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*Time to Rethink Privatization in Transition Economies?*

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## **FOREWORD**

It is now universally acknowledged that ownership matters; that private ownership in and of itself is a major determinant of good performance in firms. But as the more careful students of the subject have long admitted, ownership is not the only thing that matters. Decent economic policy and well-functioning legal and administrative institutions, especially those that create and enforce property rights, and regulate both capital markets and the network and natural monopoly elements of infrastructure firms, matter greatly as well.

In "Time to Rethink Privatization in Transition Economies?" John Nellis looks at what happens when the shift to private ownership gets far out in front of the effort to build the institutional underpinnings of a capitalist economy. The emphasis is on what went wrong and what, if anything, can be done to correct it.

The conclusion is that privatization in Central Europe and the Baltic states has generally proven its utility. But a fair amount has gone wrong, mainly (but not exclusively) in the countries emerging from the former Soviet Union. This part of the study is sobering reading. Still, it concludes that the solution is not to halt or retreat from privatization, but to find ways to carry it out correctly. While it may be time to rethink the concept a bit, it is not time to discard it.

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## **ABSTRACT**

Worldwide, evidence is increasing that privatization improves firm performance. But in some institutionally-weak transition economies, ownership change has so far not delivered on its promise. Why? Mass and rapid privatization schemes turned over mediocre assets to people lacking the incentives, skills and resources to manage them well. Most high-quality assets have ended up in the hands of the resourceful, agile and well-connected few who for a variety of reasons have tended not to embark on the thorough restructuring that might have justified their acquisition of the assets. In an institutional vacuum privatization can and has led to stagnation and decapitalization rather than to better financial results and increased efficiency.

What is to be done? Proposals include renationalization and/or postponement of further privatization, both to be accompanied by measures to strengthen the managerial and administrative capacities of the state. Neither approach seems likely to produce short-term improvements; the regrettable fact is that governments that botch privatization are equally likely to botch the management of state-owned firms. And there is no need for such measures in a number of Central European transition countries, where privatization is (in the main) living up to expectations. For institutionally-weak countries, the less dramatic but reasonable short-term course of action is to push ahead, more slowly, with case-by-case and tender privatizations, in cooperation with the international assistance community, in hopes of producing some success stories that will lead by example.

## I. Privatization wins the day

Privatization<sup>1</sup> appears to have swept the field and won the day. More than 100 countries, on every continent, have privatized some or most of their state-owned companies, in every conceivable sector of infrastructure, manufacturing and services. Including the very large number of firms privatized in Central and Eastern Europe (CEE) and the former Soviet Union (FSU), an estimated 75,000 medium and large-sized firms have been divested around the world, along with hundreds of thousands of small business units. Total generated proceeds are estimated at more than US \$735 billion.<sup>2</sup> Every country, including India, Russia, China, Vietnam, Cambodia and Laos, that still retains a significant number of publicly-owned firms, is privatizing some or most of them (save for Cuba and Democratic People's Republic of Korea).

One crude but telling measure of success is that the process has not been reversed: To date, only a small number of privatized firms has been renationalized. Where this has happened, the instrument has usually been indirect (for example, in Chile and the Czech Republic a state owned or dominated bank converted bad debt to equity) and the period of renewed state ownership temporary.

What have been the operational results of this massive shift of ownership?

Summing up their recent, extensive survey of the empirical record on the financial and operating results of privatizations around the world, Megginson and Netter state unequivocally :

...the evidence is now conclusive that privately-owned firms outperform SOEs...  
...empirical evidence clearly shows that privatization significantly (often dramatically) improves the operating and financial performance of divested firms.<sup>3</sup>

Much of the positive privatization experience reviewed in Megginson and Netter—and in earlier and other work of Megginson and his colleagues—is drawn from OECD countries. But while privatization started in industrialized market economies it subsequently spread widely; and recent assessments of the results in non-OECD settings are also generally positive. For example, Boubakri and Cosset review before- and after-performance of 79 privatized firms in 21 developing countries—mostly middle income, but including Bangladesh, Jamaica, Nigeria, Pakistan and Philippines—and conclude that

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<sup>1</sup> In this paper, privatization means the transfer of a majority of ownership equity from state to private hands.

<sup>2</sup> *Privatisation International* (London: Issue No. 123, December, 1998), p. 4. Proceeds are of course a partial and imperfect measure of privatization's magnitude and importance, as thousands of firms have been privatized through voucher or give-away schemes.

<sup>3</sup> William L. Megginson and Jeff Netter, "From State to Market: A Survey of Empirical Studies on Privatization," paper presented to the Global Equity Markets conference, Paris, December 1998, unpublished draft, quotation from the Abstract.

on average the firms in their sample “...showed significant increases in profitability, operating efficiency, capital investment spending, output.... and employment, and a decline in leverage and an increase in dividends.”<sup>4</sup> A late 1998 IMF study surveys the literature and distills what is known about privatization in the transition economies of CEE and the FSU. It finds that private owners generally outperform state-owned firms.<sup>5</sup>

The multi-country surveys are supported by the positive findings of a growing number of country case studies. Some examples: A 1998 review of the post-privatization performance of 28 divested firms in Egypt reveals increased sales (71 percent of the sample), increased earnings (68 percent), increased average salary per worker (96 percent), and a decline in both short- and long-term debt (82 percent).<sup>6</sup> A 1997 study of 218 privatizations in Mexico found, on average, “...a 24 percentage point increase in the ratio of operating income to sales,” and documents increases in profitability and output, and substantial declines in unit costs and employment levels (though the blue-collar workers who retained their jobs received large salary increases).<sup>7</sup> Seven of ten large loss-making manufacturing firms privatized in Bangladesh returned to profitability, showing increases in output, sales, capacity utilization and labor productivity, and declining unit costs.<sup>8</sup> Much more along these lines could be presented. The fact is that almost every rigorous study comparing pre- and post-privatization operation indicates, on average, sizable performance improvement.<sup>9</sup>

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<sup>4</sup> Narjess Boubakri and Jean-Claude Cosset, “The Financial and Operating Performance of Newly Privatized Firms: Evidence from Developing Countries,” *Journal of Finance*, Vol. 53 (June 1998); 1081-1110.

<sup>5</sup> Oleh Havrylyshyn and Donal McGettigan, “Privatization in Transition Countries: A Sampling of the Literature,” Washington: International Monetary Fund, unpublished draft, December 1998.

<sup>6</sup> Mokhtar Kattab, “Constraints of Privatization in the Egyptian Experience,” paper delivered at the conference on Public-Private Partnerships in the Middle East and North Africa Region, Marrakech, September, 1998, p. 35. No information is given on how this set of 28 privatized firms was selected for analysis from the 91 privatized firms in the country.

<sup>7</sup> Rafael La Porta and Florencio Lopez-de-Silanes, “The Benefits of Privatization: Evidence from Mexico,” summary of their longer article appears in *Viewpoint* No. 117 (Washington, DC: World Bank, 1997).

<sup>8</sup> C. A. F. Dowlah, “Privatization Experience in Bangladesh, 1991-1996,” Dacca, unpublished paper submitted to the World Bank, 1996.

<sup>9</sup> Other studies showing positive results from privatization include: Ahmed Galal *et al.*, *Welfare Consequences of Selling Public Enterprises* (Washington, DC: Oxford University Press, 1995); Hafeez Shaikh *et al.*, *Argentina Privatization Program: A Review of Five Cases* (Washington, DC: World Bank, 1996); David Newbery, and Michael G. Pollitt, “The Restructuring and Privatization of the U.K. Electricity Supply—Was it Worth It?” in *The Private Sector in Infrastructure: Strategy, Regulation and Risk*, (Washington, DC: World Bank, 1997). Articles demonstrating the superior efficiency performance of private versus public firms include Sumit Majumdar, “Assessing comparative efficiency of the state-owned, mixed and private sectors in Indian industry,” *Public Choice*, Vol. 96 (1998), pp. 1-24; and Kathryn Dewenter and Paul Malatesta, “State-Owned and Privately-Owned Firms: An Empirical Analysis of Profitability, Leverage and Labor Intensity,” Working Paper, University of Washington, 1998.

### *Or does it?*

And yet, despite the ubiquity of divestiture—Megginson and Netter note that privatization moved “...from novelty to global orthodoxy in the space of two decades.”<sup>10</sup>—despite the assessment by investment bankers that privatization’s “success has been indisputable;”<sup>11</sup> and despite the large and growing amount of evidence from a variety of settings showing that privatization tends to improve firm-level performance; doubts remain, and are growing. Indeed, suspicions and concerns about privatization, driven under by the liberalizing pressures of the 1980s and early 1990s, are resurfacing, to the point where one can say that there is a multifaceted spirit of “revisionism” in the air. Of what does this consist? It is composed:

- of concerns of observers dissatisfied with the analytical rigor of either the theory or the empirical studies supporting privatization;
- of arguments from those who were never convinced that privatization was the socially right solution, at least for certain firms or in certain sorts of economies;
- of fears that while privatization may be generally beneficial from the viewpoint of the shareholders, and perhaps the selling state, it has not proven so from the standpoint of society, or at least from the standpoint of significant groups of generally poor and powerless actors in society; and
- of doubts of many whose previous acceptance of divestiture has been shaken by recent events in Russia and some other transition economies

This study does not attempt to address the entire range of concerns and criticisms of privatization. The less ambitious objective is to review the accomplishments and shortcomings of privatization in transition economies—where the scope and pace of privatization has been larger than elsewhere, where the expectations surrounding the concept were so great, and where some problems of magnitude have surfaced. The study looks into where and why unsatisfactory performance has been found, and discusses what the effected transition governments, and those who assist them, should do about it. Thus, section II proceeds from a general doubt concerning privatization to specific reviews of the process in transition economies. Section III examines a number of possible and suggested ways to address the problems. Section IV concludes.

