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Institutional Reform in Eastern Europe: Evolution or Design?

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I. INTRODUCTION

Most recent studies of privatization in Eastern Europe focus on its impact on individual enterprises.[1] In our previous work, we examined this issue from the viewpoint of the future corporate governance structure in Eastern Europe.[2] The aggregate effects of privatization have been largely neglected, perhaps on the assumption that they have no particular bearing on how privatization is to be effected at the enterprise level. It is very important, however, to link the discussion of the various approaches to large-scale privatization with a consideration of other obstacles in the transition to a market economy. These

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1. *See* OLIVIER BLANCHARD ET AL., REFORM IN EASTERN EUROPE (1991); Irena Grosfeld, *Privatization of State Enterprises in Eastern Europe: The Search for a Market Environment*, 5 E. EUR. POL. & SOCIETIES 142 (1991); David Lipton & Jeffrey Sachs, *Privatization in Eastern Europe: The Case of Poland*, *in* BROOKINGS PAPERS ON ECON. ACTIVITY 293 (William C. Brainard & George L. Perry, eds., 1990); Irena Grosfeld & Paul Hare, Privatization in Hungary, Poland and Czechoslovakia (Mar. 1991) (mimeo).

2. *See* Roman Frydman & Andrzej Rapaczynski, *Markets and Institutions in Large-Scale Privatizations. An Approach to Economic and Social Transformations in Eastern Europe*, *in* REFORMING CENTRAL AND EASTERN EUROPEAN ECONOMIES: INITIAL RESULTS AND CHALLENGES (Vittorio Corbo & Fabrizio Coricelli eds., The World Bank, Washington, D.C., 1991); Roman Frydman & Andrzej Rapaczynski, *Privatization and Corporate Governance in Eastern Europe; Can a Market Economy Be Designed?*, *in* CENTRAL AND EASTERN EUROPE: ROADS TO GROWTH (Georg Winckler ed., International Monetary Fund and Austrian National Bank, Washington, D.C., 1992).

obstacles, which include the weakness of existing capital stock, the absence of a banking system and the absence of capital markets, can be overcome through the use of a combination of design and reliance on market mechanisms. This combination can provide a successful transition to a market economy.

II. WHY DESIGN IS NECESSARY

As a natural reaction to the dismal failure of planning in Eastern Europe, there is a tendency among both Eastern European and Western commentators to disparage reform proposals involving significant state activism. Instead, these commentators favor solutions which rely on the spontaneity of economic developments. If the criticized reform proposals advocated long-term state involvement in the economic life of the region, the commentators' skepticism would be fully justified. However, this skepticism may be stifling to the extent it discourages reformers from making significant choices concerning the forces that will fill the vacuum created by the state's withdrawal from the management of the post-Communist economies. Paradoxically, Eastern Europe cannot rely solely on market forces to initiate the transition to a spontaneously functioning market economy. Indeed, the only force powerful enough to set the market forces in motion is the very state that is supposed to remove itself from the picture. Thus, what passes for spontaneity may often amount to a simple entrenchment of the *status quo*.

The East European economies are not virgin territory, where capitalism could evolve gradually. On the contrary, Eastern Europe has a very specific industrial infrastructure, a product of the command economy. In Eastern Europe, typical enterprises are extremely large[3] and have developed links that will be costly to sever. Thus, a mere withdrawal of the state would leave intact the established special interest groups. These include the old management chosen for its loyalty rather than its competence, a labor force intent on resisting any changes that may endanger its job security, and a network of monopolies. All of these groups stand to lose from the institution of a truly competitive market. What is needed is genuine *reform*: that is, a design which establishes a new

3. For example, in Poland 100 enterprises are responsible for 40% of industrial production.

system of property rights and, above all, a new institutional arrangement of control and supervision over the performance of managers and labor. *Design* is thus necessary to overcome the inertia of the *ancien régime* and to initiate a process of restructuring and change.

III. THE ATTRIBUTES OF A SUCCESSFUL DESIGN

Choosing an appropriate design for each of the Eastern European countries is a complex task, especially when one considers the various institutions of capitalism. These capitalist institutions include corporations, banks, institutional investors, and stock exchanges. Thus, one can say that there is not one, but *many* market economies. Each has its own peculiar mode of operation, financing, and complex institutional interrelationships, which shape how managers respond to signals conveyed by the market. In some countries, such as Germany and Japan, corporate governance includes a significant role for banks and other financial institutions; other countries, such as Britain and the United States, rely on the stock market to discipline corporate managers. However, in both systems the institutions of control have evolved slowly, and the resulting economic order is exceedingly complex.[4]

