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PRIVATIZATIONS

An Approach to Economic and Social  
Transformations in Eastern Europe

by

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## MARKETS AND INSTITUTIONS IN LARGE SCALE PRIVATIZATIONS

### An Approach to Economic and Social Transformations in Eastern Europe

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This paper is designed to provide a systematic approach to the problem of privatization in the context of Eastern European economies. The approach presented here will be "systematic" in the sense of providing a theory of what privatization is supposed to accomplish in Eastern Europe and supplying the means of evaluating the relative advantages and disadvantages of each privatization strategy. While the case of Poland will serve as the focal point of our discussions, the analysis presented here is intended to have more general significance, applicable to the region as a whole.

## I. WHY PRIVATIZE?

The first thing to understand about the privatization process in Eastern Europe is that, in contrast to other countries, privatization, in the environment of these transitional economies, is not a simple transfer of ownership from the state to private individuals. It is rather a process by which the very institution of property, in the sense in which lawyers and economists are used to employ this term, is reintroduced into East European societies.

At the core of every socioeconomic order is the problem of the efficient use of socially available resources. Whenever the use of

these resources is not restricted, there arises the so called "problem of the common." Consider the case of a primitive society in which no one has exclusive rights to land and every member of the community is free to use it for his own purposes. In this society, every time a person invests his time and energy to cultivate the land, he bears all the costs of producing the new crop, but can only derive a small part of its benefits; conversely, whenever any person removes something from the common, he derives all the benefits of what he removes, but bears only a fraction of the costs of producing it. In a system of this kind, there is a systematic incentive to underproduce and overconsume, and the resources become depleted at a rate that may not be socially desirable.

There are two standard ways of dealing with the problem of the common: regulation and the creation of property rights. In the first case, a communal decision is made concerning the use of the common resources, and this decision is then coercively enforced against those who attempt to free ride on the efforts of others. In the second case, resources are assigned to the exclusive use of individual agents who, having to pay all the costs and deriving all the benefits from the use they choose to make of the resources assigned to them, have the appropriate incentives to choose those uses which yield the greatest net benefit. In the first case, the social use of resources is made on the basis of political decisions; in the second, it relies on individual interest maximization, in conjunction with the market as a resource

allocation mechanism.

While all societies use political decisions to regulate certain aspects of the economy (in particular those in which market mechanisms are vitiated by persistent free riding and externalities), the socialist systems of Eastern Europe made practically all decisions concerning production<sup>2</sup> through the political system, with factory personnel playing the role of state functionaries. What the name "command economy" conveys is precisely this eschewing of market mechanisms, but also the fact that all property-related arrangements in general have been replaced by an administrative system in which the state prefers to control the behavior of each agent directly, rather than relying on his own pursuit of self interest. In this sense, the socialist economies of Eastern Europe did not have *any* property system (including state and not just private property) governing its productive activities. It is not surprising, therefore, that in all East European countries it is nearly impossible to answer the simple question who owns what in the state enterprises: the legal determination of ownership was simply irrelevant under the old system, which relied instead on directly prescribing the conduct of factory officials.

The need to reintroduce the very institution of property in the productive resources of East European societies means that the structural reform of the economies of these countries cannot proceed primarily on a macroeconomic level. This realization, given

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<sup>2</sup> Agricultural production in Poland was the most significant exception.

the recent reform efforts in a number of East European countries, is of great importance.

The case of Poland is quite instructive. The first stage of the economic reform there, known as the "Balcerowicz Plan," consisted in a series of macroeconomic measures, such as credit restrictions, wage restraints, and reduction of subsidies, designed to arrest inflationary pressures in the economy. The effects of this series of moves was in part quite predictable: the prices at first shot upwards, then inflation slowed down quite dramatically and prices remained relatively stable (although not as much as had been hoped). Among other expected effects was a fall in production and a rise in unemployment. Both of these did indeed happen, though to an extent different than expected and perhaps for reasons that had not been foreseen.

The authors of the Balcerowicz Plan also expected, however, that the macroeconomic measures undertaken since January 1990 would result not only in the elimination of the strong inflationary pressures evident at the end of 1989, but also in the creation of the basic conditions of a market economy. The lifting of subsidies, together with other monetary measures, was expected to result in a readjustment of prices. By bringing out a more realistic assessment of costs and revenues of each particular enterprise, this in turn was supposed to provide the proper incentives for the management and put the state enterprises on a sound footing. Privatization, in this view, would merely complete the process begun by the macroeconomic reform: when the real viability of individual

enterprises was going to be determined by the market, they could then be valued and gradually sold off through a variety of well known techniques.

It is a relatively safe proposition that, without some fairly dramatic steps on the microeconomic level, the hopes for a structural adjustment of the Polish economy, associated with the macroeconomic stabilization program, could not be fulfilled. The reasons for this are related precisely to the absence of an appropriate legal and organizational structure at the enterprise level.

The structure of the Polish enterprises, like those of the other countries in the region, is still largely a function of the old regime and the behavior of their managers is determined by the conditions in which they operate. Polish enterprises at this time are not even structured as joint stock companies. They are governed by state-appointed bureaucrats--so-called "nomenklatura"--who used to respond to other bureaucrats higher up in the mammoth hierarchy of the planned economy. This hierarchy has been by and large dismantled and the enterprises were said to go it alone. But in the absence of any new external control over management, the old nomenklatura people, instead of maximizing the enterprises' returns, are scrambling to find the best deal for themselves. Some of them are trying to convert the state enterprises into their own fiefdoms that could then be converted into joint ventures with foreign participants, whereby the management would get a hefty payoff and the foreigners would get the enterprise for a song.

Others are attempting a home-grown "privatization" by which, without any capital input or another legitimation, they might end up as owners of the previously state companies. But most of them, by now devoid of their traditional bureaucratic basis of support, are trying to maintain themselves by forging a new alliance with their workers to whom the reform has given an inordinate amount of power at the enterprise level. The managers are thus willing to decapitalize their firms and neglect all measures that may require sacrifices from the work force, while maintaining the highest possible levels of salaries and employment.

In this situation, the freeing of prices and the emergence of markets for the products manufactured by state enterprises are by themselves not sufficient to discipline the managers' behavior. Without the pressure of shareholders, who can cashier the management which does not produce high enough rates of return on the firm's investments, the only remaining sanction provided by the product market is bankruptcy. Before that happens, however, a state enterprise can continue for a long time in its traditional inefficient ways by using up the available sources of credit, cutting back on reinvestment, or at best coasting along on the borders of profitability. And when a bankruptcy does happen, there is no mechanism of restructuring available to put things aright. Thus, the reliance on the product market, with its threat of bankruptcy, as a disciplining mechanism is potentially very dangerous. To be sure, there are some enterprises which should simply be closed down, without any more. Insofar, however, as a

large number of bankruptcies might be caused by inefficient management of potentially viable enterprises, a lot of resources might be wasted and the economy might plummet, without there being any clear way of moving out of the depression.

The only way of remedying the crippling inefficiency of post-socialist state enterprises is to move as fast as possible toward a genuine property regime. An immediate move, of a limited scope but considerable practical importance, is to move into a new legal system of genuine *state* property, even before a transfer of ownership from the state to private hands can take place. This process of "corporatization" or, as it is sometimes called, "commercialization," would consist of an immediate transformation of all the state enterprises into joint-stock companies (with the Treasury being the sole shareholder) and the appointment of outside directors. While the establishment of a genuine form of state *property*, especially in a society without a significant private sector which could shape the behavior of the state-appointed directors, could not be expected to result in a far-reaching improvement in the functioning of the enterprises, it could provide some remedy for the worst cases of mismanagement and abuse now common in the Polish economy.<sup>3</sup>

But nothing will remove the need for speedy privatization. This is not just the last stage in the process of transition from a centrally planned economy to capitalism, a stage at which final

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<sup>3</sup> We would like to thank Professor Jeffrey Sachs for turning our attention to the importance of "corporatization."

touches are applied to an already functioning system. On the contrary, insofar as privatization consists in a transfer of control into the hands of private shareholders who, in a mutually competitive environment, are trying to maximize the returns on their investments, it is an indispensable condition of an efficient control of management performance. This control over management is, in turn, the essence of the genuine restructuring process, i.e. a process of transition from a command economy to a true market order in which not only the value of particular products, but also of the enterprises producing them, is determined by the relation of supply and demand. Unless this process is completed, the reform efforts in Poland and the other East European countries will probably fail and the economic situation is likely to deteriorate even further.

## II. THE GENERAL PRINCIPLES OF PRIVATIZATION

There are four main requirements that must be satisfied by any privatization plan that has a chance to work.

### 1. Privatization must be accomplished quickly.

This should be evident from what was said already. If privatization, as we have argued, is the core of the process in which the state enterprises become restructured, the economic reform in Eastern Europe cannot proceed without a radical ownership transformation.

