an efficient allocation of new property entitlements. The assumed expectations of the reformers were not met, either. In the Czech Republic, for example, it is reported that fund managers sometimes do not want to trade on the markets even in situations when they believe their stocks are overpriced. Managers fear that they would not be able to reinvest the proceeds from the sale.[341] The problem of the governance of the privatization funds, especially in the Czech Republic, was not resolved. Bypassing the provision that banks were not allowed to set up privatization funds created an incestuous relation between banks and funds, whereas the extreme fragmentation of vouchers did not secure any monitoring of the fund managers from the owners of the vouchers. Weak incentives to perform efficiently created, on the other hand, strong perverse incentives, when the latter exceeded over the former. Experts of corporate governance even had to construct new expression for this phenomenon in the Czech Republic, which was called "tunneling" to describe many different methods of out-stripping the firms.[342] In the words of Stiglitz, this was a situa-

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[340] "To be sure, Czech Fund managers can expect additional compensation as the result of an increase in the value of the fund's assets, but close-end funds cannot sell additional shares to raise the denominator on which their 2 percent annual fee is based. Hence, Czech funds have an even stronger incentive to pursue a cost minimization policy and avoid expending funds on corporate governance activities." Coffee, *supra* p. 170.

[341] Coffee, *supra* at 80, p. 143.

[342] Roland, *supra* 336, p. 9. On the practice of "tunneling" *see* also Coffee, *infra* 344, who described some of the most frequent practices. One way of out-stripping the firm was to sale or transfer firm's products or assets at below market prices to another company that is controlled by the same controlling group as the original group. Of great importance is Coffee's insight that tunneling was more likely to occur in bad economic times and that investors expected this.

A 1997 report by the Czech Ministry of Finance identified 15 different techniques of "tunneling." A summary of the various methods of out-stripping firms that were brought about by the minimal regulation of investment funds, companies and securities markets is presented by Bernard Black, Reinier Kraakman, Anna Tarassova, tion where the returns per unit to such theft, given the weak legal structure, clearly exceeded the returns to the efforts devoted at wealth creation.[343]

We already saw that the role of the privatization investment funds varied significantly from one country to another country. Poland, especially, was able to avoid many of the aforementioned byways of the privatization investment funds. The mandatory creation of the 'top down,' limited number of investment funds, with carefully selected managers and an assigned portfolio of the privatized firms, created a comparatively more beneficial and transparent role for the investment funds.[344] Capital market liquidity, prior to the creation of investment funds, the regulation and transparency of the capital market was decisive for its efficient role in corporate governance. Speaking comparatively and on a global level, the privatization funds did not fulfill the expectations of the reformers and the citizens who trusted their vouchers to the fund managers. Fund managers were unable to create closer links to their firms, and they did not manage the portfolios of their firms as we encounter in the West. They lacked the means, incentives and in the context of transition, the external constraints did not leave much room for improvement. Thus, in the eyes of many fund managers, the privatization funds played a parasitic role of new owners who preferred collusion and rent-seeking over economically fair and efficient activities. It did not have to be that way, and the role of funds can still be institutionally and practically improved, if the policy-makers choose so. In so doing, however, the biggest impediment would most likely be the eroded trust of the citizens.

What are the possible regulatory steps toward improving the governance of the funds with the aim to improve their overall impact on long-term restructuring and the improved competitiveness of the privatized firms? If the decision-makers decide that a strengthened role of privatization funds is necessary, several regulatory steps can be taken, bearing in mind the limited and delayed impact of regulatory changes on the governance of the funds.[345] One possible step toward improving the

Russian Privatization and Corporate Governance: What Went Wrong?, John M. Ohlin Program in Law and Economics, working paper no. 178, September 1999; available at the Social Science Research Network electronic library at: http://papers.ssrn.com.

[343] Stiglitz, *supra* 332, p. 12.

[344] Analysis of the divergent approaches toward privatization in the Czech Republic and Poland was recently made by John Coffee, *Privatization and Corporate Governance: The Lessons from Securities Market Failure,* THE JOURNAL OF CORPORATION LAW, vol. 25, no. 1, 1999, pp. 1–39, available also at Columbia Law School, the Center for Law and Economic Studies, available at Social Science Research Network electronic library at: *http://papers.ssrn.com* or Columbia Law School working Paper Series at: *http://www.law.columbia.edu/lawec.*

[345] Should the second generation of reformers decide not to rely on the privatization funds, it is also possible to order the sell out of the fund assets and allow investors to withdraw their capital and turn privatization funds into open-ended funds. One

governance and raising the interests of the outside owners for the restructuring of the firms would probably be to raise the maximum stake that funds can hold in one company. Studies show that the activism of the shareholders is proportional to the extent of ownership concentration, which might consequently turn the large shareholders into strategic investors of the firms.[346] In the Czech Republic, the legal maximum of the stake in one company was set to 20 percent, but several different funds could form a coalition of owners, if they so desire. In practice, however, it turned out that the funds had divergent interests, which did not allow for a coherent approach toward restructuring the firms. We also learned that large or even increased stakes in the firms did not necessarily raise the activism of shareholders.

Since the regulatory framework and the institutional environment did not create enough incentives, the decision to raise the maximum stake in one firm could be particularly risky and would there require a host of other regulatory measures. Among the most important are the measures that would secure the transparent and accountable operation of the funds and their managers in a highly competitive environment. The measures that would achieve such goals are, for example, stringent disclosure requirements for the funds, additional incentives for the managers and the improved monitoring of the funds. The market for the funds control would have to be created. Citizens should be able to withdraw their capital from one fund and transfer it to another without any restrictions.

More concretely, Coffee believes, for the Czech Republic, that raising the maximum of shares in company to 30 percent would be a reasonable measure, which could likely contribute to strengthened activism of the funds.[347] Raising the maximum of shares in one company must be

such attempt was seriously contemplated in the Czech Republic: "...After the amendment passes the Senate later this summer all funds will be forced to become open-ended by the end of 2002, allowing shareholders to redeem their shares at their net asset value per share (NAV) rather than the stock exchange trading price. Funds which are trading at a 40 percent discount to NAV will be forced to become open-ended in the first year after amendment is passed... Jari Spicka, head of the financial markets department of the finance ministry, says: "Voucher privatization resulted in a freezing of the structure of ownership. The funds are bad owners. Our companies must be restructured but the funds do not have the expertise to do this and they're not able to provide addition capital..." FINANCIAL TIMES, *Czech Funds to be Forced to Sell,* April 20, 1998.

[346] Coffee, *supra* 80, pp. 141–140.

[347] "Valid as this latter point may be, it would be at least partially addressed by moving up the ownership ceiling from 20 to 30 percent – and then requiring that additional shares be acquired only pursuant to a tender offer. This would still leave a shareholder who was blocked by diversification rules from acquiring 100 percent in a very influential position. Such a compromise would also closely resemble the British rules on takeovers, which have long required a shareholder seeking to acquire more than 30 percent to do so by a tender offer for all the remaining shares." Coffee, *supra* 80, p. 167.

accompanied by measures that would improve the governance of the privatization funds. One such necessary measure is the disclosure rule that requires the funds to achieve higher level of transparency and confidence. Mandatory disclosure rules for the funds that acquire shares beyond the determined threshold should also be seriously considered. Shareholder activism of the funds, should policy-makers opt for such possibility, must also be accompanied by the rules that prevent speculative mutual purchases among the funds to increase the volume of trade to justify higher compensations to the fund managers.

A market for investment fund control needs to be established. If easy entry is granted, it is equally reasonable to create an easy exit for inactive and poorly organized funds, which will be taken over by the stronger and better organized funds. It is also possible to agree with Coffee's argument that it is not likely to achieve shareholder democracy at the level of privatization funds, especially bearing in mind the extreme fragmentation of voucher holders and poor knowledge about the role and function of the funds. Instead, he advocates the consolidation of funds through market mechanisms, such as mergers and acquisitions, as a natural process and also as a disciplinary instrument for fund managers.[348] Such consolidation would likely lead to a reduction of administrative and operational costs forcing fund managers toward greater market discipline.

Again, Poland seems to have several advantages with regard to investment fund design. The limited number of funds, only 15 compared to 420 funds in the Czech Republic, established by the State Treasury, carefully chose fund managers, assigned portfolios from the list of selected enterprises and provided a strong regulatory framework. These measures apparently created stronger links between funds and privatized firms. Prior to mass privatization, liquidity on the capital market was another important moment in the Polish experiment, because it guaranteed better transparency and more information to the fund, managers and about the fund managers. The 'top down' approach in the pre-established regulatory environment did not require the funds to make as many false promises as the Czech funds initially did to attract the interest of the citizens. The only decision Polish citizens could make was in which of the 15 funds to place their vouchers, keeping in mind that all the vouchers could be placed only in the funds and not directly to the firms. Finally, each of the investment funds in Poland was assigned with a controlling 33 percent stake in its share of the privatized companies. Funds were prohibited to sale shares of a company in which they owned more than 20 percent of the shares for a period of three years.[349]

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[348] Coffee, *supra* 80, p. 174–175.

[349] An overview and analysis of the main institutional and regulatory differences is made by Saul Estrin, Domenico Nuti and Milica Uvalic, *The Impact of Privatization*

Controlling stakes in the firms helped solve the collective action problem and, perhaps more importantly, the problem of the contest for control over the privatized firm. Once the controlling stakes of the firms were assigned to a single outside owner, the fight for the control over the firm was finished and the environment became conducive for restructuring the firms. Paradoxically, the active regulatory role of the government created an environment that was more conducive to restructuring than the passive, anti-regulatory approach that counted primarily 'bottom up' spontaneous development.[350] Therefore, if a controlling mechanism exists, and a regulatory framework is in place with at least basic liquidity on the capital market before actual steps are taken, the likelihood that the new owners will engage in active, though costly monitoring, is higher than in cases when such minimum requirements are not in place. The comparison between the Czech Republic and Poland with regard to governance improvement is particularly interesting, because the corporate laws of both countries are heavily rooted in the same German corporate law system. Based on the German system of corporate law, both countries do not provide much protection to small shareholders. What is more important, however, is the empirical evidence which shows that despite similar corporate laws belonging to the same legal tradition, both countries experienced a significantly different outcome in terms of corporate governance. Scholars have come to the conclusion that not only substantive laws matter, but for actual practice the whole institutional context and pre-established regulations matter.[351]

If the conclusions reached in the current debate are valid, these insights are *a fortiori* true for the Russian example. The debate on what went wrong in Russia is continuing. We made some observations about the Russian broader institutional framework and about its course of mass privatization. Russia is standing away from the standard compara-

Funds on Corporate Governance in Mass Privatization Schemes: the Czech Republic, Poland and Slovenia in Marko Simoneti, Saul Estrin, Andreja Böhm (eds.), THE GOVERNANCE OF PRIVATIZATION FUNDS, *supra* 227, esp. pp. 139–160.

[350] "Thus, one implication of the Czech experience may be that unregulated control contests and the rapid transition from dispersed to concentrated ownership can give rise to externalities – both political and economic", Coffee, *supra* 344, p. 18.

[351] "Yet, if Poland and the Czech Republic had similar corporate laws, their approaches to securities regulation were entirely different. Not only did Poland impose high disclosure standards from the outset (including quarterly reporting), it also created an SEC-like agency to enforce its laws from the beginning of its privatization experience. In addition, Poland adopted provisions that resembled the Section 13(d) of the U.S.'s Williams Act in order to require ownership transparency – that is, the disclosure by a potential acquirer of ownership of specified thresholds of a company's shares. Finally, Poland (but not the Czech Republic) followed the British model of takeover regulation by requiring any shareholder who acquired more than a specified level of stock to make a mandatory bid for the remaining shares. In sum, as Katharina Pistor has shown, Poland had 'weak' corporate law, but 'strong' securities law." Coffee, *supra* 344, p. 17 (footnotes ommited).

tive analyses of the countries in transition for several reasons; above all due to its size and the immense difficulties it met during the transition. What we are interested in here, however, is the role – potential and practical – of the Russian privatization funds in contributing something to the corporate governance of the firms. In Russia we found that the problems of corruption, stealing and rent-seeking by and large overshadowing all other processes of mass privatization, ownership restructuring and institution-building.[352] The attempt to build a new corporate law system "from scratch" did not work, but the external factors, such as consecutive government, market and regulatory failures make it difficult to make independent assessment of this attempt.[353]

The method and outcome of mass privatization in Russia created specific ownership structures where, on average, managers and workers became 65 percent owners of their firms. Dealing with this situation, the authors of Russian corporate law tried to secure the presence of the outside owner, primarily Russian privatization funds, to prevent the possible self-dealings of the management. They advocated for the "self-enforcing" model of corporate law, which meant that law relied on its direct actors (shareholders, managers) instead of indirect actors and institutions (courts, regulatory bodies).[354] In particular, the authors of the corporate law tried to empower and protect outside owners of the firms. The envisaged role of the outside owners was "to police the opportunism of managers and controlling shareholders."[355] The enhanced role of the outside and minority shareholders was to be achieved through various methods of empowerment, for example, by granting votes and sometimes veto rights to the outside directors, non-controlling shareholders or both. Among the methods of empowerment are cumulative voting requirements for the election of directors, which stipulates supermajority shareholder approval or approval by a majority of outside shareholders for broad classes of major transactions and self-interested transactions; preemptive rights when companies issue new shares; appraisal rights for shareholders who do not approve transactions; and takeout rights when a controlling stake in the firm is acquired.[356]

Critics of the described 'self-enforcing' model point out that such a model, which gives comparatively greater powers to outside owners than, for example, customary Delaware law, carries with it many risks. According to the critics, the major deficiency of the 'from scratch'

352 Anders Aslund, *supra* 317.

353 The summary overview of the manifold of reform failures in John Nellis, *supra* 156, pp. 7–10.

354 Bernard Black, Reinier Kraakman and Jonathan Hay, *Corporate Law from Scratch,* in Roman Frydman, Cheryl W. Gray, Andrzej Rapaczynski, CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, *supra* 80, p. 249.

355 *Id,* p. 298.

356 *Id,* pp. 268–286.

approach is that it does not take into account the existing institutional context and social environment. Instead, the model falsely pretends that it is possible to design an a-historical model outside the given institutional context.[357] Moreover, the idea of empowering outside owners and small shareholders disproportionately carries a double jeopardy. One danger is that the idea to empower outsiders to police while controlling the managers to prevent self-dealings, carries with it the spell of selffulfiling prophecy. By assuming that we are dealing with intrinsically corrupt and incorrigible managers/owners, the model essentially works against them and therefore will likely force them into the self-dealings that the model attempts to prevent. In other words, the model of corporate law works against the majority owners, those whom the mass privatization process conceded the majority of ownership entitlements. *Mutatis mutandis,* the same might be true about the distrust against larger outside institutions, such as the judiciary or regulatory bodies. There is little doubt that the state of affairs in post-Soviet legal institutions, legal science and academics included, was in a poor and undeveloped condition. The more local the legal institutions, the bigger the probability that these institutions would be influenced and tainted by the corruption of the other two branches of the local authorities. However, by *ex ante* exclusion of those institutions from participating in creation of an efficient and transparent legal framework, the spell of corruption worked through the other two branches and went unnoticed in front of the courts. This is not to say that the system could have been less corrupt, including the judiciary and regulatory bodies in the model of corporate law, but that the investments in legal development and legal institutions should have been made as they were in other transition countries.

The second danger of the 'self-enforcing model' comes from another deficiency in the model. Namely, if all the authors' bets on corporate law in Russia were placed on outside blockholders as agents of modernization, the critics emphasize, their identity and role should have been more carefully designed. Why, then, would outside owners have more interests in reorganizing and restructuring privatized firms in, say, some removed one-factory towns in Russia, than managers and workers of this factory, which was their only hope in economic crisis and would prevalent immobility of people?[358] Would it not be cheaper for outsiders, especially in

[357] Though critics believe that the diagnosis about the ills of self-dealing are correct, the recipe in the form of a utopian-teleological model (aiming at the Delaware style "enabling" corporate model) is not likely to work, because authors of the corporate law deny the value of existing institutions and social arrangements: "That is, the authors overlook the lingering influence of two critical legacies of centrally planned economies – the worker control over the shop floor and the complex informal vertical and horizontal alliances among economic actors and localities." Vedat Milor, *Critical Reflections on a Self-Enforcing Model of Corporate Law for Russia,* Stanford Law School, 1997 (*mimeo*).

[358] Empirical studies vary somewhat on the role of insiders in restructuring of firms.

economic crisis, to collude with inside owners, and management in particular, to apply the similar out-stripping methods as in the Czech Republic?[359] Consequently, the sequel to mass privatization was either the collusion between managers and outside owners or the continued struggle between the inside owners. The struggle further deteriorated the slim chances of the Russian firms to restructure and reorganize under the existence of extremely volatile macroeconomic conditions.

To summarize the discussion on the 'self-enforcing' model, one could say that it was not the best possible or the only available model. The 'self-enforcing' model excluded external institutions, other potential stakeholders in firms, most notably suppliers, to create the network of firms monitoring each other, and overlooked another group of inside owners with stakes in the firm – the employees. By trying to shift the power from the insiders to the outsiders, perhaps unwittingly, the model extended the struggle for the control over the firms. Biased against managers and legal institutions, in many cases with good reason, the model was not equally suspicious of the emerging outside owners of the firms, and did not do enough to create accountability and transparency of the fund managers. On the other hand, it ignored and excluded other potential stakeholders, such as employees, by dismissing the idea of codetermination. Finally, the empirical evidence compiled before privatization occurred, suggests that many senior managers believed the optimal structure of ownership should consist of between 40 and 50 percent in the hands of suppliers and customers who supply raw materials and buy

Some studies show that insiders did not contribute to restructuring, others show different evidence. Frydman, Pistor and Rapazcynski believe that in most Russian companies insider control has prevented enterprise reform: managers discouraged employees from selling their shares and in return guaranteed employment. Such strategy allegedly secured the position of managers and ensured the nominal survival of firms, while it crowded out outside investors. Roman Frydman, Katharina Pistor, and Andrzej Rapazcynski, *Investing in Insider-Dominated Firms, supra* 276. Blasi, on the other hand, believes that inside owners, particularly managers, once their ownership was consolidated and government gave a clear signal that it would not bail out any more firms, engaged in certain processes of restructuring. He also reminds us that in the environment of high inflation, where consumers are without cash and bank credits, managers fought hard to stay afloat, while it was difficult to engage in risky and long-term restructuring of the firms. Blasi, *supra* 288, p. 128 and ff.

[359] "Therefore since social costs are greatest in situations where the local market opportunities are few and migration is costly, and since these situations characterize the current plight of the Russian industry, one can surmise that outside ownership by wealthy individuals in one-factory towns will either be unattractive or will be driven by speculative motives. Clearly adverse selection is a palpable danger, but Black and Kraakman never discuss this issue. In short, given both the concentrated and territorially specialized nature of the Soviet industry, it is hard to believe that wealthy outside investors will make up a sufficiently large class with a legitimate claim on exercising property rights for the sake of shareholders when such interests are pit against the survival of local communities." Vedat Milor, *supra* 357, p. 13.

their products. Also, the possibility to create a network of firms that are mutually monitoring, cooperating and learning from each other, did not materialize either. To be sure, dealing with the networks of firms brings its own regulatory requirements and risks, but it also differently distributes incentives, accountabilities and potential gains. Instead, isolated firms, struggling with the contest for control over the firms, had to rely on their abilities to stay afloat or go under in an environment more conducive to out-stripping and outright theft than to real development and growth.

In the discussion on privatization funds we saw that, until now, these funds did not meet the expectations and hopes of the reformers. To date, the opportunity for a more active role in restructuring the firms has been missed. The reasons for such an outcome are various, but more important than analyzing the missed opportunities is the debate what are the potential policy-measures that might contribute to a more active and productive role of the funds in the future.

Strategic outside owners: debt or equity

Thus far we saw some of the unresolved issues and existing constraints of privatization investment funds as the agents of restructuring and development. The situation varies from country to country and depends primarily on the methods of mass privatization and the regulatory capacity of the government. Closely linked to the debate on the privatization funds and their role in transition is the debate regarding the role of capital markets in the transition countries. To what extent can the decision-makers rely on capital markets as the source of clear signals and proper incentives for the actors to engage in the dynamic development of the economy?

