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***PRIVATIZATION AND CORPORATE GOVERNANCE
IN EASTERN EUROPE
Can A Market Economy Be Designed***

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ABSTRACT

The usual view of the problem of transition in Eastern Europe is that the industrial plant is technologically obsolete and the countries involved lack many of the technical and managerial skills necessary to run a modern production process. In addition, the absence of a rational price system causes great misallocations of resources and creates wrong incentives for the people in control of enterprises.

While we share these concerns, we believe that the analysis of the difficulties facing the East European economies is often flawed by insufficient attention to what constitutes the most basic systemic obstacle to the growth of the region's economies. For in addition to all these problems, and beyond the political crisis they may generate, there remains what we consider to be the most challenging question of the whole economic reform: what will fill the gap created by the withdrawal of the state from the position of control? Indeed, without solving this problem, the process of modernization is bound not only to be costly, but also to fail.

We argue that the infrastructure of the market society will have to be created for the market forces to begin to operate and that the main task of privatization in Eastern Europe is to introduce a rational structure of corporate governance. We have thus the makings of a genuine paradox which constitutes the most fundamental systemic obstacle to the economic transformation in Eastern Europe: The most important aspect of the transition to a spontaneously functioning market economy cannot be initiated by market forces themselves. Indeed, the only force powerful enough to set the market forces in motion is the very state which is supposed to remove itself from the economy.

We examine a potential role of economic theory in creating such an institutional infrastructure of market economy and analyze some theoretical and practical difficulties of the institutional design proposed in our earlier papers.

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PRIVATIZATION AND CORPORATE GOVERNANCE IN EASTERN EUROPE

Can A Market Economy Be Designed?

Roman Frydman, Andrzej Rapaczynski¹

It is quite common to be somewhat skeptical about the chances of a smooth transition to a market economy in Eastern Europe. The standard fear is that the cost of the transition may be so high that the process may be thwarted by political obstacles and popular resistance facing the still fragile democratic institutions.

The usual view of the problem is that the industrial plant of Eastern Europe is technologically obsolete and the countries involved lack many of the technical and managerial skills necessary to run a modern production process. In addition, the absence of a rational price system causes great misallocations of resources and creates wrong incentives for the people in control of enterprises. The transition is thus envisaged to entail

¹ Martin Gargiulo and Markus Kreuzer were very helpful with their research and comments. and Rebecca Berlow kindly went through the paper and improved its style. Roman Frydman gratefully acknowledges the support of C.V. Starr Center for Applied Economics at New York University. Roman Frydman's research on this paper was completed while visiting the Institute of Economics at the University of Copenhagen. He would like to express his gratitude to Niels Thygesen for making the visit pleasant and productive.

enormous social costs, since, as subsidies are cut and prices are freed, many enterprises will have to be closed, workers will have to be dismissed, and a great amount of social dislocation will occur.

While we share some of these fears, we believe that the analysis of the difficulties facing the East European economies is often flawed by insufficient attention to what constitutes the most basic systemic obstacle to the growth of the region's economies. For in addition to all these problems, and beyond the political crisis they may generate, there remains what we consider to be the most challenging question of the whole economic reform: what will fill the gap created by the withdrawal of the state from the position of control? Indeed, without solving this problem, the process of modernization is bound not only to be costly, but also to fail.

I. The Paradox of Designing a Market Economy

1. Markets and Institutions: The Case of Poland

It is a commonplace that what the economies of Eastern Europe need most at this moment is a free market. The introduction of a rational pricing system, it is believed, will force companies to sink or swim. Those that will be able to transform themselves into viable entities will survive; the others will either be liquidated or have to restructure in bankruptcy proceedings. In this context, privatization is often

understood as the state's withdrawal from the running of the firms, thereby subjecting them to a genuine discipline of the market.

In our opinion, this view is based on two essential misunderstandings: it misses the main purpose of privatization in Eastern Europe, and it represents a very simplistic view of what the market economy is all about.

The common feature shared by market societies is a pricing system which results from a large number of transactions among producers and consumers of goods and services. This pricing system in turn coordinates private activities and directs the available resources to their more profitable uses. However, in any developed economy, agents who act in the market are, for the most part, not individuals, but institutions, such as corporations, which comprise a large number of individuals acting in a coordinated fashion. If this internal coordination process does not work properly, the information conveyed by prices will be very imperfect (leading to a host of misallocations), and the agents themselves will be unable to react properly to the cues provided by the price system. In other words, markets function well (provide an effective external coordination of economic agents) only when embedded in them is a system of institutions which provide a socially desirable internal coordination mechanism, including a complex set of incentives for individuals to respond in a particular way to the information conveyed by the market environment. In all known market societies, such an

effective mechanism involves a certain definite control structure, i.e. a mechanism which insures both that someone within the institution (the management) is in charge of the coordination process and that those who are in charge within are in turn controlled by someone outside the institution, so that they serve the interest of the owners (shareholders) and indirectly of the society at large. It is this rational structure of corporate governance that the state enterprises in Eastern Europe are lacking, and the main task of privatization is to introduce it. Without it, no amount of deregulation and decentralization will produce a well functioning market economy.

The history of the economic reforms in Eastern Europe up to this point illustrates this rather nicely, since nearly all of these reforms, both before and after the demise of the communist regime, were also based on the belief that a decentralized system of decision making was going to release the productive energies thwarted by central planning. What happened instead, however, at least in Poland, was a release of a completely different kind of forces: those of special interests.²

The earliest attempts to reform the control mechanisms of the East European economies were undertaken by the state bureaucracies under the mounting pressure of popular discontent.

² In the next few paragraphs, we shall use the example of Poland to illustrate the development of the corporate governance structure in Eastern Europe during the last 40 years. But we believe that the story, mutatis mutandis, is quite similar in Hungary as well. The case of Czechoslovakia deserves perhaps a separate treatment, but it would lead too far from our main subject.

In Poland, by mid 1950's, it became clear to many that the very size of the enterprises created by Communist authorities in the preceding decade, together with the sheer complexity of the resulting coordination problems, posed insurmountable technical difficulties for the totally centralized planning system. As the public became increasingly dissatisfied with the economic outcomes of rapid industrialization, and as the discontent erupted in the popular uprising of Poznan (in June 1956), the uppermost echelon of the Stalinist party hierarchy was eased out of power and the new leadership undertook the first efforts at decentralization. The previous system, in which government ministries controlled the entire industries according to the requirements specified by the Central Plan, has been replaced by a system of so called "branch associations" (zjednoczenia) within each industry. These branch associations were still subordinated to the ministries and had to adhere to the requirements of the Plan, but they were endowed with some discretion to reallocate the available funds among their constituent enterprises, so as to enable them to introduce some badly needed flexibility into the productive system.

Not surprisingly, the results were quite disappointing. The allocative decisions made by the branch associations were, by and large, politically motivated and on the whole detrimental to the national economy: the associations came represent a new special interest, intent on entrenching its own power and control. Thus, for example, instead of strengthening the most productive

enterprises and cutting out the "losers," the associations were more interested in maintaining output and employment levels for the branch as a whole. As a result, they often reallocated "excess" funds from the more efficient enterprises to those which were threatened with failure. Individual enterprises continued to have no autonomy, and the interactions among all layers of the state sector remained governed by administrative decisions and political bargaining. In the ultimate reckoning, this first attempt at decentralization, instead of creating a new control structure conducive to a more efficient economy, created a new powerful layer of the state apparatus and had the perverse effect of further strengthening the bureaucratic control over individual enterprises.