With regard to privatization, Eastern Europe's most significant challenge is to make difficult choices concerning the direction of institutional development and to set in motion the forces which can fill the gap left by the state's withdrawal. However, it is important to note that the reformers operate under a tremendous handicap.[5] Not only do they face an extremely uncertain future, which makes all planning risky, but they also lack solid information about the existing state of affairs. Thus, they run the risk of unintentionally exposing

4. For comparisons among the different corporate governance systems, see Julian Franks & Colin Mayer, *Capital Markets and Corporate Control: A Study of France, Germany and the UK*, 5 ECON. POL'Y 191-231 (1990). For a discussion of the German system and its history, see ANDREW SHONFIELD, MODERN CAPITALISM 239 (1965); Josef Esser, *Bank Power in West Germany Revised*, W. EUR. POL., Oct. 1990, at 17; and Jürgen Kocka, *The Rise of Modern Industrial Enterprise in Germany*, *in* MANAGERIAL HIERARCHIES 77-116 (Alfred D. Chandler, Jr. & Herman Daems eds., 1980). For Japan, see THE ANATOMY OF JAPANESE BUSINESS (Kazuo Sato & Yasuo Hoshimo eds., 1984); RAYMOND W. GOLDSMITH, THE FINANCIAL DEVELOPMENT OF JAPAN, 1868-1977 (1983); JOHANNES HIRSCHMEIER & TSUNEHIKO YUI, THE DEVELOPMENT OF JAPANESE BUSINESS 1600-1980 (2d ed. 1981).

5. In our view, this is a crucial aspect of the transition.

weak spots of the existing system to reform shocks which they may not be capable of absorbing. The only way to proceed, therefore, is to combine the element of design with a reliance on an array of market mechanisms that will correct the inevitable flaws in the design.

In order to successfully combine market mechanisms and policy intervention, the design must have two basic formal features. First, it must reduce the unacceptably high level of uncertainty regarding the current situation. To do this the design must reveal as much information as possible in the early stages of the reform process. Policy makers can then use this information to refine and modify the design and avoid commitments which may have serious unforeseen consequences. Second, the design must contain self-corrective mechanisms that will spontaneously adjust the reform system. These self-corrective mechanisms are necessary since it is impossible to foresee all of the potential problems. These two formal features distinguish all successful institutional innovations from conventional planning schemes and should represent a general principle of institutional reform.

IV. A GENERAL FRAMEWORK FOR MASS PRIVATIZATION PROPOSALS

The discussion in this section focuses on the most important Eastern European privatization schemes, namely, those which propose to transfer the beneficial ownership of a large portion of state enterprises to the general population (or a large fraction of it), while concentrating control functions in a small number of intermediary institutions.[6]

In most privatization proposals of this kind,[7] the intermediary institutions function as holding companies or mutual funds, although some plans foresee a role for pension funds and other institutional investors. The intermediaries usually contain an essential foreign component. Foreign

6. Schemes of this kind are now being prepared in Poland and Czechoslovakia. Given the slow progress of conventional privatizations in Hungary, it may be only a matter of time before related solutions are developed there as well.

7. For an example of such a plan, see Roman Frydman & Andrzej Rapaczynski, Privatization in Poland: A New Proposal (June 1990) (mimeo). For a revised version of this paper published in Polish, see Roman Frydman & Andrzej Rapaczynski, *Sprywatyzowac Prywatyzacje: Nowa Propozycja Przemian Wlasnosciowych w Polsce, Res publica* (Sept., 1990). For other proposals, see BLANCHARD ET AL., *supra* note 1.

financial institutions commonly obtain management contracts for the newly created funds. These proposals usually envisage the conversion of state enterprises into joint-stock companies, with the intermediaries becoming legal owners of a large portion of their shares (some plans reserve a block of shares of the privatized enterprises for the state or distribute a portion of the shares directly to the population). The shares of the intermediaries themselves are in turn owned by individuals who acquire them free of charge or for a nominal fee.

The use of vouchers is often contemplated for this purpose. Individuals can use vouchers to purchase shares of the intermediary which they would like to own or to allow the intermediaries to purchase shares of specific privatized companies for their portfolio. Thus, vouchers allow individuals and intermediaries to determine their own ownership interests.

The advantages of these types of privatization proposals (although there are significant differences among them) include the following: the speed with which they can be implemented, the avoidance or lessening of problems associated with the valuation of the enterprises, the legitimization of the privatization scheme through a distribution of the national wealth among the population, thus ensuring a degree of equality, and, above all, a facilitation of the restructuring process through the institution of an effective mechanism for control of management performance. Other advantages include the possibility of a rapid development of a financial infrastructure and a link to outside sources of capital and expertise.

Despite the numerous advantages inherent in these types of privatization proposals, significant economic and political obstacles must be addressed. The following section analyzes these potential obstacles and recommends possible solutions.

