

Needed mechanisms of corporate governance and finance in Eastern Europe¹

Roman Frydman*; Edmund S. Phelps; Andrzej Rapaczynski and Andrei Shleifer**

* Department of Economics
New York University
New York NY 10003
Tel:+(1)212-998 8967

** Department of Economics
Columbia University
New York NY 10027
Tel:+(1)412-854 2060

1. Introduction

That enterprises are operated in the interests of the owners, approximately at any rate, is a fundamental assumption in the classic efficiency argument for a market economy. Yet, in actual capitalist economies, the enterprises are seldom owner-operated, the smallest ones aside. These enterprises are owned by shareholders who must rely upon imperfect mechanisms of enterprise control in seeking to select the manager and motivate the manager to act in their interest. Hence the degree to which the classic efficiency argument applies to a country's market system depends on the available mechanisms of corporate governance through which owners exercise enterprise control. Without arrangements to facilitate owner control, the managers' efforts will to some extent be misdirected; the allocation of investible funds across industries will be distorted by investors' control problems; and the cost of equity finance will be inflated.

The role of debt finance and the corresponding control problems faced by creditors are also important at the large enterprises which are the focus of this paper, not only at small firms. Since the control that shareowners can exert over management is imperfect, owing to the difficulties of obtaining information and of acting cooperatively, the cost of equity finance will at some firms be so high that some debt financing would be advantageous. But suppliers of credit face hazards of their own in entrusting funds to enterprises. Hence the controls that corporate governance provide for creditors are also of considerable importance. Without safeguards for potential creditors, the cost of debt finance will be driven up and the availability of credit contracted, so the credit market will do little to improve the misdirection of enterprises and the misallocation of investible funds across enterprises.

For the former communist countries in the region of Eastern Europe, this observation implies that in their transitions to a market economy they run the risk of creating a mutant system that cannot come close to matching the efficiency and dynamism of a normal capitalist system. Instituting a price system through the decentralization of resource allocation and the deregulation of enterprises, and instituting private enterprise

through legalization of private shareowning and mass privatization, are necessary but far from sufficient to achieve the potential of a capitalist market economy. The step that is so far missing in the privatization plans of most of the Eastern European countries is the creation of an appropriate mechanism of enterprise control. To realize in full the opportunities before them these countries face a double task: to create private owners, and to establish arrangements giving owners and creditors some control over the enterprises.

Two strategies now present themselves to the Eastern European countries. One is to create the owners forthwith and to hope that suitable mechanisms of enterprise control will evolve with time. The other is to introduce rudiments of an efficient enterprise control mechanism from the beginning in the process of widespread privatization. It may very well be that without good mechanisms of enterprise control, opting for mass privatization would still be better than the *status quo* because separating the enterprises from the political sphere would give restructuring a better chance. The main dangers of the first strategy, however, are that privatization without enterprise control will not be good enough to promote desirable restructuring of the enterprises; indeed it may create enterprises too weak to stand independently of the state. Also, if a satisfactory control mechanism does arrive, it may come too late to save whatever is salvageable of the state enterprises. Accordingly, this paper will suggest introducing some basic corporate governance arrangements explicitly into the programmes of transition² wherever this is politically feasible. Yet most of these arrangements could be introduced piecemeal, as they become practicable, and would be no less valuable later on.

Several proposals for enterprise control will be presented and analyzed here. Following a discussion of the limitations of insider ownership (by employees and management), we consider various control arrangements: dependence on the initiative of so-called core (large-stake) investors, outsider ownership of large blocks of shares by financial intermediaries, and large-bank lending along the lines of the German or Japanese models. The prospects for financial markets as the basis for enterprise control in the next few years will also be assessed.

In what follows, Section 2 surveys in some detail the variety of organizational forms of enterprises existing at present in the region in order to bring out the changes that would be entailed by alternative proposals for corporate governance arrangements. With this review as background, Section 3 takes up the issues of corporate governance and the various proposals. Some tentative conclusions regarding options for transition policy in the countries of the region are provided in Section 4.

2. The existing enterprise system

The creation of the classical command economies involved a wholesale nationalization and unprecedented concentration of the economies in the region, accompanied by the establishment of the highly centralized mechanism of enterprise control. This replaced all property-related arrangements by an administrative structure striving to control the behaviour of each agent directly. All decisions concerning industrial production were made through the political system, with factory personnel playing the role of state functionaries. In this sense, the command economies of the region did not have any legal property-based system (including state and not just private property) of enterprise governance. Instead, the industrial base of these economies was organized and centrally controlled through what we will call "socialist enterprises" (SE's). Various reforms since the 1950s involved attempts at a partial devolution of control to enterprise insiders, management or workers, leading to claims to entitlements (especially in Hungary and

Poland) creating a confusion over the distribution of property rights³. Consequently, as the communists fell from power, the countries of the region typically found themselves with unintelligible property arrangements and various mixtures of central and insider control over the various aspects of the socialist enterprises.

In addition to the socialist enterprises, in the 1980s there appeared on the scene two other forms of state or *quasi*-state enterprises: the limited-liability company and the joint-stock company (both to be defined). These organization forms are similar to their counterparts in Western Europe. Some of these latter companies have subsequently become privatized.

This initial state of institutional governance forms in the region appears to be one of the important determinants of the policy options for privatization, corporate governance, and reform of the financial system. This necessitates a review of the existing enterprise forms in the region, and sorting out their diverse policy consequences. The present paper begins this exploration with an overview of the main forms of enterprise in four countries: Czechoslovakia, Hungary, Poland, and Russia.

2.1 *Socialist enterprises (SE's)*

2.1.1 *Hungary: the role of the managers*

The passage of the Law on Enterprise Councils in 1984 marked the beginning of a major reorganization of enterprise governance in communist Hungary. The Law introduced a self-management system into the bulk of the socialist enterprises. The right to appoint the chief executive and to decide on organizational structures, such as mergers, spin-offs and joint ventures, were given to the employees in general meetings, to their representatives, or to enterprise councils (depending on the type of enterprise). The socialist enterprises were divided into the following three legal categories:

- (a) Enterprises (such as public utilities and other strategic units) intended to remain under direct state control and to be supervised by the corresponding sectoral minister.
- (b) Small enterprises employing up to 500 employees. These were to be governed by a body elected by the employees.
- (c) All other medium and large enterprises, governed by a newly created enterprise council. According to knowledgeable local observers (Mizsei 1990, Voszka 1993), despite the apparently substantial representation of the workers on the enterprise council, employees exerted only a minor influence on the key enterprise decisions.

The creation of the self-management system in Hungary has reinforced a longer-term trend toward the replacement of the state at enterprise level with the enhanced prerogatives of management. This dominant role of the managers in the governance structure of many large and medium size enterprises is a distinguishing mark of the Hungarian situation, and stands in sharp contrast to Poland, where the dominant role has been played by labour.

2.1.2 *Poland: The role of the workers' councils*

Following the explosion of expenditures financed by foreign borrowing between 1973 and 1976, Poland found its access to international funds dried up by the late 1970s. As a consequence, by the turn of the decade the economy experienced its deepest downturn since World War II. This significantly decreased the power of the Polish state authorities, which could not block the emergence of the Solidarity union, and agreed, in September 1981, to a legal guarantee of worker participation in the management of socialist

enterprises. Despite the imposition of martial law (in 1981) and the attendant temporary reassertion of the state power through the military, the 1980s marked a significant shift of power within the governance structure of the socialist enterprises from the state administration to the employees. The demise of communism has further reduced the state's powers, and left workers' councils and general workers' assemblies as the dominant stakeholders and supervisors of the enterprises' activities. The rights of these bodies resemble those normally held by the board of directors and the general shareholders' meeting in a Western-style joint stock company⁴.

The managing director is usually selected through an open competition. He is responsible for day-to-day management of the enterprise. As noted, his activities are reviewed by the workers' council, which can dismiss him.

2.1.3 Czechoslovakia: the classical governance structure

Although different groups of insiders have played a dominant role in the governance structure of the Hungarian and Polish socialist enterprises, these two countries have been characterized by a significant shift of power from the state to the insiders. In contrast, the state managed to retain its historically commanding role in the Czechoslovak socialized enterprises.

Although, similarly to Hungary, Czechoslovakia was preparing a large reform package to be introduced at the end of the 1960s, the Soviet invasion of 1968 thwarted the Czechoslovak plans. Subsequently, the state reasserted its administrative powers over the enterprises, effectively preventing the emergence of powerful insiders. This situation persisted throughout the 1970s and 1980s, and consequently at the time of the demise of communist rule, the Czechoslovak socialized enterprises were still a part of the state administrative system, with a governance structure moulded during the long period of the command economy.

Each socialist enterprise in Czechoslovakia was headed by the managing director. The director may be nominated by the founding organ (usually the relevant sectoral ministry) or may be elected by the workers council. However, even in the latter case, the government retained the right to approve or reject the choice of the council. The ministry also approved the compensation of all employees, including top management, and retained the right to interfere with current production decisions. Thus, although workers' councils formally exist in Czechoslovakia, their role in enterprise governance is not important.

2.1.4 Russia

Until Gorbachev's reforms of 1985-1988, Russia had a classic central planning system with fewer attempts at reform than its East European neighbours. Beginning in the mid-1980s, the reforms took a great deal of power away from the central ministries and gave it to the managers of the socialist enterprises (see Ausland, 1991). While state orders remained important, the managers obtained considerable control over the procurement of inputs, the sale of output, and wage and employment policies. Though some nominal power went to the workers as well, it is fair to say that control remained largely with the managers. Yet the desire by managers to get along with the workers, partly in anticipation of future reforms inviting collusion between managers and workers against the state, has led to a wage explosion (Shleifer and Vishny, 1992).

Though in the late 1980s the ministries retained considerable power over enterprises, by the beginning of the 1990s that power disappeared almost completely. Ministries transformed themselves into associations that received payments from enterprises in exchange for R&D services, coordination of supplies and other public goods. These

associations are trying now to play an active role in the privatization process by effectively transforming themselves into holding companies that will control the assets of, and thus monopolize, individual industries. They have the support of the managers of some enterprises who fear privatization. Whether they will succeed remains to be seen.

2.2 State companies and related forms

There also exist in the state sectors of the four countries discussed here two, more traditional, forms of business organization, namely the limited-liability company, whose shares are not publicly traded, and the joint-stock company, whose shares are so traded (and which may also enjoy limited liability). These types of companies have arisen in two ways. The first way, peculiar to Hungary, was driven by the old communist management's desire to solidify its control and independence from the state administration. This was made possible by a peculiar arrangement through which a socialist enterprise might contribute a part of its assets to a newly created company, limited-liability or joint-stock (or both), in exchange for the shares of the new company. In this way, the management of the old enterprises shields the "socialist" assets in a separate legal entity, often diverting them for private gain and excluding the state from effective control (see Széleányi, 1990).

The second way in which non-private joint-stock and limited-liability companies have arisen in Eastern Europe was driven by the opposite force, namely the state which, since 1989, has tried to reassert its legal ownership of the "socialist enterprises", and thus to overcome the tangled and obscure entitlements created by the communist decentralization policies. The procedure through which these enterprises arose is often referred to as corporatization, meaning here a conversion of a socialist enterprise into Western-style company - joint-stock or limited-liability - wholly owned by the state. However, the inherited governance structure of the socialist enterprises in Hungary and Poland has made the declaration of state ownership much more complicated than the process of assigning legal titles to the socialist assets. In fact, this process has proceeded relatively unimpeded only in Czechoslovakia.

2.2.1 Czechoslovakia: state enterprises as transitional forms

After the demise of communism, the dominant role of the state and the weakness of the insiders in the inherited governance structure of the socialist enterprises in Czechoslovakia facilitated a relatively smooth wholesale switch to formal state ownership of industry. However, except for a special group of companies, chosen for a variety of reasons to remain under state control, the state is supposed to retain its ownership rights in the new joint-stock companies for a strictly limited period of time. Thus, for most industrial enterprises, corporatization is only the first legal step before privatization.

It is worth noting that the assertion by the state of its property rights over the socialist enterprises in Czechoslovakia results in a very centralized structure of ownership. Upon selection for the mass privatization programme, the assets of the selected enterprises are transferred to one of the three newly created Funds of National Property (one federal, and two republican). These Funds are then responsible for transforming the socialist enterprises into joint-stock companies, wholly owned by the state. The shares of these companies are then to be sold to the Czechoslovak public (mostly in exchange for vouchers), domestic and foreign institutions, and private investors.