The next major attempt to decentralize the economy came in the wake of the workers' unrest in December of 1970. The branch associations of the earlier period came to be replaced by the so-called Great Industrial Organizations (Wielkie Organizacje Gospodarcze). Enterprises grouped into these organizations were granted limited autonomy. New incentives were introduced, which attempted to link the compensation of workers and the management to the enterprise's performance, and the level of investment funding became tied to profitability. At the same time, however, the state did not release its centralized grip over some of the most important decisions at the enterprise level: in particular, it continued to set prices in a centralized fashion and to exercise indirect control over the amount and allocation of

profits retained by the enterprises. A system of progressive taxation was introduced, which penalized those enterprises which retained more than the mandated proportions of profits or allocated them for investment, bonuses, and working capital in proportions different than those recommended by the center. In fact, the key feature of the new economic mechanism was the embedding of the enterprises within a structure of external coordination and control based on a system of arbitrary restrictions, directives, and centrally mandated prices, which made the newly increased autonomy of the enterprises incapable of influencing the overall performance of the economy. The illusory improvement, due to the to the influx of foreign debt capital, disappeared together with its cause: when the loans stopped flowing at the end of 1970's, the economy collapsed.

Following the collapse, and the rise of the Solidarity labor union, the evolution of the economic control and coordination mechanisms entered a new stage. In a desperate attempt to introduce some elements of a market economy into the production system based on state ownership, the state for the first time allowed individual enterprises to set prices of some goods through a bargaining process, although the prices of such basic inputs as coal and energy were still determined administratively. Even more importantly, the structure of the state's control over individual enterprises began to disintegrate. In September 1981, in an effort to allay workers' dissatisfaction, the state, under pressure from Solidarity, allowed the creation of workers'

councils in individual enterprises and endowed them with considerable influence over the choice of management, the allocation of bonus funds between labor and the management, and over the employment policies of the enterprise. Unlike previous efforts to introduce, in a cautious and controlled fashion, a limited autonomy of the enterprises, the rise of the workers' councils initiated a process of genuine decentralization, with the state progressively losing its ability to make decisions at the enterprise level. Moreover, while the state was able, at least temporarily, to reassert its political control during the period following the introduction of martial law in December 1981, its loss of economic control was never reversed: in fact, the Jaruzelski government continued the policy of supposedly market-oriented decentralizing reforms, which freed an increasing proportion of prices from the dictates of the center.

The results were, again, far from encouraging. The centralized state control continued to wane and prices of many goods were being liberalized, but no new mechanisms of external accountability of the enterprises were substituted for the old system of bureaucratic control. Consequently, the forces of management and labor, both committed to the defense of their (often interdependent) vested interests, came to dominate the productive and allocative decisions at the company level, causing an explosive spiral of price and wage increases. At the same time, the state, still committed to full employment and accepting the responsibility for the success or failure of each enterprise,

continued to maintain an ever increasing system of subsidies and other payments designed to appease one or another special interest group. The original model of the active communist state was thus progressively reversed: the state became a basically reactive force, increasingly responding to pressures from below, and financing its responses through an expanding budget deficit. The resulting macroeconomic imbalance and the monetization of the deficit ultimately led to hyperinflation and the demise of the Communist rule.

The basic presupposition of the economic reform program of the first post-Communist government in Poland was that the failures of the economic policy of the old regime were due to the absence of a commitment to genuine market discipline. Among the main goals of the Balcerowicz plan, therefore, was the elimination of the macroeconomic imbalance, price and trade liberalization, and the stability and convertibility of the currency. The reform freed most prices and eliminated the bulk of subsidies which had bloated the previous budgets: before January 1990, administered prices applied to an estimated 50 percent of the nominal value of legal transactions; the reforms reduced this proportion to 10 percent.³

Despite the unquestionable achievements of the Balcerowicz

³ For an analysis of the Polish reforms, see G. Calvo and F. Coricelli, "Stagflationary Effects of Stabilization policies in Reforming Socialist Countries: Supply-Side vs. Demand-Side Factors" (mimeo), May 1990; and R. Frydman and S. Wellisz, "The Ownership-Control Structure and the Behavior of Polish Enterprises during the 1990's Reforms," in: V. Corbo and F. Coricelli (eds.), Adjustment and Growth: Lessons for Eastern Europe (forthcoming).

plan in terms of creating some of the necessary conditions of a long-term transformation of the Polish economy, a number of observers have noted that, contrary to initial expectations, very few state firms failed to survive the effects of the introduction of free-market prices and the elimination of most subsidies, tax abatements, etc. Nor is there much evidence that this fact is due to any large-scale rationalization of the production process at the enterprise level. What is more likely--and more ominous from the longer-term perspective--is that most firms have been able to weather the effects of the recent reforms by cutting down on reinvestment, increasing various forms of mutual indebtedness, and generally decapitalizing themselves and the economy as a whole. Very significantly, despite dramatic cuts in production, layoffs have been relatively rare, indicating that the hold of labor over the enterprises continues undiminished.⁴

While it may be too early to draw any definitive lessons from the experiences of the Balcerowicz plan, it is by now rather uncontroversial that, without the next stage of the reform, designed to reintroduce the concept of external accountability into the everyday life of the enterprises, there is relatively little hope that the market forces released so far will lead anytime soon to a profound structural transformation that would

⁴ For a discussion of this point, see M. Hinds, "Issues in the Introduction of Market Forces in Eastern European Socialist Economies," World Bank mimeo (1990); and R. Frydman and A. Rapaczynski, "Markets and Institutions in Large Scale Privatizations: An Approach to Economic and Social Transformations in Eastern Europe," in: V. Corbo and F. Coricelli (eds.), Adjustment and Growth: Lessons for Eastern Europe.

be required to move Poland out of the doldrums of the post-Communist economies. In some sense, unless followed by rapid privatization, the economic order introduced by the recent reforms only completes the process of decentralization initiated under the old regime, together with many of its structural deformations, due to the absence of a system of ownership and monitoring of the performance of the enterprises on a daily basis and the entrenchment of special interests (above all, those of labor and the nomenklatura management) united in their resistance to a fundamental reorientation of the production process. Thus, although free market prices are certainly necessary for a proper functioning of the economy, the processing of the information conveyed by prices and the economically desirable responses to market signals at the enterprise level require the existence of an appropriate corporate governance structure.

2. Economic Theory and the Designing of Corporate Control

Privatization, as understood here, is thus a way of constructing a new corporate governance structure in Eastern Europe designed to fill the gap left by the withdrawal of the state from the management of the productive assets of the society. That imposing such a new structure may be difficult is not hard to see. To begin with, there is the already diagnosed problem of the lacking managerial expertise, without which the job of coordinating and supervising a large number of people composing a corporation is unlikely to be accomplished. But this is just the

beginning, for while Eastern Europe may not have very good managers, it has at least some experience in running large enterprises. Where the corresponding experience is nearly totally lacking is in controlling the managers themselves: the past experience of political control is quite useless in this respect, and a new breed of capital owners, company directors, supervisory board members, financial experts, etc. is still missing.