## 2. Privatization must be socially acceptable.

The East European industry, antiquated and inefficient as it is, has been built at the price of enormous sacrifices by the general population over the last 45 years. The industrialization program of the 1950-ies has been pursued at the cost of drastic cuts in consumption, and although the austerity was somewhat relaxed in later years, the rise of life standards has been constantly retarded by the policy of investment in heavy industrial infrastructure. If this industry is now sold at prices which are seen as very low, the popular opinion might turn against the privatization program as a whole.

The people of Eastern Europe also have a somewhat ambivalent attitude toward the privatization program and the market economy as a whole. On the one hand, nearly everyone understands that the move in the direction of capitalism is necessary and can be expected to yield, in the long run, significant improvements in the life standards of the region. On the other hand, it is also clear that, in the short run, the move toward market economy means further sacrifices, involving potentially high rates of unemployment with which the people of Eastern Europe are not familiar.

Finally, while a certain amount of wealth differentiation based on risk taking and superior business acumen is usually socially acceptable, an extremely unequal wealth distribution, which creates a permanent division between the haves and have-nots, is inherently destabilizing. This might be especially dangerous in Eastern Europe, where the people have been accustomed to a certain

amount of equality and where the political climate is not very stable for the time being. Great attention must therefore be paid to choosing a strategy of privatization which will not exacerbate the anxieties of the population, but rather give it some tangible stakes in the success of the undertaking.

3. Privatization must assure effective control over management of the privatized enterprises.

The move away from bureaucratic control over the economy cannot mean a simple removal of all control mechanisms with respect to the functioning of the enterprises. This important point does not appear to be widely understood and was apparently responsible for the belief that the removal of price controls and the emergence of markets would by themselves usher in a significantly more efficient system of production at the enterprise level. In fact, however, a system of decision making in a complex modern economy, involving a very large amount of information necessary for making even the most trivial decisions and a complicated system for the allocation of responsibilities, requires a whole panoply of institutions which properly structure the incentives of the actors involved and reduce the complexity of real-world situations to a manageable number of relatively simple rules. In other words, when the control mechanisms of the command economy are eliminated, something else must be put in their place that will play the same role as the historically evolved, and often taken for granted, control institutions of a Western market economy.

Prime among these institutions is a system which sets the

incentives of the managers of enterprises so that they attempt to maximize the interests of the shareholders, which, in a properly competitive environment, means that the production process is structured to correspond with the interests of the consumers. In the developed capitalist societies, this task is accomplished through a variety of institutions, such as takeover mechanisms (with the whole legal, financial, and organizational infrastructure of the stock market which they require) or an elaborate banking system which supervises company management in Germany and Japan. Without something that fulfills a similar role in the Eastern European economies, privatization might result in an extreme fragmentation of holdings and replace the stifling system of bureaucratic control with a system that leaves managers without any effective external supervision. This in turn would undermine the whole meaning of privatization, which, as we have argued, consists not in a simple change of ownership, but in a radical restructuring which transforms the incentive system of the economic agents at the enterprise level.

4. Privatization must assure access to foreign capital and expertise.

Nearly everyone understands that the capital-starved and heavily indebted East European economies badly need an infusion of Western funds in order to modernize the aging industrial infrastructure, introduce new technologies, etc. It is equally clear that Eastern Europe also needs Western know-how and management expertise, without which it will not be able to use properly

whatever Western financial aid is made available and to bring its production up to the standards of the developed world. But what is less often realized is that the area where Western expertise is most needed is precisely in the effort to construct the general infrastructure of a modern market economy, and particularly the already mentioned control institutions necessary for the supervision of the management at the enterprise level. Moreover, in order to be effective, the entry of foreign capital and expertise into Eastern Europe cannot take place through a provision of advisory and consulting services. The only way in which Western financial institutions can play a truly creative role in the region is if their entry is based on sound business principles, so that they stand to gain or lose by their activities. This in turn means that the privatization program must create the conditions which make such entry attractive from a business point of view and that this entry must take place in a properly competitive environment.

While serious Western participation in the construction of the infrastructure of the market economy in Eastern Europe is a condition of a successful move away from the bureaucratic command systems in the region, the entry of foreign capital also gives rise to special political problems and raises additional questions of legitimation. The people of Eastern Europe very much want to catch up with the Western world and they expect to be helped in their efforts to do so, but at the same time they are afraid that their economies will come to be dominated by foreign capital and that their economic and political interests will be jeopardized in the

process. In order to succeed, therefore, a privatization plan for Eastern Europe must, on the one hand, provide a clear avenue for the entry of foreign capital and expertise, but, on the other hand, it must place this entry in a setting that makes it acceptable from the point of view of the East Europeans' perception of their own interests.

### III. THE PROBLEM OF VALUATION

It is clear that privatization involves a need for the valuation of enterprises to be privatized. It might be possible, of course, for the state to convey title to a company to some private party without engaging in an assessment of its value, but such a naked transfer, quite apart from the legitimacy problems that might arise, would not, by itself, accomplish anything. The purpose of privatization, as we have argued, is not to transfer title, but to initiate a restructuring of enterprises and a rationalization of the Eastern European economies. In order for this to take place, someone *must* evaluate the potential of each enterprise to be privatized, i.e. assess its relative value as compared other possible investment opportunities, since only in this way is it possible to come to some decisions as to where best to invest the limited resources available for the upgrading of the economy.

Nevertheless, given the absence of a developed market economy, traditional forms of enterprise valuation encounter seemingly insuperable obstacles in the environment of Eastern Europe.

Traditional valuation methods used in the developed capitalist economies essentially aim at an "objective," i.e. intersubjectively recognized, assessment of the value of an enterprise. In the case of a publicly traded company, the intersubjective element is self-evident, since it is equal to the price obtainable on the market at any given point, although even then individual valuations may differ from the market price.<sup>4</sup> In the case of a privately held company or a fully state-owned company, where the market price is not available, different individuals may have different subjective assessments of the company's value and the subjective element cannot be separated from the valuation process. In the general context of a market economy, however, it is possible to come up with some approximations of the price that would be arrived at by the market itself, since the agent doing the valuation may base his estimates on a number of analogies to the methods commonly used by investors in the market under similar conditions, such as relying on price-earning ratios, the firm's performance over the last few years, the average prices of similar enterprises on the market, etc.

The very idea of an "objective" valuation does not make much sense, however, under the conditions prevalent in Eastern Europe, since the absence of markets makes it impossible to establish any reliable benchmarks against which the value of the enterprises

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<sup>4</sup> One of the reasons for this difference may be due to a premium that an investor may be prepared to pay for a certain block of shares that would give him control of the company. Another may be due to an individual assessment of the company's future that differs from the one implied in the market price.

could be measured. Data from the past, when the enterprises functioned within the regime of a command economy, tell us nearly nothing about a firm's present value. The peculiarly Eastern European institution of "interfirm credit," i.e. a chain of mutual indebtedness among the companies along the production process, introduces a further element of uncertainty into the already clouded company books: around 40% of the book value of the companies being prepared for privatization in Poland is in the form of outstanding liabilities from other enterprises, much of it of very long standing, and without evaluating the soundness of all of the enterprises involved, it is impossible to predict what portion of these funds will ever be recovered. The absence of capital markets makes it impossible to reason by analogy with other enterprises of the same type. Given no reliable track record, it is impossible to make any informed guesses about how a given firm would do in the conditions of a free market economy. Moreover, the economic situation in Poland changes all the time, and it is impossible to predict the state of the whole economy or even of its particular segments a few months ahead. The long term interest rate, some assumptions about which are necessary for a calculation of the present value of future streams of income, is still simply set by the state and its future course, if only for the next few months, is largely unknown, even though relatively small variations in the interest rate may very radically affect the estimated value

of an enterprise.<sup>5</sup>

All of these factors put together mean that the "objective" elements of valuation are, in the conditions of Eastern Europe, *de minimis*, and the subjective elements, which are present in any valuation process, must dominate the assessments of the companies during the transition to capitalism. First, given the absence of reliable benchmarks for an objective assessment, the agents who perform the valuation must make more or less arbitrary guesses about such things as the real value of fixed assets, the appropriate price-earnings ratio, or the interest rate for the next few years, and these guesses will, of course, differ from person to person. Second, when the market does not convey certain types of information through the pricing system, the informational differentials among individuals will increase dramatically. Thus, for example, someone involved in shoe manufacturing will have a lot of information about the conditions of the shoe industry which would normally be conveyed to the world at large through the price system, but which remains private in the absence of a market economy. Third, when assets are largely illiquid (because there is no established market), certain assets, quite apart from any informational disparities among agents, will have very different value to different people. A beer producer, for example, might put a very high price on a ton of yeast, but the same yeast will be

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<sup>5</sup> In order to show the difficulties and the arbitrariness of valuation of East European enterprises, Appendix I discusses a case of an enterprise valued by a prestigious British accounting firm for the Polish government in connection with the privatization program there.

useless to a shoemaker, who, if he cannot readily resell the yeast to someone who needs it, will not offer any price for it. Fourth, by the very fact that an agent has certain plans with respect to some assets for which he is bidding, he is in possession of some information which other people, such as accountants or outside consultants who will not be involved in the exploitation of the assets in question, are lacking, and again, this informational disparity is compounded by the absence of a historical knowledge concerning the most predictable uses of even the most standard resources. Finally, every valuation process contains some elements of skill or "hunch" or "tacit knowledge" which is not quite arbitrary (since it may be shown that some people, using their "hunches," do consistently better than others), but which cannot be explained in objective terms, understandable to a third party. Thus, for example, a good venture capitalist does not base his assessment of a given firm's prospects exclusively on the value of its assets, price-earnings ratios etc; he attaches the greatest importance to his "feel" of the managerial skills of the people involved which, while intangible and often impossible to explain, may be decisive for the venture's success.

