

Competition and Corporate Governance in Transition

By: Saul Estrin

William Davidson Working Paper Number 431
December 2001

Competition and Corporate Governance in Transition

Saul Estrin*
December 2001

Abstract

This paper examines the elements of institutional development critical to the enhancement of company performance in transition economies. This includes initial conditions, forms of privatization, institutional frameworks and the competitiveness of markets. Comparing empirical evidence, the paper concludes that there is a clear distinction in effectiveness of policies followed and their impact between Central Europe and CIS countries. This divergence is attributed to fundamentally different political attitudes toward reform, the need of CIS governments to gain political support for reform and as a consequence of the desire of Central European countries to join European Union.

Forthcoming in the Journal of Economic Perspectives

JEL Classification:

D21, G34, L10, P21, P31

Key Words:

Privatisation, corporate governance, competition, soft budget, transition economies

*London Business School, Regent's Park, London NW1 4SA, United Kingdom

Tel: +44 (0)207 262 5050

Fax: +44 (0)207 724 7875

Email: sestrin@london.edu

Improved company performance must be at the heart of any successful transition from a command to a market-oriented economy. The standard pattern in the transition economies has been to seek improved companies by heightening competition and sharpening corporate governance in various ways: through privatization of state-owned firms; by allowing and encouraging new firms and competition between existing firms; and via the withdrawal of government subsidies so that firms must face their own profits and losses -- what is referred to in this literature as a "hard budget constraint."

However, this pattern has had mixed success. The ability of these reforms to improve corporate performance appears highly sensitive to the institutional environment and initial conditions in which the policies were introduced, along with the specific nature of the policies enacted. As Djankov and Murrell (2000, pp. 69) write of the experience in the Commonwealth of Independent States (CIS), which is made up of Russia and 11 other nations that were formerly republics of the Soviet Union: "[P]rivatization, hardened budget constraints and product market competition all appear to be important determinants of enterprise restructuring in non-CIS countries, while they are less effective in the CIS. We hypothesise that the difference in impact is due to varying degrees of institutional development between the regions." Similarly, while privatization seems to have improved company performance in almost all developed and middle income countries, the record is less convincing in transition economies, and notably in the former Soviet Union (Estrin and Wright, 1999; Nellis, 2000). Once again, the reason relates to the forms of privatization used and variations in the legal and institutional environment.

The transition economies make a particularly good laboratory for understanding the dynamics of market evolution and for evaluating the impact of alternative policy frameworks (Djankov and Murrell, 2000). It is useful to distinguish two elements in microeconomic transition:

the restructuring of existing activities and the reallocation of resources (Commander, Dutz and Stern, 2000). Restructuring entails enhanced performance within existing firms through changes in objectives, incentives and constraints on managers and results from ownership changes, though improvements also depend on the resulting ownership structure, the legal and institutional arrangements for corporate governance and the nature and performance of the capital market. Reallocation of resources depends more broadly on whether the market structure is competitive and on the rules and institutions affecting entry, exit, bankruptcy and the competitive interactions between incumbents, as well as the trade regime and government policy with respect, for example to enterprise subsidies. The two forms of restructuring are related because success in the development of institutional and legal frameworks for corporate governance and capital market regulation is likely to be associated with success in promoting competitive entry and exit, as well as effective competition and trade policy.

This paper explores the elements of institutional development critical to the enhancement of company performance in transition economies. These include the initial conditions; the forms of privatization; the institutional and legal framework, especially the corporate governance structure; the relationship between the private sector and the state; and the competitiveness of product markets, including the impact of international trade.

The Legacy of Central Planning for Enterprise Reform

At the beginning of the transition process, the functioning of the centrally planned economy was well understood (for example, Ellman, 1989). But in retrospect, the implication of this heritage for subsequent microeconomic behavior was probably underestimated.

In most communist countries, the allocation of resources was primarily through quantity-

based planning. There was no market in the supply of goods, either for final products or intermediates. Labor was effectively rationed via an internal passport system. Capital was allocated centrally through a single institution, typically described as a "monobank." Firms were not autonomous decision-making units; it is better to conceive of them as production units within an economy that was run as a single giant firm. Firms were not financially independent and did not have the responsibility for sales or pricing.

Central planning left behind a legacy of grave difficulties for market-oriented reform. Since planners provided the mechanism whereby supply and demand were intermediated, firms rarely had direct contact with suppliers, purchasers or final consumers. These relationships, which form the glue for a market economy, were therefore largely nonexistent when planning was abolished, and there were significant transaction costs in their creation. One especially painful manifestation of the lack of relationships with suppliers arose as part of the deep recessions that the transition economies experienced in the early 1990s, when the disappearance of the central planners greatly disrupted production, especially production with longer and more complex supply chains (Blanchard, 1997; Blanchard and Kremer, 1997).

Not only were firms in a planned economy out of touch with suppliers, but they were out of touch with consumers as well. The planning system was more aimed at the preferences of planners, with a focus on heavy industrial production, than on the preferences of consumers. As a result, major restructuring was needed in the transition process to bring supply in line with the patterns of consumer demand.¹

The planning system also encouraged persistent excess demand for labor and capital, since firms would ask for a high level of supplies and then expect the central planner to send them a lower amount. Thus, there was no experience, either on the side of lenders or on the side of borrowers, in decentralized allocation of investment. Instead, managerial incentives were focused

on production targets. Rewards for innovation or quality enhancement were weak or perverse; that is, those who innovated were often expected to start meeting higher standards or quotas than those who did not.

The structure of the planned economy did not permit competition, entry or exit. To ease the informational demands of planning, firms in the communist economies were often gigantic and vertically integrated in ways that would not have emerged in a market economy (Ellman, 1989). Small state-owned firms were rare and privately-owned firms were officially nonexistent. Once markets were liberalized post-transition, their structures were therefore highly concentrated. Moreover, the processes of competitive rivalry were weak or nonexistent. Entry was effectively impossible, except if the state wanted to create a new firm. Exit was also usually impossible, given the political objectives of full employment supported by a system of government subsidies to loss-making enterprises (Schaffer, 1998). The political system fundamentally favored incumbent firms; at the local level, relationships were very close between politicians and senior management (Aslund, 2000). The communist countries also typically experienced little competition from foreign producers, since trade relationships across the Soviet bloc were governed and limited by a communist planning arrangement called the Council for Mutual Economic Assistance (CMEA).

A final legacy of central planning was an impetus toward illegal activity. As early as the 1970s, a number of transition economies ran ongoing budgetary deficits, which meant that there was more purchasing power in the economy than the official plan production could absorb. Since prices were fixed, this excess of purchasing power resulted in shortages and in the accumulation of monetary balances (Bennett, 1989). These features, along with the other shortcomings of the planned economy in meeting the desires of consumers, helped to create a black economy, which has been associated with corruption and organized crime and which has persisted into the transition period (Johnson, Kaufman and Shleifer, 1997).

This legacy was not identical across the Soviet bloc, because central planning was conducted in a variety of ways. Three of the largest differences across the transition economies involved the extent and effectiveness of the planning system; the degree of openness of the economy; and the institutional and legal traditions.

Not all communist countries were centrally planned in the Soviet-type mould. Yugoslavia - which has since turned into five successor states of Slovenia, Croatia, Serbia and Montenegro, Macedonia, Bosnia -- had adopted its own lighter form of economic planning in 1952, as did Hungary in 1968 and Poland in the early 1980s. In these countries, consumer preferences were allowed to guide production decisions at least to a limited extent, so that the inconsistency between the pattern of domestic demand and the structure of supply was less serious. In 1989, for example, industrial production, much favored of central planners, represented 55 percent GDP in Armenia, 48 percent in Russia and 59 percent in Czechoslovakia, but only 36 percent in Hungary and 44 percent in Slovenia. Moreover, in the former Yugoslavia, as well as in Hungary and Poland, some progress had been made in establishing enterprises as autonomous units, with some responsibility for employment, production, sales, exports and even investment decisions. However, there had been only limited progress in incentives for managers or the imposition of financial disciplines.² Poland took some steps toward allowing the entry of small private firms and Hungary even took tentative steps towards an autonomous financial sector, though market structures even in these countries remained everywhere highly concentrated (Newberry and Kattuman, 1992). The problems in establishing a market economy and the issues of black economy and corruption were less serious in countries that had already decentralized the planning process.