In the debate on privatization funds, we saw they generally lacked the capacity to engage in active firm monitoring, raising capital and, more importantly, providing new technology and managerial skills to the privatized firms. In most countries, the unfinished regulatory reform gave wrong signals and perverse incentives, whereas the undeveloped system of legal institutions and control did not provide any control mechanisms over the funds' activities. On the other hand, in the eyes of reformers, the funds were perceived as the true and real owners of the firms. Disillusionment with the funds came later, only after it became clear that the funds did not become the engines of restructuring and development, but in many cases engaged in out-stripping or controlling the firms. Weak incentives to the new outside owners and a weak regulatory system played a crucial role in the first phase of the transition.

The unsuccessful attempt at creating funds as some kind of natural engines of restructuring signaled the need for further fund reforms.

Essentially, decision-makers have two strategic options that could determine the future role of the funds. One possibility is to transform the funds through a set of regulatory reforms and economic incentives into institutional investors and strategic owners of the firms, or to transform the funds into mutual funds that will run portfolio and other corporate activities primarily on the capital markets. Each possibility has certain advantages and certain constraints, which will be discussed in this section. Although the first possibility resembles the German bank-based system, as it was developed in the last few decades, and the second possibility resembles the Anglo-Saxon system of deep and liquid capital markets. We should not forget that the given analogies have limitations, as we are dealing with a different system of institutional constraints and structural limitations than the ones that developed in the most advanced countries in the world. Ultimately, two different types of structural arrangements are undergoing fast and deep structural changes.

Regardless of the strategic decisions, further steps in improving the role of the funds are challenging for several reasons. In the past years they received – deservedly, to be sure – a lot of negative publicity, because they were involved in speculations, participated in or even launched Ponzi-pyramid schemes, participated in out-stripping firms and many other frauds. On the other hand, through mass privatization, they became important players on the markets, so regulators must strengthen and increase their monitoring over the funds and require their transparent and efficient functioning. As opposed to the first phase of transition, characterized by a large-scale institutional transformation, the next stage requires very patient and narrow-tailored work on the regulation and creation of competent legal institutions with the capacity to supervise and adopt the enacted legislation. It is a delaying and somewhat tedious process, but vital for the success of reforms.

Having one strategic owner of the privatized firm with a large enough stake to be able to monitor the managers without this proving too costly for him is one such possibility. Strategic owners could have been banks, but this possibility will be explored in more detail in the following section. Here we are exploring the possibility and consequences of the strategic outside owners – the investment privatization funds – as a form of concentrated ownership. Thus, instead of widely dispersed ownership, concentrated ownership would stop the contest for control over the firms and reduce the costs of monitoring, because it would add to the potential benefits of active monitoring. In other words, incentives to continue production and improve productivity might become clearer and stronger. In this scenario privatization funds would function analogous to the role of German banks in the last decades.

The main distinctive characteristics of the German corporate model that was developed in the last few decades – and indeed changed rapidly in the last few years – is a highly organized labor and capital market, highly concentrated shareholding with banks that are allowed to hold equities, shares and companies that do not change hands often, capital markets that do not present a 'market for control' where only small parts of productive capital are traded, and the representation of workers through work councils and membership on supervisory boards.[360] As far as the firms' financing is concerned, firms finance themselves less through equity and more through long-term bank credits, whereas banks can cast votes on behalf of the shares they hold in deposit, thereby effectively monitoring management performance.[361]

Although German banks, which combine modest direct holdings of stocks with extensive holdings of custodial stocks, participate regularly on supervisory boards, they do not interfere with the day-to-day business decisions of the management. The structure and importance of the German supervisory boards, as Roe pointed out, is not as much in controlling the management of the firms, but to "advise and consent to treaties and appointments, which yields consultation and influence but not supervisory control – analogous to the U. S. senate's powers".[362] The importance of the banks on supervisory boards is not in day-to-day decision-making, but to follow the development of the firm up close, which in return facilitates the bank's decisions on approving credits to the firms. Therefore, banks play the monitoring role over the firms and provide external capital to them.

Such a sketchy overview of the German corporate model carries with it many oversimplifications, especially now, when the actual role of the German banks is being carefully reexamined. The study of Edwards and Fischer showed, for example, that the role of banks as providers of external finance has been exaggerated and that the ratio between internal financing and debt financing through the banks' credits was not much different compared to other economies with a less emphasized role of the banks.[363] The monitoring role of the banks on the supervisory boards has also been reexamined, and there were signs that the banks did not monitor more extensively than banks in other economies. On the other hand, what is more difficult to assess is the informal impact of the presence of the banks as large stakeholders for management's decision-making, especially when they decide to make new investments.

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[360] The most distinctive characteristics of the German corporate model summarized by Wolfgang Streeck, *German Capitalism: Existence and Survival* in Colin Crouch and Wolfgang Streeck, POLITICAL ECONOMY OF MODERN CAPITALISM, Sage 1997, p. 37 and ff. Streeck emphasizes "social institutions and not just networks of private contracts or the property of their shareholders" as one of the main characteristics of the German model. *Id.*

[361] *Id.*

[362] Mark Roe, STRONG MANAGERS, WEAK OWNERS, *The Political Roots of American Corporate Finance,* Princeton 1994, p. 176.

[363] Jeremy Edwards, Klaus Fischer, BANKS, FINANCE AND INVESTMENT IN GERMANY, Cambridge 1994, esp. pp. 49–70.

But this is not primarily a debate on the potential advantages, deficiencies, and future development of the German corporate model. This is a debate about the possibility to transform investment funds into large stakeholders in the countries in transition in order to provide incentives for more active monitoring and restructuring of the firms. Central and Eastern European decision-makers do not live in a constraint-free world, where they could pick any model and transplant it easily into their own system. First and foremost, they have to deal with their own constraints and look for the most appropriate solutions that are specific to their context. At this stage of the reforms, they are not looking for an ideal financial and governance arrangement, but they are looking for an accountable owner who would more likely engage in monitoring and restructuring instead of outstripping. The less than perfect institutional structure of the countries in transition do not seek for a state of the art corporate governance model, but for a practical, workable and transparent system of ownership, finance and control. Because of the difficult economic situation for many of the firms in the region, it would be successful to engage in any kind of restructuring, defensive for most and active for only few.[364] But even such modest success could only be achieved if carefully designed and clear incentives are sent to the firms, managers and employees.

In our debate about the improvement of corporate governance, thus far, we came to the conclusion that at this stage of reforms it is probably better to have a significant concentration of ownership,[365] but only in the situation when supportive institutions are present, and in my view, if employee participation is secured either in the form of work councils or supervisory board representatives, or both. It is perhaps for this reason – the lack of an appropriate regulatory framework and the lack of trans-

[364] Helpful distinction between defensive and active restructuring was made by Roland, *supra* 336, p. 15: "Defensive restructuring relates to the redundancies that must be achieved in order to cut loss-making activities. It is a painful process that requires determination from management. It can however be achieved by incumbent management, in principle without further help, and especially without outside funds. On the contrary, strategic restructuring refers to the establishment of a business strategy related to enterprise expansion. Defensive and strategic restructuring thus require different skills. Strategic restructuring also requires outside funds when the business strategies cannot be financed from internal funds."

[365] This view is shared by a growing number of scholars. *See*, for example, Dyck, *supra* 331, p. 24: "In sum, by examining ownership structure it is clear that governance politics, like institutions, provide the functions of corporate governance. Relative to a situation with anonymous, disperse shareholder, owners identified with a network, and with significant concentration can have a comparative advantage in providing information, managing incentives and lowering the costs of resolving competing claims over the wealth of the firm. Evidence in support of this contention comes mainly (but not exclusively) from countries where legal protections are weak. This is consistent with theory, which shows that with weak legal protections other ownership structures are not supportable, and even costly. When legal protections are strong, the theoretical results are more ambiguous, as is the evidence."

parency and monitoring of the privatization funds – that Coffee is more skeptical about the possibility of turning the Czech funds into investment funds, analogous to the German bank-based system. While Coffee recognizes and advocates the increase of the maximum number of shares per company for the Czech funds, he does not believe it would be possible to create privatization funds as investment funds with long-term stakes in the privatized companies. It seems that Coffee's skepticism has origins in the fact that privatization investment funds in the Czech Republic lack too many important attributes to play a role that is similar to the German banking system. Among the missing attributes are the curious and unregulated relations between the banks and the investment funds, comparatively small stakes in the firms held by the funds, and weak incentives for the funds to maximize the value of their portfolio shares, because they do not have further opportunities to sell their shares.[366]

Still, Coffe extensively supports the strengthened role of privatization in the Czech Republic under some specified conditions. He emphasizes that whatever attempts are made to enhance the role of the privatization funds, special attention must be devoted to the corporate governance problem at the level of the funds. His caution is based on the fact that the funds in the form of voting trust are beyond the control of their shareholders and most of the funds themselves, crowded on the small market, are ill equipped for monitoring, financing or any other assistance to the firms.[367]

Although Coffee believes that an effective IPF market for control must be established prior to any attempts in strengthening their role, he is equally aware of the constraints in achieving such measures. Namely, even if the majority of the closed-ended voting trusts are transformed into open-ended voting trusts, so that the holders could withdraw their investment, these individual holders would have little chance to place their investment somewhere else, because the market is thin and secondary trading is only sporadic.[368] An additional impediment to achieving any meaningful control and voice over the funds is the existence of long-term management contracts – up to six years in some cases. Still, instead of making efforts monitor the funds by shareholders, which in fact works poorly in most advanced economies, Coffee argues that a potentially more efficient way for regulators would have been to create a corporate control contest to achieve the consolidation of funds as a natural process.[369]

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[366] Coffee, *supra* 80, pp. 158–159 and 180–183.

[367] *Id*, pp. 171–172.

[368] *Id*, pp. 172–173. Thus he believes that "Czech shareholders in IPFs today lack both voice and exit." P. 173.

[369] *Id*.

To this point, our discussion has shown that there is still a lot of room for improvement, should the decision-makers decide to take additional steps. This is perhaps the most important conclusion of this part of the discussion. For example, raising the maximum number of shares to 30 or 35 percent, creating the "fire wall" between the funds and banks or strengthening accountability of the fund managers either through shareholders control or market for funds are only few possible additional steps. It is up to decision-makers to decide whether to pursue such an option. On the theoretical side, however, it is necessary to stress that even if these steps are taken, there can be no guarantee that this reform would automatically bring more efficient and transparent governance and restructuring of the firms. Largely discredited funds from the past might also in the future find no real incentives to engage in the restructuring of the firms. Again, they might find the whole system too weak to monitor and continue with what worked well in the past: out-stripping the firms without bringing any new finance, technologies, skills or other types of assistance into the firms. It is of a lesser importance whether the governance model more closely resembles the German bank-based model or UK-US model with the capital market in its center. It is more important to find the structure and set of complementary institutions from which the coalition for development and growth will emerge.[370] In doing so, the decision-makers should start from the constraints and limitations of the existing structure, before start borrowing from elsewhere. The roles, capacities, incentives and accountabilities of the potential agents should be carefully evaluated. To build a system of good governance, it is my firm belief that other actors beyond the owners and managers should have their voice and chance to participate in the decision-making processes. Employees, experts and workers, citizens holding vouchers, suppliers and consumers, and creditors should have their own say with regard to the improved governance. The multiple stakeholder approach, with clear-cut incentives for all of the stakeholders, might prove to be a workable and efficient solution for the firms in transition.[371] Instead of having fragmented ownership and uncontrollable privatization investment funds, it is possible to have a few large stakeholders with defined incentives for development that are still capable of monitoring each other. Even if such an approach does not necessarily

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[370] "In short, the process of transition in general and privatization in particular demonstrates an old lesson of market economics – incentives matter; but it also demonstrates a key lesson that was lost on many of the so-called reformers: only under highly idealized situations do incentives result in efficient outcomes; misdirected incentives can provide incentives for asset-stripping rather than wealth creation. In many countries in transition, that is precisely what happened. Stiglitz, *supra* 332, pp. 12–13.

[371] This is an approach that is supported by a growing number of scholars. *See*, for example, Stiglitz, *supra* 332, pp. 14–16. *See* also Berglof and vanThaden, *supra* 322.

guarantee the immediate improvement of productivity or restructuring, it is more likely to prevent at least the most egregious cases of out-stripping. From here, stronger governance might gradually start building a coalition for development and growth.

There is little chance to have efficient outside ownership in the form of privatization funds without developed and well functioning capital markets. In the introductory chapter the dilemma whether the wrong financial model had been proposed was briefly discussed.[372] The adoption of privatization investment funds changes this proposition. After introducing privatization funds into the countries in transition, it is necessary to discuss the organization, regulatory framework and importance of the capital markets. Other models, especially the possibility of debt-for-equity swaps by the (predominantly) state-owned banks, or cross-ownership of the firms, were not that high on the list of preferences by the reformers.

The idea that banks would become large owners of the firms, primarily on the basis of bad loans in the past, had many disadvantages and was never very high on the list of priorities among different models. Distrust against banks was developed before the transition started, because state banks were traditionally prepared to lend credits to the large firms even if they were likely to default on their obligations. In return, the state banks were allowed to turn to the state for bail outs in cases of serious financial difficulties. As we saw in the case of Poland or Hungary, due to the mounting financial crises both governments were forced several times to intervene to bail out banks. This was probably one of the most important reasons why reformers did not see the banks as appropriate candidates for becoming large holders of the privatized firms.[373] Banks also lacked expertise in corporate governance, producing a potential moral hazard with the government since a majority of the banks were in state hands. On the other hand, other institutions, most notably emerging privatization funds, did not have any serious experience in corporate governance either. And unlike other potential institutional owners of the firms, banks were practically the only part of the financial sector capable of financing the firms. Therefore, banks as the sole providers of external finance at the beginning of transition did not play a comprehensive role in mass privatization. Only in individual cases of restructuring the large enterprises did banks assume a more active role, but not on the larger, institutional level. The idea that banks could not play an active role in mass privatization as long as they remained in state hands prevailed over

[372] *See supra,* pp. 24–25.

[373] "For this, banks must be free from state interference and subject to strong competition from market forces and adequate supervision." Peter Dittus and Stephen Prowse, *Corporate Control in Central Europe and Russia – Should Banks Own Shares?, supra* in Roman Frydman, Cheryl W. Gray, Andrzej Rapaczynski, CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, *supra* 80 (vol. I), p. 21.

the possibility to engage banks more comprehensively into the process of privatization.[374]

Alternatively, the role of capital markets as an external source of finance and corporate control was designed for the countries in transition. Many of the scholars were indeed skeptical of the capital markets as appropriate institutional solution for the countries in transition. Setting up efficient and transparent capital markets capable of raising capital and channeling it into productive investments, while monitoring the use of the raised funds, was thought to be too demanding of a task for the countries in transition. If some of the requirements for setting up the host of interrelated institutions could not be met, the capital markets by design would create further distortions in the markets. Consequently, the criteria for choosing good managers over bad, good investment projects over risky ones and investment opportunities over speculations might be distorted. If capital markets, due to lack of regulation, transparency and control do not provide proper criteria and send appropriate signals to investors, there can be even more room for speculation, outright fraud and out-stripping of the firms.

Capital markets are not merely a place where demand and supply for capital and ownership shares occur. In truth, it is a complex mechanism of aggregating savings and allocating funds, while reducing the risks for the savers by allowing diversification.[375] While capital markets perform several important roles in advanced economies, the capital markets in the countries in transition should be able to provide some very specific and concrete tasks, such as providing finance, monitoring and restructuring for the firms in transition. We saw that the firms in transition behave somewhat differently than the firms in advanced economies for two reasons. First, the ownership structure of the firm depends on the form and method of mass privatization, and second, the firms in transition by and large lag behind in terms of productivity, organization and management, technology, and finance. Therefore, unlike the situation on the developed markets where the most developed and competitive firms issue shares through public offerings and become publicly traded companies, in the countries in transition the firms enter capital markets in order to become efficient and competitive. This means that the capital markets in transition are more risky for investors; in other words, the investors would be less protected than in the capital markets in advanced economies.[376] If so, in what circumstances are the potential investors

[374] On the potential and actual role played by the banks in transition, *see* Dittus and Prowse, *supra* 373, esp. pp. 55–63.

[375] Joseph Stiglitz, *Financial Markets and Development,* OXFORD REVIEW OF ECONOMIC POLICY, vol. 5, no. 4, Winter 1989, p. 56.

[376] Coffe found strong correlation between the legal protection of shareholders and the size, depth and liquidity of securities markets. He also believes that the correlation is mutually reinforcing: "In particular, common law legal systems seem to vastly out-

prepared to take risks? Conversely, what are the best sources of finance for the firms in transition?

Empirical data suggest that entering capital markets and raising capital through initial public offerings was a successful decision in certain circumstances. After analyzing the different regulatory and methodological approaches toward mass privatization in the Czech Republic and Poland, we see that their differences are also visible with regard to their capital markets. For example, in times when investors heavily divested from the Czech capital markets, the Warsaw Stock Exchange recorded significant sales of equities for cash. More concretely: "Between 1991 and 1998, no Czech company sold equity for cash as part of its privatization program; conversely, some 50 Polish companies did. Over the same period, no Czech company effected an initial public offering over the Prague Stock Exchange, while some 136 Polish companies did on the Warsaw Stock Exchange. In short, only the Polish system intentionally developed its stock exchange so that it could perform the classic role of serving as an engine for growth."[377]

Capital markets played a significantly different role and level of importance in both countries, which can be attributed to the prudent regulatory approach in Poland as opposed to the spontaneous development of a securities market in the Czech Republic. What is interesting in both countries is that they have a similar macroeconomic environment, while the size, liquidity and importance of their capital markets grew significantly apart. This shows that more important than macroeconomic policies is the appropriate design of financial institutions aiming at efficient allocation of savings to the corporate sector as the crucial moment in development, as argued by some scholars.[378] Other important data comparing the capital markets in the Czech Republic and Poland not only confirm this thesis, but also show that the Warsaw Stock Exchange endured international financial crisis in 1998 significantly better than the Prague Stock Exchange.[379]

perform civil law legal systems (and particularly French civil law systems) in providing investor protections – and, in turn, encouraging capital market growth and ownership dispersion. The size, depth and liquidity of securities markets has clearly been found to correlate directly with the quality of the legal protections given shareholders. In consequence, because the nature and quality of these protections differs widely across nations, the corporate world subdivides today into rival systems of dispersed ownership and concentrated ownership, with different structures of corporate governance characterizing each." (footnotes ommited). Coffee, *supra* 344, p. 2.

377 Coffee, *supra* 344, p. 15.

378 *See* Stiglitz, *supra* 375, p. 66.

379 "When the Asian financial crisis struck in 1998, Poland had a relatively mild experience. Between the end of 1996 and August 1998, the Polish stock index fell only 13.1 percent, while the Czech market had already partially collapsed and fell further. Up until late 1998, the NIFs that had listed on the Warsaw Stock Exchange seemed to

We already saw and analyzed some of the main differences in setting up capital markets in the Czech Republic and Poland. A strong regulatory framework prepared in advance, strict disclosure rules based on international accounting standards and established monitoring mechanisms, including the presence of the state on NIF boards, led to significantly better results and higher levels of efficient corporate governance in Poland than in the Czech Republic. A comparison between the two different arrangements, the regulatory one and the 'permissive' one, also shows another interesting insight into the nature of governance the transition: the contest for control and concentrated ownership was fueled by the poor protection of small shareholders. The chances that the large shareholders would try to exploit them to the extent of *de facto* expropriation were high. Yet the existence of state-created financial intermediaries in Poland, holding controlling stakes, presented, according to Coffee's analysis, assurance to small shareholders against the expropriation or ride of the predatory control seekers. On the other hand, Coffee believes that the contest for control in the Czech Republic has been defensively motivated: "Each large shareholder essentially realized that if they did not acquire control, someone else would, with resulting injury to them. In short, the fear of loss may have provided a greater incentive to compete for control than the expectation of any synergistic or opportunistic gain."[380]

The importance of state-created financial intermediaries in Poland has been confirmed at another interesting instance. In 1998, it was an attempt to "deregulate" or privatize NIFs by replacing old investment managers on the boards. Observers describe this attempt as a kind of 'coup d'états,' and speculate this attempt contributed to the sudden sharp fall of prices similar to the levels of discounts in the Czech Republic. The immediate loss of investors' confidence followed because of the fear of control struggles within NIFs, making the decline of stock prices inevitable.[381] This incidence shows again how important it is to build a stable environment with clear incentives and without detrimental struggles for control.

be trading at or near their net asset value, while Czech funds during this period often traded at steep 20 percent to 70 percent discounts off their net asset value." (footnotes omitted). Coffee, *supra* 344, p. 15.