The predominance of the subjective aspects of valuation poses significant problems for a privatization program, primarily because even to the extent that valuation is not arbitrary, it is impossible to explain or legitimize it in objective terms. As a consequence, any help or advice that might be gained from even the most reputable consulting or accounting firms is likely to be

worthless, since advisers of this kind must explain their conclusions to their principals, and this task is, under the circumstances, simply impossible. This in turn means that a privatization model that has a chance to work must avoid the situation in which the duty of valuation rests on the state (which, in order to legitimize its decisions, must use outside consultants and try to arrive at an "objective" valuation). The only way to avoid this is *to place the burden of valuation on those parties which, like an ordinary investor in a market economy, will bear the consequences of their own decisions, since only the parties in this position can rely on their subjective estimates, without having to explain their reasons to the anyone else.*

But even if the burden of valuation is placed on the party that will bear the consequences of its decisions (deriving extra gains from having arrived at a more precise valuation than other parties and losing by making errors greater than the others), the remaining high degree of uncertainty may make agents very reluctant to place their assets at risk on the basis of what must be at best a very imprecise guesswork. If, for example, an investor must decide whether to purchase some shares of Nowa Huta (a somewhat antiquated steel mill in Poland) or a piece of real estate in Switzerland, the uncertainty attendant on making any assessments of the value of Nowa Huta will make the investor choose the safer investment in Switzerland, unless the price of Nowa Huta is discounted to such an extent as to make it competitive. But then the price may be perceived as too low and serious problems of

legitimation may arise. To deal with this problem the agents must be put in a position in which either their risk or the uncertainty of their judgments is reduced. A way to accomplish both of these objectives is *to reduce the universe of competing opportunities relative to which the agent must evaluate the enterprise in question*. Thus, in the example just given, if the agent has no choice but to invest some of his assets in one of the privatized enterprises in Poland, his valuation problem is reduced to an assessment of the value of Nowa Huta relative to other Polish enterprises, and no longer to all other possible investment opportunities. Not only is the problem of the size of the discount due to uncertainty lessened in this way, but the uncertainty itself may be reduced as well. This is because large areas of uncertainty, which make the valuation of Polish enterprises so difficult, pertain to all of these enterprises in the same way and may therefore be ignored for the purposes of internal comparisons. It is precisely this reduction of the universe of competing investment opportunities that is accomplished through the device of issuing special privatization vouchers. Making the agents bid for the privatized companies in a specially restricted form of currency (vouchers), which cannot be used for any other purpose, rather than in money, which is a universal medium of payment, eliminates all the other options which compound the already serious valuation problems.

#### IV. THE SALE MODEL

The imperative of a speedy privatization of most of the East European industry, together with the already discussed problems of valuation, mean that privatization in Eastern Europe cannot follow the models elaborated in recent years in such countries as Great Britain or France. In these highly developed Western European countries, privatization had an entirely different significance from the process to be embarked upon in Poland: there, it was not a restructuring of the national economy, but merely a sale of a few state-owned enterprises, functioning in a fundamentally market environment, dominated by private property. This means that already prior to their privatization, state enterprises in, say, Great Britain had to operate in competition with other private companies and that their managerial system (even if often less efficient than that of their private analogues) was basically a product of the surrounding capitalist business culture. If some of these state enterprises were in the red, it was relatively easy to provide a measure of subsidies and reform, so as to bring them, within a relatively short period of time, to profitability and to put them up for sale. The sale itself was also a rather easy matter: in a full market economy, in which most of the industry is in private hands, in which there exists a developed stock market, and in which all enterprises use modern accounting methods, a sale of a state enterprise does not differ very much from the process by which a private closely held corporation "goes public" by issuing shares to

investors at large. It is enough for the state to hire the services of an investment firm (or a consortium of such firms) which underwrites the issue and sells the shares to the public.

This simple description of privatization in the West is enough to show that it cannot serve as a model for privatization in Eastern Europe, where capital markets do not yet exist and the very structure of market economy is to be introduced precisely through the process of privatization. First, the very idea that most enterprises can continue to be owned by the state until they are profitable, in order to be sold off afterwards, is not to be taken seriously: the state has been unable to run these enterprises efficiently for 45 years and it is not likely to change now, even if it is no longer Communist. Indeed, if the state had been at all able to take care of the enterprises it owns, there would be no need to privatize them!

Second, even if we abstract from this problem, we immediately come up against the already discussed valuation problems which make the ordinary sale through a public offering (with or without an underwriter) impractical, insofar as no objectively acceptable price could be put on the shares of the enterprises to be privatized. And third, if we ignore this problem as well, valuation, even when the existence of a market economy makes such an undertaking meaningful, is a costly and time consuming proposition. The process of valuing 7,000 state enterprises in Poland (or even the 1,000 or so of the biggest firms) would take decades and make the whole

exercise completely futile.<sup>6</sup>

But, even if one were to assume all these problems away (by proposing, for example, to auction off all the state enterprises without any preliminary valuation and hoping that the buyers would be able to make some decisions on the basis of the scarce information available), there still remains one more crucial argument against large-scale privatizations through public sales, especially in those countries in which a stabilization program eliminated the accumulated "overhang" of local currency. Taking Poland as an example, we have calculated that, under the very optimistic assumption that people are prepared to spend 20-30 percent of all their savings to buy the shares of privatized enterprises, the amount of money available for the purchase of the state companies would equal between 2.4 and 3.6 percent of their book value! While this last number says relatively little about the "true" value of the state enterprises, the discrepancy is staggering enough to make clear that, if purchases by foreigners are left aside for the moment, the privatization through so-called sales would in fact be a form of giveaway, which would increase the existing inequalities by a factor of several scores. And given the fact that the existing wealth differences in Poland are perceived by the society not as a legitimate reward of thrift or industriousness, but as spoils distributed to its loyalists by the

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<sup>6</sup> A look at the number of enterprises reprivatized in Britain during the ten years of the Thatcher administration gives one an idea of how time consuming is the process of valuation and sale.

old regime, the giveaway in question would result in tremendous political problems for the new authorities.<sup>7</sup> (If, on the other hand, the government were to try to avoid the accusation of giving away the national wealth to the old "nomenklatura" and set the prices too high, it would then run the risk of not finding enough buyers, which might, in turn, have very harmful effect of lowering the general level of confidence in the Polish economy.)

In Poland at least, the practical and political problems of a similar kind would be just as serious (if not more so) if the state were to contemplate a sale of a large proportion of the Polish industry to foreign investors. To begin with, despite widespread fears of foreign domination among the Poles, foreign capital is by no means eager to invest seriously in the Polish economy. It might thus be very hard to find foreign buyers, unless the prices offered are very low. But the very threat of an accusation of having given away the national wealth to foreigners has been enough to cause the authors of the Polish privatization law to restrict foreign entry and require a special permission for any foreign interest to acquire more than 10% of a privatized enterprise. This, in turn, in conjunction with a proposed preferential sale of up to 20% of the shares in enterprise to the workers employed in it, makes investment in Poland even less attractive from the point of view of a foreign investor, who might be seriously hampered in his efforts

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<sup>7</sup> It should also be considered whether it is really a good policy to suck out all the capital reserves still kept by the people in Poland in order to feed the state treasury, instead of utilizing them for other badly needed investments.

to restructure the company (which might often require significant layoffs) and put it on a sound business footing.

For these and similar reasons, it is just about clear to most people, at least in Poland, that large scale privatization cannot be accomplished through sales. There are still many attempts, however, to sell off at least a part of the state enterprises through one or another form of a public offering, with a hope that a significant portion of the shares might be sold to a foreign investor who would to become an active participant in the restructuring efforts.

We shall not return here to the already discussed technical difficulties related to valuing the enterprises to be sold through a public offering of the British kind. But there is still a number of political issues that have to be considered. Let us note the following coincidence. According to the Polish privatization law, a considerable portion (up to 20%) of the shares of state enterprises will be sold to employees at discount prices. The existing management is also frequently interested in buying a large block of shares that would allow it (perhaps in coalition with the workers) to maintain control. Both of these groups (which have key access to information and are often in a position to keep it secret) are therefore interested in having the enterprises valued as low as possible, since then they would strike the best deal for themselves. What is more, the Ministry for Ownership Transformations is also interested in not setting the price too high, since otherwise the enterprise might not sell and this, after

months of preparations and hundreds of thousands of dollars spent in the process, would be regarded as a proof of the Ministry's inefficiency. The end result might, therefore, be that, if a foreign buyer is not found for a significant block of shares, a substantial portion of the ownership of the privatized enterprises will end up in the hands an alliance of workers and the old "nomenklatura," with the rest being held by small shareholders (if they are found) who would be too insignificant to interfere. All in all, therefore, the situation might not be very much different from the present, in which there is no significant outside control of the enterprises.

