



# The World Bank, Privatization and Enterprise Reform in Transition Economies:

## A Retrospective Analysis

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2002  
The World Bank  
Washington, D. C.



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## Contents

This conceptual account details the approach to privatization and enterprise reform of three major countries in transition: Poland, Russia, and the Czech Republic and Slovakia. It discusses the states of mind that prevailed in each country, the perceptions of the World Bank at various places and moments, the initial conditions faced by reformers and those who assisted them, and the policy frameworks that evolved.

- **Bank thinking on public enterprise reform and privatization prior to its large-scale involvement in transition:** It was thought that there was no need to break conglomerates up because import competition would prevent abuses of market power-and that new owners would lobby for further liberalizing reforms and for supporting institutions.
- **Original moments of contact:** Changes were enormous in scope, lightning-like in speed.
- **Poland:** a very slow privatizer
- **Czechoslovakia:** mass privatization through vouchers
- **Russia:** special and complex
- **What works and what doesn't:** Concentrated owners far outperform diffuse owners; institutions make the difference in that outperformance.
- **Conclusions**

## Policy summary

The speedy, astonishing collapse of communism demonstrated that one had entered a period of "extraordinary politics." It was easy to conclude that this was also a period of "extraordinary economics"-that one could:

- Privatize conglomerates without breaking them up and assume that import competition would prevent the abuse of market power (without thinking too much about structural barriers to imports from exchange rate issues, poor transportation systems, and activist and often corrupt sub-national governments that moved to protect "their" firms from competition of any sort).
- Assign the primary restructuring and corporate governance responsibilities to second-phase private owners (and downplay the absent or very weak mechanisms that would make it feasible and worthwhile for this secondary trading to take place).
- Depend on a mass of brand new and often bewildered and suspicious private shareholders to lobby for further liberalizing reforms and supporting institutions (without noting that there was not much historical evidence of a "demand-pull" causation sequence for institutions).

**In many cases privatization could have-and probably should have-been better managed, and opportunities were missed.** But it is inaccurate and unfair to hold privatization accountable for all the problems of transition. First, the evidence shows that in East and Central Europe, privatization has proven its worth. Second, even in the former Soviet Union, most early reformers were careful to state that the first objective of privatization was to depoliticize the links between enterprises and the state; they accepted that efficiency and equity considerations had to come later. They were especially convinced there was a need for speed; one had to act quickly to forestall the return of the communists.

**A change of ownership by itself was not sufficient to cut the political-financial links.** But that was not clear at the outset and it still looks like a necessary condition. It also is now clear that far more time was available than had been thought. "It might have been possible to approach privatization in a more deliberate manner; the results might have been less insider ownership and domination, less resistance to external investors, more protection for minority shareholders." This may be the case. But again, counter to this speculation is the fact that countries in the former Soviet Union that pursued an alternate path-of trying to transit without much change of ownership-have not had any great success.

**A unifying thread in Poland, Czechoslovakia, and Russia is the importance of establishing control over managers.** Managers were the group that emerged from the wreckage of central planning best placed to further their interests. Methods and policies that established rules and surveillance, that opened the doors to foreign investors (who were subject to some extra-national reviews of and limits on their behavior), that pushed competition and freer entry and exit alongside change of ownership, proved better, both in promoting restructuring in the firms and in gaining public acceptance of the process.

**Faith in the voucher approach was misplaced-or at least too heavily overemphasized.** We-the Bank-should have been searching earlier for ways to introduce concentrated owners; we should have paid more attention (earlier than we did) to prudential regulations in capital and financial markets and other institutional development matters. Note that these were not ignored; but the relative effort devoted to these activities was small in comparison to the push for mass privatization.

**The use of vouchers might have been limited to minority stakeholders.** Specifically, the Bank might have done better to advocate more widely the approach used by the Estonians: that is, limiting the exchange of vouchers to minority stakes in firms in which a controlling majority share had already been sold to a core investor. This increases the chances of turning over the firm to a good owner, possessing the incentives to look after and develop the health of the assets. It also increases the chances that voucher holders will obtain a share that will maintain or increase its value. Indeed, the Estonians applied this procedure in a small number of the higher potential firms, further increasing the prospects for the new minority shareholders. The counter argument is that Estonia was a special case with conditions that could not easily be replicated-and that elsewhere core investors could not so readily have been found. But this use of vouchers would have been worth a try, particularly in Russia, at least for a set of firms.

## ***I — Introduction***

The Operations Evaluation Department (OED) of the World Bank commissioned this analysis. Unlike the typical OED study, it does not analyze the specific details of any particular Bank project or set of projects. Rather, it offers a conceptual account of the approach to privatization and enterprise reform of three major countries in the transition region. It discusses for each the states of mind concerning enterprise reform and privatization that prevailed in the country and the World Bank at various places and moments prior to and in the transition process, the initial conditions faced by reformers and those who assisted them, and the policy frameworks that evolved.

In each of the three chosen cases restructuring and privatization were seen as critical by reformers, their Western academic and financial advisors, and Bank and other international financial institution's (IFI) staff. In each case the debates on the privatization issue raised questions of importance beyond the single country. The intent is to complement the more traditional and detailed OED review of projects, by illustrating the major problems and issues faced, the solutions proposed, their evolution over time, and the policy paths rejected or missed by Bank staff, and reformers in the transition governments, concerning the contentious topic of privatization.

The paper is organized as follows: Section II summarizes Bank thinking on public enterprise reform and privatization prior to the large-scale involvement in transition. Section III briefly sketches the original moments of contact. Sections IV, V and VI discuss the three country cases. Section VII then offers a general discussion of what has been learned concerning what works and what does not; this is followed by conclusions in Section VIII.

In the order they are discussed the countries are: Poland, Czechoslovakia (now the Czech Republic and Slovakia), and Russia (at the very first, the Soviet Union). The privatization approaches of a number of other countries will be mentioned, though not analyzed, in passing.

## ***II — The “mindset” of World Bank staff, prior to their arrival in transition countries, regarding state-owned enterprises and public corporations.***

From the 1960s through the 1980s, the World Bank lent and credited member governments throughout the world very large sums for the purpose of creating and financing, and then strengthening and reforming, public enterprises.<sup>1</sup> These activities focused mainly on infrastructure firms—electricity companies, telecommunications, ports, railways—but there was from the outset considerable involvement, at least through financing and attention to the policy framework and supervisory mechanisms, in commercial, manufacturing and industrial entities as well. The Bank had assisted member governments in this field in the hope that, in

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<sup>1</sup> Throughout this report the terms public enterprises and state-owned enterprises (SOEs) are used interchangeably.

addition to providing basic and needed services in an efficient and cost-effective manner,

...public enterprises would assist the development of “strategic” sectors, gain access to commercial credit that would be denied to small private businesses, fill “entrepreneurial gaps,” empower numerically large but economically weak segments of the population, maintain employment levels, and raise the level of savings and investments.<sup>2</sup>

Towards the end of the 1970s, and certainly by the early 1980s, there was pervasive doubt as to the attainability of these goals. Why? First and foremost, despite concerted, intellectually innovative, expensive and repeated reform efforts of a variety of types<sup>3</sup>, the objectives of SOE reform operations persistently were not met. The financial and operating performance of public corporations in most client countries remained generally poor, or actually worsened;<sup>4</sup> the financial burden imposed on strained governments by loss-making SOEs overwhelmed first budgets and then banking systems, and (presumably) crowded-out desirable spending activities of governments; infrastructure companies, even profitable ones, could not raise sufficient investment funds, and in general firms that had been created with a view to providing the state with surplus capital to develop the country now survived as loss-makers mainly because of the politics of vested interests.

Second, partly as a result of disappointments and unfulfilled expectations, many analysts and economists shifted their view of “market failure” and natural monopoly. Changes in technology and perception introduced competition (sometimes *for* rather than *in* the market) into formerly closed areas, particularly in ports, railways, water, telecommunications and electricity generation and distribution. The perception arose that the merits of non-market alternatives had been oversold, and that both the potential of introducing competition and contestability, and the possibilities for introducing private entry and participation had been underestimated.

Third was the dramatic and powerful demonstration effect of restructuring and privatization in several leading OECD countries, beginning with the United Kingdom at the end of the 1970s, and followed thereafter by Canada, New Zealand, France and others. If privatization could successfully be applied in these settings, why not in developing countries where the need and scope for improved efficiency was so much greater?

By the mid-1980s, the dominant view among Bank staff working on SOE reform was that the available set of improvement mechanisms, short of ownership

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<sup>2</sup> John Nellis & Mary Shirley, *Public Enterprise Reform: The Lessons of Experience*, World Bank, EDI Development Studies, Washington, DC, 1991, p. 1.

<sup>3</sup> The range of reforms short of ownership change were summarized by Mary Shirley in *Managing State-Owned Enterprises*, World Bank Staff Working Paper No. 577, Washington, DC, 1983; and in Nellis and Shirley, *Public Enterprise Reform*, *op. cit.* For a listing and analysis of public enterprise reforms attempted by the Bank in adjustment lending in the 1980s see John Nellis, “Public Enterprise Reform in Adjustment Lending,” Working Paper WPS 233, World Bank, August, 1989.

<sup>4</sup> See for example, the information on poor performance, despite repeated reform efforts, summarized in John Nellis, *Public Enterprises in Sub-Saharan Africa*, World Bank Discussion Paper No. 1, Washington DC, 1986.

change, was hard to apply and even more difficult to sustain,<sup>5</sup> and that more hope was offered by privatization—which had begun to occur in some non-OECD settings, primarily in Latin America.<sup>6</sup> The premises for operational action were:

- SOEs did not function well; more importantly, it was next to impossible to make them function well.<sup>7</sup>
- However, up to the middle 1980s there was no widespread or solid foundation of empirical evidence proving the operational superiority of private versus public firms<sup>8</sup>; and a number of academic studies contrasting public and private ownership had concluded that market structure and the

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<sup>5</sup> The argument is developed in John Nellis, *Is Privatization Necessary? Viewpoint*, FPD Note No. 7, World Bank, May 1994:

...most governments find it difficult if not impossible to apply the entire package of qualifying conditions that are essential for reforms short of ownership change to work. The landscape, particularly in developing countries, and now in ex-socialist countries as well, is littered with partial attempts to impose reform where the government owners hadn't the will or the capacity or the luck to impose the whole of the reform package—and the results were minimal, modest or nonexistent..... Second, in the few cases where governments do establish and maintain the precedence of commercial aims, the results are.....very good. *But they tend not to last.* In most instances there is pronounced backsliding. The common story is that bad times make for good policies—in crises governments do establish the precedence of commercial objectives, they do impose a harder budget constraint, and they do give autonomy to public enterprise managers to achieve commercial aims. But again and again, when the crisis fades, or when the regime changes, or when some major political claim arises, commitment to the priority of commercial aims and to non-interference in day-to-day management of the firm fades with it.....Ultimately.....”politics trumps economics.” (p. 4)

<sup>6</sup> Recall that by the end of 1988, largely without prodding by donors, Mexico had reduced its very large SOE sector (1155 firms in 1982; accounting for 14% of GDP) by more than two-thirds, by selling 150, liquidating 260, and transferring or putting into mergers an additional 400 entities. And all this was before the major infrastructure firms were sold in the main wave of privatization in the 1990s.

<sup>7</sup> Almost but not quite impossible. In 1984 New Zealand “corporatized” a number of its SOEs, by reducing political controls in these firms; enshrining managerial and board autonomy and rewarding them accordingly; establishing commercial profitability as the over-riding goal, and using changes in net worth as the measure of success; requiring parliamentary passage of any subsidy or deviation from commercial operation, and a number of other radical departures from typical SOE governance. Performance generally improved. However, most developing country representatives sent to observe the process (usually by the World Bank) came away daunted by the revolutionary scope and pace of the needed reforms rather than impressed by the operating results, and daunted by the fact that despite the gains from reform, the New Zealanders had eventually proceeded to privatize most of the corporatized firms.

<sup>8</sup> Later empirical research has persuasively demonstrated that privatization is generally and strongly associated with improved financial and operating performance at the level of the firm. For a full review of the issue see William Megginson and Jeffrey Netter, “From State to Market: A Survey of Empirical Studies on Privatization,” *Journal of Economic Literature*, Vol. XXXIX (June 2001), pp. 321-389.



degree of competition were more important than ownership in determining performance and efficiency outcomes.<sup>9</sup>

- In addition, while first assessments were very promising, arguments were nonetheless common that it was too soon to tell whether privatization was working in Europe, and a debate started (and still continues) as to whether perceived performance improvements are due more to enhanced competition and liberalization rather than ownership change.
- Moreover, even if ownership change did account for a good part of the positive results seen in OECD settings, and perhaps in middle-income economies such as Mexico, many—even within the World Bank—argued that one could not anticipate similar results in lower-income developing countries, with their thinner capital markets and weaker institutional settings.
- Almost all acknowledged that privatization was intrinsically complicated and intensely political in nature; meaning
- Sales tended to take a great deal of time to structure (because of deficient records and accounts, the size of both normal and contingent liabilities, and the need for financial engineering prior to sale), to “sell” to the various and usually opposed stakeholders, and to win final approval from authorities. Moreover,
- The larger the firm the more time needed to complete the transaction.<sup>10</sup>

All this instilled within Bank staff a general preference for privatization, tempered by a recognition that it was a contentious, difficult and slow process; and that definitive evidence was not yet in as to its utility, or the possibility of its application in non-OECD settings. Still, ever-increasing losses, seemingly insurmountable—under public ownership—investment constraints, and mounting evidence of other and serious performance flaws in SOEs, led Bank staff increasingly to consider the privatization option.

By the end of the 1980s public enterprise reform had become a key objective of Bank assistance. A 1989 review calculated that SOE reform had, to that date, featured prominently in 101 adjustment operations in 34 different countries, 18 of these in sub-Saharan Africa. (Through 1989, Bank-supported adjustment operations containing SOE reform had taken place in only one country that would enter transition, Yugoslavia.) Twenty-one of the 101 operations imposed as conditionality the full or partial sale, lease or liquidation of an SOE or

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<sup>9</sup> For example, Robert Millward reviewed the (scant) information available in the 1980s and concluded: “There is no evidence of a statistically satisfactory kind to suggest that public enterprises in LDCs have a lower level of technical efficiency than private firms operating at the same scale of operation.” Found in his “Measured Sources of Inefficiency in the Performance of Public and Private Enterprises in LDCs,” in Paul Cook and Colin Kirkpatrick, eds., *Privatisation in Less Developed Countries* (New York: St. Martin’s Press, 1988, p. 157).

<sup>10</sup> This was the principal and oft-repeated conclusion of many of the early students of the process, for example Roger Leeds: “There is an unflinching tendency to underestimate the time required to execute each privatization transaction.....” In his “Privatization in Developing Countries: Some Lessons Learned,” unpublished paper delivered to the International Privatization Conference, Saskatoon, Canada, 1990, p. 9.

set of firms, and a large number of other reforms/conditions were clearly viewed as preparation for sale or closure.<sup>11</sup> Indeed, conditions concerning privatization or preparation for divestiture were more numerous than any other single reform category.

Nonetheless, taken cumulatively, measures other than ownership change—including performance contracts between managers and government owners, financial and management audits and restructuring, rehabilitation and restructuring schemes under continued public ownership, and review and guidance mechanisms by which government would improve supervision of its SOEs—far outnumbered privatization measures: The study tabulated 29 ownership change conditions versus 104 non-ownership change conditions. This continuing emphasis on reform under state ownership, alongside privatization, would prove to be an important and revealing difference from the SOE reforms later proposed and supported by the Bank in transition countries. Operations to reform SOEs in transition economies were limited to “isolation” exercises in a number of countries; that is, efforts to impose something akin to a Chapter 11 workout on a set of large loss-makers as preparation for either their full or partial sale, or closure. An overall assessment of this specialized aspect of enterprise reform remains to be done (and is not attempted here); a rigorous study of the Bank-supported Romanian “isolation program concluded it had been a failure.<sup>12</sup>

### ***III — What were the conditions at the outset?***

Prior to transition, the World Bank had made loans to several centrally planned or socialist European governments: Romania, Hungary, Poland and Yugoslavia. While at least some staff had a general awareness of the situation they would find in these countries, it could not be said in 1990 that the Bank possessed a great deal of specialist knowledge on the workings of centrally planned economies. Nor were many such specialists employed to take part in first missions to these countries. Recall, however, that the political and economic change that swept over the centrally-planned and socialist economies at the very end of the 1980s was enormous in scope and lightning-like in speed; it was vast, swift and largely unanticipated—at least by outsiders.<sup>13</sup>

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<sup>11</sup> The numbers and the type of reform requested or required are found in Nellis, “Public Enterprise Reform and Adjustment Lending,” *op. cit.*, see especially Table 3, p. 15.

<sup>12</sup> Simeon Djankov, “Enterprise Isolation Programs in Transition Economies,” Policy Research Working Papers No. 1952, Washington, D.C.: World Bank, 1998.

