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Privatization in Eastern Europe: The Case of Poland

THE TRANSFORMATION of the Eastern European economies into market economies requires comprehensive action on three fronts: macroeconomic stabilization, liberalization of economic activity, and privatization of state-owned enterprises.¹ Each of these is a monumental task. Nonetheless, privatization stands out as the most difficult and novel of the three, both conceptually and politically. There are enormous challenges in transferring state-owned property—which constitutes around 90 percent of industrial capital in Eastern Europe—to private hands in a manner that is rapid, equitable, and fiscally sound, and that accomplishes two fundamental goals: the efficient operation of the resulting private enterprises and the development of efficient capital markets.

The task of privatization in Eastern Europe is not widely understood in the West, partly because misleading analogies have been made to

This paper draws heavily upon the policy debate in Poland in recent months regarding strategies of privatization. As such, it has benefited enormously from extensive discussion with various officials and advisers of the Polish government, including Finance Minister Leszek Balcerowicz, former Minister of Ownership Transformation Waldemar Kuczynski, Stefan Kawalec, Jerzy Kozminski, Jacek Rostowski, Matthew Olex, Andrew Berg, Homi Kharas, and Joseph Bell. Of course, the views expressed here are strictly our own, and not those of the government of Poland. We also thank Janos Kornai and Lawrence Summers for very helpful discussions. Our work is supported by a project on economic reform in Eastern Europe at the World Institute for Development Economics Research (WIDER), of the United Nations University, Helsinki, Finland.

1. For a discussion of the authors' preferred strategy for making the transition to the market economy in Eastern Europe, see Lipton and Sachs (1990). For two other discussions of a comprehensive strategy for transition to the market economy in Eastern Europe, see Blue Ribbon Commission: Project Hungary (1990), and Kornai (1990).

privatization in other parts of the world.² In a typical country that has recently “privatized” some state enterprises, only a handful of firms—perhaps up to a few dozen—have been sold by the government to the private sector. These sales may have made an important economic difference in some sectors, but they have not involved a fundamental transformation of the economy. The amount of capital transformed through privatization has generally been a small proportion of total business capital and national income, and the economies typically had large, private industrial and financial sectors before the privatizations.

In Eastern Europe, privatization is a very different task, involving nothing less than the complete redefinition of property rights for literally thousands of enterprises. Privatization means creating anew the basic institutions of a market financial system, including corporate governance of managers, equity ownership, stock exchanges, and a variety of financial intermediaries, such as pension funds, mutual funds, and investment trusts. The importance of such financial intermediaries can be gauged from the fact that institutional investors now hold more than half the value of shares in the United Kingdom, Italy, and Japan, as well as more than half the value of the New York Stock Exchange.³ The economic challenge, then, is to combine the redefinition of property rights with the creation of vital financial market institutions. The political challenge is also awesome: to design a mechanism for creating private property rights that can win broad, lasting social approval (and prevent special interests from paralyzing the process through a fight for the spoils).

Ironically, the rush of investment bankers and Western experts who have been proposing privatization strategies in Eastern Europe have not addressed the real needs of the privatization process. Not surprisingly, the bankers have focused almost exclusively on a *firm-by-firm* strategy not unlike the programs in which they have participated in other parts of the world. In Eastern Europe, however, this customized approach is likely to bog down for political, economic, and financial reasons well before a significant portion of state firms are actually privatized.

2. There are, of course, exceptions. Trenchant recent analyses may be found in Kornai (1990) and Milanovic (1990). For an excellent overview of the privatization experience throughout the world, see World Bank (1988).

3. Cited in Milanovic (1990, p. 45). For evidence on the rise of institutional investors in the United Kingdom and Japan, see Cosh, Hughes, and Singh (1989). They report that in the United Kingdom, for example, financial institutions held 58.9 percent of the value of listed securities in 1985, up from 44.8 percent in 1976 (table 6, p. 16).

In this paper, we review the enormous scope of the privatization task, and suggest means for a rapid, efficient, and equitable transformation of state property into private property. Our focus will be Poland, where we serve as economic advisers. Some of the problems that we discuss are more urgent there than elsewhere. Particularly problematic for Poland is the fact that workers' councils are powerfully organized in many enterprises, and are fighting for worker self-management and against privatization. Nonetheless, most of the analysis of privatization in Poland applies throughout Eastern Europe.

We should offer one disclaimer at the outset. Even though we favor rapid privatization, we doubt that privatization will produce immediate, large increases in productivity or managerial efficiency. The real gains from private ownership will take years to manifest themselves—the length of time needed for managers to be upgraded, supervisory boards to gain experience, stock markets to improve the quality of valuation of enterprises, and real economic restructuring to take place. Nonetheless, we believe that in order to enjoy those enormous long-term gains, it is necessary to proceed rapidly and comprehensively on creating a privately owned, corporate-based economy in Eastern Europe.

Since privatization is such a vast topic, and cannot be treated comprehensively in a single paper, it is important to spell out what we will *not* discuss here. We do not discuss the problems of the “small-scale” privatization of retail shops and smaller industrial enterprises.⁴ We will not touch on the socially complex question of *restitution* of property (or reprivatization as it is called in Eastern Europe) that was nationalized from the 1940s through the 1960s. We will not discuss the ground-up development of the private sector in Eastern Europe, which is at least as important, and in Janos Kornai's view, even more important, than the privatization of state enterprises.⁵ Finally, we will say relatively

4. Small-scale privatization is moving forward in Poland. Approximately 17,000 retail outlets had been privatized through September 1990. It is still not clear, however, if the government will be able to achieve its target of privatizing roughly two-thirds of retail establishments during 1990.

5. The available evidence in Poland suggests a surge of private sector activity during 1990, with high rates of return and the rapid establishment of new enterprises. According to the official data, approximately 360,000 new private enterprises had been established during January–November 1990. However, the data are subject to many biases. Many establishments are not registered in order to avoid taxes; other establishments are simply shell organizations created to reduce taxes for other related businesses.

little about the crucial question of managerial compensation, which can provide a vital link between the interests of managers and the interests of the owners of the enterprises.

The Debate over the Pace of Privatization

Perhaps the central debate about privatization in Eastern Europe concerns the feasible pace of an effective privatization strategy. Some authors believe that the potential efficiency gains from private ownership and private capital markets are so overwhelming that the process must be speeded up as much as possible. Advocates of rapid privatization are typically confident that even if quick privatization initially leads to an inappropriate distribution of ownership with, for example, too diffuse ownership, or firms in the wrong hands, then the capital markets will encourage a reshuffling of ownership through takeovers, mergers, and buyouts so that there is a proper matching of owners and firms. For these analysts, privatization should be undertaken as rapidly as possible, to reap the full benefits of private ownership.

Many authors who take this point of view have recently called for the free distribution of the enterprises into private hands as a way to speed privatization.⁶ In Poland, the landmark study calling for a free distribution of shares in order to speed privatization is by Janusz Lewandowski and Jan Szomburg.⁷ In Czechoslovakia, the minister of finance, Vaclav Klaus, and his deputy, Dusan Triska, have been outspoken advocates of rapid privatization through the sale of enterprise shares for vouchers. In Hungary, Tibor Liska has been an outspoken advocate of the free distribution of shares to the population. Other important and influential pieces are those by Manuel Hinds and Roman Frydman and Andrzej Rapaczynski.⁸ Other researchers advocating rapid privatization through the free distribution of shares include Olivier Blanchard and Richard Layard, Fernando Saldanha and Branko Milanovic, and Anders Aslund. The president of the Hungarian-American Enterprise Fund, Alexander

6. Our own views have been influenced by several of the contributions mentioned in the text.

7. Lewandowski and Szomburg (1989).

8. Hinds (1990); Frydman and Rapaczynski (1990).

Tomlinson, has also proposed rapid privatization through the free distribution of shares.⁹ *The Economist*, too, has advocated rapid privatization in this manner.¹⁰

For other analysts, privatization should take place at a more measured pace in order to ensure the development of effective enterprise ownership. In Kornai's view, the apparatus of the state is obliged to handle the wealth it was entrusted with carefully until a new owner appears who can guarantee a safer and more efficient guardianship. The point now is not to hand out the property, but rather to place it in the hands of a really better owner.¹¹

Kornai believes that in order to bring about effective ownership, the enterprises should be sold carefully and mostly on a one-by-one basis, rather than freely distributed to the public.

We are sympathetic to the concerns that Kornai raises. As he stresses, the privatization strategy should focus on establishing effective ownership and corporate governance, rather than on simply transferring nominal ownership to the private sector. The secondary market for corporate control, which might operate, for example, through takeover bids on a stock market, will not be reliable enough to ensure efficient matches between enterprises and owners. Nonetheless, we believe that privatization can proceed faster than the one-by-one sale of enterprises would dictate. The process can be accelerated through the free distribution of shares in a manner consistent with the development of effective ownership.

One reason that we stress rapid privatization is that the current pattern of ownership in Eastern Europe is itself prone to massive inefficiencies. The potential costs of overly rapid privatization must be traded off with the high cost of maintaining the present system in which state-owned enterprises lack clear incentives (or actually have perverse incentives) in the face of the market forces now being introduced in Eastern Europe. But our reasons go beyond that, to the politics of privatization. In our opinion, the real risk in Eastern Europe is not that the privatization process will be less than optimal, but that it will be paralyzed entirely. We believe that unless hundreds of large firms in each country are brought quickly into the privatization process, the political battle over

9. Tomlinson (1990).

10. *Economist*, July 21, 1990.

11. Kornai (1990, p. 82).

privatization will soon lead to stalemate in the entire process, with the devastating long-term result that little privatization takes place at all.

Consider the current political situation. While the state enterprises are presumably owned by the state, the various components of ownership—including the rights to use the property, to benefit from financial returns, and to dispose of the property—are in fact jointly held, in a shifting and imprecise way, among managers, workers, and the state. In this situation, workers and managers have incentives to wrest the income and assets of the firm away from the state, often in ways that are highly inefficient and politically explosive.

If property rights are not clearly defined in the near future, enormous energy will likely be wasted in a bruising fight over property rights. As in Argentina, for example, the nation's political and social energy will be spent defining the rules of the game, rather than operating efficiently within stable rules. Groups of workers and managers, both at the enterprise level and at the political level, will surely try to strengthen their claims (both legal and implicit) over the enterprises in ways that will further confuse the ownership structure. Their efforts may simply block the state's political and legal capacity to privatize the firms at a later date. Insiders such as influential bureaucrats and state managers might well use their positions to grab an inordinate share of the state property. Such actions could undermine the public consensus to proceed with privatization.

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 firm. 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 enterprise's 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.