The preservation of the *status quo* could be avoided, of course, if a foreign investor were to be found for a significant block of the shares of each privatized enterprise. That is why bringing in foreign capital is an integral part of the program of selling selected state enterprises for cash. But, as we have noted already, it is by no means obvious that foreign capital is actually willing to enter Poland under the conditions that are offered. If a foreign investor can buy no more than 10% of the enterprise (and this is the portion he is allowed to hold without special dispensation under the privatization act), 20% of which is controlled by the employees and a significant portion of the rest by the nomenklatura management, the enterprise does not seem to be a promising investment. In order to make it more attractive to the foreign investor, he must be given an opportunity to buy a larger block of shares (that would assure him of some influence) at a

price that would be low enough to outweigh the uncertainty involved.

While the entry of foreign capital is of crucial importance for the restructuring process in Eastern Europe, it is not clear that this way of bringing it in is the most advantageous one. First, the capital brought in from abroad in this manner, does not come in the form of a productive investment, but is fed into state treasury. Not only is this likely not to be the best use of the money, but also, given the very high external debt of most East European states, large inflows of the proceeds from privatization might result in an intensified pressure for an increase in debt repayment (which would make the money flow right back out of the country). Second, the fundamental rule of trading is not to sell before the prices go up. In view of the general political and economic situation in Eastern Europe, the price of the privatized enterprises is likely to be very low. After several years, if the general situation improves and the enterprises are restructured, the same companies may be worth several times more. If the state of the East European economies cannot be improved without selling a very substantial portion of the existing assets to the foreigners, perhaps the price is worth paying. But if there are any other ways of utilizing foreign expertise, without mortgaging the country, the restructuring of the East European economies should bear fruit for the people of the region.

Finally, let us assume that in spite of all the difficulties it will be possible to privatize a portion of state-owned enter-

prises through traditional forms of sale. Since only the most profitable enterprises are likely to find buyers, the companies selected for the British-style privatizations will be the few most attractive plums of the Eastern European economies. What, however, will happen to the rest (and with them, to the economy as a whole)?

## V. FREE DISTRIBUTION MODELS

The inviability of the sales model of privatization means that the restructuring of the East European economies must proceed through more unconventional means. An important element of this strategy is rapid privatization through a program of free distribution of the shares of the state-owned companies. There are basically *three variables* along which the free distribution plans can be analyzed. The first concerns the *beneficiaries* of the free distribution: to whom is the ownership given away? The second variable concerns the *mode of distribution*: the shares can be distributed directly, or through some intermediaries, or the beneficiaries may receive some form of currency (vouchers) with which they can choose which shares to acquire. (The mode of distribution is decisive with respect to the question of whether the beneficiaries will have some say over which shares they will receive.) The third variable concerns the *role of the beneficiaries in the governance of the privatized companies*: are the beneficiaries to become active or passive owners, and if they are to be passive, who will exercise the control functions with respect

to management supervision.

#### A. Labor Ownership.

The most deeply flawed free distribution proposals envisage a giveaway or heavily subsidized sale of the shares of state-owned enterprises to the workers employed in them. From the point of view of social justice, free or subsidized distribution to workers involves fundamental inequities, since some workers, who happen to be employed in the most valuable factories, will receive an undeserved windfall, while many other citizens, including those employed in state administration or the private sector (potentially the most dynamic and entrepreneurial segment of the population) will be left with nothing. Moreover, quite apart from equitable and distributive considerations, the proposal to give to the workers the ownership of enterprises in which they work would constitute a step in a radically wrong direction from the economic point of view as well. The interest of the workers, who care, above all, about their employment and remuneration, is not at all parallel with the interest of the public (which wants the best products at the lowest possible price) or with the long-term requirements of the economy as a whole (which requires long-term investment and productivity growth). Moreover, if the individual workers were to be in some ways restricted in their ability to sell their shares (as would seem logical, given that they receive them precisely qua workers), the plan might impede a transfer of control to an outsider whose

input could discipline management behavior. Effective supervision would have to come from the workers themselves, and there is very little evidence that such supervision, especially in an economy in which worker-owned firms do not really compete with firms organized along more capitalist lines, can produce desired results. In other words, like some of the flawed sales plans, a program of free distribution to workers threatens to leave things much as they are at present in countries such as Poland and to impede the economic restructuring efforts. (This is not to say, of course, that the interests of the workers are not very important or that they should not be protected by some institutional arrangements. The appropriate institutional protection of the workers' interests, however, should come in the form of trade unions and governmental regulations of employment conditions, rather than worker ownership.)

Despite the dangers involved in worker giveaways, the political pressure in many Eastern European countries to move in this direction is very considerable. In Poland, this pressure has resulted, despite the initial resistance of the government, in a series of provisions in the privatization law which allow the workers to buy up to 20% of the shares of the companies in which they are employed at seriously discounted prices. Thus, any privatization program in Poland will probably have to be reconciled with a significant element of worker participation. If possible, however, the potential damage resulting from this giveaway should be contained in some way. One method would be to give the workers

a choice between their right to acquire the shares of their companies through this avenue and benefitting from any other forms of free distribution to which they may be entitled (*qua* citizens, for example), rather than allowing them to avail themselves of both opportunities. Another method of containing damage from worker giveaways is to restrict the shares acquired in this way to beneficial ownership, without the right to appoint directors or otherwise actively participate in the governance of the company.

#### **B. Free Distribution to the General Public**

While a giveaway of shares to workers presents both justice and efficiency problems, a program of free distribution to the citizenry at large offers the promise of an equitable and potentially efficient solution to the problem of speedy privatization. The main advantages of a free distribution program are twofold: first, it reduces the problems of valuation, and second, it eliminates the problems related to the shortage of available domestic capital or the reluctance of foreign investors to enter. It would be a mistake to say that a giveaway program eliminates the valuation problems entirely. To be sure, it might be possible to execute a free transfer ownership to some party, without worrying about valuation at all. But, as we have stressed already, if privatization is to result in a restructuring of the company, and not just an ownership transfer, someone will have to value the enterprises involved in order to make decisions concerning the best

way in which each company could be restructured. Similarly, the choice of who should be entitled to exercise the control powers associated with ownership (and not just enjoy its benefits) requires some method of discovering the party best able to supervise the restructuring process, and the best (indeed, probably the only) way of determining this is to find the party who puts the greatest value on the enterprises in question. But a free distribution program potentially reduces the valuation problems, because at least some of the most troublesome aspects of valuation may be left out of account. The prime among them is the need to express the value of the privatized companies in monetary terms (which requires establishing their value relative to all other investment opportunities, such as real estate in Switzerland or paper mills in Sweden). Instead, the allocation problems may be dealt with even if the valuation is done in some form of restricted currency, such as vouchers which can be used only for the purchase of the shares of the privatized companies (thus narrowing the universe of opportunities to the set of the companies to be privatized).

Even more obviously, free distribution programs eliminate the problem of capital shortage: regardless of whether the shares of the privatized companies are distributed directly to the beneficiaries or whether the beneficiaries are given vouchers with which they can "buy" them (either at a preset price or at an auction), there is no danger of the state being unable to "sell."

Free distribution to the public at large also solves most of

the legitimacy problems associated with selective giveaways and the sales model. Selective giveaways are, by their very nature, suspect: the question why someone is more deserving than others is one to which, in this context, there can be no satisfactory (sufficiently objective) answer. Similarly, given the valuation problems, sales in the East European context inherently raise the question of whether a given asset is sold at a price that corresponds to its "real" value (whatever that means) and give rise to accusations of covert selective giveaways. If, on the other hand, the privatization program distributes the state owned assets in some demonstrably equal manner, the giveaway needs no special justifications. This is especially true in the East European context, in which it makes eminent sense to say that the whole society has paid a very heavy price for the construction of the national industry in the last 45 years.

The main problem with free distribution to the public at large is to assure that the new owners, either directly or through some representatives, exercise sufficient control over the management of the privatized enterprises, since otherwise no change in the *status quo* can be accomplished and the industry will not be restructured. It is for this reason that some free distribution schemes can be immediately eliminated from the realm of acceptable possibilities. Suppose, for example, that the state wants to distribute directly the shares of the privatized enterprises to the population at large. Clearly, without determining the relative value of each company with respect to every other company to be privatized, any

attempt to give different portfolios of shares to different people must raise serious problems of equity, since there is no way of assuring that one portfolio is worth as much as another. A direct distribution of shares to the population at large must therefore imply that every person receives exactly the same portfolio. But this means that each person must receive the same number of shares (say, one) of each company to be privatized. This, in turn, means that, in a country like Poland, each company must issue at least thirty five million shares and end up with thirty five million shareholders. But then the coordination problems faced by the shareholders in their efforts to supervise the management are so staggering that no such supervision can come about, and the management will remain without any external control.