V. Obstacles in the Transition to a Market Economy

The transition to a market economy faces a number of serious obstacles. A large portion of the existing capital stock in the Eastern European economies may turn out to be nonviable in a competitive market environment. Moreover, and perhaps more importantly, the governments of the Eastern European countries lack reliable information regarding the state of the capital stock. This makes effective policy planning extremely difficult and poses the realistic threat of an avalanche of bankruptcies. These problems may be compounded by extensive interfirm links which have been developed in the command economy.

In addition to practical problems, the transition to a market economy also presents serious political problems. The reformers must balance an acute need for investment capital and at the same time avoid relying extensively on foreign capital or ownership. Thus, the new economy must not only satisfy economic imperatives, but must also avoid destabilizing the fledgling political systems of the new Eastern Europe.

A. The Allocation of Capital Stock: The Lack of Information and the Speed of Privatization

The various mass privatization proposals envisage different methods for distributing the shares of the privatized enterprises to the intermediary institutions. Some proposals advocate a mechanical or administrative allocation. This would be accomplished either by giving each intermediary an equal number of shares in each company to be privatized, or by dividing all of the companies into several groups of "roughly equal value"[8] and allocating each group (perhaps at random) to one fund. Other proposals envisage a specially designed auction as an allocative mechanism, with the intermediaries bidding for the shares of the privatized companies using vouchers or investment points.

1. The lack of information

In evaluating the relative merits of the alternative methods of allocation, sufficient consideration must be given to the nature of the capital stock of the post-Communist economies. This is because the perverse evolution of the planned economy precluded the weeding out of nonviable enterprises and contributed to the creation of enterprises that had no *ratio essendi*.

The natural temptation of Eastern European policymakers (and, surprisingly enough, many Western analysts as well) is to try to ensure that the state does not find itself bereft of all valuable enterprises, left only with the worthless scrap of the

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8. We put this phrase in quotation marks because we believe that the task of assigning even rough values to state enterprises before privatization is truly Herculean (or perhaps rather Sisyphean). The idea that anyone would be able to assign values to several hundred companies within a span of a few months appears to us entirely unrealistic.

Communist inheritance. A mechanical or administrative allocation of shares among the intermediaries would prevent this by forcing the intermediaries to accept the weakest enterprises along with the strongest. The effect of this tempting move, however, may turn out to be unexpectedly harmful.

Since a large part of the country's capital stock may be nonviable, rapidly exposing a large number of enterprises to the rigors of a hard budget constraint and a truly competitive environment may result in a spate of bankruptcies, leading to a swift fall in production and a rapid rise in unemployment. This, in turn, may destabilize the political situation and endanger the whole reform process. Therefore, one of the main problems with the schemes of rapid privatization is that, not knowing the real state of the capital stock, it is impossible for the government to predict whether moving into a market economy will produce this devastating avalanche effect.

Suppose, then, that using an administrative or mechanical allocation scheme, the government forces the intermediaries to take an unknown number of nonviable enterprises along with the viable ones. In this scenario, if the intermediaries are free to behave as ordinary owners of capital, they will simply let the nonviable companies fail. However, if the government imposes a regulatory regime to avoid these mass failures, it will likely destroy the intermediaries' effectiveness as agents of genuine restructuring. For instance, by providing subsidies the state will signal to the intermediaries that the safest source of income lies not in the strenuous task of restructuring, but in extracting increasing amounts of money from the state coffers. Thus, the state will be open to the opportunism of the financial institutions.

However, this outcome may be avoided if the privatized enterprises are allocated to the intermediaries through an auction. A competitive bidding procedure will reveal the extent of the capital stock problems in advance of irrevocable decisions, thus allowing the state to determine how the resulting dislocations should be handled.[9]

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9. The design of an auction to be used in this context is a very complex matter which transcends the scope of this paper. For some of our suggestions, see Roman Frydman & Andrzej Rapaczynski, *Evolution and Design in the East European Transition* PRIVATIZATION PROCESSES IN EASTERN EUROPE: THEORETICAL FOUNDATIONS AND EMPIRICAL RESULTS (Luigi Paganetto & Edmund Phelps eds., 81 RIVISTA DI POLITICA ECONOMICA 63, (1991)).

An auction offers many advantages as an allocative mechanism. First, potential managers of the intermediaries are likely to have varying skills: some may specialize in certain types of companies, others may have particular foreign business contacts, still others may be good at liquidating businesses and selling their assets. Under the auction system, each manager is able to tailor the selection of the companies in his fund's portfolio and the extent of the fund's investment in any company to suit his expertise. This would be impossible in a mechanical allocation of shares. By allowing such preferences to be reflected in the ultimate allocation, the auction would thus properly match the skills of the individual fund managers with the needs of the economy.