<sup>13</sup> At the first meeting in Moscow, in September 1990, with the first review team from the IFIs (World Bank, IMF, EBRD and OECD), the “All Union” Soviet Minister of Justice began by stating: “I hope that when the present debate ends the constituent parts of the present Soviet Union will retain a degree of economic relations equal to that of the European Community.” The statement astonished the team; few of us were fully aware of the extent of decay of the Soviet state and economic system; and indeed the final report of the IFI team was still entitled *The Economy of the USSR*, although the report itself noted that “by December of 1990, all 15 union republics had declared either independence or sovereignty.” (p. 11). We non-specialist outsiders were among the last to know; it was later brought to our attention that one of the reasons Andrei Sakharov had been internally exiled as far back as 1980 was his assertion that the Soviet Union would eventually collapse due to irrational economics and unmanageable ethnic tensions. The points are (i) as so

At the same time, the group of centrally planned economies was not viewed as monolithic. Poland's internal struggle between the labor movement, Solidarity, and the regime, and its increasing democratization had been closely followed; and the establishment of the first non-communist government in Poland in September 1989 was clearly a defining moment in the transition to transition. Moreover, Hungary's long-standing set of cautious but cumulatively significant liberalization steps had been recognized and analyzed, and Yugoslavia's distinctive socialist path, and wide and deep economic relations with Western markets, were acknowledged facts. Nonetheless, even careful students of the region were caught unawares; the speed with which the seemingly solid system collapsed—the fall of the Berlin Wall, the Velvet Revolution in Czechoslovakia, the overthrow of Ceausescu in Romania, the demise of the Soviet Union, the collapse of Yugoslavia—all were more unexpected than not.

Poland, because of its early starting point, the manner in which most of the key enterprise reform issues—speed of privatization, choice of method, use of vouchers and a “mass” approach, and the respective weights and roles of ownership and institutional/policy change—is clearly the place to begin.

#### *IV — Poland*

In Poland at the beginning of 1990 one found a radical reformist regime, willing and able in this period of “extraordinary politics”<sup>14</sup> to undertake sweeping reform, and convinced that privatization of the massive state enterprise sector was an essential next step. As in a few other centrally-planned economies, most notably Hungary and to a lesser extent the Soviet Union, enterprise reform efforts of the 1980s (and even earlier) had tried to overcome falling rates of return on investment by lightening the amount of control of planners and decentralizing decision-making to the level of the firm. One result, here and in every country that tried this approach, was the increase of enterprise autonomy and the margin of maneuver of firm managers. This had resulted in only modest benefits in terms of increased production and cost cutting, while the disadvantages of increased managerial autonomy would subsequently, in most settings, prove to be very high.

Another feature of pre-transition Polish enterprise reform was that workers' councils had been created and empowered to negotiate with management and branch ministries on the entire range of production issues. Russia and Czechoslovakia too had created such councils, but at the last minute, in the latter half of the 1980s. In Poland, this was a much more serious and long-standing effort, partly in response to the decentralization ethos, but also clearly in an effort to placate Solidarity (Hungary's experience with workers councils was somewhere in

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often, what seems in retrospect to be obvious and inevitable was not so evident at the time; and (ii) it is not in the nature of the IFIs to be ahead of the political curve.

<sup>14</sup> The term comes from Leszek Balcerowicz, Minister of Finance and Deputy Prime Minister in the first non-communist government in Poland, established in September 1989; and applier, if not inventor, of the “Big Bang” approach to transition. The idea was that the euphoria created by the escape from the communist system (and Russian domination) resulted, for a time, in a suppression of normal political competition and gave, again for a time, remarkable policy latitude to the replacement regime.

between). The overall point is that by the time World Bank teams arrived in Poland, the responsibility for SOEs had been substantially decentralized from a discredited central government and weakened sector (“branch”) ministries; decision-making powers at the level of the firm were split basically between managers and workers.

The second and obvious factor of import was the sheer number of medium and large sized firms to be dealt with: the official starting count in Poland was 8,400 SOEs,<sup>15</sup> accounting for between 70 and 80 percent of GDP—and this did not take into account a number of subsidiaries of the larger firms, nor a good number of economic entities controlled by sub-national governments. Most Polish authorities met announced their complete support for rapid privatization of this mass of firms; the official goal was, as soon as possible, to “develop an ownership structure akin to that of industrially developed nations.”<sup>16</sup>

Privatization of small units was, indeed, implemented very rapidly. By the end of 1992, small privatization in Poland was almost complete, with the privatization of 194,000 units, i.e., 82 percent of the units existing in 1989. Most such units were in retail trade and services; they were allocated to former employees at well below market value. Small-scale privatization in Poland (and indeed almost everywhere else in transition) was relatively non-contentious, and has been judged to have been a great success, in terms of improving the quality and quantity of the services and goods provided, in creating a large number of jobs for those shifting out of the restructured SOEs and privatized firms, and in generally smoothing the path for the return of capitalism. The importance of small-scale privatization in the region is very great, yet the topic has never received the analytical attention it deserves.<sup>17</sup>

*The basic problem.....*

The fundamental privatization problem quickly became apparent; the issue was the medium and large sized firms. Methods and experience derived from the OECD and middle-income privatizing countries clearly showed how slowly the process normally unfolded. In the United Kingdom, Mrs. Thatcher’s enthusiastic and dedicated privatization team had managed to divest about 20 companies in a ten-year period. The Mexicans, starting with a larger number of (much smaller) firms, had sold off about 150 entities in six years. Assuming that the Poles could somehow double or treble the average annual sales numbers of these leading privatizers, it was estimated they might be able to sell, say, 30 large firms a year, relying on the sales methods that had been used elsewhere.

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<sup>15</sup> Due to sectoral and size classification problems, there was some confusion as to the number of SOEs to be dealt with. For example, Jeffrey Sachs and David Lipton stated that as of 1988 Poland possessed a precise 3,177 “state enterprises in the industrial sector...” “Privatization in Eastern Europe: The Case of Poland,” in Andreja Bohm and Vladimir Kreacic, *Privatization in Eastern Europe: Current Implementation Issues* (Ljubljana: International Center for Public Enterprises in Developing Countries, 1991), p. 29.

<sup>16</sup> Personal mission notes, January 1990.

<sup>17</sup> Save for an early and excellent study by John Earle, Roman Frydman, Andrej Rapaczynski and Joel Turkewitz, *Small Privatization: Transformation of Retail Trade and Service Sectors in Poland, Hungary and the Czech Republic* (New York: Central European University Press, 1994).

The math was daunting: 8,400—or even 3,177—divided by 30, or by 60 or 100, yielded what seemed like ludicrously long periods of time before privatization would be substantially underway, much less complete. In the early days in Poland, and as we shall see, even more so in Czechoslovakia and Russia, most reformers and many external analysts and observers were aghast at the prospect of privatization unfolding slowly over a decade.

Just why was it thought that extensive delays in privatization would be a serious, indeed dangerous problem? The primary reason was one of political economy: the fear that delaying change of ownership would provide opportunities for the return of the communists. The very speed and relative ease of the victory over the communists had its worrisome aspects. It raised concerns that the victory might just as readily be reversed; that the communists, with or without external assistance, might somehow regain power and attempt to set back the economic clock.<sup>18</sup> The idea gained credence that one way to increase quickly support for the reintroduction of capitalism was to create more capitalists; that is, through privatization, to build up rapidly and dramatically the number of private owners of productive entities. This, it was thought, would create a group of people with a stake in and commitment to the market reforms so vigorously pursued by the new, non-communist Mazowiecki government.

A second justification for speedy privatization was the fear that leaving the firms in the control of largely unaccountable managers would open the door to more “wheeling, dealing and stealing.” It was apparent from the beginning that the breakdown of the old order and the increase in control rights of firms managers was leading, in Poland and elsewhere, to “spontaneous privatization,” whereby managers obtained full or partial ownership of the firms they had worked in, at low or no cost, and in a non-transparent manner. The assumption at the outset was that delays in privatization would exacerbate unfair transfer and asset stripping in the unsupervised firms, and that when formal privatization did occur, there would be little remaining of value. Ironically, given privatization’s present reputation in many transition countries as a prime cause of increased corruption, it was originally viewed as the best available measure to increase transparency and probity.

The belief in the necessity of mass and, in particular, rapid ownership change was widely but not universally held. The most eminent of those with reservations was Janos Kornai. Writing in 1990, he offered the contrary and prescient view that the state, even the post-communist state, “...is obliged to handle the wealth it was entrusted with...until a new owner appears who can guarantee a safer and more efficient guardianship. The point now is not to hand out the

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<sup>18</sup> For Poles this was not an abstract possibility. Recall that as recently as December of 1981 the Polish army, with the approval of Soviet authorities, had declared martial law, suspended civilian rule, interned 10,000 members of Solidarity, sent tanks into the Gdansk shipyards, shot dozens of demonstrators, and tried to resurrect “traditional” socialist production methods. Recall as well that in late 1989 and for some time to come there were still substantial numbers of Soviet troops stationed in East Germany, Poland, Hungary, Czechoslovakia and, of course, Lithuania, Latvia and Estonia. Recall further the August 1991 attempt by hard liners to reinstate more traditional rule in Russia. The threat seemed real enough.

property, but rather to place it in the hands of a really better owner.”<sup>19</sup> A decade along not many would contest the wisdom of Professor Kornai’s point. But at the time the assessment of most—in which group I numbered—was that his prescription was perhaps applicable to Hungary, which had since 1968 (with the launching of its “New Economic Mechanism”) been experimenting with piecemeal introduction of market mechanisms into a modified central planning structure. But what might work in evolutionary Hungary was unlikely to work in more closed, less liberalized countries, especially those that had not wrested a margin of maneuver from their internal hard-liners. Thus, most reformers and observers, while acknowledging their respect for Kornai, retained their conviction in the need for speed.

*Differences in views...*

However, it soon became clear that there were deeply conflicting views among Polish reformers on how to proceed with privatization. The period of extraordinary harmony among the various partners in the anti-communist coalition was real, but it proved easier to gain consensus on seemingly abstract pricing and trade policy reform than on the more tangible question of precisely how to privatize a state-owned firm.

The conflict played out in the formulation of the law on privatization, which went through some twenty or more drafts and endless and heated debate in the first semester of 1990, before finally receiving passage in July. The saliency of Solidarity within the coalition was the cause. As with unions worldwide, Solidarity leaders were suspicious of privatization and wanted workers to have some substantial say in how, and to whom, an SOE would be sold. They first suggested a process whereby each workers council would have to be consulted before a firm could be put on the market. If the council rejected the privatization option the firm would simply remain in state hands. Bank staff, strongly supported by a vocal and visible cadre of external analysts and advisors (most notably, Jeffrey Sachs and David Lipton), argued against this position. The fear was that this was a recipe for inaction and continued losses and inefficiencies in the mass of firms.

Bank staff and others cited evidence from socialist and non-socialist countries showing that workers, when given ownership or management powers, tended to use them to protect their jobs and increase their wages rather than restructure firms to enhance their competitiveness.<sup>20</sup> Bank staff, along with the

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<sup>19</sup> Janos Kornai, *The Road to a Free Economy: Shifting From a Socialist System—the Example of Hungary* (New York: Norton, 1990), p. 82. Kornai has recently revisited the subject; see the section on “Ownership reform and the development of the private sector,” in “Ten Years After ‘The road to a Free Economy:’ The Author’s Self-Evaluation,” paper delivered to the Annual Bank Conference on Development Economics, Washington, D.C. April 2000, pp. 6-20, in which he makes a good case that his diagnosis and prescription was superior to the alternatives pursued. Peter Murrell of the University of Maryland was another early skeptic regarding the need for and utility of massive and rapid ownership changes; see his “Evolution in Economics and in the Economic Reform of the Centrally Planned Economies,” in Christopher C. Clague and Gordon Rausser, editors, *The Emergence of Market Economies in Eastern Europe* (Cambridge, Mass.: Blackwell, 1992), pp. 35-53; and “Conservative Political Philosophy and the Strategy of Economic Transition,” *East European Politics and Societies*, Vol. 61, No. 1 (Winter, 1992), pp. 3-16.

<sup>20</sup> This view was strongly presented in a widely read, very influential Bank paper of the time. See Manuel Hinds, “Issues in the Introduction of Market Forces in Eastern European Socialist

external advisors and many in the Polish government, thought that restructuring of Polish state firms was desperately needed, to cut costs and improve quality—or shift product lines entirely—to allow these firms to compete in non-socialist markets. Recall that the extent of the trade shock due to the collapse of COMECON was becoming apparent. By mid-1990 Poland had lost huge amounts of its pre-transition export markets. Production in Polish state firms had declined 30 percent from the year before, and official unemployment had risen from 10,000 in early 1989 to 640,000 just a little over a year later. The perception was that this growing crisis could not be contained unless the mass of productive assets, presently being used sub-optimally in state firms, was shifted quickly to better use. The consensus view among Bank staff and external observers was that acceding to the claims of the workers would compound Poland's economic difficulties by delaying or halting restructuring.<sup>21</sup>

In sum, based on non-transition experience and a first reading of evidence on the ground, Bank staff generally thought that Polish privatization would take time to unfold, and that the claims being made on behalf of the workers would further delay and dilute divestiture. Believing that these delays might prove fatal to reform, staff suggested that the Polish government reassert centralized, government control over the firms so that (i) they could more readily be privatized, and (ii) be more effectively and efficiently managed in the interim.

Polish authorities rejected this suggestion, arguing, “If the state was capable of managing firms effectively, then central planning would have worked.” Their “... main rationale for this position was that the workers had better motivation than bureaucrats in ensuring efficient work by their managers.”<sup>22</sup>

Bank staff were taken aback by the vehemence of the rejection, and the faith in the workers' councils. At the outset they did not comprehend the depth of the mistrust of state apparatuses that communism had left in the minds of reformers, or the extent of the debt the reformers owed to Solidarity. Reformers' deep-seated suspicion of bureaucrats translated into rejection of any tactic of withdrawing one step—by reasserting state control and disempowering workers' councils—in order to jump ahead two steps. Bank staff may have still been thinking in terms of SOE reform and privatization in mixed economies, where it was generally (if incorrectly)

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Economies,” World Bank Europe-Middle East-North Africa Region Discussion Paper IDP-0057, April 1990.

<sup>21</sup> Thus Sachs and Lipton argued in mid-1990:

“Workers' desires to block privatization may also increase rapidly in the near future if, as expected, unemployment rates rise sharply in Eastern Europe. Workers may assume, with some justification, that their job tenure will be undercut by the privatization of their firms. Even if workers in a particular enterprise do not actually block privatization, they may attempt to bargain with the government, demanding for example a cut in the enterprises' debts or various guarantees on employment levels, as their “price” for letting the privatization go forward. If the government becomes enmeshed in case-by-case bargaining, there will be no end in sight, given that hundreds of large enterprises must be privatized.” They feared the outcome would be “paralysis.”

(“Privatization in Eastern Europe: The Case of Poland,” *op. cit.*, p. 28)

<sup>22</sup> See the excellent study by Marek Dabrowski, Stanislaw Gomulka and Jacek Rostowski, “Whence Reform? A Critique of the Stiglitz Perspective,” Warsaw: Center for Social and Economic Research, 5<sup>th</sup> draft, March 2000, p. 21, footnote 23. All three of these reforming Polish economists were personally involved in the early discussions on privatization with the World Bank.

supposed that a new regime could more or less impose its will on to the bureaucracy. Those who came to power immediately after the communists had no such illusions; this was a principal reason for the failure of staff to persuade reformers to introduce measures to more effectively manage assets in the run-up period to privatization. The reformers realized how thin was the veneer of change so far imposed on to the largely unreformed (and in their eyes, unreformable) inherited administrative machinery.

The Polish privatization law passed in July of 1990 thus stipulated that enterprises would only be sold with the approval of insiders, meaning the managers and workers councils. Insiders were encouraged to voluntarily submit their firms for sale to the newly created Ministry for Ownership Change. As a compromise, the law allowed the Ministry the possibility of designating a firm for sale without the approval of insiders, and the insiders could appeal a ministerial designation to a parliamentary committee, whose decision would be final. But this feature was rarely if ever applied. Ministry officials acknowledged in private that only firms voluntarily entering the process would be privatized. The hope was that insiders in a group of high potential firms—most likely consisting of those already exporting to hard-currency markets, in fairly good financial shape, and not likely to require major layoffs—would be persuaded by self-interest to submit themselves for privatization, thus gaining skilled management, capital, market access and technical know-how for their companies. The authorities hoped that 80 to 150 firms would enter the process in the first year. “Trade sales”—negotiated case-by-case transactions— and sales through share offerings on the rejuvenated Warsaw Stock Exchange were the anticipated methods.

Article 37 of the law also allowed for what was termed “privatization through liquidation.” Mainly applied to smaller SOEs, this article permitted firms, without passing through a court insolvency procedure, to sell assets (usually but not exclusively to insiders, and usually by means of installment payments), lease out assets (also to insiders), enter into joint ventures, and merge with other firms. Thirty-three transactions were concluded by these means in 1990, but the number jumped to 397 in 1991 and continued high thereafter. This became a principal, invaluable method for providing small and SME start-up businesses with the assets and real estate they desperately required.