Problems of this kind are endemic to many other free distribution schemes. Suppose that, given the difficulties just described, the state decides not to distribute the shares directly to the population, but rather to issue special vouchers which are distributed in equal numbers to all citizens who can then use them to "purchase" (either at a preset price or an auction of some kind) the shares of the privatized companies of their choice. Through such an indirect distribution, it is possible to avoid the extreme outcome of companies with thirty five million shares, but still the voucher "capital" of any individual purchaser is insufficient to allow him to acquire more than a small fraction of any one

enterprise.<sup>8</sup> This means that the ownership of all the privatized companies will still be extremely fragmented and no effective shareholder control mechanisms will arise (at least for some time). It is this problem that need to be solved if free distribution is to constitute a basis of a viable privatization program.

## VI. THE PROBLEM OF CONTROL

### A. The Core Investor

One way to deal with the problem of control, proposed by some in connection with the privatization discussion in Poland, is to combine free distribution to the population with a sale of a significant block of shares (around 10% or more) to a "core investor" who would assume an active role in the restructuring process and subsequent management supervision.

We have already discussed some of the difficulties related to the core investor idea in connection with our analysis of the sales model. The core investor must, for a number of reasons be a foreigner: there are very few East Europeans who could afford to buy a significant block of shares in a large company, there are not many people in Eastern Europe with sufficient expertise to facilitate and supervise the introduction of modern production and

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<sup>8</sup> Appendix II discusses the problems involved in the attempts to combine the use of vouchers with ordinary sales and the question of whether privatization vouchers should have monetary denominations.

management techniques, and only a foreign investor could facilitate contacts with potential foreign joint venture partners or an entry into foreign markets. One of the problems with this may be that, despite his holding a relatively small block of shares, the core investor will be the only significant investor in the company. He may thus be very hard to dislodge in a system in which corporate raiders are not likely to appear for some time. This means, in turn, that the core investor will be basically uncontrolled, and if he does not supervise properly or exploits the company in favor of other (foreign) entities in which he has a higher share of ownership, there will be no one in a position to do anything about it. But the most troublesome aspect of the core investor idea is that, as we have noted, it may be very difficult, for both political and economic reasons, to bring foreign investors into the Polish market, and a privatization plan that relies on finding a core investor for every company to be privatized does not offer a realistic chance of moving with enough speed to restructure the Polish economy.

#### **B. Financial Intermediaries**

The other, more promising, way of resolving the control problems associated with free distribution is to *separate ownership from control* and to vest the latter with special intermediary institutions. These intermediaries are usually envisaged as holding companies or mutual funds which would be the legal owners of the

shares of the privatized enterprises, although they may also hold these shares in some looser form of trust accounts on behalf of individual small investors. If the intermediaries are the legal owners of the shares of the privatized enterprises, the individuals hold, in turn, the shares of the intermediary institutions themselves, and are therefore indirect beneficial owners of the assets held by the intermediaries. The intermediaries may then perform various services on behalf of the small investors, from pooling their resources for purposes of diversification, to making all kinds of investment decisions on their behalf, to, most importantly, exercising supervisory functions with respect to the management of the enterprises in which they are invested.

There are a number of privatization proposals involving financial intermediaries of one kind or another. We shall attempt to provide a systematic way of analyzing their respective advantages and disadvantages.

Again, there are *several variables* along which a taxonomy of the intermediary institutions can be devised, and it will be helpful to begin by listing them separately, before coming to the discussion of concrete proposals.

The *first* variable concerns *the relation between the intermediaries and the state*, including the role of the state in their formation and later functioning, the conditions of entry which determine the existence of the intermediaries, and the nature of their regulation.

The *second* variable concerns *the relation between the*

*intermediaries and the small investors* for whom the intermediaries perform a variety of services. Of particular importance here is the way in which small investors acquire the shares of the intermediaries and the degree of choice they have concerning such issues as entry and exit.

The *third* variable concerns *the relation between the intermediaries and the companies in which they are invested*, and particularly the way in which the intermediaries acquire the shares of the companies in which they invest and their level of involvement in the supervision and control of the management of these companies.

The *fourth* variable concerns *the relation between the intermediaries and other kinds of financial institutions*, especially banks and investment banks.

Finally, the *fifth* variable concerns *the relation between the intermediaries and foreign and international financial institutions*, in particular the role of these institutions in organizing and managing the intermediaries, as well assisting the Eastern European participation.

1. *The intermediaries and the state.*

Several privatization proposals for Poland envisage financial intermediaries which would set up by the state. The state is envisaged in some of these proposals as appointing the directors of the funds (in one of the plans, they would be nominated by the Ministry of Ownership Transformations and confirmed by the

Parliament) and the intermediaries would receive the shares of the privatized companies directly from the state according to a set formula (one of the plans, for example, proposes that each of the five funds receive 4% of the shares of each privatized enterprise). In many of these plans, the government would strictly control the number of the intermediaries and would use them as an exclusive medium for the free shares distribution plans (so that, at least initially, individuals would be limited to owning the shares of the intermediaries and would not be able to acquire directly the shares of the privatized enterprises themselves).

Plans of this kind run very serious risks of making the intermediaries into essentially new bureaucratic institutions which would be closely associated with the activities of the state and dependent on the state for their existence and functioning. A foreseeable effect of such an arrangement would be a dramatic reduction in the fund's readiness to make decisions on the basis of ordinary business principles, their reluctance to take risks of any kind, and above all, their security in the assurance that the state, closely identified with the intermediaries in the minds of the public, would have to come to their aid if either they or the companies in which they were heavily invested were ever to find themselves in danger of going under. Another obvious risk is that the small number of the intermediaries might encourage their collusion and empire building tendencies.

The only way of making the intermediaries perform genuinely business-oriented control functions with respect to the management

of the companies under their supervision and of assuring that they have the interest of their shareholders, rather than of the state bureaucracy, at heart, is to make them into private, profit-driven institutions functioning in an environment which forces them to compete with one another for the favor of their shareholders. This does not mean that the intermediaries should be unregulated, but they must be independent from the state. While the amount of compensation of the funds' managers may be left for the market to determine, it should be tied by law to their performance on behalf of the funds' shareholders. Similarly, the state may limit the number of the intermediaries, but the right to operate should not be issued on the basis of an administrative, bureaucratic decision; instead, the state should, in such a case, auction off a certain number of licenses to operate an intermediary to private parties satisfying certain basic conditions.

Clearly, the matter of state regulation of the intermediaries is a very broad subject, related to the totality of their operation. We shall discuss some aspects of this problem as we go along, but the issue requires a special treatment touching on nearly the entirety of the field of securities regulation.

## 2. The relation to the small investor.

The main question regarding the relation between the intermediaries and the small investors is whether the latter would have a choice of the intermediaries in which to invest or whether they would simply receive a certain number of shares of the

intermediaries automatically. A corollary of this question is whether individuals would be able to invest in the shares of the privatized enterprises directly or whether they would be limited to acquiring the shares of the intermediaries.

There is a certain appeal to restricting the individual beneficiaries of a free distribution to the shares of the intermediaries, rather than devising some ways of allowing them to acquire the shares of the privatized companies themselves. Similarly, there are some advantages of not giving the beneficiaries, at least initially, the right to choose the intermediaries of which they are going to hold some shares. The reasons for all these restrictions are always the same: administrative simplicity (which eliminates a lot of transaction costs involved in other solutions) and the informational barriers facing small investors which would limit their ability to avail themselves of the benefits from the choice of which they would be deprived. Thus, for example, if the shares of the privatized enterprises are somehow distributed among the intermediaries (and we shall deal with constraints on this allocation later), it might be administratively much simpler to give every citizen one share in each intermediary, rather than to worry about devising a scheme that would allow individual beneficiaries to choose among the intermediaries or to acquire directly the shares of the privatized enterprises, especially since any such scheme would have to involve a costly distribution of vouchers to all the individuals involved who would then choose between using them to purchase shares of the

privatized enterprises or to acquire an interest in the intermediaries. It might also be argued that, if given this choice, most individuals would not know how to use it, and to find out might require more effort than the choice itself, given the small investments involved, would be worth.

A decision to restrict consumer choice in these matters is not, however, without its costs. To be sure, consumer choice might be quite uninformed in a situation in which, as is the case in all East European countries, there would be no reliable information concerning the relative value of the alternatives among which the consumer is supposed to choose. Nevertheless, with consumer choice there also disappears an important factor that could potentially provide a significant element of external control with respect to the intermediaries' performance. If the intermediaries had to compete for the vouchers to be received from the public at large or if they had to "sell" their shares in some other way, their success would in part at least depend on the satisfaction of those very persons whom they are supposed to serve. If, on the other hand, the shares of the intermediaries are automatically distributed to the beneficiaries, the dependence of the intermediaries on the consumers must diminish and that on the state must increase, if for no other reason, then because the decision concerning their very creation would have to be made not by the consumers of their services, but by the state. (If the consumer has no choice about which intermediaries he will "invest" in, the entry of the intermediaries must be a function of a state decision.) To be sure,

some forms of consumer approval could still play a role in the intermediaries' behavior; it would be possible, for example, to tie the managers' compensation to the price of the shares of the intermediaries. But the fact that at least the initial position of the intermediaries' would be independent of consumer choice might allow some funds to entrench themselves, especially if their origin in a state decision were to lead to their having a leverage on state assistance if they were to meet with adversity.