By way of summary, the study’s principal findings are:

- Privatization has generally proved its worth in Central and Eastern Europe and the Baltic states.
- But too much was expected and promised of privatization in institutionally-weak transition economies, mainly but not exclusively in the former Soviet Union.

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<sup>10</sup> Megginson and Netter, *op. cit.*, p. 5.

<sup>11</sup> Richard Morse, Global Head of Industry at Dresdner Kleinwort Benson, “The paradox of privatisation,” *Privatisation International* (London: Issue No. 123, December, 1998), p. 6.

- There, for what seemed excellent political reasons, the emphasis was usually on massive, speedy transactions with substantial ownership stakes awarded to “insider” stakeholders. The reasoning was that one needed to cut the links between the enterprises and the state, and to create swiftly a mass of private property owners; and that the only feasible way to do this was by offering substantial ownership stakes to workers and managers in the firms being privatized. If these powerful insiders were not rewarded, and quickly, it was thought they would block indefinitely the privatization—and transition—processes.
- There is some evidence, again from those transition states closest to Western markets and traditions, that this approach has been successful.
- But the farther east one travels, the more the required supporting, larger economic processes of financial discipline, competition, and freedom (and promotion) of entry of new businesses have not been attended to.
- In these instances, the speedy, massive, insider-oriented forms of privatization have generally not, so far, led to the restructuring required to allow firms to survive and thrive in competitive market operations.

Despite the severity of this indictment, there is very little reason to think that had these states retained the firms in public ownership their restructuring performance would have been better. The fact is that states that botch privatization botch public ownership of enterprises as well. Overall, privatization has delivered remarkably well in many settings, especially when contrasted not to some theoretical ideal, but to the realistic set of alternatives. Thus, while agreeing that methods of privatization have to be altered and improved, and that much more attention must be paid to supporting institutions, the argument is against renationalization or for a search for ways to make state ownership efficient and effective. The key unanswered question is how to go about correcting and improving privatization in institutionally weak settings.

## II. Privatization and its Discontents

Doubts concerning privatization's necessity, concerns that the concept has often promised more than it has delivered and that the many studies cited above have reached dubious conclusions, stem from several sources. The prime general argument is a long-standing one; that competition and market structure are as, if not more, important than ownership in determining efficiency outcomes at the level of the firm. An up-dated empirical testing of this viewpoint comes from Pankaj Tandon, who argues, on the basis of a 1994 literature survey, that

...there are many cases where privatization has not led to efficiency improvement; these are generally associated with situations where the degree of competition has remained unchanged before and after privatization.....there are of course many cases where privatization appears to have "resulted" in efficiency improvement; in most of these cases, however, the privatization appears to have been contemporaneous with deregulation or other types of competition-enhancing measures.<sup>12</sup>

The conclusion Tandon finds "most consistent with the evidence" is that "...it is the level of competition, not ownership..." that best determines efficiency outcomes.

Tandon acknowledges that private owners have the right incentives to promote efficiency; and, in line with modern amendments to neo-classical theory, he thinks it quite likely that government owners mismanage principal-agent issues to a greater extent than private ones. He nonetheless preaches caution: In a competitive market "...there exist mechanisms that could enable a public enterprise to operate as efficiently...as its private cousins. But if a market is monopolized, privatization by itself will not guarantee efficiency."<sup>13</sup> Tandon's view is that (i) if government owners enhance competitive forces, and/or use management methods and incentives similar to those used in the private sector, this could or should produce efficient behavior and outcomes; and (ii) ex-post perceived positive results attributed to ownership change may actually be due to increased competition. The implication is that some, perhaps many, of the conclusions of privatization proponents are more ideological than scientific; insufficiently judicious and cautious concerning both the ways to achieve objectives without changing ownership, and regarding the possible negative effects of poor privatization.

An additional methodological criticism is that of "selection bias." The idea is straightforward: improved performance in privatized firms does not necessarily show that private owners are better; the improvements may rather indicate that it is the better firms that are privatized. This criticism has particularly troubled studies of privatization in

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<sup>12</sup> Pankaj Tandon, "Welfare Effects of Privatization: Some Evidence from Mexico," *Boston University International Law Journal*, Vol. 13, No. 2 (Fall, 1995), pp. 329-330. Note that Tandon is one of the four authors of the justly celebrated *Welfare Consequences...* study cited in footnote 10, above; generally regarded as one of the strongest pillars of the pro-privatization argument. He specifically does *not* exclude his previous study from his conclusions.

<sup>13</sup> *Ibid.*, p. 332.

transition economies, with their thousands of transactions, the general tendency to reward insiders (who might be thought to possess good information on the firm's prospects), and the lack of constraints on insider trading.<sup>14</sup>

In the transition economies the evidence supporting privatization has come from CEE. The strongest evidence in support of privatization's benefits in this part of the transition world comes from two studies that examine enterprise performance to mid-1994 in the first case, and to the end of 1995 in the second.<sup>15</sup> It is reasonable to ask if the highly positive findings from these relatively early days have been sustained; as shall be shown below for the case of the Czech Republic, the answer may be "no."

What is clear is that the farther east one travels, the less likely is one to see rapid or dramatic returns to privatization. Some examples: A survey of 92 state- and privately-owned firms in the Republic of Georgia concluded that it was not private ownership that was associated with restructuring—or at least with what restructuring could be discerned—but rather competition and financial discipline.<sup>16</sup> A study of 50 medium and large privatized enterprises in Armenia noted that only three of the set had generated any new investment post-sale; for most "the prognosis was for continuing decline and ultimate bankruptcy."<sup>17</sup> A forthcoming study on Mongolia concludes that partially state-owned firms perform better than privatized companies.<sup>18</sup> Early surveys in Russia indicated few discernible differences in performance between state- and privately-owned firms,<sup>19</sup> or

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<sup>14</sup> But note that Havrylyshyn and McGettigan review three recent studies that attempt to take selection bias into account, and still conclude that privatization is associated with better performance. (*Op. cit.*, para. 18.)

<sup>15</sup> Roman Frydman *et al.*, *Private Ownership and Corporate Performance: Some Lessons from Transition Economies* (Washington, DC: World Bank Policy Research Working Paper No. 1830, 1997); and Gerhard Pohl *et al.*, *Privatization and Restructuring in Central and Eastern Europe-Evidence and Policy Options* (Washington, DC: World Bank Technical Paper No. 368, 1997). We return to these studies in section III.

<sup>16</sup> Simeon Djankov and Vladimir Kreacic, "Restructuring of Manufacturing Enterprises in Georgia: Four Case Studies and a Survey," World Bank, unpublished draft, 1998.

<sup>17</sup> Center for Economic Policy Research and Analysis, "Mass Privatisation of Enterprises in the Republic of Armenia: An Early Assessment," unpublished assessment prepared for USAID, Yerevan, Armenia, November 1997, p. 1. The firms in the sample had been privatized for slightly more than one year.

<sup>18</sup> Personal communication from Peter Murrell, noting this as a central conclusion of James H. Anderson, Young Lee and Peter Murrell, "Do Competition and Ownership Affect Enterprise Efficiency in the Absence of Market Institutions? Evidence after Privatization in Mongolia," forthcoming as a working paper from the Department of Economics and IRIS Center, University of Maryland, 1999.

<sup>19</sup> "...ownership changes are generally rather weakly associated with most indicators of performance, including sales, wages and employment." From the "Introduction" to Simon Commander, Qimiao Fan and Mark Schaffer, *Enterprise Restructuring and Economic Policy in Russia* (Washington, DC: World Bank, EDI Development Series, 1996), p. 8; see also Chapter 7 in this volume by John Earle, Saul Estrin and Larisa Leshchenko. The data in this study run to mid-1994.

modest positive differences in the privatized firms.<sup>20</sup> One of the few studies in Russia clearly showing positive restructuring returns to privatization dealt with small shops, most of which had been privatized for only a few months when the assessment survey was made between June of 1992 and August of 1993.<sup>21</sup> Examining enterprise survey data from 1997 and 1998, for 960 privatized manufacturing companies in Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia and Ukraine, Djankov found that the most restructuring occurred in the small number of firms where foreigners had acquired a significant ownership stake. Managerial owners had a mixed record of performance; and both outside local investors and worker-owners seemed not to produce much restructuring.<sup>22</sup> In other words, the most likely forms of private ownership to occur were those least likely to promote active restructuring. And even in Central Europe, Poland's experience of comparatively slow and cautious privatization,<sup>23</sup> combined with quite robust and sustained growth, has cast doubt on the necessity of privatization as a key element in the process of transition.<sup>24</sup>

### *The Rise and Fall of Russia*

Russia's privatization experience has come in for particular criticism. The voucher-led mass privatization program of 1992-94 transferred ownership of some 15,000 plus firms, mainly to "insiders." At the end of the exercise managers and workers combined controlled about 2/3 of shares in the average privatized firm. The program's designers had tried to avoid such a level of insider dominance, but the financial mechanisms that might have prevented this outcome were swept away by the near hyperinflation prevailing at the time. Still, the mass program had taken place without major claim of fraud, and by the fall of 1994, hopes were modestly high that:

- financial discipline and perceived self-interest would start to force secondary trading in the insider-dominated companies and introduce outside ownership; and

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<sup>20</sup> Saul Estrin and John Earle, "After Voucher Privatization: The Structure of Corporate Ownership on Russian Manufacturing Industry," *CEPR Discussion Paper No. 1736* (London: Center for Economic Policy and Research, 1997).

