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*Privatization in Eastern European Transformation*

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One of the central reforms in socialist economies is privatization. This research examines the main issues of privatization in the formerly socialist economies, drawing on experience from privatization in Poland and Hungary, and to some extent Czechoslovakia. Agreement has been reached on a "standard approach" of fast sale of small commercial and industrial firms, corporatization of large industrial and commercial firms, and privatization of financial intermediaries, housing, agriculture and land. However, disputes remain on the sale of state assets, the role of holding companies or mutual funds, demonopolization of former state monopolies, the role of foreign capital and management in the privatized firms. The successes of small-scale privatizations, and the extraordinary growth of very small firms, suggests that the key to the long-run transformation of the formerly socialist economies may lie less in the privatization of the very large industrial firms than in the development of new firms and the growth of existing small firms.

PRIVATIZATION IN EAST EUROPEAN TRANSFORMATION

Stanley Fischer<sup>1</sup>

The creation of a viable private sector, owning and managing the bulk of the economy's assets, is the essence of the transformation problem in formerly socialist economies (FSEs). And since virtually all production is currently carried out in the state sector, privatization of state assets is an essential step in the creation of the private sector.

Advice from most Western institutions and economists on how to privatize has rapidly converged on a standard approach. Small firms should be privatized by sale almost immediately, perhaps with some financing provided by the state. Larger industrial firms should be corporatized as soon as possible, moved out of the shelter of the ministries that now in principle control them, and put under the direction of corporate boards; shares should be distributed to some combination of current workers in the firms, current management, mutual funds, holding companies, banks, insurance companies, pension funds, citizens, and the government.<sup>2</sup> Plans envisage the corporatization phase being completed within a

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<sup>2</sup>For a review of such plans, see Borensztein and Kumar (1990), and Milanovic (1990); see also details of proposals and analysis in Blanchard *et al* (1990), Feige (1990), Frydman and Rapaczynski (1990), Grosfeld (1990), Lipton and Sachs (1990), and Tirole (1991). Tirole (1991) draws on the industrial organization literature in analyzing principles that should guide the privatization process. The absence from this paper of plans presented in languages other than English is unfortunate: the richness of the debate within each country can be discerned by reading authors familiar with those literatures, for example Kornai (1990) on Hungary.

year or two. In most variants the initial post-corporatization ownership structure is transitional, because the government retains a large ownership share, and because the holding companies (or their equivalent) are to be phased out. The period from corporatization to full private ownership of firms that are to be privatized is generally expected to last several years, and in some instances, up to a decade.

Ownership reform in agriculture, housing, and land, has drawn less attention than industrial and commercial restructuring. The issues are less difficult in the cases of housing and land than for operating enterprises; in agriculture, there is already a significant private sector to build on in Poland, and some private sector activities in other FSEs. While Bulgaria and Romania passed land reform laws early in 1991, there has as yet been little privatization of land.

The standard advice does not draw complete agreement. Kornai (1990), along with others, argues that state assets should be sold and not given away. The role of the holding companies or mutual funds has not been entirely clarified (Hinds, 1990): privatization plans for Czechoslovakia place less emphasis on holding companies than those for Poland, which in any case are more eclectic concerning the role of financial institutions than some earlier proposals.<sup>3</sup> Hungary is relying more on privatization from below, initiated by the firm, than other countries. Some, basing their advice on the finding by Vickers and Yarrow (1988) and others that successful privatization in the U.K. required the privatized firm to operate in a competitive environment, believe that demonopolization should precede privatization. Other questions remain

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<sup>3</sup>Contrast for instance, the proposals in Lipton and Sachs (1990), with the program of the Government of Poland (1990).

open. What is the role of foreigners? How should firms that are not yet privatized be managed? Is it necessary, as argued for instance by Brainard (1990), to build up the banking system before privatizing? What other sources of finance can be created?

The debate over privatization has been intensely practical, conducted in real time with real interactions between the academic literature and policy. By early 1991 major legislation had been passed in Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia, and of course the former East Germany; significant small case privatization and some large firm privatization is taking place.<sup>4</sup> While it cannot yet be claimed that there is a wealth of experience of privatization in FSEs on which to draw, the experience -- and certainly the legislation -- is growing.