There are a number of other features of the Czechoslovak mass privatization programme that testify to the dominant role of the state in the privatization process. The most significant of them is the limited role of the insiders. In preparation for the privatization process, each enterprise prepares a so-called privatization project, often with

the help of outside consultants. This, to be sure, gives the managers a significant role in the process. However, any other party of outsiders is also entitled to prepare a "competing" project. The decision as to which project is implemented is then made by the Federal Ministry of Finance or an agency of one of the republican administrations (see Mladek, 1992, and Lindsay, 1992). Moreover, once the project is approved by the designated state organ, the Privatization Law stipulates that the enterprise will merely "inform the competent trade union authority about the privatization proposal" (Lindsay, 1992, emphasis added). This stands in sharp contrast to the situation in Poland, where the workers' representatives have played a dominant role in the socialist enterprises and were ultimately able to retain significant decision-making powers in the process of ownership transformation initiated by the first post-Communist government.

2.2.2 Poland

After several months of intense discussions, the Polish privatization law was enacted in the summer of 1990. In most cases, the law ceded to enterprise employees virtual veto power over the corporatization decision. The transformation of a socialist enterprise into a state company is carried out by the Minister of Privatization, at the request of the founding organ or at the joint request of the managing director and the workers' council. Even in the former case, however, the consent of both the managing director and the workers' council is required. While the law also gives the Prime Minister the right unilaterally to order the corporatization of an enterprise, the framers expected that this prerogative would be exercised only in unusual circumstances⁵.

In order to make corporatization more attractive to insiders, exemptions from the special tax on enterprise capital ("dividend") were granted to the transformed enterprises, and they were also relieved of a portion of the excess wage tax. Thus, contrary to the spirit of corporatization, which should in principle result in greater protection of enterprises' assets, the transformation of the Polish socialist enterprises into state companies has been linked with the softening of the budget constraint and the formation of unrealistic expectations of wage increases at the expense of other factors of production.

With corporatization, the supervisory and management boards of the new company are appointed. By law, two-thirds of the supervisory board is nominated by the Minister of Privatization, and one-third consists of the representatives of the workers. In addition, the Minister can decide to take over all or part of the company's debt and issue new shares to increase the share capital. The Minister is also formally in charge of the activities leading to privatization.

Only limited information is available on the actual governance practice of the newly transformed enterprises. However, systematic research (e.g., Chelminski *et al.*, 1991) and anecdotal evidence indicates that the insiders, especially the management, have continued to preserve their privileged status. As a rule, there are no significant changes in the key management positions in the new companies. Also, although workers' councils cease to exist upon corporatization, workers' representatives on the supervisory board often continue the activist Solidarity tradition and play an important role in enterprise decisions⁶. Other informal reports indicate that the supervisory boards are either passive or simply ignored by the insiders. It thus appears that in most cases corporatization has not yielded the hoped-for changes in the corporate governance structure and behaviour of the state enterprises.

2.2.3 Hungary: "cross-ownership" of state companies by SE's

In Hungary the Company Law of 1988 permitted a peculiar hybrid between company and socialist forms of economic organization. As mentioned earlier, the law gave the enterprise council of a self-managed enterprise the right to create a new economic entity and exchange enterprise assets for the shares of the newly created joint-stock or limited-liability company. This mechanism has led to a widespread transformation of socialist enterprises into mere holding companies, "owning" the shares of new companies created out of their assets. In this way, the state lost control over a large portion of the socialist assets (indeed, often the best portion) and, despite later attempts to reassert its rights through a specially created State Property Agency, has never succeeded in fully restoring it.

In addition to this hybrid of a Western-style company owned by a socialist enterprise, a number of other socialist enterprises in Hungary have been converted to a corporate form in accordance with the Transformation Law of 1989. This law, enacted toward the end of the communist regime, allowed a reorganization of whole socialist enterprises (rather than of a portion of their assets) into joint-stock or limited-liability companies, with most of the shares formally owned by the state. However, as with the corporate forms created on the basis of the earlier Company Law, the corporatization of the whole enterprise was often driven by the management's desire to gain an ownership stake in the new company and to insulate it further from state control⁷.

A public outcry against the abuses of the corporatization process prompted the last communist government to take some steps to assert state ownership rights over the remaining socialist property, although no genuine enforcement occurred until the first post-communist coalition. This effort involved, above all, the creation in March 1990 of the State Property Agency (SPA), which was made the formal owner of certain types of state property (Lindsay, 1992, pp.115-116).

Under the new structure, insiders of the self-managing enterprises (as opposed to the state-managed enterprises) have still retained a right to initiate and prepare the transformation of their enterprises, but the SPA can veto the proposed transformation. Also the SPA can, and occasionally does, place enterprises reluctant to undergo transformation under direct state supervision.

Despite all these efforts, the insiders continue to play a crucial role in the corporatization and privatization processes. To begin with, the SPA cannot properly process all the transactions within its jurisdiction, leaving much of the actual work to the insiders, with negotiations settling the more controversial cases. Most importantly, a loophole in the law left the companies created on the basis of the 1988 Company Law outside the SPA's jurisdiction (Mizsei, 1990). Finally, in the case of new transformations under the Company Law of 1988, the SPA supervises only the larger transactions, involving amounts in excess of \$400,000⁸.

The Company Law and the Transformation Law have resulted in a further complication of the governance relations of Hungarian companies, namely spreading cross-ownership. Under the Company Law, ownership of newly created companies is limited to institutions, and new companies are often owned by several institutions (banks and other companies). Under the Transformation Law management has a clear incentive to diversify the ownership of the shares in order to dilute the influence of the state. This has led to extremely tangled property relations that may, in the long run, have significant implications for the effectiveness of the corporate governance of the Hungarian economy. Often the ownership is sufficiently diffuse to leave management in control.

The system of insider control developing in Hungary is also evolving a number of mechanisms that prevent outsiders from gaining control of the companies created in the

process of corporatization. Thus, for example, new issues of shares on the Budapest stock exchange are primarily used to augment the share capital of the state companies, without ceding ownership or control to outside private investors. Not even foreign investors have managed to overcome this barrier to the ownership of publicly traded companies, with only one company traded on the Budapest stock exchange having a foreign majority stakeholder.

Among the other important institutional players emerging in the Hungarian corporate governance system are the state commercial banks established as a result of the breakup of the former unitary banking system. In the process, the banks have inherited non-performing enterprise loans as part of their assets, and some of these loans have since been converted into equity⁹. These banks, with their long standing links to the state enterprise sector, are an integral part of the insider-controlled institutional cross-ownership network of the Hungarian economy. On the other hand, the Hungarian banks, unlike their counterparts in the other countries of the region, have had several years of experience with more market-oriented policies, and the recent measures undertaken by the Hungarian government to tighten capital adequacy requirements and to discipline the enterprises in the state sector, raise some possibility that the banks could play a more constructive role in the future evolution of the Hungarian corporate governance structure.

2.2.4 Russia: emergence of spontaneous share societies

In Russia many socialist enterprises have taken the initiative to transform themselves into share societies. The stock issued has tended to be placed with other socialist enterprises (in exchange for services, supplies, etc.), with banks and other state institutions. In many cases, the shareowners include various state organs: municipal governments, state wholesalers, research institutes, and so forth.

At these stock companies, control over the selection of personnel and the direction of the company are in the hands of the insiders, not outside shareholders. This is supposed to be changed by the Corporatization Decree of July 1992, though the extent to which this decree will be obeyed by the managers is not yet clear.

Many enterprises in Russia have in recent years formed leasing arrangements with the ministries or with their parent firms. These leased enterprises often occupy the premises of the parent firms and divert human resources and materials and other capital as well from the state sector. Nevertheless, the leased firms may become very important in the privatization process as they have accumulated substantial financial resources and in some cases market know-how to make them potential leaders in privatization.

2.3 Foreign investments in joint ventures

The participation of foreign investors in the ownership of companies in Eastern Europe gives rise both to a separate type of legal form, the joint venture, and to a whole host of special issues related to their role in the corporate governance structure.

2.3.1 Hungary

Hungary has a liberal climate for foreign investors, including the possibility of full repatriation of profits and one hundred *per cent* foreign ownership, except in the banking sector where governmental permission for foreign participation is required. Foreign investment typically takes the form of joint ventures with domestic state or socialist enterprises¹⁰. According to recent estimates (Csaki, 1992), Hungary has attracted as much as fifty *per cent* of total foreign investment in Eastern Europe, with about \$1.9 billion in 1991 alone.

Apart from the sheer size, the most remarkable feature of the pattern of foreign investment in Hungary is that foreign investors seem quite willing to acquire minority stakes in Hungarian companies. In particular, the average foreign ownership share in joint ventures of companies established under the 1988 Company Law has been under fifty *per cent*. To be sure, a foreign investor may acquire *de facto* control without owning a majority of the shares. Nevertheless, the fact that the foreigners are in many cases willing to trust their investments to domestic management is quite remarkable. One explanation for this may be that the Hungarian managers are viewed as significantly superior to their counterparts elsewhere in the region. While this is certainly the case, other reasons may also play a decisive role. The most important among them is the possibility that the Hungarian managers cause their companies to contribute their most valuable assets to the joint ventures, and that the foreign investor is offered a particularly attractive "deal" in exchange for accepting the continued control of the other parent's insiders. The position of these insiders is significantly strengthened by their ability to attract foreign capital, and they may often derive significant pecuniary benefits as well¹¹. Some indirect evidence for this proposition comes from the fact that foreign partners are most willing to accept minority positions in those cases where the new entities are created from parts of a parent state company (or socialist enterprise) in accordance with the Company Law of 1988. As we have seen, these transactions are the least scrutinized ones, and it is plausible that the most valuable assets of the domestic parent are included (at a low valuation) in the joint venture (see Faur, 1992, p.16). It may also be significant that out of the total of \$1.9 billion foreign investment in 1991, only \$350 million was spent by foreign investors on trade sales processed by the SPA. Thus, about eighty *per cent* of foreign investment consisted of "deals" between foreign investors and domestic companies, banks, or socialist enterprises outside the domain of the SPA (see Mizsei, 1992).

2.3.2 *Czechoslovakia and Poland*

Similarly to Hungary, Czechoslovakia and Poland also have liberal foreign investment laws. The foreign investment record to-date in both countries is weak in comparison with Hungary¹². Therefore, the effect, if any, of foreign participation on corporate governance is naturally even less pronounced in Czechoslovakia and Poland than in Hungary. Furthermore, the few larger transactions which have been concluded have often involved the option of an initial majority purchase by the foreign investor. The domestic party to the transaction has been the state and not the self-managed enterprises, as is often the case in Hungarian joint ventures¹³.

As for other transactions involving foreign participation, few in Poland involved the sale of shares to foreign investors and the Polish general public through initial public offerings, and it is expected that in the on-going Czechoslovak large scale privatization programme, foreign investors will participate in the privatization of only 49 enterprises or their parts out of the total of 1491 units in the first wave of the programme (Havel, 1992, p.4). Although the expected increase in foreign investment in Czechoslovakia may modify the picture, foreign investors have not yet played a significant economy-wide role in the corporate governance system in either of the two countries.

2.4 *Privatized companies*

Although there has been substantial foreign investment in Hungary and there is an expectation of a sizeable increase in Czechoslovakia, domestic investment by the general public in privatized companies has been minimal¹⁴. So far, the participation by domestic residents in the process of privatization has primarily been confined to insiders. However this situation will soon change in Czechoslovakia, where the on-going large scale voucher

privatization programme will transfer ownership of socialist enterprises to a large part of the Czechoslovak population and vest an as yet unknown measure of control over the newly created companies in the financial intermediaries¹⁵. Furthermore, insiders have not been granted any special preferences in the Czechoslovak programme.

In contrast, the only programmes that have yielded any results in Poland and Hungary have involved the insiders and various sales programmes aimed at the general citizenry of both countries have yielded disappointing outcomes. In Hungary, domestic residents have not acquired any shares of large and medium size companies in the first groups of sales attempted by the SPA. In Poland five companies were put up on sale through the initial public offering in November of 1990¹⁶. Due to deficient demand, the subscription period had to be extended and the five companies were finally sold for a total of \$31 million; moreover, to avoid under-subscription of some issues, the state bank acquired the remaining shares (Berg, 1992). According to a recent report published by the Polish Ministry of Privatization, sixteen months after the first initial public offerings (as of February 29, 1992), 30 state companies had been privatized "individually", 8 had been fully privatized through initial public offerings, 2 by employee "buyouts", 12 through negotiated trade sales, 5 using a mixture of initial public offerings and trade sales and 3 through auctions. The total sale proceeds were about \$190 million, which amounts to about 5 *per cent* of the estimated book value of the state assets. Meanwhile, many more enterprises in Poland were privatized through a process involving a form of instalment sale, usually to insiders, called liquidation.