<sup>21</sup> Nicholas Barberis, Maxim Boycko, Andrei Shleifer, Natalia Tsukanova, "How Does Privatization Work? Evidence from Russian Shops," *Journal of Political Economy*, Vol. 104, No. 4, 1996, pp. 764-790. The authors are aware of the limitations of their data set and did their best to focus on short-term, quickly visible restructuring measures.

<sup>22</sup> Simeon Djankov, "Ownership Structure and Enterprise Restructuring in Six Newly Independent States," Washington, DC: World Bank, unpublished paper, October 1998, pp. 2-3.

<sup>23</sup> Through 1996, about half of the Polish 1989 state-enterprise sector remained in government hands, including many of the largest firms. See Barbara Blaszczyk, "Privatization and Ownership Transformation in Poland," in B. Blaszczyk and Richard Woodward, eds., *Privatization in Post-communist Countries*, II Volumes (Warsaw: Center for Social and Economic Research, 1996), Vol. I, pp. 177-204.

<sup>24</sup> The issue is examined in Brian Pinto and Sweder van Wijnbergen, "Ownership and Corporate Control in Poland: Why State Firms Defied the Odds," *CEPR Discussion Paper No. 1273* (London: Centre for Economic Policy Research, 1995). Hungary eschewed vouchers and mass privatization methods, but did divest the bulk of state-owned assets.

- transparent and sound, but non-voucher methods would be used to privatize the half, or more, of industries still in state hands.

A number of factors combined to largely prevent the proper unfolding of this process. First, insiders in the newly privatized firms generally and deeply feared a loss of control; for most workers it was a case of “better the devil we know” (i.e., the existing management) than some cost-cutting, perhaps job-slashing outsider. In turn, many of the old managers turned owners found it easier to lobby the state for assistance than to set the firm on the path to competitive performance. Second, the financial and physical condition of many firms was unattractive; not too many outsiders were interested. Third, there was an acute lack of institutional underpinnings and safeguards—and thus incentives—for transparent secondary trading; this further and deeply discouraged outsiders. Fourth, varying Russian governments failed to put in place the required set of supporting policies and institutions that would have, or might have, channeled enterprise activity to productive ends; e.g., a hard budget constraint, reasonable taxes and services, and mechanisms to permit and encourage new business entrants. Fifth, and in general, there was an absence of institutionalized property rights, and indeed an absence of a consensus on the economic rules of exchange. For the firms transferred in the mass privatization program, this mixture blocked the taking of the “...essential second steps opening ownership of privatized firms to external investors and owners...” who would “...bring needed capital, market access, managerial know-how and a bottom-line mentality to privatized companies.”<sup>25</sup>

And worse was to come: A donor-led effort to persuade the Russian government to sell at least a few large firms by transparent, credible “case-by-case” methods, expended considerable effort but led nowhere. Much of the post-1994, second wave of privatization that did take place, for cash and investment promises, and in particular the “loans-for-shares” scheme, turned into a fraudulent shambles, a situation pointed out by the strongest supporters of, and contributors to, the first, mass phase of Russian privatization. The second phase

...was non-transparent ... involved clear conflicts of interest ... created collusion ... involved a nonlevel playing field, excluding foreign investors and banks not favored by the government. In two years the Russian privatization program has moved from the outstanding accomplishments of the MPP to the point where the program is now widely regarded as collusive and corrupt, failing to meet any of its stated objectives.<sup>26</sup>

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<sup>25</sup> John Nellis, “Introduction,” in Ira Lieberman and John Nellis, *Russia: Creating Private Enterprises and Efficient Markets* (Washington, DC: World Bank, Private Sector Development Department, 1994), p. 2. See also Joseph Blasi *et al.*, *Kremlin Capitalism: Privatizing the Russian Economy* (Ithaca: Cornell University Press, 1997), which concludes that the needed post-privatization restructuring of Russian firms proved “far more complex” than was anticipated. (p. 122, *passim*.)

<sup>26</sup> Ira Lieberman and Rogi Veimetra, “The Rush for State Shares in the ‘Klondyke’ of Wild East Capitalism: Loans-for-Shares Transactions in Russia,” *The George Washington Journal of International Law and Economics* Vol.29, No. 3 (1996), p. 738.

Others go farther, arguing that the entire Russian privatization program, including the voucher-led mass effort, has been a principal cause of the country's economic decline. The argument is: By emphasizing swift ownership change before (or instead of) the building of market-support institutions—basic capital market framework, minimal shareholder information and protection systems, enforceable contracts, a modicum level of capacity and probity in the supervising public sector—and without breaking-up the huge monopolistic or oligopolistic producers in order to stimulate internal competition, the voucher program left the mass of new shareholders powerless to counteract the manipulations of the well-placed managers and their supporters in the financial community. So what was supposed to be a program to distribute ownership and launch enterprises on a positive restructuring path became instead a transfer of productive resources from the state to a fortunate few who—unconstrained by tradition, effective laws, or countervailing powers—stripped the assets from the firms, and did not restore growth and create jobs; actions that might have justified such a transfer.

Over time, the lack of turnaround, the continuing steep fall in output, the concentration of wealth, the demise of probity, the resistance to standard “case-by-case” methods, the ever-deepening malaise, and increasingly common anecdotes that only state-owned firms have resisted criminalization,<sup>27</sup> have combined to persuade many presumably well-predisposed observers to reject all or most of the Russian privatization approach, not just the notorious “loans-for-shares” scheme. Thus Kenneth Arrow calls Russian privatization “a predictable economic disaster;”<sup>28</sup> arguing that it should have been easy to foresee poor outcomes, given Russian institutional weakness and the very high inflation in 1992-1995. Jeffrey Sachs says he would now favor the Russian government re-nationalizing the natural resource firms wrongly privatized at an earlier date.<sup>29</sup> Simon Commander argues that Russian “insider privatization has sanctioned” “...a low investment—low productivity equilibrium...” and as such has contributed greatly to Russia's “fiscal impasse.”<sup>30</sup> And any number of Russian economists, along with some few Western colleagues, have concluded that the whole privatization approach was wrong; that it should have been preceded (not accompanied) by institution-building; and that the proper way forward is to strengthen the structures of the state.<sup>31</sup> In particular,

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<sup>27</sup> A **Washington Post** story on the criminal take over of coal mines in the Kuzbass Basin region of Russia asserts: “The most productive mines are still largely state-owned, and regional government officials serve on the boards of directors.” “A Hotbed of Crime in Cold Siberia,” Thursday, January 7, 1999, p. A16.

<sup>28</sup> Notes of Arrow's presentation taken by the author at a World Bank seminar on *What Went Wrong in Russia?* Washington, DC: October 26, 1998.

<sup>29</sup> Notes of Sach's presentation taken by the author during a video conference made by Sachs to the Economic Development Institute of the World Bank's Core Course on Privatization, Washington, DC: November 2, 1998. Sachs is much more critical of the “loans-for-shares” scheme than the MPP.

<sup>30</sup> Simon Commander, “Russia: What is to be Done?” *EDI Forum*, Vol. 3, No. 2 (Fall, 1998), pp. 7-8.

<sup>31</sup> Three vocal Russian critics are Nekipelov Alexandr, Stanislav Menshikov and Oleg Bogomolov; Western economists associated with a “move more slowly; concentrate on institutions in advance of ownership

these critics stress the need to recreate or reinforce mechanisms to supervise and assist state-owned firms. One suggestion is through the use of a state-owned holding company, which would, supposedly, manage assets rationally and prepare firms for a smooth transition to competitive market operations.<sup>32</sup> The negative attitude on privatization is such that a fair number of members of the federal legislature, the *Duma*, have urged that the huge tax arrears owed by most privatized firms to the federal government be transformed into equity, which would effect a massive renationalization of industrial assets.

### *Difficulties in the Czech Republic*

Limited expectations for privatization were perhaps reasonable in Russia, given the length and intensity of the non-market approach, the unfavorable economic and structural conditions existing at the moment transition was launched, and the magnitude of the parallel political and institutional collapse. But this could not have been said of the Czech Republic. Conditions and history there made it reasonable not simply to hope but to claim that the dramatic mass privatization program of 1992-1995 would cut fully and permanently the links between the state and the divested enterprises and set the privatized firms on the road to unassisted competition in both domestic and foreign markets.

First signs were very encouraging. Czech privatizers by 1995 had divested more than 1800 firms in two waves of exchanges for vouchers, sold a group of high-potential firms to strategic investors, and transferred to previous owners or municipalities a mass of other assets.<sup>33</sup> By 1996, then Prime Minister Vaclav Klaus was able to claim that transition had been more or less completed, and that henceforth the Czech Republic should be viewed as an ordinary European country undergoing ordinary economic and political problems. Comparatively low inflation, very low unemployment, a rapid, indeed explosive rise in the private sector's share of GDP, high rates of investment and export growth to countries in the European Union, a resumption of GDP growth starting in 1993 and peaking at 6.4 percent in 1995—all indicators appeared to confirm this judgment.