The second advantage of an auction is that it forces the managers of the intermediaries to seriously research the companies which will be privatized. If a list of such companies is announced a few months before the auction, every fund manager will know that his future success depends to a large extent on the wisdom of his initial assessments. Therefore, each fund manager will find out as much as possible about the enterprises, particularly those in which he may have some competitive advantage. As a result, a necessary precondition of genuine restructuring--the preparation of plans which will turn around the privatized enterprises--will begin in earnest immediately after the auction is announced.

In other words, the inclusion of a well-designed auction in a privatization plan will immediately engage the private sector in a competitive process of information gathering, the results of which will also become available to the government. Unlike the endless enterprise valuations commissioned by the Eastern European states, the research here will be done by businessmen and entrepreneurs who will be backing their estimates with investment decisions.[10] While no valuation of post-Communist enterprises can be completely reliable (because the level of uncertainty is simply too high), these entrepreneurial estimates are probably the best possible.

From the government's perspective, the most important

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10. Also, the valuations will be simpler because the prospective fund managers, looking to purchase the shares of the privatized enterprises with otherwise worthless vouchers, will try to assess the enterprises' *relative* value (*i.e.*, to rank them with respect to one another), rather than determine their monetary worth (which makes it necessary to compare them with all other potential investments).

information resulting from the auction will be the number of enterprises that the fund managers believe have no potential for recovery.[11] This information will provide the government with a relatively good estimate of the extent of the worthless capital stock in the state sector. Since these worthless enterprises will be left under state control, the state will be able to make the appropriate decisions as to their final disposition without risking a shock wave of plant-closings and unemployment, and without compromising the restructuring of enterprises with potential.

Confident that the intermediaries will consider their new acquisitions to be of value, the state can give the funds full responsibility for the companies in their portfolios and refuse to subsidize them in any way. The state can adopt a number of policies to deal with the companies in its possession, which will avoid destabilization and social unrest. The state may decide to pay off the debts of some of the enterprises and auction them again later, or it may give them to the workers. Another option would be to subsidize them temporarily in some other way and proceed with a staggered program of closures, so that the unemployed can gradually be absorbed by the newly developing private sector. The state could even put the "white elephants" into special liquidation funds, to be auctioned off to those who would undertake to manage them for the lowest subsidies. In all of these cases, the good enterprises would be separated from the bad, and a continuation of some subsidies would not endanger the restructuring of the whole economy.

2. *The speed of privatization*

Much of the discussion regarding the speed at which Eastern European privatization should proceed is misguided. Those who say that the state should privatize everything immediately have no real appreciation of the political and social problems that might result from a sudden string of bankruptcies. However, the proponents of a more gradual process usually underestimate the difficulty that the restructuring will encounter if the state remains in control for too long and new vested interests develop a hold over the process of privatization.

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11. If there is only one bidder for a given enterprise, a well-designed auction might give it to that bidder at no cost. Thus, if no one bids for an enterprise, it means everyone thinks it has negative value.

The answer to the question "How fast?" needs to be more nuanced than "fast" or "slow." Those enterprises that are capable of being privatized, i.e., those which are either viable in a competitive environment or could be profitably liquidated, should be privatized immediately. Those which are not viable and require a period of transition should be dealt with differently, and not closed down overnight. The problem is how to distinguish the former from the latter. The solution is a well-designed auction system as a component of the privatization program. An auction will reveal important information at the outset of the reform process and allow for necessary subsequent modifications.

B. *Transaction Costs*

The problem with the capital stock in Eastern European economies has another, more complex, dimension which has not received proper attention. The very nature of the planned economy contributed to the creation of links between enterprises. These links may make them incapable, or at least much less capable, of functioning within a market economy.

One of the fundamental features of a market economy is the considerable amount of duplication among firms in a given branch of production.[12] Although this duplication of firms encourages innovation and flexible responses to consumer demands, the central planner considered it wasteful and messy since it undermined his desire to simplify the center's chain of command. Moreover, a socialist enterprise never faced the possibility of losing the demand for its products since its "customers" were captives within the planned economy. Consequently, each firm in the command economy occupied a specific "niche," and there was very little incentive to organize firms as genuinely independent units.

Therefore, unlike a market economy in which vertical integration or other forms of common organization always have their cost in terms of diminished flexibility and the loss of alternative competitive sources of supply,[13] the extent of inte-

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12. For the role of duplication in the capitalist economies, see RICHARD R. NELSON & SIDNEY G. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE (1982); Richard R. Nelson, Capitalism as an Engine of Progress (unpublished paper, on file with authors); and Richard R. Nelson, Why Do Firms Differ and How Does It Matter? (unpublished paper, on file with authors).