This form of privatization can be initiated by the founding organ or the workers' council. However, in nearly all cases the initiative came from the workers' councils. Moreover, privatization through liquidation is usually closed to domestic and foreign capital. Out of 353 privatizations through liquidation, in 283 cases insiders leased the newly created company and outsiders only bought the company in 20 cases (Szomburg, 1992).

Russia has a reasonable foreign investment law as well as liberal rules for foreign investment in the initial privatization of enterprises. In fact, hundreds of joint ventures have been formed in Russia in recent years. Unfortunately, many government agencies are fighting bitterly about jurisdiction over foreign investment, which imposes extremely high bureaucratic costs on investors. The absence of clear rules and authority is probably the single most important deterrent of foreign investment in Russia as well as an important obstacle to investment in general (Arrow and Phelps, 1991).

2.5 Summary

The thrust of what has been learned from this survey can be stated briefly. In the East European region in general, the state is not the sole effective owner of the socialist enterprises, free to distribute shares in them as it wishes. The managers and workers also claim effective ownership rights and take economic and political actions to defend these rights. In Russia the local governments and branch ministries are also claimants. These various "stakeholders" exercise a degree of *de facto* ownership in the sense of being able to exert some influence over enterprise assets in their own interests. But these claims are conflicting, or overlapping, and often vague, hence not comprising a well-defined pattern of property rights.

This combination of very extensive insider autonomy with extremely ill-defined property rights and expectations in the Eastern European region yields a set of incentives that is seriously detrimental to the prospects for the region's economies. The situation varies somewhat among the countries involved, but the incentives of the people in control of the larger economic units are clearly at odds with the interests of the state, enterprises

and the health of the economy as a whole. This state of affairs leads to all kinds of attempts at wild appropriation, the diversion of enterprise resources to private uses even when such uses are not efficient, attempts to maximize present wages and employment, a decapitalization of enterprises through lack of reinvestment and modernization, increase in future indebtedness to cover present expenses, and so forth. Where the old state subsidies to these enterprises have become less plentiful, a system of inter-firm credit has arisen by which the enterprises are able to support each other in their desire to continue in this fashion.

3. Alternatives in corporate governance and corporate finance

Corporate control, as that term is used by economists, refers to the corporate governance arrangements by which shareowners hire and fire managers and monitor and reward them in order that they optimally serve shareowners' interests. Every system of corporate governance is a structure of control rights, and the owners of enterprises want the system that is best for the price of their shares and thus best for them. In analyses of these arrangements, the shareowners are said to be the principals and the problem is to choose and to motivate a manager, called the agent, to pursue their interests to a cost-effective extent¹⁷. Corporate control is not the standard agency problem, though, since there are many principals in a large enterprise and the principals want to be able (if the terms are favourable) to transfer their control rights to new principals.

Of two control difficulties, the one more frequently discussed is the task of monitoring and motivating the manager so as to restrain his self-interested behaviour. The manager has his own objectives, such as survival of the firm, its growth and diversification, managerial salaries and perquisites, and so forth, while the objective of shareholders, in contrast, is typically value maximization, achieving the highest possible price for their shares. The agency problem is compounded in situations where all the shareowners have small holdings. There it is too costly for any one of them to engage in the monitoring and analysis that would be required to ensure that the manager acts in their interest; each shareowner finds it advantageous to be a free rider. In Western market economies, corporate governance mechanisms have evolved that serve to alleviate this control problem.

It could be asked how severe that agency problem is in Western corporations. It is true that, in most cases, the manager would not want to set so high an annual salary and expand the scale and prestige of the firm so much as to jeopardize severely the prospects for the firm's survival and thus the manager's own job. But, short of crippling the firm, there can be a wide discrepancy between the optimum for the manager and the optimum for the shareowners. Since the balance of benefits and costs truly attributable to actions is typically estimable only with some error if at all, the manager is often able to portray actions taken as profitable and actions not taken as unprofitable or too risky for the owners where the latent function (in Merton's terminology) of these policies is simply to serve his self-interest; the shareowner cannot sort out legitimate cases of tacit knowledge from cases of misrepresentation. Another source of such a discrepancy is the difference in time horizon between manager and shareowner. The shareowner knows that his shares, being alienable, will have a market value when he sells or makes a gift of them and how valuable they will be depends on the (expected) subsequent profitability of the enterprise. So as a shareowner he will care about the profitability of the enterprise far beyond the duration of his own shareholding; in contrast, the manager cannot sell or

donate the rights to his managerial post, so he has no direct stake in the profitability of the firm beyond his own tenure¹⁸. The effects of this discrepancy could persist since the replacement of a manager is costly for the shareowners or creditors instituting the action. Moreover the pursuit of this self-interest by all managers may largely remove the risk to each¹⁹.

The more serious of the two control difficulties may be the problem of changing managers for reasons of their lack of capacity or qualifications. It is of great importance that the owners have a mechanism by which to replace the manager, and also important that, if the existing owners are unwilling or incapable, the market have a way of changing the owners if other would-be owners place a high enough value on doing so. Bankruptcy provisions whereby creditors can change the manager in the event of default serve to ensure low-interest credit and also to assure owners of effective control in this contingency (see Aghion and Bolton, 1992).

This dimension of enterprise control will be especially important in Eastern Europe. In the West, managers have arrived at their positions through a process of suitable training and subsequent evaluation. In Eastern Europe, in marked contrast, the background of the extant managers, for all their talents and experience, is surely less suited to running capitalist enterprises. Worse, many enterprises in Eastern Europe now require for their survival a major restructuring for which many of their managers will be poorly equipped. Finding the right managers for restructuring and subsequent operations is going to be extremely important. Many managers will need to be replaced by new blood. The cost or indeed the very feasibility of meeting this problem appears to hinge on the mechanisms of enterprise control that are going to arise in the privatization process²⁰. For this reason especially, consideration of the appropriate governance structures for the newly privatized firms is crucial for the success of the market-economy transitions in the region.

This paper will now present and analyze what seem to be the major corporate governance arrangements being considered in the region, leaving for later the possible role of financial institutions and paying special attention to the potential effects of these alternative arrangements on restructuring. The discussion will be confined to large and medium-size enterprises owned or expected to be owned by a number of shareowners.

3.1 Ownership and control by insiders

The crucial issue in the corporate governance of large and medium size economic units in Eastern Europe concerns the establishment of an appropriate distribution of property rights that will radically reduce the existing agency problems of enterprises, privatized or to be privatized. As discussed in Part I, the insiders (management and/or labour) have *de facto* unsupervised control over most decisions concerning socialist enterprises (except in Czechoslovakia) and this inherited structure is not favourable to the massive restructuring required by these economies. The key issue now is which new governance mechanism will be most conducive to the necessary restructuring, recognizing that existing interests may force adoption of some less favourable governance arrangements.

3.1.1 (Non-managerial) employee ownership

It is possible in Russia and some other countries in the region that non-managerial employees (henceforth employees) will be major recipients of the shares of enterprises distributed in large-scale privatization²¹. In the privatization programme recently enacted in Russia, the manager may elect Variant 1 giving the employees 25 *per cent* of the shares free of charge, or Variant 2, a closed subscription to insiders, in which they will be able to purchase for cash or vouchers up to 51 *per cent* of shares at a low multiple

of book value. (There is no limitation on workers and management separately.) If the sale of shares to the public proceeds slowly, which would not be surprising, then in many companies the employees, together with the management and the government, will be the only shareholders in the near future.

This prospect raises the issue of governance of enterprises with a substantial worker ownership share. The prevailing view among Western economists has long been that worker ownership is a bad idea. Nevertheless it must be noted that there is a distinction to be made between employee ownership of a claim to a portion of the cash flows of their enterprise on the one hand and, on the other hand, employee control of the enterprise. In the United States, a country where employee stock ownership is unusually common, of the one thousand public corporations with the largest employee stock ownership, only four had a worker representative on the corporate board, according to a recent survey (Blasi, 1992). Even in those cases, board representation by no means entailed substantial control rights. In the majority of the other firms in the survey, the governance arrangements specifically ceded the employees' vote to the management. In general, worker ownership in the United States is widely regarded as a mechanism for entrenching the control rights of the managers against those of outside shareholders, particularly the takeover practitioners. In the rest of the world as well, there is evidence that where we see employee ownership we see virtually no employee control or even significant participation in control (Hansmann, 1990).

There are several reasons for expecting this to be so. Hansmann has argued that employees differing in age, the part of the plant they work in, and their value to the company have different objectives, which makes worker control problematic. Unable to govern the firm effectively, the workers are usually willing to vest the control of the firm in another agent, the manager. Another point is suggested by Polanyi's notion of tacit knowledge: there is a need in enterprises for decisions whose adequate justification to all the interested parties would be so expensive to communicate to them and for them to master that a collective decision process would not be cost-effective.

On the other hand, one wonders how independent from the employees a manager would be willing to be if employee ownership is so substantial that they can often influence heavily the terms and the tenure of the manager. To the extent that the manager then caters to the employees several ill-effects can be expected to result. The managers of the enterprises will tend to raise wages and, although a small increase might be repaid with improvements in absenteeism or alcoholism, the economy will suffer side-effects in the form of reduced hiring of young workers²². Also, the managers in enterprises that are over-expanded or over-manned will postpone the necessary adjustments, causing such misallocations in the economy to be prolonged. In the Eastern European region such misallocations are massive so the need for adjustment is acute. We conclude that if employee ownership impinges on what would otherwise be full or near-full manager control, the resulting behaviour of the enterprises is likely to be a further bias away from concern with future profitability.

The strategy adopted in the Russian privatization programme is to offer the employees the substantial ownership described above but in a way that may weaken and shorten employee influence over enterprise control. A measure embedded in Variant 1 of the plan makes the employees' shares non-voting, although it is increasingly expected that the managers choosing the privatization course will opt instead for Variant 2 in which the shares may be voted. These shares are alienable, however; the employees can sell them on an informal market. As they sell their shares to outsiders, they will lose whatever influence came from their power as shareowners to vote for their interests as employees²³. If the employees will sell as hoped, the privatized companies will begin

to look more like companies with managers and outside shareholders. But then the further question is whether the outside shareowners will be able and willing, in view of the governance structure set up by the privatization plan, to exert important influence over the control of the enterprises. The risk is that the managers will be entrenched, and the lack of qualifications and capacity of many of them will impede the restructuring badly needed to revitalize the enterprises.

3.2 Ownership and control by outsiders

If, with privatization, the worst problems of insider control are to be removed, additional arrangements must be made empowering and motivating outsiders of one kind or another to engage in enterprise control.

Students of economics and of corporate governance have identified a number of forces and instruments that operate in varying degrees to give outsiders influence over the management of the enterprise. They are listed below with a citation for each:

- A. Incentive devices
 1. Giving managers an equity stake or other incentive pay. (Jensen and Meckling, 1976; Jensen and Murphy, 1991)
 2. Firing the manager if he performs poorly. (Morck, Shleifer and Vishny, 1988; Jensen and Murphy, 1991)
 3. Not hiring the manager to a new job if his reputation is bad. (Fama, 1980)
- B. Product-market forces
 1. Product-market competition leading to bankruptcy.
- C. Shareholder mechanisms
 1. Takeover or proxy fight. (Jensen and Ruback, 1983)
 2. Interference by active block investors, through the board or not. (Shleifer and Vishny, 1986)
- D. "Debt" mechanisms
 1. Public debt with the threat of bankruptcy and liquidation. (Jensen, 1986; Hart and Moore, 1989, 1991)
 2. Private bank debt with the threat of bank control or liquidation. (Jensen, 1986; Hoshi, Kashyap, and Scharfstein, 1991)

Consider, first, the incentive schemes, in group A. Each of these devices is obviously a tool to encourage efficiency and is utilizable with almost any system of corporate governance, but is not a governance mechanism itself. Indeed, in discussing each of these incentive devices it is convenient not to specify a particular governance structure. (It may be, though, that, despite the mutual gain to the interested parties offered by certain incentive-providing reward structures, some governance structures would fail to evolve appropriate incentives - incentives for managers as well as for employees - in the pursuit of efficiency.)

Of these group A mechanisms, the view in the technical literature is that A2 and A3 are not as strong as one would like. Of course it is true that managers earn large rents and have considerable firm-specific human capital, so being fired is certainly not costless to them. One reason for the view in the literature is that the market for managers is extensive in the United States and other large economies, so there the threat of firing or reduced pay may impart less discipline than might be expected. However, in the Eastern

European countries, the mobility of managers is a great deal more constricted, so the risk of dismissal would undoubtedly be more effective than the literature in the West would suggest. The more important reason is that, as managers are naturally influential with the board of directors, they are seldom fired except for extremely poor performance. On the other hand, in Eastern Europe, where managers will typically face a difficult time, they may come under more than the usual scrutiny and criticism.