[380] Coffee, *supra* 344, p. 18. He further believes that the "inefficient exposure to loss that the Czech system imposed on minority shareholders may also explain the earlier noted absence of equity offerings for cash in the Czech Republic as contrasted with their frequency in Poland. Because an offering of equity securities inherently dilutes large shareholders, it exposes them to an increased risk of exploitation (footnotes omitted)." *Id.*

[381] The incident is described more in detail by Coffee *supra* 344, p. 16. Based on this experience, Coffee concludes that: "Although the number of firms traded on the Warsaw Stock Exchange has continued to grow and no such cases of "tunneling" were recorded, the Polish attempt of "deregulation" or more accurately "privatization" of the NIFs, may be repeating the sorry history of the Czech funds."

A comparison of two similar countries with different approaches toward mass privatization, regulatory bodies and the creation of supportive institutions, shows that concrete institutional choices do play a role in transition. From the comparison it is not possible to say that there is one best available set of institutions and structural adjustments that would guarantee restructuring and growth. The initial strategic decisions, such as whether to rely on outside owners or inside owners, on concentrated or dispersed ownership, on bank-based financing or capital markets, on strict regulatory approach or *ex post* regulation, do have significant effects on the subsequent behavior of the management, employees, suppliers, customers or creditors of privatized firms. It is not possible in advance to say that certain institutional solutions will provide restructuring and growth, whereas some others will not. Stability and the macroeconomic context matter, but in the concrete national contexts, stability can be as much a result of concrete institutional development than its cause. Certain institutional solutions are substitutes, whereas others are complimentary.

To put it more concretely, certain institutional solutions and regulatory standards are more likely to trigger the desired behavior on the markets than others. The institution-building process usually delays the actual events, but the active regulatory approach can enable and secure the realization of pronounced goals. However, there are certain institutional solutions and methodological approaches in certain stages of reforms that are more likely to produce better results. For example, concentrated outside ownership combined with strict regulation and transparency rules is more likely to lead to effective governance and restructuring of firms than dispersed outside ownership accompanied with weak legal framework and no state presence or control. Strict regulation and disclosure rules based on international standards are more likely to lead to liquid and transparent capital markets than weak regulation based on simple, natural 'demand and supply' rules. Subsequently, a liquid and transparent capital market will bring about in return more IPOs, less trading with discounts, and less fraud and out-stripping attempts.

The dilemma whether to rely on debt or equity to finance restructuring, the introduction of new technologies or new products, remains less clear. Not only do the firms in the advanced economies primarily rely on retained earnings, but they also rely on the relation between firms, ownership and external finance, which remains substantially different in comparison with the firms in transition. If a causality claim between corporate ownership and corporate finance is raised in the advanced economies, such a causality claim should be implied for the firms in transition. Berglof and von Thadden question whether corporate law drives corporate finance and not the other way around.[382] Then, by implica-

[382] "It is not difficult to come up with examples of how corporate law in writing and

tion, the same can be true for the firms in transition: it is the structure of ownership and the method of privatization that primarily determines corporate finance, not corporate laws. Therefore, it is not likely to expect that large inside owners of the firms would rely on external finance, especially not through the capital markets. There might be a similar situation with concentrated outside owners of the firms: they are likely to be equally unwilling to raise additional capital by selling or issuing new stocks.

Therefore, the interrelation of corporate ownership, finance and corporate law presents for the firms in transition a set of constraints that are difficult to overcome even with the help of additional regulation and new incentives. Hypothetically speaking, the inherited structure from the transition further deters other important providers of external finance, such as banks, suppliers, employees, corporate networks and the state. Ignoring other potential investors, and not providing sufficient legal protection and incentives for them, certainly influenced the behavior of the firms in transition.[383] Perhaps the inability of the reformers to create a broader network of stakeholders in the firms prevented some of the potentially crucial actors (banks, employees, suppliers, and governments) from actively participating and holding their stakes in the process of restructuring.

For the firms in need of restructuring there are other important aspects that are exogenous to the discussion on the most appropriate sources of finance. Among the exogenous constraints are the lack of investment opportunities with low enough risks.[384] The less stable the

enforcement has been shaped by existing financial structures. Countries with a tradition of strong bank involvement in corporate control have often found effective ways of accommodating this tradition in legal practice (*see*, e.g., Japan and Sweden). Similarly, in countries where closely held firms predominated, legislators and regulators have often found it unnecessary to specifically regulate the composition of boards of directors." Berglof and von Thadden, *supra* 322, pp. 11–12.

383 Berglof and von Thadden have identified four potential inefficiencies for the creditors in terms of legal protection: "Debtor-creditor law may be excessively hard (or too soft) on management or controlling owners, but the law can also lead to inefficient liquidation (when continuation would be optimal) or inefficient continuation (when liquidation is the optimal decision). In addition, there may be conflicts between creditors ex post, and probably ex ante. All these inefficiencies cannot be characterized along a single dimension. Simply maximizing creditor protection does not provide much guidance as a general policy." *See supra* 322, p 17.

384 "The presumption of LaPorta, Lopez-de-Silanes, Shleifer and Vishny and in many of the related articles is that external finance really constrains the growth of firms. In most developed market economies this is probably true, internal finance is more important and new issues of equity and debt are relatively rare events in firms, but bank debt is frequently used. In developing countries the actual or potential role of external finance is not as clear. Finance, internal or external, will only help when firms have access to profitable projects with low enough risks; the risk premium is high in many developing countries (weaknesses in investor protection, the rule of

macroeconomic framework, and the less predictable the behavior of new owners and their true commitment toward restructuring the privatized firms, the higher the level of risk involved in such an enterprise. It is therefore logical to expect that the managers of the firms in transition would – similar to the firms in advanced economies – primarily rely on their internal sources to finance the restructuring and development of the firms. The problems with the governance of the firms, the unclear incentives to the managers and employees and the systemically unresolved issues of corporate finance did not create environment for large scale restructuring. The risks and potential benefits were unequally spread among the crucial actors. Restructuring the firms takes time and involves a great deal of risk, and the firms in transition pose different kinds of requirements to the inside or outside owners.

New owners were expected to invest in the privatized firms first by strengthening their governance and introducing new technologies. But empirical studies show that the new owners were unable to raise large quantities of investment capital, lacked skills and incentives to engage in the active monitoring of the firms, or lacked the abilities to introduce new technologies. Instead, new owners were often engaged in the contest for control over the firms or colluded with management in out-stripping the firms. Poorly regulated capital markets and unresolved issues of the transparency and governance of the privatization funds allowed the new owners to participate in many detrimental practices. On the other hand, uncertainty with regard to the ownership changes and limited internal sources of finance, in most cases, did not allow managers to engage in delaying and protracting the efforts of restructuring the firms. Inside limitations and an outside lack of support were among the main limitations. Observers and analysts of the privatized firms described the partially privatized firms in which the state remained the largest owner as one of the biggest surprises of mass privatization.[385] Perhaps the substantial presence of the state in the privatized firms prevented uncertainties with regard to the struggle for control, which, in turn, offered more guarantees to the investors. On a speculative level it could be discussed whether the substantial presence of the state lowered the risk premiums for the investors, inside and outside, but we still do not have enough empirical data on the actual behavior of the firms in transition to make any conclusions.

The banking sector could have become one of the important pillars in the process of restructuring the firms. It had several advantages over

law, enforcement and transparency are, of course, part of this premium)." Berglof and von Thadden, *supra* 322, p. 22.

385 Roman Frydman, Cheryl Gray, Marek Hessel, Andrzej Rapazcynski, *Private Ownership and Corporate Performance: Some Lessons from Transition Economies, supra* 155, p. 32.

other sources of finance. Banks had long established relations with the firms, so they had accumulated knowledge and experience. Unlike other sources of external finance, they could provide long-term firm financing without expecting immediate profits and benefits. But the banks themselves were not immune to the severe economic crisis to which they had to react. Bad past loans forced banks to go through the process of restructuring under the control of the state. Subsequently, in times when firms needed capital most, banks were no longer capable and willing to lend money. Instead of strengthening the ties between banks and firms before restructuring, those ties fell apart. Banks changed their strategy before privatization and restructuring. Thus, their main goal became to retrieve past loans from the firms to the largest extent possible.[386] Only in some cases did banks assume the role of actively restructuring the firms, whereas in most cases the role of banks was limited to filing bankruptcy cases or organizing work-out agreements with the firms to retrieve their loans.

Theoretically speaking, banks could have assumed a larger role in the process of restructuring the firms. One argument in favor of the larger role of banks is that they can finance long-term restructuring projects without expecting immediate profits from the firms, as long as the firms duly pay annuities to the banks. Restructuring the large firms in transition involves the introduction of new technologies, new lines of production, or new products, and is a demanding endeavor that requires several years before the efforts pay back. The question of external finance in the process of restructuring the firms in transition is synonymous with the question of risk-sharing. Not all financial institutional arrangements can be equally suitable for such goals. The relation between financing the restructuring and the new ownership structure of the firms in transition has been identified, and reluctance of the banks to provide finance might be one of the by-products of the chosen method of mass privatization.[387] Without sufficient guarantees and monitoring of the firms to prevent misuse of funds, it is not realistic to expect the banks to generously finance the long-term privatized firms' restructuring projects. Subsequently, if the risks for demanding long-term restructuring processes are

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[386] This conclusion is based on the empirical evidence from Hungarian and Polish banking restructuring. In both countries banks were reluctant to engage in debt-for-equity swaps. In Poland banks resorted to debt-for-equity swaps in 30 percent of the cases and in Hungary even less so. For an empirical analysis of the banking sector restructuring *see* Peter Dittus and Stephen Prowse, *Corporate Control in Central Europe and Russia – Should Banks Own Shares?, supra* 373, pp. 52–54 and Baer and Gray, *Debt as a Control Device in Transitional Economies: the Experience of Hungary and Poland, supra* 185, pp. 104–105.

[387] The available empirical studies show that banks became aggressive not only in retrieving past loans, but at the same size undercut allocation of new credits to the firms, which was especially the case in the first years of transition. *See* Baer and Gray, *supra* 185, pp. 101–104.

not shared, it is likely that the managers of the firms will be forced to cut on their restructuring efforts.

The theoretical discussion on the important role of banks in restructuring the firms in transition stems from the comparative experience of the countries pursuing rapid development. From the comparative experience it is possible to conclude that countries in the early stages of development rely primarily on banks. After the economy matures, capital markets become more important.[388] For an enhanced role, banks need sufficient mechanisms to monitor the firms and sufficient information about the firm to effectively participate in project selection processes. This is true for the short-term as well as for the long-term financing of the firms. The division of risks between the firms and the banks can be efficient only as long as the banks with skillful personnel have access to the firm's investment projects and other important information. Conversely, inefficient monitoring and poor information about the firms could cause widespread bank failures, especially if the banking regulation and supervision requirements are not met.[389]

Based on the available data, we see that strong links between banks and firms in transition did not occur in any of the countries in transition. We showed some of the most important theoretical underpinnings and practical reasons for the described path of reforms. Every step in reforms brings with it certain opportunities, risks and costs. To date, we do not know the opportunity costs for the minimal role of banks in privatizing and restructuring the firms. On the other hand, reliance on the capital markets brought other opportunities and problems. The study of the development of the Warsaw Stock Exchange showed some very encouraging signs, and the lessons from the failure of capital markets in the Czech Republic, Russia and other countries are also very telling. Without a comprehensive regulatory framework, supervising mechanisms and disclosure requirements, it is not possible to rely on capital markets as an efficient tool for providing liquidity, external financing and corporate governance for the privatized firms. We saw that in advanced economies, the securities market is not a simple place where demand and supply meet, but a sophisticated system of institutions allocate aggregate savings based on risk sharing.[390] Without sufficient information about the privatized firms, investors will not be prepared to place their savings in

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[388] "This suggests that the role of banks in economic development is related to the life cycle of firms in economies. In their early years, firms are heavily reliant on bank finance. As an economy and firms in that economy mature, bank finance dwindles in importance relative to security markets." Paul Collier, Colin Mayer, *the Assessment: Financial Liberalization, Financial Systems, and Economic Growth,* OXFORD REVIEW OF ECONOMIC POLICY, vol. 5, no. 4, Winter 1989, p. 3.

[389] On the risk of banking failure *see* Collier and Mayer, *supra* 388, p. 4 and Dittus and Prowse, *supra* 373, p. 62.

[390] *See* Stiglitz, *supra* 375, p. 61.

those firms. Asymmetry of information is particularly strong when we are dealing with the firms in transition that are undergoing the process of restructuring, and especially when dealing with the new creation of transition – the privatization investment funds. Unless the monitoring mechanisms and disclosure rules are provided, the practices of "tunneling" and out-stripping firms are likely to occur, especially in difficult economic times. Once such practices occur, the following erosion of investors' confidence causes a rapid downward spiral of the capital markets.

In terms of the prospective development of capital markets, the second generation of reformers will have to take into account the fact that it takes years to re-establish trust into the capital markets. To start relying more extensively on the capital markets in the future, regulatory requirements aside, reformers need to take into account the fact that in advanced economies the secondary trading in the organized markets is more important than the IPOs.[391] The function of the secondary trading is to provide liquidity on the markets and prevent share price volatility. An effective market for corporate control can be established only when a secondary market is functioning and not occurring only sporadically, as is currently the case in most of the emerging capital markets in the countries in transition.

A market for corporate control is especially important at the level of the investment privatization funds, because their non-transparent and poorly monitored functioning presents one of the weakest links in improving corporate governance in the countries in transition. Without reassigning incentives for the privatization funds and linking the premiums of the fund managers to the actual performance of the privatized firms, it is not possible to improve the overall transparency and efficiency of the capital markets. The measures to improve governance and monitoring at the level of the investment privatization funds should include *inter alia* adjustment of the management fee structure, the introduction of performance-linked compensations for the fund managers, making the contracts of the managers terminable on an annual basis, and allowing funds to buy each others shares, allowing citizens to withdraw vouchers from the funds and place them into other funds.[392] Additionally, competition regulation and strict disclosure requirements should be imposed on the funds. Bearing in mind the different ownership struc-

[391] *Id,* p. 63.

[392] For a good overview of the variety of measures used to improve the governance of the privatization funds in the context of the Slovenian experience *see* Bozo Jasovic, *Management Companies and Issues of Governance of Privatization Funds* in Marko Simoneti, Saul Estrin, Andreja Böhm (eds.), THE GOVERNANCE OF PRIVATIZATION FUNDS, *supra* 227, pp. 117–118. *See* also Saul Estrin, Domenico Nuti and Milica Uvalic, *id, The Impact of Privatization Funds on Corporate Governance in Mass Privatization Schemes: the Czech Republic, Poland and Slovenia,* esp. pp. 157–160 and Coffee, *supra 80*, esp. pp. 171–183.

tures and the different roles of funds in the countries in transition, some of the suggested measures are valid across the countries, whereas some other measures should be made within a nation-specific context.

Empirical insight to date suggests that capital markets could play, and in some countries in transition do play, an important role in the overall development of the economies in transition. What has not been clearly established, however, is the fact that functioning capital markets have the capacity to contribute to the rapid and substantial restructuring of the privatized firms. Indirectly, capital markets certainly play an important role in the countries in transition in several ways: they provide information that was not previously available to potential investors, they send signals to the managers of the firms listed on the markets about current firm valuations, or they create disciplining mechanisms through takeover opportunities. For the countries in transition, capital markets proved less capable in raising finances to restructure the privatized firms and to provide sufficient incentives for the privatization funds to engage in long-term restructuring of the firms. Although these observations lead us to the conclusion that capital markets perform many of the necessary and important tasks for the economies in transition, it would be too much to expect the capital markets to contribute to the substantial costs of restructuring the firms in transition.

In fact, despite becoming an important part of the institutional arrangement for the countries in transition, some of the functions of the capital markets might hamper the long-term restructuring efforts of the firms. If capital markets are to become an important instrument for takeover activities, they can directly contradict the requirements for long-term firm restructuring engagements. Some of the comparative data from the well-functioning capital markets in the advanced economies even suggest that there is an inherent danger of adverse selection, which in turn causes capital markets not to always select only efficient firms for survival.[393] By the same reasoning, this problem can occur even more so in the countries in transition, which are dealing with much thinner and less transparent markets. It will take time before capital markets in the countries in transition reach the level of capitalization in the advanced economies, and only at that point will it be possible for the capital markets of the countries in transition to assume a variety of tasks.[394] Having

393 Alan Hughes and Ajit Singh have made a historical analysis of takeovers in the developed capital markets and found no solid base for a claim that takeover activities necessarily lead to improved market efficiency, and that only efficient firms act as 'predators' and inefficient firms as 'victims'. According to the authors, the more important variables of takeover activities are size, first and foremost, and profitability and change in profitability. *See* Alan Hughes and Ajit Singh, *Takeovers and the Stock Market,* in John Eatwell, Murray Milgate, Peter Newman, THE NEW PALGRAVE – FINANCE, Macmillan Press 1989, pp. 252–264.

394 The comparative study by Ajit Singh brings with it an important *caveat* against overstating the role of capital markets for the developing countries: "The rapid develop-

realized all this, we should be able to recognize the importance of a well regulated, liquid and transparent capital market for the countries in transition. They provide many of the tasks and operations that otherwise could not take place in the countries in transition. It would be a mistake, however, to rely on capital markets as the only and sometimes exclusive engine of growth and development in the countries in transition.

Perhaps a better approach in solving the dilemma of choosing between loans and equity is to take steps to soften the legal differences between the two different forms of corporate finance and make efforts in bringing the two institutions closer together. For long-term loans it would be possible, for example, to provide monitoring mechanisms similar to equity owners, to secure access to all the necessary data about the firm throughout the period of financing, and to give creditors voting rights. The discussion on how to soften the sharp legal distinctions between loans and equity has been present in the most advanced economies and there is no reason why the second generation of reformers would not pay attention to it.[395] In the context of transition, it is even more important to guarantee financiers, either in the form of equity or in the form of loans, insight into the firm's strategic decisions, an understanding of its restructuring plans and also voting rights to participate in the long-term decisions of the firm. To paraphrase Berglof and van Thadden, we can say that the monitoring and voting rights of the firms in transition should belong to those who are ready to finance the long-term restructuring of the firm.

To summarize the discussion on corporate governance, ownership and finance, it is fair to conclude that there exists no clear blueprint on how to create an optimal institutional framework that leads toward substantive restructuring and rapid development of the firms in transition. There exists no clear formula on what would be the optimal ownership structure of the firms in transition. The diversity of restructuring problems requires different activities, strategic decisions and sources of finance. Not all forms of ownership lead to greater efficiency, improved governance and higher productivity. We saw that some types of new owner-

ment does not, however, mean that even the most advanced emerging markets are mature. In most markets, trading occurs in only a few stocks which account for a considerable part of the total market capitalization. Beyond these actively-traded shares, there are serious informational and disclosure deficiencies for other stocks. Further, supervision by regulatory authorities is often far from adequate. The less developed of the stock markets suffer from a far wider range of such deficits." Ajit Singh and Bruce Weisse, *Emerging Stock Markets, Portfolio Capital Flows and Long-term Economic Growth: Micro and Macroeconomic Perspectives,* WORLD DEVELOPMENT, vol. 26, no. 4, 1998, p. 609.

[395] Lester C. Thurrow, *Let's Put Capitalists Back into Capitalism,* SLOAN MANAGEMENT REVIEW 30, 1988, pp. 67–71. Cited from Margaret M. Blair, OWNERSHIP AND CONTROL, *Rethinking Corporate Governance for the Twenty-First Century,* Brookings 1995, p. 196 (appendix 5–1).

ship relations destroyed wealth instead of creating wealth. The optimal ownership structure for the firms in transition is context specific and depends on the multiple types of challenges facing the firms in transition. This is the reason why it is not possible to abstractly state which forms of ownership are superior to others, especially in a context where the incentives of some actors are not tailored narrowly.