But even if we were to abstract from the fact of the missing personnel, the East European countries would still be facing a monumental problem in their restructuring effort: how to choose the precise form of corporate governance that might work in the conditions of their economies. For if one considers the institutions of capitalism, such as corporations, banks, institutional investors, stock exchanges, etc., as an integral part of a market economy, then there is not one, but many market economies, each with its own peculiar mode of operation, financing, and a set of complex institutional interrelationships which determine the incentives that make the managers respond to signals conveyed by the market.

Even a cursory look at a few developed countries shows how significantly they differ among themselves with respect to the institutional arrangements through which the behavior of the management is subjected to external control. In the old days the owner and the manager may have often been the same person. As the size and complexity of the modern corporation grew over the last century, however, and as its capital requirements began to be

satisfied in large part through the sale of stock to the public, there arose a large degree of separation between ownership and control, with the concomitant need for new ways in which the behavior of the management could be supervised on behalf of the owners. In Germany, for example, most of the supervisory functions came to be exercised by big financial institutions which hold, on their own or on behalf of their customers, a very large fraction of the shares of German corporations. In the United States, by contrast, most financial institutions are either legally precluded from playing such a role or they are unwilling to play it. Consequently, in the age of dispersed ownership, the control functions have largely devolved on the stock market: when management does not perform sufficiently well, a company may be subject to a takeover and the management will be dismissed.

In both Germany and the United States, the institutions of control evolved slowly over the course of history and the resulting economic order is exceedingly complex: in fact, as the many disputes among the economists and policy makers attest, we are far from understanding fully the way it really works.

The importance of this last point is not to be underestimated. The institutions of the market economy have been a subject of much study recently, and a number of attempts have been made to account for them from a full-fledged theoretical perspective. The most fruitful of these efforts has attempted to explain the need for institutions in terms of the so-called "transactional

approach."⁵ When parties come together in a market, their relations are often of sufficient complexity and duration that the cost of regulating their interactions through a system of explicit contracts (the normal structure of a market interaction) would involve prohibitively high transaction costs. Institutions are said to develop in order to economize on these costs by establishing an alternative system of coordination, involving hierarchies, routines etc.

Despite the undoubted accomplishments of the transactions approach to the theory of institutions, it is doubtful that such a theory could ever hope to be able to decide that one or another set of institutional market arrangements is the "best," in the sense of best solving the coordination, supervision, and other contractual problems facing agents in an economic market. The institutional theorists who believe that the "best" institutional arrangement can be identified are inspired by neoclassical economics, and they view the optimal arrangement as an

⁵ The classic text in this tradition is J.R. Commons, Institutional Economics, University of Wisconsin Press (Madison, 1934). The historical evolution of economic institutions is discussed in Andrew Shonfield's Modern Capitalism, Oxford University Press (Oxford, 1965). More recently, transaction-cost economics has gained increasing attention among organizational theorists and Oliver Williamson's Markets and Hierarchies: Analysis and Antitrust Implications, Free Press (New York, 1975), is largely responsible for this. For a review of later work, see O.E. Williamson, and W.G. Ouchi, "The Markets and Hierarchies Program of Research: Origins, Implications, Prospects," in: W. Joyce and A. Van de Ven (eds.), Organizational Design, Wiley (New York, 1981). See also, O. Williamson, The Economic Institutions of Capitalism, Free Press, (New York, 1985).

equilibrium in the "market" for competing institutional forms.⁶ Each one of these forms is, in turn, related to optimal individual behavior subject to constraints which include transaction costs and the structure of property rights.⁷ In essence, this approach assumes that an external observer would be in principle capable of making all the calculations necessary for selecting the optimal institutional setup in any given situation.

But such an assumption is questionable in several respects. To begin with, even if the necessary calculations could be made in theory, it is quite clear that in fact we lack sufficient knowledge and information, as well as neoclassical models of sufficient specificity, to be able to make the relevant judgments in the actual world.⁸ As we have seen, the advanced economies have developed quite different institutional solutions to what are arguably quite similar problems, and it would be fatuous to pretend that the literature contains any decisive arguments why this or another system is the "optimal" one. Furthermore, even if the observed institutional arrangements correspond to some neoclassical equilibria this would be the case of multiple equilibria and if such is indeed the case, the choice facing the

⁶ Exposition of this view is contained in T. Eggertsson, Economic Behavior and Institutions, Cambridge University Press, (Cambridge and New York, 1990).

⁷ For an argument in support of this approach and further references, see L. de Alessi, "Rights, Transactions Costs, and X-Efficiency," American Economic Review 73 (No.1, March 1983), 64-81.

⁸ This is just a special case of the view elaborated in H. Simon, Models of Man, Wiley (New York, 1957).

Eastern European countries may not have a determinate theoretical solution.⁹ But in fact, the continuous evolution of the institutional arrangements of the advanced economies makes it doubtful that any of these economies has actually reached an equilibrium of the kind talked about by the neoclassical economists. Moreover, even the more ardent supporters of the neoclassical school recognize that this approach encounters serious difficulties in explaining institutional change;¹⁰ indeed, if the historical evolution of institutions were to be fully explicable with the help of the neoclassical approach, we would be dealing with no less than a scientific theory of history.¹¹

Recognizing problems such as these, much of the transaction costs literature does not in fact rely on the economic optimality paradigm; instead, it argues that institutions arise to solve problems stemming precisely from the impossibility of performing the complex calculations that would be required to form optimal plans and to compute the resulting institutional equilibria. Consequently, every actual institutional arrangement is seen as

⁹ Adding to the theoretical difficulties is the equally plausible possibility that there may be no equilibrium solution to the standard problem of the institutional setup of the capitalist corporate governance structure.

¹⁰ D.C. North, Structure and Change in Economic History, Norton (New York 1981).

¹¹ For a discussion of the implausibility such a theory, see K. Popper, The Poverty of Historicism, Routledge & Kegan Paul (London, 1961), and F. Hayek, The Counter-Revolution of Science, Free Press (New York, 1955).

an adaptation mechanism of a different kind, often relying on a number of contingently present cultural milestones around which the agents habitually orient their behavior.¹² This presence of an irreducible element of contingency, idiosyncrasy, and cultural specificity, deriving from the fact that individual decisions lying at the basis of any specific institutional setup contain certain rationally non-reconstructible components, indicates that a genuine equilibrium theory of the capitalist institutions, which would be grounded in a rational reconstruction of the Western models to be transplanted in Eastern Europe, is likely to be impossible.¹³

Compounding the already mentioned problems is the question of transition: even if the institutional equilibrium models were to be available, it is clear that the East European economies are starting from different (and obviously non-equilibrium) conditions, and have to be moved to an equilibrium over time. To have a genuine theory of how to get there, one would also need to have a theory of what economists call the "convergence" to an (institutional) equilibrium. As is known from the literature, however, such transitions cannot be described in terms of fully

¹² For a classic exposition of this view see A.A. Alchian, "Uncertainty, Evolution and Economic Theory," Journal of Political Economy 58 (No.3, June 1950), 211-221. For an alternative approach which still eschews the optimality postulate, see O.E. Williamson, Markets and Hierarchies.