In this paper, I reexamine the main issues in privatization in the FSEs, drawing on experience of privatization in Poland and Hungary, and to some extent in Czechoslovakia.<sup>5</sup> In Section I I set out the standard approach in more detail, and discuss privatization of small and medium scale enterprises. Then in Section II I discuss the privatization of the core of large industrial and commercial firms. The privatization of financial intermediaries, housing, agriculture, and land, are discussed briefly in Section III. Conclusions are presented in Section IV.

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<sup>4</sup>Developments in Hungary, Poland, and Yugoslavia through late 1990 are reviewed in Milanovic (1990).

<sup>5</sup>I do not describe the privatization process in Yugoslavia, where implementation has been heavily affected by political instability. The Yugoslavian approach was interesting because labor management and ownership was most heavily entrenched there. See Milanovic (1990).

## I. The Standard Approach

The sheer scale of the privatization needed in the FSEs makes the problem very different from that faced by other countries that have undertaken major privatization programs. Table 1 presents data on the share of the state sector in value added in commercial and industrial activities in different countries during the 1980s. The largest completed privatization program so far is that of post-Allende Chile, which moved firms producing about 25 percent of GNP into the private sector, some of them firms that had only recently been nationalized. The much-studied U.K. program shifted only about 4.5 percent of GNP and employment out of the state sector.

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Table 1: SHARE OF STATE SECTOR IN VALUE ADDED  
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Czechoslovakia (1986)	97.0
East Germany (1982)	96.5
USSR (1985)	96.0
Poland (1985)	81.7
China (1984)	73.6
Hungary (1984)	65.2
France (1982)	16.5
Italy (1982)	14.0
West Germany (1982)	10.7
United Kingdom (1983)	10.7
United States (1983)	1.3

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Source: Milanovic (1990)

Reforming governments have opted for the principle of rapid privatization. This choice reflects their commitment to move decisively from socialism to capitalism, avoiding as far as possible any detours into a third way. The experience of privatization in almost all developing countries has

been disappointing:<sup>6</sup> the loss of patronage and political rents attendant on privatization reduce its attractiveness to the political system.<sup>7</sup> This experience, along with the political need for a credible reform program in the face of the unprecedented scale of the privatization necessary in FSEs, accounts for the decision to go for rapid privatization. Even though credibility demands that an irreversible program be put in place as rapidly as possible, it is clear that the process of privatization will take many years. It is also likely that the relative decline of the state sector will after a few years result more from an increase in production by new private firms than from privatization.

The issue of the ownership rights of current employees confronts all the reforming countries, particularly because the decentralization programs of former communist governments typically moved in the direction of worker management. The issue arises most forcefully in considering spontaneous privatizations, in which current employees in one way or another privatize the firm for their own benefit. The standard approach argues that existing workers have no special claims on the firm's assets on fairness grounds. For instance, why should industrial workers obtain larger claims on capital than workers in less capital intensive industries, such as teaching? Or why should workers in successful firms become wealthier than those in less successful firms? Although it is likely in the latter case that workers in more successful firms

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<sup>6</sup>See the special issue of World Development, May 1989, that focuses on developing countries, but also examines lessons from the U.K.

<sup>7</sup>Any political economy model of slow or halting privatization would have also to account for the fact that state sectors stopped growing in the eighties, and that many of them began to recede. Any such model would include a political tradeoff between the efficiency of production and the availability of rents; the perceived terms of that tradeoff must have changed in the 1980s.

have on average worked harder and invested more than those in less successful firms, the general point is correct. However political power as well as fairness shapes privatization programs, and it has already been decided that existing workers will receive special treatment, at least in Poland and Hungary.

Similarly, the issue of the rights of former owners is a live one in several countries, most notably East Germany, Hungary, and Czechoslovakia. Explicit legal treatment of the rights of former owners not only strengthens the credibility of a country's commitment to the rights of private property, but also prevents the legal confusion over ownership that could arise if the issue were left to be settled later in the courts. However, redress should be provided to former owners in a way that does not slow the privatization process: compensation should not take the form of giving the original owners the rights to the property itself, but rather the right to compensation, by the state. New owners cannot get on with running their businesses if they face the possibility of claims for restitution by former owners.

The standard approach summarized in Table 2 is not monolithic. It is standard in rejecting a case-by-case approach to privatization along U.K. lines -- on the grounds that the process would take far too long, in separating as the heart of the issue the core of large commercial and industrial enterprises, and in insisting on rapid progress in establishing the principle and the fact of private ownership. It has not yet devoted as much attention to the privatization of other assets and industries. There are however many important details on which different plans, including those already embodied in legislation, differ. Borensztein and Kumar (1990) list six different

distributive plans;<sup>8</sup> if they were writing now they would have to add the programs passed by the Czechoslovak and Polish parliaments, which do not exactly coincide with any of their six.