Some of the approaches toward the reorganization of ownership relations were unambiguously more successful than others. Among the characteristics of the successful approaches toward mass privatization and the reorganization of the economies was a strict regulatory presetting, an existing monitoring institution and a competition policy. In the aftermath of privatization it is not possible to say that certain types of ownership were superior to others. For example, based on empirical evidence to date, it is not possible to say that the outside owners unambiguously perform better than the inside owners in terms of improved governance, productivity or extensive restructuring of the firms. The same is true for the privatization investment funds. On the other hand, firms in transition owned by inside owners, managers and employees, and the firms partially or fully owned by the government, did not necessarily perform worse than other firms, and in many cases were in fact performing better than firms with other types of ownership.

On the basis of our comparative analysis, it follows that reformers were unable to find a property mixture that would guarantee a rapid improvement of governance and productivity while engaging in extensive long-term restructuring of the firms. Some of the institutions, such as privatization investment funds, created in the process of privatization, posed many new issues and new problems for the reformers. There is certainly no doubt that corporate governance and the organization of production of the firms in transition can and should be improved, but the appropriate measures and the best mixture of different actors to secure such development and growth is less clear. A coalition for growth and development of the firms in transition, combining inside and outside actors of the firms, has not yet been firmly established. The safest bet to create such a coalition is to improve the regulatory framework, implement monitoring mechanisms and an institutional setting. Establishing such a context should provide clear incentives for the firms in transition, their employees and owners, to engage in long-term development of their firms. In doing so, no actor can be excluded in advance, no potential agent of development can be discounted and no institutions can be taken on their face value, assuming the second generation of reformers want to embark on the path of real development and growth.

There are many obstacles exogenous to domestic policy making, such as the limited access to developed markets, scarce domestic financial resources, and limited inflow of foreign capital. But even after taking into account those exogenous impediments, there remains much to be done at home to improve the efficiency and competitiveness of domestic economies.

THE ROLE OF THE GOVERNMENT

The government, one of the potentially crucial agents of selective turnover and economic restructuring, has been, in the eyes of the first generation of reformers, the least equipped and capable of contributing anything positive to the development of the firms. It was the main goal of the reformers to sever the ties between government and business and to stop the government from running firms through its ministries. But we saw that in the course of transition the government was supposed to perform many other complex tasks in order to make the reforms successful. Thus, the first generation of reformers found themselves in a difficult situation: they had to dismantle the state apparatus and prevent it from running the businesses, while keeping it alive for many other tasks in the transition. To be sure, most reformers were unaware of this dilemma at the beginning of reforms and even publicly declared their goal was to 'break the back of the ministries' in order to bring new life and initiative to the (privatizing) business.

Soon, however, it became clear that dismantling the government was a much more difficult and complex task than previously believed. Even in the Czech Republic, where reformers were rhetorically and in practice most committed to limiting the role of the government to its minimum, the government played a more important role than initially expected. Brom and Orenstein showed that after a few years of ambitious reforms the state had to "claw back" into many large enterprises, directly through retaining the ownership or indirectly through the ownership of the majority of the banking sector, which established the majority of the privatization investment funds.[396] In Poland we saw, for example, that the privatization program was not only delayed for several years but also that a large segment of the biggest enterprises remained in state hands. The situation was similar in other countries in transition.

Moreover, there were many other ways in which the government remained deeply engaged in the reforming policies and preserved a dominant role. The aggressive anti-bankruptcy policy in the Czech Republic stood out in comparison with Hungary, which opted for an active approach toward bankruptcies. Practically all of the countries in transition were forced to financially restructure and consolidate their banking sectors, which were burdened with irretrievable loans. From the Polish

[396] Brom and Orenstein, *supra* 81, pp. 903–904.

and Hungarian example of bank restructuring, we saw the long-term repercussions in the economy. A regulatory policy, or the absence of such a policy, made a decisive impact on the behavior of firms in various sectors and was particularly important for the behavior of the state monopolies, prior to and after the privatization process. The effects of the policy of subsidization, especially the decisions on when to withdraw subsidies, belonged amongst the most important decisions regarding the industrial policy of the countries in transition.

In short, the government played an important role throughout the process of transition, and it will continue to play such role even after the period of transition formally ends. It would be a major strategic mistake for the reformers to ignore the importance of building a capable, well-educated and flexible bureaucratic apparatus based on accountability and transparency. Focusing solely on market development without improving the functioning of the state bureaucracy could have – and in many cases do have – a negative effect on the overall performance of the economy. Mass privatization, for example, was one good example how inefficiency, lack of accountability and transparency have reverse effects on the capacity of the emerging private sector to develop. On a comparative basis we saw that the countries with developed regulatory framework, coherent industrial policies and a transparent, functioning bureaucracy tend to develop faster than the countries with a poorly developed regulatory framework, an incoherent or no industrial policy, and a lack of transparency and accountability.

John Nellis made an important remark noticing that the countries with a well-organized and accountable bureaucracy are capable of successfully running the state-owned enterprises, whereas in the countries with inefficient and corrupt bureaucracies, it is unrealistic to expect that privatization will solve all the economic problems.[397] In other words, the relations between government and business are in any given country so complex and multifaceted that it is not possible to hope for the successful functioning of a relatively autonomous sphere without the successful functioning of the other sphere. The preoccupation of reformers with privatization often was at the expense of an unreformed public sector, including the slow restructuring of state-owned enterprises. The belief that rapid privatization was the best way to restructure firms did not materialize in practice, or at least not to the extent expected before mass privatization took place. Little by little, reformers recognized not only that mass privatization without the supportive institutions and clear

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[397] John Nellis, *Time to Rethink Privatization in Transition Economies?, supra* 156: "As Shirley has shown, the irony is that countries with the administrative skills and political capacity to run state-owned firms in an effective and efficient manner are usually the very same countries that can privatize well. Conversely, the forces and conditions that lead government to botch privatization are the same that hinder decent SOE management." P. 22.

incentives for the new owners would not automatically bring rapid development, but also that many of the privatized firms faced similar problems compared to the state-owned enterprises.

Soft budget constraint and bankruptcy reorganization

In this section I would like to tackle two difficult issues that reformers tried to confront in their efforts to improve the competitiveness of the firms in transition. One set of problems relate to the phenomenon of socialist economies, called soft budget constraint; the other set of problems relate to the bankruptcy policy of the firms in transition. Both sets of problems are particularly interesting, because they reveal the expectations of the reformers that the best answer to these problems is rapid privatization.

The first set of problems, known to experts of transition as the soft budget constraint, is the phenomenon when the government was prepared to finance continuous loss-making socialist enterprises without requiring the enterprises to restructure. The phenomenon has been detected and extensively analyzed by Janos Kornai, one of the leading experts of the socialist economies. When loss-making state enterprises do not go bankrupt but receive additional financial means from the government or state owned banks, the government does not want to shut down the loss making enterprises due to social and political reasons. In the environment of almost exclusive state ownership the residual owner is the government, whereas managers of the enterprise are only the middle-level members of the state bureaucratic apparatus. Ultimately, it is the government's responsibility to run the enterprises. Signals from the market, prices of goods or interest rates of credits are of lesser importance to state managers, whom are obedient to the government. The government in the socialist economies ran an interventionist policy, which was based on redistributing resources from profitable enterprises to the loss-making enterprises, thus further distorting market criteria.[398]

This sketchy overview of the soft budget constraint, developed in the socialist economies, shows how uneconomic activities and projects were financed by the governments throughout the era of socialism. Managers of the state enterprises had no incentives to maximize profits, which subsequently led to an overall inefficient economy plagued by sever crises. Before the large-scale institutional reforms took place, some economists feared that unless private firms, who are responsive to the market signals, were created, the soft budget constraint would continue to thwart the market-based development of the firms in transition. The only way to discipline enterprises and create undistorted markets is to harden

[398] Janos Kornai, THE SOCIALIST SYSTEM, Princeton 1992, pp. 489–500.

the budgets of the firms, and the best way to harden the budgets is to separate the firms from the government. Kornai believes that such separation cannot be achieved effectively under a regime of predominantly state owned enterprises, because the government will always find ways to subsidize unworthy enterprises, and the managers of those enterprises will always find ways to extract subsidies from the government.[399]

The existence of the soft budget constraint in the socialist economies shaped not only the (typically hierarchical) relations between the government and the state-owned enterprises, but also affected the relations among the enterprises and the banking sector. State enterprises, for example, were not penalized when they refused to pay their bills and they could always hope that the government or the state banks would step in and rescue them from their financial debts. As a consequence, the inter-enterprise debt started to amass in some of the socialist economies back in 1970s.[400] In socialist economies, inter-enterprise indebtedness has a long history and deep structural and institutional roots. It was a part of the specific coordinating mechanisms in the planning economies and a by-product of specific bargaining positions among the key actors of those economies. As such, it required certain behavior from the participants in the bargaining process, which determined the rate of new investments and distribution, socializing the losses among the state enterprises. The study by Dewatripont and Maskin detected, for example, that the system of bargaining under soft budget constraints required the state banks to chase after its money and continue financing uneconomic investment projects under the system of centralized credits.[401]

The embeddedness of the 'soft budget constraint' in the system of socialist economies led the first generation of reformers to the conclusion that the best way to end the practice of socializing the losses of the state enterprises and to impose realistic constraints on the firms is to stop providing soft loans via state budgets or state banks. To put it more simply, the reformers decided to immediately stop subsidizing the loss-making enterprises and leave them to the robust market environment. The underlying assumption for such a decision was that only the private

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[399] *Id*, p. 495, ft. 35: "Exceptionally, the hardness of the budget constraint on publicly owned firms can be ensured artificially if there are not too many of them and they are surrounded by privately owned firms in a capitalist system. The behavioral norm of the narrow public sector then resemble the behavior of the dominant private sector of the economy."

[400] *Id*, pp. 500–502. Kornai refers to the studies of S. J. Gedeon and Laura Tyson to point out that: "For example, in [the old] Yugoslavia the annual growth rate of inter-firm indebtedness was around 30–50 percent in the late 1970s and early 1980s." Similar phenomenon occurred in Hungary. *See* Kornai, *id*, p. 501, ft. 44.

[401] Michael Dewatripont and Eric Maskin, *Credit and Efficiency in Centralized and Decentralized Economies*, Harvard Institute of Economic Research, discussion paper no. 1512, 1990. Cited in Kornai, *supra* 398, p. 494, ft. 34.

– 'real' – owners would pay attention to the signals from the market instead of lobbying the government to cover the losses. Thus, according to the first generation of reformers, only rapid privatization could lead to the decisive change of behavior of the firms: the privatized firms would finally start maximizing profits like the firms in advanced economies.

The fight against 'soft loans' and extensive subsidization took place, however, in times of severe macroeconomic shocks. In the introductory chapter I pointed out that the 'credit crunch' and liquidity crisis was for some scholars among the main culprit for the sharp and unexpected decline of production in the first phase of reforms. In the second chapter on mass privatization I came to the conclusion that despite the hopes for restructuring the privatized firms, the problem of financing the restructuring efforts remained unresolved for many privatized firms. And now we can see that the fight against 'soft budget constraint' might have caused an 'overkill' against the firms because of the following reason: after the decades of poor financial and payment discipline among the socialist enterprises, irresponsive to market signals and existing in the absence of bankruptcy a threat, it was extremely difficult to discern between potentially viable and non-viable enterprises. In times when all the enterprises suffered from severe liquidity problems, it was not possible to discern between viable and non-viable enterprises based solely on the emerging market criteria, while neglecting other criteria such as quality of products or the level of human and physical capital in the firms.

The cut in subsides was immediate and massive. Mark Schaffer's study on the elimination of subsidies in the Visegrad group shows a cut of subsides between 15 and 25 percent of GDP in 1986 to only between 3 and 5 percent in 1993, which is the average level of the EU countries.[402] He attributes the cut to the policy of price liberalization, which made most of the price administration system superfluous.[403] Although Schaffer shows us the level of budgetary subsidy cuts, less visible were the levels of implicit subsides through the ailing state banking sector in the countries in transition, which were writing off past bad loans or refinancing firms with new credits. We saw in the cases of Hungary and Poland different methods of restructuring the banking sector, while gradually severing the ties with the privatizing enterprises. The explicit and implicit changes of subsidy policy in the countries in transition make an overall assessment of the changes in behavior of the privatizing enterprises difficult, although it clearly had a substantial impact on the firms in transition.

What made the fight against the soft budget constraint so decisive was

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[402] Mark Schaffer, *Government Subsidies to Enterprises in Central and Eastern Europe – Budgetary Subsidies and Tax Arrears,* in David M. G. Newbery (ed.), TAX AND BENEFIT REFORM IN CENTRAL AND EASTERN EUROPE, Center for Economic Policy and Research 1995, pp. 116–117.

[403] *Id*, p. 117.

its impact across the industries without discriminating between the economically justified and economically unjustified subsidies. The downside of imposing the hard budget constraint is that it could not only deter bad entrepreneurs from starting projects, but it can induce short-termism among good entrepreneurs, as pointed out by von Thadden, and Dewatripont and Maskin.[404] Since socialist economies were characterized by low productivity in the state sector, and suffered from a severe misallocation of resources, the authors feared that an instantaneous reallocation of resources could have led to an adverse productivity shock, due to contractionary effect of such a policy at the level of the state-owned enterprises. As we saw, such an adverse productivity shock actually occurred and the authors claim that the speed of the sectoral reallocation was counterproductive to the point of slowing down the process of private job creation, due to its contractionary effect.[405]

One possible explanation of the adverse effects of the reallocation of resources is that the first generation of reformers were "over-committed" to rapidly ending the practice of extensively reallocating resources and the practice of subsidizing the loss-making state enterprises. In doing so, the contraction of production and the slower than expected development of the private sector was a result of the first phase of reforms. Alternatively, one can imagine the approach of organized credit allocation to the state-owned enterprises, contingent upon the explicit government requirements to restructure the enterprises within the given time framework. The approach should be based on an enterprise-to-enterprise assessment, evaluating their capacity to successfully restructure.[406] According to Begg and Portes, the introduction of bankruptcy laws without the appropriate incentives for creditors to foreclose, and without the government reallocating credits based on redesigned incentives, was

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[404] Mathias Dewatripont and Gerard Roland, *Transition as a Process of Large-Scale Institutional Change,* ECONOMICS OF TRANSITION, vol. 4 (1), 1996, p. 20.

[405] *Id,* p. 21. Based on continuous-time model by Castanheira and Roland, the authors have come to the conclusion that: "... an adverse productivity shock in the state sector depresses aggregate capital accumulation if it occurs in an early phase of transition but increases investment if it occurs later in transition. Productivity shocks are usually not self-inflicted. Nevertheless, this analysis sheds some light on the output contraction in Central and Eastern Europe, following price and trade liberalization, which are recognized to have produced an adverse productivity shock in the state sector. By contrast, in China, where the state sector was relatively insulated from early reforms in the countryside, an impressive and sustained process of capital accumulation has occurred and structural shifts are taking place in a context of high growth." Pp. 21–22.

[406] Such an approach was recommended by David Begg and Richard Portes, *Enterprise Debt and Economic Transformation: Financial Restructuring of the State Sector in Central and Eastern Europe,* CENTER FOR ECONOMIC POLICY RESEARCH, discussion paper no. 695, June 1992. They proposed a sequencing of recapitalization of banks and of enterprises that was designed to be credible and robust to the identified incentive failures.

unlikely to promote substantially greater inefficiency even in case when privatizing banks and state-owned enterprises.[407] Although we do not possess precise empirical data, the fear of the aforementioned authors that the unresolved problems of reorganized incentives, the unresolved credit and equity rationing problem for the public and private sector, which would not automatically enhance the efficiency of the emerging private sector, seem to materialize to a substantial extent. The absence of institutions for credit and equity rationing in the first phase of reforms greatly influenced the subsequent slow restructuring process, regardless of the form of ownership.[408]

Another important, but largely overlooked dimension of the soft budget constraint, is the fact that the soft budget constraint is not a phenomenon of only socialist economies, but that it can occur in various ways and even in advanced economies. Zhiyuan Cui gave a theoretical explanation on why the problem of the soft budget constraint transcends the borders of the former socialist economies. His studies show that the soft budget constraint is not caused by state ownership *per se,* as accepted by many scholars of the former socialist economies, and that the soft budget constraint can also be a good and not inherently a bad thing to the economy.[409] Cui provides a number of examples from the advanced economies where the soft budget constraint is present. One of the most important examples is the commercial banking sector, for which the ordinary bankruptcy rules do not apply directly. On one hand, the government in most advanced economies guarantees for deposits, at least to a certain amount, on the other hand, the central banks in financial crises assume the role of a "lender of last resort" to provide liquidity for troubled banks. The Savings and Loan debacle in 1982, when hundreds of S&Ls had negative net values, but were permitted by the Federal Home Loan Bank Board to overstate their net worth by using the so-called "regulatory accounting," is a good historical example of the presence of the soft budget constraint.[410]

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[407] *Id.*

[408] Stiglitz and Weiss pointed to the credit-rationing problem on markets with imperfect information in the early 1980s. The authors show the difficulties banks have to face in conditions of short-term market disequilibrium that are due to exogenous shock, while making decisions on whom to lend money and at what price. The adverse selection problem exacerbates in cases of exogenous shocks, which means that banks have additional difficulties and concerns in selecting "good borrowers" from "bad borrowers." The laws of supply and demand for credits in such conditions do not function properly, what should be taken into account while preparing sound policy-makers in difficult economic times. *See* Joseph E. Stiglitz and Andrew Weiss, *Credit Rationing in Markets with Imperfect Information,* THE AMERICAN ECONOMIC REVIEW, vol. 71, no. 3, 1981, pp. 393–410.

[409] Zhiyuan Cui, *Soft Budget Constraint and Inclusive Property Rights,* paper presented at the Conference on Political Economy, University of California at Davis, April 22–24, 1994.

[410] Zhiyuan Cui, *Incomplete Markets, Second Best, and Soft Budget Constraint, http://web.mit.edu/polisci/www/faculty/Z.CuiLinks.html, see* esp. the chapter 6.

The existence of the soft budget constraint in the form of a 'lender of last resort,' and special treatment of the commercial banking sector or bankruptcy reorganization under Ch. 11 in the advanced economies suggests that the general goal of policy-makers should not be the overall abolishment of the soft budget constraint. Instead, as Cui suggests, the focus should be on how to create an institutional arrangement that reduces the probability of "bad SBCs" ("bad risk" projects) and increases the probability of "good SBCs" ("good-risk", but slow projects). In the "suboptimal" environment of the countries in transition, the requirement for access to information about the proposed projects and increased transparency of the surrounding institutions might improve the chances for a selection of the good projects, which might ultimately result in the turnover of the economy. Instead of an all-out fight for hardening the budget, the more appropriate approach for the countries in transition is to create an institutional environment that is capable of distinguishing between potentially good and bad projects, regardless of ownership.[411] If the issue of dynamic commitment is the central problem of the soft budget constraint phenomenon, as suggested by Dewatripont and Maskin such a commitment can be clarified and enhanced in an environment with a strong regulatory framework and transparent surrounding institutions. In such a scenario, a dynamic commitment might lead toward greater efficiency instead of the "overkill" of public and private enterprises.

Closely related to the problem of the soft budget constraint is the problem of bankruptcy regulation in the countries in transition. Begg and Portes warned back in the early stage of reforms that the mere introduction of bankruptcy codes, without incentives to the creditors to enforce contracts or to commit foreclosures, could not guarantee an efficient bankruptcy framework.[412] The decision whether to refinance or to foreclose was delegated to the ailing banking sector and other creditors, majority of whom were in financial distress. Analyzing the soft budget constraint problem in the countries in transition, we saw that it was not a mere 'technical' deficiency of the old system that could be simply abolished after introduction of market reforms. The line between "good risk" projects and "bad risk" projects, or between "good" SBC and "bad" SBC was very thin, and was most frequently confirmed only after the fact, that is, *ex post*. The macreconomic shock at the beginning of transition further marred the ability of the policy-makers to make a distinction between good and bad projects.