*Funds and vouchers.....*

Some reformers and Bank staff recognized at once that the procedures sanctioned by the law would move slowly, and that the interim asset management problem had not at all been solved. They thus began to cast about for additional measures to speed and deepen the process. In March of 1990 the Ministry of Finance proposed that between ten to twenty “state holding companies” be formed, “guided by purely commercial criteria,” fully managed by reputable and experienced (and thus most likely foreign) private businesspeople, with the objectives of first shifting firms in their portfolios to market-oriented operations, and then privatizing them.<sup>23</sup> The idea was at first solely one of asset management leading to privatization. Over the next year it became combined with a second

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<sup>23</sup> Ministry of Finance, Warsaw, “Holding Companies as a Means of Accelerating Privatization in Poland,” March 7, 1990, p. 1.



notion, that of distributing widely a portion of the ownership in the holdings—and thus indirectly in the firms in the holdings’ portfolios—to the populace by means of share give-aways, or vouchers.<sup>24</sup>

As vouchers became the chief and widely applied innovation in privatization in transition countries it should be noted that they were a Polish invention at the very beginning of the transition period.<sup>25</sup> The Polish government’s original intention in using vouchers was not necessarily to speed privatization; rather it was designed, stated a high privatization official in November of 1990, to deal with “...the disparity between household savings and the net asset value of state enterprises...”<sup>26</sup> That is, vouchers were viewed as a means of providing citizens with the power to purchase shares and assets in state firms that, if sold strictly for cash, would go only to wealthy locals (who were assumed to have amassed their cash in dubious ways) or to foreigners.

The marriage of the holding company idea with a give-away scheme took root in 1991, as evidence mounted as to the very meager results of privatization through either trade sales or share offerings. There were no or extremely few IPOS concluded in 1990, as opposed to the dozens that had been predicted by authorities (the Warsaw stock exchange did not officially re-open until April of 1991, trading the shares of precisely five privatized firms); and the number of trade sale transactions was also very small and far less than anticipated. This slow pace of sales of large firms continued to be the case for years to come. The authorities, with the approval and assistance of the Bank, responded in 1991-92 in two ways: first, by dividing the SOEs into nine sectors,<sup>27</sup> and seeking advisory assistance on how to deal with the set of firms on a sectoral basis; and second by what was called a

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<sup>24</sup> On reading the MoF note, in May of 1990 I wrote and distributed in the Bank a memo saying this was a generally good idea, and added: “But why not go one crucial step further; why not think about the free distribution...of say 20 percent of the shares in each holding company, to a portion of the general public? The idea here is to assign...to a group of citizens a minority of shares in each holding created...In this way self-interested citizens, and not just disinterested bureaucrats, would at least begin to have a direct personal stake in the holding’s performance....A share give away to all citizens would mute the need to award concessions to workers in the privatized firms.” That this approach would probably cause large “technical, administrative and political problems” was acknowledged “...but I think the potential benefits of widespread private ownership, even in this partial, preliminary and indirect fashion, outweigh the evident costs.” World Bank Office Memorandum of May 3, 1990, “Poland: Proposal to Form State Holding Companies for Public Enterprises,” p. 1. Others in Poland and among the advisory community were thinking along the same lines and advocating similar schemes.

<sup>25</sup> The idea was first put forward by Janusz Lewandowski and Jan Szomburg, in their “Property Reform as a Basis for Social and Economic Reform,” *Communist Economies*, Vol. 3, January 1989, pp. 257-268. Lewandowski later became Minister for Privatization. For the record, it should be noted that the first recorded free transfer of equity in government-owned firms to the public was in the Canadian province of British Columbia at the end of the 1970s; see Guy Heywood, “Giving it Away: Case Study of the British Columbia Resources Investment Corporation,” unpublished paper presented to a World Bank Conference on Privatization in Less Developed Countries, Washington, DC, June 12, 1990.

<sup>26</sup> Gregory T. Jędrzejczak, “Privatization in Poland,” in Bohm and Kreacic, *op. cit.*, p. 85.

<sup>27</sup> Construction, pulp and paper, glass, cement/limestone, rubber and tires, cables and wires, furniture, breweries and confectionery goods. In 1991-92 the IFC was involved in one or more sectors.

“Mass Privatization Program,” or MPP; a combination of the asset management concept with a give away scheme.

The basic idea of the MPP was as follows: Between 400 and 600 (eventually 512 firms entered the MPP) medium- to large-sized SOEs would be selected, converted to joint stock companies, and allocated in an equitable manner to 15 “National Investment Funds” (NIFs)—all of which would be managed by “international firms that have demonstrated experience in managing investment funds and giving strategic guidance to companies...”<sup>28</sup> Firms being privatized by some other route, in severe financial difficulty, or monopolies requiring post-privatization regulation were excluded. Sixty percent of the shareholding in each selected firm would be held by the NIFs; 33 percent by a lead NIF (for this firm), and 27 percent distributed equally among all other NIFs. Ten percent of shares were to be distributed free of charge to employees in the affected firm. The remaining 30 percent would continue to be held by the State Treasury. NIF managers would receive a fee for their services, plus a portion of the sale price upon subsequent privatization, thus giving them an incentive both to privatize and to maximize the value of their holdings. Finally, for a small fee, any and every adult citizen of Poland could obtain a “bearer MPP share certificate,” giving the holder a share in each NIF.

Though conceived in 1991, the law establishing the MPP was not passed until April of 1993. Moreover, due to bitter and divisive arguments over the powers and selection of the foreign managers, exactly which firms should and should not enter the program, and fears of workers that entry into the MPP would mean loss of jobs, the system was not started until the end of 1995—and did not list the shares of the funds in their portfolios and enter an active phase until the first half of 1997.<sup>29</sup> This illustrates the intense and continuing difficulty of forging a consensus in Poland on privatization procedures for the large-scale firms.

#### *Outcomes....*

The upshot was that by the end of 1996—at which time a number of other transition states, that had begun privatizing some time after the Poles, had worked well through the process—there remained in Polish state hands a surprisingly large number of firms, and a surprisingly large percentage of assets and initial value (see Table 1).

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<sup>28</sup> Jerzy Thieme, Jacek Bukowski, Michai Mrozek and Teresa Pinski, “Privatization in Poland — 1992,” in Andreja Bohm and Marko Simoneti, editors, *Privatization in Central and Eastern Europe 1992* (Ljubljana: Central and Eastern European Privatization Network, 1993), p. 192.

<sup>29</sup> Barbara Blaszczyk and Richard Woodward, editors, *Privatization and Company Restructuring in Poland*, edited by Warsaw, Center for Social and Economic Research, Case Report No. 18, 1999, p. 11.

Table 1

**Numbers & Methods of Polish SOEs Privatized as of December 1996**

| <u>State Firms as of 31/12/90</u>                                   | <u>8,441</u>        | <u>Comments</u>   |
|---|---------------------|---|
| Transformed to companies wholly owned by State Treasury             | 1,227               | 183 privatized; 512 to NIFs   |
| Of these, some designated as of "special importance"                | 160                 | Held out of privatization   |
| Liquidated under 1990 Privatization Law (asset sales)               | 1,247               | as of end 1996, 26 cases still pending                              |
| Liquidated under State Enterprise law                               | 1,464               | Only 494 of these completed; by end 1996, 441 in bankruptcy         |
| Insolvent or liquidated under Bankruptcy Law                        | 662                 | 304 of these still in process                                       |
| Taken over by Agency for Agricultural Property                      | 1,654               | Some sold, some some subject to management contracts; figures vague |
| Turned over to local governments                                    | 263                 | Subsequent status not given   |
| Total number of enterprises "subject to "ownership transformations" | 5,592               |   |
| Of which, privatization completed                                   | 1,898 <sup>30</sup> |   |

Thus, official figures suggest that only 22 percent of the starting stock of 8,400 SOEs was privatized after six years of transition. Even taking the smaller number "subject to ownership transformations," the privatization percentage is just one-third. Clearly, despite official statements and hopes, and despite considerable

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<sup>30</sup> Source: Blaszczyk and Woodward, *ibid.*, p. 11, citing the Central Statistical Office, 1997, and other official sources.

prodding and assistance from the World Bank,<sup>31</sup> Poland turned out to be a very slow privatizer.

The question is, does it matter? The fact is that Poland has enjoyed just about the overall best growth record of all European and Central Asian transition countries. It returned to growth more rapidly and with more vigor than most other transition economies, and for a time in the mid-1990s had the highest GDP growth rate in Europe. By late 1999 its GDP was estimated at 125 percent that of GDP at the end of 1989, an excellent record of positive economic achievement. Did the Poles manage this accomplishment despite the slow pace of privatization, or because of it?

In retrospect one can discern a “Polish model of transition” that succeeded without mass or rapid privatization. This consisted of complete liberalization of entry (January 1989); abolition of communist organizations in SOEs and formal endorsement of the power of workers’ councils (end/1989); liberalization of about 90 percent of prices (throughout 1989); stabilization through tight fiscal, monetary and wage policies, including hard budgets for SOEs (January 1990); and near complete trade liberalization and current account convertibility (January 1990).<sup>32</sup> Note, however, that all involved, from Balcerowicz on down, readily admit that this winning policy package was initially regarded as incomplete. Many reformers, and most in the advisory community, felt at the time that the lack of rapid, mass privatization—consistently blocked by union power and a lack of political consensus among the many and vigorously competing non-Solidarity parties, evidenced in the frequent change of governments and ministers—was a serious, probably crippling omission.

Regarding privatization, one can see in hindsight that in the Polish context the introduction of free trade and free entry for new start-up businesses, combined with a tightened budget constraint on most remaining SOEs, and the introduction of the mechanism for spinning-off productive assets from SOEs without formally privatizing them, presented a viable alternative to mass and rapid divestiture. First, in conjunction with quick and extensive small-scale privatization, these policies encouraged the explosive growth of *de novo* private firms, which turn out to be the principal engine of recovery and growth in transition economies. In terms of restructuring they consistently outperform privatized firms, much less SOEs.<sup>33</sup> Second, one also has to admit that the workers’ councils, so worrisome to both Bank staff and external advisors in 1990, ultimately proved to be a positive force in Polish SOEs. In other transition economies—Bulgaria and Ukraine, for example—where the old centralized state structures and sectoral ministries crumbled, where firm managers took over the control of assets, and where

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<sup>31</sup> Early real sector reform operations of the World Bank in Poland included a Structural Adjustment Loan approved in July 1990, a Privatization and Restructuring Loan (with minimal and rather general conditions and lots of technical assistance) and a Financial Institutions Development Loan, both approved in July 1991, and an Enterprise and Financial Sector Adjustment Loan approved in May 1993.

<sup>32</sup> Dabrowski *et al.*, *op. cit.*, p. 12.

<sup>33</sup> A finding confirmed by many, including Oleh Havrylyshyn and Donal McGettigan, “Privatisation in Transition Countries,” *Post-Soviet Affairs*, Vol. 16, (July-September 2000), pp. 257-286.

privatization was accepted in principle but not extensively carried out in practice, but where workers' councils were weak or non-existent, the result was asset-stripping and deterioration of firm quality on a large scale. Poland avoided this outcome by good macro-economic and financial policies, but also because in the firms the workers' councils were keeping an eye on managers, and checking if not totally preventing them from asset-stripping and "spontaneous" privatization. The combination of good policy, vigorously applied, in-firm watchdogs, and small-scale privatization limited both output fall and criminal behavior in Polish SOES.<sup>34</sup>

One might thus argue that the Poles, even if by default more than intent, (i) did well not to privatize their medium and large firms rapidly; and that (ii) many other transition countries would have been better off had they followed the Polish approach and privatized larger firms more slowly.

My view is that the first conclusion is quite conceivable but not proven—and perhaps not provable. The problem is the counterfactual: The same good policy set that minimized production falls in the SOEs might have spurred privatized firms to even better efficiency and effectiveness levels. Some evidence for this was provided (later) by Blaszczyk and Woodward, whose 1999 study on restructuring in Polish firms showed that "ownership status is the most important factor differentiating the sample....the best financial standing or the fastest growth rate was recorded by privatized enterprises." They agree that "indicators for state treasury companies and firms from the Polish privatization group were similar through 1995..." But then the performance of privatized firms ".....stabilized, while state-owned firms have been hit by a dramatic decline caused by the capital shortage barrier."<sup>35</sup> Ownership matters, at least eventually.

Overall, it is undeniable that Poland did well, but the feasibility and the benefits of the privatization path they followed were not at all clear at the outset. And, given the sound policies quickly established and enforced in Poland, they might even have been better off with more and earlier large-scale privatization.

The second assertion, that other transition countries might have done well to adopt the Polish approach, is even more problematic. The problem here is that one cannot borrow a single part of an integrated policy package applied elsewhere and expect it to replicate the full range of effects achieved in the original instance. In other words, it is illegitimate to concentrate on the pace and scope of privatization in Poland without taking into account the surrounding policy and institutional environment. Evolutionary and cautious large-scale privatization worked in Poland because it was enmeshed in a setting of sound and well-applied economic and

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<sup>34</sup> Some, including some at the World Bank, saw this earlier than others. See B. Pinto, M. Belka and S. Krajewski, "Transforming State Enterprises in Poland: Microeconomic Evidence on Adjustment," World Bank Policy Research Working Paper, WPS 1101, 1993, which showed no or insignificant differences in performance between the SOEs and privatized firms in their sample. See also B. Pinto and S. van Wijnbergen, "Ownership and Corporate Control in Poland: Why State Firms Defied the Odds," World Bank Policy Research Working Paper 1308, June 1994, which details the policy and financial measures that contributed to good SOE performance, and explains why privatization was, nonetheless, still necessary. In light of the findings later reported by Blaszczyk and Woodward, this conclusion holds up pretty well.

<sup>35</sup> Blaszczyk and Woodward, *op. cit.* pp. 45-6. They also note that as of late 1999 there was not yet much information on performance on the firms in the NIFs.

financial policies, vibrant new entry, robust political competition, and the rudiments of corporate governance in remaining SOEs provided (certainly) by the workers' councils on the one hand, and (perhaps) by the professional and private NIF managers on the other. Had any one of these mechanisms been absent, the outcomes might have and probably would have been very different. Since few other countries, especially those to the east of Poland, possessed the macroeconomic frameworks and vigorously exercised internal political competition of Poland, it is not obvious that their adoption of slow privatization would have produced equivalent results.

As for the World Bank, it did miss the potential of the workers' councils to serve as a countervailing power—indeed, the only countervailing power at the level of the firm—to managers. But it recognized fairly early on the utility and viability of the alternative route the Poles had found and did not stand in the way of its application.

#### *V — Czechoslovakia*

The first World Bank mission to then Czechoslovakia took place in May of 1990, a few months after the appraisal of the first Polish structural adjustment loan by the Bank. For a variety of reasons, the Czechoslovaks borrowed hardly at all from the World Bank for real sector reform; this remained the case for all governments through the 1990s.<sup>36</sup> But Bank staff entered into an active dialogue with the privatization authorities, particularly in the Czech Republic, and kept up to date on the approach they followed. Bank staff were generally (not universally) persuaded as to the correctness and efficacy of the approach, often employed Czech privatizers to preach elsewhere the gospel and techniques of voucher privatization, and expended considerable effort in analyzing and understanding the method and its effects. Thus, regardless of the lack of direct operational involvement, the path followed in this country is worth analysis since it had a very significant influence on the Bank's privatization efforts elsewhere in the region.

##### *A different starting point....*

Production in Czechoslovakia had been, along with that in the German Democratic Republic, organized and managed in a most classic socialist manner almost up to the moment of the fall of the communist regime. Central planners and branch ministries had retained their dominance. There were no quasi-market mechanisms or small private firms along Hungarian lines, no powerful independent labor union or workers' councils, or much decentralization to firm managers, or private agricultural production, as in Poland, indeed, little experimentation with industrial cooperatives, leases and non-quota production, as in the Soviet Union.<sup>37</sup>

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<sup>36</sup> Vaclav Klaus, Minister of Finance of Czechoslovakia from 1990 to 1992, and Prime Minister of the Czech Republic from 1992 to 1997, doubted the utility of World Bank involvement in the economy. When asked if he needed international technical assistance, he famously replied, "Why pay hard money for soft advice?"

<sup>37</sup> Lajos Bokros portrays pre-transition Czechoslovakia as "a truly neo-stalinist stronghold until the very last minute before the Velvet Revolution." For an excellent discussion of the importance of initial conditions and much else, see his "Visegrad Twins' Diverging Paths to Relative Prosperity: Comparing the Transition Experience of the Czech Republic and Hungary," Analysis based on a lecture presented at the Czech National Bank, September 2000, p. 1.

The country, especially the “Czech lands” of Bohemia and Moravia—what would become after 1992 the separated Czech Republic—had a long manufacturing tradition and produced many comparatively high quality industrial goods for the COMECON countries and some non-COMECON markets. Living standards were about the highest in the socialist bloc and measured inequality about the lowest in the world. Official unemployment in May of 1990 was 1,100—in a country of 16 million. Part of this comparatively good performance was due to the solid economic base with which the country had entered the socialist period in 1948; part of it was due to the intelligence and industry of the Czechoslovak work and managerial force. As someone in the first mission said of the technocrats and plant managers encountered, “these guys are so good they almost made socialism work.”

At the last moment some cracks had appeared in the Stalinist walls: Officials in Prague in May 1990 told the first Bank mission that from late 1988 workers in large firms were allowed to select their managers, from a list of three presented to them by the branch ministry. They said they had regarded this as a revolutionary change at the time. What was striking, however, was that the post-communist regime reversed this decision in April of 1990, and reinstated managerial appointment solely by the branch ministries. Why? Because “the professors and researchers”<sup>38</sup> who made up the new administration accepted—unlike the Poles, with their longer history of struggle and suspicion and the availability of alternatives—that it was the state that had to define and allocate property rights.