Countries in the former Soviet bloc also varied significantly in their degree of openness to international trade. A few countries were virtually autarchic; for example, in 1989 Albania exported only 5 percent GDP of GDP and Romania only 12 percent, which are exceedingly low trade shares

for small economies in the middle of Europe. Other countries exported a larger share of GDP, but mostly within the CMEA trading arrangement between Soviet bloc countries; for example, of Russia's 28 percent of GDP that was exported, 64 percent was within CMEA, and of Ukraine's 30 percent of GDP that was exported, 82 percent was within CMEA. Other countries had relatively high levels of trade, at least by the standards of the transition economies, and exported mainly to developed western economies; for instance, Czechoslovakia, Poland, Slovenia and Hungary exported 24, 33, 24 and 28 percent of GDP, respectively, but 59, 50, 81, and 65 percent of these amounts, respectively, went to western countries. These differences in trade clearly reflected the extent of market interconnectedness, but they also reveal something about the levels of competition in these economies and their levels of exposure to market-oriented business practices.

The transition economies also had significantly different histories, which was reflected in their institutional and legal traditions. Countries and areas from the former Austro-Hungarian empire such as Czechoslovakia, Hungary, southern Poland and Slovenia had a western European legal tradition as well as a rich experience of capitalism prior to World War II. Indeed, these countries typically already had a fairly complete (if outmoded) commercial code on the statute books. However, most of the Balkan states had inherited a Turkish legal and institutional system, with a less clear-cut or enforceable commercial code and rather less experience of the market economy. Soviet experience with capitalism had been shorter, and was far more distant, so the legal basis and the mindset for a market system in Russia and the countries of the Commonwealth of Independent States was even more tenuous.

Many of the differences in initial conditions at the time of the transition away from command economies tended to disfavor the former Soviet Union, and thus left an especially difficult legacy for Russia and the countries of the CIS. As just mentioned, the Soviet economy had especially inflexible and extensive central planning, relatively low openness to western trade, and a

market-unfriendly legal system. In addition, the Soviet economy was much larger and more complex, in the sense of degree of vertical integration, than most countries of central Europe. Thus, the removal of central planning left a larger gap behind, which was a factor in the deeper and more sustained output decline in Russia and the CIS in the 1990s (Blanchard and Kremer, 1997; Bevan et al., 2001a). Moreover, the size, population dispersion and the poor transport infrastructure of Russia and many of the other CIS countries made it harder for international trade to play a pivotal role in introducing competition. Many central European economies such as Poland, Hungary, Czechoslovakia and the Baltic states looked to western Europe as a role model and therefore sought speedy admission to the European Union, while Russia and the other states of the CIS did not. This desire to become part of western Europe led to more accelerated trade reform, price liberalization and enhanced competition policy in central European countries.³ Finally, macroeconomic imbalances were particularly severe in the Soviet Union, which meant that the extent of bottled-up purchasing power was very large, and the black economy was deeply entrenched.

Enterprise Reform Paths

Improving company performance must mean, in part, providing incentives for efficient behavior. Owner-managed firms, private firms and state firms each create a distinctive set of incentives for efficiency.

Under owner-management, the prospects for accumulation and dissipation of firm-specific rents through inefficiency, by managers or the labor force, are likely to be significantly lower than in private or state firms, because owners have a direct incentive to keep a close eye on things.

In some cases, ownership may be concentrated into the hands of banks, funds or families who undertake monitoring of enterprise performance directly. Such monitoring by a concentrated

ownership blocks does not quite have the same powerful incentives for efficiency as actual owner-management, but it can also work fairly well.

But when ownership and control are widely separated, then problems can arise. In a private firm when hired managers have different objectives than the often diffused group of owners, then managers will have an incentive to use firm-specific rents to satisfy their own objectives like providing a low level of effort or gaining personal control over corporate income and assets. In firms where workers have significant ability to share in company-specific rents -- for example, via formal collective bargaining structures -- the focus of workers on higher wages or reduced effort can also reduce efficiency or profitability (McDonald and Solow, 1985).

However, a private ownership system also has a range of mechanisms for placing significant limits on insider discretionary powers, including capital markets, statutes prohibiting certain behaviors, transparent accounting procedures, and monitoring mechanisms. The stock market, for example, can be an important mechanism for corporate control. The quality of managerial decision-making is an input in the choice of investors, whose judgement on company performance is summarized in the share price. If the managerial team is thought to be incompetent or venal, the share price will be low relative to otherwise comparable firms, which can place pressure on managers in various ways. Stock price can be linked to managerial pay and bonuses. It can get a manager fired or hired. A persistently poor corporate performance can also encourage an alternative managerial team to make a takeover bid.

A state-owned firm suffers from the separation of ownership and control in an especially virulent way, and it is very hard for state economic planning to replicate the pressures that are available to privately owned firms. The state as owner often has ambiguous objectives -- say, meeting an output quota, adding to employment, providing quality-of-life benefits to workers, and not losing money. These various objectives can lead to the setting of inconsistent targets which, in

the context of inadequate performance monitoring and governance structures, increases managerial discretion (Estrin and Perotin, 1991). The state may need to subsidize firms to ensure that the firm reaches the range of desired outcomes, which can further dilute managerial incentives (Kornai, 1980). State-owned enterprises are not subject to private capital market disciplines, so the competitively driven monitoring systems and the threat of takeover or bankruptcy is absent. Moreover, even though the state ownership stake is concentrated, the government rarely has people with sufficient skills, resources, and clout to monitor efficiently or to enforce constraints on insiders.

These arguments have particular resonance in the transition economies. Under communism, the monitoring of management and the incentives for efficiency were already weak. But with the collapse of central planning and the lack of any other external constraints, managers and insiders in transition economies gained almost total discretion to follow their own objectives, leading to "asset stripping" by managers, job and wage guarantees for workers, and rent absorption by all parties. This pattern was exacerbated in countries with a well entrenched black economy, and sometimes led to a virtual "capture" of the state owned apparatus, including the natural resource and utility sectors, by unscrupulous managers (Aslund, 2000).

The transition economies have tried in a number of ways to improve incentives for efficiency. Privatizing state-owned enterprises is often thought of as a major first step toward creating better incentives for enterprise efficiency, and in this section, we begin with a discussion of privatization in the transition countries. However, as noted earlier, privatization is dependent on a range of other policy changes and institutions to work well. Thus, we next turn to market-supporting institutions, notably the encouragement of product market competition, international trade and limits on government subsidies to the enterprise sector.

Privatization

At the beginning of the transition process, privatization of state-owned firms was widely regarded as the most significant element of reform at a microeconomic level. The Czech privatization minister, Dusan Triska said in 1992 (as quoted in Nellis, 2000): "Privatization is not just one of many items on the economic program. It is the transformation itself." While in retrospect this statement seems too sweeping, privatization is clearly a useful method to focus enterprise objectives on profits and efficiency, to sharpen managerial incentives to attain these objectives and to institutionalize a separation between the state and the enterprise sector.

The sheer scale of privatization in the transition economies has posed a number of practical problems. After all, in the transition countries, privatization involved selling the bulk of firms in the previously state-owned industrial sector. At the aggregate level, the stock of domestic private savings in these countries was too small to purchase the assets being offered. Foreign direct investment has rarely been available on the scale required, either (UN World Investment Report, 1999). In addition, the administrative capacity of transition governments -- many of them ruling newly created countries -- to establish a suitable legal and institutional environment for privatization, was also open to question (EBRD Transition Report, 1999; Estrin and Wright, 1999).

For a few selected firms, many transition economies used auction or public tender methods. Such sales could in principle be to domestic or foreign purchasers but, in practice, only Hungary and Estonia were willing or able to sell an appreciable share of formerly state-owned assets to foreigners. Foreign capital ended up purchasing about 20 percent of the privatized assets in Hungary and up to 50 percent in Estonia. Even in these countries, the preponderance of foreign ownership has given rise to considerable public disquiet. Because of the fear of foreign ownership, sales of state-owned enterprises have mainly been to a country's own citizen: either to external capital owners or to insider management-employee buyouts. Managers and employees were the

more common initial buyers, perhaps because they had insider knowledge about their company's business prospects. Some governments, with Romania as a prominent example, have also actively encouraged the emergence of insider-owned firms with ownership centered upon trusts controlled by managers and or workers (Earle and Estrin, 1996).