¹³ This may explain why much of the comparative literature concerning the corporate governance structure of the various advanced economies is so largely dependent on "soft" ex post explanations, full of references to "the way Japanese (or Germans) do it," rather than hard-nosed economic analysis.

optimal decisions; in fact non-optimal individual decision rules appear to be the basic assumption of all stylized models of convergence to equilibria.¹⁴

The significance of all this for the East European situation is the following: The complicated institutional framework which assures the proper governance of the corporation constitutes the very core of the capitalist infrastructure which is completely missing from the East European societies. The task of privatization is to construct such a governance structure and institute it in an environment in which there is a pronounced lack of available personnel and a potentially unfavorable political structure. But even assuming that, by some feat of magic, Eastern Europe were somehow to become overnight populated by Harvard M.B.A.s and that the political system were to be completely resistant to the opportunistic pressure of special interests which, at least in the short run, may have a lot to lose from the restructuring process, the problem of providing a new institutional structure of control for the existing productive sector would still be monumental. For while decisions have to be made now that may predetermine much of the developmental chances of the East European economies, the choice is largely not determined by any firm knowledge of what will work. Devising entirely new and untried institutional arrangements carries with it an enormous

¹⁴ For a discussion of these issues, see R. Frydman and E.S. Phelps Individual Forecasting and Aggregate Outcomes: Rational Expectations Examined, Cambridge University Press (Cambridge and New York, 1983).

risk of failure. But trying to learn from the experience of other countries, while safer, is also dangerous: we do not reliably know which of the existing institutional models are the best and we cannot confidently say why they work (to the extent they do) in the countries that use them. And perhaps most importantly of all, it is by no means clear that the institutional setup of any particular market economy can be made to work outside its own very specific context, so that we cannot be sure how to transplant the tried models into the unique environment of Eastern Europe.

It might be said perhaps that the countries of Eastern Europe should not embark on the road of designing the corporate governance structure of their economies, any more than the Western countries did: after all, the known successful institutional arrangements arose in a way that was, to a large degree, spontaneous and unplanned.¹⁵ Why shouldn't, say, Poland follow

¹⁵ It should be noted, however, that the state played a far from negligible role in this development. It has been claimed by many, for example, that the move away from management supervision through the banking system and toward a system of stock-market control in the United States was largely determined by political decisions. See M. Roe, "A Political Theory of American Corporate Finance," Colum. L. Rev. 91, 10 (1991); see also E. Herman, Corporate Control, Corporate Power, Cambridge University Press (London and New York, 1981), esp. Chapter 4. The German system of control through banking is also thought to have resulted from a conscious decision at the end of the last century. See J. Esser, "Bank Power in West Germany Revisited," West European Politics, vol. 13, No.4, (1990) See also A. Shonfield, Modern Capitalism, Oxford University Press (1965), Chapter 11, and J. Kocka, "The Rise of Modern Industrial Enterprise in Germany," in A. Chandler and H. Daems (eds.), Managerial Hierarchies, Harvard University Press (Cambridge, 1990), pp. 77-116. Finally, the Japanese system of keiretsu developed out of the prewar zaibatsu's, which were broken up by the stringent divestiture measures imposed by the American

the same path?

Unfortunately, spontaneous development of the institutional arrangements is not a solution. The East European economies are not virgin territory, where capitalism could develop over a long period of time, starting with small owner-controlled enterprises that could gradually expand into larger and more complicated units. On the contrary, Eastern Europe has a very specific industrial infrastructure, for the most part composed of large industries, which it took decades to build and which should not be facilely assumed to be all fit for the garbage heap. And the physical structure of this industry corresponds to the nature of the command economy within which they were constructed: a typical enterprise is very large (in Poland, for example, 100 enterprises are responsible for 40% of industrial production), and no attention whatever has been paid to diversifying the sources of supply (so that competition is very difficult to introduce). In order to set the economy on the right footing, the state must withdraw from its position of control. But the gap created by the state withdrawal will have to be filled by the privatization program, and the infrastructure of the market society will have to be created for the market forces to begin to operate.

occupation authorities after World War II. See J. Hirshmeier and T. Yui, The Development of Japanese Business 1600-1980, Allen & Unwin (London, 1981), and K Sato and Y. Hoshimo (eds.), The Anatomy of Japanese Business, Croom Helm (London, 1984.) For an assessment of the specific role of the banks in the emergence of the keiretsu's, see R.A. Goldsmith, A Financial History of the New Japan, 1868-1977, Yale University Press (New Haven, CT, 1983).

We have thus the makings of a genuine paradox which constitutes the most fundamental systemic obstacle to the economic transformation in Eastern Europe: The most important aspect of the transition to a spontaneously functioning market economy cannot be initiated by market forces themselves. Indeed, the only force powerful enough to set the market forces in motion is the very state which is supposed to remove itself from the picture. And for a number of reasons, the state may be unable to accomplish this task.

The first major reason is one of potential intellectual failure; a failure linked not just to the individual limitations of those in charge, but to the inherent limitations of human knowledge. The task before us is nothing less than creating a "market by design".¹⁶ But despite the economists' ambitions, there exists no economic theory of sufficient scope to tell us how to design a market economy; indeed, we know too little, and we may in principle never know enough, about markets themselves¹⁷ (and especially about the institutions embedded in a market economy) to make the East European transition a matter of applying proven economic theories to a new material. Thus, it

¹⁶ We would like to thank Mr. Peter Dougherty for coining this phrase for us.

¹⁷ For a classic statement of this too often neglected point, see F. Hayek, Individual and Economic Order, University of Chicago Press (Chicago, 1948). For contemporary analysis of this issue, see R. Frydman "Towards an Understanding of Market Processes: Individual Expectations, Learning and Convergence to Rational Expectations Equilibrium," American Economic Review, 72 (Sept. 1982), pp.652-88; and G. Soros The Alchemy of Finance, Simon & Schuster (New York, 1987).

would be fatuous to expect that any design can be failure-proof; the only promising strategy is to try to set up an institutional arrangement which contains in itself some mechanisms of self-correction. Such mechanisms must, of necessity, be imperfect, in the sense that the achievement of an optimal solution cannot be assured. Indeed, the very working of a self-correction mechanism of this kind cannot be precisely known in advance; this is just a special case of our earlier general point about institutional design. For this reason, the task of the designer of these mechanisms is in many respects more like that of a constitutional "founding father," attempting to institute something in the nature of "checks and balances" or "separation of powers," than that of an economist devising, say, a scheme of airline deregulation or another policy designed to improve the competitiveness of a failing market arrangement.

The second major danger is one of a failure of will: the state, in addition to lacking the requisite knowledge, may be unwilling or unable to resist the political pressures of the special interests bound to lose their privileged position as a result of the required changes in the control structure of the national economy. Given the absence of any existing powerful constituency which is likely to gain by the process of privatization in the short run, a democratic system directly responsive to popular pressures may be simply incapable of securing enough support for the required radical transformation, despite its being in the long-term interest of the nation.

Paradoxically, it may be only because the East European democracies are still very young, and because the normal channels by which organized interest groups exert political influence in the more mature democratic systems are not yet fully crystallized in Eastern Europe, that the governments of the region may be able to accomplish the task before them.

But even if such a chance exists, it is only a narrow window of opportunity, which is bound to close within a relatively short period of time. For this reason, the only way to prevent the state power from being captured by the forces of special interest intent on undermining the process of transition is to create a situation in which the state, having set the stage for further developments, can credibly claim to have no further direct influence on the decisions of the most important economic agents. This the state can do only if it initiates the process of transition by setting up the rules of the game, and then goes on to play as minimal a role as possible within the newly created structure of control. Furthermore, while the market forces cannot be relied upon to initiate the process of transition by themselves, they should be set in motion from the very beginning in structuring the new institutions of control. This means, above all, that the various private agents in favor of whom the state withdraws from its role in the running of the enterprises should be both diverse and placed from the start within a firmly competitive environment. This would allow for a self-correcting and spontaneous evolution to take over as quickly as possible,

thus mitigating the problems arising from the imperfection of the initial design and strengthening the credibility of the state's commitment to a withdrawal from participation in the corporate governance structure.