13. For a discussion of the advantages and limits of vertical integration in the

gration in a socialist economy is not limited by any factors beyond administrative convenience.[14] Thus, each unit of production becomes rigidly fitted within the plan, and to the extent the system provides incentives to produce more efficiently, individual units develop as many synergies as possible with their immediate suppliers and the recipients of their outputs. As a result, each unit invests very heavily in "niche specific" assets. This asset specificity makes it very difficult for the firm to function in another environment.

If this analysis is correct, the transition to a market economy may entail staggering costs. In fact, if privatization separates the purely administrative units of the Communist economy and forces them to sink or swim on their own, the economy's initial performance may deteriorate to even lower levels. The new companies would be hard pressed to find new markets for their very specific goods. Additionally, they would naturally tend to continue their old associations with their partners in the socialist chain of production. However, in addition to resisting genuine transformation, they would now try to renegotiate the terms of their old relationships in order to gain as many advantages as possible under the new circumstances. The transaction costs of these negotiations would be high. In fact, as the firms attempt to exploit their mutual dependence, the cooperation among the old partners would likely be less smooth and more wasteful than ever.

A partial solution to these problems may be provided by a proper mechanism for allocating the privatized companies to the intermediaries. A well-designed privatization auction can reduce the problems that would arise from enterprises taking advantage of their "niches." An auction allows the intermediaries to choose the companies in their portfolios. Therefore, the intermediaries can acquire interests in companies with special

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capitalist economies, see OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); and OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985). For an alternative approach to the same issues, see Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691-719 (1986).

14. For an analysis of the theory of the firm in a centrally planned economy, see Józef Zieleniec, *Microeconomic Categories in Different Economic Systems: The Firm*, *in* OPTIMAL DECISIONS IN MARKETS AND PLANNED ECONOMIES 1 (Richard E. Quandt & Dušan Tříska eds., 1990). For a claim that one could talk about the whole command economy as a single firm, see P.J.D. WILES, ECONOMIC INSTITUTIONS COMPARED 39 (1984).

links to one another and prevent these companies from exploiting each other. To the extent that these links are genuinely efficient, common ownership will protect and improve them, sometimes to the point of full-fledged mergers. If, however, these links have no beneficial long-term effect, the common owners will ensure that the firms are weaned from one another and that they develop relations with new customers and suppliers. However, this weaning will be gradual, and the exploitative opportunities will be accordingly diminished. In this context, the auction does not serve to reveal information, but rather to trigger a *self-correction mechanism.*

C. *Financial Infrastructure*

One of the main obstacles to further development of the post-Communist economies is the absence of a genuine banking system and the necessary capital markets. Since it may be difficult to create these institutions quickly, financing the development of the post-Communist economies is bound to be problematic. This problem also bears on the choice of a privatization strategy.

Banking reform in Eastern Europe, especially in Poland and Czechoslovakia, is in its infancy. Until recently, banking was completely centralized, with commercial banking being handled by the central bank. The central bank was merely an instrument of state planning and control, and its importance grew as other central planning institutions relinquished some of their direct power over the enterprises. In its expanding capacity, the central bank, through its local branches, was supposed to ensure that the enterprises maintained the balance among investment, wages, and working capital that the state considered desirable.

Post-Communist reforms in Poland and Czechoslovakia divided the central banks into a number of independent institutions and attempted to introduce some commercial realism into enterprise financing. However, in practice, reforming the banks has not produced a significantly more rational system. Even now, large state enterprises of dubious viability can obtain significant amounts of credit (with which they continue to maintain high levels of employment and postpone radical managerial changes), while the new private sector, with its very thin capitalization, is unable to obtain affordable financing. It seems quite likely that without the entry of a significant foreign component in the banking area, the reform of the financial infrastructure of the Eastern European economies will be seriously retarded.

In this connection, one of the most promising but controversial features of mass privatization plans which involve intermediaries is the intermediaries' potential to finesse the existing banking system and provide the germ of a new financial order. Privatization strategies involving intermediaries are often criticized for the high transaction costs they generate. In these plans, many individuals (perhaps every citizen) must receive notice of their new entitlement and an explanation of how the system works. In addition, the funds themselves must be set up and managed, which requires the establishment of a separate account for each of the participants. Since each participant's share may be of small value, administrative costs might consume a large portion of the proceeds.

Governments are therefore looking to reduce the administrative costs of the new order, perhaps by "piggybacking" their mass privatization schemes on existing mechanisms, such as social security registration. However, it might be worth incurring the somewhat higher initial transaction costs of certain proposals in order to lay the foundations for new financial institutions. Since the intermediaries would have to open and maintain individual accounts for a very large number of people, it might require very limited additional expense to link these activities with other types of services usually associated with consumer banking.