Rather than using auctions to privatize state-owned assets, some countries also experimented with restitution to former owners; prominent examples include the former East Germany, Hungary, the former Czechoslovakia and Bulgaria. Restitution has the advantage that it immediately creates a property-owning middle class and re-establishes "real ownership." However, the process of restitution entails legal complexities. For example, suppose that a factory has been built on a plot of land formerly owned by a farmer. Does the farmer receive the land, and therefore rental for the factory? Should the farmer be compensated for the value of the property at the time of its seizure, and if so how is such an evaluation to be made some 50 years later? Restitution also raises the deep question of how the assets accumulated during the communist era, when consumption levels were held down for national capital accumulation, should be distributed. Since the burden of lower consumption was imposed on everyone, the argument that the distribution of the resulting assets should be egalitarian has been a powerful one.

Problems in implementing the auction and the restitution strategies for privatizing led a number of transition countries to attempt "mass privatization." This approach entails placing into private hands nominal assets of a value sufficient to purchase those state assets to be privatized. To avoid the inflationary consequences of such wide-scale "money" creation, the new assets must be nontransferable and not valid for any transaction other than the purchase of state assets. This method has usually been implemented via privatization vouchers or certificates.

Mass privatization has been carried out in a number of different ways, which can be categorized along three dimensions. The first issue is whether the vouchers or certificates are

distributed equally to the population as a whole or whether, as in Russia and many CIS states, management and employee groups receive highly subsidized shares. Governments in these countries used the offer of subsidized or free shareholdings to insiders to diffuse potential opposition to privatization from managers and workers. Second, policymakers need to determine whether vouchers can be exchanged directly for shares in companies, or whether the vouchers are invested in funds that own a number of different companies. In the Czech and Slovak republics and in Russia, vouchers could be exchange directly for shares, although financial intermediaries soon emerged, offering their services to voucher-holders in the selection of share portfolios (Estrin, 1994; Coffee, 1996). In the Polish scheme, citizens' vouchers were exchanged for shares in government-created funds that jointly owned former state-owned enterprises. Funds and other financial intermediaries were expected to provide some counter to the dangers of ownership diffusion inherent in a mass privatization scheme. A third question for mass privatization concerns the mechanism whereby the vouchers would be traded for ownership rights in firms. The Czechs and Slovaks set up a computerized system to mimic a general equilibrium market clearing process, so that shares in enterprises were transferred in waves comprising hundreds of firms simultaneously (Earle, Frydman and Rapaczynski, 1993). In Russia, Ukraine, and many of the CIS states, firms were privatized singly or in groups, at a time chosen by management. Insider control of the process often led to nontransparency and insider domination of ownership.

Table 1 reports the methods of privatization used in the transition economies. Nineteen of the 25 countries listed used some form of mass privatization as either a primary or secondary method (Estrin and Stone, 1997). Nine countries used management-employee buyouts as their primary methods, with six more using them as their secondary method. Only five countries used direct sales as the primary privatization method -- and these five are among the most developed and advanced transitional economies.

Mass privatization was an excellent solution to the problem that state ownership was omnipresent and domestic wealthholders were insufficient to buy the assets. The mass privatization strategy also facilitated an extremely speedy ownership change in most transition economies, as few countries had contained a private sector of any significance in 1990. (Exceptions were Hungary and Poland, where the private sector represented over 40 percent of GDP in 1991.) But in the transition economies as a whole, the private sector contribution to GDP was usually less than 20 percent. The resulting transformation, as traced in a series of reports by the ERBD (1994, 1995, 2000) is extraordinary. As early as 1994, the private sector share was above 50 percent in nine countries: again Hungary and Poland, along with Russia, the three Baltic nations of Estonia, Latvia, Lithuania, and Armenia, Czech Republic and Slovak Republic. However, it remained true in 1994 that eight former republics of the Soviet Union -- Belarus, Turkmenistan and others --- still had private sector shares of less than 20 percent of GDP. By 2000, the private sector in five additional nations had reached at least 50 percent of GDP -- Armenia, Bulgaria, Croatia, Georgia, and Kazakhstan -- and only two laggards, Belarus and Turkmenistan, still had private sector activity below 25 percent of GDP.

This remarkable performance should not conceal the real concerns about the extent and quality of privatization, and therefore about its consequences for enterprise restructuring. First, much privatization remains to be done, especially of large-scale firms in the industrial sector and utilities. When one looks at privatization of assets in large-scale enterprises, only in five transition countries -- Bulgaria, Czech Republic, Estonia, Hungary and Slovakia -- were more than half of the assets in large-scale enterprises in private hands by 2000 (EBRD, 2000).

A second issue is that even where a degree of privatization has occurred, in many transition economies the state has continued significant shareholdings in companies. For example, the Russian state retained more than a 20 percent share in 37 percent of privatized firms, and kept more

than a 40 percent share in 14 percent of the firms that it privatized (Earle and Estrin, 1997). Only in half of privatized firms did Russia sell its entire holding. Bennett, Estrin and Maw (2000) report the findings from a survey of privatized firms undertaken in every transition country in 1999. In 20 of the 23 countries listed, the state has retained some shares post-privatization. On average, the state retained some shares in around 20 percent of privatized firms, with more than a 20 percent shareholding in around 12 percent of the firms. Retained state shareholdings are negligible in some of the leading transition economies: Czech Republic, Hungary and Latvia. But the state kept a share of more than 15 percent of privatized firms in Albania, Belarus, Georgia, Lithuania, Poland, Romania, Russia, and Ukraine, and more than 30 percent of privatized firms in Bulgaria, Croatia, Slovenia and Uzbekistan.

But perhaps the most important problem with privatization is not that more remains to be done (although it does). Rather, it is that the privatization has rarely led to effective corporate governance mechanisms. Indeed, Stiglitz (1999a, b) has argued that the long "agency chains" implicit in mass privatization -- the many links that separate the citizen who receives a privatization voucher from a company manager -- cannot provide appropriate incentives for corporate governance. Voucher privatization usually led to ownership structures that were highly dispersed. Typically the entire adult population of the country or all insiders to each firm, were allocated vouchers with which to purchase the shares of the company (Estrin, 1994). In principle, it was possible that financial intermediaries would aggregate individual voucher holdings and carry out effective monitoring of management. Indeed, in Czech Republic, Poland, Slovenia and Slovakia, some effort was made to create such concentrated intermediate agents. However, even in this case, it was not always clear who was monitoring the monitors. (Simoneti, Estrin, Bohm, 1999). To quote Stiglitz (1997), "The voucher investment funds provided a vehicle for high power abuse."

The way that mass privatization was carried out in many countries often led to majority

ownership by insiders. This was probably largely for political reasons (Boycko, Shleifer and Vishny, 1995), especially in countries where the pro-reform forces were politically weak (Bennett, Estrin and Maw, 2000). According to Earle and Estrin (1997), insiders held a majority shareholding in 75 percent of firms in Russia immediately post-privatization (1994) and outsiders only 9 percent. Insider ownership predominantly took the form of majority worker ownership. However, this created little problem for management because worker ownership was so highly dispersed. Indeed Blasi, Kroumova and Kruse (1997) argue that control was effectively in the hands of management in Russian employee owned firms, a hypothesis supported in Bevan et al. (2001b). Outsider ownership was also typically highly dispersed, with much of it in the hands of banks, suppliers, other firms and an assortment of investment funds.⁴

This pattern of extensive employee ownership seems broadly consistent with the evidence for other countries in the Commonwealth of Independent States. In Ukraine, insiders owned 51 percent of shares in all privatized firms in 1997 -- managers 8 percent and workers 43 percent -- while outsiders held 38 percent and the states residual share was 11 percent (Estrin and Rosevear, 1999).

The situation appears somewhat different in central Europe, although we lack the accumulated firm surveys that are available for Russia. However, discursive evidence suggests that, for example, insider and foreign ownership were predominant in Hungary, and insider and *de novo* ownership in Poland. The Czech Republic is an alternative case where investment fund ownership predominated. Takla (1999) carried out enterprise-level surveys in Czech Republic, Hungary, and Poland that suggest such a composition of ownership of firms in these countries.