Vaclav Klaus, at the time the Federal Minister of Finance, made this clear in his first meeting with the Bank mission. He said that there was an acute need to introduce both a private *and* a public sector. At the moment, he said, there was neither, but only “a fuzzy sector in between.” Defining the division between the two was crucial for the future of the polity and the economy; and defining and allocating property rights was the principal task that would confront the newly constituted public sector.<sup>39</sup> Privatization was the method by which property rights would be assigned.

*Mass privatization through vouchers....*

The body responsible for this process was the newly constituted Board for Temporary Administration and Privatization of State Property (later renamed the National Property Fund), headed by an economist, Dusan Triska—who would become the principal architect of the voucher scheme in the country, and a leading proponent of its application elsewhere. In his first meeting with the mission he expounded his *leitmotiv*; that the overarching purpose of privatization in post-communist systems was to cut the link between the state and the productive firms. Though written later (in 1992), the following summarizes Triska’s position from the outset:

Privatization.....is not just one of the many items on the economic program. It is the transformation itself. Without a well-defined and feasible privatization strategy the program would become just another hopeless

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<sup>38</sup> Bokros, *op. cit.*, p. 2.

<sup>39</sup> Personal notes taken at mission meeting with Minister Klaus and his team, Prague, May 7, 1990.

attempt to reform the unreformable. Privatization is the element that distinguishes transformation from reform. That is why privatization must be conceived of and viewed as an end in itself.<sup>40</sup>

Triska had previously written that “In the highly improbable case that privatization engenders—in the short run—declines in growth and efficiency, it would remain the Government’s policy to privatize.”<sup>41</sup> Speed, he consistently stated, was of the essence: “the faster the better.”

In May 1990 Triska met with the first World Bank mission, and outlined how the process would work: All SOEs would be transformed to joint stock companies. This “commercialization” process would entail some financial restructuring to clean or minimize debt and deal with eroded assets. This restructuring would be the “last task” of the sectoral ministries; following this they would be abolished (and they were).

The policy prerequisites for privatization were price liberalization, a bankruptcy law, and convertibility of the currency. He stated that macroeconomic changes, though necessary, would not be sufficient to alter or guarantee good SOE performance. Therefore, privatization had to be widespread and quick to extend and lock in the incentives coming from macroeconomic change. He explicitly put forward the view that immediate action on divestiture was required despite the imperfect policy and institutional foundation. Delay would simply allow those presently stealing the assets to complete the job. “If we wait too long, there will be nothing left to privatize.” There would be no attempt to reform those firms temporarily left in state hands; the solution was mass and rapid privatization.

How would this be done? Use of the methods applied in the West would take too long, and place the mass of enterprises either in the hands of *nomenklatura* who had stolen money in the communist period, or foreigners; neither outcome would be acceptable. Rather, government would “give quite big portions of the state property to the people,”<sup>42</sup> for free, through vouchers. This program would, said Triska:

- Reward the public,
- Help develop markets in general and capital markets in particular,
- Deal with the problem of insufficient local savings and capital, and
- Generate resources that would pay for the effort of producing information on the firms being privatized.

“Everybody,” said Triska, would be given vouchers (booklets of “coupons” were eventually made available to all over the age of 18, for a fee equal to one week’s average wage), and we must now work out the many details of which firms will be brought into the process, and how the vouchers will be exchanged for shares. Still, he thought the process should be simple. Most people would probably

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<sup>40</sup> Dusan Triska, “Voucher Privatization in Czechoslovakia—1992,” in Andreja Bohm and Marko Simoneti, Eds. *Privatization in Central and Eastern Europe 1992*, *op. cit.*, p. 104.

<sup>41</sup> Dusan Triska and Charles Jelinek-Francis, “A Study of Privatization in the Czech and Slovak Federal Republic,” Bohm and Kreacic, *op. cit.*, p. 119.

<sup>42</sup> Personal mission notes, Prague, May 7 1990.



use their vouchers to buy shares in firms they knew, in their neighborhoods or in the immediate vicinity.

The vouchers would not be convertible to currency, nor would they be tradable (in fact, unlike in many other countries, the vouchers were not denominated in currency units but in “points”); they did not want those with ill-gotten gains to speculate and end up as major owners. Firms to enter the program would be lightly evaluated to determine general prospects and attractiveness for voucher-holders, but this and all other technical, preparatory processes would be, must be, simple and quick. They were aware of the problem of selling off the winners, leaving the state holding the losers. But, he said, who knows whether today’s loser could not be tomorrow’s winner, as changes occur in the macroeconomic framework, the trade regime, managers, etc.?

In this meeting Triska outlined the approach they would use to exchange vouchers for shares. In essence, this consisted of rounds of bidding in which prices, expressed in points per share, in the second and subsequent rounds rose or fell according to the level of demand expressed in the previous round. Early bidders had a high likelihood of getting the amount of equity they wanted, but at a relatively high “price” (expressed in coupon points); later bidders might pay a lower price, but ran the risk of less-than-desired quantity. This scheme was designed to equate supply and demand in a situation of little information. The method was seen as fast, equitable, and a solution to two vexing problems: how to value firms and how to prevent “dirty money” from buying up the assets.

The Bank team was impressed with this presentation, but not completely persuaded. A quotation from mission notes is in order, reflecting the team’s various reactions and questions. The scheme

...strikes one as cumbersome administratively. It doesn’t guarantee revenues, either for the enterprise—for restructuring—or for the government—for financing the social safety net. It places an enormous information burden on the public. People have to decide which enterprises to bid on. They may have to do so in a distorted price and macro environment which, when changed, will result in some seeming winners becoming dreadful losers (and vice versa). Perhaps most important, this scheme in general doesn’t solve the problem of putting good managers in charge of the resources.<sup>43</sup>

Triska dismissed all these queries, especially those concerns about whether the public could make good choices and serve as good owners. Indeed, at one point he asked if the World Bank lacked faith in markets. First, he said, “the present system is more cumbersome, uninformed, unfinanced and unmanaged” than we could imagine; almost any alternative was preferable. Second, we did not understand the strength of the forces still existent in Czechoslovakia that were opposed to rapid change. These opponents were espousing a seemingly reasonable gradualism—but this was a cover for their desire for no change, or even a reversal

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<sup>43</sup> Personal mission notes, Prague, May 7 1990.

of transition.<sup>44</sup> Delay would play into the hands of the anti-reformers. Third, getting good owners with capital and know-how was important, but it must be the second step. The imperative and essentially political, or indeed psychological, first step was to get the firms out of the hands and implicit responsibility of government and into the hands of private citizens. This crucial break with the communist past had to be sweeping and rapid; if it were not, the transition would falter and perhaps slide back.

In an argument later repeated and refined by Russian reformers, Triska placed a lot of faith in the secondary market. He said that lack of capital and managerial know-how would force the new owners to open the equity in the firms obtained by vouchers to external investors having the needed skills and resources. In other words, natural, automatic market forces would eventually supply monied and experienced owners. Note that in this first, long and wide-ranging discussion, no mention was made of investment funds.

*The Rise of Czech voucher privatization...*

It took the reformers somewhat longer than originally anticipated to get started, but the privatization program was launched in 1991.<sup>45</sup> From the outset it was a homegrown product; the Bank's role was limited to that of an interested and then increasingly impressed observer and commentator. By 1995 some 1800 medium and large firms had been privatized through two waves of a voucher process. Another 350 enterprises had been sold on a trade sale basis to strategic investors; and substantial assets had been transferred to local authorities or restituted to identifiable owners who had suffered expropriation by the communists.

Public interest in vouchers was originally quite weak, but picked up dramatically after dozens of private investment funds came into being, claiming specialized information, promising to diversify risk, and in several cases guaranteeing positive returns on any investment.<sup>46</sup> Citizens responded by buying vouchers, with 70 percent putting their vouchers into investment funds in the first round, and slightly less in the second. At the end of the voucher exchange most citizens thus held shares in an investment fund, and not in a specific firm; and the investment funds became the major holders of all privatized equity.

The initial results were tremendously encouraging. Privatization contributed to the rapid growth of the private sector share of GDP, which reached a region-leading 74 percent by 1996. Exports shifted from Eastern to Western markets. Growth resumed, having spent but a brief time in low negative territory, and topped six percent in 1995. This transformation and growth were accompanied by single digit inflation and, most surprisingly, extremely low rates of unemployment. Compared to Poland and Hungary, with their initially high rates of unemployment and difficult to contain inflation, the Czech Republic looked good. Compared to

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<sup>44</sup> Some opponents of rapid change advocated a "third way" to transition, somewhere between socialism and rampant capitalism; this allowed Mr. Klaus to declaim: "The 'third way' is the shortest route to the Third World." (Mission notes, May 1990)

<sup>45</sup> As in Poland and Hungary, the mass of small firms and business units were auctioned off at an early date, with generally positive results.

<sup>46</sup> As noted, citizens had to pay about a week's wage to obtain the coupon booklet; the guarantee offered by the investment funds was a multiple on that original purchase price.

Russia and many points east, it looked miraculous. By 1996 Prime Minister Klaus could state that the transition was more or less complete and henceforth the Czech Republic should be viewed as an ordinary European country undergoing ordinary political and economic problems. He characterized the voucher privatization program as “rapid and efficient.”

Most observers and most World Bank staff working on the real sector in transition agreed.<sup>47</sup> The early and apparently resounding success story influenced Bank staff in their recommendations on privatization in general and voucher use in particular in a number of other transition countries. Table 2, below, shows the principal and secondary methods of privatization employed in transition economies. In nine of 26 reviewed countries vouchers were the prime divestiture method; in 10 they were the secondary method. In several instances, such as shall be shown for Russia, the World Bank did not initiate the voucher idea; but in many cases the Bank pushed for the use of this method. Moreover, it was quite clear in this period that the Bank generally approved of the method and was willing and able to aid in its implementation.<sup>48</sup>

In addition, in several cases, in Bulgaria (for sure) and possibly elsewhere, the Bank employed the dynamic and persuasive Dusan Triska to explain the Czech approach and techniques to seemingly reluctant or slow privatizers. Czech representatives featured prominently in Bank-sponsored and supported seminars and conferences of the period, disseminating what they increasingly assumed to be “the” correct privatization method. The Bank’s 1996 World Development Report on transition noted some potential problems but concluded: “The Czech Republic’s mass privatization program has been the most successful to date.”<sup>49</sup> In 1997, two widely cited Bank research publications offered empirical data supporting the claim that the Czech privatization program was producing solid and positive results.<sup>50</sup> The point is that, in the mid-1990s, when one looked to the World Bank for guidance on how to privatize in a transition setting, the Czech model was clearly the recommended approach.

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<sup>47</sup> Not all; for example David Ellerman had long expressed doubts as to the utility of the approach, and later wrote a strong critique of the approach; see his “Voucher Privatization and Investment Funds: An Institutional Analysis,” World Bank, Working Paper No. 1924, May 1998.

<sup>48</sup> The Bank was not alone in this; most other donors, including the EBRD, the EU, USAID and several other bilaterals, endorsed, advanced and supported this approach.

<sup>49</sup> World Bank, WDR 1996, *From Plan to Market*, p. 56.

<sup>50</sup> Roman Frydman *et al.*, “Private Ownership and Corporate Performance: Some Lessons from Transition Economies” (Washington, D.C. World Bank Technical Paper No. 1830, 1997), and Gerhard Pohl *et al.*, “Privatization and Restructuring in Central and Eastern Europe—Evidence and Policy Options” (Washington, D.C. World Bank Technical Paper No. 368, 1997). Note that both of these studies used firm level data dating from the first few years of transition. The data set analyzed by Frydman *et al.* ran through 1994; Pohl and his team reviewed data through 1995 or 1996.

**Table 2**  
**Scope of Privatization & Method Used—1999**

| <u>Country</u>  | <u>Large scale score*</u> | <u>Primary method</u> | <u>Secondary</u> |
|---|---------------------------|-----------------------|------------------|
| <u>method</u>   |                           |                       |                  |
| (In descending order, according to amount of privatization completed) |                           |                       |                  |
| Czech Republic  | 4                         | Voucher               | Direct           |
| Hungary   | 4                         | Direct                | MEBO             |
| Slovakia  | 4                         | Direct                | Voucher          |
| Estonia   | 4                         | Direct                | Voucher          |
| Poland  | 3.3                       | Direct                | MEBO             |
| Russia  | 3.3                       | Voucher               | Direct           |
| Kyrgyzstan  | 3                         | Voucher               | MEBO             |
| Lithuania   | 3                         | Voucher               | Direct           |
| Georgia   | 3.3                       | Voucher               | Direct           |
| Slovenia  | 3.3                       | MEBO                  | Voucher          |
| Bulgaria  | 3                         | Direct                | Voucher          |
| Croatia   | 3                         | MEBO                  | Voucher          |
| Kazakhstan  | 3                         | Voucher               | Direct           |
| Latvia  | 3                         | Direct                | Voucher          |
| Macedonia   | 3                         | MEBO                  | Direct           |
| Moldova   | 3                         | Voucher               | Direct           |
| Armenia   | 3                         | Voucher               | MEBO             |
| Romania   | 2.7                       | MEBO                  | Voucher          |
| Uzbekistan  | 2.7                       | MEBO                  | Direct           |
| Ukraine   | 2.3                       | MEBO                  | Direct           |
| Azerbaijan  | 2                         | MEBO                  | Voucher          |
| Albania   | 2                         | MEBO                  | Voucher          |
| Tajikistan  | 2                         | Direct                | Voucher          |
| Turkmenistan  | 1.7                       | MEBO                  | Direct           |
| Belarus   | 1                         | MEBO                  | Voucher          |
| Bosnia  | NA                        | Voucher               | Direct           |

Source for the scores and estimates of methods: EBRD, *Transition Report 1999*, p. 32.

\* The score is the numerical ranking of the EBRD; its classification system for assessing progress in large-scale privatization is: 1 — minimal progress; 2 — scheme ready for implementation; some firms divested; 3 — more than 25 % of assets privatized; 4 — more than 50 % of assets privatized, and substantial progress on corporate governance; 4+ — more than 75 % of assets in private hands; standards and performance comparable to advanced industrial countries.

*...and the fall.*

While Poland and Hungary continued to enjoy four and five percent growth rates, the Czech GDP growth rate fell by 40 percent in 1996, sunk to 0.3 percent in 1997, turned negative in 1998, and did not recover markedly until 2000.<sup>51</sup> Several factors account for the prolonged slide, aspects of privatization among them. First, the privatization investment funds were insufficiently regulated; this “opened the door to a variety of highly dubious and some overtly illegal actions that enriched fund managers at the expense of minority shareholders, and harmed the health of the firm...” Second, some of the largest of these funds were owned by local banks, which themselves were only partially or not at all privatized. Investment funds owned by banks “tended not to treat aggressively poor performance in firms, since pulling the plug would force the fund’s bank owners to write down the resources lent to these firms.”<sup>52</sup> These banks, in turn, persisted in lending or rolling over loans to poorly performing firms privatized by vouchers. As late as the summer of 1998, the CEO of one of the largest Czech banks stated that as “a national institution”<sup>53</sup> his bank could not ignore the needs of Czech industry, even in instances where the appraisal numbers were weak.

The results were twofold: (i) The expropriation (called “tunneling”) of firm assets by investment fund and firm managers<sup>54</sup> defrauded many minority shareholders and led to widespread public dissatisfaction with privatization, and (ii) the tunneling, and deficiencies in the capital and financial markets, retarded needed restructuring in the privatized firms, leaving them overstaffed, undercapitalized, unable to raise investment funds, and poorly managed. The low unemployment rate, formerly seen as a sign of success, began to be interpreted as an indicator of lack of change in the firms.

An additional factor causing problems was that a number of foreign portfolio and institutional investors had entered the Czech stock exchange, anticipating steady positive returns on the privatized firms’ and investment funds’ equities they obtained. As pervasive tunneling led to severe price drops in the minority shares of many firms and funds, these investors were burned. Unlike most Czechs, who could do little but grumble, the international investors could make a great deal of noise, on the street, in the financial press and in meetings with officials.<sup>55</sup> The international image of the Czech Republic suffered.

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<sup>51</sup> At time of writing, in the first half of 2001 GDP growth rate in the Czech Republic is 3.9%; versus 0.9% in Poland, and 4.0% in Hungary.

<sup>52</sup> John Nellis, “Time to Rethink Privatization in Transition Economies?” in O. Havrylyshyn and S. Nsouli, editors, *A Decade of Transition: Achievements and Challenges* (Washington: IMF, 2001), p. 170.

<sup>53</sup> At the time of the interview this particular bank was, in theory, privatized. But government retained 45% of the equity and another 15% was in the hands of local governments, and not normally voted. Government thus remained the largest single and dominant shareholder; and this was the case for the other major banks up to 1998, and beyond in some cases.

<sup>54</sup> Given weaknesses in the legal framework, many of these acts were formally legal; thus, one cannot use the term “theft.”