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Table 2: THE STANDARD APPROACH  
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1. Small commercial and industrial firms.

Privatize fast, by sale, if necessary with special financial arrangements, including leasing.

1. "Micro" enterprises, such as small retail stores can be sold very rapidly.
2. "Small and medium" scale enterprises can either be (a) first corporatized and shares then disposed of through sale to an individual or group, or (b) the assets sold or leased after liquidation of the state enterprise (as in the 1990 Polish legislation).

2. "Core" of large industrial and commercial firms.

1. Corporatize or commercialize, setting up corporate boards  
Issue: Membership of boards and control of firms
2. Privatize by distributing or selling shares.  
Issues: Speed of privatization, types of firms privatized, and extent of restructuring before privatization  
Share sales or free distributions  
To whom (roles of foreigners and former owners)  
Role of financial institutions (mutual funds, holding companies) between corporations and households  
Does the government hold back shares for later sale, and role of stable core of investors.

3. Financial institutions, housing, land, agriculture.

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Small commercial and industrial firms.

Existing small firms, typically in retail trade and distribution, are being privatized fast. The privatizing agency may be the local rather than a

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<sup>8</sup>These six are presented under the headings: citizen shares (Feige); vouchers (Romania); financial intermediaries (Frydman/Rapaczynski); financial intermediaries (Lipton/Sachs); privatization agencies (Blanchard); and self-management.

higher level of government. Very rapid progress has been made in this area in Poland, where most shops had been privatized by the end of 1990; governments in Czechoslovakia expect to sell over 100,000 small firms in 1991 -- with auctions having begun in February; and Hungary expects to privatize most of retail trade this spring. More public sales of small firms, especially in transportation and distribution, can be expected as larger vertically integrated firms are restructured, and parts are sold off separately. The number of new privately owned small firms in the reforming countries far exceeds the number of privatized firms. For example, by one estimate there were 200,000 small firms in Poland in November 1990, of which more than 80 percent were newly created rather than privatized.<sup>9</sup>

Despite the rapid increase in the number of firms, problems of both financing and red tape are frequently reported. Any banking system would have difficulty in appraising small firms headed by new entrepreneurs wanting to operate in a new and highly uncertain economic environment; all the more so would the underdeveloped banking systems of the FSEs. The red tape is a holdover from socialism and underdevelopment, and has to be attacked as soon as possible. The financing problem for privatizations can be mitigated if the state or local government provides term loans or leases that enable the purchasers to pay for their assets slowly. The financing problems of new firms will have to be addressed through rapid banking sector reform, for instance by creating new banks or separate entities within existing banks to finance new firms, perhaps using externally provided finance.

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<sup>9</sup>These data are taken from Jackson (1990), who warns of their likely imprecision.

There is an intermediate class of "small and medium" scale enterprises, about 5,500 of them in Poland (where the core group of the largest companies consists of 500 firms.) Polish legislation proposes an extremely eclectic approach for the privatization of these companies, to be carried out by representatives of the government with the firms taking the initiative. The legislation envisages some firms being corporatized and shares distributed. The privatization may be initiated by a prospective buyer, who will buy a significant bloc of shares; employees will be entitled to some of the shares, free. Other shares may be sold through auction, public offer, or negotiated sale, with stock exchange listings to follow. Alternatively, small and medium scale firms may be liquidated and the assets disposed of through sale, through absorption of the assets into a new company, or through lease, which may also offer the right of purchase. The legislation envisages few restrictions on these sales, aside from the setting of a minimum price. Under this heading, firms could also be sold to their current employees. Important issues that will arise in the privatization of the largest firms, such as the treatment of the firm's debt, will have to be handled here too. Presumably the firms that are more heavily indebted are likely to be liquidated before being disposed of, though it is not yet clear how the creditors will be compensated, if at all. The eclecticism of the approach to the privatization of these small and medium scale enterprises in Poland is justified by the need to move fast.<sup>10</sup>

While the privatization of small firms has received less attention than that of large firms, its importance should not be underestimated. Future growth is more likely to come from firms in this size class than from the

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<sup>10</sup>The eclectic approach described in this paragraph is being followed also for larger firms in Hungary (see Bokros, 1990), as will be discussed below.

larger firms, so that the rapid progress that has already taken place in the development of micro enterprises, and the rapid pace of privatization that is possible for small and medium scale enterprises, can make a key contribution to the development of market economies in the FSEs.