Thus, practical problems of privatizing most of the firms in an economy, combined with the perceived political need to privatize and in an equitable manner, led to the widespread use of mass privatization methods. But these methods failed to ensure the initial establishment of "a strategic

owner:" a single shareholder with sufficient stake to provide motivation for monitoring effectively. Moreover, ownership structures have not been evolving towards concentrated outsider ownership. For example, in Russia, outside shareholding has increased at the expense of the state and insiders during the 1990s, but ownership is also becoming increasingly dispersed and the greater degree of outside ownership may largely represent the fact that former insider voucher owners have left the firm but retained their shares. In Ukraine, insiders have increased their shareholdings, though concentration has slightly increased as managers have been buying shares from workers. Thus, rather than evolving towards the structure of a firms owned by a concentrated group of outsiders, as was hoped by reformers (Boycko, Shleifer and Vishny, 1995), enterprises in the CIS appear to have remained primarily owned by dispersed groups of employees or outsiders. This pattern suggests major deficiencies in the legal, institutional and market environment in which the newly privatized enterprises have been operating, which are hindering the emergence of efficiency-enhancing ownership structures. The success of privatization in providing incentives for managers has been linked to the existence of other institutional developments that have allowed dispersed owners to monitor enterprise managers.

Institutional Developments Supporting Private Ownership

A number of authors have laid out what they see as the important institutional steps through which dispersed owners can provide incentives for managers to act in their interests, rather than to expropriate surpluses for themselves. For example, Stiglitz (1999b) emphasizes that with dispersed ownership, one needs to see the rapid evolution of effective securities market and clear protection of shareholder rights. Black (2000) outlines five institutions that he considers to be important to permit effective monitoring in a situation of dispersed ownership: i) effective regulation of the securities market; ii) accounting rules, independent audits, and extensive financial disclosure; iii) a

sophisticated accounting and banking profession; iv) a stock exchange with meaningful listing standards; v) company and insider liability for false or misleading information. Many analysts also emphasize that if minority shareholders are not protected, then controlling owners or managers have incentives to strip assets from the firm – for example, by selling the assets of the enterprise to their own wholly-owned subsidiary at a knock-down price.

The situation in transition economies in these areas is perhaps best summarized by indicators given by the European Bank for Reconstruction and Development on the securities market and non-bank financial institutions. On a scale of 1-4, 1 represents little progress; 2 indicates a rudimentary exchange and legal framework; 3 means making some progress (securities are being issued by private firms, there is some protection of minority shareholders and the beginnings of a regulatory framework); 4 means that countries have relatively liquid and well-functioning security markets and effective regulations; while 4+ countries have reached the standards and performance norms of advanced industrial countries.

These rankings make uncomfortable reading for those who believed that a growing private sector would drive the emergence of supportive capital market institutions. By 1994, when most countries had attained significant private sector shares, only five countries had a ranking of 3 in developing matching capital market and corporate governance mechanisms. All five of these countries were central European countries that had commenced transition in a relatively advanced situation: Czech Republic, Hungary, Poland, Slovakia and Slovenia. The situation had not improved markedly by 2000. Ten countries had not altered their category in the five years, and the situation in financial institutions had actually deteriorated in Russia, Slovakia and Slovenia. The main bright spots were Poland and Hungary, which had achieved a ranking of 4 (albeit a 4-), and the improved rankings in the Baltic states of Lithuania, Latvia, and Estonia (EBRD, 1995, 2000).

These capital market failures were almost certainly an important element in the failure to

improve company performance after privatization in many countries. Most shares in privatized companies were either in effect nontradeable or only tradeable in a nontransparent way. Outsiders were not motivated to purchase majority stakes in firms because the information available to them before purchase was too weak and their protection from abuse or theft by insiders was insufficient. Ownership structures therefore on average changed little or not at all, while asset stripping by management was rife, particularly in Russia and countries in the Commonwealth of Independent States (Aslund, 2000; Estrin and Wright, 1999).

Competition and Trade

The weakness of product market competition has also been particularly serious in the transition economies. Of course, monopoly power yields firm-specific rents that distort resource allocation. But in the context of this paper, the important issue is that product market competition can complement capital market pressures as a mechanism for exercising discipline on management (Nickell, 1996).

As noted earlier in this paper, many transition economies entered the reform era with highly concentrated market structures. In Poland, in 1990, the leading firm had a market share in excess of 30 percent in more than 60 percent of markets, and more than 60 percent in 25 percent of markets (Newberry and Kattuman, 1992). Any overall measure of concentration for Russia misses the very real regional fragmentation of product markets. Even so, Earle and Estrin (1998) find Russia's four-firm concentration ratios in 1994 have a mean of around 27 percent with a standard deviation of 21.6 percent. Moreover, 25 percent of the firms surveyed reported that they have no major competition in their primary market. Brown and Earle (2001) report a relatively high Herfindahl index across 264 Russian sectors of 0.3, with a standard deviation of 0.156.

Transition economies had few small firms in 1990, and despite the success of small-scale

privatization programs in most countries (Earle, Frydman and Rapaczynski, 1993), their impact has remained relatively slight in much of the region. Table 2 shows that the employment share of small and middle sized firms (with fewer than 200 employees) was low, and always well below that found in advanced western economies.⁵ The share for small and medium firms is relatively larger in the countries of central Europe -- Croatia, Czech Republic, Poland, Hungary, Romania and Slovakia -- and the relatively lower share in Russia and the CIS states. However, it may be that many smaller firms in Russia and the countries of the CIS are involved in informal sector and illegal activities, and thus are not reported in official data.

Entry of new firms has generally been weak in most transition economies, with the exceptions of Hungary and Poland. Poland in particular is frequently held up as the economy that has nurtured rapid *de novo* growth (Johnson and Loveman, 1995). An interesting international study by Blanchflower, Oswald and Stutzer (2001) sought to measure "latent entrepreneurship" as shown, for example, in an individual preference for self-employment as against employment. They found that latent entrepreneurship is globally highest in Poland (with 80 percent of survey respondents) as against 70.8 percent in United States, 64 percent in Germany and 45 percent in United Kingdom. Some transition economies do have very low latent entrepreneurship scores, like Russia at 33.2 percent and Czech Republic at 36.8 percent, but so do a few western countries, like Norway at 26.9 percent. In commenting on these results, Dabrowski, Gomulka and Rostowski (2000, p. 14) conclude: "[O]ne cannot distinguish between ex-Soviet and mature Western market economies on the basis of the willingness of their population to undertake self-employment."

Evidence on the rapid pace of new entry in Poland and the rest of central Europe can be derived from data on the number of firms, and the size distribution of firms in the early years of transition (Bratkowski, Grosfeld and Rostowski, 2000). In the Czech Republic, for example, the total number of firms increased from around 1,600 in 1990 to more than 7,100 in 1994 while the

average employment of firms decreased, with the share of firms employing fewer than 300 workers rising from 25 percent to 56 percent. In Hungary, the number of limited liability companies increased from 19,000 in 1990 to 91,000 by 1994. In Poland, the increase was from 36,000 limited liability companies in 1990 to 95,000 in 1994. These patterns offer strong evidence of additional firms, whether created from scratch or by the break-up of existing enterprises.

Nonetheless, entry barriers in transition economies are nonetheless significantly higher than in the west. Djankov et al. (2000) address this issue in a study on the regulations for *de novo* firms in 75 countries. Table 3 reproduces their findings on the cost of entry for the transition countries covered in their survey, in comparison with the United States, Germany and Sweden. It is significantly harder, takes longer and is relatively more costly to set up a new firm in all the transition economies than in western Europe or North America. However, transition economies show considerable variation in entry costs: they are surprisingly low in Romania, Ukraine and Bulgaria, and highest in Hungary, Czech Republic and Russia. The authors find that entry costs are correlated with higher corruption and larger unofficial sectors of the economy.

Russia and the nations of the CIS seem to combine low levels of "latent entrepreneurship" in their populations and high costs of entry, which helps to explain why entry of new firms has been much slower in Russia and the CIS than in, say, many countries of central Europe. Russia continues to have few firms; there were 2.7 million legally registered enterprises in Russia in 1997; one enterprise per 55 Russians, compared with a ratio of around 1 in 10 in western countries and in Poland or Hungary. Although the number of Russian firms is increasing, and the market structure is tending to become slightly less concentrated (Brown and Earle, 2001), domestic competitive forces have developed more slowly in Russia than in central Europe.