Similar to the dilemmas relating to the soft budget constraint were the introduction of bankruptcy laws and their practical implementation in

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411 "Recommending the first-best-policy of hardening budget constraint indiscriminately in a second-best world of post-communist transformation may be a problem leading to recession and decline of growth, rather than a solution." *Id.*

412 David Begg and Richard Portes, *supra* 406.

the economies in transition. The introduction of bankruptcy laws carry with many dilemmas and questions that seek answers from the policy-makers. In practice, policy-makers in different countries in transition developed markedly different approaches toward bankruptcy laws that were similar on paper. Needless to say, similar legal texts in the different countries in transition produced a variety of results. Different results stemmed from different theoretical underpinnings and different practical responses of the policy-makers, creditors and borrowers altogether. For example, Hungary and the Czech Republic took opposite paths with regard to bankruptcy policy in the early stage of reforms. In the Czech Republic, the implementation of the stringent bankruptcy laws had been postponed twice, whereas Hungary opted for an aggressive implementation of the bankruptcy laws. As a result, while there were about 10,000 filings for bankruptcy and liquidation in Hungary in the same period there were only 993 bankruptcy filings in the Czech republic.[413]

Diverse approaches toward bankruptcy policy clearly suggest underlying theoretical and practical differences in understanding the nature and functioning of the market economy in its early phase of reforms. Two similar emerging economies with the similar history, differing mainly in the size of their domestic and foreign public debt, opted for radically different approaches toward bankruptcies. The comparison does not necessarily suggest that one of the governments more faithfully implemented market reforms than the other, but it shows the plethora of difficult decisions that the reformers had to make under time constraints and in the face of growing economic and financial difficulties in the early stage of reforms. Retrospectively, it is not possible to say without careful empirical analysis that one of the governments acted more responsibly and more economically. It is possible to add another important dimension, which was apparently ignored among the first generation of reformers. The analysis of the 'soft budget constraint' showed already that the link between privatization and ending of soft loans to the loss-making state enterprises was not a simple, one-way relation. It had many implications for the public and private sector. In the given circumstances, such as the aggregate macroeconomic shock, soft lending might have turned out to be a prudent, though risky policy. To what extent such policy can be justified and accepted, the final judgment can be made only retroactively, and the judgment itself always depends on the criteria chosen and the policy goals declared in advance.

The bankruptcy policy goes hand in hand with the policy of subsidization, known as 'soft budget constraint' in the former socialist economies, but is also present in advanced economies. David Stark noted that wanton destruction in a period of deep economic crisis is not necessarily creative destruction. He refers to Cui emphasizing that "in such circum-

[413] Stark, *supra* 170, n. 14 on p. 135. *See* also Brom and Orenstein, *supra* 81, p. 899.

stances, an absolute hardening of firms' budget constraints not only drives poorly performing firms into bankruptcy, but also destroys enterprises that would otherwise be quite capable of making a high performance adjustment."[414] Stark believes that in the condition of extraordinarily high uncertainties that the post-socialist economies encountered, recombinant property offers a risk-sharing mechanism, which do not require massive state bailouts. Instead, the cross-ownership devices (covering losses, providing loans and guarantees) could mitigate the differences across the firms and secure at least the minimum of new investments in distressed economy. If such an admittedly risky scheme works, it might ultimately avoid the low-level equilibrium trap, that the post-socialist economies might encounter without creating risk-sharing mechanisms. On the other hand, if such a scheme is not adopted, Stark stresses the danger of negative strategic complementarities, where the firms forgo investments because they expect a sluggish economy based on the lack of investments by others.[415]

The implementation of bankruptcy laws is another pillar of the supportive institutional framework that can trigger a chain of events across the whole economy. In other words, we must understand that there is no "natural" formula where to draw a line between viable and non-viable enterprises. It was Zhiyuan Cui who showed the intricate nature of bankruptcy laws and bankruptcy policies for the countries in transition. His historical analysis of the development of bankruptcy laws shows the substantial shift in understanding this legal instrument. If early understanding of the bankruptcy laws was the punishment of the fraudulent debtors, the real meaning of this legal instrument became clearer in the period of The Great Depression. At that time the bankruptcy law was implemented for an utterly different reason: it became a tool that provides relief to honest debtors who were suffering from a general financial situation that was beyond their control. The shift from involuntary bankruptcies (those triggered exclusively by creditors to punish fraudulent debtors) to voluntary bankruptcies (those triggered also by debtors suffering from financial externalities) was the shift from a punitive nature of bankruptcy procedure to the financial restructuring between creditors and debtors based on mutual agreement and trust.[416]

If bankruptcy laws are understood as an agent of the 'invisible hand' capable of discerning between "good" and "bad" firms, the role of this instrument can be achieved only if we are dealing with perfect markets. Any recessions or external shocks to the firms are not anticipated or

[414] Stark, *supra* 170, p. 127.

[415] *Id.*

[416] *See* more on the shift and about the underlying theoretical and practical underpinnings in Zhiyuan Cui, *Incomplete Markets and Strategic Bankruptcy*, *http://web.mit.edu/polisci/www/faculty/Z.CuiLinks.html*

built into this legal instrument, when taken outside the actual economic context. We saw, however, that in economic distress many different forms of financial externalities occur. Among the most important externalities in the countries in transition were inter-enterprise indebtedness, credit crunches due to problems in the banking sector, limited resources available on emerging capital market and the immediate ending of state subsidies. As Cui shows, various forms of financial externalities (left out of the complete market thesis picture) and macroeconomic shocks cause "good" firms go bankrupt more often in the times of a macroeconomic recession. Financial externalities caused the bankruptcies that drove "bad" and "good" firms, which were unable to get access to short-term credits or resolve financial issues with their creditors, out of market.

After understanding the intricate nature of bankruptcy laws, especially in times of macroeconomic shocks or financial externalities, the need for a more sophisticated approach toward implementing bankruptcy laws becomes obvious. The real issue for the reformers is to efficiently draw the line between "good" firms suffering from financial externalities and "bad" firms that might play on the moral hazard ticket. Cui believes that similar to facing "good" and "bad" cases of the 'soft budget constraint,' we might have to face the cases in which "bad" firms are rescued while hoping to rescue "good" firms. Such dilemmas are unavoidable, but it would be irresponsible not to apply the possibility of strategic bankruptcy reorganization in times of financial distress while leaving potentially good firms to the 'invisible hand.'

Using the reorganization provisions of the bankruptcy laws becomes the central theme of the second generation of reformers. Its purpose is to save "good" firms that are suffering from financial externalities regardless of their ownership structure. Namely, the macroeconomic shocks and financial externalities hit all firms – public and private – altogether. Even if the reorganization provisions hurt some of the creditors, especially in the short run, the benefits to the economy and society at large should prevail in making strategic decisions in times of economic distress.[417] Speaking in the context of the countries in transition, the previously mentioned approaches in applying bankruptcy regulation reveal all the theoretical and practical dilemmas discussed in this section, although the lesson seems pretty obvious again: the more transparent the institutions, the stronger the incentives to invest and grow; the more coherent public policy, the better the chances that such an approach will be able to efficiently delineate between potentially "good" firms and those who should go bankrupt. In practical terms, perhaps the policy in the Czech Republic was too rigid and the policy in Hungary too aggres-

[417] *See* more about the shift from the "trust fund" theory (in the interest of shareholders and creditors) to the "corporate personality" theory (in the interest of managers, and supposedly, of society at large) in Cui, *id,* section on multiplier effect and recession.

sive, but this issue deserves additional study to give us more insight into the instruments and decisions that try (or not) to delineate viable from non-viable firms in adverse economic conditions.

Restructuring of state-owned enterprises

The reformers' preoccupation with mass privatization often left the need of restructuring the state-owned enterprises outside or in the periphery of the reformer's scope. The faith in the arrival of new owners and emerging market forces put aside many of the problems that state-owned enterprises carried as a legacy of the former socialist system. Among the most pressing issues were, speaking generally, indebtedness, poor technology, poor quality of products, overemployment and poor management. This is the most general picture of the state of development of socialist economies before reforms, although there were notable exceptions throughout the region.[418]

At the beginning of reforms, firms suffered from multiple exogenous shocks: a liquidity crises due to macroeconomic stabilization, overnight price and trade liberalization, and loss of markets due to disintegration of the former common market. At that stage of transition most of reformers believe that only the immediate arrival of new, 'real' owners would facilitate restructuring and development of the firms. It was expected that mass privatization would present the best available cure to all of these problems, while the establishment of supportive institutions and the creation of a monitoring system was secondary to the goal of rapid privatization. The sobering moment for the first generation of reformers arrived when it was clear that mass privatization would take much longer than previously expected and that even after a successful privatization process a relatively large segment of the economy would remain in the hands of the government.[419] Once recognized, serious debate on how to improve the governance of the state-owned enterprises started.[420]

[418] Alice Amsden, *supra* 67.

[419] Excellent explanation of the context of corporate governance of state-owned enterprises offered by Dominique Pannier and Salvatore Schiavo-Campo in their introduction to Dominique Pannier (ed.), CORPORATE GOVERNANCE OF PUBLIC ENTERPRISES IN TRANSITIONAL ECONOMIES, The World Bank, Washington, D.C., 1996, p. 3: "...policy-makers overlooked the problems of public enterprises (PEs) that would remain in government hands, for four reasons. First, there was an expectation that most enterprises would be privatized quickly. Second, the importance of improved PE performance for the implementation of the reform was not well understood. Third, when it was recognized that PEs would continue to remain a substantial and important part of the economy, the state lacked the capacity to foster better performance by PEs. Finally, it was often considered that attention to better management would weaken the privatization effort. A comprehensive governance policy for PEs has rarely been adopted."

[420] The argument of the analysts, skeptical that SOEs could engage in any restructur-

An understanding the context in which state-owned enterprises found themselves at the beginning of reforms, as presented by Pannier and Schiavo-Campo, should enable us to better understand the underlying premises that led reformers to their generally passive approach toward the state-owned enterprises. On the other hand, the Polish experience, delaying with mass privatization for several years compared to other countries in transition, offers us interesting insight into the (lost) opportunities of improving the governance of the state-owned enterprises. Unlike reformers in the transition countries, the Polish reformers were forced to tackle the problem of restructuring and improving the governance of the state-owned enterprises as a complementary part of their reforms.

The Polish example is particularly interesting, because empirical studies show the responsiveness of the state-owned enterprises to the package of reforms that forced them to adopt new, market-oriented behavior without changing ownership. Contrary to the expectations of many analysts,[421] the state-owned enterprises (SOEs) in Poland did engage in substantive restructuring prior to any privatization attempts and the SOEs did adopt a profit-maximizing strategy similar to private firms. So, why did this happen? According to the study by Pinto, Belka and Krajewski, after the adopted package of reforms, the Polish SOEs in manufacturing found that they had to change their behavior in order to survive. They found themselves in a situation without any government help or promises and without any imminent new owners due to the impasse in privatization legislation. In this situation, the managers of the firms, whose autonomy from the government was guaranteed, opted for a substantive shift in the behavior of the firms. The anecdotal evidence suggests that

ing, was the following: "Unless rapidly privatized, many analysts argued, state manufacturing firms would not respond to the new economic environment, would decapitalize companies by paying out surpluses as wages, and would then use their bargaining power to negotiate a bailout with the government. The resulting fiscal burden would thus sabotage macroeconomic stability." Brian Pinto, Marek Belka, Stefan Krajewski, *Transforming State Enterprises in Poland: Evidence on Adjustment by Manufacturing Firms,* BROOKINGS PAPERS ON ECONOMIC ACTIVITY, 1:1993, p. 213–270, p. 214. As this study showed and will be discussed in this section, the fears of the analysts did not materialize and SOEs were in fact responsive to market changes and engaged in substantial restructuring. *Id,* p. 214.

[421] "When managers who had clearly engaged in deep restructuring (introducing new products, venturing into new markets, or bringing firms back from the verge of liquidation) were asked what motivated them to take a long-run view given the compensation system, they mentioned such motivations as emotional reasons, patriotism, and personal ambition. However, a few candidly admitted that they expected to gain from privatization, hoping to acquire part of the shares at below-market prices. Such a benefit would be their deferred compensation. Managers were certain about keeping their jobs after privatization. They reasoned that they are the best repository of restructuring talent in this economy; even if fired, they expected to find new jobs easily." *Id,* p. 253.

the managers, who were elected and therefore trusted by the work councils, opted for the changes not only because the exogenous changes forced them to, but also because they believed they would be awarded for their efforts in the future. The managers of the SOEs believed they would be compensated for their efforts in both cases: either if they remain owned by the state or if they start with the privatization.[422]

Despite the fact that the agency problem existed due to an unresolved matter of ownership, the SOEs across the industries engaged in restructuring, which included the introduction of new products, venturing into new markets or bringing firms back from the verge of liquidation. Many of the scholars predicted that unless privatization took place at once, managers and workers in the state-owned enterprises would start squandering state assets, decapitalizing the firms and thereby preventing the beginning of privatization. There was a fear that worker-dominated SOEs would lack the will to shed labor or improve efficiency through investment. As the empirical study by Pinto, Belka and Krajewski shows, their fears were unnecessary.[423] Factors other than the change of ownership proved to be more decisive in creating incentives for the managers and workers to engage in deep restructuring of enterprises.

At the beginning of transition, the SOEs were 'self-organizing' under the direction of workers' council that hires and fires the managers, determines managers' compensation, and clears all important strategic and even operational decisions."[424] In the period of transition, there was a shift toward a greater role of management, which developed independently from any government intervention or meddling. The government's fiscal crisis brought about the rapid end to a bulk of the subsidies to the industry, whereas price and import liberalization freed the market forces practically overnight. The workers and unions did not try to divert the firms' assets and revenues to increase their incomes,[425] and the work councils accepted measures to adjust labor to the new conditions. In the midst of the economic crisis it seems there was little else they could do.[426]

On the other hand, SOEs did become responsive to the changes in the

[422] *Id,* pp. 217–219.

[423] *Id,* p. 215.

[424] Contrary to initial fears the study shows that wages have not been set to exhaust surplus, instead, wage setting has come to resemble bargaining outcomes commonly seen in the West. Despite the presence of work councils, measures were taken to control labor costs, including restraining wages, shedding labor, and maintaining output. *Id,* p. 219 and p. 225.

[425] In fact, as the study of Pinto, Belka and Krajewski shows, substantial labor shedding has occurred: "for the total sample, labor was reduced by a remarkable 27 percent, with the labor-intensive A group leading the way. However, this group has also been plagued with the biggest marketing problems, which have led to falling productivity." *Id,* p. 225.

[426] *Id,* p. 219.

market, primarily due to the multiple shocks they suffered from. The aforementioned study emphasizes the importance SOE management in its efforts to adjust and restructure, but we already saw that the significant support also came from the workers and the workers' councils. According to the previously mentioned study, the following three decisive forces prompted SOEs into adjustment and restructuring: "First is the adjustment force exerted by hard budgets – even when changes in governance lag behind. Second is the importance of big bang methods, which rapidly achieve relative price changes anchored to foreign prices; these automatically set performance targets for prices, costs, and quality. Third is the managers' expectations that performance will be rewarded once privatization occurs."[427] The forces behind adjustment and restructuring and the government's commitment and the implicit structural incentives to the managers and workers in the SOEs were responsible for a relatively successful first stage of reforms in Poland. And the lesson that authors drew from their study shows that restructuring before privatization might be desirable in a setting with combined macroeconomic policies and structural incentives that benefit the enterprises.[428]

The Polish experience suggests that excessive or almost exclusive focus on mass privatization, which leaves aside the everyday operation of SOEs, might further reduce the capacities and abilities of all the firms in transition to engage in substantial restructuring. On the other hand, creation and implementation of structural incentives for management and labor, regardless of the ownership change, might have positive effects on the firms in transition – those in the hands of the government and those which underwent a process of privatization.

CONCLUDING REMARKS

The discussion on the role of government in transition not only recognizes its importance in the whole process, but it also tries to determine the most appropriate measures and instruments the government might use in the process of a large-scale institutional transformation. Whereas some of the measures are contextual and can be applied only in nation-specific contexts, there are other measures which importance and practical value go beyond the context of reforms in Central and East Europe. Many of the persistent myths and dogmas have been dispelled in the process of transition, and many new, important and useful findings

[427] *Id*, p. 255.

[428] The characteristics of social policies and of institutional arrangement in the countries in transition analyzed by Guy Standing, *Social Protection in Central and Eastern Europe: a Tale of Slipping Anchors and Torn Safety Nets* in Gøsta Esping-Andersen (ed.), WELFARE STATES IN TRANSITION, UNRISD 1996, pp. 225–255.

emerged from the process. For these reasons it seems worthwhile and rewarding to engage in a lengthy analysis of the logic and characteristics of the large-scale institutional transformation in the countries in transition. In doing so, it would be possible to find many surprising events and institutional settings that did or did not spur the expected behavior of the key actors.

Among the underestimated players of the transition were the government and its bureaucracy, the banking sector, the SOEs and the conglomerates of firms as recombinants, and the workers. Among the overestimated players were the privatization investment funds, the capital markets, and foreign direct investments. Additionally, policy measures that favored one set of players over the others helped create an environment with (dis)incentives for some players over others. Exogenous factors, such as international trade arrangements, the rapid development of the world trading and financial system and financial crises, played an important role and further obfuscated the analysis of the successful and unsuccessful domestic institutional choices and policy measures. The link between certain institutional solutions and their practical results is difficult to trace, but the available empirical material and comparative studies offer a fairly good overview of the process, policy measures and practical outcomes. Some of the lessons are of purely theoretical interest, while some of the lessons have practical value for the next generation of reformers in the countries in transition and beyond.

Finally, the lessons from the transition might shed some new light on the complex relations between institutional choices, economic behavior and development. Clearly, we do not possess a secret formula wrapped in a few simple policy recommendations, but we are becoming increasingly certain that some institutional choices and policy measures are more likely to trigger the desired behavior and spur growth over others. On the basis of empirical analysis, thethe chapter on mass privatization in Central and East Europe tried to show the actual behavior of the firms, managers and workers, financial institutions and state bureaucracy in the process of large-scale institutional transformation. It is important to understand that the debate in various sections of this chapter were not about the allegedly pressing issue whether to bark upon state-led or market-led reforms, as this dilemma is false and misleading. The debate was on how to conceive reforms in a way to create a compatible set of institutions capable of accelerating development and growth, while penalizing rent-seeking and 'tunneling-out' behavior.

WELFARE REFORM IN TRANSITION COUNTRIES

INTRODUCTION

Former socialist economies were traditionally generous toward social policies. Apart from the policy of full employment (even at the expense of 'overemployment') several other segments of social policy were developed as a part of a comprehensive safety net. Among the most important segments were universal health care insurance and universal pension insurance. After introducing comprehensive reforms and beginning of macroeconomic stabilization it became clear that the mentioned pair of welfare policies, health and pension insurance, were among the most expensive items in the state budgets. Additionally, new forms of social policies had to be designed; most notably, compensations for increasing number of unemployed people.[429]

In the setting of macroeconomic stabilization and large-scale institutional transformation the social expenditures became unsustainable. The question put before reformers therefore was, how to reorganize the welfare system. The goal of welfare reforms in the countries in transition was twofold: (1) to provide the basic social safety net for the people in need, (2) to secure the sustainability of the welfare system. In practice, however, it became increasingly difficult to pursue the mentioned goals. Rapid fall of tax revenues due to the economic decline accompanied by the growing number of people who became dependent on the welfare system created additional set of problems for the countries in transition. Some of the problems were addressed in the early stages of transition, whereas some others remained unresolved to date. As we shall see in this chapter, some of the unresolved issues remain the object of the heated debates among experts and among politicians even today.

In the chapter on the social welfare reform I would like to focus on the pension reform, because in my opinion it well reflects the theoretical and practical dilemmas of the welfare reforms in the countries in transition. Analysis of the approach toward pension reform in the countries in tran-

[429] A World Bank Policy Research Report, AVERTING THE OLD AGE CRISIS, *Policies to Protect the Old and Promote Growth,* Oxford University Press 1994. An overview of the topics and issues presented by Michael Bruno in his forward to the Report.

sition will reveal us theoretical assumptions as well as practical hopes of the reformers. Comparison with other developing and developed countries will show us that the theoretical debates and practical approaches in the countries in transition do not depart significantly from the reforms in other parts of the world. What made pension reform in the countries in transition as a special case, was the imminent economic and social crisis and especially the fact that these countries were in the past relatively generous with regard to the pension system. The normative dimension, relying primarily on the social-democratic constitutional provisions referring to the welfare system, must be added to this specific setting. Other aspects of the pension reform in the countries in transition, such as the old-age crisis, the increasingly unfavorable ratio between employed and retired people, the debate on how to reform the pay-as-you-go system, the growing fiscal burdens, do not deviate from other countries which are presently trying to tackle the pension systems.