Our fears of paralysis are not hypothetical. In almost all countries where privatizations have been attempted, there have been major political obstacles to the case-by-case approach. These obstacles are likely to develop more rapidly in Eastern Europe given the thinness or,

in some cases, the nonexistence of capital markets, the difficulties of valuation, the likelihood that privatizations will be followed by layoffs, and the sheer number of firms that must be privatized. Already, after just a handful of privatizations, Hungary has entered into a heated internal debate over political accusations that the privatization process is selling Hungarian assets too cheaply to the rest of the world. The first director of the Hungarian State Property Agency was fired in part because of the controversial flotation of shares of the tourist agency Ibusz on the Austrian stock exchange. In Poland, an increasingly powerful coalition of interests that favor worker management is already organizing itself against widespread privatization.

We propose a series of detailed steps to address the various pitfalls of privatization. At the outset, we recommend that hundreds of the largest enterprises be converted into Treasury-owned joint-stock companies. This step will ensure that the enterprise sector is indeed transformed into corporate form. Right from the start, some firms could be managed on a case-by-case basis (for instance, where a private bidder comes forward). Most firms, however, would follow a special track emphasizing the rapid distribution of shares. A portion of shares would be given at a low price or at no charge to workers, and another portion of shares would be transferred rapidly and free of charge to various financial intermediaries (such as mutual funds, pension funds, and commercial banks). Shares in these intermediaries will in turn be distributed or sold to households. Finally, the government would retain a portion of the shares of each enterprise and would gradually sell them off as a *block* to "core investors" who are to take a key role in management of the enterprise.¹² In this way, we hope to combine rapid privatization through free distribution with the advantages of case-by-case sales.

Current Ownership Patterns in Poland

The government of Poland aspires to an ownership structure like that of Western Europe. First, the bulk of the productive sector should be held in private hands. Second, the ownership of large enterprises should

12. As we mention later, the idea of a "stable core" was central to the French privatization process in the mid-1980s. Notably, Kornai (1990, p. 91) has independently stressed the importance of such a stable core in his recent book.

Table 1. Size of the State Sector, Measured by Output and Employment, Selected Countries

Percent		
<i>Country</i>	<i>Output</i>	<i>Employment</i>
<i>Command economies</i>		
Czechoslovakia (1986)	97.0	...
East Germany (1982)	96.5	94.2
Soviet Union (1985)	96.0	...
Poland (1985)	81.7	71.5
China (1984)	73.6	...
Hungary (1984)	65.2	69.9
<i>Market economies^a</i>		
France (1982)	16.5	14.6
Austria (1978-79)	14.5	13.0
Italy (1982)	14.0	15.0
Turkey (1985)	11.2	20.0
Sweden	...	10.6
Finland	...	10.0
United Kingdom (1978)	11.1	8.2
West Germany (1982)	10.7	7.8
Portugal (1976)	9.7	...
Denmark (1974)	6.3	5.0
Greece (1979)	6.1	...
Norway	...	6.0
Spain (1979)	4.1	...
Netherlands (1971-73)	3.6	8.0
United States (1983)	1.3	1.8

Source: Milanovic (1989), tables 1.4 and 1.7.

a. Figures exclude government services, but include state-owned enterprises engaged in commercial activities.

be predominantly in corporate form, with shares held by households, financial intermediaries, and other nonfinancial firms. And third, financial markets should be developed to facilitate the trading of shares.

As can be seen in table 1, the proportion of enterprise capital in state hands in Poland and the rest of Eastern Europe is vastly above the proportion in Western Europe.¹³ Nowhere in Western Europe does the share of state ownership currently exceed 20 percent. Even the Social Democratic regimes in Scandinavia—which serve as role models for many politicians in Eastern Europe—have very little state capital, and almost none in the industrial sector.¹⁴

13. These data are out of date and overstate the extent of state ownership in many cases, such as France and the United Kingdom, which have reduced the share in the 1980s.

14. In Poland, the social democratic faction within Solidarity argues for a more gradual, less free-market strategy of reform.

State-owned Industrial Enterprises in Poland

Poland had 3,177 state enterprises in the industrial sector in 1988.¹⁵ The country aims to privatize most or all of these firms, so that the ownership structure in industry will approach Western Europe's. As in Western Europe, privatization is likely to come first in industry and small-scale services, and then later and perhaps to a lesser extent, in utilities, communications, and railway transport. Privatization is typically more complicated in these latter cases, since the output markets in these sectors tend to be less competitive than in industry. Therefore, in these cases privatization must be accompanied by a regulatory apparatus for controlling the pricing and output decisions of the privatized firms.¹⁶

While some observers have worried that privatization in Eastern Europe should be delayed until after widespread demonopolization has occurred, we do not believe that monopoly power is an urgent problem in the industrial sector. Since most Polish industry is now subjected to strong international competition resulting from a policy of low tariffs and free trade, the problem of industrial monopoly is rather small even in sectors that are dominated by a few firms. Indeed, the Polish Ministry of Finance recently reviewed the competitive environment facing the 500 largest industrial enterprises and concluded that there are few cases, if any, where concerns over monopoly power should stand in the way of rapid privatization.

To some extent, the figure of 3,177 state-owned industrial enterprises exaggerates the task of privatization, since output and employment are concentrated in only the top few hundred firms. The size distribution of firms by employment, output, and earnings is shown in table 2. Note that the top 500 firms, ranked by sales, account for 40 percent of employment, 66 percent of sales, and 68 percent of net income in the socialized industrial sector.¹⁷ If most of the top 500 firms can be

15. According to the official statistics, there were 231,000 private establishments in the industrial sector in 1988. These firms tend to be very small, with an average employment of 2 workers. Polish authorities estimate that the private industrial sector accounts for only about 5 percent of sectoral output, though this figure is almost surely understated by the high level of activity in the underground (and, therefore, underreported) economy.

16. For an extensive discussion of the difficulties and trade-offs involved in privatizing natural monopolies and other firms in noncompetitive environments, see Caves (1990) and Vickers and Yarrow (1988).

17. Sixteen firms have been dropped from the top 500 firms owing to a lack of adequate data on performance during the first half of 1990. We use the remaining 484 firms as a proxy for the top 500.

Table 2. Poland: Size Distribution of State Enterprises, 1990

Number of enterprises	Sales ^a		Net income ^a		Employment ^b	
	Billions of US dollars	Percent of total	Billions of US dollars	Percent of total	Thousands of workers	Percent of total
Top 100	18.1	39	2.9	43	711	18
Top 200	23.1	49	3.6	53	1,036	26
Top 300	26.5	57	4.0	59	1,261	31
Top 400	29.1	62	4.4	65	1,461	36
Top 500 ^c	30.9	66	4.6	68	1,612	40
Total of socialized industrial sector	46.8	100	6.8	100	4,051	100

Source: *Lista 500 and Informacja Statystyczna*. Firms are ranked by sales.

a. Data are annualized from January–June 1990.

b. Employment refers to 1989 employment levels.

c. Sixteen firms have been dropped from the top 500 firms. We use the remaining 484 firms as a proxy.

privatized, then an important part of the industrial sector, measured by employment, sales, and net income, will have been privatized.

It is useful to divide the task of privatization into three categories depending on the sizes of firms. *Large-scale* privatization refers to firms that are too large to be sold or distributed to a single Polish buyer. For these firms, privatization will require that ownership be vested in several groups of owners, or sold to a large foreign buyer. *Medium-sized* privatization refers to firms in which the majority stake can be sold to a single buyer, either through a management-worker buyout, or in a sale to an outside group. *Small-scale* privatization refers to very small firms, mainly in retail trade but also to some extent in the industrial sector. In these cases, privatization will be accomplished mainly by transferring ownership to the firms' workers, through a lease or an outright purchase.

As a working assumption, the Polish authorities are presently focusing on the 500 largest industrial firms as the universe for large-scale privatization, although the privatization program will simultaneously go forward for small-, medium-, and large-scale enterprises. Since large-scale privatization is the most difficult kind, and since such privatization will involve the bulk of the industrial sector, we limit our attention to these firms.

Legal and Political Aspects of Ownership

Many of the deepest problems of privatization arise from the ill-defined current ownership structure in Poland, and in the rest of Eastern

Europe.¹⁸ In Western thought, ownership entails several rights over a resource: the right to determine its use; the right to the earnings of the resource; and the right to dispose of the resource. In Eastern Europe, however, those rights are now rather vaguely distributed among the workers, managers, and state bureaucracies.

Under classical central planning, the state maintained all ownership rights. The enterprise had a "founding organ," usually a branch ministry, which maintained formal oversight of the enterprise. The enterprise's functions, of course, were largely determined by the central plan. It was during the process of reform communism (in Yugoslavia after 1948; Hungary after 1968; Poland after 1980; and the Soviet Union after 1985) that the situation became highly muddled.

Part of the process of reform communism in all these countries was the granting of increased operational and financial autonomy to the enterprise.¹⁹ In Poland, these reforms were adopted in September 1981, with the Law on State Enterprises and the Law on Self-Management of the State Enterprises' Employees, just before the imposition of martial law. In theory, the enterprises were to become largely self-managing and self-financing, with less reliance on transfers from the state. Investment spending was to come increasingly from retained earnings, rather than from a state budgetary allocation. The enterprises were to develop more of their own work plans, with less top-down direction from the bureaucracy. In this way, enterprises were to become increasingly subject to market forces.

We know well that these decentralizing reforms in Poland, and elsewhere in Eastern Europe, were at best partial, and failed to create

18. This section draws heavily upon the research of Gregory Moffatt (1990), of the Washington law firm of Hogan and Hartson. We thank Joseph Bell for sharing this research material with us.

19. While we focus on the phase of reform communism in Poland after 1980, in contrast to the period of strict central planning before that time, we should note that the extent of centralization and decentralization waxed and waned throughout the postwar period. In the early years after the war, workers' councils exercised some measure of management rights. These rights were largely lost with the Stalinist crackdown in the late 1940s, when the instruments of central planning were strengthened. There was a brief thaw in 1956 (at the time of Khrushchev's attack on Stalin at the 20th Party Congress), in which workers' councils were again invigorated. By 1958, however, they were once again demoted in real influence.

hard budget constraints for enterprises.²⁰ Under reform communism enterprises escaped from central planning into an endless series of negotiations with the bureaucracy over taxes, subsidies, prices, and output, rather than into a true market environment. Nonetheless, the devolution of power upon the enterprises did blur many of the ownership rights previously exercised by the central bureaucracy.

Workers' Councils

The reforms also raised the question of which group was to assume these ownership rights. In all countries, the formal answer was that *the workers of the enterprise* exercised responsibility for the enterprise, usually through a collective assembly of all the enterprise workers (like an annual shareholders meeting), and through a representative workers' council, which was to govern the enterprise between meetings of the general assembly.

A workers' council in Poland is composed of fifteen workers who are elected by secret ballot for two-year terms. The councils are charged with "the formation of the enterprise's annual plans, investment decisions, changes in the scope of enterprise activities, acceptance and approval of the annual balance, and decisions on merger and enterprise dissolution."²¹ In most enterprises, the workers' council has been given the power to appoint the manager. In enterprises of "primary importance," the workers' council has been given veto power over the choice made by the government.