Foreign trade can also serve as a source of product market competition, so that import competition substitutes for relatively weak competitive pressures from domestic markets (Estrin

and Holmes, 1998). In fact, increased competition from imports has been one of the most successful aspects of transition policies, though primarily for the central European countries seeking accession to the European Union. Table 4 reports scores on trade and foreign exchange liberalization in 1994 and 2000. Again, the scores vary on scale from 1 to 4, with 1 representing widespread import and export control and limited access to foreign exchange and 4+ the benchmark of advanced industrial economies. As early as 1994, there were relatively few trade or exchange controls in central Europe, the Balkans and the Baltic states.⁶ Trade liberalization was less advanced in the Russia and the CIS, but even in Russia, foreign exchange was readily available and few import restrictions existed. Trade liberalization had spread even more widely by 2000; 11 transition countries had attained the standards of advanced industrial economies and a further six had removed all restrictions on trade as well as abolishing discretionary tariffs and introducing free access to exchange rate markets. However, Russia had slipped somewhat between 1994 and 2000 and several other CIS countries remained at the start of trade liberalization.

This liberalization with respect to international movements of trade and capital has heralded an extraordinary growth in the trade share in many transition economies, as well as a reorientation of trade from within the old CMEA trading arrangement within the Soviet bloc toward western Europe. For example, trade in Poland increased from 32.7 percent of GDP in 1991 to 43.6 percent in 1999; in Hungary from 54.9 percent to 93.8 percent; and in the Czech republic from 66.9 percent to 104.2 percent. However, in Russia the trade share dipped from 61.7 in 1993 to 36 percent in 1997, though with the recent rise in oil prices it has since recovered to 62.7 percent.

The forces of competition, both domestic and foreign, could doubtless become more active in the transition economies. However, the substantial increase in competition that has occurred is one of the most important contributions to better incentives for efficient corporate governance in these economies.

Enterprise Exit and Hard Budget Constraints

Exit of firms with negative long run profitability is another crucial element in creating appropriate incentives, both to push managers toward efficient behavior and also for the economy as a whole to reallocate resources. Given that the transition process entailed a major shift in the pattern of demand across the economy -- from industry to services, from demand within the geographic sphere of Soviet bloc planners to world demand, from intermediates to final products -- exit is the mechanism whereby scarce labor, capital and managerial talent departs on its journey from one use to another. However, exit relies on the existence of "hard budget constraints," so that firms which are unable to survive in the market place cannot stay afloat through direct or indirect subsidy. Institutionally, exit relies on the existence and enforcement of bankruptcy laws. Firms that are employee owned and /or managerially controlled may choose to remain in operation, even if expected net present values is negative, if continuation of operations yields significant nonpecuniary benefits like housing, social benefits or black market opportunities.

Establishing realistic avenues for exit has been a problem in many transition economies. Many countries had formal arrangements for bankruptcy, but little actual enforcement (EBRD Report, 2000). There is surprisingly little evidence on exit rates. One example is the work of Balcerowicz, Gray and Hoshi (1998) on the experience of the Czech Republic, Hungary and Poland. They find that government subsidies were withdrawn from firms fairly rapidly in all three countries. In the face of large monetary and trade shocks, however, all three countries found mechanisms for financial accommodation: Poland relied on trade restrictions; the Czech Republic on increases in bad debts; and Hungary on a large budgetary deficit and bad debts in the banking system. Overall, the most important reason for failure to reallocate resources through bankruptcy in the transition economies was not because of legislative weaknesses in the bankruptcy code, nor

because of direct government subsidies to money-losing firms, but rather because of informal financial flows from the government sector to failing businesses.

Table 5 reports the share of direct budgetary subsidies to firms (as a percentage of GDP) in a selection of transition countries from 1991-99. Subsidies were already very low (less than 2 percent) in a few countries in central Europe and the Baltics in 1991, though they exceeded 5 percent of GDP in a number of countries, including Russia and some CIS states as well as the Czech Republic and Hungary. Outside Russia and the CIS, direct government subsidies to firms had been largely eradicated outside by 1999 (though surprisingly, the direct subsidy share remained in excess of 5 percent in the Czech Republic).

However, measures of formal subsidy can significantly understate the extent of indirect government support, especially in Russia and the CIS states. In these countries, weaknesses in the legal system allowed enterprises to survive when they were consistently losing money. Among the most important unpaid creditors were employees and suppliers; wages arrears in Russia rose to an average of six months by 1997 (Earle and Sabirianova, 1998). One of the most significant nonpayers was the Russian government itself, which allowed significant arrears to accrue in state-owned firms and with pensions. Another important indicator of soft budget constraints was the remarkable growth in barter payments, which exceeded 40 percent of enterprise sales in 1997 in Russia, and was only marginally less in Ukraine (Estrin and Rosevear, 1999). Barter facilitates tax avoidance and evasion. For example, it is hard to calculate a value-added tax in a setting where no monetary value is placed on bartered products. In some cases, enterprises were able to trade tax debt for product orders. Indeed, barter can be considered a mechanism whereby the state provided large enterprises with tax subsidies (Gaddy and Ickes, 1998).

The enterprise reform process has seen an array of policies: privatization and new forms of corporate governance; encouragement of entry, exit and trade liberalization; and weakening the

financial relationship between the state and enterprise sector. The story of enterprise reform is still evolving. Considerable work remains to be done, for example, in identifying the extent of competition and the amount of exit, as well as figuring out the effects of different constellations of policies. The variation in policies across transition economies is large, providing an important laboratory to test the impact of particular packages on enterprise performance and restructuring.

Policies and Enterprise Reform: Empirical Findings

There is now a substantial literature on the determinants of enterprise restructuring in transition economies. The most complete recent survey by Djankov and Murrell (2000) cites 89 studies on the impact of privatization; 29 analyses of managerial turnover; 17 on product market competition and 10 on hard budget constraints. Other summaries include Carlin and Landesmann (1997), Estrin and Wright (1999), Nellis (2000) and Commander, Dutz and Stern (2000). Here, we survey the main results established in this literature.

The impact of privatization on the performance of firms in transition economies has for the most part been positive. However, the privatization effect is significantly stronger in central Europe than in the Russia and the CIS countries; in most cases, the impact is around twice the size (Djankov and Murrell, 2000). For example, in Poland the difference in sales growth rate between private and state-owned firms is estimated to be between 5.4 and 8.7 percent; and in central Europe the difference in productivity between to be 4.3 percent. In contrast, the findings for Russia and CIS state are more mixed, with some studies indicating positive performance effects from privatization and other zero or even a negative effect (Estrin and Wright, 1999).

These positive effects of privatization were not apparent in reviews of the literature a few years ago (for example, Carlin and Landesmann, 1997), which suggests that the impact of

privatization on company performance was not immediate. However, while the weight of the evidence has clearly shifted in favour of positive privatization effects in central Europe (Frydman et al, 1999; Claessens and Djankov, 1999), few positive effects have been identified yet in Russia or CIS (Earle and Estrin, 1997; Estrin and Rosevear, 1999; Bevan et al., 2001b).

One warning about all of these privatization results is that the firms were not selected randomly for privatization, but were chosen for political and economic reasons. It may be, for example, that firms more likely to survive on their own were also more likely to be privatized. Although some studies have tried to grapple with this issue, it is intrinsically difficult, and it raises a question about the robustness of all results relating to the effects of privatization.

The empirical evidence confirms the expectation that the identity of the eventual owner affects the outcome of privatization. As discussed earlier, privatization has resulted in a wide variety of ownership structures: large-scale insider ownership by workers and managers, diffuse private ownership, ownership concentrated in investment funds, a few traditional "strategic owners," and foreign investors. Based on 23 studies, Djankov and Murrell (2000, p. 33) conclude that differences in ownership are very important: "Privatization to workers is detrimental, privatization to diffuse individual owners has no effect and privatization to Funds or foreigners has a large positive effect." They find that privatization to investment funds is five times as productive as privatization to insiders, and privatization to foreigners or blockholders is three times as productive as privatization to insiders. Banks and blockholders on average improve company performance about as much as foreign owners. One interpretation of these findings is that the concentration of ownership is crucial, since blockholders, funds, foreigners and banks all have concentrated holdings. The impact of concentrated holdings is also significant in individual studies; for example, Claessens and Djankov (1999) show that a 10 percent increase in the percentage of shares held by the largest five shareholders in the Czech Republic raises labor

productivity by 5 percent.