The Czech GDP growth rate fell at the end of 1995, and again in 1996 and 1997, when a one percent growth rate was achieved. Results in 1998 were starkly negative, with

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change" include Michael Intriligator, Lance Taylor, Marshall Pomer, Kenneth Arrow and Dorothy Rosenberg.

<sup>32</sup> Nekipelov Alexandr, "On the Nature of Russian Economic Catastrophe and Possible Approaches to Dealing with It," unpublished paper presented at the Second Boston Seminar on Economic Globalisation, October 1998, pp. 16-17.

<sup>33</sup> Note however that, as of the end of 1998, there remained in the Czech Republic a great deal to privatize: majority or controlling stakes in three of the four major banks, parts or all of infrastructure firms, a number of large industrial concerns (taken together, the state retains 40 large firms classed as "strategic"), and minority stakes of varying size in more than 325 non-strategic commercial and industrial concerns. Tellingly, the Czech State today still retains a significant ownership interest in nine of the ten largest firms in the country.

an annual GDP contraction of about two percent; projected growth in 1999 is zero or very slightly positive. The Czech economy is thus officially in recession—in contrast to four to five percent expansion in neighboring countries. There are many reasons for the slide including a mini-recession in Germany (now the Czech Republic’s largest trading partner), and some financial mismanagement at the end of 1995 and in early 1996. Nonetheless, and increasingly, a large amount of blame is placed on the way privatization was carried out.

A 1998 OECD report states the argument: The Czech voucher approach to privatization produced ownership structures that “...impeded efficient corporate governance and restructuring.”<sup>34</sup> The crux of the problem was that insufficiently regulated privatization investment funds ended up owning large or controlling stakes in many firms privatized by vouchers, as citizens diversified risk by investing their coupon points into these funds. But most of the large funds were owned by the major domestic banks—banks in which the Czech state retained a controlling or even majority stake. The results, say the critics, were predictable:

- Investment funds tended not to treat aggressively poor performance in firms, since pulling the plug would force the fund’s bank owners to write down the resources lent to these firms.
- The state-influenced, weakly managed and inexperienced banks tended to extend credit to high risk, poor potential privatized firms (whether or not they were owned by subsidiary funds), and to persistently roll-over credits rather than push firms into bankruptcy.
- The bankruptcy framework itself was weak and the process lengthy, diminishing further financial market discipline.
- The lack of prudential regulation and enforcement mechanisms in the capital markets opened the door to a variety of highly dubious and some overtly illegal actions that enriched fund managers at the expense of minority shareholders, and harmed the health of the firm; for example,
- by allowing fund managers to load firms with debt, then lift the cash and vanish, leaving the firm saddled with debts it had not used for restructuring.

Many thus conclude that Czech firms privatized through vouchers, in which investment funds hold the controlling stakes, have not sufficiently or persistently restructured.<sup>35</sup> And while the proximate and most visible determinants of inadequate

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<sup>34</sup> OECD, *Czech Republic* (Paris: OECD, 1998), p. 49.

<sup>35</sup> A. Weiss and G. Nikitin looked at financial performance in a set of Czech firms and concluded that while “ownership concentration in hands other than funds has a major (and positive) effect on performance,” there is “no evidence of a positive effect of ownership shares by funds on the performance of operating companies.” (“Performance of Czech Companies by Ownership Structure,” unpublished draft, Boston University, 1997, p. 21.) Pavel Mertlik (now Minister of Economy in the Social Democrat government that came to power in 1998) argued much the same thing in his “Czech Privatization: From Public Ownership to Public Ownership in Five Years?” in Blaszczyk, *op. cit.*, Vol. 1, pp. 103-122.

restructuring lie in glaring weaknesses in capital and financial markets, the voucher privatization method itself—with its emphasis on speed, its postponement of consideration of many aspects of the legal/institutional framework, and its atomization of ownership—is seen as the underlying cause. David Ellerman is but the most outspoken of those who view the Czech scheme as a disaster, arguing that the negative outcomes were predictable given the “separation of ownership from control.” Moreover, the funds themselves lacked stable ownership, and the broader economy provided few institutional mechanisms to instill decent corporate governance, in either the funds or the firms. The natural result, says Ellerman, was a “two-sided grab-fest by fund managers and enterprise managers” accompanied by “drift, stagnation and decapitalization of the privatized industrial sector...”<sup>36</sup>

### *Additional concerns and arguments about privatization...*

Similar or related concerns have been raised in a number of other transition economies. Many officials and observers, particularly in the smaller and/or more geographically isolated transition countries, say “yes, but” to privatization in general and argue against rapid and mass privatization in particular. (Much of the concern is expressed by those in countries that were formerly part of the Soviet Union, but Albania and Mongolia are also on this list.) Their reasons? First, they see little good coming of any form of privatization in Russia; and since they view their industrial assets and business environments as about as bad or worse than those existing in Russia, they conclude it unlikely they can avoid the problems encountered there. Second, a widespread fear is that the administrative and legal mechanisms needed to transform rapacious grasping into tolerable and productive acquisitiveness are almost entirely lacking.

Third, voices from those countries that were once part of the Soviet Union note that many aspects of their economies are still under the influence if not the control of Russian supply, transport, energy and sometimes criminal networks. Fourth, in several countries that tried mass privatization schemes, such as Kazakhstan, Mongolia, Moldova and Albania, many conclude that they have not yet gained much from this effort. Even though they may not have encountered the problem of privatization investment funds failing to protect the interests of shareholders, they have found that dispersing ownership among the inexperienced population has not led to effective governance of firm managers—who in all too many cases have not changed, have failed to restructure, and who remain largely unaccountable for their actions. Leaders in Uzbekistan, for example, are

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<sup>36</sup> David Ellerman, Voucher Privatization and Investment Funds: An Institutional Analysis,” *Working Paper No. 1924*, World Bank, Development Economics Unit, , May, 1998, p. 11. Katharina Pistor and Andrew Spicer, in their “Investment Funds in Mass Privatization: Lessons from Russia and the Czech Republic” (*Viewpoint* No. 110, World Bank, 1997), were also quite critical, concluding that funds generally “have been unable to enhance the value of their holdings” because of the import of “the initial design problems in mass privatization—asymmetric information and imperfect property rights.....” (from the Summary).

increasingly convinced by their neighbors' experience of the correctness of their policies of general gradualism, and their opposition to handing over firms to owners lacking financial strength and expertise. All these factors are claimed to justify, to necessitate, a slower, more cautious, more evolutionary, more government-led path to ownership transfer.<sup>37</sup>

In light of all this, it is not surprising that in some post-Soviet countries—especially those where the political transition entailed less of a break with the past than in Russia, and where the inherited state structure maintained some cohesion and effectiveness—a Chinese-style approach to enterprise reform and ownership change is seen as the proper model to follow.<sup>38</sup> The overall Chinese record of high and sustained growth, largely without a shift to formal private ownership, poses a stark contrast to generally poorer transition performance elsewhere. Moreover, the approach is the subject of encouraging comments from a number of Western economists. For example, Joseph Stiglitz states that Chinese experience shows “...that an economy might achieve more effective growth by focusing first on competition, leaving privatization until later.”<sup>39</sup> Thomas Rawski states that

...the generally negative evaluation of state enterprise performance is overdone...China's state industry has increased output, productivity, and exports...the upper tier of state firms is not far removed from international market standards....The main source of SOE financial problems lies in their history, not their ownership....(Without politically imposed financial burdens) SOE profitability may equal or exceed the financial performance of China's highly touted collective factories....the productivity performance of state industry may match or surpass the accomplishments of the collective sector...<sup>40</sup>

Rawski's overall conclusion is that “economists overstate the importance of ownership.”<sup>41</sup>

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<sup>37</sup> Though it has to be pointed out, now and later, that many who preach this line are benefiting from the substantial rents produced by a system of heavy government involvement in the economy.

<sup>38</sup> For an assessment of the various approaches in use and under consideration by the Chinese regarding enterprise performance and reform see Harry Broadman, *Meeting the Challenge of Chinese Enterprise Reform* (Washington, DC: World Bank Discussion Papers No. 283, 1995). For a discussion of the competing and hotly debated interpretations of the results of Chinese reforms short of privatization, see Jeffrey Sachs and Wing Thye Woo, “Understanding China's Economic Performance,” Harvard University, HIID Development Discussion Paper No. 575, March, 1997, esp. pp. 18-31, section entitled “The SOE Sector Under Reform.”

<sup>39</sup> Joseph Stiglitz, “Knowledge for Development: Economic Science, Economic Policy and Economic Advice,” paper given at the *Annual Bank Conference on Development Economics*, World Bank, 1998, p. 2.

<sup>40</sup> Thomas Rawski, “China and the Idea of Economic Reform,” unpublished draft paper for Symposium on China's Gradualism Reconsidered, Yokohama, Japan, 1997; paper produced at the Department of Economics, Pittsburgh University, March, 1997, p. 14.

<sup>41</sup> *Ibid.*, p. 16.