There is no doubt, however, that an equity stake or other incentive pay (A1) can be efficacious. Jensen and Murphy (1991) found that direct ownership of shares is by far the most effective incentive device for manager motivation. It appears from this research that giving managers some small though significant stake in the enterprise, say a 5 *per cent* stake as provided in the Russian programme, is a good idea. Yet, at some point further increases in the manager's holdings are actually detrimental to his managerial performance, according to empirical evidence from the American economy presented by Morck, Shleifer and Vishny (1988).

It must be stressed, however, that even with optimal incentive packages for managers throughout the economy, there still have to be control mechanisms enabling outsider principals, first, to monitor the performance of the manager and, second, to fire the manager and to choose his replacement. These two control functions have special urgency in the region of Eastern Europe, as emphasized earlier. The mechanism in groups C and D are control mechanisms of this sort.

Before turning to the governance mechanisms, though, let us address the idea of competition as a disciplinary force, the method under B. The matter of industrial concentration is obviously highly relevant for the countries in the Eastern European region which contain to varying degrees highly concentrated industries created by the central-planning system. A long tradition in Western economics is the thesis that monopoly is the enemy of efficiency and dynamism²⁴. Although dissonant voices are sometimes heard, for example Schumpeter and most recently Hart (1983), the weight of opinion continues to regard competition as an important spur to improved performance.

The stronger position has sometimes been espoused that competition could serve as an adequate substitute for effective mechanisms of outsider control over enterprises. This position has its roots in the earlier "Chicago" argument about the "evolutionary" effects of competition in driving out firms failing to meet some standard level of performance in keeping up profits. The hypothetical firms in that argument, however, were capitalist firms, perhaps even owner-managed firms. In the radical extension now sometimes heard, the same argument is said to apply even to economies in which the firms (at least the great majority) are effectively controlled by insiders or are state-owned. The claim is that the managers cannot afford to do anything other than to maximize the value of their respective enterprises if they are faced with the pressures of a competitive product-market environment.

The more persuasive view is this: More competition is better than less, up to a point at any rate. In Eastern Europe more competition would be a major improvement. Even a small amount of competition might shake up some companies there. But competition is not sufficient. If all enterprises are saddled with managers who are incapable or entrenched, the product-market competition among them, however intense, will not succeed in weeding out any of these managers and correcting their common ill-effects. In our estimation, the same objection can be sustained if such managers are merely the norm, not universal. One argument is based on a view of product-market competition as beset by informational frictions and difficulties of inference. Another argument is that bankruptcy of most enterprises might bring a bail-out from the state - too numerous (if not too big) to fail²⁵. Hence our view is that competition is in no way a substitute for

a system of enterprises where outsiders have governance mechanisms by which they can exercise effective control over the managers.

However, even if a persuasive view to the contrary should be developed, the further problem with reliance upon competition is that government policy in Eastern Europe is unlikely to foster a great deal of competition. Continuing pressures on the governments to offer soft budgets, protectionism and market segmentation can be expected. Hence, again, appropriate and effective mechanisms of corporate governance appear to be especially necessary to good economic performance in Eastern Europe.

We will review now the mechanisms of outsider control over enterprises, beginning with a discussion of the shareholder mechanisms of group C.

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.

In the West, takeover and other aggressive corporate control mechanisms such as proxy fights are extremely important in the US and perhaps the UK, but not anywhere else in the world. There is a vast literature on hostile takeovers (see Jensen and Ruback, 1983, and Shleifer and Vishny, 1991). The consensus of this literature is that hostile takeovers indeed serve to discipline managers in some cases: most importantly in the US experience, to reverse wasteful diversification. However, takeovers are an extremely costly control device and one that requires very liquid and effective capital markets. It is for this reason that they are uncommon elsewhere in the world. For the same reason it is inconceivable that they would be able to play an important role in the Eastern European region for years to come.

It should be noted that even if there existed a realistic possibility of instituting liquid stock markets 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 under-perform, rather than engaging in the costly process of monitoring and fighting the management trying to ward off external interference (see Coffee, 1991). Second, reliance on takeovers for external monitoring increases the job uncertainty of company managers and may be responsible for a tendency toward 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 (see Franks and Mayer, 1990). 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 (these points were stressed in Frydman and Rapaczynski, 1992a).

An important shareholder mechanism throughout Europe is that of the core investor, generally an investor who amasses a sufficiently large holding of shares in an enterprise to make it possible and worthwhile to participate actively in the control of management. These core investors, whether or not on the board of directors, try to use persuasion with the board to get their way but sometimes work to fire the managers, replace the board, or even mount a takeover. How effective these investors are is not yet a point of

consensus. Sceptics suggest they are often captured by the managers or bribed to exit through so-called greenmail and targeted share repurchases.

In Eastern Europe the question arises, where will core investors come from? As long as there is no prospect of an extensive stock market, core investors will not arise through placements in the bourse by wealthy individuals. (The prospect that pension funds would play such an active role is also remote.) With regard to direct investments, there are very few East Europeans who could afford to buy a significant block of shares in a large company. Further, there are not many people in Eastern Europe with sufficient expertise to facilitate and supervise the introduction of modern production and management techniques, and only a foreign investor could facilitate contacts with potential foreign joint venture partners or an entry into foreign markets. Foreign investors can play this role in some cases but certainly not at the majority of enterprises.

Whether a national or a foreigner, there may be a problem with the core investor solution to outsider control. Even if he holds a relatively small block of shares, the core investor might be the only significant investor in the company. He may thus be very hard to dislodge in a system in which corporate raiders are not likely to appear for some time. This means, in turn, that, unless other shareholders have large enough stakes in the same enterprise to exercise a restraining force on the core investor, the core investor will be basically uncontrolled, and if he does not supervise properly or exploits the company in favour of other entities (say, foreign entities) in which he has a higher share of ownership, there will be no one in a position to do anything about it.

The main way open now to the establishment of holders of large blocks of shares, blockholders, is to create them artificially as part of the distribution of shares in mass privatization. The creation of blockholders, indeed two or more blockholders to guard against abuse, was a feature of the blueprint for privatization through voucher giveaways *cum* financial intermediaries in Frydman and Rapaczynski (1990). In Poland, a scheme with a single blockholder appointed and regulated by the government is embodied in the current government plan. In Czechoslovakia, financial intermediaries that have arisen in the mass privatization might become such blockholders spontaneously, though this remains to be seen, and foreign investors are also encouraged to purchase blocks of shares. In Russia, having blockholders is permitted in the privatization programme, but the shares are not going to be distributed so as to contrive the holding of two or more large blocks (or even one) at large enterprises. The failure to focus on the formation of such outsider control blocks is probably a function of the much greater power of the managers in Russia than in Czechoslovakia. Nevertheless, any blockholder in Russia would have to face the formidable power of the manager.

This brings us to the role of credit and the banks, more generally the financial system. Creditor influence over enterprises depends on legal provisions for bankruptcy. Without recourse to bankruptcy, a supply of credit will not normally be forthcoming, and the effectiveness of debt as a control, or governance, mechanism is determined by the possibility the creditors have of throwing firms into bankruptcy.

The debt mechanisms of group D are extremely important around the world, least so in the United States, most of all in Germany and Japan. Fear of bankruptcy and consequent loss of their jobs, with or without liquidation, does evidently motivate managers. Fear of aggressive interference from bank lenders, even without liquidation of the firm, also motivates managers (for relevant analysis, see Jensen, 1986, and Hart and Moore, 1989 and 1991).

Debt mechanisms are credited by some observers with the exceptional performance of the German and Japanese economies today, and of the United States economy during the Morgan era at the turn of the century. Under this bank system, banks have close

relationships to the enterprises to which they supply debt finance (and sometimes equity finance), and thus they have access to inside information not normally available to securities markets, so that the enterprises need not retain a substantial portion of their earnings to signal their own evaluation of their investment prospects and thus to encourage a supply of credit or equity finance. In fact, Hoshi, Kashyap and Scharfstein (1991) found that bank-affiliated firms in Japan exhibit smaller sensitivity of investment to internal cash flow. DeLong (1991) found similar evidence for JP Morgan-affiliated companies. All this evidence suggests that bank relationships improve efficiency. At the same time there is no clear evidence as yet on the relationship between bank affiliation and management turnover. Evidence such as this has stimulated interest in importing merchant banking to the Eastern European region. Nevertheless, as will be obvious from the following discussion, the existing state banks in the Eastern European region (including Russia) are not yet remotely equipped to play such a role.

In what follows we will survey the financial institutions that might play an important role in corporate governance in the process of providing debt (and possibly equity financing as well). In doing this we should distinguish between two aspects of the problem: the role of financial institutions in the period of transition, and their role in the long-term development of the economies of the region.

3.3 Financial market issues

3.3.1 The drag of the existing state banks

Pointing to the apparently beneficial role of banks in Germany and Japan, some analysts draw the conclusion that a principal aim of reforms in Eastern Europe should be to strengthen the existing banks and look to them as engines of restructuring and subsequent growth. Their proposals usually take two forms: that privatization in Eastern Europe should make the banks into serious equity holders of the privatized state enterprises, and that these banks be enabled and encouraged to use their leverage as creditors to initiate and supervise a programme of restructuring the state sector (Corbett and Mayer, 1991). The first objective could be accomplished through large scale debt-equity swaps (by which banks would convert their mounting bad debts into voting stock of the present state companies) or through the inclusion of the existing banks as beneficiaries in the proposed mass giveaway privatization programmes (Lipton and Sachs, 1990). The second objective could be accomplished, according to its proponents, through a programme of recapitalization of the existing banks, followed by their privatization and restructuring.

Unfortunately, the idea that the existing offshoots of the communist banking systems in Eastern Europe could be rapidly transformed into future analogues of Deutsche Bank seems to slide over some tremendous obstacles.

In the later stages of the communist regime, the state banks did indeed play a role in the governance of state enterprises. For in the process of decentralization, the planning authorities had relinquished some of their rights to make managerial decisions for the enterprises, and gave more autonomy to the managers who had to work within certain specified parameters. At this point, a number of monitoring functions devolved to the state bank which acted as an accounting unit for the central authorities and enforced the adherence by the enterprises to the financial parameters set by the planners, especially in the area of investment and the use of working capital. It is obvious that in exercising this role the bank did not act as the owner of the enterprises. More to the point, neither did it act like a creditor in the capitalist system, since its decisions were based on a system of centralized resource allocation, not on an assessment of the firms' profitability and future prospects. Finally, the budget constraint faced by the banks themselves was

even "softer" than that of the enterprises: the function of central banking and the control of money supply were not separated from commercial banking, with deficits in enterprise financing simply covered through the printing of money. The banks themselves were thus not run as business entities, even as compared with industrial enterprises, but rather served as a conduit of governmental policy and an extension of the central apparatus of economic control. In this sense, few, if any, of these banks' practices and routines could be used for disciplining the enterprises following the transition to a more market-oriented economy.

The transition from the communist regime to the present system of bank financing entailed a separation of central banking from commercial banking operations and the creation of a number of commercial banks out of the single state bank. A certain number of independent banks (some of them with a serious foreign component) were also allowed to come into being, but they do not as yet play an important role. And since the breakup of the old monobank was accomplished along the old territorial branch lines, there is relatively little competition among the existing financial institutions.

But the most important obstacle to transforming the existing banks into genuine banking institutions is that, despite the superficial reforms, the existing banks have inherited the *modus operandi* of their communist predecessors and have very quickly become entangled in a process of spontaneous evolution that, far from enabling them to function as genuine monitors of corporate performance, made them into the main tool in the state enterprises' strategy of resistance to significant departures from the *status quo*.

The starting point of this evolution was determined by the following factors:

The "new" commercial banks, being in fact the old regional branches of the state monobank, had developed a symbiotic relation with the large enterprises which they had been financing under the old regime, and were expected to continue financing under the new. This meant not only that they tended to follow the old lending patterns, but also that their managers viewed their interests as analogous with those of the *nomenklatura* managers of the industrial firms. They felt equally threatened by the new regime, and they looked with sympathy on (and often personal interest in) the industrial managers' desire to translate their temporary control over state assets into a permanent slice of personal wealth.

The new banks lacked any expertise in credit evaluation under market conditions, and thus, when they were not guided by some special reasons (or interests) in their lending policies, tended to favour those borrowers who had large fixed assets that could serve as collateral. This tended to favour the same large enterprises and starve the new businesses, regardless of their genuine long-term creditworthiness.