In the present chapter I will argue that there is more than one institutional setting which could adjust the social needs and economic constraints of the countries in transition. Despite the unfavorable economic and social conditions there are certain policy measures that are relatively cheaper and more equitable than others. Some of the 'trade-offs', involved in the pension reform might turn out to carry the unnecessarily high social price. Finally, I will argue that some of the measures aiming at greater economic efficiency are far from certain to deliver accordingly to the declared policy goals and do not necessarily reduce the administrative costs of the new pension system.

THE WORLD BANK AND THE PENSION REFORM

The World Bank prepared a comprehensive document on the present situation with regard to the pension systems in many developing countries, including countries in transition, and recommended necessary policy measures for these countries to tackle the problems with regard to the pension systems. A document, which was published as a policy research report under the title *Averting the Old Age Crisis,* was a synthesis of the research project, which highlighted the characteristics of different pensions systems, evaluated advantages and deficiencies of the individual systems and provided the policy mix suitable for individual country's needs. The study examined the functions of redistribution, saving and insurance of the pension systems around the world and dealt with the diverse concerns of poverty, employment, inflation and growth.[430]

[430] *Id,* esp. pp. 10–18. Overview of the World Bank's multipillar approach also in Mitchell A. Orenstein, *How Politics and Insitiutions Affect Pension Reform in Three Post-*

As the brief outline of the World Bank study suggests, the importance of the pension system design has substantial consequences for macro- and microeconomic activities of the given country and important social consequences with regard to safety and equity of the citizens. Especially the link between the increased macroeconomic saving rate and the higher level of investments is emphasized in the mentioned study. The impact on the labor market and the capital market is closely analyzed and beneficial effects predicted, if developing countries were to follow the proposed model of the pension reform. Many advocates of pension reform also argue that pension funds, introduced to the system of social insurance, could substantially contribute to the corporate governance of the firms in transition. Following the World Bank Report on the pension reforms, the growing literature on the pension reforms in developing and developed countries – theoretical and empirical – tries to further elaborate the findings of the Report. One strain of literature looks for further evidence to support basic ideas and recommendations of the Report, another strain of literature critically examines many of the basic ideas and recommendations of the Report and seeks to provide alternative suggestions. By juxtaposing both strains of literature I will try put forward my argument that there are available several possible institutional solutions to tackle the problems of the pension system.

The model, advocated by The World Bank Report, is based on the proposal to introduce the so called three-pillar system, which should strike a necessary balance among the redistributive, saving and insurance functions of the pension system. According to this model, the first pillar – the public pillar – should be based on the pay-as-you-go system and financed through the general tax system. Several different systems of the pay-as-you-go system can be adopted: through a flat benefit, a means-tested benefit, or a minimum pension guarantee. The second pillar should be based on the mandatory fully-funded system, where privately managed system of pension funds depends on investment decisions. Thus, contributions to the second pillar are defined, but the level of benefits would depend on the successful management of pension funds. Finally, the third pillar could be voluntary, and primarily designed as insurance, enterprise- or industry based funds, offering supplemental benefits.[431]

According to the World Bank proposal, there are various possibilities how to put the three different pillars together. Practical decision, how to combine the pillars would depend on the macroeconomic conditions of the given country and on the goals that decision-makers of the given country pursue. The best way to continue our theoretical debate on the

communist Countries, WORLD BANK POLICY RESEARCH WORKING PAPER 2310, Washington D.C., 2000, pp. 7–8.

[431] Evelyn Huber, *Social Policy in Latin America*, in Gøsta Esping-Andersen, *supra* 429, pp. 148–149.

pension reform and to evaluate the potential economic, social and political benefits and perils of the proposed models, is to look at the actual experience of Chile from which the World Bank multi-pillar model draws many empirical findings and practical solutions. Chilean experience attracted attention of the researches worldwide and inspired the World Bank proposal for a comprehensive pension reform of the developing countries around the world. Many of the dilemmas and subsequent debates about the best approach toward reforming the pension system originate from the Chilean experience.

To be sure, the Chilean experience is not the only available experience for the developing countries. Another interesting and widely debated experience relates to Singapore's approach toward the pension reform. For some scholars, it represents the competing model for welfare reform, whereas for some others it represents a model that should not be imitated by other countries. In order to be able to evaluate the theoretical predicaments and practical experience of different welfare models before applying them to the Central and Eastern European economic, social and political reality, it would be worthwile to pause for a moment to analyze the Chilean and Singaporean welfare reform. Additionally, taking a look at some of the most interesting OECD countries in designing their own welfare models might be helpful before laying down a discussion on the appropriate welfare reform for the countries in transition.

THE COMPETING MODELS FOR THE WELFARE REFORM: CHILE AND SINGAPORE

The example of Chile

In Chile, the pension reform was implemented as the part of a broader package of welfare reforms in the midst of deep financial crisis in the early nineteen-eigthties.[432] The package of reforms was elaborated and implemented under the influence of "the shock therapy", whose main purpose was to reduce the role of the state in providing social insurance and social redistribution.

The approach toward reforms based on the following measures: reduction of state expenditures from 40 to 30 percent of GDP, reduction of state bureaucracy by 5 percent per year, selling of all but 24 out of 479 state enterprises, deregulation of the financial sector which included free entrance of foreign investments.[433] As a result, partial deindustrialization followed, because many of the privatized firms could not compete

[432] Cited from Evelyn Huber, *id*, p. 164.

[433] *Id*, p. 165.

on the liberalized domestic market and became bankrupt. Foreign loans stopped coming into the country, while the government had to intervene to rescue the banks and other financial institutions from insolvency. By the year 1983, one third of work force became unemployed.[434]

In the context of severe economic crisis, social policy measures had to be adjusted equally. The debate among the bureacuratic elite how to appropriately design the social policy measures delayed the welfare reform for few years. The debate showed the split between corporatistic technocrats and the radical neoliberals. Finally, the radical strain prevailed and the social welfare took the path which is going to be described here.[435] The new pension law, which introduced the mandatory fully-funded system, was adopted in 1980. The new, fully-funded system was obligatory for all the employees. Each employee had to start paying contributions to the personal accounts, which were opened in the newly established private pension funds – AFPs. Since then, the extent of pensions entirely depended on individual contributions and the relations between profits made through investments and inflation. Employers did not contribute to the individual pension accounts. The government regulated pension funds' operation with regard to their investment activities, but not in the area of commissions and costs of operations. The market and competition among funds were supposed to determine their levels.

In practice, as it turned out, introduction of the new pension system was accompanied with massive expenditures. Namely, state contributions were abolished immediately upon introduction of the private pension schemes. Therefore, pension contributions were diverted from the state to the private pension funds, but the state remained responsible for the pensions of the current generation of pensioners. Simultaneously, the government had to facilitate establishment of the new private pension funds. As a result, in order to stabilize the new pension system, the government had to divert 4,5 percent of GDP in the years between 1982 and 1988.[436] The similar dynamics took place in the early 1990s. Radical pension reform was therefore inevitably characterized by the "massive transfer of assets from the public to the private sector".[437] As Evelyn Huber concluded, the costs incurred by the radical pension reform to the state budget were sustained only because the government kept other forms of fiscal expenditures (such as health expenditures) extremely low.[438]

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[434] *Id*.

[435] Data on the reform of the Chilean pension system are available in Peter Diamond and Salvador Valdés-Prieto, *Social Security Reforms* in table on p. 280 in Barry P. Bosworth, Rudiger Dornbusch, Raul Laban (eds.), THE CHILEAN ECONOMY, Brookings 1994.

[436] Evelyn Huber, *supra* 429, p. 167.

[437] *Id*, p. 167.

[438] "In Chile, the administrative expenses associated with the new system probably

In establishing the private pension funds – known as AFPs – one of the unexpected surprises was that the administrative costs to run the funds exceeded the costs of the former state pension system. This fact becomes even more important if we know that the argument that the old state pension system was too costly and thus inefficient was one of the main arguments of the reformers who were favoring the radical approach toward the pension reform in Chile.[439] Moreover, as the comparative analysis shows, the administrative costs of running the AFPs were significantly higher than in other developing countries. For example, "...in 1990, operating costs were 1,5 percent of covered wages and 2,3 percent of total assets in Chile, compared with 0,2 percent and 0,1 percent in Singapore..."[440] In the environment of relatively uninformed investors, private pension funds had to invest as much as 30 percent of operating costs for promotional purposes, whereas paying salespeople by commission led to high turnover of accounts and correspondingly high transaction costs. These costs were additionally passed on to consumers in the form of high fees.[441] Nevertheless, strong competition led eventually to reduction of administrative and operating costs and it is expected the costs will fall further.

Perhaps more important than the administrative cost analysis, however, is the analysis on the impact of the AFPs on the capital market development in Chile. AFPs were allowed to enter the capital market only in 1985. Before that they were allowed to engage mostly in government gurantees purchases. AFPs entrance to the capital market brought about new financial instruments, among the most popular were long-term corporate bonds. As reported by Peter Diamond and Salvador Valdés-Prieto, development of corporate bonds was rapid, and in 1988 represented already fifty percent of share of pension fund holdings in the stock of financial assets.[442] In the same period, the development of pension funds was equally rapid, and the value of pension funds as the share of pension fund holding in the stock of financial assets rose from 3,6 percent in 1982 to 35 percent in 1992.[443] Among other important effects of the rapid development of private pension funds in Chile were appearance of the second stock market in Santiago, demand for further regula-

exceed those of the old system, even though the old system was viewed as expensive because of its fragmentation and its history of political appointments. Thus it is important to recongize that these expenses are part of the cost of adopting such a reform. In addition, the expenses may be higher than they would be under other reforms." Peter Diamond and Salvador Valdés-Prieto, *supra* 436, p. 309.

[439] AVERTING THE OLD AGE CRISIS, *supra* 430, p. 224.

[440] *Id.*

[441] Peter Diamond and Salvador Valdés-Prieto, *supra* 436, p. 303. *See* also Table 6–17 on the same page.

[442] *Id.*

[443] *Id*, pp. 304–305.

tion to ensure transparency and efficiency in the financial markets, such as risk classification agencies for bonds, introduction of closed-end mutual funds, extension of solvency regulations for life insurance companies and some other rules.[444] On the other hand, however, it is necessary to emphasize the opinion of the analysts that "many developments of in the Chilean capital market would have occurred anyway, even without pension reform."[445]

The role of AFPs in developing the Chilean capital market becomes even more questionable when we compare its development with the development in other countries at the similar level of development, which did not take the path of radical pension reform based on private pension funds. Ajit Singh showed that economic results of the capital market in Chile do not significantly differ from economic performance of the capital markets in other developing countries: "...Chile is not out of line with that of other fast expanding markets in developing countries. It is equally significant that on some other principal indicators of stock market development, Chile does not do as well as a number of other emerging markets. Data shows, for example, that the number of listed companies actually declined in Chile over the period 1980 to 1992 (from 265 to 245 respectively), while in India rose from below 1,000 to nearly 3,000."[446]

Development of equities and bond market capitalization aside, the question remains whether rapid development of stock market can lead to an increase in aggregate savings. Ajit Singh believes that in principle private pension schemes can lead to a rise in aggregate private savings not just through the development of the capital market but also directly. At the same time, however, his and Atkinsons' comparative analysis shows that empirical evidence on this assumption is mixed and far from being robust.[447] And with regard to Chile the empirical data on savings and investment as of percent of GDP in the period between 1981 and 1991 show a fall in total savings and investment over the mentioned period from 21 to 18.8 percent.[448] There are other available studies that tried to assess the causal link between private pension fund development and solid economic growth in the second half of 1980s.

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444 *Id,* p. 303.

445 Ajit Singh, *Pension Reform, the Stock Market, Capital Formation and Economic Growth: A Critical Commentary on the World Bank's Proposal,* INTERNATIONAL SOCIAL SECURITY REVIEW, vol. 49, 3/96, pp. 28–29.

446 *Id,* pp. 37–38.

447 *Id,* p. 38. *See* also Table 7 on p. 38, where Singh relies on the study by Andreas Uthoff, *Pension System Reform in Latin America,* CEPAL Review, no. 56, August 1995, pp. 43–60.

448 Giancarlo Corsetti and Klaus Schmidt-Hebbel, *Pension Reform and Growth,* in Salvador Valdés-Prieto (ed.), THE ECONOMICS OF PENSION, Cambridge University Press 1997, pp. 127–159, esp. 144–145. *See* also Table 5.3 on p. 147.

A study by Giancardo Corsetti and Klaus Schmidt-Hebbel showed that pension reform affected Chile's labor markets, capital markets, public finances, and overall macroeconomy. There are several visible and measurable effects of the radical pension reform, for example: – the effects on the reduction of overall social security contribution rates from 29,3 percent to 17 percent (of which the contribution to the new fully funding scheme is 10 percent); – effects on the slight reduction of independent workers from 26 percent to 24,5 percent, possibly due to reduction of official contribution rates for workers and elimination of contributions for employers (the number of contributors to the old and the new pension system, however, remained practically the same: 62,5 percent in 1980s and 63 percent in 1993); – major shift in in the increase of the private sector saving rate, from close to zero in 1979 – 1981 to an average 17,1 percent of GDP in 1990 – 1992 which made possible higher investment levels and reduced private consumption from 73 percent to 63 percent of GDP after introduction of reforms; – finally, the growth rates which averaged around 4 and 5 percent in the late 1980s and early 1990s.[449] Based on the econometric models the study did not show, however, there was a strong causal link between the radical pension reform and the economic growth. What the study could prove – in the absence of other determinants of growth – was that the pension reform implemented led to Chile's private saving boom jointly with other structural changes.[450] The authors did not, however, change into account the massive transfers from public to private sector which blurrs the picture of financial effects of the pension reform in Chile.

Before taking a closer perspective with regard to the social situation after introduction of the radical pension reform, it is worthwile to pause for a moment at the ownership structure and performance of the AFPs. In the last years, AFPs dispose with around 30 billion USD that represents approximately half of the Chilean GDP. In accordance with legislation they invest 30 percent of their financial assets on the Chilean stock exchange, where their share of 8 billion USD represents the biggest individual investor in the country. The rest of the assets are invested in the government bonds (42 percent) and securities of other financial institutions (28 percent), while they hold a minimal part of their assets abroud. Funds compete for the clients, and for this reason they are exposed only to a minimal risk, so the difference in profit rates of the funds is minimal. The fall of the share value in the firms where funds held their investments brought about the negative profit rates of 2,5 percent on average in 1995 and –3,5 percent in 1996. Negative profitability brought a certain dose of realism about the potential and expectations regarding AFPs.[451]

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[449] *Id,* p. 153.

[450] On the role of the AFPs in Chile's economy Manuel Riesco and Hugo Fazio, *Pension Schemes in Chile,* NEW LEFT REVIEW no. 223, 1997, pp. 91–92.

Ownership structure of the APFs varied a lot at the beginning of their establishment, particularly in the period of the financial crisis between 1982 and 1986. The number of funds varied from 12 at the beginning to 22 in 1993 and fell again to 13 in 1996. According to data, available from 1996, the first five funds presented 71 percent of all the funds assets, whereas the largest fund, the Provida fund, accounted for 19,7 percent of the all the aggregated value of all the assets. The history of Provida fund is interesting, because in 1995 was taken over by a group, called Infisa that was managed by some of the former Pinochet's ministers. Before that, it was controlled by the Bankers' Trust which sold a controlling package to Inecsa SA in 1992, whereas nither depositors nor shareholders had any say. In history, Provida Fund was twice at the brink of bankruptcy due to audacious financial policy. Apart from close connection with the former members of the government who took over the Provida Fund, weak or practically absent control of shareholders and depositors over the fund policy, it is worth mentioning the expansion of the Provida and other funds to other Latin American stock markets and their presence through the ADR mechanism.

There are unambigous positive results coming out from the Chilean radical pension reform. The most obvious and most important is the raise of saving rates at around 30 percent of GDP, which is the highest saving rate in Latin America and among the highest in the world. The causality between the pension reform and the high saving rate is well documented. Less obvious seems, however, the causality between the strong economic growth, development of the capital market and the pension reform. Other determinants of growth and development played an important part, too. For this reason it is possible to say that after macroeconomic stabilization and implementationo of radical reforms Chile performed comparatively well, but the question remains to what extent it is possible for other developing countries to emulate the Chilean example, which apparently evolved in a very specific economic and political historical context.

On the other hand, there is a social dimension, usually neglected or marginalized by the advocates of the Chilean example. I mentioned already the massive transfer of finance from the public to the private sector. Large share of GDP was necessary to help finance the establishment of private pension funds. True, the pension funds became profitable and with high returning rates, but soon they also show their vulnarebility against financial market volatility. Negative profitability for several years obviously cannot guarantuee social security for the employees when they retire at the prescribed age. There are other unresolved social issues which are directly or indirectly linked to the radical pension reform approach. One important fact which cannot be ignored is the fact that

[451] Luiz Carlos Pereira, *supra* 60, pp. 37–38.

Chile belongs among the ten countries with the most uneven distribution of wealth. But there are also other, more directly to the pension reform linked social consequences. The costs of transition were high. Between 1974 and 1975 per capita income fell by 26 percent and up to 1983 for another 16 percent. Unemployment reached 30 percent in 1983. Real wages were not significantly higher in 1988 than they were in 1973, but income concentration deepened.[452] During the transition, two important achievements occurred: unemployment gradually fell to 5.7 percent and inflation was reduced. By the 1990, however, the average and minimum wages had not returned to their 1981 and had grown further apart. The average real wages outstripped their 1981 levels only in 1992.[453] Hence the industrial policy in the 1980s based on export growth combined with low wages and restrictions on unions, the recovery was accompanied by a notable increase in social inequalities. As the survey by the new government in 1992 showed, 5.2 million Chileans lived in poverty, which corresponded to 40,1 percent of the total population. Since data, and according to data available, the number of people living in poverty dropped to 4,5 million, which means that 700.000 people escaped the conditions of poverty.[454]

Bearing in mind the described larger social context of radical reforms in Chile and knowing that the large informal sector paralleled with the flexible labor market, the relation toward contributions and anticipated benefits from the pension funds becomes more visible also from the workers' perspective. Large informal sector (often eupheism for the poor workers) and low wages for the large number of employees prevented 40 percent of all the employees to contribute anything into the pension funds. Although they had opened individual accounts with the private pension funds, their accounts remain empty. Thus half of all low-paid Chilean workers do not enjoy any benefits from the newly set accounts with the private pension funds.[455] For those workers still guarantees the state in the form of minimum pensions that are currently at around 100 USD a month.[456] The flexible labor market where only the small portion of core labor is employed on the permanent basis, whereas the rest of the employees work 'in their own account' is the mixture which is often employed in the labor intensive and export oriented industries in Chile. Precarious employment based on short-term contracts[457] certainly make

452 Study on the social conseqences of the transition was made by Alvaro Diaz, *Restructuring and the New Working Classes in Chile* (trends in waged employment, informality and poverty, 1973–1990), UNRISD DISCUSSION PAPER, October 1993, pp. 20–21.

453 *Id*, p. 22.