One could extend the attack on privatization in a number of ways: By noting the insufficiency of analytical work on the macroeconomic and fiscal impact of privatization; by pointing out that the “fiscal space” justification for privatization—that is, governments should cease pouring resources into inefficient and badly managed state-owned firms; they should sell them and concentrate resources and action on those socially needed activities that only governments can and should undertake—states a hope, not a known reality. The fact is that there is very little known, in emerging markets or the transition economies, regarding how the proceeds of privatization are actually applied.<sup>42</sup> And given the nature of the political and administrative systems in many of these settings, doubts are warranted as to transition governments’ abilities to collect and allocate wisely the sums generated.

### *Political economy aspects of the question*

This takes one to the political economy aspects of privatization; the issues of precisely who in transition society wins and loses from transactions. As noted, a good part of the criticism of privatization in Russia and the Czech Republic stems from the widespread perception that reform in general and privatization in particular have yielded benefits to the very few at the expense of the many—the many being, for example, the Czech workers in Ellerman’s “decapitalized and stagnant” privatized firms; and voucher investors in the two countries who were led to believe their investments would yield an income stream and a capital gain, neither of which has materialized for most.

To date, no study of transition countries has examined these issues in the rigorous manner pioneered by the *Welfare Consequences of Selling Public Enterprises* study, which looked carefully at the gains and losses of sellers, buyers, workers, consumers and competitors. Indeed, very little empirical work of any sort has yet appeared on the question of privatization’s effects on income distribution in transition settings (or elsewhere). Analysts have begun to produce some oblique and tantalizing hints about the relation between privatization and incomes. For example, Garner and Terrell looked at movements in income distribution up through 1993 in the Czech Republic and Slovakia and concluded that “income inequality has risen much less” than was claimed in the World Bank’s 1996 World Development Report. But they predict more inequality in these countries “as the returns from asset distribution are reaped.”<sup>43</sup> Newell and Socha looked at the related issue of privatization’s impact on wage distribution in Poland and concluded that one effect was that now “private-sector workers typically earned less than their state-sector counterparts,” and that this gap was widening; but that after controlling for experience, tenure and workplace size “there existed a small positive private-sector

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<sup>42</sup> At time of writing, the International Monetary Fund is conducting a study to examine, *inter alia*, the macroeconomic and systemic fiscal impacts of privatization.

<sup>43</sup> Thesia Garner and Katherine Terrell, “A Gini decomposition analysis of inequality in the Czech and Slovak Republics during the transition,” *Economics of Transition*, Vol. 6 (1), 1998, p. 41.

premium.”<sup>44</sup> Not much can be made of these beginnings; more work is needed on the subject.<sup>45</sup>

A common allegation is that women in transition countries bear a higher percentage of the costs of privatization than men. In one of the only studies to examine this issue, Sewall argues that privatization in Hungary was triply costly to women: because they formed a disproportionately high percentage of those laid off by new owners, because privatization often involved the closing of the firm’s social services—canteens, clinics, day-care centers—so crucial to female participation in the workforce, and because women formed almost the whole of the workforce in these social service units.<sup>46</sup> This is a single study in a single country, but it is reasonable to suspect that these findings apply in many other transition countries.

It is often assumed that privatization inevitably and automatically results in increased unemployment; but the relationship between employment and privatization in transition countries is not at all straightforward. For example, the Czech Republic privatized very rapidly but maintained a very low rate of unemployment, a remarkable three percent, through 1997. The low rate was at first taken as a sign of the Czech reformers’ success; latterly, it was revealed as too good, as an indication that the needed level of corporate restructuring was not taking place in the privatized firms. The recent steep rise in Czech unemployment (seven percent and climbing at the end of 1998) has come about even as the pace of privatization has slowed to almost a halt. Something of the same phenomenon has taken place in Russia; that is, mass and rapid privatization, but a relatively small rate of increase in the official unemployment rate (though there are masses of people officially employed, but working only part time, or not at all but kept on the books, or not being paid, etc.). In Poland and Hungary, in contrast, privatization started and moved much more slowly and neither country followed a “mass” approach. Yet official unemployment grew rapidly in both countries, reaching 16.7 percent in Poland in 1993-94 (down to 9.6 percent in 1998), and 14.1 percent in Hungary in 1993 (falling to 10.8 as of the end of 1996). The conclusion must be that employment levels are as much a function of the scope and pace of overall economic restructuring as they are of ownership.

### *A summation of the critique*

The perception of many—citizens, analysts and a number of leaders—in transition settings, especially in the FSU, as well as a set of knowledgeable external observers, is something quite close to the following:

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<sup>44</sup> Andrew Newell and Mieczyslaw Socha, “Wage distribution in Poland: The roles of privatization and international trade, 1992-96,” *Economics of Transition*, Vol. 6 (1), 1998, p. 47.

<sup>45</sup> The Eastern Europe and Central Asia region of the World Bank is commissioning a study on this topic.

<sup>46</sup> Rebecca Sewall, “Gender Impact of Privatization,” unpublished paper delivered to the World Bank Group — NGO Dialogue on Privatization, Washington, DC: October 21-22, 1997.

In far too many privatization transactions, in far too many transition countries, mass and rapid privatization has turned over mediocre assets to large numbers of people who have neither the skills nor the financial resources to run them well. Most high-quality assets have in one way or another (sometimes by “spontaneous privatization” that preceded official schemes; sometimes by manipulation of the voucher schemes; perhaps most often and acutely in the non-voucher second phases or in secondary trading) gone to the resourceful, agile and politically well-connected few. In many instances where ordinary citizens managed to obtain and hold minority blocks of shares in the high-quality firms, they have been induced to turn over these shares to others at modest prices, or they have seen, without warning or much of a subsequent explanation, the value of their minority shares fall to nothing.

These outcomes occur most acutely where the post-transition state structures are weak and fractured. This allows significant parts of government to become captured by groups whose major objective is to use the state to legitimate or mask their acquisition of wealth. (Poor outcomes can also occur when stronger governments fail to create a modicum of prudential regulation for financial and capital markets.) The international financial institutions must bear some of the responsibility for the poor outcomes, since they so often insisted on the primacy of economic policy (or uncritically followed the lead of intensely committed reformers). That is, they requested and required transition governments to privatize rapidly and extensively, assuming that private ownership by itself would provide sufficient incentives to shareholders to monitor managerial behavior and push firms to good performance. Competitive policies and institutional safeguards could follow at a later date; the key need was to create a basic constituency of property-owners. The prime assumption was that to build capitalism, one needed capitalists; lots of them, and fast.

But capitalism is revealed to require much more than private property; it functions because of the widespread acceptance and enforcement in an economy of fundamental rules and safeguards that make the outcomes of exchange secure, predictable, and of reasonably widespread benefit. Where such rules and safeguards, such institutions, are absent, what suffers is not just fairness and equity, but firm performance as well. Why? Because in an institutional vacuum the chances are high that no one in a privatized firm is interested in maintaining the long-run health of the assets.

Too many supervising state officials become interested mainly in extracting rents, selling licenses, permissions and protection to the firm, rather than enforcing policy. Even, or perhaps especially, when the state retains a significant minority share and representation on the firm’s Board of Directors (as is common in many transition countries), the likelihood is high that the representatives are looking more for perks, payoffs and protection of bureaucratic interests rather than ways to boost shareholder value. Faced with many voiceless shareholders, and a rapacious or ineffective state that makes it difficult to believe in the sanctity of property rights (and inflicts punishing tax and interest rates), the manager of the firm may conclude that it is simply not possible or at least not worthwhile to try to promote shareholder value. The easier courses of action

are to lobby the state for assistance, or to strip assets and walk away—and this last can often be arranged with the collusion and blessing of supposedly supervisory government officials or private bankers or fund managers. Workers, shareholders or not, are caught in the maelstrom, searching for some stability and safety, and hoping only to maintain their jobs. The other mechanisms of corporate governance—financial and capital markets, the economic and financial press, the insolvency/bankruptcy regimes—are too weak or embryonic to constitute much in the way of counterweights.

In such circumstances, privatization is more likely to lead to “stagnation and decapitalization” than to improved financial results and enhanced efficiency.

### III. Can the problems be corrected?

This is a substantial indictment of privatization, sufficient to establish that at least in some institutionally-weak settings privatization's promise has not been fulfilled, and a number of mistakes made. But is the evidence sufficient to condemn the concept? The answer is no.

#### *The defense...*

The first counterpoint to criticism is the mass of rigorous studies cited in section I. Conducted in a wide variety of sectoral, geographical and income settings, they show that firms tend to perform much better after privatization than before, as measured by a number of financial and operating efficiency indices at the level of the firm. There is a smaller amount of evidence, mainly from a number of middle- and high-income economies, showing welfare improvements resulting from privatization.

The question, of course, is whether one can expect similar positive results in transition settings. Country conditions do matter; several studies indicate that the lower a country's income, the less dramatic or speedy the results of privatization, and the more likely the process can go wrong<sup>47</sup>. As noted above, and again below, countries in CEE—closer geographically, historically and culturally to Western commercial traditions and markets—have generally privatized more swiftly and with much better results than their more Eastern counterparts (a more optimistic interpretation would be that the positive results of privatization are taking much longer to turn up in most of the FSU than in CEE or the Baltic states). There are important differences among countries, in terms of location and history, and in vital if conceptually murky areas such as institutional density and capacity, and adherence to the rule of law. These factors affect the choice of privatization policies and approaches, the ways in which these will be implemented, and the financial and economic outcomes obtained.<sup>48</sup> But these caveats do not contradict the main point: the mass of empirical evidence indicates that privatization, correctly conducted, produces positive benefits. For transition countries, on the basis of this worldwide evidence, the question to ask is not, “should one privatize?” but rather, “how can privatization be better done?”