## II. Core of large industrial and commercial firms.

The core of largest firms (500 firms in Poland, 5000 in the USSR) accounts for the bulk of industrial output. Typically these firms are larger and more vertically integrated than they would be in a market economy. In considering such firms, we distinguish those that are close to being natural monopolies and are publicly owned in many market economies, such as the railroads and telephone company, from firms that have no such claim, such as heavy industry. The latter are likely to face competition from new entry and from imports, while the former are not. Given the need to develop a regulatory framework for the quasi-natural monopolies,<sup>11</sup> and the time pressures on competent government bureaucrats, the privatization of such firms should be left for later.

### Corporatization.

Corporatization (or commercialization) of the core firms is expected to take place quickly. In Poland, it is estimated that over half of the largest 500 firms will be corporatized in 1991 and the remainder in 1992. At the end of the corporatization process, the firm has a legal structure similar to that of most state-owned enterprises in market economies. The Board of Directors

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<sup>11</sup>They are described as quasi-natural monopolies because there is a potential role for competition in many such industries -- such as telephone communications.

will be primarily responsible to the government<sup>12</sup>, which will appoint the bulk of the members. Workers are also to be represented on corporate boards in several countries; while this can be seen as a vestige of worker management, it is also a feature of German corporations.

The performance of the newly corporatized firms will depend on the quality of both management and corporate boards. Current management is likely to be retained initially, but both management consultants and management contracts can be used to improve the quality of current management. Technical assistance funds should be available to help finance the use of foreign consultants and managers. Management training on a large scale is also beginning; foreign financing should be available for this purpose. There is nonetheless no doubt that the quality of management should improve over time as more experience is gained of working in a market environment.

The quality and independence of the boards of directors will also be an important influence on the performance of the firm and the completion of its privatization. Given their knowledge of the operations of the firm, it would seem natural to put the bureaucrats who were formerly responsible for the firms onto the boards. Where exceptional individuals are involved, that will help; otherwise the temptation should be avoided. New directors can be trained, as is happening in Poland. Foreign experience can be drawn on by putting one or two foreign businessmen on the more important boards. The quality of the

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<sup>12</sup>The government agency to which the SOEs will be responsible differs from country to country. Czechoslovakia and its constituent states will set up Funds of National Property to which the assets will belong, and which will be responsible for privatization. In Poland, the commercialized firms will belong to the Treasury but their privatization will be carried out by the Ministry of ownership Transformation. In Hungary, the State Property Agency has to approve privatizations.

boards will improve with experience, and government will have to keep a watchful eye at the early stages.

There is a general issue of the extent to which (a) firms and (b) industries, should be restructured before privatization. This "triage" phase of the privatization program has not received much attention, but the difficulties that beset the Treuhandanstalt, which draws on a large stable of former west German business executives, suggest that it could take longer and be much more difficult than expected. Some of the newly corporatized firms will lose money. It is not at all clear how the government will decide which firms to subsidize before privatizing, and which to close down or liquidate. Given that many of the largest firms in FSEs are excessively vertically integrated, there is a good case for attempting a relatively rapid restructuring of the firm before privatization. The separate pieces will probably be easier to sell than the whole. Restructuring of an industry will not be necessary so long as the firms that are privatized face potential competition from abroad and from new entries; as argued above, firms that are likely to remain monopolies should be privatized relatively late, after a regulatory framework is in place.

The government and corporate boards will also have to decide how far to restructure firm balance sheets before privatization.<sup>13</sup> The firms' liabilities to banks, inter-enterprise credits, and the treatment of implicit or explicit pension liabilities, will be at issue. Direct sales of some firms are anticipated in all countries, and in these cases balance sheet restructuring will be part of the negotiations and will help determine the sales price.

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<sup>13</sup>This is the key problem in privatizing banks, to be discussed below.

There is less need to restructure the balance sheet where firms are being given away, provided the shares in different firms are distributed equitably over the population. However, the management of newly privatized firms will have enough on their plates in operating in the new market environment without also having to engage in extensive debt negotiations, so that cleaning up of balance sheets would be helpful -- and offsetting cancellations of inter-enterprise credits should not be too expensive for the government.