<sup>55</sup> Then Czech Minister of Finance Ivan Pilip attended a dinner in New York in 1997, given by a group of Wall Street investment firms, the representatives of which complained of what they saw as criminally poor regulation of Czech capital markets. They explicitly blamed Mr. Pilip and his predecessors for the substantial losses this had caused them and their clients. Mr. Pilip was unfazed;

Academic papers began to appear, asking whether the voucher approach to privatization was living up to its promises—or at least the implied promises. One of the first critiques was by Pavel Mertlik, who in 1995 questioned both the extent of privatization (noting the large amount of assets retained, directly or indirectly, by the state), and whether the scheme was producing, or was even capable of producing, concrete, good owners.<sup>56</sup> Criticism appeared of the investment funds, arguing that their very design made it unlikely that they could or would “enhance the value of their holdings.”<sup>57</sup> Another paper reviewed financial performance of a set of firms and argued that there was no evidence that funds were managing shares well; but the authors did find that “ownership concentration in hands other than funds had a major and positive effect on performance.”<sup>58</sup> That is, the set of Czech companies initially privatized to core investors (often foreign) were generally doing well, supporting Kornai’s argument that the key to good privatization was finding good owners. Subsequent research has largely confirmed that concentrated, core owners—of the type produced by trade or “case-by-case” sales, but not by voucher schemes that disburse ownership widely in a population—are associated with more, faster and better restructuring<sup>59</sup>—though it may be that countries with good policy frameworks attract core investors, while poor policy countries do not; and it is the policy environment as much or more than the degree of ownership concentration that accounts for the progress seen.

So, concentration of ownership is probably not the whole of the story. In the Czech Republic and elsewhere, secondary trading, led by privatization investment funds, did produce a high percentage of concentrated owners within two

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he fielded their criticisms calmly and competently, arguing that the worst was over and corrective mechanisms installed.

<sup>56</sup> See Pavel Mertlik, “Czech Privatization: From Public Ownership to Public Ownership in Five Years?” in Barbara Blaszcyk and Richard Woodward, *Privatization in Post-Communist Countries* (Warsaw: Center for Social and Economic Research, 1996), pp. 117-21. Mr. Mertlik was a left-leaning economist at the time he wrote the article, quite critical of privatization. In 1998 he became Minister of Economy in the social democratic government elected in that year; he later became Minister of Finance, where his policies and actions earned the high respect of the business and international community. Mr. Mertlik resigned from the government in April of 2001, partly because he was unable to convince his more interventionist cabinet colleagues to speed the few, but very large and important, remaining privatizations, and partly due to his opposition to proposals to subsidize ailing industries.

<sup>57</sup> To its credit, it was the World Bank that published these criticisms; the citation is from Katherina Pistor and Andrew Spicer, “Investment Funds and Mass Privatization: Lessons from Russia and the Czech Republic,” World Bank, *Viewpoint* No. 110, 1997.

<sup>58</sup> A. Weiss and G. Nikitin, “Performance of Czech Companies by Ownership Structure,” Boston University, unpublished paper delivered to World Bank seminar, 1997, p. 21.

<sup>59</sup> The most recent and rigorous analysis confirms the general (though not total) superiority of private over state ownership, and among private owners, the superiority of concentrated over diffused owners. Note that the data also reveal a large variation in results by subregion, with privatizations in East and Central Europe and the Baltics yielding generally positive results, while those in Russia and the other parts of the Commonwealth of Independent States (CIS) yielding much poorer, and in a very few cases, negative results. See Simeon Djankov and Peter Murrell, *The Determinants of Enterprise Restructuring in Transition: An Assessment of the Evidence* (World Bank, September 2000). “Restructuring” refers to the cost cutting, efficiency- and competitiveness-enhancing steps required to position a firm to survive and thrive in a market environment.

years of the voucher auctions.<sup>60</sup> After the break-up of the federal state, the Meciar government in now independent Slovakia abandoned the second round of voucher privatization and turned over a mass of manufacturing firms, at very low prices and with long payment periods, to concentrated owners—the bulk of them politically connected to Mr. Meciar and his party. In both cases, and in others one could cite, the resulting concentrated owners were not associated, at least in the short term, with improvements in output, restructuring or probity.

The important point is while concentrated owners may be a necessary condition for successful enterprise transformation; they are not a sufficient condition. They have to be buttressed and guided by policy and regulatory frameworks in capital and financial markets that shed light on corporate decisions and actions, create and sustain proper procedures (regarding trading channels for example), and offer protection to minority shareholders and creditors. Indeed, one reason why direct foreign investment is so important is that the higher reputational risk of such investors may lead them to adhere to decent behavior standards, even in the absence of local regulations or enforcement capacity. The conclusion is that the nature of the new owner is important, but so is the legal and institutional climate into which the firm is divested.

By 1998 the bloom was very much off the Czech privatization rose, to the point where an OECD country review could state bluntly that Czech voucher privatization produced ownership structures that “...impeded efficient corporate governance and restructuring.”<sup>61</sup> Since that time, government has addressed the deficiencies in the legislative and legal framework, particularly with regard to investment funds and capital markets, privatized fully or more completely most of the commercial banks, and started—but has not yet completed—the last remaining large privatization projects, in electricity, energy, radio-television, and railways.

#### *Implications*

The implications of this brief review are several: From the viewpoint of the Czech economy, one could argue that the application of the voucher approach resulted in substantial losses and missed opportunities. The approach turned over—planned or not—the bulk of the equity privatized by vouchers to investment funds. This was combined with the insufficiency of prudential regulation in capital and financial markets, the failure or inability to attend to corporate governance concerns, the continuing state ownership and influence in the banking sector, and the ownership of investment funds by banks. This mixture resulted in a small group of people benefiting while the mass of citizens received little or nothing from the transfer of former state property. Equally and perhaps more important, the approach failed to impose sufficient constraints and incentives on the new owners to restructure the firms. Kornai notes that labor productivity in Hungary in 1998 was 36 percent higher than in 1989; in Poland it was 29 percent higher. The Czech Republic registered a six percent increase.<sup>62</sup> It is reasonable to assign some of the explanation for this to the mass privatization method.

<sup>60</sup> Stijn Claessens and Simeon Djankov, “Ownership Concentration and Corporate Performance in the Czech Republic,” *Journal of Comparative Economics*, Vol. 27 (1999); see Table 1 B, p. 503.

<sup>61</sup> OECD, *The Czech Republic* (Paris, OECD, 1998), p. 49.

<sup>62</sup> Kornai, “Ten Years After...,” *op. cit.* pp. 10-11.

The average citizen's utility was probably increased more by the trade sales than the voucher privatizations.<sup>63</sup> Had the Czechs applied more widely this case-by-case approach (as did Hungary and Estonia, for example) then one might have seen faster restructuring, a less severe recession, and a smaller and less costly problem of bad debts in the banks.

In response, the Czech architects of the program would downplay the costs and criticisms of the voucher approach.<sup>64</sup> They could note that the group of firms sold by means other than vouchers were arguably the "blue chip" enterprises, of high potential; and they could say that many of the companies privatized through vouchers would not have attracted core, and certainly not foreign, investors. They might argue that the option of leaving these firms in state hands was not open to them, since, unlike the Poles, they had no workers' councils; that is, no countervailing mechanism in the firms to watch over the managers. They could note that concentrated owners did arise in fairly short order in many of the firms privatized through vouchers. The Czechs could also say, look around the region and note how very few countries have been able to mount good, extensive case-by-case programs. The countries that have successfully applied case-by-case as their principal sales method—East Germany, Estonia and Hungary—had different or superior, and in the case of Germany, unique starting conditions, or, in the case of Estonia, a situation where sales to foreign investors were welcome because of the fear of Russian domination. On the larger political front, the Czech reformers could state, correctly, that the near total collapse of communism was not predictable. One could not have known at the outset how weak the forces of reaction would prove to be, and how much time was thus available to experiment with ownership reform, and to attend first to the institutional and legal foundations of privatization.

All these arguments have merit, though the conclusion is still that history and geography endowed the Czechs with many more chances for direct, case-by-

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<sup>63</sup> In the sense that these privatized firms are among the most profitable, dynamic firms in the economy, and, in contrast to most voucher-privatized firms, they have increased their workforces, improved conditions of work, and generated growth among local suppliers. At least the Czechs did sell a set of firms in this manner; the Russians did not—and are still paying the price for this.

Firms privatized to foreigners recently received support from an unusual source. In a seminar at the Bank/Fund Annual Meetings in Prague in 2000, Mr. Richard Falbr, Secretary General of the Czech-Moravian Trade Union Congress, stated that union members had opposed privatization in general and privatization to foreigners in particular. Experience has led them to change their views, he said; "we now see that the flag outside the building is less important than the quality of management within." Falbr said that foreign owners, especially from multinational corporations, tended to be easier to negotiate with than Czech owners, and more likely to accede to union demands.

<sup>64</sup> One could expect a spirited defense of the approach taken. As an illustration, in a seminar in Warsaw in late 1999 to review ten years of transition, Vaclav Klaus was asked to account for the relative poor performance of the Czech economy vis-à-vis those of Poland and Hungary in the past several years. He said first that the differences were quite minor and would be invisible and unremembered in a few year's time, and second, that what economic problems existed in the Czech economy were attributable solely to the excessively tight interest rate and monetary actions of the independent Czech Central Bank, and not at all to the policies of his government, prior to his stepping down from the Prime Ministership in November of 1997. At an earlier seminar (in Ljubljana), when asked what he might change in his policies and approach in the light of experience, he had answered, "nothing whatsoever."



case sales than they seized. The least that one can say is that opportunities were missed.

From the point of view of the World Bank, the general infatuation with the Czech voucher approach<sup>65</sup> reveals a number of interesting points:

- *The primacy of the economic.* Here, and even more so in Russia, most Bank staff tended to agree with those reformers who thought that ownership change was "...not just a necessary condition of capitalism, but a sufficient one."<sup>66</sup> As several observers have noted, the primacy of the economic was almost Marxian in its intensity. This led to the belief that
- *The required legal/institutional framework would arise from demand by the new, private property owners.* Many reformers and their Bank supporters did see the need, the urgent need, for legal, regulatory and administrative mechanisms to channel and guide the acquisitive behavior of property owners. But they hoped and believed that this increasingly populous and powerful group would itself pressure government for, and support the creation of, the required institutional framework. Bank staff generally agreed with this reasoning, and tended to downplay or reject alternative approaches because of
- *A strong bias towards concrete, substantial and near-term action, as opposed to necessarily less dramatic actions laying the foundation for future developments.* Voucher programs cut through the many and serious obstacles/questions posed by direct sales. How to attract investors? How to value the entities being sold? How to enforce contracts in the post-sale period? Use of vouchers made it relatively easy to meet quantitative conditionality targets on numbers of firms, or percentage of assets privatized; other methods<sup>67</sup> were slower, more complicated, and more prone to delay. Bank operations and Bank staff had—and have—a predilection for immediate and substantial action as opposed to longer term, “foundation laying” measures. Thus, the reformers’ arguments on the need for speedy and massive transfers fell on receptive ears.

## **VI — Russia**

From the very beginning it was clear that Russia would be a special and more complex transition case, particularly with regard to real sector reform. Poland and the Czech Republic were geographically and historically part of central Europe, with long-standing commercial, legal and institutional ties with Western markets and cultures. Both were part of the communist bloc for about 40 years, meaning that there were plenty of citizens in both countries who remembered the non-communist past. Both could dust off old laws and memories and try to re-start a rusty but not completely forgotten system.

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<sup>65</sup> This author was among the infatuated.

<sup>66</sup> Kornai, “Ten Years After....,” *op. cit.* p. 15.

<sup>67</sup> Management-employee buy outs (MEBOs) were also relatively simple and fast, especially when installment purchases were allowed or encouraged, as they were in Romania, Slovenia, Croatia and elsewhere; see Table 2. There is little evidence that this divestiture method is associated with extensive post-sale restructuring.

This was not the case in Russia. Its socialist experience had endured for more than 70 years. In any event, despite considerable progressive strides in the twenty years prior to the Revolution, Russia was not a full-fledged capitalist system in 1917. This heritage resulted in much more uncertainty at the end of the socialist period than in countries farther to the west.

*First contact....*

The first Bank mission (in conjunction with the Fund, the European Bank for Reconstruction and Development, and the Organization for Economic Cooperation and Development) to the then Soviet Union took place in September-October of 1990. Regarding enterprises, it found confusion. There were, reportedly, 47,000 medium and large-sized industrial firms in the Soviet Union as a whole; adding the energy, infrastructure and large service-oriented firms brought the number to 55,000. Many of these were classed as “amalgamations,” “associations” and “concerns;” that is, multidivisional entities containing subunits that could be regarded as self-standing companies. This meant that the actual number of state-owned productive units was higher than the official numbers indicated.

As in some other socialist states, the way in which these enterprises functioned had been evolving, slowly in the 1960s and 70s, and then much more rapidly in the mid-1980s with the advent of Gorbachev’s *perestroika* reforms. A 1987 Law on State Enterprises reduced the power of the branch ministries in favor of enterprise managers and workers. Firms were given an increased capacity to negotiate planned annual production, modify products to meet consumer demand, market their products abroad, contract with foreign partners, retain an increased amount of any foreign exchange earned, and allowed to look for credit outside the traditional funding sources. Some enterprises had won the privilege to sell some or all their production to any willing buyer, at a more or less “market” price; this privilege was to be expanded. “The goals of these changes were to decentralize some decision-making to the level of the firm, to widen the scope for personal and private initiatives, and to substitute (partially) indirect financial signals for direct planning as a means to guide enterprises.”<sup>68</sup> It was already clear at the time that the managers had gained most of the controlling power in this shift; other than make claims for wage increases, workers tended to defer to managerial decisions.

The 1987 law also allowed increased latitude for nonstate forms of enterprises; i.e., joint ventures, leases, cooperatives, “collectively owned” and “limited” firms. Data were scant on the exact organization, total number and impact of nonstate firms, but it was thought that these tended to be small in size, growing in number, and more productive than the larger enterprises out of which they had been spun. Spokespersons in the cooperative movement claimed 215,000 units in existence in October 1990, accounting for five percent of “net material product,” employing 5.2 million people, registering huge output and employment increases in the past two years, and growing rapidly. Another source stated that 12,500 leasing arrangements were officially registered, and estimated that many more were in informal existence. Enterprise interviews revealed one or more leases

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<sup>68</sup> John Nellis, *Improving the Performance of Soviet Enterprises*, World Bank Discussion Paper No. 118, March 1991, p. 3.

or cooperatives in every firm visited, and the contrast was striking between the dynamism and enthusiasm shown by managers and workers in these units and the lethargy generally prevailing elsewhere—not surprising, given that employees in these nonstate units escaped the wage caps that still were applied in the traditional firms.

Some have argued that these promising developments should have been greatly encouraged and extended, and, had that been done, that the nonstate sector—operating somewhere in between private and public ownership—could have evolved and become, as it did in China, a major contributor to employment and growth.<sup>69</sup> The implication is that the subsequent dismantlement of the real sector and the attempt to reconstruct it in largely privatized fashion was both unwise and unnecessary, and that a less revolutionary, less painful, more incremental and productive path had been available, and should have been chosen.

That was not the way the IFI mission saw it:

A process of spontaneous privatization is taking place in large sectors of industry through the leasing of facilities to cooperatives consisting of the managers and workers of state enterprises. Given the uncertainty of ownership rights, including the right to sell enterprise assets, the incentives of the new managers tend towards short-term income maximization at the cost of enterprise decapitalization.<sup>70</sup>

The IFI mission assessed the nonstate sector as an improvement, in incentive and productive terms, over SOEs, but as an inadequate and improper basis for long-term growth and transition. Inadequate because the lessees, and those in cooperatives, controlled the assets (liabilities remained in the parent firms) but did not own them; and it was apparent that the weakened state was in no position to monitor and enforce the obligations of the lessees to maintain the health of the assets. Improper because it seemed clear that managers in SOEs were using their new-found latitude to hive off the higher quality assets in their firms to leases and coops in which they personally had a stake. Nonstate activities thus appeared to be thinly disguised expropriation of good assets by managers and favored groups of workers, and not a foundation on which one could base a policy of real sector reform.

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<sup>69</sup> This is the general argument of Peter Nolan, for example. “Tragically, the Soviet economic system had a large potential for improvement under a suitable set of incremental reforms. It was not necessary for there to be a period of ‘surgery’ and steep decline of output and living standards before improvement set in.” See his *China’s Rise, Russia’s Fall* (New York: St. Martin’s Press, 1995), p. 311. He adds, however, that “...successful implementation of such policies required the maintenance of a strong and effective state apparatus...” without indicating just how that last, crucial political condition could have been fulfilled. Specifically with regard to unleashing the Russian lease-holders and cooperatives, Joseph Stiglitz later argued that “(R)eformers who recognize that real transformation requires participation and involvement would have welcomed this reform movement and would have pushed it all the way to full privatization...In Russia, the leasing movement was stopped dead in its tracks in favor of voucher privatization.” “Whither Reform? Ten Years of the Transition,” paper delivered at the Annual Bank Conference on Development Economics, Washington, April 1999, p. 24. More discussion on Stiglitz’s arguments is offered below.

<sup>70</sup> *The Economy of the USSR*, *op. cit.* p. 26.