Note that the development of workers' councils was not the only logical alternative for Eastern Europe, though it was universally taken to be the one most consistent with Marxist ideology. Another possibility, for example, could have been the classic state-owned enterprise in the British tradition, which is governed by an independent board of directors appointed by the government.²² The board of directors possesses some operational independence from the government, and appoints the management, approves its plans, and monitors its performance.

20. See the discussion on Kornai's concept of the soft budget constraint in Kornai (1990), as well as other references therein.

21. See Sajko (1987, p. 1372).

22. For an excellent discussion of the different forms of governance of state-owned enterprises, see Milanovic (1990).

Interestingly, privatization would now be much easier had enterprises taken the form of British state enterprises. In that case, the enterprise would already be in corporate form, and privatization would merely involve the transfer of control from the board of directors to new private owners. In the case of worker-managed firms, however, privatization requires a disenfranchisement of the workers' council at the same time that corporate governance is vested in a new board of directors.

In practice, the workers' council has played a lesser role, even under the communist system, than what had been set forth in the legislation. While workers' councils were set up in roughly 90 percent of Poland's state enterprises, it is commonly estimated that they have been fully effective in only about 15 percent of the enterprises, though these have typically been among the larger enterprises.²³ In many other firms, where workers' councils were not effectively organized, the state enterprise managers have acted with considerable independence, not only from the workers but from the state bureaucracy as well.

Consequences of Greater Autonomy for Enterprises

The Communist party, when it was in power, also played a key role in the management of the enterprises. Not only was the choice of managers heavily influenced by the "nomenklatura system," in which the party nominated politically acceptable directors, but also important decisions for the enterprise were referred to the "enterprise collective body," which was composed of the first secretary of the party, together with the managing director of the enterprise, the chairman of the trade union, and the chairman of the workers' council.²⁴

After the collapse of Poland's communist regime, the independence of the enterprises increased enormously. The nomenklatura system collapsed, as did the direct intervention of the party in enterprise matters. In many enterprises, the workers' councils gained new strength, and ousted enterprise managers. In other cases where the workers' councils remained weak, the state managers inherited the powers previously held by the bureaucracy and the party. Although in March 1990 the rights of the workers' councils were reaffirmed, emphasizing that "the council

23. See Rudolf (1988, p. 424).

24. Rudolf (1988, p. 426).

must approve the decision by the enterprise to sell assets, to form or to enter into an existing trade company, to buy shares of stock in corporations, or to sell off shares in those corporations,²⁵ there have been few legal changes in the power of the workers' councils.²⁵

As the room for maneuver increased for the enterprises, the problems arising from the muddled ownership structure became acute. Workers and the managers gained control over the firm, but lacked the clear title to its assets; they therefore had the overwhelming incentive to appropriate the capital income of the firm and strip it of its assets. As Lewandowski and Szomburg put it, "There is still no one to lose anything from the decapitalization of state property."²⁶ For example, with increased freedom to set wages, workers' councils pressured managers to raise wages in order to absorb an increasing amount of the firms' cash flow. Liberalization in 1987–88, therefore, ushered in an enormous real wage explosion and a wage-price spiral.²⁷

The possibilities for asset stripping became even more dramatic when various property laws were changed during 1988–89, the final period of communist rule. First, the private sector was liberalized, and state firms were allowed to do business with the private sector. Second, joint ventures with foreign partners were encouraged. As a result of the changes, managers quickly discovered ways to appropriate state property by making sweetheart deals with an outside partner in a process that quickly became known as "spontaneous privatization." Lewandowski and Szomburg call the process "legal parasitism."²⁷

Consider the case of joint ventures. The enterprises were given enormous freedom to enter into joint venture arrangements subject to little central control. Many state managers, particularly in firms without strong workers' councils, quickly realized that they could make deals with foreign partners. They would grant the foreign partner a highly favorable stake in the enterprise, and in return the foreign partner would grant the manager an attractive position in the new venture. The manager effectively traded the state property for personal gain.

Even more egregious cases ensued in which the state enterprises

25. Reported by Moffatt (1990, p. 18), regarding the Amending Law on State Enterprises, March 9, 1990.

26. See Lewandowski and Szomburg (1989, p. 258).

27. The average real wage in industry increased by 15 and 12 percent in 1988 and 1989 respectively. See Lipton and Sachs (1990).

entered into contracts with newly established private firms in which the state manager had a personal stake. The manager might then lease to the private firm the plant and machinery of the state enterprise at highly favorable terms. The profits of the state enterprise would thereby be transferred to the private firm. These abuses became recognized by the general public in 1989, and led to an enormous storm of protest. The public realized that during the communist-managed transition to a market economy, the communist-appointed managers were appropriating the best property for themselves. The public's revulsion against spontaneous privatization was intense and surely helped to speed the demise of the old regime.

Since the start of 1990, Poland's industrial enterprises have had almost complete freedom with regard to pricing, production, and international trade decisions. Thus, the autonomy of the enterprises has been greatly enhanced. At the same time, though, administrative means have been introduced to cope, however imperfectly, with the anomalous ownership structure. Wage controls have been put in place to prevent enterprises from appropriating their own profits, and indeed the profitability of the industrial sector has increased markedly during 1990, despite a domestic recession.

While the government's oversight of joint ventures has been strengthened, there is anecdotal evidence to suggest that at least some joint venture arrangements still serve the self-interest of managers. Also, while new conflict-of-interest laws have been put in place to prohibit spontaneous privatizations through sweetheart deals, the effectiveness of these regulations is not yet clear. The government has also undertaken to review and reverse cases of conflict of interest that occurred in the past.

In some ways, however, recent reforms have made it harder, not easier, to define real claimants to the assets and residual income of a firm. On the one side, the government has drawn a sharper line between an enterprise's earnings and the state budget. Enterprises now receive fewer transfers from the state budget, and are allowed to retain more of their earnings after paying various corporate taxes. But they are not free to distribute those earnings through wage payments, without incurring substantial financial penalties under the excess wage tax law. And clearly because there are no private shareholders to whom the profits can be distributed, the residual income remains with the firm. There, the

retained earnings can be used for only two purposes: to amass financial wealth or to make investment expenditures.

We can expect that unless the claimants of the residual income are quickly defined through the privatization process, management and workers will, through indirect means, find ways to enrich themselves. Some of the profits might be enjoyed through a reduced work effort, or through low-return investments, like new factory cafeterias, for example, that benefit the incumbents of the firm.

In yet a final facet of the ownership rights debate, most legal analysts in Poland believe that the state remains the holder of enterprise capital, but even this point has become muddled. The book value of the capital of the firm has been divided between the "founder's fund," which represents the initial capitalization of the firm, and the "enterprise fund," which reflects the book value of retained earnings. Some managers and workers' groups have asserted that the enterprise fund should be viewed as already belonging to the enterprise, while most legal scholars in Poland assert that the enterprise fund as well as the state fund belong to the state.

Privatization and Worker Management

The shift to a Western European ownership structure will require that enterprise governance be removed from the workers' councils and managers and be placed squarely with a supervisory board (or board of directors) controlled by the owners of the enterprise.²⁸ In essence, privatization requires first that certain ownership rights, now vested in the enterprises, and particularly in the workers' councils, be eliminated so that the property rights to an enterprise can be transferred to the real owners.

The transfer of power to private owners poses a significant political challenge to the governments of Eastern Europe, since support for worker control and worker ownership remains powerful in many enterprises and in some political circles. Not only was the worker management

28. We do not rule out the possibility that workers might appoint a minority portion of the board as in the company law in many Western European economies. Poland's company law, which dates from the 1930s, does not have any such provision for worker representation.

ideology validated in years of struggle against central planning, but it also enjoys well-organized support in enterprises that have active workers' councils. These councils now aim to strengthen their control and perhaps win outright ownership of the firms. In enterprises facing cutbacks in employment, many workers view their workers' councils as the best hope for avoiding layoffs and protecting workers' interests, if not the interests of the capital.

It is clear that for political reasons, and perhaps for ethical reasons as well, workers will have to be partially compensated for the transfer of control from workers' councils to private owners. After all, workers stand to lose some property rights because of privatization. The standard suggestion is that workers should be allowed to purchase a *limited proportion of shares* (20 percent according to the Polish Privatization Law) in their enterprise at a discounted price when the firm is privatized. The practical question is whether this concession will be politically palatable, at least enough so to permit the privatization process to move forward smoothly. It is possible that even with the concession of favorable purchase terms for shares, some workers' groups will fight to slow the privatization process in order to assert their claims for complete worker control.

There are strong reasons, on grounds of equity as well as efficiency, for rejecting workers' demands to deliver greater firm ownership to them. To begin, workers were never really granted ownership of their enterprises in the communist reform process because that would have created vast and unjustifiable inequalities in income and wealth. Only 4 million of Poland's 18 million workers are actually employed in the state-owned industrial sector, so that less than one-fourth of the workers would have received any benefits from the full distribution of ownership to the industrial workers. Moreover, some workers are in highly profitable firms while others are in loss-making firms. To give the workers ownership of their respective firms would be highly capricious in its distributional consequences.

From an efficiency standpoint, it makes little sense for workers to own their own enterprises (or to lease the capital in their enterprises), except in the case of small, labor-intensive operations. Worker ownership or labor-management tends to cut firms out of the capital markets. Outside investors often shun enterprises in which workers have a controlling interest, since the workers can act opportunistically to absorb

Table 3. United States: Employee Ownership of Large Industrial Firms

<i>Company</i>	<i>Business</i>	<i>Persons employed</i>
<i>Ownership greater than 50 percent</i>		
Science Applications	Research and development	10,000
Parsons Corporation	Engineering	10,000
Amsted Industries	Manufacturing	8,300
Weirton Steel	Steel manufacturing	8,100
Avondale Shipyards	Shipbuilding	7,500
W.L. Gore Associates	High-tech manufacturing	5,000
Simmons Company	Furniture manufacturing	4,900
Republic Engineered Steel	Steel manufacturing	4,900
Graybar Electric	Electrical equipment manufacturing	4,700
Treasure Chest Advertising	Printing	4,000
National Steel & Shipbuilding	Shipbuilding	4,000
Stebbins Engineering	Engineering	4,000
CH2M Hill	Engineering	2,300
Northwestern Steel and Wire Steel	Manufacturing	2,300
McLouth Steel	Steel manufacturing	2,000
Cranston Print Works	Textile printing	1,800
Okonite Company	Wire and cable manufacturing	1,700
North American Rayon	Rayon manufacturing	1,500
Total		87,000
Percent of total manufacturing employment ^a		0.4
<i>Ownership between 25 and 50 percent</i>		
Phillips Petroleum	Petroleum	28,400
PMC Corporation	Industrial manufacturing	28,000
Tyson Foods	Chicken processing	25,000
Ashland Oil	Oil refining	22,800
USG	Construction material	22,000
Colt Industries	Industrial products	19,700
Olin Corp.	Chemicals/Defense	17,000
Hallmark Cards	Greeting cards	15,521
Lowe's Companies, Inc.	Lumber and hardware	14,700
CBI Industries	Energy and manufacturing	11,400
Stone and Webster	Engineering	10,000
Harcourt Brace Jovanovich	Publishing	8,000
Herman Miller Inc.	Furniture manufacturing	5,000
Dentsply International	Dental equipment	3,500
Applied Power, Inc.	Automotive equipment	3,400
Swank, Inc.	Leather goods	3,100
Anderson Corporation	Window manufacturing	2,800
Tyler Corp.	Cast iron pipes	2,700
H.K. Porter	Manufacturing	2,600
Nationwide Automotive	Auto supplies	2,200
U.S. Sugar	Sugar manufacturing	2,100
Granite Construction Co.	Highway and heavy construction	2,000
Anthony Industries	Recreation products	2,000
CF&I Steel	Steel manufacturing	2,000
Quad/Graphics	Printing	2,000

Table 3. (Cont.)