II. Privatization Proposals and the Corporate Governance Reform

In the remainder of this paper, we will try to use the theoretical insights sketched so far in order to analyze and evaluate some of the privatization proposals recently suggested for Eastern Europe. In particular, given our understanding of privatization as, above all, a mechanism of institutional governance reform, we shall concentrate on the solutions proposed by each plan to the problem of corporate control.

Three types of privatization proposals have received the most attention in recent discussions. The first type, modelled after the United States and Britain, aims at the creation of viable stock markets and a system of external financing of corporate investment; it is believed that the resulting market for corporate control would have the desired disciplining effect on the behavior of company managers. The second type, inspired by the German or, to a lesser extent, the Japanese model, advocates a so called "internal market," i.e. a system in which banks and other financial institutions play a crucial role in supervising corporate management and the financing of corporate investments. Finally, the third type advocates so-called "spontaneous

privatization," to be initiated by the present management with the support of the workers; this type of proposals favors the preservation, indeed strengthening, of the present control structure.

1. The Stock Market Model

The East Europeans often view stock markets as an ultimate symbol of capitalist maturity. For this reason, as well as because of the inherently non-bureaucratic modus operandi of the market, many East Europeans see stock markets as very attractive devices for exercising a measure of external control over corporate management. Creation of a market for corporate control can be attempted in a number of ways. At one extreme, one can try to sell state enterprises to foreign and domestic investors, hoping that each firm will end up with at least one significantly large owner who will take an active interest in the way it is run.¹⁸ At the other extreme is a "naked" giveaway plan: the population at large (or some fragment of it) might receive special vouchers which each holder can exchange (either at a predetermined ratio or through some kind of auction) for the shares of a corporation of his or her choice.¹⁹ Through later trades, a market for the shares of the privatized companies is expected to develop and, because of the possibility of takeovers,

¹⁸ In addition to spontaneous privatizations, Hungary has been so far proceeding with a plan essentially along these lines.

¹⁹ Czechoslovakia has been considering a plan of this kind in recent months.

create some pressures on company management to improve performance.

The problems with the stock-market approach are well known by now and need not be rehearsed here in detail. In brief, the sales model of privatization appears both economically and politically unfeasible. If the prospective buyers are to be domestic, there is not enough capital available internally in Eastern Europe to make the sale of most state enterprises a realistic possibility. If foreign investors are to be relied upon, however, the uncertainty concerning the stability of the region and the high cost of monitoring foreign investments there are likely to make the prospective buyers impose a politically unacceptably high discount on the price of East European corporations.²⁰ Insofar as the giveaway plans are concerned, they would lead, at least initially, to extreme fragmentation of ownership, with the concomitant inability of the investors to exercise any meaningful control over management. As already explained, the quintessential type of discipline exercised by the stock market is the possibility of a hostile takeover, which is likely to result in the management's dismissal. Takeovers would not be likely to occur, however, until a large degree of ownership concentration were to arise. As time goes by, this could happen, of course, but given the initial fragmentation of

²⁰ See our "Markets and Institutions in Large Scale Privatizations: An Approach to Economic and Social Transformations in Eastern Europe," in: V. Corbo and F. Coricelli (eds.), Adjustment and Growth: Lessons for Eastern Europe.

holdings, any effective restructuring of East European enterprises, which is the main purpose of privatization in the first place, would have to wait for years before a sufficient pressure could build up.²¹

While the problems with the capital-market-oriented approach are quite well known, it should be noted that even if there existed a realistic possibility of instituting a viable stock market system in Eastern Europe, some people have argued that the resulting increase in the liquidity of investments would have certain deleterious effects that should not be ignored, perhaps especially in the context of Eastern Europe. First, the high degree of liquidity that developed stock markets introduce is said to lessen the incentives of investors to monitor their investments, even if these investors do not face the coordination problems facing small players: the very fact of easy exit may provide a sufficient incentive for selling the stock of companies that are perceived to underperform, rather than engaging in the costly process of monitoring and fighting the management trying to ward off external interference.²² Second, reliance on takeovers for external monitoring increases the job uncertainty of company managers and may be responsible for a tendency toward

²¹ Ibid.

²² We owe this valuable observation to Professor Jack Coffee, who makes it in his still unpublished paper "Liability Versus Control: The Institutional Investor as Corporate Monitor". Coffee builds upon A. Hirschman's seminal work Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States, Harvard University Press (Cambridge, 1970).

"short-termism": the managers who fear being dismissed in the wake of a takeover may lose incentives to postpone a part of their compensation in exchange for greater security and may be reluctant to develop firm-specific skills that can become useless if they are not retained by the new owners.²³ Both of these potentially negative consequences of the market-oriented approach toward corporate control may be particularly dangerous in the context of the East European economies which badly need a strong commitment of the new owners to the costly restructuring effort and the long-term improvement of corporate performance.

2. Spontaneous Privatization

Before moving on to the discussion of the proposals oriented toward the model of corporate control through financial institutions, we should but briefly pause to consider the proposals advocating the so-called "spontaneous privatization." The first thing to observe here is a certain pitfall that awaits those who would too mechanically transplant into Eastern Europe certain institutions that may have had a large degree of success in the West, but which acquire an entirely different meaning in the East European context. The idea of spontaneous privatization looks, at first sight, like an East European equivalent of a management buy-out. To begin with, even if the managers were in fact to acquire control of their enterprises, having been chosen by the

²³ See J. Franks and C. Mayer, "Capital Markets and Corporate Control: A Study of France, Germany and the UK," Economic Policy, vol. 5, 1990, pp. 191-231.

largely negative selection of the old regime, they would be extremely unlikely to reveal the level of entrepreneurial drive and competence characteristic of their Western counterparts, to say nothing of the understandable social resistance to this kind of "nomenklatura privatization." But in reality, the managers are in fact very unlikely to gain genuine control through spontaneous privatization. The pressure for this type of ownership change comes instead from an alliance between the workers and the management who are intent on resisting significant departures from the status quo: it is precisely the opposition to a restructuring that is likely to result from a genuine privatization that motivates the alliance. In addition, in the Polish context at least, the change is unlikely to lead to increased efficiency; quite to the contrary, one of the primary incentives toward spontaneous privatization is an attempt by the workers to go around the very stiff tax on wage increases which applies to the employees of state enterprises, but which may be relaxed for the companies that privatize. Thus, the pressure for spontaneous privatization is primarily political, and as such it may turn out to be a threat to genuine restructuring: apart from pure worker ownership, it is the only form of privatization for which there exists a very considerable constituency. And interestingly enough, the analysis of the nature of spontaneous privatization may only strengthen our previous conclusion concerning the peculiar importance of the initial role of the state in the privatization process: if the state turns out to be incapable of

resisting the political pressure in favor of spontaneous privatization, and does not assert its power in setting up the genuine forces of competition at the very start of the ownership transformation process, the withdrawal of state power will leave intact the stifling structure created by the old regime.