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<sup>47</sup> This was, for example, noted by Boubakri and Cosset, *op. cit.*

<sup>48</sup> This has long been recognized. Sunita Kikeri, John Nellis and Mary Shirley (in *Privatization: The Lessons of Experience* (Washington, DC: World Bank, 1992)) concluded that the two key factors determining privatization outcomes were the nature of the market into which the firm was being divested—competitive or non-competitive—and “country conditions;” i.e., a country's “overall macroeconomic policy framework and capacity to regulate....In unfavorable country settings, where the existing private sector is small, capital markets are thin, and the interest of external investors is limited, the sale of enterprises even in competitive sectors may be more difficult.” (pp. 4-5)

This conclusion is not accepted by all. Given the difficulties elaborated above, and drawing on the general criticism of Tandon, one could argue—and many do—that the best course of action for transition economies, especially in the FSU, is to postpone further privatization until competitive forces and an enabling institutional framework are in place. And as noted, there are those who call for the renationalization of some or many firms already divested, with the intention of managing them more in the public interest, through greater state involvement. The more liberal of these critics might add that some or all of these could be sold again in the future, when firm and market conditions are improved, and investors are offering better prices.

The response to this line of reasoning is made up of three parts.

***1. In some transition settings, privatization produces clear benefits...***

The first and easy point to make is that a return to statism would be blatantly nonsensical in CEE and the Baltic states. There, the trials of the Czech approach notwithstanding, the evidence is strong that privatized firms generally and significantly outperform state-owned companies. Two studies (previously referred to; see footnote 16) presented very strong evidence of the superior performance of privatized firms, particularly in Poland, Hungary and the Czech Republic. Looking at a variety of performance indicators, in 6,300 firms, in seven countries, up to the end of 1995, Pohl, Anderson, Claessens and Djankov found that privatization was “the key to restructuring,” as divested firms registered much higher rates of productivity growth, investment, and positive operating cash flows than SOEs in the sample.<sup>49</sup> This study also concluded that any form and method of privatization, other than giving ownership to workers, produced these positive results, a disputed issue to which we shall return. Note that the highest percentage of strongly performing privatized firms in this study are found in the maligned Czech Republic; and that the principal author states that an updating of the data base shows this still to be the case as of the end of 1997 (though Hungarian firm performance was by then just about as good as that of the Czechs).<sup>50</sup>

Frydman, Gray, Hessel and Rapaczynski reviewed the effects of privatization on corporate performance in a sample of 188 Czech, Polish and Hungarian firms (half privatized, half state); the data examined were drawn from the years 1990 through 1994. They found that private ownership, except for cases where workers become owners, “dramatically improves the most essential aspects of corporate performance,” particularly in terms of revenue generation.<sup>51</sup> Moreover, the privatized firms in their sample laid off relatively few employees in the early days of transition, and “generate significant employment gains relative to state firms.” Indeed, the authors argue that “privatization is the dominant employment strategy in transition.”<sup>52</sup> This study also tested for the presence

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<sup>49</sup> Pohl *et al.*, *op. cit.*, pp. V of the summary, and p. 10.

<sup>50</sup> Communication from Gerhard Pohl, August 1998.

<sup>51</sup> Frydman *et al.*, *op. cit.*, p. 29.

<sup>52</sup> *Ibid.*, p. 30.

of selection bias (see above, pages 5-6) and found none, indeed the opposite: Where insiders obtained better firms they tended to manage them badly; outsiders tended to get below average firms but turned them around, as measured by later revenue performance.<sup>53</sup>

Papp, Long, Kopanyi and Mihalyi reviewed Hungary's privatization efforts and found them far from faultless, with neither income to the seller nor competitive forces being generated to the extent feasible (but note that Hungary has earned more than \$8 billion US from privatization sales, more than any other transition country in CEE and the FSU). Still, their overall conclusion was that:

privatization has led to better asset management and corporate governance; to greater efficiency in production, restructuring and modernization of older enterprises; to the production of new and improved products; and to a greater export orientation.<sup>54</sup>

Simonetti, Rojec and Rems looked at the relationship between financial and operating performance and ownership form in Slovenia. Because of the Yugoslav heritage of the "social capital" concept, ownership is a particularly tangled issue in Slovenia. Six ownership categories were examined: private firms (but not privatized); foreign owned firms, firms majority privatized to insiders, firms majority privatized to external buyers, non-privatized (socially owned), and state firms (mainly public utilities). Their sample of 1,902 firms represents about ¾ of industrial assets, sales, and employment in Slovenia; the period covered was 1994-96. The results: Foreign owned firms (few in number) are doing the best, averaging a respectable 5.4 percent return on equity in this period, versus 3.9 for private firms, minus .03 for internally privatized, 1.2 for externally privatized, minus 4.6 for non-privatized firms, and minus .60 for the state firms.<sup>55</sup> When one adds profit margin

foreign and private companies remain much better than companies from other ownership categories, followed by internal and external companies with positive figures, while non-privatized and state companies are pretty much under water.<sup>56</sup>

While their performance is hardly outstanding, Slovenian privatized firms are doing much better than the companies remaining in the category from which they escaped, which is the poorest performer by just about every measure. This last is an important point: the standard against which privatized firms should be measured is the performance of the non-privatized sector from which they were drawn, and not some theoretical ideal.

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<sup>53</sup> *Ibid.*, p. 29. The methodological rigor of this study is exemplary; but it must be admitted that the sample size is small, the firms are medium in size (perhaps larger firms are more difficult to turn around?), and the data somewhat dated.

<sup>54</sup> Anita Papp, Millard Long, Mihaly Kopanyi and Peter Mihalyi, "Privatization: Restructuring Property Rights in Hungary," in Lajos Bokros and Jean-Jacques Dethier, *Public Finance Reform During the Transition: The Experience of Hungary* (Washington, DC: World Bank, 1998), p. 339.

<sup>55</sup> Marko Simonetti, Matija Rojec and Marko Rems, "Enterprise Sector Restructuring and EU Accession of Slovenia," unpublished paper that will form Chapter 6 in the World Bank's forthcoming Country Economic Memorandum for Slovenia, 1999, p. 12 of draft.

<sup>56</sup> *Ibid.*

Looking at large privatized firms in Slovakia, Djankov and Pohl found generally improved performance, even though most of them had been turned over to the old managers; that is, to the very insiders whose ownership is so often hypothesized to account for poor performance elsewhere.<sup>57</sup>

Much indirect evidence suggests that liberalizing reform in general and privatization in particular produce good results. Estonia privatized the vast bulk of its enterprises in quite short order (mostly to external investors; vouchers were used in a minority of cases, in each instance to divest a minority of shares).<sup>58</sup> The country returned to positive GDP growth quite rapidly, and sustained it; Estonia is the only transition country to register some double digit growth rates, and is still growing at a high rate despite the world and Russian crises. Haltiwanger and Vodopivec, analyzing the effects of Estonian reform on labor, found that in the early days following the separation from the Soviet Union, “job destruction dramatically increased, but later in transition, hires and job creation surged as well.” The layoffs tended to take place in large, manufacturing and remaining state-owned firms. Job creation took place in smaller, service-oriented, private companies. “These results suggest that Estonia’s liberal and radical reforms enabled huge worker and job reallocations without producing massive unemployment.”<sup>59</sup> Much of the job creation came about in new entry firms, but the privatized companies contributed to the growth as well.

Thus, there is a fair amount of evidence to suggest that privatization in CEE and the Baltic states in the main works, and works well, and that the portrait of privatization drawn at the end of section II is excessively negative and critical, at least in this part of the transition world.

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<sup>57</sup> Simeon Djankov and Gerhard Pohl, “The restructuring of large firms in the Slovak Republic,” *Economics of Transition*, Vol. 6 (1), 1998, p. 67.

<sup>58</sup> See John Nellis, “Finding Real Owners: Lessons from Estonia’s Privatization Program,” *Viewpoint* No. 66, The World Bank, 1996.

<sup>59</sup> John Haltiwanger and Milan Vodopivec, “Gross Worker and Job Flows in a Transition Economy: An Analysis of Estonia,” unpublished paper in the World Bank seminar series on Poverty, Household Economics and Rural Development, December 1998, from the Abstract.

## 2. Renationalization is unlikely to work....

The second part of the response is that renationalization would be a desperate measure, with a high likelihood of failure, particularly in those FSU settings where it is most likely to be espoused. The idea certainly has *prima facie* appeal: select some or all of the most egregiously misprivatized firms and put them back in the portfolio of the state; then sell them again, but this time do it correctly. Correctly, presumably, would mean: in an open, transparent manner, with valuation procedures in line with standard international practice, with the heavy involvement of internationally recognized, professional financial and transaction advisors, with full disclosure of all relevant information to all bidders, with no restrictions on the number or nationality of these bidders, with no restrictions post-sale such as maintaining the same line of business, the same number of employees, etc.