<i>Company</i>	<i>Business</i>	<i>Persons employed</i>
Ormet Inc.	Aluminum manufacturing	1,700
E-Systems	Electronics	1,500
Total		261,121
Percent of total manufacturing employment ^a		1.4

Source: "The Employee Ownership 100," National Center for Employee Ownership, May 1989, and U.S. Labor Department.

a. Total manufacturing employment in U.S. equals 19,167,000 employees.

all of the income of the firm in the form of wage compensation.²⁹ Moreover, it makes little sense for workers to hold most of their equity wealth in their own enterprise, since on diversification grounds they should hold their financial capital and human capital in separate investments.

Ironically, many supporters of U.S. employee stock-ownership plans (ESOPs) have traveled to Eastern Europe recently to organize support for worker ownership. In many ways, the effect has been pernicious. In the United States, the ESOP tends to promote a modest extent of worker ownership, almost always below the 20 percent threshold envisioned by the Polish authorities.³⁰ As shown in table 3, there are fewer than fifty industrial firms in the United States employing more than 1,500 workers in which employees own more than 25 percent of the shares. There are still fewer in which the workers own a majority stake in the enterprise. These firms account for a tiny proportion of the industrial labor force. Yet in Poland, the U.S. ESOPs have been used to support the political case for more complete worker management and ownership.

29. For a sophisticated theoretical discussion of this point, see Dreze (1989). Dreze summarizes his findings as follows (p. 114):

In economies operating with uncertainty and incomplete insurance markets, it is natural to find capital hiring labor [rather than labor hiring capital], because efficient labor contracts in capitalist firms are easier to draw and monitor than efficient equity contracts for labor-managed firms.

The point is that it is generally more efficient for capital owners to hire labor than for laborers to rent capital.

30. See Blasi (1988, table C-2, pp. 264-66), which reports the proportion of Fortune 500 companies owned by internal employee funds (ESOPs, retirement funds, savings funds, stock-purchase plans, and so on). There is no case in which an ESOP plan contains as much as 15 percent of the shares of a firm, and only 7 firms of the Fortune 500 have an internal stock fund of any kind that contains more than 20 percent of the shares.

The Polish Privatization Law

In June 1990, the Polish Parliament overwhelmingly passed the Act on the Privatization of State-Owned Enterprises, which is designed to be the guiding legislation for privatization. The act does not embrace a specific strategy for privatization, but rather sets a general framework that could accommodate a variety of strategies.

The history of the legislation is enlightening. In the fall of 1989, just after the Solidarity-led government ascended to power, it tried to introduce a Law on Transformation of State Enterprises, which would have converted state enterprises into joint-stock companies with the Treasury as the sole owner (this process is usually termed "corporatization," or sometimes, "commercialization"). This Transformation Law stalled in the Parliament and was ultimately withdrawn as a result of the objections of workers' groups, who rejected the state's claim to sole ownership of the enterprises.

The Mazowiecki government then went ahead with the Act on Privatization, which in many ways reflects the confused state of affairs. The new law allows for the transformation of state enterprises into Treasury-owned joint-stock companies, under the direction of a new Ministry of Ownership Transformation. The law also provides that the process should be approved by the state enterprise manager, the workers' council, and the founding organ. Thus, the enterprises are given a veto. The state, however, retains a trump card, since the Prime Minister, on the motion of the Minister of Ownership Transformation, can order the transformation of an enterprise. In the end, there remains the delicate balancing act between the interests of workers, managers, and the state.

The act has several other key provisos, but in general provides enough flexibility that the government has a wide range of options. Most of the legislation seems to envision a standard case-by-case privatization. Several articles in the act detail how shares are to be sold to the public, with the workers getting a half-price discount on up to 20 percent of the shares.³¹ Once again, flexibility is built into the act by allowing the Council of Ministers (the executive body of the government) to permit State Treasury shares to be sold in a manner different from that specified

31. The value of this discount is to be capped, however, at less than the value of one year's average compensation of the workers in the firm.

in the act. The act also provides that shares might be distributed for vouchers, "scrip" issued by the government, but does not specify how that would be done. The deputy prime minister publicly stated during the debate on the law that the free distribution of shares, through one mechanism or another, would play some role in the privatization process.

During the period between corporatization of the firm and its sale, the enterprise is to be governed by a supervisory board of which two-thirds is appointed by the government, and one-third is elected by the workers. A maximum of two years can pass between the time of corporatization and privatization (defined as the point at which the state's holdings fall to less than half of the shares).

The law also restricts the role of foreign investors, who are allowed, in aggregate, to purchase up to 10 percent of the shares of an enterprise without restriction, but who must obtain government approval for ownership of more than that. The Mazowiecki government had stressed that it would be liberal in granting access to foreign investors, though it emphasized that the process must be controlled in order to prevent abuses and to monitor the extent of foreign participation in the economy. Since the law builds in so much flexibility, it is clear that politics, and policy choices, rather than the legal constraints of the new privatization act, will determine the pace and strategy of privatization.

In August and September of 1990, Deputy Prime Minister Balcerowicz publicly outlined the shape of the privatization program to be developed by the Mazowiecki government. The program would not be based on the case-by-case sale of medium- and large-scale enterprises through initial public offerings. Instead, the process of privatization would be accelerated by means of several techniques, including among other things the discount sales of shares to workers and a voucher system to place shares in the hands of the public.

Corporate Governance and Financial Intermediaries

A privatization program in Eastern Europe must do more than simply return enterprise ownership to private hands. The government should also strive to create an ownership structure that will effectively oversee the management of the newly privatized assets. That is, the government should foster an effective structure of corporate governance. Moreover,

the government should encourage the development of financial intermediaries that will be important both for monitoring enterprises and for allowing the private sector to diversify the risks of property ownership.

We put enormous stress on creating adequate long-term oversight of management for two main reasons. First, there can be little confidence in the current managerial class in Eastern Europe. Many managers owe their positions to their Communist party allegiances rather than to their technical competence. Also, many competent managers won their positions because of their engineering expertise, which was crucial in a planned economy, rather than their ability to navigate the enterprise in the uncharted waters of an open market economy. Thus, an enormous effort will have to be made to evaluate current managers and to train and promote new ones.

Second, Eastern Europe lacks many of the individual and institutional actors that are normally involved in corporate governance in the West. Therefore, special care must be taken to assure that at least some institutions capable of effective corporate governance are created. In particular, unlike in normal market economies, Eastern European countries cannot rely on corporate oversight by any of the following: the original families and entrepreneurs that established an enterprise; outside directors who have a long involvement with an enterprise and understand its history and corporate culture; a vast financial press and investment analysis sector that investigates, reports, and evaluates management behavior; or experienced regulatory institutions such as the Securities and Exchange Commission, which pursue investigations of malfeasance and which require various forms of disclosure that are widely analyzed by the investment community.

Our basic proposal, described in the next section, is that the ownership of most enterprises should be divided up in *tranches* among various groups and financial institutions that will each have an incentive to monitor the enterprise and promote sound management. In our proposal, a portion of shares is sold or given to workers; another part is transferred to pension funds and commercial banks; another part is transferred mainly to mutual funds that in turn will be owned by individual households; and another part is sold to a "core investor" group that commits both to hold a substantial proportion of the shares for several years and to manage the firm.

A Strategy for Achieving Effective Corporate Governance

There are two essential tasks in establishing effective governance of the productive capital now in state hands. The first, more urgent, task is to introduce a provisional system of corporate governance that can monitor a firm's management and prevent both managers and workers from squandering its capital income and capital assets before full privatization takes place. The second, longer-term task is to foster a structure of ownership in which the new private owners will be in a strong position to manage their newly acquired assets.

A vital, first step to privatization is the conversion of state enterprises into corporate form (their corporatization), in order to concentrate the property rights of the enterprise in a corporate board of directors appointed by the owners. Inevitably, given a realistic timetable for any privatization scheme, the initial boards of almost all enterprises will have to be appointed by the government, with the subsequent boards to be appointed by private owners as they emerge during the privatization process. To reduce the enormous administrative burden of creating a large number of corporate boards, the task should initially focus on the 500 largest firms.

The urgency of corporatization results from the complete inadequacy of the current structure of governance, in which the manager is completely unmonitored in most firms, or is monitored by workers' councils in others. We have stressed that the lack of effective governance has already produced enormous social, political, and economic problems that are likely to continue or worsen despite attempts at administrative controls.

The process of corporatization was one of the first steps in the recent German economic unification. The *Treuhandanstalt*, the state property trust, mandated the conversion of all 8,000 state enterprises into corporate form by administrative decree. So far, the Poles, Hungarians, and Yugoslavs have avoided this step for fear of running into political conflict with powerful workers' councils, known as "enterprise councils" in Hungary. These governments also fear being accused of politicizing the economy by attempting to reconcentrate control in the hands of the state.

In our view, the political risks of corporatization pale in comparison

to the potential economic gains. If the principle is not accepted early in the privatization process, managers and workers' councils together with the state will likely end up bargaining over the terms for privatizing on a firm-by-firm basis, thus paralyzing the process. Moreover, without early corporatization there will be no effective way of replacing the most incompetent managers in those enterprises that have weak or nonexistent workers' councils. Since the boards of directors will monitor joint venture arrangements and other major corporate decisions, the ability to forestall "spontaneous privatization" will be greatly enhanced.

At the same time, the risk of politicizing the process through appointing boards of directors can be significantly reduced if first, the task is largely and visibly subcontracted to professional institutions, such as a consortia of Polish and international management advisory firms, and second, the initial board of directors is made provisional, until the enterprise is at least partially privatized (at which point, the new owners would assume some of the responsibility for forming the board of directors). In fact, Polish company law requires that the first board of directors be constituted for one year, while subsequent boards of directors be constituted for three-year tenures.