Another, and perhaps more significant, cost of disallowing the beneficiaries of the free distribution to own directly the shares of the privatized companies is a long term concentration of all shareholding in very few hands. While some concentration of holdings is undoubtedly desirable (since it allows for effective shareholder control), the exclusion of the small investor has the consequence of making a genuine securities market impossible. If there are ten, twenty, or even one hundred shareholders in the country, especially if most of their holdings are large blocks of shares giving them privileged access to inside information, the volume of trading is certain to be very small; indeed so small that all trading is likely to be private and most holdings are likely to remain illiquid. This, in the long run, might not only seriously impede the creation stock markets, but also make the intermediaries very difficult to value and for ever "closed," i.e. incapable of moving to a system in which they would have to redeem their shareholder's shares on demand.

The "closed" nature of the funds is related to another

possible means of consumer control over the management of the intermediaries: the possibility of exit. As long as the fund remains closed, exit is possible only through a sale of the intermediary's shares to a third party, and the illiquid nature of the intermediary's assets might make the market price of the fund's shares a rather unreliable indicator of how the fund is doing. On the other hand, the illiquidity of the fund's assets is, under the East European conditions, entirely unavoidable, at least for the time being: it will be some a while before the privatized companies, in which the intermediaries are invested, will have a reliable market price. Still, it is a consideration to be kept in mind that a move to "open" funds (i.e., those obliged to redeem their shares through a sale of a portion of the fund's assets) might be desirable in the future, since this will not only make the funds' valuation more reliable, but also might allow for the dissolution of at least some of them and a move away from a system in which the same intermediaries are a fixture on the economic landscape of Eastern Europe.

### 3. The relation to the privatized companies.

There are two main issues under this heading: how active is the role of the intermediaries in exercising the control functions on behalf of the small investors, and how will the intermediaries acquire the shares of the companies to be privatized.

The two questions are, to some extent, related, since the mode of acquisition may determine the suitability of the intermediaries

for the exercise of the control functions. In fact, the most important question concerning the allocation of the shares of the privatized enterprises to the intermediaries is to assure that the intermediaries take an early interest in examining the potential of the companies to be privatized and compete among themselves to spot the most effective ways of restructuring them. This can occur only if the intermediaries can determine, at least in part, which companies they will acquire and if they can then acquire sufficiently large blocks of shares of the companies of their choice, so as to be able to influence their management and prod the restructuring in the direction which appears to them most promising. For this reason, unlike in the case of the allocation of holdings to the individual beneficiaries of free distribution, the simplicity of a solution which allocates the shares of the privatized companies to the intermediaries in some random or mechanical fashion has very little to recommend it. To be sure, one may say that the initial mode of distribution does not matter, since the intermediaries will later trade among themselves in order to reach an allocation that they most desire. But this is not the right approach. To begin with, one would want the intermediaries to begin their research into the companies to be privatized as soon as possible, and there is no better way to insure this than to force them to make important allocative decisions by a certain fixed date (as is the case when the allocation takes place through an auction, for example). Second, once an initial allocation is made, some intermediaries are immediately put in a better position with

respect to an evaluation of some companies than others because they have access to inside information. But then, the informational asymmetries among the potential traders put some parties at a distinct disadvantage and, as a result, they may be reluctant to trade.<sup>9</sup> Third, trading presupposes a number of institutions which facilitate it, such as stock markets with well established prices for the shares to be traded, specialists who help effectuate certain transactions by underwriting them, etc. In their absence, trading may be very difficult. Consider, for example, the fact that in the East European context, especially in conjunction with a privatization plan relying on a free distribution, the funds may not have at their disposal any large amounts of cash with which to trade. But if most transactions are to take the form of barter arrangements, trading will be very slow and the needed reallocation of resources may take a very long time (during which the East European economies will languish and the reform movement might collapse under populist political pressures). Finally, back door transactions among a small number of agents are an open invitation to collusion among the intermediaries.

3.a. Underwriting. The allocation mechanism by which shares of the privatized companies are initially assigned to the intermediaries is the most complex and difficult part of any privatization plan involving free distribution. In order to understand the difficulties involved it is necessary to remember

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<sup>9</sup> We are indebted for this point to Bulent Gutelkin's and Gavin Wilson's Memorandum of August 10, 1990 to Messrs. Krzysztof Lis and Stefan Kawalec (of the Polish Ministry of Finance).

that the free distribution is necessary because the traditional sales mechanism will not work under the East European conditions. This mechanism, with respect to large issues of shares (as opposed to isolated transactions among individuals) normally involves the institution of an underwriter who assumes the risk of selling the whole issue for a small percentage of the sale price. Whatever the considerable advantages of this solution, it cannot be used, without some very significant changes, in the context of Eastern Europe. Even if one were to contemplate selling the shares of the privatized companies for money, the uncertainties of valuation, combined with the absence of any track record of past transactions or the specialists who know the local conditions, would make underwriting into such a risky proposition that, even assuming that someone foolhardy enough would be found to engage in it, the underwriting fees would have to be so staggering as to make the whole exercise not worth the effort.

Nevertheless, there have been some interesting proposals to use a modification of an underwriting mechanism in the context of a free (or near free) distribution of shares.<sup>10</sup> The problem, of course, is to find some way of underwriting, without forcing the underwriter to risk enormous amount of money that he would be able to use elsewhere. In other words, the idea is to change the incentives of the underwriter in such a way that, instead of risking a large amount of ordinary currency, he would be putting at

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<sup>10</sup> Interesting ideas on this matter came to us from two advisers to the Polish Ministry of Finance, Professors Stanislaw Wellisz and Stanislaw Gomulka.

risk his future proceeds from the activity of underwriting itself. The underwriter might, for example, obtain free credit from the state (in the form of vouchers or some other arrangement) and use it to pay for the shares of the issue he would underwrite. If the underwriter makes a mistake and is unable to "sell" (again for vouchers) all the shares at the price he expected, he will be punished by having his profits reduced to zero and perhaps forfeiting some initial deposit.

The problem with this modification of the underwriting mechanism is that the main advantage of using an underwriter in ordinary sales--obtaining in advance a reliable approximation of the market value of the shares of a new issue--would be lost. Moreover, this would happen quite independently from the already mentioned fact that, under the East European conditions, the informational gaps would require divine powers of clairvoyance to make anything like a reliable prediction of a market price of the shares of a privatized company (and note that the underwriter's task is not made any easier by the fact of his having to predict that market price not in real currency, but in vouchers, which regardless of whether they are denominated in ordinary currency or not, have quite an unpredictable market value of their own<sup>11</sup>). The main reason why, under this system, the underwriter's predictions

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<sup>11</sup> Even if vouchers are denominated in the standard currency, the very fact that their use is restricted will make them trade at a discount. For the vouchers which are restricted to the purchase of the shares of the privatized companies in Eastern Europe (the value of which is itself widely uncertain), this discount, is likely to be both highly uncertain and very large.

would be inaccurate, even if had access reliable information, is that the underwriter is not inherently interested in getting the price right, but in maximizing his profits, and only when the two coincide, does he do a good job. Now under the system just described, the underwriters optimal profits do not depend only on the accuracy on his predictions; they also depend on the size of the penalty set by the government. Now, unless the government already knows what the market prices of the shares to be underwritten really are (in which case the underwriters are not needed), there is no reason to believe that it will set the penalties at the right level. If the penalties are set too high, the underwriters will tend to be too conservative; if they are set too low, the competitive pressure will make the underwriters draw more credit from the state than they should and set the share prices too high. Moreover, it will not do to say that since the shares are bought and sold for vouchers, rather than real money, it does not matter whether the underwriters will get the price right. If this were to be true, one could simply distribute the shares randomly and not worry about underwriting. In fact, if the underwriters make mistakes in relative pricing, the allocation of resources to the most appropriate bidders will not be made (since some more or less arbitrary decisions will have to be made for the issues that either over- or undersubscribed). If they make mistakes in the *absolute* valuation (by, for example, pricing all issues too high), the market for shares-against-vouchers will not clear (there will not be enough vouchers to purchase all the shares offered or

people will be left with useless vouchers at the end).

3.b. Auction. Another way of allocating the shares of the privatized companies to the intermediaries is to "sell" them at a special auction during which the intermediaries (as well as private individuals, if they are allowed to do so) bid for these shares with the vouchers they receive for this purpose (depending on the plan) from the state or from their own shareholders.

The main difficulty of the privatization plan involving intermediaries is to design an auction that will accomplish, without the use of real money, the following objectives:

1. Allocate the shares of the privatized companies to reflect the relative valuations by the intermediaries.

2. Allow for the agents to acquire significant blocks of shares of the privatized companies which will permit them to implement their restructuring plans, and make sure that every privatized company has at least one (and optimally more than one) large shareholder (so that none are left with no effective outside control).