But how many transition governments outside the CEE (or even within) could reasonably be expected actually to undertake this process and handle it well; how many have the capacity to prevent asset-stripping in state-owned companies, or the capability (technical and political) and willingness to divest firms according to this set of procedures? Regrettably few. As Shirley has shown, the irony is that countries with the administrative skills and political capacity to run state-owned firms in an effective and efficient manner are usually the very same countries that can privatize well. Conversely, the forces and conditions that lead governments to botch privatization are the same that hinder decent SOE management. Shirley's important point, significant not just in the renationalization context but in response to the concerns of Tandon and Stiglitz as well, is that very few governments have the luxury of choosing between enhancing competition or changing ownership. Her findings reveal that it is a mistake "... to think of privatization as totally distinct from reform of enterprises under continued state ownership. Rather the two demand similar, politically costly reforms and tend to succeed or fail together."<sup>60</sup>

Shirley's recommended course of action in countries clearly not ready for major reform—into which category fall some if not many of the FSU countries—is to build the foundation for reform

...by reducing fiscal deficits to increase pressures for SOE reform by making the burden of SOE deficits explicit; easing trade restrictions to strengthen exporters who can become a constituency for SOE reform when SOE inefficiencies harm their ability to compete in global markets; removing barriers to entry since new entrants can also be a voice for reform; eliminating regulatory and policy obstacles to new job creation (such as restrictions on firing or taxes or subsidies that encourage employers to substitute capital

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<sup>60</sup> Mary Shirley, "Bureaucrats in Business: The Roles of Privatization versus Corporatization in State-Owned Enterprise Reform," forthcoming in the journal *World Development*, from p. 28 of the unpublished draft text. Shirley made related points in her earlier "Why Performance Contracts for State-Owned Enterprises Haven't Worked," *Viewpoint* No. 150, World Bank, August 1998.

for labor) and uncoupling SOE jobs and social services such as education or health care to encourage labor mobility.<sup>61</sup>

These steps might be sufficient to launch reform in a mixed economy in which the SOE sector accounts for a fifth of less of GDP. But it is hard to see these measures turning the tide, except perhaps in the very long run, in institutionally-weak transition economies. There the problem is not revealing the costs and inefficiencies of the SOE sector, but rather establishing the basic rules for any form of ownership to be efficient. Moreover, in transition countries the remaining SOEs are only part of the problem; the equal or greater question is what to do about misprivatized firms, a question the Shirley measures would only obliquely address.

Evidence suggesting that many transition governments will find it difficult to restructure firms under state ownership is provided by Djankov in his case study of Romanian efforts to “isolate” a set of large, financially troubled companies, and to subject them to analysis to determine what was required for their recovery and sale, or closure. Djankov presents data showing that “... none of the intentions of the isolation program were fulfilled. Worse still, the program may have delayed restructuring by not imposing hardened budget constraint on loss-making enterprises.” He concludes that transition governments should “... privatize rapidly, and not attempt to restructure enterprises prior to privatization.”<sup>62</sup>

The conclusion: renationalization is not the alternative; rather ways must be found to privatize correctly, and to set and enforce performance standards on those already privatized. The critical question, of course, is how can this be done?

### 3. *What’s wrong with caution?*

The third part of the response is much more intricate. Even if one accepts the notion that renationalization is unlikely to work, one could still make an argument that further rapid privatization need not be pursued. The reasoning is that in institutionally-weak and politically fractured transition countries, long removed from or never fully integrated into the Western commercial tradition, one should halt privatization of the remaining portfolio (majority or minority stakes), and shift efforts to:

- strengthening market-supporting institutions (mainly public but some private as well), with the goal of channeling present “wild east” commercial activity into socially productive and acceptable modes, and
- imposing discipline on and competition in the remaining public enterprises, accompanied or followed by staged, incremental shifts in ownership patterns, in a more or less evolutionary, Chinese-style manner.<sup>63</sup>

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<sup>61</sup> Shirley, “Bureaucrats in Business....,” *op. cit.*, p. 30.

<sup>62</sup> Simeon Djankov, “Enterprise Isolation Programs in Transition Economies,” Policy Research Working Paper No. 1952, Washington, DC: World Bank, 1998, p. 10.

<sup>63</sup> In essence, this is the approach long recommended by Michael Intriligator, Robert McIntyre, Marshall

Once again, the idea has a *prima facie* appeal; and it is what some other governments such as Vietnam have tried to do, with some early success.<sup>64</sup> But once again, the solution assumes the existence of the desired end state at which the solution aims—an effective state mechanism and institutional framework.

The paradox is that those countries which largely or fully rejected the communist state and political systems, but which possessed little or nothing of a capitalist past to anchor them, are having considerable trouble moving in an orderly manner to the market system. There is an irony inside the paradox: it is the once planned Asian economies that have avoided or evaded a political transition, and that have maintained administrative competence and political legitimacy sufficient to allow them to discipline the most blatant forms of theft and corruption, that have so far best combined the move to market principles and tactics—but without formal privatization—with maintained growth. By this reasoning the Soviet Union might have successfully adopted such an evolutionary strategy in (say) the 1960s or early 1970s, but by the time the attempt was made by Gorbachev in the late 1980s, state power and legitimacy had sunk to such a level that the attempt failed.<sup>65</sup>

A second and powerful part of the explanation for the inapplicability, or difficulty in adopting, the Chinese approach is that China's economy was structurally so different from that of Russia and other parts of the FSU. That is, China embarked on its form of transition at a time when agriculture accounted for over 70 percent of GDP, and industry only 15; the corresponding figures in Russia were 13 and 42 percent.<sup>66</sup> One should acknowledge the courage and vision of Chinese policy-makers who launched and sustained the liberalizing reforms. But one must also recognize that shifting resources from agriculture to non-traditional forms of industry was a different, more manageable task than restructuring an industrial base that produced almost nothing for private needs. It is thus not surprising that attempts in CEE or the FSU to find a slower and less painful

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Pomer, Dorothy Rosenberg and Lance Taylor; see their "Checklist for Action in the Russian Economy," *Transition*, Vol. 6, Nos. 9-10, September-October, 1995, pp. 10-11. See also my response, "The Dangers of *Dirigisme*," in the same issue, pp. 11-13, which prefigures some of the argument made in this paper.

<sup>64</sup> At least for a time. But even before the East Asia crisis, investor enthusiasm for Vietnam was waning, for reasons of both policy and interfering practices. Moreover, Vietnam has not experimented as broadly or boldly as China with ownership models. To the end of 1998 less than 50 small and medium firms have been "equitized," the Vietnamese term for divesting ownership to firm insiders. See Reza Amin and Leila Webster, "Equitization of State Enterprises in Vietnam: A Progress Report," Mekong Project Development Facility, Hanoi, Vietnam, March 1998.

<sup>65</sup> This reasoning is similar to that found in Jeffrey Sachs and Wing Thye Woo, "Structural Factors in the Economic Reforms of China, Eastern Europe and the former Soviet Union," *Economic Policy*, April, 1994, pp. 102-145.

<sup>66</sup> World Bank, *From Plan to Market* (Washington, DC: World Bank, World Development Report, 1996), p.21.

move to the market, without much privatization, have also not proven effective: in Ukraine, Romania, in Bulgaria prior to the 1997 elections, and in Belarus.<sup>67</sup> During periods of extended non-privatization, many state-owned enterprises in these countries have had their assets stripped; when privatization does eventually come, there will probably be little left to transfer.

The overall assessment appears bleak: privatize incorrectly and the result will not be increased production, job creation, and increased incomes, but rather “stagnation and decapitalization.” But keeping enterprises in the hands of a weak and venal state is likely to lead to much the same thing. In both instances the evident long-term solution is to build up the administrative and policy-making, and enforcing, capacities of the government. To repeat, exactly what needs to be done in this regard to produce a public service with the public interest in mind, exactly how one goes about doing it, what is the role of external assistance in this procures, and how long it will take to effect reasonable progress—these are all questions that have been insufficiently addressed, questions to which we lack a satisfactory and operational set of answers.

Can anything be done in the shorter term? Several transition governments have tried to compensate for managerial deficiencies by contracting out much or all of the privatization process to agents and advisors. For example, at the beginning of its privatization program the government of Estonia relied heavily on German technical assistance from the *Treuhandanstalt*, obtaining not simply expertise but an entire approach, which was applied with great success. The Bulgarian Privatization Agency has turned over to “privatization agents and transaction advisors” (PATAs, as they are termed) much of the responsibility for the sale of some 30 large firms, and has “pooled” batches of smaller firms, and contracted out the sales effort to private actors;<sup>68</sup> results are starting to flow in. The government of Uzbekistan has resolved to privatize 30 of its largest firms delegating major responsibility to international financial advisors in every step of the process. Romanian officials have expressed an intent to follow a similar procedure for 200 plus of the largest firms remaining in state hands. These efforts go beyond the common tactic of employing experienced consultants to assist a national privatization agency; they turn over significant decision-making power to the agents employed. They are attempts to circumvent the constraining political process; to find technical solutions to perceived political and institutional difficulties.

But it is neither possible, nor at all desirable, to eliminate entirely the role of the sovereign. Worldwide experience has shown that it is imperative that representatives of

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<sup>67</sup> With its regulated prices and minimal privatization of medium and large firms, Belarus is an anomaly both in terms of policy and outcomes—so far. Outside observers argue that Belarus’s relative stability in terms of output and job maintenance is fragile, heavily dependent on the volatile Russian market, and thus potentially unsustainable. The fact remains that at the moment the unemployment rate in Belarus is lower, and the wage arrears much less, than in Russia or Ukraine.