The long-term challenge of the privatization program is to create a structure of ownership in which the owners have effective control over the enterprises. For example, if ownership of the enterprises is too widely dispersed, the individual owners will have little incentive to monitor management.³² Moreover, it would be useful to match firms with appropriate owners in the privatization process itself, rather than relying on subsequent trading to establish the "right" owners for a firm. The market for corporate control through takeovers is highly flawed, with significant externalities and asymmetries of information. Therefore, the market cannot be relied upon to do a good job in matching potential

32. The seminal contribution linking dispersed ownership to ineffective corporate governance is Berle and Means (1932). An enormous debate has arisen concerning ways to solve the governance problem, and concerning the extent to which it is a problem. Some economists, such as Demsetz (1983), suggest that the problem is largely overcome in practice through a combination of managerial compensation based on stock prices and through an adequate size of share ownership by minority shareholders. Empirical evidence tending to support the Berle and Means hypothesis has recently been provided by Morck, Shleifer, and Vishny (1988). In particular, these authors show that an enterprise's market valuation (measured by Tobin's q) tends to be lower when management holds a very small share of the enterprise capital than when it holds a moderate amount of enterprise capital.

owners and firms: many efficient takeovers may never be achieved, and many inefficient takeovers may be consummated.³³

These concerns lead us to three principles for establishing effective long-term control over privatized firms. First, the privatization process should avoid creating an atomistic ownership structure for the large enterprises, in which hundreds of thousands or millions of owners each retain a small number of shares. Most ownership of the large enterprises should be held by intermediary agents such as pension funds, mutual funds, or commercial banks, or by large owners with concentrated stakes. This principle also conforms to the idea that small investors should hold diversified portfolios, through mutual funds perhaps, rather than shares in a single enterprise.

Second, the privatization process should be designed to foster at least one significant nonfinancial investor in each major industrial enterprise. This investor would hold around 20 percent of the shares, and would create a "stable core" of ownership of the firm, to use a concept developed in the French privatization process. In their privatizations of the 1980s, the French believed that their capital markets were too thin to rely primarily on public placements as the dominant method of privatization. They also lacked the investment banks that had guided public placements in the United Kingdom. Most importantly, there was concern that no single owner or ownership group would emerge with a significant stake in each enterprise.

Therefore, the French devised a scheme known as the "stable core."

33. The main problem is that takeover bidders usually gain very little from a hostile takeover, and therefore often do not undertake the effort even when efficiency considerations would recommend it (see Grossman and Hart (1980)). On the other hand, some takeovers may go forward even when they are not justified by efficiency, if the takeover process results in a gain in wealth for the bidder not as a result of a rise in efficiency, but by a *transfer* of wealth from some stakeholders in the target firm. See Shleifer and Summers (1988).

Grossman and Hart showed that takeover bidders may be forced to raise the price of the takeover bid to a point that exhausts most or all of the potential financial benefits to them of the takeover. This is because the incumbent shareholders in the target firm have an incentive to free-ride on a takeover bid, by holding on to their shares if they believe that the enterprise will indeed become more valuable if the takeover bid is successful. Thus, in order for the takeover bidder actually to acquire a firm, the bidder must make an offer that is generous enough to tempt the incumbent shareholders to part with their shares. A recent empirical study of hostile takeovers tends to confirm that the bidder gains little in the takeover bid, while all of the gains are appropriated by the shareholders of the target firm. See Bhagat, Shleifer, and Vishny (1990).

This involved soliciting a bid from a single investor, or group of investors working together, to buy 20 percent or more of an enterprise. This group committed a sum of money; prepared a management proposal; and submitted its financial bid. It also committed to hold its shares for at least five years. After reviewing the bids, the French government designated a winner to serve as the stable core. The winning bid was selected not only on the share price offered, but on the financial strength of the bidder, its reputation and experience, and the quality of its management plan.³⁴

In Eastern European privatization plans, as in the French plan, governments would attempt to market a 20 percent block of shares in each enterprise to an investment group that could be domestic, foreign, or mixed. This group would be vested with significant representation on the corporate board in return for a requirement that the group hold the enterprise for a specified period of time, perhaps three to five years.

Third, the Eastern European countries should create a legal and institutional environment in which financial intermediaries play a more active oversight role than is typical in the United States and United Kingdom. The need for oversight by financial intermediaries results from the lack of other institutions or individuals in Eastern Europe that can be relied upon to help oversee an enterprise's corporate management. Thus, a great effort will be needed to economize on information that will be vital in corporate governance. Since banks, pension funds, and mutual funds will have such information, these institutions should also be assigned a major role in the governance process.

As a first step toward strengthening the hand of the financial intermediaries, the Eastern European economies should aim to develop universal banking, as in Germany and Japan,³⁵ where the commercial

34. For discussions of the French concept and development of the "stable core" (*noyau stable*), see Friedmann (1989a, 1989b).

35. In the recent debate about the short-sightedness of American and British firms, considerable admiration for the German and Japanese patterns of corporate governance has been expressed. The argument has been summarized as follows:

Much recent criticism of the City of London by British industrialists is rooted in the belief that institutional investors are too willing to sell out to an opportunistic bidder without having due regard to the longer term strategy of incumbent management. Institutional fund managers, it is said, operate on a different time horizon from industrialists and are prone to behave as speculators rather than owners. Unlike the bankers who have played such an important role in corporate governance in West Germany and Japan, the insurance companies and pension funds which dominate the more equity-oriented markets of the English-speaking economies are remote from the

banks hold stakes in corporate assets and play active roles in the oversight of enterprises.³⁶ The new banks should place representatives on the corporate boards of directors, and strengthen their capacities to participate in the restructurings of troubled firms. Of course, qualified banks cannot be created at once, but it will be far easier to build up the operational capacity of a dozen large banks (perhaps through management contracts with foreign banks) than to rely on the decentralized oversight of thousands of individual enterprises.³⁷

As a second step toward strengthening the oversight by financial intermediaries, newly created mutual funds and pension funds should be encouraged to appoint representatives to the boards of directors of enterprises in which they hold shares, and to create the institutional capacity to monitor closely a large number of firms. When the mutual funds and pension funds are initially licensed, for example, they could be required to present plans detailing how they will appoint directors to corporate boards and how they will develop the expertise needed to monitor these companies. One possibility is that they might subcontract the management oversight to an international management consulting firm.

boards of companies in which they invest. The resulting pressure on management for short term performance, it is argued, is inimical to capital investment and research and development.

(John Plender, "Malaise in need of long-term remedy," *Financial Times*, July 20, 1990)

The argument seems to have found a recent practical response as well. French commercial banks, for example, are now moving to emulate the German pattern of bank ownership of industrial capital (*Economist*, August 4, 1990).

36. Sheard (1989) contains an excellent discussion of the role of the commercial banks in corporate governance in Japan. Sheard explains how "the main bank provides an important substitute mechanism for what in effect is a 'missing' takeover market in Japan; or to put it somewhat differently, the main bank serves to internalize the market for corporate control" (p. 407). Sheard stresses that corporate governance by a main bank economizes on scarce information, a fact of enormous practical relevance in Eastern Europe today.

37. The large banks were created by the dissolution in 1989 of the state monobank. These banks are therefore still in the state sector, and have little actual experience in corporate oversight or loan analysis. But they will have to play a vital role in reconstruction in any event, and therefore will have to be built up in administrative capacity. The banks should receive shares of state enterprises, however, only when the banks themselves have a clear timetable for privatization and have a demonstrated program for enhancing their capacities to engage in corporate oversight. Initially, the shares could be transferred to each bank as a trustee of the government's shares, with the ownership actually shifting to the bank only upon privatization of the bank.

The proposal that mutual funds and pension funds be so actively involved in corporate oversight may seem unusual, but it should be noted that several recent analysts have argued that the same change should apply in the United States.³⁸ One proposal in the U.S. context is for institutional investors to appoint a new class of professional, outside directors who would serve full time on a small number of boards of directors (perhaps six boards per person) for corporations held by the investors.³⁹ These new directors would constitute a "critical mass" on each board, but would serve together with traditional, outside directors (such as CEOs of other companies) and inside directors. The proposal for Poland is more natural in view of the fact that the newly developed financial intermediaries will have a much smaller task with regard to portfolio management than is usual in the United States. This is because the market for corporate shares will be considerably smaller and less liquid there than in the United States. Thus, they will have the time to focus somewhat more on corporate governance and rather less on portfolio management.

The Role of the Stock Market in Privatization

We doubt that the stock exchange can or should play a major role in the privatization process or more generally in the development of financial markets in Eastern Europe in the next few years. While each country will surely develop a stock exchange, the liquidity of the new

38. Some people have called for an even more active role for financial institutions by calling for the creation of holding companies that would immediately become majority owners of the state enterprises. Advocates of the holding company approach believe that it is crucial to create a dominant investor with a majority stake at once, and arrange later for the sale of shares that would transfer corporate control. In our view, it would be dangerous to entrust the ownership of a large number of state enterprises to a *single, untested financial institution*. Such an arrangement would, in all likelihood, exacerbate problems of market power and would impede restructuring and liquidation. Moreover, there would be no clear mechanism under which the holding companies would ultimately divest themselves of the enterprises. As long as the holding company maintained its control, there would be a period of limbo during which time it would be difficult to create the financial institutions needed for a market economy.

39. See, for example, Geoffrey Owen, "Improving corporate governance: Independent directors with bite on the board," *Financial Times*, September 5, 1990, p. 21, reviewing the article by Ronald Gilson and Reinier Kraakman, "Reinventing the outside director: and agenda for institutional investors." Working Paper 66. Stanford, Cal.: Stanford Law School (August).

exchanges will be low, and their capacity to raise corporate capital or serve as a market for corporate control will be highly circumscribed. Moreover, information concerning the fundamental valuation of firms will continue to be limited for many years, since firms will be operating for the first time in a market environment. Thus, we can expect that the markets will be subject to extreme volatility and will tend toward insider trading, not only because asymmetries of information will be pronounced, but also because the policing of the exchanges will be imperfect in the first few years. Nor are there likely to be many firms with a capital value that is large enough to support many institutional investors and small shareholders.

In general, the continental European economies rely much less heavily on stock markets than do the United Kingdom and the United States for raising and trading corporate wealth, and for gaining corporate control.⁴⁰ One sign of the smaller role of the stock market in Western Europe is the low number of listed companies in most European countries. Austria, for example, has only 81 listed Austrian firms; Finland, 78; Norway, 122; Sweden, 135; and Switzerland, 177.⁴¹ In addition, hostile takeovers in these countries scarcely occur. There is little evidence to suggest, though, that this relative dearth of stock market activity has hindered effective corporate governance; many observers feel that the opposite is true: that active stock market trading encourages a short-term bias in managerial decisions. Given the difficulties of establishing an active stock exchange for a large number of firms, it seems safe to recommend that Eastern Europe follow the Western European lead, at least initially, and downplay the institutional role of the stock exchange.