454 Manuel Riesco and Hugo Fazio, *supra* 451, p. 96.

455 *Id.*

456 Analysis of the precarious employment in Diaz, *supra* 453, pp. 24–25.

457 On the deregulated labor market *see* also Evelyn Huber, *supra* 432, pp. 168–169.

this group of workers more difficult or impossible to participate and contribute to their private pension schemes. Deregulated labor market with no role of government in concluding contracts between employees and employers, little bargaining power of the employees undoubtedly has important consequences for the contributions and future benefits from the private pension funds.[458]

To summarize the Chilean example it is possible to see the complex nature of the debate about the best possible model for the pension reforms in the developing countries around the world. Many aspects are involved and they embrace macroeconomic, capital market, government's capacity to regulate, industrial and labor policy, social and other important aspects. In other developing countries it is practically impossible to replicate the political, economic and social environment that allowed such a radical approach toward the pension reform. The more democratic country, the broader consensus is necessary on the nature, methods and goals of the pension reform. What is interesting in the Chilean pension reform debate, there is a split between authors that emphasize positive economic results of the pension reform and those who emphasize the negative social consequences of the radical pension reform. There still exists a strong warning of Professor Singh reminding us is it really worth engaging in such a radical pension reform with clear negative social effects, but less clear economic benefits that do not differ significantly from other successful developing countries?[459] To be sure, there are still many remaining unknowns regarding the Chilean pension funds, especially because the present generation of workers still did not retire, so we do not know to what extent the funds will be able to keep their promises to them. It is also true that it takes a long period before funds accumulate enough assets to start fulfilling their promises and in this sense it is possible to agree with Estelle James who is claiming there is still a lot of room for improvement of administration and governance of the funds.[460]

[458] "The analysis of the previous sections has shown not only that the World Bank's proposed pension plan is flawed in terms of social policy but that it is far from certain to enhance economic growth. Each of the links in the chain of causation relating pension funds to capital market development, and the latter to economic growth, can be seriously questioned on both theoretical and empirical grounds. The Bank has adopted a one-sided view, without much justification, of the relationships between these critical variables. Therefore, the proposed reform may neither protect elderly people nor achieve faster economic growth. On the contrary, the reform may contribute towards undermining growth while also exposing pensioners to greatly enhanced risks concerning the size and real value of their pensions." Ajit Singh, *supra* 446, pp. 39–40.

[459] Estelle James, *New Models for Old-Age Security: Experiments, Evidence, and Unanswered Questions,* THE WORLD BANK RESEARCH OBSERVER, vol. 13, no. 2, August 1998, pp. 271–301.

[460] "In Chile, top government officials conducted an intensive media campaign to con-

Finally, in the midst of unknowns, unanswered questions, long transition period that needs to be financed through other financial sources and in the adverse financial and economic environment, the issue remains whether it is worth taking a risk and adopt a radical pension reform or try instead to improve the existing pension fund. This certainly depends on the given context of each individual country. One intricate detail of Chile tells us that the government declared the state pension fund bankrupt and launched an extensive media campaign to convince citizens that the state pension fund is bankrupt.[461] Pension fund in other countries may not be in such a peril of bankruptcy than in the Chilean case and may seek instead certain repair, improvement or readjustment.[462] Starting from the particular economic, social and political contexts, there may be more than model for the pension reform, whereas the example of Chile can be taken only as one of the important examples in the complex debate on the models of the pension system for the developing countries. Of course, other important determinants of the pension reform, such as demography, need to be taken into account as well.

The example of Singapore

In search for alternative models of the pension system it is worth pausing for a while in the case of Singapore. Namely, in the debate on the nature and characteristics of the pension system for the developing countries, Singapore usually serves as a competing model for welfare reform in the rapidly developing countries. It also serves as an evidence that it is possible to reform the pension system in other ways than the discussed fully-funding system of private pension funds in Chile.

The pension system in Singapore is based on the centralized public mutual fund, called Central Providence Fund (CPF), in which the individual contributions are paid according to the defined contributions schemes, determined and regulated by the government. One of the most interesting and also the most debated characteristic of the CPF is the fact that in CPF the decisive role continues to play the government. Additionally, the concentration of the capital in such Central Providence Fund represent the 70 percent of the Singaporean GDP, which is in relative

vince people of the bankruptcy of the old system." AVERTING THE OLD AGE CRISIS, *supra* 430, p. 272.

461 John B. Williamson and Fred C. Pampel, *Does the Privatization of Social Security Make Sense for Developing Countries?,* INTERNATIONAL SOCIAL SECURITY REVIEW, vol. 51, no. 4/1998, pp. 3–31.

462 "Central providence funds are even more concentrated. If these funds were to invest in corporate equities, public officials could gain control of corporate affairs, a back door to nationalization." AVERTING THE OLD AGE CRISIS, *supra* 430, p, 214.

numbers the biggest pension fund with the exception of the Netherland.[463]

Historically, the Providence Fund presented a legacy from the British colonial government that set up the Fund in 1995. The Singapore government expanded the Fund, gradually raised the contribution rates and widened the pension schemes. Unlike the pension system in Chile the legislation in Singapore requires mandatory contributions from employers and employees. Although the contribution rates in the past were changes several times, in 1994 the government determined the contribution rates at 40 percent – 20 percent by employers and 20 percent by employees.[464] As is the case in most of the countries, contributions to the CPD are exempted from the tax. Not only that the contributions are tax exempted, each individual is allowed to withdraw his or her savings in certain situations. Namely, technically speaking, each individual has with CPF three different accounts: – the general account for pension insurance that can be also used for the purposes of housing; – health insurance account (up to 6 or 8 percent of the contribution rate) that can be also used for certain health related services; – and the special account in the case of emergency (up to 4 percent of the contribution rate). The CPF system is, normatively speaking, the system that is based on the mandatory individual saving in which the employers and the government also participate.[465]

The administration of CPF is autonomous. It is based on the narrowly tailored legislation with regard to the general rules of management of such Fund. There are eleven members of the board, of which six members are appointed by the Ministry of Labor, whereas at least two members represent employees and employers respectively. The sizc, structure and organization of the CPF present an extremely important financial and social institution in the life of Singapore. Organization and regulation of the CPF allow the Fund also other activities, such as financing and crediting of the housing problems of the citizens, health insurance and other social activities, and not merely pension insurance. Tripartite structure of the CPF in which different interests are combined resembles closest the concept of the "social shareholders".[466]

Mandatory contributions of the employers and employees into the public Fund, structure of the Fund, stringent and coherent fiscal policy of the government are the main reasons for the fact that Singapore enjoys the highest saving rate in the world. The saving rate is on average

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463 Mukul G. Asher, *The Role of Central Providence Fund in Singapore,* NATIONAL ECONOMIC REVIEW, no. 32, June 1995, pp. 40–49.

464 *Id.*

465 On the different possibilities of the institutional organization of ownership *see* Richard Minns, *Who Really Owns Big Business?,* NEW LEFT REVIEW, no. 219, September/October 1996, p. 51.

466 *Id.*

around 40 percent and in the past even exceeded 50 percent. Investment activities of the CPF are precisely regulated. Management board of the CPF can approve individual investment schemes for investments into prescribed funds and purchases of shares in Singapore's stoch exchange, investments into housing development, education and other activities. Since the beginning of 1995 it is allowed to place a certain amount of suprlust into purchasing the foreign shares and bonds at the particular regional stock exchanges, whereby the transactions must be approved by the management board.[467]

It is interesting that the realized surplus and profits from the foreign stock exchange do not belong to the CPF, but they are diverted directly into the government's budget, which allows the stable functioning of the state budget. On the other hand, the CPF does not lend money to the government. However, its forseeable long-term inflows creates a large pool of finance that can be channeled into the long-term investments. Critics emphasize that profits which do not return to the CPF present an implicit tax to those who contribute to the Fund.

On the other hand, the CPF has also many weak points. Two thirds of the active population participate in the Fund, but not the self-employees. Some high government officials are also exempted from the scheme. The system cannot guarantee the social security from the beginning, but it requires a long transition period which generates the savings. The difference between defined benefits and defined contributions also means that the inflation risk is carried by the individuals. Today it is also certain that many contributors to the system will not save enough even though they contributed to the CPF over a long period of time.[468] Substantive income differences in Singapore that are still increasing will leave in financial difficulties groups of people with low incomes, because their saving will not suffice for the anticipated pensions at the level of two thirds of average incomes. One third of all the employees depend exclusively on the CPF, because outside the accounts with the CPF they do not have any other savings. The present structure of the CPF does not allow for the active redistributive policy, even though it is feasible that the government might step in at the time after year 2003 when the first beneficiaries will start receiving the pensions.

An analysis and comparison of the two significantly different approaches toward the pension system and toward the general welfare policy show a variety of different possible models. *Averting the Old Age Crisis* shows one doctrinal approach, which is based primarily on Chilean empirical insight. The multipillar system, however, can be built and combined in many different ways. For example, it would be still pos-

[467] Mukul G. Asher, *The Future of Retirement Protection in Southeast Asia,* INTERNATIONAL SOCIAL SECURITY REVIEW, vol. 51, 1/98, p. 19.

[468] AVERTING THE OLD AGE CRISIS, *supra* 430, p. 142, box 4.7.

sible to maintain the first pillar as the main pillar and to establish the second pillar as the supplementary and voluntary one, based on tax incentives. Needless to say, many developed countries established more elaborate and sustainable pension systems, although many of them face serious fiscal and demographic problems.

PENSION REFORM IN THE COUNTRIES IN TRANSITION

The sketchy overview of the situation with the pension system before the second phase of reforms took place can help explain why most of the transition economies decided to adopt more or less radical pension reform. The share of pension expenditures in the GDP grew rapidly and the World Bank study on pension reform showed, "in many countries pensions are the largest single item in the government budget, accounting for more than 15 percent of spending of some 10 to 14 percent of GDP in Bulgaria, Hungary, Poland and Slovenia."[469] Comparatively speaking, the study estimates that such share of expenditures – which became the largest single budgetary item in many transition economies – is similar to the OECD countries. For the latter, however, according to the same study, per capita income and tax collection is proportionally much greater for old people compared to the transition economies.[470] The study therefore concludes that the overhaul of the system is clearly needed.[471]

The study declared the existing pension system in transition economies too generous, unsustainable, and insufficient for older population, while having a distorting impact on the labor market. It urged the transition economies and their governments to approach substantive reforms in this area. In many ways, the proposed model by the World Bank promised transition economies too much to encourage the radical reforms, whereas the promised fix, in case of a faithful implementation

469 *Id.*

470 High statutory replacement rates at about 70 to 80 percent, high dependency rates and early retirement are the main causes of the pension system crisis in the transition economies, according to the World Bank study. The consequences of the pension system crisis are high payroll taxes and the lack of indexation. The conclusion of the World Bank study is therefore somewhat contradictory: "The transitional economies offer old age benefits that the old find unsatisfactory and the young cannot afford. Too much money goes to transfers to early retirees who could still work, while the truly old receive pensions that are barely adequate. High tax rates and excess government spending on pensions encourage evasion, distort employment, deter private enterprises, and crowd out public investments in productive infrastructure that could boost economies growth. Overhauls of the system is clearly needed." *Id,* p. 143.

471 Robert Holzmann, *Starting Over with Pensions; The Challenges Facing Central and Eastern Europe,* JOURNAL OF PUBLIC POLICY, 17. 3., 1997, pp. 209–219.

of the designed model, was highly uncertain. As we saw in the previous section on the different approaches toward pension reform, there are several risks involved in implementing the pension reform.

The most important risks are the structure of the unfunded pillar, the financing of transition towards the funded pillar and the financial sector requirements.[472] None of the issues are theoretically resolved to the extent that faithful implementation of the reforms would there be any unconditional guarantees on the success of the reforms, *ceteris paribus,* of course. Holzmann himself, for example, poses the question of the Pareto efficiency of the pension reform. Welfare economics teaches us that the "Pareto-improving transition" is the situation in which at least one generation becomes better and no other worse off.[473] At the same time, Holzmann admits that "merely changing the financing mechanism of an unsustainable, unfunded retirement scheme is not sufficient to put it on a sustainable, funded basis. Any real pension reform essentially has to undertake two changes simultaneously: reduce the commitment of the given pension scheme (given the target income replacement rates, essentially by increasing the retirement age) and shift the financing mechanism."[474] The overt recognition of the lead economists show that pension reform in the Central and European countries is not primarily designed to improve the general welfare of the transition economies to a Pareto efficiency level, but to reduce the allegedly generous pension systems to a sustainable level. In doing so, the issues of higher saving rates, a higher level of productive investment and the development of the capital market were secondary to the issue of building a sustainable pension system based on the lower share of public expenditures. If so, instead trying to make the pension system a function of higher nation saving rates, higher growth rates and supposedly a more equitable system based on the direct link between contributions and benefits, it would be necessary to look at operation of pension reform in a way in a way that would require as little sacrifice across the generation as possible. Thus, I agree with Nicholas Barr, who analyzed many myths involved in the pension reform debate around the world.[475] Among many important findings he showed in his comprehensive analysis that the range of potential choices over pensions is wide.

Regarding pension reform in transition economies, it is necessary to emphasize the important differences in fiscal, economic, social and polit-

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[472] Robert Holzmann, *Pension Reform, Financial Market Development, and Economic Growth: Preliminary Evidence for Chile,* IMF STAFF PAPERS, vol. 44, no. 2, June 1997, p. 152.

[473] *Id,* n. 3 on p. 152.

[474] Nicholas Barr, *Reforming Pensions: Myths, Truths, and Policy Choices,* IMF WORKING PAPER, WP 00/139, 2000.

[475] Katharina Müller, THE POLITICAL ECONOMY OF PENSION REFORM IN CENTRAL–EASTERN EUROPE, Edward Elgar 1999, p. 63.

ical conditions among the Eastern and Central European countries. Additionally, half way through the institutional reforms in the mid 1990s, countries opted for different institutional approaches in the economic and legal environment. Only for this reason would be a mistake to expect all the countries in transition to embark upon the same path of pension reforms, as was expected in the World Bank report. We also already saw that countries differed in their success in the macroeconomic stabilization efforts, development of their capital markets and their ability to regulate and implement rules and to secure monitoring mechanisms.

Understanding the complexities of the pension system and its development is only one part of the preconditions for reform. It is also necessary to understand the ability and capacity of the existing institutional system of the country, public and private, before embarking upon the road of pension reform. In the case of a weak understanding of the nature of the pension system and a weak capacity to run the large-scale institutional reforms, it might be that implementing some basic adjustments of the existing public pay-as-you-go system would be more reasonable than undertaking radical reform. For example, some of the simple measures of improving the current system, such as partial deindexation, or a gradual raise of the retirement age, might turn out to be just as efficient as more radical reforms while not increasing administrative costs. The approach also depends, of course, on the existence or absence of a broader social consensus on pension reform and the level of difficulties the individual pension system is facing.

The example of Hungary and Poland

Hungary and Poland are among the countries in transition that took a more ambitious and radical approach toward pension reform. These two countries aside, it was Kazakhstan that adopted the most faithful version of the Chilean model, but its pension system was literally bankrupt, so it was not difficult to initiate the pension system from scratch. Some other countries in transition, such as the Czech Republic and Slovenia, did not choose radical pension reform, but opted for a more gradual improvement of their existing public pension schemes, including the introduction of voluntary supplementary schemes in the form of life insurance, while also making several adjustments to the pay-as-you-go scheme.

Unlike the radical pension reform in Chile, pension reform in Hungary and Poland started only recently. It is for this reason even more difficult to discuss the results of these reforms, because it takes years to assess the impact of reforms on the sustainability of the reformed pension systems, on national saving rates, the investment dynamics of the respective countries, the further development and improvement of capital markets and of corporate governance, and the overall Pareto efficiency of the pension reform. Still, these questions are legitimate and deserve a thorough analysis.

Pension reform in Hungary started in 1998 after a lengthy period of debates and disputes on the nature and character of reforms. The difficulties with the pension system in Hungary started, however, almost a decade earlier, and they coincided with the beginning of the transition period. The data provided and analyzed by Katharina Miller informs us about the rapid deterioration of the public pension scheme in Hungary: "Not only did the number of employed Hungarians fall by 25 percent between 1989 and 1996 – in the same period the number of pensioners rose by 22.4 percent... As the number of contributors to the pension scheme plummeted while the number of beneficiaries continued to increase, the system dependency ratio rose from 51.4 (1989) to 83.9 percent (1996)."[476] The deterioration of the pension situation led to a rapid increase in expenditures, although the rapid deterioration was a result of an increase in unemployment and early retirement, and not a result of demographic trends.[477]

Before the actual reform started, several attempts were made to alleviate the burden of the public pension system. Among them were less transparent measures, such as slower indexation compared to the growth of wages and prices, *ad hoc* indexation of the lowest pensions, the creation of new institutions, such as the introduction of IFF pension funds in November 1993, where employer contributions were exempt from taxes and social security contributions, all of which presented a boost for company and trade union funds. Still, the share of labor force in these funds by 1997 no larger than 15 percent, whereas the capitalization of these funds was minimal due to low contributions and 221 funds were suffering from extreme fragmentation.[478] Other efforts were also made, such as handing state assets that represented up to 10 percent of GDP to consolidate the social insurance and the public pension fund in particular.[479]

The reform finally started on January 1, 1998. As mentioned already, it was a result of intensive debates and internal oppositions to a radical pension reform. The main opposition came from the old trade union federation (MSZOSZ).[480] Finally, the compromise did not, according to ana-

[476] *Id.*

[477] *Id,* pp. 68–69.

[478] *Id,* pp. 66–67.

[479] As analyzed by Mitchell Orenstein, the deal between old trade unions who originally opposed any kind of introduction of a mandatory funded system and the government was reached when additional guarantees for the second pillar were provided. Among these guarantees were a smaller second pillar than originally designed, larger guaranteed minimum pension, higher indexation, and lower eligibility requirements. *Supra* 431, p. 56.

[480] "The size of the second pillar contribution was reduced from 10 percent to 8 per-

lysts, undermine the radical nature of the reform,[481] as it presented a combination of conventional measures and guidelines adopted from the World Bank pension reform proposal.[482] Originally, before a set of compromises were reached, the reform proposal envisaged the introduction of a multipillar system that was mandatory for all employees under 40 years of age. Finally, the actual proposal determined that the mandatory participation in the multipillar pension scheme was only for the newly employed workers, whereas the transition to ta multipillar pension scheme remained voluntary for the current labor force. Employers who opted to enter the new pension scheme had to divert 6 percent of their gross income into the second pillar while employees had to divert 24 percent of gross income into the second pillar for their employers. Gradually, the contribution of the employers would increase to 8 percent and the contribution of employees would decrease to 22 percent. For the employers who opted for the new pension scheme, the first pillar would continue to guarantee 40 percent of average net wages. Individuals in the new mandatory pension scheme would be entitled to minimal annuities of 21 percent of the first pillar, which should guarantee the total pension of 85 percent of the old pension entitlements. Such benefits were expected to attract the middle generation of workers to switch from the existing public pension system into the new multipillar system. However, a massive switch to the new pension scheme could rapidly undermine the existing pay-as-you-go system and increase the cost of transition toward the multipillar system.[483] Additionally, conventional measures were adopted, such as raising the retirement age to 62 years for both men and women by 2008 (before 60 and 55 years for men and women respectively) and implementing penalties for early retirement.

As mentioned earlier, it is impossible to give a substantial evaluation of the pension reform at this moment. It will take a few more years before any qualified assessments are possible. If the success of the reforms are measured by the switch from a public to a partially privatized, new pension scheme, then the reform was relatively successful: 1.4 million Hungarian employers out of 4 million opted for the new pension schemes, which was at the expected level.[484] On the other hand, public

cent, and phased in over two years, starting at 6 percent in 1998. Trade unions agreed to Swiss indexation, but won large real increases in pension levels a priori. A number of other compromises were reached." *Id.*

[481] Normative analysis of the Hungarian pension reform was made by Robert Palacios and Robert Rocha, *The Hungarian Pension System in Transition (second draft),* presented and distributed at the international symposium on the pension reform in the transition economies in Ljubljana, september 1997.

[482] *Id, see* also Mitchell Orenstein, *supra* 431, p. 61 and Katharina Müller, *supra* 476, pp. 85–87.

[483] Katharina Müller, *supra* 476, p. 87.

[484] As candidly recognized by Robert Holzmann, part of the reason for the radical pen-

media campaigns on the bankruptcy of the old pension system, similar to the above mentioned in Chile, might have similar self-fulfilling effects: declaring the old public system bankrupt should naturally urge more and more employers to switch to the new, partially privatized system, leaving behind the even more undermined old system. Because the government has to still provide pensions for the already retired people, while consolidating the new multipillar system, the costs of the transition are difficult to assess. Yet it is possible to foresee many more fiscal problems for the Hungarian government on the road toward partially or fully privatized pension system. Because 8 percent of the contributions are diverted to private pension funds, this will precipitate a loss of public income at the level between .8 to 1.5 percent of GDP, as estimated by Rocha and Palacios. Whether the new potential in the form of private savings will offset the calculated loss, is far from certain and remains to be seen in practice.