The relatively poor performance of Russia and the CIS countries in the impact of privatization can therefore be explained by two factors. The first factor is the preponderance of a relatively less effective form of private ownership – specifically, dispersed worker ownership. The second factor is the poor functioning of legal and corporate governance mechanisms and the competitive market environment, which has meant that worker owners have been less effective in improving performance than in countries with a stronger institutional framework, such as Poland (Dabrowski, Gomulka and Rostowski, 2000).

It is hard to test the impact of differences in corporate governance on enterprise performance. Many of the independent variables vary by country rather than by firm, so that it is hard to disentangle differences in corporate governance from country-specific effects. However, studies that have focused on managerial turnover suggest that new managers lead to higher productivity, by 6.2 percent in Czech Republic and 7.3 percent in central Europe (Claessens and Djankov, 1999; Barberis et al. 1996). Similarly, managerial bonus schemes appear to raise total factor productivity; doubling the manager's bonus increases total factor productivity growth by 7.4 percent.

Product market competition has proved to be another important factor in raising company productivity. The results across 67 analyses in 17 papers reported by Djankov and Murrell (2000) look at both domestic and import competition, and then measure the effect on the level of total factor productivity, productivity growth, or price-cost margins. The studies suggest that both domestic and import competition play a significant role in improving company performance. However, once again the effects are more robust for Central Europe. The findings for Russia and CIS are typically not significant, although Brown and Earle (2001) do find significant results for Russia and the CIS states.

Hardness of budget constraints is also an important factor in stimulating enterprise restructuring. Early studies of Poland found that restructuring occurred in state-owned firms prior to privatization, provided budget constraints were hard (for example, Pinto, Belka and Krajewski, 1993). Ten papers have explored the issue econometrically, and they confirm the positive impact of hard budget constraints on total factor productivity, productivity or sales growth. Again, the effect is highly significant in the studies in the non-CIS countries but less consistent for Russia and the CIS states. It is harder to measure the impact of soft budget constraints that are delivered in indirect forms. However, policies which break the links between important economic institutions and the state, like privatization of utilities or the banking sector, probably enhance enterprise performance. Hence, the private sector share of GDP may itself be an important influence on of the impact of privatization.

Conclusions

The transition countries began with very different initial conditions and have since employed a variety of policies with respect to privatization, price and trade liberalization, competition and enterprise support. A few conclusions emerge from this survey of the determinants of enterprise performance.

Initial conditions in the sense of the degree of central planning or the extent of structural macroeconomic imbalances do not appear to have been a fundamental determinant of either reform paths chosen or of subsequent economic performance. Both relatively more reformed economies before the transition -- like Slovenia, Hungary and Poland -- along with relatively less reformed ones -- like the Czech Republic and some countries that were formerly part of the Soviet Union like Estonia, and Latvia -- are all among the current leaders among transition economies (European

Bank for Reconstruction and Development, 2000). However, none of the initially advanced countries have fallen seriously behind.

There does appear to be a sharp distinction in terms of policies followed and their impact between central Europe on the one hand and Russia and the CIS countries on the other. The reasons for these divergences are complex, and may stem from fundamentally different political attitudes towards reform (Aslund, 2000). The economies of central Europe were led by legitimate governments elected on platforms of reform, while the reformers in Russia and many of the CIS countries represented a small but powerful political group advising the president but opposed by much of the parliamentary and civil service structure. Moreover, governments in Russia and other CIS countries had to make compromises in introducing policies to build internal political support for reform, perhaps because they faced more deeply entrenched managerial interests. This pattern resulted in reforms that were less conducive to improved enterprise performance and restructuring, notably with respect to privatization methods, corporate governance, competition and subsidy. Moreover, many central European countries wanted to integrate into the European Union, which provided their governments with additional legitimacy in the adoption of western European laws and institutions. Taken together, these factors imply inferior performance in economic restructuring in Russia and the CIS.

Finally, transition policies underlying enterprise restructuring must be regarded as complements, not substitutes. Privatization alone will not be enough; enterprise reform will also require effective corporate governance and hard budget constraints.

Acknowledgements

The author would like to thank Alan Bevan, Simon Commander, Renee Friedman and Mario Nuti for comments. A first draft of this paper was presented at a JEP conference at CERGE-EI, Prague, Czech Republic, held on March 23, 2001, and funded by the Andrew W. Mellon Foundation.

References

- Aslund, Anders. 2000. "Go Long on Russia." *International Economy*. 14:4, pp.38-39.
- Aukutsionek, Sergei *et al.* 1998. "Dominant Shareholders, Restructuring and Performance of Privatized Companies in Russia: An Analysis and Some Policy Implications." *Communist Economies and Economic Transformation*. 10:4, pp.495-518.
- Balcerowicz, Leszek, Cheryl W. Gray and Iraj Hoshi, eds. 1998. *Enterprise Exit Processes in Transition Economies: Downsizing, Workouts, and Liquidation*. Budapest: Central European University Press.
- Barberis, Nicholas, Andrei Shleifer and Robert Vishny. 1996. "How Does Privatization Work? Evidence from the Russian Shops." *Journal of Political Economy*. 104:4, pp.764-790.
- Bennett, John. 1989. *The Economic Theory of Central Planning*. Oxford and Cambridge, Mass.: Blackwell.

- Bennett, John, Saul Estrin and James Maw. 2001. "Mass Privatisation and Partial State Ownership of Firms in Transition Economics." Discussion Paper no.2895, Centre for Economic Policy Research.
- Bevan, Alan *et al.* 2001a. "Extending the Economics of Disorganisation." *Economics of Transition*. 9:1, pp.105-114.
- Bevan, Alan *et al.* 2001b. "The Determinants of Privatised Enterprise Performance in Russia." Centre for New and Emerging Markets, London Business School, mimeo.
- Black, Bernard S. 2000. "The Legal and Institutional Preconditions for Strong Securities Markets." Working Paper no.179, Stanford Law School, Stanford University.
- Blanchard, Olivier. 1997. *The Economics of Post-Communist Transition*. Clarendon Lectures in Economics. Oxford: Clarendon Press.
- Blanchard, Olivier and Michael Kremer. 1997. "Disorganization." *Quarterly Journal of Economics*. 112:4, pp.1091-1126.
- Blanchflower, David, Andrew Oswald and Alois Stutzer. 2001. "Latent Entrepreneurship Across Nations." *European Economic Review*. 45:4-6, pp.680-691.
- Blasi, Joseph, Maya Kroumova and Douglas Kruse. 1997. *Kremlin Capitalism: Privatizing the Russian Economy*. Ithaca: Cornell University Press.
- Boycko, Maxim, Andrei Shleifer and Robert Vishny. 1995. *Privatizing Russia*. Cambridge, Mass.: MIT Press.
- Bratkowski, Andrzej, Irena Grosfeld and Jacek Rostowski. 2000. "Investment and Finance in *De Novo* Private Firms: Empirical Results from Czech Republic, Hungary and Poland." *Economics of Transition*. 8:1, pp.101-116.

- Brown, David and John Earle. 2001. "Privatization, Competition and Reform Strategies: Theory and Evidence from Russian Enterprise Panel Data." Discussion Paper no.2758, Centre for Economic Policy Research.
- Buck, Trevor *et al.* 1996. "The Process and Impact of Privatization in Russia and Ukraine." *Comparative Economic Studies*. 38:2-3, pp.45-69.
- Buck, Trevor *et al.* 1999. "Corporate Governance and Employee Ownership in an Economic Crisis: Enterprise Strategies in the Former USSR ." *Journal of Comparative Economics*. 23:3, pp.459-474.
- Carlin, Wendy and Michael Landesmann. 1997. "From Theory to Practice? Restructuring and Dynamism in Transition Economies." *Oxford Review of Economic Policy*. 13:2, pp.77-105.
- Claessens, Stijn and Simeon Djankov. 1999. "Ownership Concentration and Corporate Performance in the Czech Republic." *Journal of Comparative Economics*. 27:3, pp.498-513.
- Coffee, John C. Jr. 1996. "Institutional Investors in Transition Economies: Lessons from the Czech Experience," in *Corporate Governance in Central Europe and Russia*. Roman Frydman, Cheryl Gray and Andrzej Rapaczynski, eds. Budapest: Central European University Press.
- Commander, Simon, Mark Dutz and Nicholas Stern. 2000. "Restructuring in Transition Economies: Ownership, Competition and Regulation," in *World Bank Economic Review: Annual Development Conference Proceedings*. Joseph Stiglitz ed. Washington D.C.: World Bank.
- Dabrowski, Marek, Stanislaw Gomulka and Jacek Rostowski. 2000. "Whence Reform? A Critique of the Stiglitz Perspective." Warsaw: Centre for Social and Economic Research, mimeo.