A Strategy for Privatization

We now return to the basic question: how can a very large number of enterprises be privatized quickly while at the same time establishing an effective structure of corporate governance? We have argued that a large

40. See Franks and Mayer (1990) for evidence that hostile takeovers in the stock market play a larger role in the United Kingdom than in Germany in correcting "managerial failure." In Germany, a change in management is not commonly associated with a change of ownership.

41. International Finance Corporation (1990).

role must be played by new institutional investors, and a relatively small role by the stock market. We now describe a strategy for privatization that might be used for transferring ownership and control to private owners.

One key point in our strategy is that much of the privatization should be accomplished through the free distribution of shares to various groups, including workers, pension funds, and mutual funds, rather than through the sale of shares in an initial public offering (IPO), which was standard practice in the well-known British privatizations. In Eastern Europe, the free distribution of shares would help sidestep the difficult, costly, and time-consuming process of enterprise valuation, and recognizes the scarcity of financial capital in private hands.

There is good reason to expect that the problem posed by asset valuation will be far more severe in Eastern Europe than it has been in the West. The economic environment is shifting in fundamental ways as the transformation into market economies proceeds. Not only is the domestic environment undergoing a profound change, but in several countries, international trade is being liberalized and currency convertibility has been introduced. The COMECON system governing trade and payments among the Eastern European countries will be revamped in January 1991. Furthermore, the legal and regulatory environment is changing. Indeed, the level of interest rates needed to discount future profits for the purpose of valuation could be greatly influenced by the strategy for privatization itself. As a result of all of these changes, many key relative prices have shifted and will continue to do so. Finally, in many enterprises there will be changes in the structure of management or in the management itself that will have profound effects on the value of the enterprise. These factors each pose fundamental conceptual problems for asset valuation and, taken together, cast grave doubt on the viability of privatization schemes that require careful valuation of assets as a prelude to the sale of most enterprises.⁴²

Another key point in our strategy is that most enterprises should be privatized in a common manner, to avoid debates between the govern-

42. If, on the other hand, valuation is done in a mechanical way, without close approximation to true economic value, privatization will inevitably generate large windfall gains and losses that can become focal points for political protest against the entire privatization process.

ment and individual enterprises. To the extent that a common procedure is followed, it will be harder for individual enterprises to bargain for special advantages in the course of the privatization process. At the same time, however, it should be possible for an enterprise to proceed outside of the common procedure (for example, if it receives an attractive bid), and yet remain subject to various due process standards and government oversight.

Before detailing a method of privatization that uses the direct distribution of shares, let us consider the four fundamental limitations of IPOs in the Eastern European context. First, public offerings require a careful valuation of each firm, and a great deal of financial preparation. They tend to be time consuming in normal circumstances, and would be far slower in Eastern Europe, where valuation of firms is nearly impossible and where the financial infrastructure for IPOs does not yet exist. Second, the financial capital currently in the hands of the public is a small fraction of the value of the enterprises to be privatized, assuming a reasonable market interest rate (and thus a reasonable price-earnings ratio for the firm). Thus, any attempt to sell a large proportion of the enterprises would create serious financial problems. Third, IPOs are typically used, as has been the case in Britain, to secure a widespread ownership of shares by small investors (in order to create "people's capitalism"). While this aim may be desirable, it does not generally produce an effective structure of corporate governance, and from a logistical point of view is surely inappropriate for all but the largest enterprises. Fourth, reliance upon IPOs would lead to the privatization of only the most profitable enterprises, and leave the marginal or unhealthy enterprises—which are viewed as less marketable—in the hands of the government.

Let us consider each of these four points in more detail. Table 4 shows the total, worldwide number of privatizations through public offerings between 1980 and 1987, according to a World Bank study. The United Kingdom accomplished thirteen IPOs during this period, and the country with the largest number, Italy, accomplished fifteen. Many authors have discussed the laborious preparations involved in each IPO. Given that there is as yet no stock exchange in Poland, no Polish investment banks, and indeed no tradition of valuing enterprises for public sale, privatization through IPOs would likely be quite slow in Eastern European countries.

Table 4. Completed Privatizations by Method, Various Countries, 1980-87

Country	Completed public offerings	Completed private sales	Completed worker/management buyout
<i>Africa</i>			
Equatorial Guinea	0	6	0
Gabon	0	1	0
Gambia	2	1	1
Ghana	0	1	0
Guinea	0	25	0
Ivory Coast	1	18	5
Mali	0	2	0
Mauritania	0	1	0
Niger	0	12	0
Senegal	0	4	0
Sierra Leone	1	1	0
Uganda	0	1	0
Zaire	0	0	0
<i>Asia and the Pacific</i>			
Bangladesh	4	1	0
Japan	3	2	0
Korea	2	5	0
Malaysia	2	5	0
Singapore	12	0	0
Sri Lanka	1	4	0
Taiwan	2	3	0
Thailand	1	1	0
Papua New Guinea	1	0	0
New Zealand	1	3	0
<i>Europe</i>			
Austria	2	0	0
Denmark	1	0	0
France	14	10	1
Germany	6	0	0
Italy	15	17	1
Netherlands	1	0	0
Spain	5	25	0
Sweden	1	1	0
Turkey	2	0	0
United Kingdom	13	18	12
<i>North and South America</i>			
United States	1	2	0
Brazil	6	46	0
Chile	12	24	1
Jamaica	2	22	0
Mexico	3	7	0

Source: World Bank, *Techniques of Privatization of State-Owned Enterprises*, vol. I, *Methods and Implementation* (by Charles Vuylsteke), 1988, table I, Annex E, pp. 169-72.

Table 5. Poland: Capital Value of the Largest State Enterprises, 1990

Billions of dollars

Number of enterprises	Net income ^a	Estimated capital value			Ratio to household financial savings ^b		
		P/E = 6	P/E = 8	P/E = 10	P/E = 6	P/E = 8	P/E = 10
Top 100	2.9	17.6	23.5	29.4	1.6	2.1	2.7
Top 200	3.6	21.6	28.8	36.0	2.0	2.6	3.3
Top 300	4.0	23.7	31.6	39.5	2.2	2.9	3.6
Top 400	4.4	26.3	35.1	43.8	2.4	3.2	4.0
Top 484	4.6	27.5	36.7	45.9	2.5	3.3	4.2

Source: Authors' own calculations. Data were provided by the authorities and *Informacja Statystyczna*.

a. Data are annualized from January-June 1990.

b. Ratio includes household holdings of cash and domestic and foreign currency deposits in the banking system, which totaled \$11 billion in mid-1990.

The normal problems of IPOs are greatly compounded by the shortage of public savings with which to purchase shares. Table 5 presents a rough illustration of the problem. We assume that the firms are valued as a multiple of annual earnings, with three alternatives considered: price-earnings ratios of 6, 8, or 10. In each case, the market value of the 500 largest enterprises is compared with the financial savings of private households, which consist of currency and bank deposits. Even for the lowest price-earnings ratio of 6, the value of the largest enterprises is roughly 2.5 times the current stock of savings.

Thus, the shares could not be sold quickly unless one of three things were to happen. First, the price-earnings ratio could fall sharply, leading to the sale of enterprises for close to nothing to those in the public who hold cash. Second, the government could lend money to the public for share purchases, in the form of a grand leveraged buyout. Third, the enterprises could be sold mainly to foreigners. Of course, none of these alternatives would be remotely acceptable on a political or economic basis.

Interestingly, there is one case in which a country tried to sell a large number of enterprises very cheaply in the context of an enormous credit squeeze: Chile, during 1975-78, just after the coup that toppled Allende and brought Pinochet to power. There, 232 firms were rapidly sold to the public through leveraged buyouts. The outcome in Chile confirms the worst fears of such a process.⁴³

43. For three analyses of the debacle of Chilean privatization in the 1970s, see Luders (1990), Hansson (1990), and Yotopoulos (1989).

Not only did the Chilean experiment produce weak firms and an undue concentration of wealth, but the government was (rightly) attacked for selling the firms at very low prices to the few financial groups that had some access to cash. According to Rolf Luders, a former Chilean finance minister (1979–81) and a strong advocate of privatization in general,

The First Round [of privatizations] was carried-out in the midst of a deep structural transformation process, during which there was little interest on the part of foreigners to invest in the country, and which was accompanied by considerable political, social, and economic uncertainty. . . . These debt-led privatizations carried-out in an economically unstable environment, contributed to generate a considerable degree of *financial asset concentration, financial instability, and some important macro-economic problems*.⁴⁴ (Emphasis ours)

Ironically, because the newly privatized firms were undercapitalized and heavily indebted, many of them collapsed during the financial crisis of 1982–83, and had to be renationalized.

One novel approach might rescue IPOs from the problem of limited purchasing power. The government might transfer purchasing power to the public in direct grants, rather than loans. This is the basic idea behind *voucher schemes*. The government issues purchasing power in a kind of voucher (scrip) that can be used solely to purchase shares. The initial distribution of vouchers can be made on an equal basis for the entire population, or according to other criteria. Care would have to be taken to ensure that vouchers do not become money substitutes, otherwise the issue of vouchers could lead to a sudden expansion of the money supply that is not synchronized with the sale of shares.⁴⁵ As we mention later, the voucher schemes are still likely to suffer from the other weaknesses of IPOs: their time-consuming nature and their inability to create an effective ownership structure.

In particular, the use of a voucher scheme in connection with IPOs may involve prohibitive administrative costs. If individuals swap vouchers for shares, the pattern of share ownership will involve a dispersion of holdings in small lots. A company worth \$10 million—medium-sized by Polish standards—might be in the position of distributing only \$300,000 in dividends per year (with a 15 percent rate of return and a 20

44. Luders (1990, p. 3).

45. It seems that the most effective way to ensure that the vouchers do not become near-monies is to limit their liquidity by issuing them in registered and nontradable form.

percent dividend payout ratio). If a voucher system involved the sale of 500 enterprises to 25 million adult Poles, it could well lead to 100,000 or more shareholders per enterprise. As a result, the administrative costs would leave few resources for profit distribution.

The discussion in Eastern Europe of privatization through IPOs has led to the notion that only profitable enterprises would be privatized. Accordingly, the marginal or unhealthy enterprises would be left to the government to restructure or liquidate. This proposition arises naturally from an approach to privatization based on the case-by-case sale of enterprises, because of the apparent difficulties of valuing and marketing enterprises that may not be sustainable. It would be preferable, in our view, for all enterprises regardless of their financial position to be corporatized and quickly put into private hands. There are several reasons not to leave the marginal and unhealthy enterprises in the hands of the state. First, these enterprises could remain in state hands for a long period as the government tries to determine whether restructuring or liquidation is appropriate. During this time, the enterprises would be targets for further asset stripping by an unrestrained management. Second, a corporate board of directors will be more competent and less subject to political pressures than the government in guiding the process of restructuring and, if necessary, liquidation.