In the midst of the unknowns regarding the pension reform it is possible to say that the transition from a public to a private system involved many risks and perils. As always, gradualism, and the given public guarantees designed in a transparent way for all generations, might help alleviate these risks.[485]

Similar to the pension reform in Hungary was the path of reform in Poland. In the period of transition, the government in Poland faced similar difficulties compared to other transition economies. The number of contributors rapidly fell while the number of beneficiaries rapidly grew, evidenced by the fact that between 1989 and 1996 public expenditures relative to GDP doubled and represented 14.5 percent of the GDP. Not surprisingly, rapid change in the existing public pension scheme also required substantial reform. In preparation for the pension reform a broader social consensus needed to be reached.

The negotiations took place in a tripartite body that consisted of the representatives from the government, business and labor. The main old trade union (OPZZ) supported the fundamental pension reform, but not unconditionally.[486] Aside from the requirements to maintain the public pay-as-you-go pillar as the main pillar during and after the transition to a new pension scheme, the main trade union also tried to actively partici-

sion reform in the transition economies lies outside the scope of reforming these economies and their fiscal problems: "A successful move towards an unfunded-funded multi-tier pension scheme in Eastern Europe could stimulate and encouarage discussion in those countries of the European Union where pension reform is urgently required." *Supra* 472, p. 219.

[485] Mitchell Orenstein, *supra* 431, p. 57: "The OPZZ demanded that the PAYG pillar remain the 'main source of income for present and future pensioners,' and expressed concern over how the government would fund the deficit in the public pillar. The OPZZ also opposed changes to the retirement age, minimum pension levels, indexation changes, and special privileges that were essential parts of the pension reform in Poland."

[486] *Id.*

pate in establishing the second pillar. Namely, unions tried to establish a joint venture with the Belgian subsidiary of Bankers Trust to have their own second-pillar pension fund, but the application was rejected.[487] Nevertheless, Orenstein rightly points to the fact that trade unions can be innovative and productively employed even in the debates and negotiations on the most difficult economic and social issues the government is facing.

The reform itself started in 1999 and in many ways resembled the Hungarian approach. Similar to the Hungarian approach, attempts to preserve the first pillar as the dominant one, but allows the creation of private pension funds to which a portion of contributions can be diverted. Roughly speaking, two thirds of the contributions remain in the first pillar and one third is allowed to go into the private pension funds. The 'revolutionary' part of the reform is introduction of an 'NDC' ('notional defined contributions') principle within the first pillar of the pension system.[488] With the help of NDC, the government tries to bring a closer the link between benefits and contributions of individual contributors to the public pension system in the past.[489] In addition to this innovation, taken from the Swedish pension reform, 7.3 percent of the contributions are allowed to be diverted into the private pension funds, whereas the retirement age remained unchanged at 65 for men and 60 for women. Originally, the switch to the new pension scheme would be mandatory for all employees under 40, whereas people under 50 would be allowed to choose between the notionally defined public system and the switch to the partially funded two-tier system. Finally, before the actual reform started, a compromise was reached. Based on this compromise, the new pension scheme became mandatory for all employees under 30, whereas employees between 30 and 50 years of age were allowed to choose between the two existing options.[490]

According to Marek Góra and Michal Rutkowski, who were the pension reform advisors to the government in Poland there are important unknowns when implementing pension reforms. One of them is the number of employees who are planning to switch from the old pension system (transformed according to the NDC principle) and the new pension scheme. If this is impossible to predict, it is not possible to plan the future public deficit caused through the diversion of contributions. Short and middle-term transition financing might therefore become a

[487] Katharina Müller, *supra* 476, pp. 116–117.

[488] As such, NDC principle presents an attempt to create a simulation of the past accumulation of the individuals, based on the past contributions and the calculated (virtual) level of return. *See* Katharina Müller, *supra* 476, pp. 11–12.

[489] Marek Góra and Michal Rutkowski, *The Quest for Pension Reform: Poland's Security through Diversity,* SOCIAL PROTECTION DISCUSSION PAPER NO. 9815, The World Bank, October 1998, p. 29

[490] *Id*, pp. 29–31.

problem.[491] The loss of public pension system revenues will depend on the number of people switching to the new system and on the dynamics of switching from the old to the new system. While the authors estimate a loss between .82 to 1.68 percent in the first years of transition (until 2003), they expect most of the savings from the new system and the transition period – interestingly enough – from the price indexation of benefits.[492]

To sum up the attempts at reforming in transition economies we can see some efforts at improving and stabilizing the pension systems. Most of the attempts were defensive, as pension systems were stabilized at a lower level of benefits for the current and future generations. Likewise, the partial withdrawal of the government from securing the pensions established on the traditional pay-as-you-go basis should help stabilize public finance and create more investment opportunity for the private sector through higher private saving rates. The potential benefits from the partial privatization of the pension systems in Hungary and Poland remain to be seen in the relatively distant future, whereas the costs of transition are more visible.

To date, one of the important remaining characteristics of the pension reform is that the transition economies looked primarily at the example and experience of the Chilean pension reform and they did not pay much attention to examples and institutional innovation of the developed countries from the European Union, Australia, New Zeland and other OECD countries. It is also interesting to see that pension reform in transition economies relies on some conceptually unproven premises. One of them is that the step toward the privatization of the pension system leads toward a higher national saving rate, and another is that there is an automatic and presupposed link between higher saving rates and a higher level of productive investments. Many other important issues, such as the administrative costs of running the private pension funds, and the ability and capacity of the capital markets to absorb new financial institutions, were surprisingly put aside.

CONCLUDING REMARKS

The debate on pension reform in transition economies and other rapidly developing economies coincide with many reforming attempts within the OECD countries. The roots of the problems with the pension systems

[491] Winfried Schmähl, *Fundamental Decisions for the Reform of Pension Systems,* INTERNATIONAL SOCIAL SECURITY REVIEW, vol. 52, 3/99, pp. 45–55.

[492] Gøsta Esping-Andersen, *After the Old Age?,* in Gøsta Esping-Andersen (ed.), *supra* 429, p. 22.

in the OECD countries are somewhat different and originate primarily demographically, aggravated by unemployment problems in some of the developed countries. On the other hand, many of the unresolved issues that we met in the discussion on the nature and character of pension reform in the developing countries can be seen in the debates in the advanced countries.

The fundamental questions[493] about the nature of pension reform needs to be answered by each country individually in accordance with their given economic, social and political context, as well as in accordance with their proclaimed goals and desires of the reform. Inevitably, because any pension reform requires a long transition period, many unknowns and risks are involved. In this situation, the goals and means are often mixed. For example, a step toward privatization should not become a way of privatizing individual risks, but rather the means to confront them.[494] Among other unresolved issues are, for example, the question regarding how the private fully-funded system will bring about a higher level of national savings, because econometric studies for the EU countries show no significant differences.[495] Another set of questions relate to the problem of determining to what extent social security needs to generate national savings and, conversely, to what extent social security does need saving.[496] Of course, fundamental questions and trade-offs are at stake in any pension reform, but it is different to start a reform in a country with universal coverage and generous benefits compared to a country with a low degree of coverage, based on means-tested principles.

There are clearly too many contextual problems for it to be possible to develop one coherent set of propositions about the optimal pension system. The historical legacy of institutional solutions, the depth of crisis

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[493] Emmanuel Reynaud, *Financing Retirement Pensions: Pay-as-you-go and funded system in the European Union,* INTERNATIONAL SOCIAL SECURITY REVIEW, vol. 48, 3–4/95, pp. 41–57.

[494] For an excellent discussion on this issue *see* Dimitri B. Papadimitriou and L. Randall Wray, *Does Social Security Need Saving?,* available on *www.levy.org/docs/hili/55a.html.* Unlike many other authors these two authors do not focus on the financing of Social Security in the US and do not look for financial solutions. Instead, they believe that the question about the future of Social Security pertain to the size and distribution of the real economic pie: "Once this is recognized, it becomes obvious that none of the popular reforms, such as privatization, reduction of current benefits, or "locking away" budget surpluses, can relly help. We need to formulate alternative policy recommendations that are consistent with the true scope and nature of the future problem."

[495] On the historical development of the social policy in the United States *see* Theda Skocpol, SOCIAL POLICY IN THE UNITED STATES, Princeton 1995.

[496] Overview of the pension arrangement in the United States by Barry Bosworth, *Possible Effects of Ageing on the Equilibrium of Public Finances in the Unites States of America,* in EUROPEAN ECONOMY, Directorate-General for Economic and Financial Affairs, Brussels, no. 3, 1996, pp. 127–155.

that the individual country is facing, and the level of development of the supportive institutions and long term (un)sustainability of the present system are certainly among the decisive factors regarding the character of pension reform in the given country. In the United States, for example, recent debates on privatizing the Social Security Insurance (SSI) inevitably address all these decisive factors. The pension system that started to develop during The New Deal era was upgraded and improved during the period of The Great Society and amended in 1970s.[497] Participation in SSI is mandatory for all employees who contribute 12.4 percent of their (deferred) wages, and employers contribute the same amount of gross wages. Since the Employee Retirement Income Security Act of 1974, private pension contributions and earnings have been exempt from corporate tax, creating the opportunity for workers to qualify for a pension by mandating standards for the vesting rights to the pension. Another mechanism was created by the Internal Revenue Code, which allowed the establishment of private pension schemes for employees, and is known by its popular name from the Code – 401 (k).[498]

The growth of private pension funds since the mid-seventies has been tremendous. For example, private pension funds accumulated more than 1.5 trillion USD from 1970 to 1993 due to favorable legislation, debates on the SSI crisis and thanks to legislative limitations on some other financial intermediaries.[499] Needless to say, the growth of of the pension funds was equally fast in recent years and today presents several trillions of USD. The development of private pension schemes meant the gradual privatization of the public pension system even without major changes of the SSI. Today more than 40 percent of employees already participate in private pension schemes.

There are many unresolved issues with regard to the existing institutional solutions of the pension system. Leaving aside the debate on the (un)sustainability of the current SSI arrangement, an important set of debates relate to the legislative arrangement of private pension fund management.[500] Other unresolved issues relate to the problems of managing these funds, the (re)distributive effects of these funds, and their investment policies. Historically speaking, these funds went bankrupt more often due to poor management than due to cyclical events on the markets. Pension funds frequently encourage short term speculative

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[497] Mark J. Roe, STRONG MANAGERS, WEAK OWNERS, Princeton 1994, p. 124.

[498] Institutional and statutory impediments for participatory pension systems analyzed by Gregory S. Alexander, *Pensions and Passivity,* LAW AND CONTEMPORARY PROBLEMS, vol. 56, no. 1, Winter 1993, pp. 111–139.

[499] Theresa Ghilarducci, LABOR'S CAPITAL, MIT 1992. *See* also her brief review of pension funds in *U.S. Pension Investment Policy and Perfect Capital Market Theory,* CHALLENGE, no. 37, August 1994, pp. 4–10.

[500] Paul Pierson, DISMANTLING THE WELFARE STATE?, Cambridge 1995 (second edition), p. 68.

trading that focused primarily on creating profits for fund managers and financial brokers. Contrary to economic theory, the situation in which a high volume of trade does not necessarily bring about higher rates of returns has been recorded.[501]

Nevertheless, SSI remains one of the most popular pillars of public social policy in the US. Professor Paul Pierson even developed a theory of 'retrenchment,' referring to a situation in which defending the given system and benefits pose little risk for the defenders to prevent any reforms that would lead to the dismantling of the present system. In practice, the discrepancy between the strong rhetoric and less practical action can be noticed. One such situation was during Reagan era in 1987, on the brink of a world financial market collapse, President Reagan was prepared to sacrifice everything but Social Security.[502] Despite the edge in the recent debates on privatizing Social Security, radical pension changes withn the given context are not to be expected. The period of irrational exuberance and the policy of retrenchment might play its role again.[503]

In many ways, the debates in Germany resemble those in the US, except that the problems with sustainability look more imminent, as unemployment problems are more serious and the pressure from insurance companies and other potential players in the case of privatization are stronger. In the last decade, Germany already made some significant changes in its pension system. In 1992, the new Pension Reform Act introduced several major changes in the public pension system. These changes primarily aimed at the modification of indexation of pensions (a shift from gross wage dynamics to the dynamics of wages net of contributions and taxes), the gradual increase of the retirement age to 65 for both men and women until 2012, penalties for early retirement and some other mechanisms.[504] The debate on the (un)sustainability of the public pension system in Germany continues and new reform proposals are on the horizon.

Aside from the current debates on further changes of the pension system and on future projections, the German pension system has several components. The first and the main component is the "social budget", which is the public pension system, mandatory for all employees, to which employers and employees contribute 17.7 percent each. A partial

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[501] *See*, for example, ISSUES IN PRIVATIZING SOCIAL SECURITY, ed. by Peter Diamond, National Academy of Social Insurance, 1999. *See* also Norbert Berthold and Rainer Fahn, *Reforming the Welfare: The German Case,* in Herbert Giersch (ed.), REFORMING THE WELFARE STATE, Springer 1997, p. 181.

[502] On the German pension reform *see* Winfried Schmähl, *Public Pensions in Germany,* JOURNAL OF EUROPEAN SOCIAL POLICY, vol. 3 (1), 1993, pp. 239–51.

[503] Jeremy Edwards, Klaus Fischer, BANKS, FINANCE AND INVESTMENT IN GERMANY, Cambridge 1994, pp. 53–55.

[504] *Id,* p. 56.

exception to the public pension system is the – Gesetzliche Rentenversicherung (GRV) – for public employees. The second component of the German pension system are individual savings in the form of life insurance and private pension schemes. The significance of these savings is becoming gradually more important: this form of savings presented 18 percent in 1960 and already 32 percent in 1989 of all the savings collected by the German insurance companies from households.[505] The third component are the pension schemes of the firms, primarily in the form of book reserves.[506]

Diverse pension systems, most of them in flux, can be found in other OECD countries. The Swedish historical experiment with the Meidner Plan in 1970s, or their present attempt at establishing NDC accounts are among them. Also, substantial pension reforms have also been carried out in France, Italy, Netherland and elsewhere.[507] Some of the attempts present innovative approaches toward solving pension problems and linking the social security debate to the industrial and financial development debate; other attempts are less innovative, more defensive and aim primarily at sustaining the given pension arrangement, but at a lower level of obligations and promises to the citizens.

We could learn from the debate on pension reform in the OECD countries that not only does each country have to be able to cope with the problems of its system, but also that no matter how innovative the solutions are, it is not possible to solve all the problems and guarantee all the benefits with one single comprehensive pension reform. Perils and risks in such attempts are clearly visible, and the hopes and successes of any reforming step are far from certain. Therefore, any attempt at reforming requires the highest level of sensitivity, a complete understanding of the complexities of the problems and constant reminders about the long term consequences of any adopted decision. The comparative and empirical work in this area seems to be one of the most helpful backgrounds for designing the proper model of the pension system in a given country.

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505 Excellent overview in Kent Weaver, THE POLITICS OF PENSIONS: LESSONS FROM ABROAD, Brookings/National Academy of Social Insurance, 1999.

506 On the legal transplants and the legal families *see* Daniel Berkowitz, Katharina Pistor, Jean-Francois Richard, *Economic Development, Legality, and the Transplant Effect,* CENTER FOR INTERNATIONAL DEVELOPMENT, Harvard 2000.

507 For the comprehensive overview of the mentioned topics *see* Kavin Davis and Michael J. Trebilcock, *What Role do Legal Institutions Play in Development?,* prepared fro the International Monetary Fund's Conference on Second Generation Reforms, November 8–9, 1999.

CONCLUSION

LEGAL INSTITUTIONS AND DEVELOPMENT

The theoretical and empirical analysis of the institutional transformation in the Central and East European countries provide many insights into the logic of large-scale institutional transformation. Some of the findings are relevant only for the transition economies, whereas some other important findings transcend the context of the Central and East European countries.

The difficult part of the present analysis was to establish the firm link between legal institutions, regulation and economic and social development within a given context without neglecting the real limits of any individual country. In the period of reforms, most of the countries have to struggle with many exogenous factors and crises that further obfuscate an assessment of the success or failures of certain legal reforms. Causal links in these situations are extremely difficult to be detected and objectively assessed. On the other hand, not many countries do engage in large-scale institutional reforms outside a period of deep and substantial crisis. These observed facts certainly do not make the legal analysis of reforms any easier.

What is perhaps more disturbing, however, is the lack of interest in large-scale institutional reforms within the dominant circles of legal thinking. The impression is that only individual attempts in comprehensive analyses were made, and even these valuable attempts were not understood as something that can broaden our knowledge and understanding of the role of law and legal theory in general.

Still, leaving these disturbing findings aside, the analysis of the links between legal reforms and development show some observations that are in my opinion worth taking into account. One of the findings is that legal institutions do behave differently in the countries in transition, no matter how faithfully they are copied from other countries. In itself, they do not automatically provide the same type and character of social activities and their outcomes. A deeper understanding of the logic of institutions and the ability to understand the given institutional context in both the country that is taken as an ideal model and in the country that is trying to copy certain institutional solutions are necessary. Still, this is not an argument against emulation and against legal transplants. Borrowing or emulating legal institutions can be productive to the extent the reformers understand both, the logic of a given legal institutions in the model country and the logic and requirements of the country in need for reforms.[508]

An interesting and important debate pertains to institutional hybrids, such as the combination of the strong banking sector with a presence on the supervisory boards of the firms and the functional capital market dominated by other financial intermediaries, such as investment and mutual funds. In the section on the best formula for ownership structure for transition enterprises, we have seen that no such abstract formula can be given. Sometimes it is better to have strategic outside owners capable of restructuring the enterprise, sometimes a mixture of inside and outside owners of the enterprise. As long as we understand the ownership structure as a vehicle toward development and growth and not as a given fiat, we do not make a mistake of mixing the means and ends of privatization and of the ownership structure. Japan, for example, was capable of successfully combining many European (German) institutional solutions with the American institutional solutions that were all transferred and rearranged within the Japanese context of rapid development, innovative modes of productions and close networks of enterprises that are sometimes captured under the phrase "flexible rigidities."

On a global level the debate showed that we do not possess a working model of development that could be advocated as the blueprint for the developing countries.[509] External constraints and exogenous factors might turn out to be decisive even in countries that appear to be doing "everything right." There are, of course, also the countries that were progressing in the past by doing things wrong.[510] Despite the poor understanding of the logic of development and the role of legal institutions within the path of development, certain causal links can be observed and certain causalities improved. In most cases, this improvement can work within a given context and it is difficult to transfer this knowledge to

[508] On dffierent development strategies *see*, among many other valuable studies on the development strategies, Dani Rodrik, *Development Strategies for the Next Century*, prepared for presentation at the conference on "Developing Economics in the 21st century", INSTITUTE FOR DEVELOPING ECONOMIES, Japan External Trade Organization, January 26–27, 2000, in Chiba, Japan.

[509] For the comprehensive overview of the mentioned topics *see* Kavin Davis and Michael J. Trebilcock, *What Role do Legal Institutions Play in Development?,* prepared fro the International Monetary Fund's Conference on Second Generation Reforms, November 8–9, 1999.

[510] On dffierent development strategies *see*, among many other valuable studies on the development strategies, Dani Rodrik, *Development Strategies for the Next Century*, prepared for presentation at the conference on "Developing Economics in the 21st century", INSTITUTE FOR DEVELOPING ECONOMIES, Japan External Trade Organization, January 26–27, 2000, in Chiba, Japan.

other contexts, at least not directly and automatically. In case of any emulation of legal institutions, additional efforts are necessary to make any kind of institutional solutions workable within the new context.

Interaction between the legal and economic institutions is another difficult issue for the scholars and practitioners around the world. Is dispersed ownership of the corporation better than the concentrated ownership, what is the best ratio between debt and equity, what is the ownership structure that gives enough incentives for investment and development instead of the "tunneling out" and other forms of misappropriation? These are questions which do not have easy answers. Convergence or divergence of institutional solutions around the world is a topic beyond the scope of my thesis, but the comparative and empirical overview of the institutional transformation of the transition economies show us there is no presupposed link between a given institutional solution and its practical outcomes. True, more often than not, this was proven in a negative way, that is, through the failure of certain reform attempts, but on the other hand, no one can deny some theoretical and practical success stories in this huge enterprise, called the institutional transformation of the countries in Central and Eastern Europe. If my thesis was able to point convincingly enough to some of them and to show simultaneously the complex logic of institutional and practical development beneath the actual decisions and regulatory environment, sometimes against the conventional expectations and the textbook logic, the goal of the present work is more than fulfilled.

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