#### Sale or Distribution of Shares.

The first choice after commercialization is whether to sell shares or give them away, or both. This decision involves tradeoffs among the speed of privatization, the amount of revenue that can be raised, and the ownership role of foreigners. Because of the difficulties of valuation of companies, a commitment to rapid sale on a large scale would imply low revenues; because domestic financial intermediaries are weak, and there are few individuals with the necessary resources, rapid sale would imply a large ownership share for foreigners. Accordingly most countries envisage rapid free distribution of some shares to the public. Thirty percent is being distributed in Romania, a complicated formula applies in Poland, and Czechoslovakia is using its voucher scheme to distribute between 40 and 80 percent of each privatized company to the public.

Free distribution of shares would be unattractive if the main motive for privatization were to raise government revenue. The revenue motive has been important for governments in other countries, including the U.K., and added revenue would no doubt be welcome to FSE governments at the start of the reform process. Nonetheless, revenue is not the main goal; rather it is to move firms rapidly into the private sector, with the intention of increasing their

efficiency and that of the economy. With an eye on future revenues, governments generally plan to hold back some shares for later sale.

In Poland shares will be distributed 30 percent to the public, 20 percent to the pension system, 10 percent each to commercial banks and workers, and the remaining 30 percent will be held by the government. The distribution to the pension system makes sense as a means of funding existing pension liabilities and thereby reducing future calls on general revenues; further, by funding the pension system the government encourages the principle of funded rather than transfer pension schemes.

It would be a mistake to give shares to banks at this stage of the reform process. Two arguments can be made in favor of bank share ownership. First, the banks have some financial expertise, so that their ownership of equity will help improve the efficiency of the stock market. Second, share distribution to banks is a means of building up banks' assets and correspondingly their capital in advance of the balance sheet restructurings and writedowns that have to come. Since some of the assets written down will be loans to the firms whose shares are being distributed, there is some logic in compensating the banks in advance. However, share distribution gives the banks assets of highly uncertain value at a time when the value of their assets is in any case unknown, and when the main need is to restore the safety of banks and confidence in them. Bank share ownership would also give them inappropriate incentives to lend to firms in which they have ownership shares. It would be preferable to hold the shares that have been earmarked for banks in a separate general fund, which could be used later to infuse funds into banks that need them, and to restructure bank balance sheets with safer assets.

In Czechoslovakia vouchers for the purchase of shares will be distributed to all citizens, with the government retaining at least 20 percent to deal with claims on the firms made by former owners. The proportions are reversed in Romania, where the government retains 70 percent. Although there are fiscal reasons for the government to retain shares, the more it does so, the less credible is its commitment to move rapidly to a private ownership market economy.

The voucher schemes have to be completed by a pseudo-market to establish the initial voucher prices of firms. Triska and Jelinek-Francis (1990) discuss alternative schemes for the initial allocation of shares, favoring a pro-rata allocation method in which the number of shares an individual receives in a given company is equal to his or her pro-rata share in the total bids for that firm.

While this method would clear the market, some alternative schemes being considered would not, at least not rapidly. A "tatonnement" is proposed for Czechoslovak privatization: initial prices will be set for 2000 companies, individuals will then tender vouchers for shares in individual firms, prices will be changed on the basis of the excess of supply or demand of shares, and the process repeated. Despite its conformity with the textbooks, this process has few benefits to recommend it. The information on which individuals base their bids for shares must be extremely imperfect, and the final prices correspondingly poor guides to investment decisions. It would be preferable to distribute shares in mutual funds to individuals, on an equitable basis, and allow the mutual funds to trade in the shares of individual companies. Individuals would be allowed to sell mutual fund shares after a specified period, say two years.

### The role of foreigners

The potential role of foreigners has been a matter of concern in all the FSEs. Countries want the benefits of foreign expertise and foreign finance. But they are concerned that, in the absence of domestic sources of finance, foreigners will acquire a large part of industry at fire-sale prices. Accordingly at the same time as countries seek foreign expertise, for instance in the form of technical assistance or management contracts, they make provisions to control the share of foreign ownership. For instance, in the auctions of small firms in Czechoslovakia, foreigners were not allowed to bid in the first round. Similarly the distribution of ownership shares or vouchers to citizens or residents limits the initial extent of foreign ownership.