An Illustrative Plan for Large-Scale Privatization in Poland

We now show how the considerations of the previous sections can be integrated into a single, workable plan. The goal would be to complete the privatization of the 500 largest state enterprises in Poland's industrial sector within a period of four years. While the privatization strategy of the Polish government is still evolving and is likely to change further after the presidential elections, we believe that it will share some—though certainly not all—of the features that we outline here. Indeed, we would like to stress once again that we have benefited from extensive discussions with Polish officials in crystallizing our own ideas.

To achieve a rapid privatization, a common track would be followed for most of the large enterprises. This has two advantages: the minimization of negotiation between the state and the individual enterprises; and the routinization of the process. Most firms would be privatized in tranches, with each "slice" of shares transferred or sold to a different

kind of investor. A minority of firms would be sold outright in a standard kind of privatization (either a public offering or a private sale).

At the beginning of the process, each of the 500 largest enterprises would be corporatized—that is, converted into a joint-stock company with the shares initially issued to the state as 100 percent owner. An initial board of directors would be appointed according to the privatization law: two-thirds of the seats would be appointed by the government (most likely by a private investment group that would be hired to advise the government), and one-third of the seats would be elected by the workers. The initial board of directors would serve for one year.

A few enterprises would then proceed with a British-style privatization through IPOs, private sales, or auctions, though we do not discuss these enterprises in this paper. (The privatization law should leave room for individual firms to pursue these routes, especially when private bidders come forward.) The bulk of the enterprises would begin the privatization in tranches. The first tranche would be the transfer, or possibly sale, of shares to an enterprise's workers. The government could most simply mandate that the workers receive 10 percent of the enterprise shares for free (the law provides for the sale to workers of up to 20 percent of the enterprise for half price). The allocation of shares among the work force would be determined by the manager with the approval of the new corporate board. On this particular issue, it may be wise to require that the worker representatives on the board of directors also approve the share distribution plan among the workers.

In addition to the 10 percent distributed to the workers, around 5 percent of the shares would be reserved for compensation for the managers and the corporate board. Managers could receive stock options or outright share ownership as part of an incentive compensation package. We expect that the distribution of shares to managers, as part of their compensation package, could provide an important early spur to increased efficiency within the firm.⁴⁶

The second tranche of shares, around 20 percent of the total, would be used to capitalize a new private pension system. The shares would be distributed to several new pension funds, which would in turn be distributed to enterprises and individuals in order to back retirement payments. Each pension fund would receive a portfolio of enterprises,

46. For a discussion of managerial compensation schemes and their effects on firm efficiency, see Murphy (1985).

and would be responsible for the active oversight of the corporations in its portfolio. It could also trade its shares.

During the following few years, enterprises would be “hooked up” with the new pension funds according to the size of the enterprise and the age and wage distributions of the employees. The basic idea would be for the state to scale back its own social security payments that are now made directly from the budget, and to increase the payments being made from the capitalized pension fund.⁴⁷ The actual transition from budgetary expenditures to payments by private pension funds could be phased in over a period of five to ten years. If the pension funds receive the income from 20 percent of the shares of the 500 largest enterprises, the annual earnings of the pension funds would equal about \$900 million, or about 20 percent of the annual pension payments now being made from the central budget.

The use of share distribution to capitalize the pension system is not without complexity, and numerous logistical problems will have to be resolved in order to distribute claims in a fair way and reduce social security payments from the government in line with growing benefits from the private plans.

The third tranche would consist of 10 percent of the shares and would be used to capitalize the existing state-owned commercial banks and the insurance sector. Commercial banks would receive 6 percent of the shares (60 percent of this tranche) and would be expected to develop into active investors along German lines. At the same time, the commercial banks themselves would be converted into joint-stock companies and prepared for privatization.

The process of capitalization and commercialization of commercial banks would have two main benefits. First, as active investors, the commercial banks would begin to play an important role in scrutinizing the management of enterprises. Second, the capitalization would also help the banks to improve their weak balance sheets, which need recapitalization in any case. We estimate that with 6 percent of the shares in the 500 largest enterprises, commercial banks would receive a transfer equivalent to about 10 percent of commercial bank gross assets.

47. In essence, the income for part of the retirement payments would come out of enterprise profits. These profits are now financing the accumulation of physical and monetary capital by the enterprises. It is likely that as the enterprises are pressed to pay out part of their earnings to the pension funds, the retained earnings of the enterprises would fall, with a consequent fall in domestic investment spending.

Privatization schemes that rely in large part on the free distribution of shares are sometimes said to be disadvantaged in that the government forgoes a large, potential revenue source. While this may be true when shares are distributed freely to workers or households, the revenue loss may not be incurred when public or quasi-public institutions are capitalized, as in the case of the pension funds and the commercial banks. The capitalization of the pension system will reduce the requirement for budgetary funding of the social security system by an equal magnitude. The capitalization of the commercial banks will likewise reduce a future claim on budgetary resources of the banks, by anticipating the need for a commercial bank recapitalization.

The fourth tranche will consist of 20 percent of the shares of the enterprises that will be distributed generally to the adult population of Poland (roughly 25 million). This part of the share distribution will cause a loss of wealth for the state sector, since the distribution to households will not be recouped by budgetary savings elsewhere. There are two prevailing models of how to distribute these shares. In one model, the shares of the enterprises would be distributed to several private investment trusts (which are closed-end mutual funds), whose shares in turn would be freely distributed to the adult citizens of Poland. After the initial distribution of the shares, the investment trusts would be free to actively manage their portfolios.

Each individual would receive one share in one of the investment trusts, so that if there were, say, ten trusts each would have around 2.5 million subscribers. The investment trusts would pass through dividends and other income to the shareholding public, after deducting the fund's expenses and fees. Each trust would be managed by a Polish entity, but would contract with a foreign advisory firm to assist in the establishment of the trust, in the active management of assets, and in the administration of dividend distribution.

An alternative model has suggested free distribution through vouchers. Individuals would receive vouchers with a fixed face value in the domestic currency. Shares would be tendered at a fixed price after a quick valuation. Households could either buy shares with their vouchers or buy claims on investment trust companies, which in turn would use the vouchers to purchase the tendered shares. The government could encourage the households to deposit their shares with the investment trusts as a sound method of diversification.

This second approach has won widespread support in Poland and is viewed as politically superior to the direct distribution of investment trust certificates, since it offers more choice to households. On the negative side, however, it is vastly more complicated, and could in fact greatly slow down the privatization process. With the voucher plan, unlike the plan to directly distribute investment trust shares, there must be a valuation of individual companies as well as a time-consuming public offering. In addition, the vouchers could be complex to issue and process.

The free distribution of investment trust shares could be completed within about one year, while the system relying on vouchers would probably take a couple of years more. In either case, after this phase is completed, the government will retain roughly 35 percent ownership in the partially privatized companies. A second board of directors would have to be formed upon the expiration of the one-year term for the initial board appointed by the government. The second board would be elected by the shareholders for a three-year period. The shareholder groups created by the pension funds, the banks, and the investment trusts would presumably dominate this board of directors and, thereby, firmly establish control over management. The board of directors could be elected by cumulative voting (essentially, proportional representation), to make sure that each of the major holders of shares places representatives on the supervisory board.

Following the free distribution of shares, any number of methods might be used to dispose of the remaining government holdings, including public offerings, private placements of shares, and further free distributions. Of course, if share sales are the predominant means of disposing of the last tranche, the government will have to undertake a careful valuation of each enterprise and prepare the sale. In addition, the government may wish to encourage enterprises and investor groups to come forward with privatization proposals in a decentralized manner, provided that each deal receives an adequate degree of scrutiny. In certain cases, the government may wish to retain a minority holding, and can look to Western European experience for an appropriate pattern of government equity positions in the corporate sector.

We consider the French concept of selling a block of shares to a stable core of investors to be an attractive technique for disposing of the last tranche. In the case of Poland, the government would entertain bids

from domestic, foreign, or mixed investor groups. It should be possible to establish a stable core for most of the 500 largest enterprises and complete the privatization of these enterprises within a three-year period. The stable core would eventually become the primary investor group and, because it would be entrepreneurial in nature, would take a dominant role in supervising corporate management. In time, the supervisory role of pension funds, investment trusts, and commercial banks, although important, would no longer be the main force monitoring and controlling management behavior.

Central Features of the Illustrative Plan

We conclude this section by stressing what we regard to be the central features of the plan, and what we regard as illustrative but not fundamental. In our view, there are several key steps: corporatization that will establish the legal basis of the new economic system; a partial distribution of shares to workers and managers for political and incentive reasons; and the distribution of some shares to financial intermediaries such as banks and mutual funds, which will have some early responsibility for appointing corporate boards. Once this process goes forward for the bulk of the largest few hundred enterprises, it is not vital what fraction of shares the government holds; it could range from 30 percent to 50 percent of the enterprise. In the latter case, however, we would expect the government to be a silent partner in the day-to-day management of the enterprise.

We accept the proposition that long-term management of the enterprises will be enhanced if the government can sell a significant block of each enterprise to a core buyer. This will take time. The risks of waiting, however, will be significantly reduced if a large part of the enterprise is already in private hands, and if the preliminary struggle over the form of ownership, corporate versus worker management, for example, is decisively settled in favor of a corporate structure.

Conclusion

The most daunting challenge facing the countries of Eastern Europe today is the transfer of state property to private hands in a manner that

is rapid, equitable, and fiscally sound. To achieve this in the Eastern European context is particularly difficult, because it requires the complete redefinition of property rights and wealthholding in the society, and the creation anew of the basic institutions of a market financial system. In this paper, we have reviewed the enormous scope of the privatization task, and suggested principles that should govern the process of privatization. We have used the case of Poland to illustrate the political, legal, and logistical problems that lie in the way of privatization. We have also suggested a concrete plan for privatization in Poland aimed at demonstrating how these constraints can be met and how the main economic objectives can be achieved.

Poland, and the other countries of Eastern Europe, must devise strategies for privatization that ensure that the transformation of ownership structure goes forward uninterrupted. The standard, case-by-case approach based on initial public offerings is prone to get bogged down for political, economic, and logistical reasons. An alternative approach is needed.

We are advocating the rapid conversion of state enterprises into corporate form and the distribution of tranches of shares to various groups in the population, including workers, commercial banks, pension funds, and mutual funds. This strategy differs substantially from the standard methods of privatization that have been used in the West: the sale of shares in an initial public offering and private placements to investor groups. The free distribution of shares helps to sidestep the difficult, costly, and time-consuming process of enterprise valuation, as well as the scarcity of financial capital in private hands in Eastern Europe. More importantly, corporatization combined with the free distribution of shares can occur quickly. Rapid privatization is needed to combat the inevitable social, political, and economic problems associated with the lack of corporate governance.