In view of the tremendous contribution to investment, production and growth made by nonstate firms operating under what has been termed “fuzzy property rights” in China,<sup>71</sup> it is possible that an opportunity was missed in not pushing harder for a general unleashing of these halfway measures to private industrial ownership. But the conditions prevailing in Russia were quite different from those in China, where fairly well-functioning local governments were able to subject nonstate firms to competition, and had the capacity and authority to step in and correct at least some of the most egregious self-enrichment by firm managers, and where the central state could impose some discipline and penalties on the flagrantly corrupt. Since that was decidedly not the case in Russia,<sup>72</sup> a recommendation to follow this approach (it probably would not have been adopted even if recommended; but that is another story entirely) would likely have resulted in the further empowerment of managers. In the absence of competitive and institutional checks on their behavior, this probably would have produced neither production gains nor social benefits. One cannot say for sure, but it was not then thought (and I do not think now) that this approach would have worked.

Thus, the real sector reform policies advanced by the 1990 IFI report were (i) eventual full privatization of “almost all enterprises in the USSR.” Concluding that this was a long-term proposition, the report called for demonopolization and commercialization of the SOEs, the imposition of hard budgets, and efforts to approximate the effects of private sector management through state holding companies.<sup>73</sup> In the final analysis, the issue became moot: the impact of these recommendations was nil, as the political disintegration of the Soviet Union, and the rebirth of Russia, occupied center stage from the end of 1990 through to the fall of 1991.

*The Mass Privatization Program....*

As the political dust settled, the World Bank was called back to Russia, in November of 1991, to assist the newly appointed Gaidar government in its privatization efforts. It found this government thoroughly committed to the concept of privatization; leading officials entertained no hopes that one could reform state firms by means other than divestiture. There was thus no interest in state holding companies, performance improvement in SOEs, or any other halfway houses such as leasing and cooperatives. However, exactly how privatization should and could proceed was unclear.

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<sup>71</sup> The extent and nature of the Chinese nonstate sector’s contribution was not fully documented in 1990, but enough was known—much of it from World Bank research and reports—to make it plausible that one might have made a recommendation to follow this path.

<sup>72</sup> Peter Murrell characterizes, in an admittedly exaggerated manner, the distinction in approach at the end of the 1980s in the two countries as follows: “The Chinese were given a license to compete and a death sentence for stealing; the Russians were given a license to steal and punishments for competing.” (Personal communication, July 2001) This lends weight to the interpretation of the situation in the IFI report.

<sup>73</sup> *The Economy of the USSR*, *op. cit.* pp. 26-28. In light of later events, it is worthwhile to quote the report’s statement on mass privatization through vouchers. While acknowledging that their use could speed up ownership transfer, “...such giveaways have a number of disadvantages. Most importantly a voucher system would result in widely scattered ownership which would be unlikely to result in effective monitoring of enterprise managers.” (p. 26)

The government had recently appointed a new head and assistant head of the State Committee for Property Management (GKI, from its Russian initials; this later became a Ministry, or MKI), one of the bodies responsible for privatization; these were Anatoli Chubais and Dmitri Vasiliev, both from Leningrad (as it still was), the leading reform city in the country; they were producing a plan of action. As in Czechoslovakia, these officials had been “professors and researchers.” They had some legislative base to guide them: In July of 1991 (before the final collapse of the USSR) the Russian Supreme Soviet had passed two relevant laws; one on Privatization of State and Municipal Enterprises in the Russian Federation, the second on Personal Privatization Accounts. Neither law was terribly detailed. The Privatization act established that government must submit to the legislature an annual program specifying what would—and what would not—be divested, and in what manner. It assigned management responsibility for parts of the process to several different bodies, but there appeared to be considerable overlap in the responsibilities. It gave enterprise workers collectives the power to approve or reject, or at least delay, privatization proposals. It said very little about foreign investment and ownership. The second act vaguely indicated that “investment certificates” would be distributed to all citizens for use in the privatization process.

In the troubled political situation after August 1991, nothing had been done to implement these laws. In late October, Yeltsin announced that privatization must now go forward. Debate intensified over how to proceed. The threat of a communist resurgence was palpable, much more so than in Poland or Czechoslovakia. The attempted coup had taken place in August of 1991, and the only slightly reformed Communist Party was still a major presence in the legislature and, for all one knew, in society at large. The reformers argued that speedy and decisive action was required, but—as in Poland—the various key actors in the process had differing and often competing ideas. Workers, managers, branch ministries (rapidly transforming themselves into “industrial associations”), and the sub-national governments were all putting forward claims.

The November 1991 Bank mission gravitated naturally towards dealing with and supporting the GKI. The July law assigned it (more or less) the prime responsibility for policy-making and program design. Its leaders were young, clear-headed, market-oriented reformers who saw their primary objective as advancing privatization rapidly and transparently. It was the only agency the mission encountered that was using high quality, obviously competent technical assistance; and the leaders had already established contact with supportive and enthusiastic Western academic advisors—who were marshalling financial and technical support for the organization. Thus, the GKI had the authority, the vision (what seemed to us the proper vision, one might add) and the capacity to act; and the World Bank began at this time its long relationship with this agency and its ministerial successor.

In the November 1991 meeting Dmitri Vasiliev had stated an aversion to vouchers, but by April of 1992 a mass privatization program had been defined, cleared by the executive and submitted to the legislature, with vouchers as the centerpiece. The now-familiar and overpowering logic was at work: Sales for cash would be too slow, would exclude the bulk of the populace, and thus might

stimulate political opposition to privatization in particular and reform in general. Giving away shares only to the workers in that particular firm was fine if the firm were a winner; otherwise not. Moreover, this policy would exclude the military, civil servants and professionals from ownership. A mass program based on vouchers for all citizens seemed the only available way to deal with these concerns.

This reasoning was accepted, and the reformers and their supporters swung into action. Between the spring of 1992 and the end of June 1994, the Russian authorities—actively supported by the Bank, the IFC, the EBRD, USAID and the EU, and with important smaller inputs from other donor organizations such as the British Know-How Fund—organized and implemented the largest and fastest privatization program ever seen, then or since.

In just two years the Russian government was able to....: (1) corporatize and register over 24,000 medium and large state-owned enterprises as joint stock companies; (2) distribute vouchers to virtually the entire population in some 89 oblasts, territories and autonomous republics; (3) privatize over 16,500 enterprises, most of which were in the tradable sector. Over forty-one million Russian citizens became shareholders through either direct ownership of shares in the newly privatized companies or share ownership in voucher investment funds. Moreover, private hands control more than fifty percent of Russia's industrial production and twenty-two million workers are employed by private enterprises.<sup>74</sup>

These accomplishments came at a price: The need to reward the key stakeholders had led to firm managers and workers, “insiders” as they became known, ending up with a dominant 2/3 of the shares in about 2/3 of all firms divested.<sup>75</sup>

The World Bank was deeply involved in every step in this process. In the crucial policy-making days of December 1991 and January 1992 the IFC Resident Representative in Moscow (the only Bank group person consistently on the scene) had provided and channeled advice and badly needed logistical support; IFC's critical contribution needs to be acknowledged. The IFC later became the primary supporting force for the extensive and highly regarded program of small-scale privatization through auctions, in Nizhny Novgorod and other Russian cities. (As is generally the case, few Russians were or are troubled by small-scale privatization.) From mid-1992 on, there were frequent Bank missions to prepare a Privatization Implementation Technical Assistance loan, in the course of which advice and

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<sup>74</sup> Ira Lieberman and Rogi Veimetra, “The Rush for State Shares in the ‘Klondyke’ of Wild East Capitalism: Loans-for-Shares Transactions in Russia,” *George Washington Journal of International Law and Economics* (Vol. 29, No. 3), 1996, p. 739.

<sup>75</sup> For a discussion of the politics of the process see Andrei Shleifer and Daniel Treisman, *Without A Map: Political Tactics and Economic Reform in Russia* (Cambridge: MIT Press, 2000). Shleifer was a key participant in the process; see his earlier (with Maxim Boycko and Robert Vishny) *Privatizing Russia* (Cambridge: MIT Press, 1995). For data on the outcomes of voucher privatization see Joseph Blasi *et al.* *Kremlin Capitalism: Privatizing the Russian Economy* (Ithaca: Cornell University Press, 1997). Note that the reformers had taken some steps to prevent insider dominance, but had been defeated on this matter by the need to bring stakeholders on board, and by the high rate of inflation, which wiped out the financial barriers they had tried to erect against insider control.

assistance was provided on the design, mechanics, production, distribution and use of the vouchers; on a wide range of matters related to preparing the selected firms for entry into voucher auctions and the mechanics of the auctions themselves; on the gamut of issues surrounding the distribution, registration and recording of shares; on a host of legal concerns that arose; on assisting a “National Auction Process” in 80 participating oblasts; in managing the cash sales that accompanied the voucher auctions; and in helping staff, furnish, promote and defend the GKI.

The Bank, jointly with the EBRD, in 1992 prepared and negotiated this loan of close to \$100 million. Disbursements were seriously held up by political and legal issues in Russia, and by Russia’s ability to generate much of its needed TA through grant-funds. USAID (and others) then undertook many of the privatization assistance activities, but all involved acknowledged their reliance on the detailed appraisal and tactics established by the Bank and set out in the loan documents. The point is that the extent of the support provided by the Bank to the Russian MPP cannot be discerned simply by reviewing disbursements. The sums in the first Bank privatization assistance loan were, I believe, transferred to other, later privatization efforts, to consolidate and extend the MPP, and move into the next, post-voucher phases of privatization—parts of which are discussed below

At the end of the voucher privatization effort in 1994 almost all involved assessed the experience as positive. Dmitri Vasiliev summed up the “basic lessons” for those starting later:

- Privatization should be carried out in the “shortest possible period of time, using...the simplest and most standard procedures...”
- “Restructuring should be postponed until the completion of privatization.”
- “The maximum possible amount of property should be transferred to the population on a free basis.”
- Incentives should be provided to enlist the support of all important stakeholders, including “workers, managers, population, officers of privatization bodies, local authorities...”

He acknowledged the need to create “a securities market...to provide the reallocation of property rights to efficient owners following privatization,”<sup>76</sup> and that “deep institutional changes” were required for privatization to bear fruit. Still, the implication was that the required institutional changes were on the way and would appear in the foreseeable future. His central message was that Russia’s experience “proved that countries in transition...can make efficient use of voucher privatization methods.”<sup>77</sup>

Anatoli Chubais and his principal advisor, Maxim Boycko, agreed; they stated—in a June 1994 celebratory conference on Russian privatization held in Washington at the World Bank—that the unprecedented Russian mass privatization program had successfully achieved its principal goals of removing firms from the control of politicians, and creating a constituency for a market economy.

<sup>76</sup> Dmitri Vasiliev, “Privatization in Russia—1994,” in Andreja Bohm, ed., *Privatization in Central and Eastern Europe 1994* (Ljubljana: Central and Eastern European Privatization Network, 1995), pp. 372-3.

<sup>77</sup> *Ibid.*, p. 372.

The summer of 1994 was the high water mark for mass and rapid privatization in Russia. The program had been carried out with remarkable speed and efficiency, in a fairly transparent manner (compared to what followed), and the contributions of the World Bank had been important and acknowledged. The program seemed to justify the view of privatization as an end in itself, essential to severing the links between enterprises and the state. The characteristics of the optimal method of divestiture were speed, simplicity, and breadth of application. The risks—that neither corporate governance nor restructuring would initially be optimized—of privatizing to a set of diffused and inexperienced owners were recognized. Reformers and Bank staff called for legal and institutional measures to promote and regulate secondary trading. But as in the Czech Republic, the assumptions were that (i) the reformers in power could and would initiate this institutional change, and (ii) that the new group of private property owners created by mass privatization would constitute an active lobby, pressuring and assisting governments to both pass the required laws, and back the new legislation with the will and resources required to make the laws effective. And—again, as in the Czech conception—financial need stemming from “depoliticization” and the demise of soft government money (imposition of a hard budget constraint) would force secondary trading among the capital-short insider owners, opening these firms to competent, concentrated ownership, and setting them on the path to restructuring and growth.

The prevailing attitude among involved Bank staff generally matched the positive view of the Russian reform team—tempered by a realization that the bulk of equity had been transferred to insiders, and that there was a substantial amount of state assets that the program had not touched. This led to acknowledgement of the considerable ground still left to cover.

Transfer to insiders was a striking step, but only a first step. It must now be followed by equally essential second steps opening ownership of privatized firms to external investors and owners. These...will complete the restructuring of firms begun by the transfer of ownership....Such is the hope.....much stands in the way in the achievement of this grand aspiration....Insiders fear that the restructuring brought about by external investors will cost them their jobs; thus, they do their best to prevent or minimize sales of large blocks of share to external investors.....12,000-14,000 enterprises remain unincorporated, unprivatized....what will happen to this important set of firms?<sup>78</sup>

#### *Problems.....*

Optimism concerning Russian privatization did not take long to fade. In July of 1994 the Russian parliament rejected government’s proposed second phase program. The program was promptly promulgated by presidential decree, and while this solved the problem in the short-run, the frequent use of such decrees gave

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<sup>78</sup> John Nellis, “Introduction,” in Lieberman and Nellis, *Russia: Creating Private Enterprises and Efficient Markets*, *op. cit.*, pp. 2-3 (containing the papers presented at the World Bank June 1994 conference on Russian privatization).



ammunition to those who claimed privatization was being foisted upon an uncomprehending, unwilling polity.

In 1995, production failed to recover, few external and even fewer foreign investors became involved in secondary trading in the privatized firms, and—most importantly—signs appeared that the second “cash” phase of privatization was not proceeding in a rapid or transparent manner. Though many medium sized firms were privatized for cash in the next few years, the methods were murky, and most of the remaining large firms and valuable assets were not brought to market—at least in anything resembling an open and competitive manner. Potential external investors, especially if foreign, complained of being blocked from participating in bids. Those few external investors who had obtained shares in the MPP often complained that their stake was being illegally diluted or eliminated. Citizens began to grumble that the shares they had acquired for their vouchers were worth little if anything.

Concern changed to serious alarm, in late 1995-early 1996, over the “loans-for-shares” transfers (ostensibly auctions) in which significant stakes in thirteen high potential, natural resource-based firms were handed over, in a manner neither competitive nor transparent nor lucrative to the selling state, to Russian commercial banks, all apparently owned by a group of financial “oligarchs” connected to the presidency. No Russian banks (foreign banks were completely excluded) other than those in a self-designated inner circle were allowed to bid, and the bids were totally rigged. The government did not repay the loans and the shares, and ownership of some of the best remaining Russian assets passed to the oligarchs.<sup>79</sup> To give some idea of the results, the Uneximbank obtained 38 percent of the shares of Norilsk Nickel, a firm that is (reportedly) presently making annual profits of \$2 billion U.S., on the basis of a \$170 million U.S. loan.

The differing interpretations of the significance of the loans-for-shares (LFS) auctions are quite instructive. The Russian managers, and some of their advisors, of the LFS were the very same, previously lauded reformers working under Anatoli Chubais. Their view is essentially that of the exigencies of political economy: To succeed in the 1996 presidential elections Yeltsin required financial support. Had those supporting Yeltsin not allied with the powerful bankers and managers, the Communist Party candidate might well have regained the presidency, and transition might have come to a halt or been reversed. LFS was thus an unpleasant but unexceptionable and necessary means to a critical end; alternatives were unavailable or worse, especially the alternative of leaving the firms in the hands of the state. Shleifer and Treisman make the argument:

By 1995, the government had formed a political alliance with important bankers and enterprise managers, and the interests of small investors lost out in the political struggle. (Good laws had been passed but)...the implementation of these laws has been derailed by the new ‘oligarchs’ whose fortunes were consolidated by the loans-for-shares program. Russia’s situation in this respect is troubling, but not exceptional. Many countries in the emerging world suffer from similar corporate governance

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<sup>79</sup> See Cynthia Freedland, *Sale of the Century: Russia’s Wild Ride from Communism to Capitalism* (New York: Crown Business, 2000), for an analysis of the details of these transactions.

failures....the limits of the achievable in Russian privatization were defined by the interests of the stakeholders already in place.....privatization in Russia worked considerably better than its politically feasible alternative: doing nothing.<sup>80</sup>

A number of involved Bank staff are on record as having opposed and deplored LFS. I recall a 1995 memo—drafted by several staff working on Russian privatization—to ECA management, calling attention to the clear deficiencies of the LFS proposals. I do not recall that this led to any official reaction, though it probably did add to the pressures that led to a change of tactics in the Bank’s support to Russian privatization (discussed below). Ira Lieberman, who had managed the Bank efforts to assist the MPP, coauthored and published a blistering article on the shortcomings of LFS, depicting it as

...non-transparent...involved clear conflicts of interest...created collusion...involved a nonlevel playing field excluding foreign investors and banks not favored by the government. In two years the Russian privatization program has moved from the outstanding accomplishments of the MPP to the point where its program is now widely regarded as collusive and corrupt, failing to meet any of its stated objectives.<sup>81</sup>

As the citation indicates, Bank staff tended to make a distinction between what they regarded as the generally decent and potentially positive MPP and the uncompetitive, corrupt LFS. The semi-official Bank position was expressed in less pointed language in a later Bank publication. “The lack of transparency in the way these latter privatizations (i.e., LFS) were carried out has raised serious concerns about equity, concentration of market power, and corporate governance. Moreover, because the processes utilized were insufficiently competitive, government revenues from the transactions were substantially reduced.”<sup>82</sup> Nonetheless, the conclusion on the part of the Bank was not to withdraw from privatization, but to change the approach.