These limits may appear redundant at present when there is no large flow of foreign finance into the FSEs. However some limits are justified because large scale foreign purchases at low prices could discredit the entire privatization process. Further, governments have shown their interest in negotiating or encouraging joint ventures and other means of foreign participation. Constraints on foreign ownership can be relaxed once the privatization process is well established.

### The Hungarian difference.

Practice in Hungary will differ from that in the other countries in two major respects. First, there will be greater reliance on privatizations initiated by the firms themselves. These "privatizations from below" continue to be referred to as spontaneous privatizations (e.g. Bokros, 1990). However, the spontaneous privatizations that led to an outcry in Hungary and other countries in 1989 usually referred to a particularly favorable deal that involved either the current management or other members of the nomenklatura.

Since 1989 all Hungarian privatizations have had to be approved by the State Property Agency, which has exercised its right of refusal in almost one third of the cases it has considered. The State Property Agency also intends to initiate privatizations, and will consider proposals originating from potential purchasers. Hungary hopes to privatize one-third of state assets within the next three years.

Second, Hungary has hardly accepted the principle of free distribution of shares. Kornai (1990) argues strongly that property should be purchased, and that the basis of the new system will be undermined if it starts with a free gift. Bokros (1990) allows for some distribution of vouchers, but refers to free distribution of shares as a marginal solution that is part of a social compensatory scheme rather than a serious attempt at privatization, adding (p.7) "it is not considered seriously as part of any 'grand design' even by social researchers and leftist intellectuals". The arguments in favor of free distribution on an equitable basis are that the property has already been paid for by the population, and that those currently able to purchase assets may have obtained their wealth illegitimately. Countering the argument that property acquired freely is unlikely to be treated seriously, Hinds (1990) points out that individuals who inherit property do not seem to mistreat it. While the argument against free distribution is not compelling, Hungary does avoid the complication of the free distribution schemes that some form of concentrated ownership or control has then to be introduced, for example the holding companies.

The pragmatic Hungarian approach is making progress more rapidly than the alternative approaches being followed in other countries. There is a tradeoff

between the speed with which the privatization process takes place and the fairness of the process. Speed matters.

The development of a stock market.

All privatization programs envisage a major role for a stock market. While there has been considerable scepticism about the absolute efficiency of the U.S. stock market in the academic literature (e.g. Shiller, 1989), the question is one of relative rather than absolute efficiency -- and here it is difficult to envisage any other arrangement that will perform the information processing and corporate control functions that a stock market provides. However the importance of the stock market varies across countries, with the banks playing a relatively more important role especially in Germany.

It will take some time to develop stock markets with the necessary depth and efficiency. Trading should be restricted up to that time. Hungary has already instituted a stock market. Poland has decided to follow the French model of the stock market, stock registration, and clearing, in part because of the technical assistance offered. It envisages that the stock market will open for business by the middle of 1991. A securities commission is also being set up, with training assistance from the United States SEC. The Securities Commission will register securities to be traded, license brokers and mutual funds, promulgate and enforce regulations, and attempt to educate the public.

Mutual funds and holding companies.

It is unlikely that an efficient stock market can be developed until shares begin to be exchanged for money rather than vouchers or other shares. The share or voucher distribution schemes lead to widely dispersed share ownership, and raise concerns about both the efficiency of the stock market and the role that shareowners can play in corporate control. If all shareholders

are small, none of them has much incentive to do the research that will lead to efficient asset pricing. Further, small widely dispersed shareowners cannot exercise control over corporate boards and management, because they lack the financial resources to back their judgment with sales or purchases of shares.

Two approaches have been suggested to deal with these problems. The first is to develop institutional investors, such as pension funds and mutual funds. The second is to set up self-liquidating holding companies. For simplicity we refer to these as the mutual fund and holding company proposals respectively. It is taken for granted that it would in any case be desirable to encourage institutional investors such as pension funds, and that can be done immediately under any approach in which shares are distributed rather than sold. Pension funds will also develop over the course of time as newly privatized firms have to provide pensions for their employees. The sooner these institutions can begin trading in the stock market for money, the more rapidly the stock market can develop.