It is vital to establish effective governance quickly. The first, most urgent, task is to introduce a provisional system of corporate governance that can monitor the management and prevent the managers and workers from squandering the capital income and capital assets of the firms before full privatization takes place. The second, and long-term, task is to foster a structure of ownership in which the new private owners will be in a strong position to manage their newly acquired assets.

Comments and Discussion

Lawrence H. Summers: David Lipton and Jeffrey Sachs's excellent paper addresses what may be the most difficult aspect of economic transition in Eastern Europe—the privatization of large-scale enterprises. Lipton and Sachs make a powerful case for what might be called the rapid eclectic approach to privatization. They believe that the job must be done fast, and they believe that privatization can and should be used to help bring a whole set of new financial institutions into being. I label their approach eclectic because of the variety of branches of ownership—four or five—that they propose to create.

It has always struck me as odd that when Dan Rather provides only two economic statistics in a newscast, one of them is volume on the New York Stock Exchange. Lipton and Sachs are generally skeptical about the role of the stock market in developed economies. They condemn Western-style initial public offerings (IPOs) as an unfeasible and undesirable approach to massive privatization in Eastern Europe.

I think this skepticism about stock markets is warranted. Except in the United States and the United Kingdom, the supply of publicly tradable equities is low relative to national income. In Germany, for example, the ratio is now about 20 percent and was less than 10 percent just a decade ago. In Italy, four companies comprise 60 percent of the total market value. And even Japan, after making adjustments for cross holdings, yields estimates of the "open" stock market of only about 60 percent of GNP before the market's rapid decline. The Eastern European situation is already unstable enough without adding stock market volatility. I have little doubt that the Lipton-Sachs rapid eclectic plan is better than the alternative: the world's most active IPO market.

My questions, and I do not claim to know the answers, are whether

Lipton and Sachs propose to move too rapidly, and whether or not there are alternatives. More conservative reform strategies might reduce the risk of generating politically difficult regrets down the road. The case Lipton and Sachs make for rapid action turns heavily on the ambiguous ownership situation of current public enterprises and the resulting problems. They are particularly critical of spontaneous privatizations—essentially forms of self-dealing by managers—and of worker ownership, both of which lead to asset stripping. Their hope is that by establishing new and active owners these difficulties can be avoided. In my comments, I raise some questions about the blueprint Lipton and Sachs lay out. In assessing the risks of their strategy, it is important to remember that alternative strategies are risky as well. Slow, partial privatization could easily turn into no privatization. Policy judgments in this area depend as much on politics as on economics, and I have no basis for questioning those of Lipton and Sachs.

I think they put too little stress on the rule of law, and too much on what a board of directors, appropriately motivated, can accomplish. American corporations do much that is wrong, but they are rarely faulted for buying from companies privately owned by their managers or their relatives. The law, auditors, and some sort of cultural norm police corporate behavior, not monthly board of directors meetings. I would have thought that creating state corporations that are unambiguously owned by the state, and passing and enforcing tough conflict-of-interest laws, along with management compensation schemes that give managers a stake in profits, could alleviate the ambiguous ownership problem without the problems associated with rapid privatization. A nation whose legal infrastructure cannot stop blatant self-dealing by managers of huge enterprises seems unlikely to carry out any sort of corruption-free distribution of assets.

Lipton and Sachs hold out the hope that by distributing rather than selling assets, the difficulty of valuation can be sidestepped. I think this is a chimera. The banks, pension funds, and insurance companies, which would receive assets under the Lipton-Sachs plan, are or will be owned by people. If they get valuable assets, their ultimate owners will benefit; if not, their ultimate owners will not. Without a fair method of asset valuation, I do not see how they can be distributed equitably across different institutions. Excessively rapid distribution without accurate valuation will, I think, lead to blatant inequities down the road, between

different banks and pension funds. If institutions are permitted to exchange blocks of shares, these effects will be accentuated.

Essentially the fairness aspect of the privatization dilemma boils down to the following. In the current climate of massive uncertainty assets have a low ex-ante value. If after everything, things work out well, there is a sense that those who received assets stole them, and there will be pressure for getting at the windfalls, pressure to undercut private property rights in the process. If after everything, things do not work out well, that is not a good outcome either. The only possible resolution is to delay selling or distributing assets until valuations become clearer. This is the practice of American companies when they spin off subsidiaries. They do not simply assume that the market will instantly give them a fair price.

What about the efficiency aspects? Here the Roman question *quis custodiet custodiet*—who watches the watchers?—becomes central. One gets the sense reading their paper that they think that each of Gdansk's many Roger Smiths needs his own Ross Perot. The greenmail that Perot eventually received points up one difficulty with this image. The fact that he was a personal stakeholder, not a representative of a stakeholder, points up another problem. It is all very well to say that tough-minded owners are needed to make management do the right thing. The problem is that when owners are institutions, their representatives have agency problems of their own. Lipton and Sachs could do more to make it clear what the comparative advantage of bank and pension representatives will be in influencing management to do the right things, especially in the near term when banks and pensions are themselves state operated.

This "who watches the watchers" problem seems especially acute in the case of the "mutual funds plan" advocated by a number of observers of the Eastern European situation. Placement of all assets into ten pots rather than one and reliance on the law of large numbers to ensure fairness also raises the question of how enterprise managers will be watched. My guess is that mutual fund managers will find ways to self-deal too. They may sell assets to entities with which they have some involvement. They are also unlikely to vote themselves out of existence.

What then should be done? American venture capitalists recognize an important aspect of incentives. They are much more concerned with the fraction of an entrepreneur's net worth that he or she puts into a new venture, than with the total amount of money put in. It is the former not

the latter that indexes the degree of commitment and is, therefore, relevant for mitigating moral hazard and adverse selection problems. This should be kept in mind when designing institutions in Eastern Europe.

Suppose that the Lipton-Sachs plan were modified to apply to only half of the shares in state enterprises, with the state passively retaining the remainder. The same creation of institutions could occur. Managers could still be compensated on the basis of performance. Board members could still represent institutions that would be large by the standards of owners in the capitalist world. Yet the risk of a wildly inequitable distribution would be reduced. Moreover, the state would maintain the ability to act if corruption set in.

More generally, the whole privatization area is fraught with uncertainty. At least from an economic standpoint, there is little to be gained and much that could be lost by the state giving up its ownership claims too quickly. In public finance courses, we often point out that if the corporate income tax really made the state a passive shareholder in enterprises, it would be wholly nondistortionary. Western corporate taxes are distortionary given depreciation schedules and the like. But it is natural to wonder when a new system is being crafted whether consideration should not be given to the state taking an equity stake as an alternative to levying a high rate of corporate tax.

An alternative device for hedging the state's bets is leasing assets or maintaining a debt interest in them. Both these schemes hedge against some form of disaster when they operate. They also reduce the risk of conferring windfalls unfairly. And they both offer the possibility of bringing in new profit-oriented management with a hard budget constraint. Relative to the state's maintaining an ownership share, these schemes have the disadvantage of creating inefficiency from conflicts of interest. For example, think of tenants' attitudes toward maintenance, or mortgage holders' attitudes towards risk taking. On the other hand, they have the virtue of increasing the sensitivity of private owners' rewards to their performance. The right approach will vary from case to case. But I would be very surprised if leasing and debt, which are barely touched on by Lipton and Sachs, do not have some role to play in an optimally designed privatization program.

Less than 100 percent privatization has the additional virtue of allowing time for aspects of industrial organization to be worked out. Lipton and Sachs are not worried about monopoly problems. Others are

less sanguine. And there is the important issue of cross holdings. Automobile executives probably are in a better position to monitor tire company performance than anybody else. Should they be represented on the board? Would too much cross holding tend on the other hand to be anticompetitive? No one knows. Perhaps irrevocable commitments should be delayed until these issues and others like them can be more fully resolved.

The difficulty with allocating a larger role to the government is that slow privatization might simply serve as an excuse for maintaining the status quo. This would be disastrous. Yet, I do not see why the state's maintaining a substantial interest in the enterprises it sells off should benefit the managerial elite or current workers, if the state really keeps its interest passive and concentrates on policing corruption. This is, of course, an enormous if. A government that cannot reform itself cannot reform its economy. The worst thing that could happen in Eastern Europe is a U-turn on issues relating to private property.

General Discussion

Many panelists agreed that the crucial challenges for Eastern Europe's transformation were the privatization process and the creation of effective management structures for firms. However, some questioned certain parts of the authors' privatization strategy. Stanley Fischer doubted that the corporate boards of directors would have either the management expertise or the financial capital necessary to run companies without turning to foreigners. The lack of expertise would also limit the ability of banks and mutual funds to oversee corporations. Andrei Shleifer pointed out that in the United States mutual and pension funds do not participate in the governance of the firms in which they hold stakes. He also disagreed with Lawrence Summers's proposal that government should play an important oversight role at the beginning of the privatization process. He doubted that the government could be a "passive" owner and argued that it was sure to interfere in ways that would reduce the firms' efficiency. Jeffrey Sachs noted that Shleifer's doubts were widely shared in Poland.

Shleifer suggested that managers be given significant ownership stakes as a means of tying control and incentives. He also stressed the need for

a stock market as an effective mechanism for sharpening these incentives and for sending signals to managers. Robert Barro reasoned that secondary markets for securities were particularly needed in Eastern Europe because such a large number of new shares would be distributed in a way not determined by markets. The form of the initial distribution would be less important if a functioning stock market existed that could reprice and redistribute securities after they were issued.

Benjamin Friedman reasoned that the debate over how to privatize wealth must explicitly consider the question of the distribution of ownership shares. He observed that the privatization process would have a strong impact on the way Poles felt about capitalism. In the Soviet Union, and presumably in Poland to a lesser extent, liquid assets are extremely unevenly distributed, and the people who have the most assets have often accumulated them by unsavory means. Without some constraints on the rapid redistribution of ownership, most stock would end up in the hands of these few, and the public's support for private ownership of property would be undermined.

Sachs responded that the Poles do envision an active role for the stock market—both in valuing claims and in providing incentives to management—but not necessarily a large role in the privatization process itself (that is, through public offering of shares). Although sympathetic to Friedman's view that trading should be restricted for a time, Sachs predicted that it would not be possible because of the strong desire of the Poles for the freest possible market economy.

Charles Schultze observed that many of the behavioral norms that are taken for granted in Western economies, particularly those informing relations between firms and workers, are conventions that have gradually built up because they were economically efficient. He cited both Robert Hall's finding that adult males exhibit very long job tenure for most jobs and Arthur Okun's models of the invisible handshake as evidence of the importance of such arrangements. Because newly liberated economies would have no such established conventions, the emerging new laws governing market relations may need to provide somewhat more social insurance and other protection than is now the case in Western economies.

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