Before discussing the revised approach it should be noted that a good number of Russian and external critics do not make much of a distinction between the MPP and LFS; indeed, the more conspiratorial among them regard the LFS “as the logical and inevitable conclusion of the MPP.”<sup>83</sup> The reasoning appears to be that from the outset the so-called reformers had in mind the mass transfer of ownership to a particular group and set of people, and that the MPP and LFS were simply different tactics, applied at different times, to achieve that end. Many observers who do not go so far as to regard the outcome as planned, and who make some distinction between the MPP and the LFS, are nonetheless severely critical of the end results:

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<sup>80</sup> Shleifer and Treisman, *op. cit.* p.38.

<sup>81</sup> Lieberman and Veimtra, *op. cit.* p. 738.

<sup>82</sup> Harry Broadman, “The Emergence of Case-by-Case Privatization in Russia: Principles and Institutions,” in Harry Broadman, editor, *Case-by-Case Privatization in the Russian Federation*, World Bank Discussion Paper No. 385, 1998, p. 23, material in parenthesis mine.

<sup>83</sup> Personal communication from a Russian economist who asks that a name not be used.

Taken as a whole, Russian privatization led to several distinct outcomes. First, a new kleptocracy emerged. A small number of individuals, who mostly achieved initial wealth through favorable deals with or outright theft from the government, ended up controlling most of Russia's major firms and, to a nontrivial extent, the government itself.<sup>84</sup>

In response to internal concern and external criticism, over the next three years the World Bank scaled back on privatization efforts and shifted its focus to building within Russia an acceptance of, and a capacity to execute, case-by-case transactions. The premise was very different from that which had underpinned support to the MPP. Instead of emphasizing speed of ownership change and quantity of privatizations these efforts would concentrate on the transparency and quality of a small number of transactions, carried out in accord with accepted international sales standards. The objective was to produce a demonstration effect; "...to send a signal to both domestic and foreign investors that Russia's business environment is open, competitive and investor-friendly, and that private sector development is market-driven."<sup>85</sup> Raising revenues for the cash-strapped government, and promoting domestic support for the transition to the market also featured among the goals of the attempt to promote case-by-case divestiture.

Through 1996 and into 1997, Bank teams negotiated with Russian officials to create a case-by-case sales framework that would be open and competitive, use reputable and experienced financial advisors, value the firm to be sold by methods consistent with international standards, and allow all bidders—and the public at large—access to all needed and available information concerning the firm to be privatized.

The government eventually (in April of 1998) passed a resolution endorsing this approach, but—tellingly—referred to it, before and after, as “the World Bank resolution” and mostly ignored it. The time-consuming focus of Russian-Bank privatization discussions in this period concerned the list of firms that would be sold according to the case-by-case rules. Despite a major educational effort on the part of the Bank to expose the client to best practice on privatization of large, high-potential firms, and repeated explanations of the benefits that could and should accrue were the process correctly handled, the Russian authorities were unwilling or unable to place high-potential companies in the case-by-case program. In several

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<sup>84</sup> Bernard Black, Reiner Kraakman and Anna Tarassova, “Russian Privatization and Corporate Governance: What Went Wrong?” *Stanford Law Review*, Vol. 52, 2000, pp. 1746-47. Regarding their distinction between the MPP and the LFS, in an earlier (and much shorter, May 1999) draft of this paper they concluded that small-scale privatization was entirely positive, that “...mass privatization of medium-sized enterprises was probably a positive step on balance, but that the rigged sales of the largest enterprises was a major error.” (p. 35) On the other hand, they seemed to contradict this distinction in the last paragraph of the draft paper where they write: “Mass privatization of large firms in an otherwise badly run country is no panacea. In the case of Russia, and perhaps more generally, it might be worse than no privatization at all.” (p. 41) I could not find these words in the published version of the paper, though they may well be there.

<sup>85</sup> Broadman, *op. cit.* p. 25. Building a capacity to execute good case-by-case privatizations was not a new idea; Bank staff had from the beginning stressed the importance of this approach—but given the press of the MPP and the demands on the small Russian reform team, it had received insufficient attention.

instances seemingly good firms, placed in the program after lengthy and contentious debate, were without notice removed from the list, and other firms—of lesser or dubious potential—substituted.

At the end of the day, and given the client's resistance to the concept, the conditions dealing with case-by-case privatization in a first structural adjustment loan (SAL I; May 1997) specified that just four companies would be tendered in a "pilot" case-by-case approach. While the number of firms in the program rose in SALs II and III (President's Reports in November 1997 and July 1998, respectively), the conditions concerning transactions consistently remained modest in the extreme. Achievements, either in terms of inculcating within the Russian government a commitment and capacity to carry out case-by-case sales, or in terms of completing a fair number of well-managed "open and competitive" transactions, were very slight. Involved staff recall that at the most two, or perhaps just a single firm was ever sold according to this method. One reason for the lack of enthusiasm (to put it mildly) for case-by-case sales was the apparent and widespread concern within Russia, even among privatization officials, of foreign takeover of key assets. A less charitable interpretation is that privatization officials were either involved in or powerless to stop the corrupt and non-transparent transfer of these assets to the well connected. For whatever reason, the Bank was never able to find much of a constituency for open and competitive transactions.

Problems continue to the present day. For example, Russian market watchers judge the September 2000 sale of the Onako Oil Company as a big improvement over past transactions, given that government put up a controlling stake, allowed bidders access to key information, and generated decent revenues from the sale. But once again, foreign bidders were not allowed. Clearly, there is much more to the matter than choosing the "right" sales method.

*Interpretation.....*

Critiques of the Russian approach to transition, of its privatization program, and of World Bank (and other donors) support of the program, have burgeoned in recent years. Nobel laureate Kenneth Arrow termed Russian privatization "a predictable economic disaster." Jeffrey Sachs—formerly an advocate of mass and rapid privatization—stated that the Russian government should renationalize the particularly valuable firms mis-privatized in the LFS, with a view to re-privatizing them, the second time correctly.<sup>86</sup> And in 1999, Joseph Stiglitz, at the time Chief Economist of the World Bank (and now Nobel laureate), wrote and presented—at World Bank development economics conferences in Washington and Paris—two influential critiques of the approaches applied in transition.

With regard to privatization, the thrust of Stiglitz's argument was that privatizing in the absence of a sufficient, market-supporting "institutional infrastructure" was a serious mistake that could and did "lead more to asset stripping than wealth creation."<sup>87</sup> He argued that this should readily have been

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<sup>86</sup> Arrow and Sachs made these statements in 1998; they are cited in Nellis, "Time to Rethink Privatization in Transition Economies?" *op. cit.* p. 168.

<sup>87</sup> Joseph Stiglitz, "*Quis Custodiet Ipsos Custodes?* Corporate Governance Failures in the Transition," Annual Bank Conference on Development Economics—Europe, Paris, June, 1999, p. 7.

foreseen, if not by the first generation of transition reformers, than at least by their Western economic advisors and presumably by the involved World Bank staff (there was a strong “they should have known better” tone to the papers). Again, the implication was that the headlong rush to privatization was a basic mistake; that much of the decline and pain associated with transition in general and privatization in particular was avoidable; and that much more attention could have and should have been paid to building the institutional/legal/administrative foundation on which properly functioning capitalism is based. The upshot of Stiglitz’s reasoning was: If only one had followed a more evolutionary, more decentralized and participatory approach to ownership reform the costs might have been much lower, and the benefits more substantial, and faster in coming.

In their study Black, Kraakman and Tarassova specifically asked the question, “what might have happened with staged privatization and more institution building?” They regard as inadequate the reformers’ argument that the same amount and type of theft would likely have occurred under continued state ownership. They acknowledge that theft was and is present in SOEs, but argued that in Russia:

- theft often became worse in privatized firms;
- while weak, some control mechanisms did exist in SOEs;
- in SOEs, one might steal the flow of income, but in privatized firms one could steal the entire stock;
- Government would have been better off financially had it retained the control of the major natural resource producing firms; and
- politically, theft in newly privatized firms harms attempts to move to a market system, while theft in SOEs adds to the political case for transition; ergo, retention of SOEs would have been the wiser course of action.<sup>88</sup>

Black, Kraakman and Tarassova speak from personal, practical and extensive involvement in the Russian privatization process. They are not naïve; they are acutely aware of the deficiencies of the Russian governmental and administrative systems, and they expend considerable effort to keep their suggested policy alternatives realistic and feasible—“attainable,” in their word. They conclude that Russia should have effected a slower, staged privatization of the larger firms, through more case-by-case sales to strategic investors and foreigners, expanded leasing, and cash auctions. They reason that had the reformers and their supporters put the level of energy they expended on mass and rapid privatization into selective divestiture, accompanied by efforts to build the basic foundations of a market economy—to control self-dealing, attack corruption, and reform the tax regime—the results could have been, would have been, considerably different and better.<sup>89</sup>

It is possible they are correct. But the problem with these recommendations, as with the Stiglitz critique; indeed, the problem with all of the alternative policy

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See also his somewhat different paper delivered to the Washington ABCDE, in April, 1999: “Whither Reform?” *op. cit.*

<sup>88</sup> Black, Kraakman and Tarassova, *op. cit.* pp. 1777-1782.

<sup>89</sup> Black, Kraakman and Tarassova, *ibid.*, p. 1778.

constructions suggested for Russia, is that they assume (i) a certain amount of freedom, or neutrality, on the part of the existing Russian government to choose from a menu and select the optimal policy (in terms of enhancing efficiency or welfare), and (ii) a modicum amount of capacity in government that would have allowed it to implement the chosen policy.<sup>90</sup> It is not clear that either the will or the ability was ever there, or could easily have been put there. It is this inability to construct a persuasive political/administrative counterfactual that gives weight to the *realpolitik* argument of the reformers and their close supporters—that is, that the mix of political forces in early transition Russia led almost inevitably to the privatization outcomes one saw, and what the reformers were able to achieve was, in the circumstances, justifiable and as good as one could expect (the argument advanced by Shleifer and Treisman; see above).<sup>91</sup>

Thus, the Black *et al.* counterfactual is appealing but not convincing. I do not see sufficient signs that a set of policies along these lines could have or would have been adopted at any point in the 1990s in Russia. Had they been adopted it is unlikely they would have been implemented or enforced. Had it been possible for the Russians to move slowly on privatization while freeing entry and imposing hard budgets (along the lines of the Polish approach), then slow or no large-scale privatization might have been acceptable—but one did not see until very recently any indications of either freer entry or hard budgets.

One can make a case that the likely alternative to mass and rapid privatization to insiders in Russia was not some close approximation of the Polish or Hungarian approaches, but rather what one sees in Ukraine: Very slow privatization of larger firms, rampant and rapacious bureaucratic interference in firms (this exists in Russia as well, perhaps not quite so acutely), and, in the absence of a powerful set of insider-owners, political stagnation as the various factions fight over the still initial division of the spoils.

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<sup>90</sup> Another illustration: In 1995 a group of concerned U.S. economists (Michael Intriligator, Robert McIntyre, Marshall Pomer, Dorothy Rosenberg and Lance Taylor), appalled by Russia's plight and the outcomes of privatization (and this was before LFS), wrote and distributed "A Checklist for Action in the Russian Economy" (summary published in the World Bank's *Transition* quarterly, September-October 1995, pp. 10-11.) Almost all the corrective measures proposed began with "the government should..." They advocated price and wage regulation, restrictions on capital movements, protection of domestic fledgling industries, expansionary fiscal policy, state-owned development banks, financial support to enterprises, limiting food imports, and subsidizing fuel and fertilizer purchases. Institutionally, they called for efforts to modernize the legal system, eliminate the criminal underworld, set right the banks, the tax code and collection procedures, the subnational governments and the health and education systems. Note once again that these views were printed in a Bank publication, and Professor Intriligator was invited to Washington to present his views in a Bank seminar. To most of us working on Russia, this set of prescriptions seemed not to be in touch with Russian political and administrative realities: We saw no evidence that the Russian administrative mechanisms possessed either the altruism or the competence required to put these policies into effect.

<sup>91</sup> A few transition countries—Belarus and Uzbekistan most prominently—have neither privatized nor fully liberalized, and yet have, so far, avoided the massive growth and production declines seen elsewhere. But their approaches are seen not as examples of an alternative, gradualist route to transition, but rather as an avoidance of transition and a continued reliance on state-ordered production, of largely unsellable products. This course is seen as unsustainable.

Overall, despite the dismay caused by the poor results of Russian privatization (so far), and despite a reluctance to accept the somewhat mechanistic inevitability, the aura of predestination, of the *realpolitik* interpretation of Russian events, I conclude that that interpretation is superior to the alternatives so far proposed.

Even if one accepts this line of thought, a second, and important—at least for the World Bank—question remains to be answered: Did the efforts undertaken by the Bank in aid of Russian privatization best fulfill its mission? On the basis of their experience, technical expertise, and what they could perceive as the process unfolded, should staff have advocated (or advocated earlier) a different approach or a different set of techniques and tactics? Specifically, should the Bank have pushed harder for the break-up of large firms prior to sale? Should it have resisted the exclusion from the voucher program of the natural resource firms, advocated earlier a track parallel to the MPP for case-by-case sales of some high potential companies, denounced more forcefully the loans-for-shares scheme? More generally and perhaps most importantly, should it have perceived earlier that the transfer of ownership to insiders and the general public would—in the absence of enforceable contracts, capital and financial market regulation, a willingness and capacity on the part of government(s) to impose hard budgets, and a modicum of probity in the public administration—result in weak corporate governance in the privatized firms and produce sub-optimal results both in terms of efficiency and equity? Should the Bank, in sum, have pushed harder for SOE control and reform, and less for privatization? Even if the political dynamics were such as to lead to the likely rejection of this advice, was it not incumbent upon the World Bank to at least give it?

There is considerable merit in this view; one can make a good case that all the questions posed above should be answered in the affirmative. Recall (see footnote 73) that concerns over the corporate governance effects of a voucher approach had surfaced as early as 1990, in the IFI report on *The Economy of the USSR*. Recall as well that there were, persistently, at least a few voices within the Bank pointing out the dangers of privatizing unbundled conglomerates and transferring ownership to insiders and investment funds; that from an early date a number of Bank staff with experience in China were critical of the ECA approach to privatization in general and that in Russia in particular; and that many involved Bank staff expressed concern, at various points, that too much was being promised of privatization.

The point: It was not that nobody in the Bank saw the potential problems. But once again, the seeming primacy of the economic (summed up in the idea that if we could just get ownership “right” much else would follow), the conclusion that the differing initial conditions of Russia did not allow it to take the Chinese path, and especially the strong sentiment that persisted up to and through 1995—that one had to seize the perhaps fleeting moment, and support forcefully the one clear center of liberalizing reform in the country—overcame doubts and concerns, and led the vast majority of Bank staff and management to support rapid privatization in general, and the MPP in particular.

Finally, bear in mind that while the “yes” answer to the questions posed above seems reasonably evident in 2001, those answers were not at all clear in 1991 or indeed much before 1996—by which time the Bank approach to privatization in Russia (and elsewhere in transition) was changing, and becoming more cautious and longer-term. In a sense this says that as the Bank learned the complexity of the issue, it adjusted its advice to suit the circumstances—exactly as one would wish. But it also raises the important question of why, in the far less clear days of 1991-94, was the Bank—were we—so willing to push for a major reform, the outcomes of which were so highly dependent on a series of additional and supportive reforms, the likelihood of enactment of which was uncertain?

Part of the answer, as this paper tries to show, lies in the mindset and incentives of Bank staff and management, with their emphasis on action, indeed on “action this day.” An undocumented and thus less analyzable part of the answer, particularly with regard to Russia, was the external political pressure that influenced Bank policy on assistance in general and privatization in particular. There is no piece of supporting paper to point to; one can only assert that many Bank staff working on Russia throughout the 1990s concluded that senior management was often being pressured by the G-7 to take rapid and large-scale action to relieve Russian economic distress and speed its reform, and that this pressure subtracted greatly from the amount of scrutiny and credulity applied to loan packages.

## ***VII — Privatization and Institutions***

Stepping away from the specifics of the country cases, and looking at the overall approach to privatization in transition, what general points can and should be made? A general view requires a summary statement on the economic and financial results of privatization in this set of countries. Such a review exists: In 2000, Simeon Djankov (of the World Bank) and Peter Murrell (of the University of Maryland) produced a comprehensive and rigorous assessment of the empirical results of privatization in transition economies.<sup>92</sup> They conclude:

- In the aggregate, the microeconomic effects—i.e., performance at the level of the firm—of privatization in post-communist states are positive and significant;
  - In most countries and sectors, any and all forms of privately owned firms achieve better performance, as measured by the amount of restructuring undertaken, than do firms left in the hands of the state;
  - Even in those cases where the differences in restructuring between privatized and state-owned firms are slight and not statistically significant, they are nonetheless almost always positive, meaning that
  - There is little evidence that privatization has harmed firm performance; with the very important possible exception of Russia, where firms privatized to workers appear to be doing even worse than SOEs.<sup>93</sup>
- Moreover, the study reveals both

<sup>92</sup> Simeon Djankov and Peter Murrell, *The Determinants of Enterprise Restructuring in Transition*, *op. cit.*

<sup>93</sup> But see Table 1 (row 6, columns 1 and 2); one set of studies indicates a probability that in the CIS, state-owned firms have more effectively restructured than privatized firms (p. 7).