3. Corporate Control By Financial Intermediaries

In order to make our discussion of the privatization programs oriented toward the control of management by financial institutions more concrete, we shall analyze one special version of this type, namely the plan adopted by the Polish government for its so-called "mass privatization" program, involving the largest 500 state enterprises in Poland.²⁴ We intend to use this plan, however, as a springboard for making some points of a more general significance.

The main features of the Polish government plan are the following:

Each of the 500 large enterprises scheduled for privatization will be first converted into a joint-stock company. Following this "corporatization," 10 percent of the shares will

²⁴ This plan is one of the branches of the overall privatization program in Poland. The other branches deal with the so called "small and medium size" companies (some 2,000 industrial companies and 3,500 others) which are scheduled to be privatized through sales or liquidation. For a description of the plan as originally announced, see Rzeczpospolita, Nov. 21, 1990, and our "Markets and Institutions," Appendix III.

be given (free of charge) to the workers,²⁵ and the state will retain another 30 percent, while the remaining 60 percent will be transferred to new owners with the help of privatization vouchers.

The 500 enterprises will be disposed of in several phases, with 150-200 to be privatized in the first phase. An appropriate number of vouchers will be issued for each phase, with $\frac{2}{3}$ most likely going to the public at large (each citizen receiving one voucher), and $\frac{1}{3}$ to the Social Security office (to capitalize the state pension fund).²⁶ (Thus, the citizens will receive vouchers equivalent to 40% of the value of the privatized enterprises, and the state pension fund 20%.)

The state will then invite the creation of a number of intermediary institutions (investment and restructuring funds) which will offer their shares in exchange for vouchers. (The entry will be free, so that any person or institution, foreign, domestic, or mixed, will be able to create an intermediary, as long as the minimum conditions specified in a special law are satisfied.) The vouchers received by the citizens will have to be

²⁵ The Privatization Law foresees that the workers should receive up to 20% of the shares of the privatized enterprises at half price, but not to exceed the value of their last year's wages. The present plan proposes to give up the idea of selling at half price and the limitation relative to last year's income because of valuation difficulties. It is not clear, however, that this proposal accords with what the Privatization Law requires, and may be abandoned.

²⁶ As initially announced, the plan had foreseen that the public would receive $\frac{1}{2}$ the vouchers and $\frac{1}{6}$ would go to a number of state banks. The idea of the banks' share now appears to have been abandoned, with the vouchers presumably going to the public.

used to "purchase" the shares of the intermediaries, with each person having a choice among the intermediary institutions he or she wants to invest in. The Social Security office will have a choice of depositing all or some of its vouchers with the intermediaries or of creating one or more special pension funds of its own.

Once the vouchers are transferred to the intermediaries, the 150-200 companies privatized in the first phase will be sold at a specially designed auction.²⁷ The state will also deposit the 30% of the shares owned by it in the intermediaries according to some predetermined formula.²⁸ However, the state will not become an ordinary shareholder of the intermediary institutions; its share will be apportioned to the intermediaries, and the state's role in the them will be limited to appointing one director on the board of each intermediary. The intermediaries will be charged with selling the state's shares in each privatized company to other investors, either by private placement or in the open market, and once a certain percentage of the total state holdings administered by a given intermediary is sold, the state director will disappear from the board of the intermediary.

²⁷ The type of auction to be used has been described in our paper, "Markets and Institutions."

²⁸ Beyond specifying that the state will not be able to hold directly the shares of the privatized companies and will have to use the intermediaries, the formula for the distribution of the state holdings is not clearly specified in the Government plan. Presumably, vouchers may be used in this connection as well.

The transfer of ownership and control having been thus completed, new directors will be appointed by the intermediaries and other shareholders for each company, and the business of restructuring will begin. The new owners (with, it is hoped, the intermediaries in the dominant position) will be free to change the management of the privatized companies, to split them up (or perhaps combine them, insofar as no antitrust violations would result), to sell a part of their holdings, to approve various joint venture arrangements between the privatized companies and other entities (foreign or domestic), etc. The sale by the intermediaries of the 30% of the shares held by them on behalf of the state will, it is hoped, allow for an introduction of "core investors" into a number of the privatized companies, as well as (together with the transactions involving the 10% of the shares held by individual workers) create a market for a sizeable proportion of the shares of the privatized companies (thus allowing for a market valuation of the privatized companies and the intermediaries, and for the possibility that some of the funds may become "open").

For the record, it should be clear that we favor a plan of the type adopted by the Polish government. But as we have argued already, the limitations on what we do or can know about markets make it in principle impossible to construct a priori an optimal institutional design of an advanced market economy. The best we can do is to try to set up institutions containing within themselves appropriate self-correcting mechanisms which may

mitigate some of the problems resulting from the limitations of our knowledge, and to use market forces as much as possible from the very beginning.

A. Potential Institutional Failures

The first step in designing an institutional arrangement containing an appropriate self-correction mechanism is to identify, insofar as it is possible, the most likely failures, or types of failures, of the design and then try to make sure that there are some forces operating that will make the failures less likely or effectuate the appropriate ex post corrections.

With respect to the Polish plan (as much as any other plan involving control through financial intermediaries), the most likely dangers appear to us to be the following:

1. The plan may turn out not to be attractive enough for the type of entrant who would be the most desirable from the point of view of his ability to contribute to the restructuring process. In the case of the Polish plan, this would mean, above all, the failure to attract a sufficient number and caliber of foreign financial institutions interested in, and capable of, forming effective and active intermediary institutions.

2. Under certain conditions, the intermediaries, instead of becoming aggressive, mutually competitive institutions, devoted to the idea of profit making, could become sluggish and entrenched bureaucracies, in some respects not unlike the old Industrial Branch Associations which had controlled much of the

industry under the Communist regime.

3. The financial intermediaries charged with supervising the corporate management of the privatized enterprises may opt for a strategy of passive investment and, rather than devoting their resources to exercising their supervisory functions, attempt to free ride on the efforts of others.

4. The management fee of the managers of the investment funds may not assure sufficient incentive compatibility between them and the shareholders of the intermediaries (the public at large), so that the people in control of the intermediaries may develop conflicts of interests with respect to their fiduciary obligations vis à vis their shareholders. It might be very important in this context to identify particular types of possible opportunistic behavior on the part of the intermediaries through which they may use their power over the companies in their portfolio in order to extract extra profits through self-dealing, loans paying above average interest, insider trading, etc.

5. Finally, the system may not provide for an effective allocation of financing for the developing economy. The financial markets might not develop properly, regulation (including that designed to deal with the conflict-of-interest problems discussed above) may stifle the intermediaries' ability to move funds among the different parts of their portfolio or to procure sufficient access to external financing, or the intermediaries may engage in empire building, rather than allocate the available funds accord-

ing to a formula designed to maximize shareholder returns.

B. Remedies

To deal in detail with even the rough and incomplete list of the possible institutional failures identified here, a whole implementation design for the Polish plan would have to be presented. Clearly, this would be outside of the scope of this paper. What we shall do here, therefore, amounts to no more than an overview of the main issues that need to be addressed.