Even if the banks were to try to move toward a more rational system of evaluating their borrowers, the absence of a modern market accounting system, the lack of any reliable historical track record of the old enterprises (since they had functioned in a regime of chronic shortages, artificial prices, and a maze of subsidies and rationing), and the rapidly changing domestic and international conditions (the collapse of CMEA trade), reliable evaluation of the worth and performance of the state enterprises was a task transcending the abilities of even the most seasoned analysts or accountants. As time proceeded, the difficulty of evaluating the company books was further compounded by the fact that the companies have become mutually indebted to each other. Much of this inter-firm debt was involuntary: customers would simply not pay for deliveries, and the supplier, too dependent on the customer for its survival, simply could not afford to demand payment. Instead, it continued production and kept the unpaid debts on the asset side of the ledger, relying on its own ability to obtain supplies in the same fashion. Since these inter-company debts came to constitute a very substantial portion of the assets of

most state enterprises, they linked the solvency of the enterprises together, and made any evaluation of an individual company very difficult (not only because its solvency may have been illusory, but also because the customers might not be able or willing to take its products if they were to be forced to pay for them in cash).

Perhaps most importantly, as part of their inherited relationships with the large industrial enterprises, the banks inherited the accounts of their old customers, together with a growing mountain of bad debt. Under the old conditions, such debt did not have great significance, since the banks had been following central directives in their lending policies, and both they and the enterprises they were lending to were ultimately protected by the state's readiness to cover the resulting deficits. But under the new conditions, the enterprises' inability to pay threatened the solvency of the banks themselves. In the absence of any strong regulations concerning write-offs on the banks' own books, the banks had every incentive to continue rolling over the bad debts and refinancing their old customers, regardless of their ultimate ability to repay.

In some countries (Hungary, Russia), the new banks were partially owned by the enterprises to which they had been lending. This of course created additional commonality of interest and additional pressures to finance regardless of profitability.

Given this starting point, and the fact that the large state enterprises had to receive continued financing to function (a complete moratorium on credit would have been both impossible and inadvisable, but *cf.* the contrary argument in McKinnon, 1991), the state banks were inevitably drawn into a process in which they became the main substitute for the previous budgetary subsidies provided by the state. To be sure, credit did become tighter and interest rates were sufficiently high (even though, given inflation, they turned out to be negative in many countries) to make the state enterprises look elsewhere for sources of additional support. This they found in the rapidly mushrooming institution of inter-firm credit, but the bank credits continued to provide an important way of postponing unpopular moves, such as cutting production even further or laying off workers. The further the process continued, the more dependent the banks became on the survival of their clients, and the more unable to refuse further rolling over of clearly bad debts. The fact that some of the banks were also partially owned by the enterprises they were lending to contributed to further deterioration.

With time, the banks' incentives to continue throwing good money after the bad only grow stronger. For the longer the process continues, the more inconceivable it becomes that the state could allow the enterprises (and the banks) to go under. The web of mutual dependence among the banks and the large enterprises (with the enterprises also tied among themselves through the institution of inter-firm credit and abnormal dependence as mutual customers and suppliers in a very concentrated economy) means that any attempt to cut off the lifeline of further credit might cause a chain reaction of bankruptcies, pulling down good companies together with the bad ones. It is then perfectly rational for the banks to play along, until the state decides to bail them all out.

It is necessary to grasp fully the depth of these problems inherent in the present banking system to see the danger of any attempts to make the existing banks into the fulcrum of a future corporate governance structure in Eastern Europe. First, recapitalizing the banks with the equity of the state enterprises might create more problems, not solve them. If the banks acquire their equity in addition to their debt claims (as they would if they were to be included in a giveaway programme), their status of equity holders would only strengthen their interest in keeping the companies afloat, since their common stock would likely be wiped out in any bankruptcy proceeding. If they acquire equity through swaps for bad debt, the situation might simply remain unchanged in this respect (since their books would still suffer if the value of their equity were to be wiped out), but

worsen in others: the chances of a genuine change to be brought about by new owners in an effective scheme of privatization of the state enterprises would be diminished.

Any other form of recapitalization, unless done within the context of a very effective transformation of the whole governance structure of both the banks and the state enterprises, is likely to be equally problematic²⁶. For the underlying problem is that the state enterprises have a very strong interest in continuing the present system (many, if not most of them, may go under without it), and they constitute a tremendous pressure group for some form of subsidization. This is a pressure that the existing banks are very unlikely to be able (or, for that matter, willing) to resist, even if their books are cleaned up at the expense of the budget. The very act of the clean-up would in fact create a reasonable expectation of future bailouts, and it would not be easy to embed it in a programme that would credibly precommit the state to no repetitions. A programme of this kind would have to modify in one fell swoop the whole incentive and decision-making structure of the economic units in the present state sector, and this type of wholesale reform is very difficult to conceive. At the very least, it would have to bring in some entirely new players, free of the old ties and interests, and powerful enough to make a difference.

The answer usually given at this point is that the recapitalization of the banks (whether through a state takeover of bad debts or with the equity of the state enterprises) should be accompanied by a privatization of the banks themselves (Begg and Portes, 1992). This, it is claimed, would change the incentive structure of the bank managers, and give them a fresh start. The problem, however, is that an effective privatization of the existing state banks is not an easy matter, and it is not clear that it is worth the trouble and expense. As they are, the banks are very likely to have negative value taken with their liabilities to depositors. The amounts it would take for the state to pay off their liabilities are so enormous that the state could probably capitalize an entirely new banking system with these funds, and this course ought to be seriously considered.

The assets of value at the state banks are the performing loans on their books, their goodwill, and whatever expertise and special knowledge they may have of the enterprises with which they have been dealing. It would be wrong to ignore these factors if they could be sold independently of the intangible liabilities attached to them: the personnel that is not only incompetent but opposed to radical changes in the *modus operandi*, the bad habits and routines, and so forth. In what follows, we shall consider some means by which this could be accomplished, though it should be realized that these intangible liabilities are likely to be extremely difficult to neutralize, and may cripple the existing banks for a long time to come.

To be sure, in a general transformation of the financial institutions of Eastern Europe, during which new institutions will be appearing, the state enterprises will be privatized, and competition among financial institutions will increase, the existing state banks may slowly evolve in a desirable direction and remain a part of the new economic landscape. But for now, their symbiosis with the existing state enterprises is among the most important obstacles to change and will naturally require a comprehensive solution.

3.3.2 *Creating new banks and shrinking the state banks*

The entry of new banks in Eastern Europe has been very slow. The reasons for this are not hard to fathom: there is very little domestic capital available, and foreign banks are deterred from entry by the existing state of the financial sector and the difficulty of dealing in an unfamiliar economic and regulatory environment. Although the number of cooperative and other private banks is quite impressive in some countries, and there is

also a sprinkling of foreign entrants (most notably in Hungary), the new banks are usually very small and the total size of the new banking sector is rather insignificant.

With time this situation may change, but there is an obvious chicken and egg problem here: the banks are likely to enter when the economy is seen as reviving, but the presence of a viable banking sector is probably indispensable for a genuine revival. This does not mean that the problem is insoluble. An evolutionary development may take place under certain circumstances, and countries like Hungary may be well on the way there. But in most post-communist economies, the development of a viable banking system is likely to require some encouragement from governments and perhaps international financial agencies.

The solution of the bad enterprise debt problem may be an occasion to foster the creation of new banking institutions. Most recapitalization schemes presume that the funds injected by the state into the system would have to go to the existing banks. Instead, as we have indicated already, they might be used to capitalize new banks. The standard recapitalization proposals suggest that the state should issue its own paper (Treasury bills or bonds) in lieu of the non-performing enterprise debt. Under this scenario, the state banks would receive the state obligations in exchange for the writing off of the bad loans. But this clearly is not the only possibility.

A better plan might be to eliminate the same bad debts from the asset column of the existing banks, and in exchange to relieve them of a corresponding amount of their own liabilities. This would mean that the state, in exchange for the banks' writing off some bad enterprise debts, would remove some depositary accounts from the banks and transfer them to a new institution, together with a sufficient amount of its own Treasury bills to cover these liabilities. The owners of the new bank would have to put down a certain amount of equity and pay for the infrastructure of the new institution, but the equity contribution would be leveraged by its new deposits transferred from the old state banks.

A scheme of this kind would not eliminate the existing state banks altogether. Instead, it would "shrink" them and allow for the creation of new large banks that would provide healthy competition to the old institutions. A move of this kind would also make the state's precommitment not to repeat the bailout more credible: the new banks would not operate according to the old rules, and their existence might make future failures of the old banks conceivable²⁷. In the long run, the state banks would have to adjust (and be privatized) or perish.

It should go without saying that this scheme is only an example intended to open up discussion of ways to create a well-functioning banking system while neither resurrecting the old system through recapitalization nor utterly bankrupting it.

3.3.3 *Other lending institutions*

Banks are no longer the primary source of commercial debt financing in the developed capitalist economies, even in those countries, like Germany, where banks continue to play an important role in corporate governance. Many other forms of credit are less expensive and easier to obtain. Bond markets provide possibilities of long-term financing, while the rapidly growing commercial paper market is a source of cheap short-term funds. Is there any possibility that Eastern European companies might gain access to this form of financing, and what would be the effect of this with respect to their corporate governance structure?

Debt holders in the international markets, unlike banks, do not exercise serious supervision over the issuers. Exit and diversification are their primary methods of protection against loss due to insolvency of individual borrowers. Extensive use of diversification means that even quite risky ventures may obtain financing (*vide* the quality

of some junk bonds in the recent past), so long as the degree of risk is known within certain parameters, and an appropriate premium is paid for the risk. Moreover, the desire of large funds to diversify their holdings geographically, so as to minimize country risks, means that the Eastern European companies might in a not too distant future obtain access to some fraction of this enormous pool of capital.

The way in which access to international financial markets relates to the issue of corporate governance is through a special kind of intermediary institution. The key to being able to issue debt in the international markets is an appropriate rating. These ratings are provided by specialized institutions, such as Moody's and Standard & Poor's in America and their counterparts in Europe, and to obtain them, companies must satisfy all kinds of requirements.

Efforts by Eastern European companies, perhaps with some degree of government encouragement and coordination, to achieve ratings, even of low non-investment grades, by internationally recognized agencies might have an extremely positive influence on the way business is conducted in the region. Ratings would imply not only a modern method of book-keeping and a degree of transparency absent at this point, but also pressure to maintain a high degree of responsibility and regularity in meeting corporate obligations, and a system of independent monitoring of management and company performance. While initially only a few companies may be able to obtain internationally recognized ratings, they might become models for others and a conduit for further investment. Moreover, even before internationally recognized ratings become available, efforts by governments and international institutions may establish a reliable local rating system that would in time smooth the flow of debt financing in the region.

3.3.4 *Privatization intermediaries*

A number of Eastern European countries are either putting into effect or planning mass privatization programmes contemplating the use of special financial intermediaries charged with exercising monitoring and control functions on behalf of a large number of dispersed shareholders. A programme of this kind is being realized in Czechoslovakia, and is in advanced stages of preparation in Poland. Russia and other countries in the region are also contemplating a role for intermediaries.

In most privatization proposals of this kind²⁸, 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 are usually seen as involving an essential foreign component, sometimes (as in the Polish plan) in the form of foreign financial institutions' being given management contracts for the newly created funds. The proposals usually envisage a conversion of state enterprises to be privatized 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 for sale to other investors). The shares of the intermediaries themselves are in turn supposed to be owned by individuals who will acquire them free of charge or for a nominal fee. The use of vouchers is often contemplated to allow individuals to choose the intermediary of which they want to own a share or to allow them to invest directly in the privatized companies.

Among the most often mentioned advantages of this type of privatization proposals (although they sometimes significantly differ in these respects) is the speed with which they can be implemented, the avoidance or lessening of the problems entailed by the valuation of the privatized enterprises, the ease of legitimizing the privatization scheme by a programme of distribution of the national wealth among the population, and ensuring a degree of wealth equality. But above all, plans of this kind are often seen as opening

the way for a quicker restructuring process by the institution of an effective mechanism of control and supervision of management performance. Moreover, the privatization intermediaries are sometimes expected to become a nucleus of a new financial and banking infrastructure for Eastern Europe, capable of providing a valuable link to outside sources of capital and expertise.

Intermediaries as the nucleus of the new banking system. One of the most promising, but also possibly controversial, features of mass privatization plans involving intermediaries is their potential to finesse the existing banking system and provide the germ of a new financial order.

The privatization plans involving intermediaries are often criticized for the high transaction costs they themselves generate, since the distribution of the new entitlements (vouchers or other certificates) can be very costly, and the new funds must set up separate accounts for potentially millions of individual participants. But the initial transaction costs might be viewed as worth incurring in order to provide an important infrastructural element of future financial institutions.