- Dramatically better restructuring outcomes when the new owners are “concentrated” that is, when ownership or a controlling stake is transferred to an individual investor, or small group of investors; and
- A generally far larger and positive effect of privatization on restructuring in East and Central Europe (which includes the Baltic states and Southern Europe) than in the Commonwealth of Independent States (henceforth, CIS).<sup>94</sup>

Djankov and Murrell calculate how different types of new private owners perform, relative to one another and to traditional state ownership, in terms of restructuring. They find that traditional state ownership is, in most cases, the worst performing category. Concentrated owners, specifically foreign owners, investment funds, “blockholders” (domestic core investors), and managers, far outperform diffused owners. Diffused individual owners, of the sort produced in Mongolia, Lithuania, Russia and elsewhere through voucher privatization, produce about a tenth as much restructuring as the top ranked, concentrated categories.

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<sup>94</sup> However, if one looks at qualitative rather than quantitative indicators of restructuring, the studies reviewed suggest a high likelihood of privatized firms outperforming state-owned firms, even and perhaps particularly in the CIS. Djankov and Murrell place more weight on quantitative than qualitative studies, and that is reasonable. But it may be that good qualitative indicators (e.g., the addition of a marketing department, whether or not a firm has a business plan) are a harbinger of good quantitative performance to come?

Institutional factors—the competence, honesty and accessibility of the legal system, particularly with regard to the enforceability of contracts; the scope and transparency of regulatory mechanisms in financial and utility/infrastructure markets; the existence of competence and probity in public administration in general—interacting with methods of sales, account for much of the difference in restructuring outcomes between concentrated and diffused owners. Privatization methods employed in the former Soviet Union (excluding the Baltic states) more often favored owners who subsequently performed weakly: diffused individuals, insiders, and workers. (Recall from Table 2, above, that six of the nine countries, seven if one counts Lithuania, that relied on vouchers as their primary privatization method were formerly part of the Soviet Union. The countries in Central and Eastern Europe that did rely on vouchers as their principal transfer method [the Czech Republic, Slovakia and Lithuania] experienced more problems with their privatization programs than did countries relying on non-voucher methods; e.g., Poland, Slovenia, Hungary, Estonia). These “...types of owners that need institutional help have received less assistance from institutions in the CIS than elsewhere.”<sup>95</sup>

Thus, former Soviet countries relied mainly on privatization methods dependent on institutional capacity—which they lacked—to make firms function well post-sale. Conversely, even though or perhaps because East and Central European transition economies were better endowed with institutional capacity, they tended more to rely on the direct sales methods that produce concentrated, less institutionally reliant owners.

The obvious point of all this is that Russia would probably have been better off had it applied privatization methods resulting immediately in concentrated owners. However, while easy to recommend this course of action would have been hellishly hard to carry out—as the narrative above makes clear. To hammer the point home: It is unrealistic to think that much would have been accomplished, even if policy makers had opted for this path; the fact is that institutional weaknesses in Russia and the former Soviet Union made these countries unattractive to medium-sized domestic core investors, and any sort of foreign investors. Thus, in scrapping early efforts at a case-by-case program, Russia missed a good bet—but it was still a bet. The realistic choice for Russia, as Shleifer and others imply, was not between voucher privatization or extensive case-by-case sales, but rather between voucher privatization or continued state ownership of the mass of productive firms. The case for and against an evolutionary approach turns on the assessment of the Russian state’s ability to at least halt the erosion of assets in SOEs, if not to manage them decently.

The one country that was formerly part of the Soviet Union that succeeded in applying, rapidly, direct sales methods was Estonia. The Estonian case is important and interesting, since it shows that investors—domestic and foreign—could be found to pay cash for generally run down and highly dubious assets and generally make a go of them. True, the prices paid were low, as the privatization authorities consciously sought to encourage employment maintenance

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<sup>95</sup> Djankov and Murrell, *op. cit.* pp. 13-14.

and creation and future investments as much or more than sales price. True, the proximity of Estonia to Scandinavian markets—and the significant Estonian *diaspora* in Scandinavia—helped greatly, as did the country’s history of independence prior to World War II, its previous relatively advanced integration into the Western European commercial system, and the extraordinary dedication to market principles of its post-communist governments. True, as noted, the distrust of foreign investors was muted in Estonia, as most considered Western investors of any sort or nationality preferable to Russians, or resident ethnic Russians, as owners. One must also note the extensive and excellent aid on privatization given to Estonia by the German government, which provided substantial technical assistance and helped the Estonians apply the sales methods and techniques first devised by the Treuhandanstalt in the former DDR. This all adds up to a special, very difficult-to-duplicate set of circumstances. But none of this should detract from the fact that this was a well-conceived, bold, very well executed program.<sup>96</sup>

A rarity it was: Djankov and Murrell confirm the view that the farther East one travels, the more difficult it has proven for firms—state or privatized—to restructure. They quantify what many—have long thought—the superiority of concentrated vs. diffused owners. In line with critics such as Stiglitz, they posit a trade-off between speed and quality of privatization, and suggest that transition countries with a large remaining portfolio of firms and assets to divest would do better to proceed more slowly, and try to create the good and stable working conditions needed to attract and retain concentrated owners of quality.

It is now a commonplace to note that institutions matter greatly, but Djankov and Murrell show the paucity of empirical work about the way in which institutions work, how they are brought into being, or which ones a reforming government should try to build first—or indeed whether government action to create and sustain institutions is at all efficacious or desirable. Senior Bank staff that have struggled with these issues for years have hammered out of experience a list of institutional/accompanying policy areas that require priority attention:

- Elimination of barriers to entry, especially for foreign investors, and more emphasis on the enhancement and strengthening of competitive forces
- Privatization of banks, closely paralleled by the establishment of prudent regulatory and supervisory frameworks to guide capital market activities
- Strengthening of creditor rights and eliminating barriers to exit, both in law and in the mechanisms that apply and enforce the law
- Enforcing contracts, and building a range of mechanisms—through the courts and less formal mechanisms—to settle business disputes in a transparent, rule-based manner

This is a reasonable list, and there is now some analytical basis for it.

In early 2000, Jeffrey Sachs, Clifford Zinnes and Yair Eilat at Harvard examined the relation between privatization, institutional reforms, and overall economic performance in transition and produced a study that is complementary to the Djankov-Murrell paper. They distinguished between what they termed

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<sup>96</sup> For details of the Estonian approach see Herbert B. Schmidt, “Methodenfragen der Privatisierung, dargestellt am Beispiel Estland,” in *Soziale Marktwirtschaft als historische Weichenstellung-Festschrift zum 100.sten Geburtstag von Ludwig Erhard*, Bonn, 1997, pp. 523-557.)

“change-of-title” privatization reforms, and “agency-related” changes. The former is a shift of ownership. The latter involves incentive and contracting reforms, i.e., policy and institutional measures aimed at hardening budget constraints, improving management and the performance and regulation of capital markets, promoting prudential regulation, and laying the foundations for decent corporate governance, along the lines of the list given above. They found that

privatization involving ‘change-of-title’ alone is not enough to generate economic performance improvements.....the real gains to privatization come from complementing (combining) [sic] change-of-title reforms with ‘agency-related’ reforms.....it is only when the legal and regulatory institutions supporting ownership are in place and functioning that owners can exercise their prerogatives conferred by a change-of-title to pressure firms to improve their productivity and profitability.<sup>97</sup>

A threshold level of agency-related reforms is required if privatization is to positively affect economic performance. If this modicum level of contracting and incentive reforms is not present, then change-of-title privatization may produce no or even negative effects. But note that they find the important obverse is also true: improvement in agency-related matters “does not guarantee economic performance improvements unless enough change-of-title privatization has already occurred.” Thus, institutional advancement matters as much as ownership, and one must avoid a simple, blanket approach to privatization: “...privatization policies must be tailored to....(the) level of complementary reforms in place.”<sup>98</sup>

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<sup>97</sup> Jeffrey Sachs, Clifford Zinnes and Yair Eilat, “The Gains from Privatization in Transition Economies: Is ‘Change of Ownership’ Enough?” unpublished paper, Cambridge, Mass: HIID, February, 2000, p. 54.

<sup>98</sup> *Ibid.*

### *VIII — Concluding Observations*

- A unifying thread in the cases is that all three show the importance of establishing control over managers, the group that emerged from the wreckage of central planning best placed to further their interests. Methods and policies that established rules and surveillance, that opened the doors to foreign investors (who were subject to some extra-national reviews of and limits on their behavior), that pushed competition and freer entry and exit alongside change of ownership, proved better, both in terms of promoting restructuring in the firms, and in gaining public acceptance of the process.
- The faith in the voucher approach was misplaced, or at least heavily over-emphasized. We—the Bank—should have been searching earlier for ways to introduce concentrated owners; we should have paid more attention (earlier than we did) to prudential regulations in capital and financial markets and other institutional development matters. Note that these were not ignored; but the relative effort devoted to these activities was small in comparison to the push for mass privatization.
- Specifically, the Bank might have done better to advocate more widely the approach used by the Estonians; that is, limiting the exchange of vouchers to minority stakes in firms in which a controlling majority share had already been sold to a core investor. This increases the chances of turning over the firm to a good owner, possessing the incentives to look after and develop the health of the assets, and it also increases the chances that voucher holders will obtain a share that will maintain or increase its value. Indeed, the Estonians applied this procedure in a small number of the higher potential firms, further increasing the prospects for the new minority shareholders. The counter argument is that Estonia was a special case (see the discussion above) with conditions that could not easily be replicated, and that elsewhere core investors could not so readily have been found—but this use of vouchers would have been worth a try, particularly in Russia, at least for a set of firms.
- Many of us in the Bank succumbed to the temptations of “the primacy of the economic” argument. The speedy, astonishing collapse of communism demonstrated that one had entered into a period of “extraordinary politics;” it was easy to conclude that this was as well a period of “extraordinary economics,” in which—
  - ❖ one could privatize conglomerates without breaking them up, and assume that import competition would prevent the abuse of market power (without thinking too much about structural barriers to imports from exchange rate issues, poor transportation systems, and activist and often corrupt sub-national governments that moved to protect “their” firms from competition of any sort);
  - ❖ one could assign the primary restructuring and corporate governance responsibilities to second phase private owners (and downplay the absent or very weak mechanisms that would make it feasible and worthwhile for this secondary trading to take place); and

- ❖ one could depend on a mass of brand new and often bewildered and suspicious private shareholders to lobby for further liberalizing reforms and supporting institutions (without noting that there was not much historical evidence of a “demand-pull” causation sequence for institutions).
- The temperament and outlook of Bank staff (they want to act, they want to do, they want to bring about substantial change, in as short a time as possible), in conjunction with the Bank’s internal incentives and financial frameworks (claims to the contrary, the pressure to lend is still substantial), explains much of this state of affairs. The alternative to large quick programs is advice, technical assistance, educational efforts, consensus building—all of acknowledged importance, and all small in scale, slow in pace, and not involving large-scale resource transfers. Eventually, some means must be found to pay for all this staff time—and the loan or credit remains at the heart of the resource system, particularly in real sector activities.
- Despite all the criticism of privatization in many transition countries, the counterfactual remains elusive. The dubious foundations of the arguments of those who recommended that an activist government should have pursued a different, more gradual and statist set of policies in Russia, for example, have already been pointed out. Let us simplify the issue by ignoring the egregious loans-for-shares program: Would Russia be better off today had it not undertaken the MPP? Black, Kraakman and Tarassova and many others think yes; I think not. I think that with all the faults of privatization, early and late, Russia is better off having these firms in private hands. The evidence and proper comparison for this assertion is not found in China, but rather in Ukraine, which has not privatized nearly as much as has Russia, and is in much worse shape.
- Still, one must acknowledge the political implications of poor privatization. Corrupt and non-productive privatization has contributed to the continuing importance of Communist parties in Russia and Ukraine. The failure of privatization to fulfill quickly its promises helped Communists return to power in Moldova, and helped defeat center-right governments in both Romania and Bulgaria. In many countries where Communists do not pose a serious electoral threat—Latvia and the Czech Republic, for specific examples—disappointment with privatization is such as to erode faith and confidence in market reforms generally.<sup>99</sup> Governments cannot effect good policies if they are not in power.
- This paper does not review project components and conditionality details to pronounce on whether the Bank imposed more or less the same prescriptions and timetables on a wide range of transition clients (as has sometimes been claimed by critics and as seems to have been implied in the paper by Sachs *et al.*). In the three cases reviewed here, this was definitely not the case. However, it would be useful to go through project documents to determine if and where and to what extent this was the case, particularly in the smaller countries that became Bank clients at a later date, in Central Asia, the Caucasus and the

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<sup>99</sup> In Moscow in mid-1998, just before the August crash, a current joke was: “Everything the Communists told us about socialism was a complete and utter lie. But unfortunately, everything they told us about capitalism turns out to have been true.”

Balkan sub-regions. Evidence of a uniform approach would strengthen the conclusion of insufficient tailoring of the operation to varying local conditions.

- Concerning the question of major firms “mis-privatized” in non-transparent ways, many observers in and outside transition countries have argued that they be re-nationalized, cleaned up and re-sold in a proper manner. But an equal number, including some highly critical of past privatizations, believe that “re-nationalization for re-privatization” is a poor idea. The Putin administration in Russia, while strongly (at least publicly) disapproving of many past privatizations, has nonetheless announced that it will not advocate a mass of re-nationalizations. Mongolian officials acknowledge that many of their privatized firms perform worse, on average, than those retained by the state—and at the same time insist that re-nationalization would do more harm than good.<sup>100</sup> A former Minister of Privatization in Armenia argued in 1999 that even though a high percentage of privatized firms in his country appear to be on the verge of collapse, their privatization was still the right thing to have done, and he would oppose any effort at re-nationalization and re-privatization. What is the reasoning behind such views?
- The concerns are several: First, re-nationalization would alarm and antagonize the already scarce and wary investors these economies so clearly need. In a few rare cases—in Russia and Slovakia, for example—when government prosecutors suggested seizing the assets of firms that were privatized in a manner that was formally legal, but morally odious, the bulk of the investor community protested loudly.<sup>101</sup> Investors want laws to be fairly and efficiently applied, and contracts to be enforced, but they are loath to upset any commercial *status quo*.
- Second, governmental capacity in the CIS has not improved so markedly in the past few years to allow one to think that a second effort at privatization would produce results superior to the first. Why should the people who mis-privatized the first time round be given a chance to repeat their errors?
- Third, even discounting the first two concerns, and under the best of conditions, it is reasonable to think that many re-nationalized firms would remain for some time in the public fold, being prepared for re-sale. How would they be managed and financed during this period; what would prevent them, in the words of the Armenian Minister, from “making irresistible demands on non-existent public resources?”<sup>102</sup>
- On balance, rather than indulge in problematic re-nationalization and a second effort at divestiture, government efforts in the former Soviet Union are better devoted to transferring remaining assets to “serious investors with long-term prospects;” to assisting the private owners they do possess to acquire new

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<sup>100</sup> Views expressed during the author’s interview with three officials of the Mongolian Ministry of Justice, seminar on privatization at the International Law Institute, Washington, DC; July, 2000.

<sup>101</sup> On the other hand, there have been a number of cases where purchasers failed to remain current on their installment payments, or broke other contractual stipulations, with the result that privatization authorities repossessed the assets for re-sale. This has happened a few times in Estonia, for example. The point is that repossession is much easier when the law or contract has clearly been broken; and even then it is viewed as a measure of last resort.

<sup>102</sup> Cited in Nellis, *Time to Rethink....*, *op. cit.*, p. 29.

management skills and fresh capital, and to developing the “mechanisms of the marketplace...to spur...formally privatized enterprises” into positive change.<sup>103</sup>

- The overall conclusion is that in many cases privatization could have and probably should have been better managed; opportunities were missed. But it is inaccurate and unfair to hold privatization accountable for all the problems of transition. First, the evidence shows that in East and Central Europe, privatization has proven its worth. Second, even in the former Soviet Union, most early reformers were careful to state that the first objective of privatization was to depoliticize the links between enterprises and the state; they accepted that efficiency and equity considerations had to come later. They were, as noted, especially convinced there was a need for speed; one had to act quickly to forestall the return of the communists.
- It turns out that a change of ownership was by itself not sufficient to cut the political-financial links, but that was not clear at the outset—and it still looks like a necessary if not a sufficient condition. It also is now clear that far more time was available than had been thought. “It might have been possible to approach privatization in a more deliberate manner; the results might have been less insider ownership and domination, less resistance to external investors, more protection for minority shareholders...”<sup>104</sup> This may be the case. But again, counter to this speculation is the fact that those countries in the former Soviet Union that pursued an alternate path, of trying to transit without much change of ownership, have not had any great success.

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<sup>103</sup> The terms are from Harald Sondhoff, “Privatisation Policy in Russia: From Ineffective Denationalisation to the Creation of Effective Ownership Structures,” *Intereconomics*, September/October, 1999, pp. 238 & 240.

<sup>104</sup> Nellis, *Time to Rethink.....*, *op.cit.*, p.29



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