1. The most desirable entrant, who is crucial to the success of the Polish plan, is a combination of a foreign financial institution, such as a German-type universal bank, an investment bank, a venture capital fund, or perhaps even a pension fund with significant experience of shareholder activism, with a Polish institution, such as a bank with local contacts and familiarity with a large number of Polish enterprises. That a foreign entrant of the kind described here would bring a wealth of experience in financial management and monitoring of investments, contacts in the foreign financial and industrial communities, etc. is quite easy to see. But equally important is the foreign entrant's very ability to recognize and interpret market signals both for the purpose of identifying investment opportunities and alerting the companies in his portfolio. Of similar importance is the foreign entrants' familiarity with the standard devices for improving enterprise performance. Much of this kind of knowledge is not fully articulated, and in fact resists articulation. Indeed, this

"tacit knowledge"²⁹ is one of the main elements of the entrepreneurial skill that constitutes the driving force of the market, and enables it to outperform even the most knowledgeable planners. And, being in principle "tacit," this knowledge can be acquired only by a process of socialization into an existing environment of a market economy, rather than by a more formal learning process. For this reason, it is nearly entirely absent in Eastern Europe and can probably only be transplanted from outside. (The role of the Polish partner would lie not only in providing some elements of a ready-made infrastructure of financial operations, such as local branches or contacts, but also the indispensable information about, and perhaps more importantly, an intuitive "feel" for, the local conditions.)

In order to assure the entry of this kind of actors, the entrants must, above all else, have a reasonable expectation that the funds which they are invited to organize will have sufficiently large assets under their management, and that their ability to exercise influence on the boards of the privatized companies will not be unduly impaired. The regulatory structure should also permit them to engage in a wide scope of activities, as well as to derive a sufficient return on their investment. This means, among other things, the following features:

1.1. To allow the intermediaries to have sufficiently large assets under their management, the assets which cannot be

²⁹ M. Polanyi, Personal Knowledge, University of Chicago Press (1962).

acquired in exchange for vouchers (which will be the sole "currency" available to the intermediaries) will have to be limited. This underscores the importance of the fact that the Social Security office will receive its allocation of assets in vouchers rather than shares of the privatized companies, and that at least a substantial portion of these vouchers should find their way to the intermediaries. Similarly, the state share must be either apportioned in vouchers or otherwise left under the management of the intermediaries.

1.2. The intermediaries' ability to exercise proper influence on the boards of the privatized enterprises is dependent, among other things, on the role of other institutional actors. While some counterweights to the financial institutions may be desirable, the presence of a significant continuing involvement of the state on the boards of the privatized companies will make them quite unattractive. This again underscores the need to transfer to the intermediaries the management of a large portion of the assets of the state and the Social Security office, since otherwise these two institutions, together with the share of the workers, will control 60% of the shares.

1.3. A number of steps might be taken to allow the intermediaries to engage in a sufficiently wide scope of activities. If the regulations do not limit the intermediaries too stringently to their functions as the fund managers, they will be able to branch out into such areas as consumer, commercial, and

investment banking, brokerage, insurance, etc. Quite apart from other benefits which may accrue to the economy from the development of the important services, the possibility of this type of expansion may make entry much more attractive to the most desirable foreign participants.

2. Among the devices designed to assure the competitive nature of the intermediaries and to prevent their bureaucratization, are the following features of the plan:

2.1. It is very important that the competitive nature of the intermediaries be attended to from the very beginning. The best way to do this is to assure, as does the Polish plan, a relatively free entry, limited only by clearly specified legal requirements, and leave no discretion to the state to pick and choose among the possible participants. This can be done only if the intermediaries must compete for the vouchers to be received from the population, and if their obtaining of the assets controlled by state institutions proceeds according to a more or less mechanical formula. If, the other hand, the state limits entry to a few firms, or deposits its assets on a discretionary basis, it will encourage political selection, identify itself with the success of its choices, and create an atmosphere of bureaucratic protection.

2.2. In addition to assuring free entry, the fact that the intermediaries, from the very beginning, compete with one another for vouchers also has a direct competitive effect. Similarly, the fact that the intermediaries will acquire their

portfolios at an auction will force them early on to compete in their evaluation of the companies to be privatized and to attempt to maximize the attractiveness of their holdings in anticipation of the further privatization tranches. If, on the other hand, as some earlier proposals envisaged, the intermediaries were to acquire their holdings according to some predetermined mechanical formula and be encouraged to trade afterwards, they could in fact, especially if their number is small, be tempted to collude rather than to compete.

2.3. The design of the compensation structure of the intermediaries is a crucial aspect of the properly competitive character of their activities. While this component of the plan is extremely difficult to devise, especially in the absence of market prices that would determine the value of the assets under the intermediaries' managements (and thus also allow for a proper evaluation of their performance), the tying, however imperfect, of the fund managers' compensation to their performance is, of course, a fundamental feature of every healthy incentive structure. In particular, making the compensation in part dependent on the value of the intermediaries' own shares may introduce a dose of competition for clients on whose behalf the funds manage the privatized companies.³⁰ What may be less obvious is the degree to which the state should regulate the fund managers' compensation. While it is quite clear that the state should regulate

³⁰ This aspect of the intermediaries compensation may make it less desirable to force them to run "open" funds. See below, note 33.

their compensation structure (so as to make sure that it creates a proper set of incentives), the regulation of the size of their compensation (by, say, fixing it at a certain specific percentage of the funds' assets or of some other benchmark values) should probably be left to the market. Not only will this increase competitive pressures, but also avoid significant mistakes. For if the state sets the amount (rather than the type) of compensation, it is extremely unlikely that it will get the numbers just "right," i.e., so that only transfer earnings and no rents are included. But then if the state sets the amount of compensation too low, the appropriate actors will not enter; if the compensation is set too high, the funds will derive unnecessary superprofits (rents).

2.4. The composition of the boards of the privatized companies will also have an effect on the degree of the intermediaries' competitive attitudes. If the company boards are dominated by the state or by other state-controlled actors, the intermediaries are likely to try to devote a substantial amount of their energies to gaining political influence rather than to pursuing a competitive advantage.

2.5. Adequate antitrust regulations will be undoubtedly necessary to prevent the intermediaries from excessive concentration in a particular area of the industry and attempting to extract monopoly rents instead of achieving competitive advantages.

3. Active supervision of company management is a costly

proposition: it requires research, close involvement with the company, assertions of power that may invite retaliation, etc. While an active investor pays the full costs of his monitoring activities, other shareholders can automatically free ride on the efforts of those who do the actual monitoring. It is thus very tempting for many institutional investors to adopt a passive posture. On the other hand, the whole purpose of privatization in Eastern Europe would be defeated if the new owners did not actively contribute to the restructuring process. Among the measures limiting passivity and encouraging activity are the following:

3.1. The design of the auction during which the intermediaries acquire their portfolios in exchange for vouchers collected from the population will have a decisive influence on the nature of the intermediaries interest in the companies in their portfolio. If the auction were to allow the intermediaries to diversify very broadly, thus taking only relatively small stakes in any particular company, it would make monitoring very expensive and the chances of its bringing sufficient benefits to any given intermediary rather small. Thus, the auction must be so designed (probably through a sale of a certain proportion of the shares of each privatized company in large blocks of, say, 15-30%), as to assure that each privatized company has some very substantial shareholders, for whom the returns from monitoring are sufficiently high to make a significant investment of time and resources worthwhile.