Similarly, the intermediaries' restructuring role has close affinities with brokerage, commercial, investment, and merchant banking operations, as well as with insurance. The funds could thus provide the following services: lenders or agents in borrowing (arranging loans or floating commercial paper on foreign financial markets), agents in the sale of stocks or assets, and representatives (and perhaps financiers) in arranging joint ventures with foreign investors, insurers, and capital pools for channelling small savings into the growing economy of a country with a shortage of capital.

In other words, the intermediaries could develop into "universal banks," similar to those in Germany or Japan. Given their flexibility, such institutions would be an attractive prospect for Eastern Europe. However, their development would also raise concerns regarding the influence such financial giants could exercise on the fledgling political systems of Eastern Europe. Therefore, any decision to move in this direction should be made carefully. If such a financial infrastructure is adopted, a system of safeguards should be implemented in advance to limit inappropriate influences.

D. The Role of Government

The quality of the civil service is another factor limiting the scope of successful reforms. The old bureaucrats were appointed based on their political reliability and lack of personal independence. The new governments have started to replace the old personnel, but the process is slow, and the new people are often without much experience, especially when the required expertise involves familiarity with business transactions. Consequently, it should not be surprising that civil service in Eastern Europe will need as much painstaking and time consuming rejuvenation as industry and the service sector. Furthermore, even in those areas in which government policy in the more stable countries of the West may successfully complement the market, there is serious doubt that the Eastern European bureaucracies could be trusted to achieve similar results. Therefore, privatization proposals must be evaluated with the idea of economizing on governmental expertise.

No easy substitute for governmental regulation exists which can provide a clear set of the "rules of the game." Yet, the very idea of the intermediaries is to remove the state as much and as soon as possible from managerial decisions, especially from the management of the privatization process itself. Thus, the intermediaries can be charged with such matters as selling and liquidating state enterprises and managing the government holdings.

This idea of "privatizing privatization" is particularly important given the low quality of government services in Eastern Europe. And yet, perhaps because many economists are not accustomed to thinking about political actors in terms as sophisticated as those they use with respect to economic agents, many privatization proposals ignore or minimize the limitations of the available governmental machine.

VI. THE MAIN DANGER IN MASS PRIVATIZATION PROPOSALS

The intermediaries created during a mass privatization plan of the type considered here are potentially very powerful and influential institutions. Their power, like all power, could easily be abused. Thus, it is important to curb this power by carefully attending to the incentives that the fund managers will have in the still largely unknown environment of the future Eastern European economies.

The intermediaries' managers face a basic choice of strategy: whether to position their funds as primarily economic or as primarily political agents. The first strategy is to prevail over one's competitors in restructuring to enhance the value of the privatized companies and to profit from their expansion. The second strategy is to collude with the other funds, to divide the markets by mutual agreements, and to increase revenues by fixing prices, extracting rents from public officials, and entrenching a complex system of state subsidies. This second alternative is the greatest danger posed by the mass privatization programs.

All mass privatization proposals that include intermediaries involve this danger. Competition and restructuring is arduous and fraught with perils and uncertainties for the manager who undertakes it. Genuine restructuring also means that the fund will encounter considerable hostility from those who are dislodged from positions of influence and control. Therefore, it is quite likely that an alliance of disgruntled special interests will attempt to use available channels of political influence to produce a new wave of state interventionism in Eastern Europe. The ability of the fund managers to resist these political pressures may be limited by their foreign connections and by the xenophobic attitudes present in all Eastern European societies. The charge of selling out to foreigners has the ability to destroy an intermediary's truly competitive strategy.

In contrast, to be a monopolist and a rent seeker can be extremely attractive to a fund manager. Eastern Europe has a long tradition of government paternalism, and forty years of communism have only advanced this philosophy. In addition, there are innumerable ways in which fund managers may associate the government with their own performance and shift to it some responsibility for their own failures. The intermediaries will have considerable resources at their disposal, while the governments will be temporarily ill-equipped to regulate the system. Thus, the funds may find it easy to manipulate the governmental agencies responsible for their regulation. Tariffs, subsidies, monopolies, and other evils would surely follow. Once entrenched, a system of this kind would be very difficult to eradicate.

VII. THE GOVERNANCE OF THE INTERMEDIARIES AND THEIR ENVIRONMENT

There are many ways in which reformers can attempt to prevent the fund managers from degenerating into rent-seekers; indeed, most of the program design questions concern this issue in one way or another. This section discusses some of the main concerns.