The difference between the mutual fund and holding company approaches is that the mutual funds are expected to take a more passive role in management. The creation of mutual funds will solve the problem of uninformed investors. The mutual funds can be set up either (a) by allocating shares in companies to them, and then allocating shares in mutual funds to individuals, or (b) by allocating vouchers to individuals to bid for shares in mutual companies. Scheme (a) would be preferable, since there can at the beginning be very little information on the basis of which individuals would bid under scheme (b). Some thought has also been given in Poland to the establishment of financial intermediaries, such as mutual funds, that will obtain outside capital (including foreign capital) and purchase shares rather than be given them

(Jedrzejczak, 1990). In any case, foreign experts are expected to take part in the management of financial institutions, including mutual funds.

Mutual funds would exercise discipline over company management by sales and purchases of shares. Managers should be given stock options to ensure that stock price movements affect their actions, though the question of whether they would act in an excessively short-sighted (supposedly American) rather than long-term (supposedly Japanese) fashion is open. A sufficient number of mutual funds -- at least 15 in the smaller countries, more in the Soviet Union -- will have to be created for the stock market to operate efficiently. The efficiency of the market will depend also on the composition of the funds' share holdings. Each firm should initially be owned by more than one mutual fund, but shares should be distributed in a way that allows mutual funds to specialize in gathering information. After a short while the mutual funds should be allowed to purchase or sell whatever shares they want. Over the course of time specialized funds can be expected to develop.

An important question arises of when trading for money can begin, and how liquidity is to be infused into the stock market. Mutual funds would need initial financial capital to be able to buy and sell shares for money rather than other shares. The source of this capital is not clear; the state could provide mutual funds with initial capital, other institutions such as pension funds, or individuals, could invest in the mutual funds. It would probably be advisable to limit both the volume of trading and the participation of individuals in the early days of the stock market. For example, the mutual funds could be kept as closed end funds, and individuals allowed to sell only some portion of their initial holdings, during an initial period such as the

first year after the stock market is opened, or after shares are distributed (since not all shares will be distributed at the beginning).

Holding companies would take a more active role in the management of companies. The holding companies would be represented and take an active role on corporate boards. Shares would be distributed so that each firm is allocated predominantly, but certainly not exclusively, to one holding company. To prevent monopolization, the holding companies should not be specialized in particular industries. The number of holding companies should be sufficiently large to make collusion difficult. This would require at least 20 companies in a country like Poland.

The holding companies would be set up not only to concentrate information in the stock market, but also because effective management in a market economy -- particularly financial management -- will be scarce in the early transition stages in the FSEs. The holding companies would be expected to include the best corporate managers, and also to draw on foreign experts in managing companies.

There are two major fears about the holding companies: first, that if they are badly run, they can create more difficulties than they solve; and second, that they will end up essentially reproducing the ministries that they are designed to replace. There is no way of ensuring that the holding companies run well. They face a formidable management task in bringing a large number of companies into the market economy, and in closing the firms that will not make it. Management incentives that tie compensation to stock market performance or the profitability of their firms will help, but cannot substitute for management skills that operatives in market economies have acquired through on-the-job and academic training over long periods.

It is inevitable that the holding companies would in part be managed by those who have managed companies in the past. The holding companies could also have enormous power. This means there is a real possibility the holding companies would end up acting like the ministries that they are in effect replacing. This danger can be mitigated by ensuring that there is competition among holding companies within each industry, and by supervising the holding companies. However their possession of superior information makes supervision difficult.

Blanchard (1990) suggests that the holding companies should be self-liquidating, required to sell off their companies over the course of time and with a specified end-date. They would thus serve as privatization agencies. This is a worthwhile suggestion for preventing the economic dominance of holding companies, even though the example of the industrial groups in Japan tempts the thought that holding companies may also be an efficient way of organizing industry.

There is no need to use only one or the other method -- mutual funds, or holding companies -- exclusively. Larger firms can be privatized individually, smaller ones can be privatized through holding companies (with the shares distributed to holding companies without creating cartels or monopolies), and mutual funds can hold shares of both the larger companies and holding companies.

#### The remaining shares.

In each of the share distribution proposals, the government retains a significant percentage of ownership, sufficient to make it the largest shareholder. A benevolent government would be able to use this power to improve firm performance, but there is no reason to expect the governments of

FSEs to behave differently than other governments. It is unwise for the government to continue to hold these shares for very long. Governments should commit themselves to divesting through some mechanism as soon as possible, when it is clear that a company is operating successfully in the private sector.