3. Reveal some information about the relative valuation of the privatized enterprises by the bidders, both to the other bidders during the auction (so that they can adjust their bids to what they learn about the emergent market prices) and to the general public.

4. The share-for-vouchers market should clear (at least approximately), so that bidders are not left with worthless paper at the end.

To devise an auction that would satisfy the above conditions

is a very complex task. While we are still working on the details of the appropriate design, we believe that the task is not impracticable. We present a more detailed discussion of the auction design in Appendix III. The main outlines, however, are the following:

The enterprises to be privatized should be divided into several groups, each comprising no more than 150-200 companies. Each of these groups should be auctioned off separately. After the first group is sold, there will be an intervening period, during which the new shareholders will elect the board of directors of the enterprises, and the policymakers and the public will be able to assess the initial consequences of the chosen strategy of privatization. In order to avoid intertemporal problems related to the bidders' trying to apportion their vouchers among all the enterprises scheduled to be privatized in the future, we envisage that there will be a separate emission of vouchers for each privatization phase and the validity of the vouchers will expire at the end of a given phase. In effect, the vouchers are a form of self-liquidating credit extended by the state to the public for the duration of each privatization phase.

Our preliminary design for the auction of each group of companies privatized at a given phase involves a multistage process in which the agents are asked to rebid several times. The actual sale will take place according to an appropriate rule designed to facilitate convergence and limit the agents' strategic manipulation. A key feature of the proposed auction is that the

enterprises *will not be auctioned off seriatim*; all of them will be bid for *simultaneously* at every stage.

There will be two basic components of every auction which will be handled separately. In the first one, the agents will be able to bid for, say, three large blocks of shares in each company: one of 20%, and two of 15%,. (This is designed to ensure that each company will have some large shareholders who will exercise effective control.) In the second one, the remainder of the shares will be sold through a different procedure: the agents will apportion their remaining vouchers among the companies of their choice, and they will receive a number of shares determined by the level at which the prices will clear.

3.c. The level of the intermediaries involvement. The intermediaries may be viewed as fulfilling a number of roles, from relatively passive to very active. At one end of the spectrum would be the institutions modelled on the American ones, which, as a rule, must diversify very broadly and cannot hold a large stake in any single company, thus taking no active part in supervising the management of the companies in their portfolios. Intermediaries of this kind serve mostly the purpose of pooling for diversification and the using expert advice. Institutions of this kind would not be suitable for the restructuring needs of the Eastern European economies.

At the other end of the spectrum are the financial institutions prevalent in Germany and Japan, which have very significant stakes in the companies in which they are invested and

exercise very active role in management supervision. While we believe that the East European economies need precisely these kinds of institutions to supervise the restructuring effort, there are clear agency problems that must be guarded against when one shareholder controls the whole corporation and has the opportunity of exploiting the other owners. While it lies beyond the scope of this paper to explore in detail the legal framework which might be the most appropriate to reconcile the requirements of management supervision with the protection of minority shareholders, the importance of such an exploration needs to be signalled here. It is also likely that a deeper analysis will yield a number of restrictions on the intermediaries' relations with the companies in which they are invested, the prime among which will be some cap on the percentage of the shares an intermediary may own in any one company (35% seems a good candidate in light of research on American companies), and a host of self-dealing and conflict of interest restrictions.

#### 4. The relation to other financial institutions

A corollary of the matter just discussed is a relation of the intermediaries to other financial institutions, especially banks and investment banks. Again, it is possible to follow here the American model, in which fiduciary institutions, like mutual funds, are forbidden by law to engage in the provision of other financial services, on the theory that the conflict of interest problems may lead to abuses of fiduciary duties due to their shareholders. At

the other end, once again, is the German model, in which banks engage in supervising companies on their own behalf as well as on behalf of their trust account clients, in the process also lending money to the companies under their control (thus further increasing their leverage). Somewhere in the middle is a standard investment house, which may arrange for the financing of the companies short of capital, place directors on their boards to guard over the lenders' interests, as well as to provide needed expertise to the management of a company in which the investment firm's clients have a stake.

It will be an important part of the regulation of financial intermediaries in Eastern Europe to determine the degree of their separation from the other types of financial institutions. It is clear that the less of this separation is required, the greater is the potential for conflict of interest situations, and the greater the need for other kinds of regulation (such as restrictions on self-dealing, etc.). On the other hand, one of the greatest lacunae in the Eastern European economies is the absence of a modern banking system, as well as of the other types of modern financial institutions. Moreover, setting up the infrastructure of an intermediary, involving, as it does, the establishment of local branches, opening up of accounts for individual beneficiaries, etc., is not unlike the setting up of an infrastructure of a standard bank, and the absence of restrictions on providing the provision of banking services by the intermediaries may greatly facilitate the establishment of a modern banking system as well as

aid the privatized enterprises in obtaining financing for their operations. Similarly, no stringent restrictions on combining the fiduciary services of the intermediaries with merchant and investment banking services may allow for the intermediaries to become a very flexible source of funds for the privatized enterprises, either through making the excess funds from some companies available to the others in the same intermediaries' portfolio or by arranging financing from outsiders. These services may be particularly important if the intermediaries are linked to Western financial institutions, since they may then provide a transmission belt for foreign banking expertise, and open a window to the Western sources of debt financing.<sup>12</sup>

5. The relation to foreign financial institutions.

We have noted several times the importance of the entry of foreign capital and expertise into Eastern Europe. We have also indicated their reluctance to enter some of the East European countries, such as Poland, and the reciprocal fears in those countries of foreign domination. For all these reasons, the entry of foreigners in their capacity of investors presents a serious political problem, while their entry as advisers is of very little use.

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<sup>12</sup> The latter may be especially useful, given the fact that the availability of foreign equity financing is likely to be restricted by the limitations on the entry of foreign capital. In many situations, especially applicable to the East European context, in which share prices may be depressed for some time, debt financing also has many advantages over equity.

We believe that the entry of foreign banking and investment banking institutions in connection with the setting up and running of the financial intermediaries related to the privatization program is particularly appropriate. First, foreign expertise may be most needed in the establishment of the infrastructure of a modern capitalist economy, with which the East Europeans have practically no experience at all. Second, this infrastructure is particularly important, since its presence liberates the forces of the market and makes possible a chain reaction of growth and development. Third, the foreigners would be entering here primarily not as buyers of East European industry (although some part of their compensation may, and should, include stock options), but as managers of the funds working on behalf of the local owners of the underlying assets. Since their success would directly contribute to the increase of the equity in the local hands, their presence might be more easily acceptable than in other contexts. Moreover, if the relations between the funds and their shareholders are structured in such a way that the capital under the intermediaries' management is directly proportional to the number of local citizens who chose that fund over others, the degree of foreign influence over the running of the local economy could be seen as also exactly proportional to the welcome of the local population.

While the foreigners have a very important role to play in the context of the intermediary institutions, it may be for many reasons appropriate to effectuate their entry in the form of joint ventures with local partners. This would speed up the transmission

of expertise to the local population and further legitimate the foreigners' role in the privatization process. In order to facilitate the formation of such joint ventures, international banking institutions could aid the Polish partners through grants and subsidies, while if the Polish government requires some payments from the intermediaries (in the form of security deposits or license fees), special reductions in those payments, in proportion to the degree of Polish participation, could be introduced.

## VI. CONCLUSION

Privatization in Eastern Europe is not a mere change of ownership: it is rather a complex social and economic transformation which is supposed to change the way every company is run and every business decision is made. Without a rapid transition to private ownership and the dismantling of the rigid Communist structure of the industry, the East European economies will continue to decline.

Moreover, privatization is not just a goal of a market-oriented economic reform. It is also a process which should be itself privatized, so that competition and market mechanisms are used from the very beginning to decide who should be in charge of the restructuring process. Otherwise, the state will try to decide what to do with each enterprise and the economy will be bogged down in the same bureaucratic quagmire which has paralyzed it for the

past 45 years.

While the restructuring should be done exclusively by private institutions, the state could influence the process by providing the general legal regulatory framework. Among other things, the law would regulate the incentive structure of the intermediary institutions, prescribe antitrust rules and tariffs, as well as provide a safety net for the work force in transition.

What distinguishes this approach from the others is its unique combination of several seemingly incompatible features: It combines widespread ownership and a measure of social justice with concentrated control and economic efficiency. It avoids the initial monetary valuation of enterprises, while immediately allocating the existing productive resources to private agents who value them most. It confers ownership on the citizens of Eastern European countries, while providing for a link to foreign financial institutions capable of assuring access to world financial markets and expertise in management supervision. And above all, it offers a chance to move very fast to a novel system of economic governance which would provide an effective private control of the East European industry.