A. *Internal Governance*

The corporate governance structure of the intermediaries will play an important role in determining their behavior. The intermediaries are likely to be organized as domestic companies in the countries in which they will operate. Since foreign managers will probably dominate these companies, the authorities might try to make the fund's manager responsible to a board of directors representing local interests. Unfortunately, the real owners of the intermediaries, the shareholders, cannot be expected to exercise their powers directly. Each fund might be owned by millions of people who will face insuperable collective action problems in trying to control the funds they own. Indeed, the very inability of the funds' owners to be actively involved in monitoring their property is responsible for the existence of the intermediaries in the first place.

1. *Boards of directors*

If the intermediaries' shareholders cannot be expected to monitor their performance, it might be difficult to find an appropriate substitute for them on the funds' boards of directors. For example, the reformers may be tempted to advocate political appointments to the intermediaries' boards of directors. This would ensure that the board would be more responsive to special interests than to the interests of the shareholders. Therefore, the best corporate governance structure is one in which the directors "represent" no one in a strict sense, but have a personal interest themselves in monitoring managerial performance. The idea of "independent directors," used in the United States, seems appropriate.

The role of the board of directors is also a matter of more general concern. If the intermediaries are to be genuinely entrepreneurial, business-oriented institutions, their management, chosen for its experience and foreign contacts, must be primarily responsible for the policies of the fund. The board of directors should be a reactive body, guarding the interests of the shareholders against managerial abuses. If, on the other hand, the board's role is viewed as more active with respect to policy formulation and interferes with what are essentially business decisions, the board is likely to decrease the funds' effectiveness and to inject into its objectives a number of special-interest aims, unrelated to the maximization of returns on investment.

2. Compensation

The design of the intermediaries' compensation structure is another crucial aspect of the properly competitive character of their activities. A compensation system is extremely difficult to devise, especially in the absence of financial markets which would help determine the value of the assets under the intermediaries' management and thus also allow for a proper evaluation of their performance. However, the tying, even though imperfect, of the fund managers' compensation to their performance is a fundamental feature of every healthy incentive structure.[15]

It is also important to determine the extent to which the state should regulate the fund managers' compensation. While it is quite clear that the state should regulate the compensation *structure* (so as to ensure a proper set of incentives), the regulation of the compensation *size* (by, say, fixing it at a certain specific percentage of the funds' assets or of some other benchmark values) should, if possible, be left to the market. Not only will this increase competitive pressures, but it will also avoid significant mistakes. For example, if the state sets the amount, rather than the type, of compensation, it is extremely unlikely that it will get the numbers "right" (i.e., so that only transfer earnings and no rents are included). Furthermore, if the state sets the amount of compensation too low, the appropriate actors will not enter, and if the compensation is set too high, the funds will derive unnecessary superprofits (rents).

15. 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.

B. The Intermediaries and the State

One of the surest ways to convert the intermediaries into essentially bureaucratic institutions is to associate their activities with those of the state, and to make them dependent on the state for their existence and functioning. Foreseeable consequences of such an arrangement include the following: a dramatic reduction in the fund's readiness to make decisions on the basis of ordinary business principles, the fund's reluctance to take risks, and above all, the fund's 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 in financial jeopardy.

1. Control of entry

The way the intermediaries are formed is a decisive factor in determining their relation to the state. If the state creates funds (as would be the case, for example, if the state were to determine their number and composition), the state will be associated with their success or failure from the very beginning. Knowing this, the funds may exploit the state's vulnerability and extract concessions by threatening to produce economic effects which the authorities would find difficult to counter. However, if the intermediaries' entry is essentially free (as would be the case, for example, if anyone satisfying some minimum regulatory conditions could create an intermediary), both the intermediaries' rent-seeking behavior and the degree of the state's association with the intermediaries would be reduced.

2. Regulatory structure

The state regulations covering the intermediaries will also play an important role. Some regulatory scheme must exist to protect the shareholders from managerial overreaching and to control self-dealing, insider trading, and other corrupt practices. But this same scheme might also put bureaucrats firmly in control and force the funds to concentrate more on capturing the bureaucracy than on the restructuring process itself. To minimize bureaucratic interference, it might be safer to rely more on disclosure requirements than on complex approval procedures and outright prohibitions. Also, the reformers may want to structure the monitoring agencies as basically prosecutorial, with the courts serving as the ultimate enforcers, rather than creating powerful rulemaking bodies which might be more intrusive and easier to capture.

3. *State ownership*

Many privatization proposals envisage the states retaining a substantial portion of the shares of the privatized companies for budgetary and other reasons. However, to the extent that the state remains a serious player as a partial owner of the companies in the intermediaries' portfolios, political behavior by the intermediaries remains a dangerously attractive option.

C. *The Relation to the Small Investor*

The main question regarding small investors is whether they later would choose the intermediaries in which they invest or whether they would automatically receive a certain number of various intermediaries.