Lipton and Sachs (1990) suggest that the government seek out a "stable core" of investors who will constitute the ownership and management nucleus of each company, and sell its shares to them. The possibility of the government at any time being able to sell off 30 percent of the shares, at a price of its choosing, would subject any other negotiations for share sales to great uncertainty. Thus it would be appropriate for the government to seek out purchasers during the early phases of privatization, in collaboration with the corporate management, but not to continue to exercise its implicit control after the firm is established in the private sector.

#### Financing needs.

One major difficulty with the proposal to distribute rather than sell shares is that companies are very likely to need financial capital as they begin operating in a market environment. Depending on how the government treats the proceeds of sales, companies that are sold can acquire this capital automatically. This is certainly one advantage of the Hungarian approach.

Alternatively, other sources of finance could be made available through the banking system. Brainard (1990) argues that financial sector reform is essential for rapid transformation. Rapid financial sector reform would certainly assist the privatization effort. However, it cannot take place very rapidly, because the value of existing assets and liabilities of the banks will not be known until the economy settles down to a more rational set of prices and the restructuring of the real side of the economy is complete. The fear,

based on experience, is that banks will make loans designed to save existing assets rather than develop new ones if they are encouraged to lend before their balance sheets are cleaned up.

Banks can help newly emerging companies by segregating financing of new investments from their ongoing relationships, and governments may want to funnel financial assistance from abroad through the banking system.

### III. Other Privatizations.

Financial intermediaries, housing, agriculture, and land, will all have to be privatized before the economies of the FSEs can be regarded as having made the transformation to private market status. The FSEs have moved to two-tier banking, with the central bank separated from commercial banks. Unless the government is willing to guarantee the value of assets transferred at the time of privatization, the banks will not find buyers until their balance sheets are cleaned up. Cleaning up their balance sheets is likely to take significant injections of funds and time. But the banks should in any case not be privatized until an adequate regulatory apparatus is in place. Because this too will take time, progress is urgent. Rapid development of the regulatory framework is needed also so that new banks, including foreign banks, and other financial institutions can begin to develop.

While there is some private housing in all the FSEs, the bulk is state owned, and there has been little attempt at privatization in the last few years. It is well understood that until rents are raised to realistic levels, and wages adjusted accordingly, there is little incentive for renters to buy their houses or apartments. Because there are so many units to privatize, because cooperative arrangements in apartment buildings will have to be

developed, and because mortgage financing will have to be provided, the sale of housing is likely to be very slow. It is nonetheless surprising that it has received so little attention so far.

Agriculture is substantially private in Poland, but agriculture remains mainly collectivized in Czechoslovakia and Hungary. There has been little progress in decollectivization, and in land reform, and there is no agreed strategy in these areas. By some reports, there has also been relatively little pressure for reform from within the agricultural sector.

#### IV. Concluding Comments.

The progress that has been made in analyzing privatization options in the FSEs and moving the analysis into legislation is remarkable. So is the progress that has been made in dealing with the privatization of small commercial and industrial firms. It remains true though that privatization of large-scale firms has barely begun, and that the evidence is not yet in on whether the ambitious Czechoslovak and Polish approaches will result in more rapid privatization than the more piecemeal Hungarian approach. There are great uncertainties about how the Czechoslovak and Polish approaches will work, particularly when the stock market can begin to play a role, whether the holding companies or mutual funds will be successful, and how rapidly it will be possible to move on a major scale from commercialization to privatization. The experience of the former East Germany, where the privatization process -- based on negotiated sales -- is gravely bogged down, is warning that there may be major disappointments in store. It should also be emphasized that privatization has soon to be tackled in other areas -- financial institutions, housing, and agriculture and land.

Given the magnitude of the task, it would be a mistake to discourage any any potentially viable form of privatization that is not theft. The pragmatic approach being followed in Hungary, and in the privatization of medium scale firms in Poland, gives promise of faster privatization than any monolithic alternative.

What if privatization turns out to be slower than hoped? That will be a setback setback to hopes for the rapid creation of a private sector. But the success of small-scale privatizations, and the extraordinary growth of very small firms, suggests that the key to the long-run transformation of the FSEs may lie less in the privatization of the very large industrial firms -- some of them dinosaurs -- than in the development of new firms and the growth of existing smaller firms. For that reason, rapid progress in other areas, such as the creation of a suitable legal environment, price decentrol, industrial deregulation, and trade liberalization, is as important to the development of a vibrant private sector as privatization of large firms.

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