3.2. As we have mentioned already, there may be a rather immediate inverse tradeoff for an investor between the ease of "exit," made possible by the existence of a market assuring the liquidity of his investment, and the attractiveness of "voice," in the form of asserting his power as a shareholder within the company itself.³¹ This relationship is very important and often not appreciated, especially among the East Europeans who are very attracted to the idea of unobstructed markets. For what follows from this observation is that the increased liquidity associated with the quick development of a stock market may come at a very significant cost in terms of the effectiveness of the restructuring process. This does not mean, to be sure, that the privatization plan should try to create obstacles to liquidity in general. Quite to the contrary, there may be some definite advantages to creating a market for a certain proportion of the shares of the privatized companies, since such a market may, among other benefits, permit a better evaluation of the assets under the intermediaries' management and allow for a much better evaluation of their performance.³² Such

³¹ See Coffee, op. cit. and Hirschman, op. cit.

³² Japan, among the industrialized countries, has this type of divided ownership structure, since many Japanese companies, forming the so-called keiretsu's, own substantial portions of each others' shares and do not trade in them, while the remainder of their shares is owned by outside investors, who trade very actively. Cross shareholdings among companies in three of the keiretsu groups (Mitsui, Mitsubishi, and Sumitomo) are between 55% and 74%. This figure is somewhat lower for the other groups, but still ranks between 32% and 49%. While the holdings by institutional shareholders in Japan are estimated at between 60-80% of all the shares on the Tokyo Stock Exchange, these institutions

a market could be achieved, for example, through a sale of the state share to the public within a certain period of time after the initial auction. But it must also be noted that if the intermediaries themselves could easily sell their stakes in the privatized companies, their incentive to monitor may be significantly decreased. The best way to prevent this from happening may be, again, to assure that the intermediaries take sizeable blocks of shares in particular companies, so that their trying to sell would be likely to entail a significant discount on the price of their shares.³³ Among other ways of "locking" the intermediaries into the companies in their portfolio may be regulation against excessive diversification and the fostering of other ties between the investment funds and the companies in their portfolio (such as cross-ownership, provision of banking services, etc.).

4. The potential conflicts of interests faced by the managers of the intermediaries are among the most serious problems to be faced by the Polish privatization plan. The very taxonomy of such potential conflicts and of the resulting agency problems is

account for only 10% of transactions on Japanese stock exchanges. See M. Gerlach, "Business Alliances and the Strategy of the Japanese Firm," in: G. Carroll and D. Vogel (eds.), Organizational Approaches to Strategy, Ballinger (Cambridge, Mass, 1987).

³³ Many people familiar with the Polish plan believe it would be desirable to make the intermediaries into open funds as soon as possible. If what we claim is correct, this view might be problematic, since the opening of the intermediaries might force them to diminish their stakes in the companies in their portfolio, in order to preserve liquidity. As a result, they are likely to stop being active. On the other hand, having closed funds might make the control of the fund's management more difficult.

a task that requires more attention than we can give it within the scope of this paper. For the fund managers may have all kinds of perverse incentives, beginning with maximizing their own power, and ending with trying to syphon off profits from the companies in their portfolio to the funds themselves or (even worse) to their foreign "mother" institutions. Moreover, even a very abbreviated catalogue of these possibilities of abuse would make it clear that, while properly structuring the fund managers' compensation may be a very important way of lessening the agency problems, it would be fatuous to hope that all the potential abuses could be taken care of through these means. The variety and complexity of the situations in which the agency problems can arise makes the writing of a perfect management contract, assuring full incentive compatibility, into a dream. In fact, even attempting to write such a contract might make us too cautious and, by an excessive curtailment of the fund managers' discretion, limit too much their ability to operate.

Thus, it is very important to devise still other mechanisms that could be used to control the possibility of these kinds of abuse:

4.1. A principal way of limiting the possibility of abuse by the managers of the intermediaries is to make sure that there are other "players" who might be relied on to monitor and control their actions. Thus, for example, it might be advisable to have other types of directors on the boards of the privatized companies, in addition to those named by the financial

institutions. Among them may be some required "independent" directors or the "core investor" brought in through the sale of the state share, or even the workers' representatives who are likely to defend the management against strong shareholder intervention.³⁴

4.2. The Polish plan envisages one state representative on the intermediaries' boards, at least as long as the intermediaries manage the state portfolio. Such a representative, if indeed his voice is not for some reason out of proportion to his number, may not be a disturbing presence, but may at the same time exercise some useful function in monitoring the intermediaries themselves.

³⁴ One can observe widespread hostility to worker participation among the commentators writing on East European privatizations. The Polish authorities have also opposed very strenuously giving workers a significant share of ownership or voice on the boards of the privatized companies. On the one hand, this resistance is quite understandable: after all, much of the present inefficiency of the Polish firms derives from the influence of the workers' councils on the management. There are also widespread, and probably justified, fears that a significant degree of worker participation would make Polish enterprises less attractive to foreign investors. On the other hand, worker participation, if kept within appropriate limits, often amounts to a degree of support for the management against external shareholders intent on "ruthless" profit maximization at the expense of worker privileges. This support may be of significant value in a situation in which a dominant outside shareholder with a potential conflict of interest (such as a supplier or a banker who is also the company's creditor) attempts to pressure the management to accede to some measures that may not be in the company's interest (such as buying goods or taking a loan at above market prices). Some observers have noted such countervailing effects in Germany, where workers' participation on the executive boards of companies is required by law. See Franks and Mayer, *op.cit.*, p. 19; and H. Monissen, "The Current Status of Labour Participation in the Management of Business Firms in Germany," in S. Pejovich, The Codetermination Movement in the West, Lexington Books (Lexington, Mass., 1978).

4.3. The existence of open financial markets, and an unobstructed access to the international sources of credit may provide some counterweight to the financial power of the intermediaries, and make a company manager less likely to be entirely dependent on a director representing a potentially exploitative intermediary.

4.4. A set of properly designed disclosure rules may make exploitative behavior on the part of the intermediaries more difficult, without excessively limiting their freedom of legitimate action.

5. Finally, insofar as the creation of an effective system of the allocation of financing is concerned, the intermediaries must be assured enough flexibility, and not be unduly restricted to a narrow range of activities. To be sure, the wider their powers, the more likely it becomes that they may find ways of engaging in exploitative or opportunistic practices and hide this fact from the public (or the appropriate authorities). If the intermediaries are allowed, for example, to arrange loans from their mother companies (foreign banks or other financial institutions) to the companies in their portfolio or to force them to use suppliers who are affiliated with the intermediary of its mother institution, the possibilities of abuse are substantially increased. Unfortunately, however, there is no fool-proof way of preventing all such abuses, without at the same time making the intermediaries incapable of fulfilling one of their crucial tasks, namely, the facilitation of the financing of

the companies in their portfolio. On the whole, it seems to us that it would be quite desirable for the East European countries to encourage the transformation of the intermediaries into something akin to the German "universal banks," and not to hem them with the American, Glass-Steagall-type restrictions. In this context, the intermediaries should be able to influence transfers of funds among the enterprises in their portfolio, combine their monitoring activities with investment and merchant banking activities, and to engage in consumer banking operations. This may be particularly important in Poland, where the banking system is woefully inadequate, and foreign banks do not seem overly eager to enter. Should it turn out to be desirable in the future to scale down the intermediaries' role and influence, a set of standard divestiture techniques is likely to be available. But it might very well turn out that the more diversified the role of the intermediaries, the more likely they are to develop a lasting commitment to the development of the country and to become increasingly stable, good citizens of the local economic community.

[A short conclusion will be added]