1. *Consumer choice and free entry*

There are advantages to not giving the beneficiaries, at least initially, the right to choose the intermediaries which they are going to own. The reasons for these restrictions are always the same: administrative simplicity, which eliminates transaction costs involved in other solutions, and the informational barriers facing small investors which would limit their ability to avail themselves of the benefits of choice.

A decision to restrict consumer choice in these matters, however, has very serious costs. Without consumer choice, the state must allocate the shares, and there is no opportunity for free entry of the intermediaries.

The only practical way of assuring the free entry of the intermediaries (subject to the fulfillment of some minimum qualification requirements) is to distribute privatization vouchers. The funds would then use these vouchers to acquire the shares of the privatized enterprises. However, if the consumer is given no control over the choice of intermediaries in which he will "invest", the entry of the intermediaries must be a function of a state decision. This will make the state seem responsible for allowing some institutions to enter. Such a certification might make it very difficult for the state to avoid the blame if some of the funds do not perform well in the future. The very awareness of this might make the state regulate the funds more intrusively, and the fund managers will be more likely to rely on subsidies than entrepreneurial success.

2. *Limiting the class of beneficiaries*

Given the importance of the free entry which is precluded by an administrative allocation of the shares to the population, it might be better to look for other ways to reduce the transaction costs of the allocation. Perhaps the best solution is to place a limit on the number of beneficiaries (as is planned in the Czechoslovakian version of this program) by making the recipients pay a relatively small amount of money for the vouchers to be distributed.[16] In addition to reducing transaction costs, this solution may also make it possible to achieve a much higher level of interest among the funds' shareholders, a higher level of information, and perhaps even a sufficient concentration of holdings for more active shareholder involvement in the governance of the funds. Finally, the smaller number of shareholders (each of whom would invest in a fund of his or her own choice) would allow each fund to develop more extensive relations with its shareholders. For example, the funds may provide other financial and banking services which may contribute to the development of the badly needed modern banking sector.

D. *Portfolio Allocation*

This paper has already discussed ways in which the method of allocating the privatized companies to the intermediaries might affect the success or failure of the mass privatization plans. In addition to these considerations, allocation method will also affect whether the funds will be primarily political or economic agents. If the allocation is administrative, the intermediaries are likely to focus from the outset on political influence. If the allocation is mechanical, with secondary trading relied upon to differentiate the portfolios at a later stage, the cash-strapped funds are likely to enter into collusive agreements to redistribute their portfolios, rather than compete with one another in lengthy trade-offs in an extremely thin market, involving perhaps a total of ten participants. In both cases, the state will associate its own prestige and responsibility with the type of assets in each fund, again opening the possibility for

16. The size of the payment could be adjusted to arrive at the "right" number of shareholders for each fund.

future exploitation by the funds. If, however, the allocation proceeds through an auction, from the outset there will be more competition and less collusion.

E. The Relation to Foreign Financial Institutions

Most commentators note the crucial importance of the entry of foreign capital and expertise into Eastern Europe. For a number of reasons, the entry of foreigners in their capacity as investors presents serious political problems, while their entry as advisers is of very little use.

However, the entry of foreign financial institutions in connection with the setting up and running of the intermediaries in the privatization program is particularly appropriate for three reasons. First, foreign expertise may be critical in establishing the infrastructure of a modern capitalist economy since the Eastern Europeans have practically no experience at all. Second, this infrastructure is particularly important because its presence liberates market forces, facilitating a chain reaction of growth and development. Third, the foreigners will initially be entering here primarily as managers of the funds, working on behalf of the local owners of the underlying assets, rather than as buyers of East European industry (although some part of their compensation may, and should, include stock options). Since the foreigners' success would directly increase the value of equity in local hands, their presence might be more acceptable than under other circumstances. Moreover, if the relations between the funds and their shareholders are structured in such a way that the assets under the intermediaries' management are directly proportional to the number of local citizens who choose that fund, the degree of foreign influence could be seen as exactly proportional to the welcome of the local population.

VIII. CONCLUSION

As the reform process in Eastern Europe unfolds, it is becoming more apparent that price liberalization alone will be insufficient, and that privatization is crucial. Furthermore, spontaneous developments alone cannot be relied upon. A careful design is necessary to anticipate the aggregate effects of mass privatization programs in economies with virtually no reliable information regarding the state of their capital stock and with no developed financial institutions to support a market economy.

However, the dearth of important information also means that all designs involve serious risks of highly negative economic and political consequences. Therefore, only a proper combination of design and reliance on market mechanisms will allow for a successful transition. The role of the market mechanisms is particularly important in revealing the lacking information and reducing the levels of uncertainty. These market mechanisms can also help avoid the dangers inherent in administrative and bureaucratic solutions and permit the creation of specially designed institutional "checks and balances" and other self-correcting mechanisms in the privatization design.