Thus, for example, the initial outlays involved in setting up the intermediaries are in many respects quite similar to those required for setting up an ordinary consumer banking system. In fact, once the intermediaries have opened individual accounts for their shareholders, it might require only a very limited additional expense to link such activities as issuing periodic statements, payment of dividends, and executing sale or transfer orders, with other types of services usually associated with consumer banking: savings and checking accounts, credit lines (perhaps with the shares of the funds serving as collateral), and so on.

Similarly, the very idea of the intermediaries' role as an active shareholder in a large number of Eastern European companies and an agent of restructuring with respect to the industries in the region suggests the possibility of extending their activities to such areas as brokerage, commercial, investment, and merchant banking operations, as well as insurance. The funds may thus be allowed to serve as lenders or agents for the companies in their portfolio for the purposes of borrowing (arranging loans or floating commercial paper on foreign financial markets), agents for the sale of stocks or assets, representatives (and perhaps financiers) for the purpose of arranging joint ventures with foreign investors, insurers, and function as pools of capital channelling individual savings into the growing economy.

Adding these activities to the normal functions of an institutional investor would significantly increase the power of the privatization intermediaries in Eastern Europe and change their incentives in dealing with the companies in their portfolios. The intermediaries would now be likely to hold both debt and equity of the privatized enterprises, and they would have a much greater incentive to become more active investors, closely monitoring the companies' performance and controlling their management. They could also leverage their equity holdings through their lending operations, thus assuring quick growth and greater diversification.

If allowed to develop in this direction, the intermediaries would naturally come to resemble the universal banks known from the German model. In many ways, such an institution would be an attractive prospect for Eastern Europe, given its potential to accelerate the much-needed growth of a modern banking sector in the region and the dim prospects of the existing banks' fulfilling this role. Moreover, the history of universal banking in Germany (where the institution played a crucial role in industrial development since the nineteenth century) confirms its potential for becoming a very powerful and constructive element in the new corporate governance structure of the region. On the

other hand, universal banking also raises concerns, historically quite common in Germany itself, about the influence that the newly created financial giants may exercise both in the economic and political domains. The political systems of Eastern Europe are still in their infancy, and the existence of very powerful financial institutions may perhaps come to dominate their development. Moreover, the absence of other centres of economic power may give the new banks a near monopoly status and contribute to their degeneration. Thus, before a potential danger develops, a decision should be made whether to move in this direction and, if the answer is positive, a system of safeguards should be considered in advance to limit inappropriate types of influence.

The privatization intermediaries might also be encouraged to form joint ventures with the existing state banks, especially if the latter were to be privatized at the same time. In this way, the old banks could provide some of their useful infrastructure, such as branch offices, and information concerning the enterprises to be privatized, while the new entrants would bring in modern banking expertise and their foreign connections.

The role of the intermediaries in the corporate governance system. It is a matter of serious concern whether the intermediaries created in the context of a mass privatization plan will indeed function in the way their proponents expect. Among the most important of these concerns is the doubt whether the intermediaries would indeed adopt the posture of active investors and exercise an important role in the governance structure of East European industry, or whether they would remain mostly passive and devote themselves primarily to trading in the securities of the privatized enterprises. As we have seen, if the intermediaries are encouraged to develop in the direction of universal banking, the chances of their being active increases, since corporate lending necessarily involves a serious effort to monitor the borrower's performance. If, on the other hand, the intermediaries are restricted in their activities to the functions usually performed by mutual funds, for example, they may very well follow their counterparts in the English-speaking world and limit themselves to purely financial operations.

Active supervision of company management is a costly proposition: it requires research, close involvement with the company, assertions of power that may invite retaliation, and so on. 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 and use the possibility of exit (*i.e.* the sale of their stakes in an underperforming company) instead of involving themselves in the governance of the firm (see Hirschmann, 1970, and Coffee, 1991).

A possible answer to this problem is to "lock" the intermediaries to the companies in their portfolios by making exit more difficult. There are many possible ways of doing this, starting from the regulation of the permissible extent of the intermediaries' diversification (so that they would have to limit their holdings to a smaller number of companies, which would in turn make monitoring less expensive) to assuring (for example, through an appropriate design of the initial distribution of the shares of the privatized enterprises) that the intermediaries take large blocks of shares of individual enterprises (see Frydman and Rapaczynski, 1991a). Having a large block of shares makes exit more costly (since a large scale sale within a short period of time might depress the price), and encourages more "voice." Simultaneously, the free-rider problems are also reduced when a single owner holds a significant percentage of the company's stock.

All of this means that there is a rather direct trade-off between the appearance of robust stock markets in Eastern Europe, which play the function of providing impersonal valuations of enterprises and of assuring the liquidity of investment (hence making exit

more easy), and the development of financial institutions with strong incentives to become involved in the monitoring of company performance. This relationship is often not appreciated among the East Europeans who are very attracted to the idea of unobstructed markets. But 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.

The threat of bureaucratization. Another concern related to the role of the intermediaries in the corporate governance system of Eastern Europe is the threat that they might become bureaucratized and retard, rather than hasten, the process of restructuring.

The people in charge of the privatization intermediaries will naturally look for the best strategy to advance their interests. The basic alternatives are to position the funds as primarily economic or primarily political agents. One strategy is to excel over one's competitors in the process of restructuring, enhancing the value of the privatized companies, and profiting from their expansion. The other, always competing strategy is to collude with the other funds, divide the markets by mutual agreements, and rely on increasing the revenues through a combination of price fixing, extraction of rents from public officials, and entrenching a complex system of state subsidies. The choice of the second alternative is the greatest danger of this type of mass privatization programme.

The incentive of the fund managers to position themselves as monopolists and rent seekers, rather than mutual competitors, is quite real. The task of restructuring is not only arduous, but also fraught with perils. The economic future of Eastern Europe is far from certain. Political pressure will be generated by the vested interests now in control and the social dislocations inevitably resulting from genuine restructuring. The ability of the fund managers to resist these political pressures may then be additionally limited by their foreign connections and the xenophobic attitudes present in all East European societies.

As opposed to this, extracting subsidies from the government may be much easier. Eastern Europe has a long tradition of government paternalism and intervention, and 40 years of communism have only fostered it further. 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 funds, with their very considerable resources, may capture the inexperienced governmental agencies responsible for their regulation and influence economic policy. Tariffs, subsidies, monopolies and other evils would not then be long in coming. Once entrenched, a system of this kind may be very difficult to eradicate.

While it may be impossible to eliminate completely the threat of a bureaucratic degeneration of the large financial institutions involved in the mass privatization programmes, there are certain elements in the design of these programmes that can lessen the dangers involved. The basic question is whether the government will be able to precommit credibly to a system of no subsidization, or whether the intermediaries will succeed in implicating the state in the success or failure of their performance. Among the factors that will decide this are the following:

- Whether the state will be responsible for the creation of the intermediaries, or whether they will be genuinely private institutions, freely entering into the field;
- Whether the intermediaries will be responsible for the choice of the companies in their portfolio, or whether the companies will be allocated to them in some way by the state, so that the state may be made to look responsible for the failure of the restructuring process;

- Whether the state will retain a substantial portion of the shares of the privatized enterprises (so as to be seen as responsible for the social dislocations resulting from lay-offs or plant closings), or whether private institutions will be primarily responsible;
- Whether the intermediaries will have to compete for their clients (citizen-shareholders), or whether their relation with the account holders will be a remote one and largely determined by official decisions;
- Whether the state will intrusively regulate the governance and behaviour of the intermediaries (so as to make it possible for them to blame state intervention for their failures), or whether the regulation will leave enough room for entrepreneurial initiative.

3.3.5 *Pension funds*

The countries of Eastern Europe have inherited from their communist predecessors an extremely heavy burden of welfare obligations toward their citizens. Moreover, benefits have usually been linked to the amount of average salary, so that they are likely to grow. Quite simple calculations show that, unless cut, their size will outpace the state's ability to pay.

In order to prevent a future crisis, a number of Eastern European governments are contemplating changing their pay-as-you-go systems and capitalizing a portion of their pension funds with a part of the equity of the state enterprises included in the mass privatization programmes. While this seems to be a good idea, capitalized pension funds might also be created independently of the mass privatization programmes, either by the state (which may decide to fund them with its debt instruments) or by private institutions responding to individuals' desire to supplement their reduced state pensions with private savings (for which the state may create special tax incentives).

The potential of such a development for the strengthening of the corporate governance system in Eastern Europe is quite considerable. To realize it, attention should be paid to how the pension system is reformed and to the direction in which it evolves.

There are two basic considerations related to the potential of the pension funds for the monitoring and supervision of corporate performance. The first is that pension funds are usually quite conservative and not particularly active investors. Their conservatism is, of course, a function of their responsibility, and a substantial portion of their investments must remain in very secure obligations. But inactivity is not an inherent or necessary feature of pension funds; on the contrary, their very size (a depository of a large portion of the savings of the whole population) makes exit progressively less effective as a means of preserving the value of their portfolios. A number of pension funds in the United States have responded to this problem by "indexing" their investments, and their trading is limited to a few adjustments. Some of these funds, such as Calpers, have consequently begun to be more active, seeking information from the enterprises and trying to raise the value of their investments through the exercise of "voice" rather than exit. While the American experiences are not easily transferable to Eastern Europe, the potential size of the pension funds and the thinness of financial markets in the region also makes it likely that the funds might have somewhat restricted exit from their positions. In this context, they might similarly turn to voice.

The forms which pension plans' activism may take are quite varied, and many of them might have a very beneficial influence on the corporate governance system in the region. One way, besides the direct involvement in the affairs of the companies in their portfolios, is to follow the practice of some US funds and require the presence of independent, professional directors on the boards of the companies in which the pension funds hold significant investments. This may create a demand for high quality monitors, set new standards for boards of directors, and generally raise the quality of performance

supervision. Another way in which the funds might get involved would be to support a reliable investment rating system for the region in connection with their purchasing of corporate bonds and other debt securities.

In addition to the problem of the pension funds' potential passivity, their future in Eastern Europe also raises other concerns, similar to those discussed in connection with the privatization intermediaries: whether the pension funds will be truly independent institutions, interested in maximizing the value of their portfolios, or whether they will become politicized and subject to special interest pressures. This phenomenon is not unknown in the United States, of course, where pension fund investments have often been used by the management to shore up their failing enterprises or by the unions to preserve employment. The additional danger in Eastern Europe relates to the role that the state is likely to play in the creation and regulation of the new pension funds. The funds might provide a rich source of political patronage, and the potentially enormous sums involved might create an irresistible temptation for politically motivated subsidization of a variety of special interests.

Again, there may be no foolproof method of dealing with this problem, but there exist a number of steps that may make the pension funds more independent. The most important among them is to stimulate competition among a large number of separate funds by allowing a relatively free entry and providing each beneficiary with an individual account and the freedom to choose how it is invested.

3.3.6 Governmental regulation of financial intermediaries

It would be an enormous task to analyze in detail the way in which Eastern European governments should regulate financial institutions in the region. In our previous discussions, we have pointed to some issues that should be addressed in an inquiry of this kind, such as whether universal banking should be allowed or whether different types of financial institutions should be separated from one another; and whether financial intermediaries should be allowed to diversify beyond a certain point or whether incentives should be created to "lock" them into certain positions. Quite clearly, all kinds of threshold requirements for various financial institutions must be defined by law, and conflicts of interest, self-dealing, and other abuses must be regulated. But instead of concentrating on all these matters, we shall restrict ourselves to one systemic observation and some lessons that flow from it.

Most economic observers fail to appreciate the main problem of regulatory reform in Eastern Europe. They usually assume that the economies of Eastern Europe are in a shambles, and then put forth a whole host of proposals how to reform them. To be sure, there are some proponents of *laissez-faire* who also claim that the process of regeneration of the market can only happen spontaneously, and that governments should not be allowed to meddle with it too much. But their claim is not tied to the peculiar problems of Eastern European governments; they simply oppose what they see as excessive government intervention everywhere. It is a matter of crucial importance, however, for any clear thinking about the future of Eastern European reforms to realize at the very outset that, quite apart from what governments in general should or should not do, the state of the governments in the region is no better than that of the industry or the service sector, and that the job of reforming the former is no easier than the restructuring of the latter. Indeed, to a large extent, it is one and the same.