Djankov, Simeon and Peter Murrell. 2000. "Enterprise Restructuring in Transition: A Quantitative Survey." Department of Economics, University of Maryland, mimeo.

Djankov, Simeon *et al.* 2000. "The Regulation of Entry." Working Paper no.7892, National Bureau of Economic Research.

Earle, John and Saul Estrin. 1996. "Employee Ownership in Transition Economies," in *Corporate Governance in Transition*. Roman Frydman, Cheryl Gray and Andrzej Rapaczynski, eds. Budapest: Central European University Press.

Earle, John and Saul Estrin. 1997. "After Voucher Privatization: The Structure of Corporate Ownership in Russian Manufacturing Industry." Discussion Paper no.1736, Centre for Economic Policy Research.

Earle, John and Saul Estrin. 1998. "Privatization, Competition and Budget Constraints: Disciplining Enterprises in Russia." Working Paper no.128, Stockholm Institute of Transition Economics.

Earle, John, Saul Estrin and Larisa Leshchenko. 1996. "Ownership Structures, Patterns of Control and Enterprise Behavior in Russia," in *Enterprise Restructuring and Economic Policy in Russia*. Simon Commander, Qimiao Fan and Mark Schaffer, eds. Washington D.C.: World Bank.

Earle, John, Roman Frydman and Andrzej Rapaczynski. 1993. *The Privatisation Process in Central Europe: Economic Environment, Legal and Ownership Structure, Institutions for State Regulation, Overview of Privatization Programs and Initial Transformation of Enterprises*. CEU Privatization Reports. Vol. 1. Budapest: Central European University Press.

Earle, John and Klara Z. Sabirianova. 1998. "Understanding Wage Arrears in Russia." Working Paper no.139, Stockholm Institute of Transition Economics.

EBRD. 1994,1995,1998, 2000. *Transition Report*. Various issues. London: European Bank for Reconstruction and Development.

- Ellman, Michael. 1989. *Socialist Planning*. Cambridge: Cambridge University Press.
- Estrin, Saul. 1994. "Labour Markets and Social Policy in Central and Eastern Europe: The Inheritance," in *Labor Markets and Social Policy in Central and Eastern Europe: The Transition and Beyond*. Nicholas Barr, ed. New York: Oxford University Press.
- Estrin, Saul and Peter Holmes, eds. 1998. *Competition and Economic Integration in Europe*. Cheltenham: Edward Elgar.
- Estrin, Saul and Virginie Perotin. 1991. "Does Ownership Always Matter?" *International Journal of Industrial Organization*. 9:1, pp.55-72.
- Estrin, Saul and Adam Rosevear. 1999. "Enterprise Performance and Corporate Governance in Ukraine." *Journal of Comparative Economics*. 27:3, pp.442-458.
- Estrin, Saul and Robert Stone. 1997. "A Taxonomy of Mass Privatization," in *Between State and Market: Mass Privatization in Transition Economies*. Ira Lieberman, Stilpon Nestor and Raj Dessai, eds. Studies of Economies in Transformation, no.23. Washington, D.C.: World Bank.
- Estrin, Saul and Mike Wright. 1999. "Corporate Governance in the Former Soviet Union: An Overview." *Journal of Comparative Economics*. 27:3, pp.398-421.
- Frydman, Roman *et al.* 1999. "When Does Privatization Work? The Impact of Private Ownership on Corporate Performance in the Transition Economies." *Quarterly Journal of Economics*. 114:4, pp.1153-1191.
- Gaddy, Clifford and Barry Ickes. 1998. "Russia's Virtual Economy." *Foreign Affairs*. 77:5, pp.53-67.
- Johnson, Simon, Daniel Kaufman and Andrei Shleifer. 1997. "The Unofficial Economy in Transition." *Brookings Papers on Economic Activity, Macroeconomics 2*. Washington

D.C.: Brookings Institution.

Johnson, Simon and Gary Loveman. 1995. *Starting Over in Eastern Europe: Entrepreneurship and Economic Renewal*. Boston: Harvard Business School Press.

Jones, Derek C. 1998. "The Economic Effects of Privatisation: Evidence from a Russian Panel." *Comparative Economic Studies*. 40:2, pp.75-102.

Kornai, Janos. 1980. *Economics of Shortage*. Amsterdam: North-Holland.

McDonald, Ian and Robert Solow. 1985. "Wages and Employment in Segmented Labor Market." *Quarterly Journal of Economics*. 100:4, pp.1115-1141.

Nellis, John. 2000. "Privatization in Transition Economies: What Happened? What's Next?" Washington D.C.: World Bank, mimeo.

Newberry, David and Paul Kattuman. 1992. "Market Concentration and Competition in Eastern Europe." Discussion Paper no.664, Centre for Economic Policy Research, London.

Nickell, Stephen. 1996. "Competition and Corporate Performance." *Journal of Political Economy*. 104:4, pp.724-46.

Pinto, Brian, Marek Belka and Stefan Krajewski. 1993. "Transforming State Enterprises in Poland." *Brooking Papers on Economic Activity, Macroeconomics I*. Washington D.C.: Brookings Institution.

Schaffer, Mark E. 1998. "Do Firms in Transition Countries Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence." *Journal of Comparative Economics*. 26:1, pp.80-103.

Simoneti, Marko, Saul Estrin and Andreja Bohm. 1999. *The Governance of Privatization Funds*:

Experiences of the Czech Republic, Poland and Slovenia. Cheltenham: Edward Elgar.

Stiglitz, Joseph. 1997. "The Role of Government in Economic Development," in *Annual World Bank Conference on Development Economics*. Michael Bruno and Boris Pleskovic, eds. Washington D.C.: World Bank, pp.11-23.

Stiglitz, Joseph. 1999a. "Whither Reform?" 1999 ABCDE Conference. Washington D.C.: World Bank.

Stiglitz, Joseph. 1999b. "Quis Custodiet Ipsos Custodes? Corporate Governance Failures in the Transition." ABCDE Conference. Paris: World Bank.

Takla, Lina. 1999. "Privatisation Enterprise Restructuring in Transitional Economies: An Empirical Investigation of the Visegrad Countries: 1990-1993." PhD. Thesis, University of London.

UN. 1999. *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development*. Geneva: UN.

Wright, Mike, Trevor Buck and Igor Filatotchev. 1998. "Bank and Investment Fund Monitoring of Privatized Firms in Russia." *Economics of Transition*. 6:2, pp.361-387.

Table 1: Methods of Privatization in Central and Eastern Europe

COUNTRY	PRIMARY METHOD			SECONDARY METHOD		
	Direct sales	MEBOs*	Vouchers	Direct sales	MEBOs*	Vouchers
Albania		+				+
Armenia			+		+	
Azerbaijan			+	+		
Belarus		+				+
Bulgaria	+					+
Croatia		+				+
Czech Republic			+	+		
Estonia	+					+
FYR Macedonia		+		+		
Georgia			+	+		
Hungary	+				+	
Kazakhstan			+	+		
Kyrgyzstan			+		+	
Latvia			+	+		
Lithuania			+	+		
Moldova			+	+		
Poland	+				+	
Romania		+		+		
Russia			+	+		
Slovak Republic	+					+
Slovenia		+				+
Tajikistan		+				+
Turkmenistan		+		+		
Ukraine			+		+	
Uzbekistan		+		+		

Source: EBRD (1998)

* Management employee buyouts

Table 2: Percentage of Employment in SMEs, 1994

Country	% Employment
Belarus	6
Croatia	30
Czech Republic	37
Estonia	45
FYR Macedonia	37
Hungary	24
Kyrgyzstan	3
Poland	23
Romania	27
Russia	10
Slovenia	23
Slovak republic	19
EU 12	69
USA	53
Japan	76

Source: EBRD (1995)

Table 3: Costs of Entry

Country	Number of Procedures for entry ^a	Time for entry (days) ^b	Cost of entry (% GDP per capita) ^c
Bulgaria	11	20	16.5
Croatia	14	77	86.8
Czech Republic	11	97	25.1
Georgia	12	70	28
Hungary	10	53	81
Kazakhstan	12	31	12.5
Kyrgyzstan	9	23	20
Latvia	7	20	27.7
Lithuania	13	66	42.4
Poland	10	26	28
Romania	11	68	11.4
Russia	16	69	37.8
Slovakia	12	110.5	13.1
Slovenia	9	35	7.1
Ukraine	11	21	19.7
US	4	7	9.6
Germany	7	90	8.5
Sweden	4	17	2.5

Source: Djankov et al (2000)

a – Total number of procedures required in order for a firm to set up, in five categories: health and safety, environment, tax, labor and screening.

b – Time represents the number of days required to undertake these procedures.

c – Direct cost of entry procedures, calculated as a percentage of annual per capita GDP.