## APPENDIX I

### Valuation of State Enterprises in the Polish Economy: A Brief Case Study

We shall discuss here a case of the valuation of a state enterprise, which we will call X. The Polish government plans to offer X for sale to the public in the Fall of 1990. Our discussion is based on a preliminary appraisal, prepared by a prestigious British accounting firm, which we will call A. The final version of the appraisal may differ from the one we use. However, even our brief discussion of the preliminary appraisal brings out the fundamental problems inherent in the "objective" valuations performed by independent experts on behalf of east European governments. What we hope to show is that valuations of East European enterprises have to involve predominantly subjective judgements, and thus, to be really legitimate, they should be performed by agents having a genuine stake in the future of privatized enterprises.

Firm A uses three standard methods of valuation: the first one is based on the book value of the enterprise's assets, the second one on the price-earnings ratio, and the third on the discounted value of future profits or operating cash flows.

Firm X has assets in the form of buildings (partly under construction), machinery, tools, equipment and motor vehicles, outstanding receivables and inventories. Pro-forma balance sheet as of December 31, 1989, displayed below, shows that the fixed assets have been valued at \$3.7 mln and they represented 52% of the appraised net asset value. The absence of the real-estate market and the secondary markets for machinery and equipment forced the government to value these assets in an apparently arbitrary manner. Firm A reports that the government recently revalued the fixed assets of the firm X by \$2.2 mln., that is, by 146 percent. This unexplained revaluation accounts for 31% of the company's whole net asset value. The valuation of the fixed assets is further clouded by the inclusion of the unfinished Center for International Cooperation, a "white elephant" being built by firm X with a view to hosting international conferences in a provincial Polish town of Kielce. In the absence of markets, firm A reports having understandable difficulties in valuing the Center. Together, government revaluation of the fixed assets of X and the value of the Center assigned to it by firm A amounted to \$3 mln, which represented 81% of the appraised value of X's fixed assets and 42% of its net asset value.

Pro-forma balance sheet of firm X as of December 31, 1989.

|                          | (Mln. USD)   |
|--------------------------|--------------|
| Fixed assets             | 3.7          |
| Inventories              | 1.8          |
| Cash and bank deposits   | 4.8          |
| Debtors                  | 7.9          |
|                          | <hr/> 18.2   |
| Bank loan                | (.8)         |
| Creditors and provisions | (9.7)        |
| Welfare fund             | (.6)         |
|                          | <hr/> (11.1) |
| Net Assets               | 7.9          |

The balance sheet also shows that the so-called "interfirm credit" (the result of a notorious practice of intercompany lending) represented 43% of X's assets (\$7.9 mln. due from X's debtors) and 87% of X's liabilities (\$9.7 mln. due to X's creditors). Prevalence of such credit and substantial uncertainty associated with its repayment add an additional level of complication to the valuation exercise. As we mentioned in Section III, to value such credit, one would have to evaluate the financial position of the enterprises which are the debtors and the creditors of a given enterprise. In turn, however, those enterprises are also likely to be burdened with their own interfirm credit arrangements, and so on. In sum, then we do not get any reliable idea of the company's real worth from the whole calculation.

The second method used to value company X, based on the price-earnings ratio, is, according to firm A, more applicable, because the main business of firm X is the export of labor services and the value of the firm primarily depends on the quality of its management. However, typically for the Eastern European economies, firm X derives a considerable portion of its earnings from exports to COMECON countries. Artificial nature of the historical prices and exchange rates in these countries makes the computation of meaningful earnings figures highly problematic. This computation is also further complicated by the already mentioned prevalence of the interfirm credit.

The absence of securities markets in Poland forced firm A to fix the price-earnings ratio arbitrarily at 3, which resulted in the value of firm X of (at least) \$17 mln., with the potential error of \$8 mln. A simple check of the robustness of this calculation shows that if one would have been uncertain about whether the price-earnings ratio should be 3 or 4, the potential valuation error would have risen to \$16 mln., that is, to 94%.

The third method, based on the discounted future cash flows, requires projections of cash flows and the proper discount rate. Here, firm A had to resort to making several "key" assumptions. First, the future rate of profit of firm X has been assumed to be the same as in 1989. This was the year before the Balcerowicz plan, and, again typically for the Eastern European economies, pre-reform data are very unlikely to be relevant in forecasting the future. Second, the 1990-1991 and 1992-1994 sales in East Germany (sic!) have been projected by firm A to lie between 30 and 120 percent of the 1989 figure, whereas sales in the Soviet Union, Czechoslovakia and Hungary have been assumed to amount to between 30 and 75 percent of the 1989 sales. Third, the inflation rate in all countries in which firm X operates has been assumed to be the same in the future years. Due to the inherently unknowable nature of the environment in which firm X will operate in the future firm A was also forced to make a number of other equally arbitrary assumptions needed to "compute" future earnings. Finally, faced with an impossible task of determining the discount rate, firm A used the figure of 25 percent supplied to it by the Polish Finance Ministry. The peculiar outcome of this procedure is that despite the arbitrariness of all the numbers used by firm A the discounted future cash flows yielded the value of firm X virtually identical to the one obtained by the price-earnings ratio method. The only way to explain this outcome of the two valuation methods is that seemingly arbitrary assumptions have been carefully tailored to yield the reported coincidence of results.

## APPENDIX II

### Money and the Question of Voucher Denomination

One of the issues which often arise in conjunction with proposals to use vouchers as a part of free or subsidized distribution programs concerns the question of whether the use of vouchers should be combined with the use of money in the privatization process and whether vouchers distributed to the population or the financial intermediaries should have some monetary denominations. This Appendix explains why we think this is not a good idea.

1. Combining vouchers with the use of money means that the price of the shares to be sold is expressed in regular currency. This in turn means that some of the valuation problems involved in the ordinary sale of the privatized companies continue to create obstacles on the way of the privatization program.

2. Combining vouchers with the use of money further means that vouchers must have money denominations. This raises several additional issues.

2.1. The amount of the vouchers to be issued presents a serious problem. Insofar as the state is concerned, the vouchers are like money: the state must accept them as payment for equity in lieu of local currency at face value. The total value of the vouchers to be issued must thus remain in some relation to the total value of the enterprises to be privatized. This makes the problem of valuation even more daunting: not only must each enterprise be valued separately, but also the value of all of them combined must be estimated at once.

2.2. Even though the vouchers will be denominated in a certain amount, their market value (either explicit, if trading is allowed, or illicit if it is not) is certain to be much less than that amount. Moreover, the discount is likely to be very significant, since not only is the use of vouchers restricted to long-term investment, but also the "real" (i.e., market) value of the shares bought for them is very uncertain. The psychological effect of this might be that people will feel cheated: the government will be telling them that they are getting, say, 1,000 zloty subsidy, while the people will look at the voucher as worth, say, 300. The resulting political liability might exceed the gain from the free distribution.

2.3. Given that the (real or hypothetical) market value of the vouchers will be much less than the nominal value, the use of the vouchers in an auction will only confuse the budding price system. Nominally, shares will be bought for, say, 1,000 zloty, while their market value outside

the auction will be much less.

3. In the face of all these troubles, one should ask, what is to be gained by combining the use of money with the vouchers? We have heard (or can think of) two such reasons.

3.1. The budget will be hurt if the state cannot sell at least a part of the enterprises for cash. This is a serious argument, but the state has alternative means of raising funds and even if these means were not otherwise more appropriate, the effect of the sale of enterprises on the privatization process would be enough to move in this direction. But these alternative means of raising revenue are more appropriate anyway. A consumption tax (such as VAT), for example, will increase the savings rate rather than absorbing the savings available for investment. A corporate tax, while perhaps not practical in the short run (and perhaps, since it involves double taxation, not a good idea in the long run either) provides an opportunity of a steady flow of revenue, instead of a one time injection to cover budgetary expansion that will have to be financed from other sources in later years.

3.2. People who have money will not be able to use it to acquire greater than average shares of the privatized enterprises. This argument would have some force if one were to suppose that the people who have savings in eastern Europe are the more entrepreneurial element that should not be excluded from acquiring a greater share. But this reasoning does not appear sound. To begin with, the distribution of savings in Eastern Europe is more likely to reflect past political connections than any genuine entrepreneurial spirit. Secondly, the sale of state enterprise will soak up savings that may be needed for other investments (such as the opening of small businesses). Furthermore, if trade in vouchers without any denomination is allowed, the people who want to invest more than their allotment will be able to buy more vouchers on the open market anyway. And finally, a good privatization proposal will envisage that shares of the privatized enterprises (or at least those of the intermediaries) will be traded on the stock exchange soon after the initial privatization auction. Those who want to invest their savings in long-term investments will thus have the opportunity to do so, and the process (more orderly and extended in time) will contribute to the establishment of genuine market prices of the privatized enterprises. (It should also be noted that the price of the vouchers or the shares acquired for them will be higher if the vouchers are the only means of payment at the initial auction. This will mean that the people at large will have a greater sense of having obtained something valuable, and this will raise confidence in the privatization process as well as in the economy as a whole.)

(To be sure many of the problems listed here cease to be serious

if so many vouchers are issued that most transactions take place in vouchers anyway. This is true, of course, but there seem to be no reason left then to use money-denominated vouchers at all, especially since they have no advantages we could discover.)