The reasons why the East European governments are mostly of very low quality are not hard to fathom. The new people, often very idealistic, are quite inexperienced: they had often begun as poets rather than bureaucrats. The rest of the government personnel derives from the old regime. The communist governments stressed the technical and

engineering, rather than managerial, background of its civil service. Moreover, its governing techniques relied most often on direct and personal intervention, rather than on a stable regulatory system yielding a set of lasting rules and procedures. As a result, the existing government bureaucracy is untrained in the intricacies of the market economy, lacking the tools of modern regulation, and deficient in the most basic managerial skills. On top of this, the political life of Eastern Europe is very unstable, with a multitude of weak parties and outdated ideologies striving for dominance. In this climate, the life of a public servant is very unrewarding: not only is his pay very low, but also his future is unclear and the sphere of his competence ill-defined. At the same time, anyone with some connections and a rudimentary knowledge of English can make quite a good living in the private sector, and the opportunities for official corruption abound. As a result, the turnover in the governmental bureaucracy is high.

This situation in Eastern Europe is a fact that must be clearly recognized and seriously reckoned with in every reform proposal. This does not mean that spontaneous developments should necessarily be favoured over the more "constructivist" ones: spontaneity may (not surprisingly) amount to an affirmation of the *status quo* or even its further degeneration. But the reform proposals should economize to the greatest possible extent on the scarce quality of governmental service.

What does this mean in practice? First of all, that government should, to the greatest possible extent, rely on regulatory techniques that require the laying down of general and transparent rules of the game rather than on-going intervention. Thus, for example, securities laws that rely on the principle of disclosure should be preferred to those that require a governmental agency to use its discretion in enforcing a complex set of values and principles. Similarly, government contracting and licensing procedures should be regulated by mandatory rules and clearly defined criteria (such as price), rather than be based on a complex balancing of a number of incommensurable factors (such as a combination of efficiency, fostering of employment, public interest, *etc.*), and they should be reviewable by an independent authority.

Secondly, government initiatives should, to the maximum extent possible, enlist the private sector and market techniques in the process of governance itself. Thus, for example, governments should "privatize" the privatization process by using independent competing institutions in the process of choosing the most appropriate methods of privatizing particular companies, executing the transition, *etc.* Similarly, self-regulation should be fostered in both the industrial and the financial sectors by favouring the creation of self-regulating private exchanges, encouraging private or semi-private institutions, such as chambers of commerce or banking and professional associations, to promulgate and enforce their own codes of professional behaviour.

4. Concluding remarks on the policy options

This paper has sought to drive home the place of enterprise control in the economic development of market economies. The essentiality of control over enterprise management, of at least a measure of influence at appropriate points by outsiders is the main theme. The need is now acute in Eastern Europe, where the departure of the state has left most pre-existing enterprises effectively in the hands of insiders.

The need to institute mechanisms of enterprise control does not mean that privatization is not worth undertaking until extensive mechanisms of corporate governance are in place. But it is a fair question whether the benefits of privatization will not be typically modest and at many enterprises so precarious as to jeopardize or end

their continued independence from the state, unless and until the privatized enterprises are subject to appropriate enterprise control.

The other issues addressed in this paper centre around the particular institutions of enterprise control that would most effectively encourage and facilitate outsider influence in those countries of the Eastern European region that are building a market-based economy. Several possible mechanisms of corporate governance offering a measure of outsider control have been reviewed here: the stock market, the core investor (domestic or foreign), other securities markets, blockholding by financial intermediaries, and involvement by banks along continental or Japanese lines.

What mix of these institutional arrangements would now be the best for these countries, given their state of economic development? Two familiar caveats are in order. One is that structural reforms are especially subject to unforeseen and unforeseeable consequences. The other point, which is related, is the tension between the best and the feasible. As Section 2 of this paper serves to underline, there is now a configuration of interests represented in most of the pre-existing enterprises and in the post-communist public sector which will understandably resist losses of power to outsider control mechanisms, with more success in some countries than in others. The influence of existing interest groups may be reflected in the actual working of the institutions set up more than in which ones are set up. In choosing the recommendations here the attempt has been made to foresee how the new institutions would actually work in the best of realistic cases. Encouraging this constrained optimism is the hope that friendly external parties such as international financial agencies, by making their assistance conditional on the actions by the countries themselves, can often help narrow the gap between the best and the feasible.

Taking into account present-day conditions in the East European region, the paper argues that one class of mechanisms, namely, outsider control by banks and other financial intermediaries, is well-designed to promote enterprise performance, while some of the other mechanisms, such as a stock market or foreign investment, will not be strong enough in the near future, if ever, to be a major source of outsider governance.

The conclusions reached here regarding some of the various possible governance mechanisms will now be briefly reviewed.

What is so wrong, first of all, with enterprise governance by the insiders, the managers or the employees? It is quite acceptable, of course, that the participants in the economy, hence today's workers and managers, be given an initial share in the ownership of the enterprises being converted to private corporations, precisely as was envisioned by the earliest architects of mass privatization through the giveaway of shares or vouchers. Indeed, in the Rawlsian perspective, economic justice is precisely about the fair distribution of rewards to the participants in the economy since it is their cooperative efforts and interactions that produce what is to be distributed. Unfortunately, in so far as employees and managers receive shares in the enterprises in which they work, so those at the less promising enterprises get less valuable shares, the result is a deviation from what is usually regarded as fair, namely equal allotments.

However, since in some countries insiders display considerable will and power to resist demands to apportion the initial shares equally across the labour force, it will be necessary for the governments there to accommodate insider interests to some degree. Furthermore, at the risk of seeming to make a virtue of necessity, one can point to a mitigating feature. If a single outsider has total control, with no other shareholders having a large enough block to take an active interest, a consequence may be the attempted abuse of that power. The presence of another one or two blocks of shares conferring sufficient incentive to monitor the holder of the largest block, even if it is a block of

shares held by the manager or by a group of employees, can serve as a system of checks-and-balances that might be better than both insider control and control by an autocratic outsider.

The dangers presented by insider stakes in an enterprise arise if they are so large as to confer appreciable enterprise control to the insiders. The ill-effects of excessive managerial power are of two sorts. There is the power of the manager to make self-interested decisions misrepresented as being in the interest of the enterprise owners, avoiding inconvenience and risk such as restructuring might entail, favouritism, *etc.*; and there is a short-term bias to the manager's preferences compared with those of the owners. As for employee stakes, as long as they remain collectively a large shareholder of the enterprise, there would be a special hazard that they would be able to induce the manager to award them short-term gains at the expense of the long-run profitability of the enterprise; so strict and extensive safeguards against insider control are particularly important as long as the workers have not sold their allotment of shares to outsiders.

Insider control exacts a further penalty if, as in Eastern Europe, restructuring and hence extensive investment is called for. With relatively little in the way of outsider controls over the managers, private suppliers of equity finance will exact a premium in the cost of capital they supply and suppliers of debt finance for other than the most collateralizable projects will similarly require a premium in the cost of debt finance they make available or, more likely, make none available. The poorer the degree of outsider control at an enterprise, other things being equal, the higher the cost of capital can be expected to be. Where there is little or no outsider control we may expect the enterprises to find no outside finance. In the worst-case scenario, they will be driven to the state. The prospects for early and extensive restructuring in this scenario are not bright. In the best-case scenario, these enterprises will finally cave in, accepting outsider control to obtain private financing. In any case, a high degree of insider ownership will not work well unless and until accompanied by mechanisms providing outside-owner or outside-creditor influence over the selecting and motivating of the enterprise managers in the interest of encouraging maximization of the value of the shares.

What is required, then, is a system of outsiders to provide a measure of control. The task is to identify the strongest mechanisms.

The view expressed here is that a stock market would not be able to provide adequate outsider control in the region of Eastern Europe. One difficulty is that, even in the US and the UK, the incentives of managers are geared only weakly to the price of stocks, and takeover mechanisms appear to be very costly. The operation of the markets for other securities markets, such as bonds and commercial paper, also offer only weak outsider influence. The inadequacy of all these markets when few investors and creditors have the wealth and knowledge to play an active role in control is even more apparent.

Two outsider control mechanisms are suggested here. One is the device of an equity stake large enough to be controlling or to offer a measure of control. In the course of mass privatization by voucher, one or two large blocks of shares at an enterprise could be placed with the financial intermediaries set up to hold shares and receive vouchers from the public. Possibly some large blocks could also be placed with private buyers where an enterprise is being sold for cash.

The other device for outside financial control is an appropriate kind of bank or other financial intermediary. If history is a guide, periods of extraordinary demands for investible funds have often brought forth large and sophisticated commercial banks providing large amounts of outside finance to firms over which they receive in return certain rights of control. Of course, the fact that, say, the large German banks have played such a role and played it well does not imply that this kind of institution is the

best feasible one to put in place. But in the absence of other viable external control mechanisms, the device of the large specialized financial institution (or mix of such institutions), possessing certain rights of enterprise control, appears to be a critical element in the desirable system of economic reforms for the countries of Eastern Europe.

This paper has been at pains to point out some of the reasons why the existing state banks are ill-suited to play the role of the continental-style banks. It is proposed here to transplant some of the assets and liabilities of these existing banks, thus shrinking their immediate future role in enterprise control, to a group of newly created financial institutions, one emerging naturally where new intermediaries are set up for the purpose of mass privatization by voucher.

It is difficult to imagine how Eastern Europe can expect to grow rapidly over the next several years without undertaking these financial reforms.

Endnotes

1. Helpful advice was provided by Philippe Aghion, John Coffee, Jean-Paul Fitoussi, John Flemming and Henryk Kierzkowski.
2. Some early proposals embedding corporate governance into the mass privatization process were made in Frydman and Rapaczynski (1991, 1992a).
3. Such confusion over the assignment of property rights was further compounded by the use of "socialist property" for private gain. This so called "informal" privatization in Hungary is analyzed by Hankiss (1990) and in Poland by Staniszkis (1991).
4. These include the following:
 - the approval of enterprise statutes;
 - the approval of long-term plans and objectives of the enterprise;
 - the annual review of the activities of the enterprise and of the director;
 - the power to decide on the proportion of the profits to be distributed to the workers;
 - the power to review the appointment and dismissal of the managing director and other managerial personnel of the enterprise;
 - the approval of mergers, transformations and the liquidation of the assets of the enterprise.
5. This expectation turned out not to have been entirely correct, since the government used the threat of prime-ministerial prerogative to prod the enterprises into action. However, the Privatization Ministry, swamped by other tasks and incapable of asserting its authority over the converted enterprises, has not pursued corporatization, except in those cases in which conversion was seen as a necessary step preceding imminent privatization. This left the majority of the Polish enterprises in their old (labour-dominated) form.
6. For example, the current abnormal employment policy of no lay-offs in the face of sharply declining sales is consistent with the strength of labour in the newly created state companies. Apparently, the maintenance of employment has often been demanded by the workers' council as a condition of their agreement to corporatization.
7. The main benefit to insiders from corporatization under the Transformation Law of 1989 (as well as a powerful inducement to an undervaluation of the assets of the enterprise to be transformed) resulted from the provision that 20% of the

shares of the new company should be set aside and made available for purchase by the insiders at a discount of up to 90%.

8. In practice this amount is much larger, with the SPA granting routine approval in cases involving amounts below some threshold. Also, the restriction on the value of newly created "subsidiaries" may be relatively easily avoided by setting up a number of smaller units, until all the units exceed 50 *per cent* of the value of the enterprise's assets. (Stark, 1990, pp.369-370).
9. The most famous debt-equity swap involved the Tungsram company and one of the largest Hungarian banks. The Hungarian Credit Bank exchanged Tungsram's outstanding debt of 6.42 billion forint for ninety one *per cent* of its equity. A controlling stake (fifty *per cent* plus one share) was ultimately sold to General Electric, but the bank has remained the second largest stakeholder (Privatization, Radio Free Europe Research Report, p.35).
10. Some of the smaller joint ventures are often created in order to gain tax preferences granted to ventures with foreign participation. Typically, a domestic investor invests his own foreign currency through a foreign "front" company.
11. These benefits include participation in the highly paid management positions of the newly created joint venture (Csaki, 1992), or a potential increase in the value of the shares acquired by the insiders of the domestic institutions when foreign investors enter into joint ventures with these companies.
12. Foreign investment in Czechoslovakia was about \$600 million in 1991 and in Poland \$700 million. The Polish figure comes from unofficial estimates by the Central Statistical Office.
13. For example, in the famous Volkswagen-Skoda transaction all the proceeds went for increased capitalization of the company (Havel and Kukla, 1992, p.19). The foreign currency proceeds from these trade sales or joint ventures usually went to the government in Poland and the newly created or privatized companies in Czechoslovakia. This difference is clearly due to substantial foreign indebtedness and budgetary difficulties of the Polish government.
14. This is primarily due to the lack of domestic capital. For a more extensive discussion of this and other problems with privatization through sales in Eastern Europe, see the forthcoming book by Frydman and Rapaczynski (forthcoming, 1993).
15. Under the Czechoslovak plan, the citizens can deposit their vouchers with spontaneously arising intermediaries. In turn, the intermediaries and the remaining citizens will bid for the shares of the privatized companies at the special auction. Although the resulting structure of ownership and control is still unclear, intermediaries may end up holding significant stakes in the companies privatized with the use of vouchers.
16. According to the Polish Privatization Law, employees can purchase up to twenty *per cent* of their enterprise at half the selling price. The total value of discounts given to employees cannot exceed the product of the average pay *per* employee in the state company during the preceding 12-month period and the number of employees purchasing shares.
17. Agency problems go back at least to Hume and Smith though it is not part of classical (and neoclassical) theory. Formal study of agency problems, which began with Arrow, Ross, Stiglitz, Grossman and Hart, and others, is one of the highlights of modern, or postclassical, economic theory.