<sup>68</sup> See N. Alexieva, J. Nellis, T. O’Brien and Lada Stoyanova, *A Review of Bulgarian Privatisation* (Paris: OECD, paper tabled at seminar on Bulgaria: Enterprise Privatization: Progress and Issues, November, 1998), p. 9, for a description of the approach.

the body politic ultimately approve and ratify, and be seen to ratify, the privatization recommendations of technical advisors and agents. If this is not done, there will be no political counterweight to offset the claims and allegations of opponents.

Technicians and politicians often, perhaps even normally, differ as to what constitutes an appropriate or acceptable transaction. In good circumstances, such as in Estonia, a spirit of compromise prevails: for example, German advisors strongly opposed the use of vouchers as harmful to corporate governance and revenue generation, while the political authorities needed a mechanism to garner public support for a contentious program. Both sides eventually agreed on a scheme whereby a minority of shares (and only in some firms) was exchanged for vouchers, after a core investor had taken a majority, controlling stake. In Russia, on the other hand, an effort to construct a case-by-case privatization program, with intensive use of private sector financial advisors has not produced the anticipated results, as Russian authorities have been reluctant to turn over to the agents anything other than accounting and valuation exercises. The Bulgarian PATA program has produced some results and promises more, but not without significant strains and disputes between the agents and the supervising government officials over the issue of the extent of the agents' decision-making powers. It took four years of difficult negotiations for a variety of Polish governments to put together their "mass" privatization program, which in effect hands over to private agents (organized in National Investment Funds) the task of taking some 500 larger firms to market—but it is now producing good results. The point is that contracting out is an option worth considering, but it is far from a generalized or speedy solution. And the effectiveness of the effort still, as always, depends heavily on the existence of a modicum of governmental will and capacity.

Based on experience with privatization in Russia, Uzbekistan, Poland and Romania, Itzhak Goldberg argues for what he terms "reprivatization."<sup>69</sup> The idea is that the principal obstacle to progressive restructuring in privatized firms in Russia and elsewhere is the excessive concentration of ownership in the hands of insiders who lack the means and incentives to lead the firms forward.<sup>70</sup> Accepting the futility of renationalization, Goldberg argues instead for increasing the capital in privatized firms, and then diluting the stake of insiders by sales of the resulting shares to external investors. His list of steps, in addition to the capital increase, required to bring about this opening to "real" owners includes:

- strengthening mechanisms that allow owners to select managers;

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<sup>69</sup> This phrase and notion, and many of the ideas in the following paragraphs, were provided by Itzhak Goldberg, of the World Bank, in several written communications in December, 1998 and January, 1999.

<sup>70</sup> In contrast to the view of Pohl *et al.*, *op. cit.*, that all forms of privatization, to insiders or outsiders alike (other than to workers alone), result in positive outcomes, Goldberg's is the increasingly accepted view. See Frydman *et al. op. cit.*, as well as Philippe Aghion and Olivier Blanchard, "On privatization methods in Eastern Europe and their implications," *Economics of Transition*, Vol. 6, (1), 1998: "...outsider ownership is a necessary, although not a sufficient condition for deep restructuring and there is little evidence of strategic restructuring in firms without outsider ownership..." (p. 88)

- improving labor mobility;
- strengthening disclosure and audit;
- strengthening the rights of shareholders.

To the question, how can new shares be issued without the cooperation of existing owners, the answer is that the Russian government, for one, could rather easily bring about a capital increase in many firms. As noted, most privatized firms are heavily in arrears on their tax payments. Moreover, government has retained a minority stake in the majority of privatized firms. A conversion of tax debt to equity would provide government with a substantial set of shares to sell. In many cases the addition to capital, when added to the retained shares, would be large enough to provide a purchaser with a controlling stake.

This proposal is both a long-term and a partial solution (in the sense that only some firms will attract core investors). Moreover, the political and institutional deficiencies elaborated above deeply effect both the likelihood that a government would undertake such a set of corrective measures, or would succeed in implementing them even if it made a sincere effort to do so. The suggestion is that the reforming elements in the transition governments, and the international assistance community—the international financial institutions, the European Community, the bilateral donors—abandon speed as a priority and shift their efforts to a necessarily slower and less dramatic form of case-by-case or tender privatization, aimed at creating, from the bottom up, the climate in which monied, core, competent investors can and will take over the presently stagnant and decapitalized firms.

Overall, despite the many and evident obstacles hindering good privatization policy and practice, there seems to be no alternative, even (or especially) in institutionally weak transition countries, to a continuation of efforts to privatize. Those efforts may differ considerably from those of the recent past; and they may need to be less ambitious in scope and accept a slower pace of implementation. But they need to continue.

#### IV. Conclusions

So the answer is, yes, it is time to rethink privatization, at least in those transition settings where history, geography and politics have so readily channeled seemingly laudable economic policy into sub-optimal outcomes. In Russia and elsewhere too much was promised of privatization, both by reformers who seemed at first to view ownership change as a sufficient condition to bring about a new liberal order, and—less forgivably—by external advisors and aid providers, whose hopes for fast and relatively simple solutions may have clouded their judgment on whether the necessary supporting systems for privatization were in place, or on how long it would take to put them in place, and what was likely to happen in their absence.

But the admission of error should not be overdone. The fact remains that:

- When it can be carried out correctly, privatization is the right course of action. Recall that in a number of CEE transition countries the policy is an undoubted success, far superior to letting the firms remain in state hands.
- In most countries and sectors around the world privatization yields great benefits at the level of the firm; it was not immediately obvious that some transition countries would differ from some of the low-middle income, institutionally weak, non-transition settings in which privatization has been successful. Early transition evidence showed a strong correlation between liberalization/stabilization and a return to growth;<sup>71</sup> and it was thought privatization was an integral part of this reform package. The problems of the approach emerged later, in corrupt second-phase sales for cash, in the lack of restructuring in insider-dominated firms, in the unregulated actions of investment funds, etc. Many critics voiced concerns about vouchers, but few anticipated how badly some of the post-voucher transactions would be conducted.
- Those who say they predicted the problem all along had and have nothing much of an alternative to offer. Given the large differences in political systems and starting conditions, the option to privatization in most transition settings is not likely to be some Chinese-style combination of macroeconomic reform and unclear property rights resulting in high growth, but rather asset stripping and further stagnation under ineffective state supervision.
- Complaints from inside the countries are more justified, but must be examined carefully. Doubtless, many transition government officials opposed to privatization are expressing sincere convictions, based on the assessment that the policy is not working or is proving too costly. But just as clearly, some are benefiting greatly from the continued state involvement in many firms, and in the close relation between government and business that provides many opportunities for rent-seeking. Their assertions of the superiority of continued state involvement are suspect.

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<sup>71</sup> See *From Plan to Market*, World Development Report of 1996, *op. cit.*, which presents the evidence for these points in the Introduction and Chapters 1 and 3.

- One must continually ask, what was and is the alternative to privatization? It is **not** clear that Russia would be better off today had it avoided mass privatization in 1992-94. Several other institutionally-weak transition economies that eschewed, delayed or approached privatization more cautiously have little to show for it: Belarus, Bulgaria, Romania and Ukraine, for example (though in no case is privatization or its absence the whole of the explanation).
- The radical reformers in then Czechoslovakia, Poland, Russia and elsewhere insisted at the outset that speedy privatization was essential to create a constituency for transition to the market, to prevent further asset stripping, to sever the links between the enterprises and the state; and most dramatically, to prevent the communists from returning.<sup>72</sup> In retrospect, it appears that more time was available than thought. The return of communism in its traditional format was not a realistic possibility (though the failure of reform may be increasing the prospect). It might have been possible to approach privatization in a more deliberate manner; the results might have been less insider ownership and domination, less resistance to external investors, more protection for minority shareholders, etc. But recall again that those countries that tried a slow approach have not made a go of it.
- Armenian officials vigorously argue that despite the problems of their privatized firms, the absence of external purchasers, plus the need for speed, gave them no choice but to proceed with voucher privatization. While they would of course prefer that a higher percentage of the privatized firms were turning round, they argue that even very weak private owners are better than state ownership. In state hands these firms today would be making irresistible claims on non-existent public resources, threatening the whole of the hard-won reform program. The same argument could be made in other countries.

So, in sum:

- Privatization remains the generally preferred course of action, but its short-term economic effectiveness and social acceptability depend on the existence of the institutional underpinnings of capitalism. Where these are present, privatization should and can go forward.
- If these underpinnings are missing, but the government is effectively addressing their construction or reinforcement, then it might be better to delay privatization until this effort is bearing fruit, Hungary and Poland are cases in point.
- The heart of the matter is where government is unwilling and incapable. The evident long-term course of action is to support measures enhancing will and capacity (assuming one knows what they are). Nonetheless, the reasonable short-term course of action is to push ahead with case-by-case and tender privatization along the lines espoused by Goldberg, in cooperation with the international assistance community, in hopes of producing success stories that will lead by example

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<sup>72</sup> The most tightly reasoned argument along these lines is found in the writings of three economists deeply involved in the Russian privatization program; Maxim Boycko, Andrei Shleifer and Robert Vishny. See in particular their *Privatizing Russia* (Cambridge: MIT Press, 1995).