Table 4: Trade and Foreign Exchange Liberalisation

Country	1994	2000
Albania	4	4+
Armenia	2	4
Azerbaijan	1	3+
Belarus	1	2-
Bulgaria	4	4+
Croatia	4	4+
Czech Republic	4	4+
Estonia	4	4+
FYR Macedonia	4	4
Georgia	4	4+
Hungary	4	4+
Kazakhstan	2	3+
Kyrgyzstan	3	4
Latvia	4	4+
Lithuania	4	4
Moldova	2	4
Poland	4	4+
Romania	4	4
Russia	3	2+
Slovak Republic	4	4+
Slovenia	4	4+
Tajikistan	1	3+
Turkmenistan	1	1
Ukraine	1	3
Uzbekistan	2	1

Source: EBRD (1994, 2000)

Table 5: Budgetary Subsidies to Firms (% GDP)

Country	1991	1994	1997	1999
Azerbaijan	11.2a	5.4	0.7	0.1b
Belarus	8.7a	6.3	1.3	5.6b
Bulgaria	2.0	1.3	0.8	1.5
Croatia	3.9	2.0	1.9	2.4
Czech Republic	6.4c	7.1	7.8	7.7
Estonia	1.5	0.9	0.3	6.9
Georgia	-	13.8	1.5	2.1
Hungary	6.6	5.9	4.9	4.8
Latvia	-	0.2	0.4	5.5
Lithuania	1.4	1.7	0.9	-
Poland	3.3	1.2	0.8	0.4
Romania	13.0a	3.8	2.6	1.9
Russia	-	8.1d	8.2	5.3
Slovakia	4.0a	3.2	2.2	1.7
Slovenia	2.8	1.6	1.3	
Ukraine	-	13.3	5.0	-

a = 1992

b = 1998

c = 1993

d = 1996

Source: EBRD (2000)

Endnotes

1. Evidence from restructuring the military sector in market economies, in periods of declining defense spending, suggests that this might rely disproportionately on entry rather than reorientation of existing suppliers.
2. Indeed, the notion of "soft budget constraints" -- that is, a situation where firms in theory faced real profits and losses but in practice government actions tended to soak up profits and make up losses -- was invented to describe post-1968 Hungary (Kornai, 1980).
3. Accession to the European Union accession meant that the aspiring members had to accept the EU legal framework "off the shelf." This blanket adoption of new laws may have disadvantages in certain fields -- for example, Estrin and Homes (1998) discuss problems that may arise with regard to competition policy -- but overall it provided a driver to more effective institutional and legal reform.
4. For studies of equity ownership in privatized Russian firms using data from 1993 to about 1997, see Earle, Estrin and Leshchenko (1996), Buck et al. (1996), Blasi, Kroumova and Kruse (1997), Jones (1998), Wright, Buck and Filatotchev (1998), Buck et al. (1999) and Aukutsionek et al. (1998). The sample size of these surveys ranges from 100 to 350 firms. Broadly speaking, they confirm the conclusions in the paragraph about the high share of insider employee ownership.
5. The OECD definition of small and medium enterprises is fewer than 500 employees, but the alternative definition makes little difference here, since there were few firms in Central and Eastern Europe in the 200-500 employee range at this time.
6. In 1994, the EBRD scale did not include a ranking of 4+.

DAVIDSON INSTITUTE WORKING PAPER SERIES - Most Recent Papers

The entire Working Paper Series may be downloaded free of charge at: www.wdi.bus.umich.edu

CURRENT AS OF 2/13/02

Publication	Authors	Date
No. 431 Forthcoming in: <i>The Journal of Economic Perspectives</i> , "Competition and Corporate Governance in Transition," 16(2) Feb. 2002.	Saul Estrin	Dec. 2001
No. 430: Corporate Governance in the Cause of Peace: An Environmental Perspective	Don Mayer	Jan. 2002
No. 429: Why do Governments Privatize?	Loren Brandt, Hongbin Li, and Joanne Roberts	Dec. 2001
No. 428: Testing Russia's Virtual Economy	Vlad Ivanenko	Dec. 2001
No. 427: War and the Business Corporation	Eric W. Orts	Dec. 2001
No. 426: Partial Privatization and Firm Performance: Evidence from India	Nandini Gupta	Dec. 2001
No. 425: Direct Foreign Investments and Productivity Growth in Hungarian Firms, 1992-1999	Jérôme Sgard	Nov. 2001
No. 424: Banking Passivity and Regulatory Failure in Emerging Markets: Theory and Evidence from the Czech republic.	Jan Hanousek and Gerard Roland	July 2001
No. 423: Conceptions of the Corporation and the Prospects of Sustainable Peace	Jeffrey Nesteruk	Dec. 2001
No. 422: The Role of the Corporation in Fostering Sustainable Peace	Timothy Fort and Cindy Schipani	Nov. 2001
No. 421: Wage Arrears and the Distribution of Earnings in Russia	Hartmut Lehmann and Jonathan Wadsworth	Dec. 2001
No. 420: Transferring Collective Knowledge: Collective and Fragmented Teaching and Learning in the Chinese Auto Industry	Jane Zhou, Jaideep Anand, and Will Mitchell	Dec. 2001
No. 419: Liberalization, Corporate Governance, and the Performance of Newly Privatized Firms	Narjess Boubakri, Jean-Claude Cosset, and Omrane Guedhami	Dec. 2001
No. 418: The European Data Privacy Directive and International Relations	Steven R. Salbu	Dec. 2001
No. 417: Capital Markets and Capital Allocation: Implications for Economies in Transition	Artyom Durnev, Randall Morek, and Bernard Yeung	Dec. 2001
No. 416: Forthcoming in: <i>The Journal of Economic Perspectives</i> , "Data Watch. Research Data from Transition Economies," 16(2) Feb. 2002.	Randall K. Filer and Jan Hanousek	Dec. 2001
No. 415: Forthcoming in: <i>The Journal of Economic Perspectives</i> , "Transition Economies: Performance and Challenges," 16(2) Feb. 2002.	Jan Svejnar	Dec. 2001
No. 414 Forthcoming in: <i>The Journal of Economic Perspectives</i> , "The Great Divide and Beyond: Financial Architecture in Transition," 16(2) Feb. 2002.	Erik Berglof and Patrick Bolton	Dec. 2001
No. 413 Forthcoming in: <i>The Journal of Economic Perspectives</i> , "The Political Economy of Transition," 16(2) Feb. 2002.	Gérard Roland	Dec. 2001
No. 412: The Response of Consumption in Russian Households to Economic Shocks	Steven Stillman	Oct. 2001
No. 411: Mark-ups in Hungarian Corporate Sector	László Halpern and Gábor Kőrösi	Aug. 2001
No. 410 Forthcoming in: <i>European Economic Review</i> , "Economic Development, Legality, and the Transplant Effect."	Daniel Berkowitz, Katarina Pistor, Jean-Francois Richard	Sept. 2001
No. 409: Development Strategy, Viability, and Economic Convergence	Justin Yifu Lin	Oct. 2001
No. 408: Labor Supply, Informal Economy and Russian Transition	Maxim Bouev	May 2001
No. 407: Corporate Governance in China: Then and Now	Cindy Schipani and Liu Junhai	Nov. 2001
No. 406: Entrepreneurship and Post-Socialist Growth	Daniel Berkowitz and David N. DeJong	Oct. 2001
No. 405 Forthcoming in: <i>European Economic Review</i> , "Policy Reform and Growth in Post-Soviet Russia."	Daniel Berkowitz and David N. DeJong	Oct. 2001
No. 404: Social Policies and Structures: Institutional Frictions and Traps in the Czech Republic after 1989	Jiří Večerník	Nov. 2001