18. If it were the case that the managers faced a perfect labour market and this market paid sole attention to the performance of the share price under a manager's previous tenure, this agency problem would be very different, to say the least. However, since the movements of share prices do not reflect only the decisions of managers, the managerial labour market will never be solely based on the share price criterion. Also, the manager may see that some decisions of his that would be costly to the shareowners might go undetected by those who might otherwise attempt to unseat the manager.
19. These remarks offer a foundation for the view that corporations in Western economies suffer from what has been dubbed "short-termism", though the source is not the myopia of the stock market but the inability of the market to curb the inherent present-mindedness of managers. Similar reasons produce present-mindedness in politicians and short-termism in government (Phelps, 1991).
20. The reference here is to privatized firms as this paper is not primarily dealing with the issues of governance of corporatized enterprises remaining in state hands.
21. Indeed, there are many people in Russia, including many members of Parliament and the head of the Moscow City privatization, Larisa Pyasheva, who are ardent advocates of give-aways of state firms to the workers. These advocates in fact criticize the Russian privatization programme for giving insufficient recognition to the workers.
22. The reason the employees are present-minded, preferring to see the firm's cash flow go to higher wages than to increased investment, is the same reason that the managers are present-minded: the employees cannot sell their job rights in the future. However the employees' short-termism is pronounced in many enterprises in Eastern Europe now because overmanning on a grand scale has created intense job insecurity. Of course, the employees' ownership of alienable shares tempers this short-termism a little but cannot offset it appreciably since only a fraction of the shares is owned by the employees.
23. Lest the workers shy away from selling their shares when they see the price they can get for them, the Privatization Plan in Russia will either give away the shares or sell them at a low multiple of book values unadjusted for recent inflation.
24. The view that the monopolist prefers the quiet life was put forth by Hicks, and an analysis showing that the monopolist is less interested in innovation than a firm in pure competition would be was produced by Arrow.
25. By this second line of argument, the Eastern European economies are going to face serious trouble, as some already have, when they open their doors to foreign competition, unless they turn out to exhibit little real-wage resistance (which they have not done so far).
26. The technical problems of any recapitalization scheme would be quite daunting. The nub, roughly, is that any wiping off of debts is likely to constitute a potentially enormous one-time redistributive transfer to enterprises that are not worth saving. The more the scheme tries to differentiate between bad and good debts, the more it leaves potentially viable enterprises burdened with the past, while it gives a new start to those that are considered unable to recover sufficiently to be able to pay. In economies that are starved for capital and in which the state budget is chronically in deficit, this may be a tremendous misallocation of scarce resources.
27. The scheme's chances of working would be much improved if the timing of the recapitalization were to coincide with a large scale privatization programme of the state enterprises. This would not only make it more likely that the enterprises

would not easily fall back into their old dependence, but might also provide an opportunity for a realistic estimate of their own viability (and of their ability to repay their debts). For an explanation how a well-designed privatization programme may provide reliable information concerning the viability of the privatized enterprises, see Frydman and Rapaczynski, "Evolution and Design," (1992b).

28. For examples of such plans, see Frydman and Rapaczynski (1990, 1991), Blanchard and Layard (1990), and Lipton and Sachs (1990).

References

- Aghion, P. and P. Bolton (1992), "An Incomplete-Contracts Approach to Financial Contracting," *Review of Economic Studies*, October.
- Arrow, K. J. and E. S. Phelps (1991), "Proposed Reforms of the Economic System of Information and Decision in the USSR: Commentary and Advice," *Rivista di Politica Economica*, Vol.81(11).
- Ausland, A., *Gorbachev's Struggle for Economic Reform*, Ithaca: Cornell University Press, 1991.
- Begg, D. and R. Portes (1992), "Enterprise and Economic Transformation: Financial Restructuring in Central and Eastern Europe," mimeo.
- Berg, A. (1992), "The Logistics of Privatization in Poland," paper presented at the NBER Conference on Transition in Eastern Europe, February 1992.
- Blanchard, O. J. and R. Layard (1990), "Economic Change in Poland," *Center for Research into Communist Economies Research Report*.
- Blasi, J. (1992), *The New Owners*, New York: Harper Business.
- CEU Privatization Reports: Czechoslovakia (1992), mimeo, Privatization Project of the Central European University.
- CEU Privatization Reports: Poland (1992), mimeo, Privatization Project of the Central European University.
- Chelminski *et al.* (1992), "Spoleczne bariery prywatyzacji," in Polish ("Social Barriers to Privatization"), Warsaw School of Economics, mimeo.
- Coffee, J. (1991), "Liability versus Control: the Institutional Investor as Corporate Monitor," *Columbia Law Review*, pp.1277-1368.
- Corbett, J. and C. Mayer (1991), "Financial Reform in Eastern Europe: Progress with the Wrong Model," *Oxford Review of Economic Policy*, Vol.7(4).
- Csaki, G. (1992), "East-West Corporate Joint Ventures: Promises and Disappointments," mimeo.
- DeLong, J. B. (1991), "Did Morgan's Men Add Value?", In: P. Temin, ed., *Inside the Business Enterprise*, Chicago University Press, (National Bureau of Economic Research conference reports).
- Demsetz, H. and Lehn (1985), "The Structure of Corporate Ownership: Causes and Consequences," *Journal of Political Economy*, Vol.93(6), December.
- Earle, J., R. Frydman and A. Rapaczynski (1992), eds., *Privatization in the Transition to a Market Economy*, Pinter Publishers and St. Martin's Press.
- Faur, T. (1992), "Foreign Capital in Hungary's Privatization," forthcoming In: Earle, Frydman and Rapaczynski, eds., *Privatization in the Transition to a Market Economy*, Pinter Publishers and St. Martin's Press.
- Franks, J. and C. Mayer (1990), "Capital Markets and Corporate Control: A Study of France, Germany and the UK," *Economic Policy*, Vol.5, pp.191-231.

- Frydman, R. and A. Rapaczynski (1990), "On Privatizing Privatization: A New Proposal of Ownership Transformation in Poland," in Polish, *Res Publica*, pp.2-14.
- Frydman, R. and A. Rapaczynski (1991), "Markets and Institutions in Large-Scale Privatizations," In: V. Corbo, F. Coricelli, and Jan Bossak, eds., *Reforming Central and Eastern European Economies; Initial Results and Challenges*, The World Bank.
- Frydman, R. and A. Rapaczynski (1992a), "Privatization and Corporate Governance in Eastern Europe. Can Markets be Designed?," In: G. Winkler, ed., *Central and Eastern Europe: Roads to Growth*, International Monetary Fund, pp.255-285.
- Frydman, R. and A. Rapaczynski (1992b), "Evolution and Design in the East European Transition," forthcoming In: L. Paganetto and E.S. Phelps, eds, *Privatization Processes in Eastern Europe: Theoretical Foundations and Empirical Results*, Macmillan Publishing Co.
- Frydman, R. and A. Rapaczynski (1993), *Markets by Design*, Basic Books.
- Grosfeld, I. and P. Hare (1991), "Privatization in Hungary, Poland and Czechoslovakia", *European Economy*.
- Hankiss, E. (1990), *East European Alternatives*, Oxford University Press.
- Hansmann, H. (1990), "When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy," *Yale Law Journal*, Vol.99(8), June.
- Hart, O. (1983), "The Market Mechanism as an Incentive Scheme," *The Bell Journal of Economics*, Vol.14(2), Autumn, pp.366-382.
- Hart, O. and J. Moore (1989), "Default and renegotiation: A Dynamic Model of Debt," MIT, (Working Paper; 560).
- Hart, O. and J. Moore (1991), "A Theory of Debt based on the Inalienability of Human Capital," MIT, (Working Paper; 592).
- Havel, J. and E. Kukla (1992), "Mass Privatization Programs in Czechoslovakia 1991-1992," mimeo.
- Havel, J. (1992), "Basic Problems Connected with Statistical Data on Privatization Process in Czechoslovakia," mimeo.
- Helwig, M. (1991), "Banking, financial intermediation and corporate finance," In: A. Giovannini and C. Mayer, eds., *European Financial Integration*, Cambridge University Press.
- Hirschmann, A. (1970), *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States*, Cambridge University Press.
- Hoshi, T., A. Kashyap and D. Scharfstein (1991), "Corporate Structure, Liquidity, and Investment: Evidence from Japanese Industrial Groups," *Quarterly Journal of Economics*, Vol.106(1).
- Jensen, M. (1986), "Agency Cost of Free Cash Flow, Corporate Finance and Takeovers," *American Economic Review*, Vol.76(2), May, pp.323-329.
- Jensen, M. and Meckling (1976), "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol.3, October, pp.305-360.
- Jensen, M. and K. J. Murphy (1991), "Performance Pay and Top Management Incentives," *Journal of Political Economy*, Vol.98(2), April, pp.225-264.
- Jensen, M. and R. Ruback (1983), "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics*, Vol.11, pp.5-50.
- Lindsay, M. (1992), *Developing Capital Markets in Eastern Europe: A Business Reference*, New York University Press.
- Lipton, D. and J. Sachs (1990), "Privatization in Eastern Europe: The Case of Poland," *Brookings Papers on Economic Activity*, No.1, Spring.

- McKinnon, R.I. (1991), *The Order of Economic liberalization: Financial Control in the Transition to a market economy*, Baltimore: John Hopkins University Press.
- Meszaros, K. (1992), "Evolution of the Hungarian Capital Market: The Budapest Stock Exchange," forthcoming In: Earle, Frydman and Rapaczynski, eds., *Privatization in the Transition to a Market Economy*, Pinter Publishers and St. Martin's Press.
- Mizsei, K. (1992), "The Hungarian Transformation," mimeo.
- Mizsei, K. (1990), "Experiences with Privatization in Hungary," mimeo.
- Mladek, J. (1992), "Alternative Paths to Privatization in Czechoslovakia," forthcoming In: Earle, Frydman and Rapaczynski, eds., *Privatization in the Transition to a Market Economy*, Pinter Publishers and St. Martin's Press.
- Morck, R., A. Shleifer and R.W. Vishny (1988), "Management Ownership and Market Valuation," *Journal of Financial Economics*, Vol.20, pp.293-315.
- Phelps, E. S. (1991), "Privatization Processes in Eastern Europe: Concluding Remarks," *Rivista di Politica Economica*, Vol.81(11).
- Privatization (1992), *RFE/RL Research Report*, April.
- Shleifer, A. and R. W. Vishny (1986), "Large Shareholders and Corporate Control," *Journal of Political Economy*, Vol.94(3), June, pp.461-488.
- Shleifer, A. and R. W. Vishny (1991), "The Takeover Wave of the 1980s," *Science*, 17 August.
- Shleifer, A. and R. W. Vishny (1992), "Privatization in Russia: First Steps," ms., National Bureau of Economic Research, Cambridge, Mass., March.
- Staniszczisz, J. (1991), *The Dynamics of the Breakthrough in Eastern Europe: The Polish Experience*, University of California Press.
- Stark, D. (1990), "Privatization in Hungary: From Plan to Market or From Plan To Clan," *East European Politics and Societies*, Vol.4(2).
- Szelényi, I. (1990), "Alternative Futures for Eastern Europe: The Case of Hungary," *East European Politics and Societies*, Vol.4(2).
- Szomburg, J. (1992), "The Decision Making Structure of Polish Privatization," forthcoming In: Earle, Frydman and Rapaczynski, eds., *Privatization in the Transition to a Market Economy*, Pinter Publishers and St. Martin's Press.
- Urban, L. (1992), "Role and Impact of the Legislature in the Hungarian Privatization," forthcoming In: Earle, Frydman and Rapaczynski, eds., *Privatization in the Transition to a Market Economy*, Pinter Publishers and St. Martin's Press.
- Weisbach, M. (1988), "Outside Directors and CEO Turnover," *Journal of Financial Economics*, Vol.20, pp.431-460.