Board of Governors of the Federal Reserve System

International Finance Discussion Papers

Number 455

September 1993

POLITICAL AND ECONOMIC CONSEQUENCES OF ALTERNATIVE PRIVATIZATION STRATEGIES

Catherine L. Mann, Stefanie Lenway, and Derek Utter

ABSTRACT

The different approaches to large-scale privatization in Hungary, Poland, and the Czech Republic imply somewhat different patterns of corporate governance -- that is, ownership, monitoring, and control of firms. Corporate governance affects economic incentives within the firm, and therefore economic performance of the firm. Similarly, patterns of ownership implied by the programs affect the distribution of gains from reform. Privatizing the large enterprises will importantly influence resource allocation, employment, and output. Consequently, the patterns of corporate governance embodied in the privatization strategies could affect macroeconomic performance and the development of constituencies in favor of or against continued reforms.

Political and Economic Consequences of Alternative Privatization Strategies

Catherine L. Mann, Stefanie Lenway, and Derek Utter[1]

Two intertwined objectives guide the structural transformation policies in the countries of East and Central Europe. From an economic standpoint, the ultimate objective of the transformation process is a robust market economy based on private ownership. From a political standpoint, the ultimate objective is to assure that the transformation process supports a growing constituency in favor of continued reforms. These two objectives are mutually supportive. If economic policies fail to increase standards of living, political support for the legislators of change cannot be sustained.

Privatization, particularly large-scale privatization, is often viewed as the key element of the transformation process. However, complementary policy initiatives and success in other areas, such as the legal environment, macroeconomic policy, and financial and labor markets are required to achieve the ultimate objectives. Moreover, in the context of East and Central Europe, the success of the large-scale privatization process is being judged not only by the change in ownership, but against multiple goals, including transparency

---

[1]The authors are respectively: Senior Economist in the International Finance Division of the Board of Governors of the Federal Reserve System; Associate Professor, Carlson School of Management, University of Minnesota; and graduate student, Wharton School, University of Pennsylvania. This paper represents the views of the authors and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System or its staff.

This paper was prepared for the conference "Markets, States, and Democracy: The Political Economy of Post-Communist Transformation", February 12 and 13, sponsored by the Center for German and European Studies at the University of California, Berkeley and the Friedrich Ebert Stiftung.

and speed of the process, equitable participation and outcome, and viability of the resulting industries.

The main premise of the paper is that the changing patterns of corporate governance -- that is, ownership, monitoring, and control -- implied by the large-enterprise privatization programs will alter a firm's performance. Industry performance as well as macroeconomic performance will affect the development of reform constituencies. Together both will determine the likelihood of achieving the ultimate political and economic objectives.

The next section elaborates on the complementarity of the economic and political objectives. Section III reviews how large-scale privatization fits into the overall transformation problem. Section IV addresses possible tensions between the various ancillary goals for the large-scale privatization strategies. Section V develops the relationship between corporate governance, economic incentives, the behavior of the firm, and the development of the reform consituency. Section VI draws a thumbnail sketch of the large-scale privatization strategies in Poland, Hungary, and the Czech Republic, focusing on likely outcomes for corporate governance. Section VII takes the framework from Section V and considers how the strategies described in Section VI might contribute to achieving the economic objective of the robust market economy based on private ownership and what the strategies imply for the distribution of gains and losses and the development of reform constituencies in these countries. Section VIII concludes.

II. Economic and political objectives are complementary

The revolutions in the countries of East and Central Europe have common roots and common goals. From economic systems of state ownership and centralized planning with little opportunity for entrepreneurship or personal reward, these countries have charted a path toward the market economy based on private ownership. From political systems with little citizen input, these countries have moved towards democracies based on popular vote and representation. These two revolutions did complement each other. The task for the next decade is to maintain a policy thrust that builds on the complementarities between the political and the economic environments.

A robust market economy and fully representative democracy take time to develop and the legacy of the socialist past in East and Central Europe has affected the transition. Overall economic wellbeing has increased little, if at all, and gains have been poorly distributed. Consequently the pace of reform has slowed. The secrets to sustained reform are economic policies that create a sufficiently broad-based constituency with a stake in the market-based economy, a political environment where these votes can outweigh the votes of those hurt by reforms, and government policies that balance economic incentives that foster reforms against redistributive policies that foster political support. However, it is simplistic to suggest that there is a one-to-one correspondence between economic policies, desired economic outcomes, and the political environment.

Privatization strategies have several important attributes that will affect how privatization contributes to the overall transformation process. Changing ownership, control, and monitoring of firms will affect their conduct, and therefore the economic outcome of reforms. Changing ownership and the power of non-owner stakeholders will affect the distribution of gains and the development of a political constituency in favor of reforms. While privatization is only one part of the transformation process and therefore by itself will not determine the viability of reform, because such a large percentage of production and employment may be directly or indirectly affected by large-scale privatization, how it changes corporate governance and influences political and economic outcomes bears special attention.

III. Privatization is part of the overall reform process

Privatization of large-scale, state-owned enterprises depends on and is part of complex effort to achieve the private market economy. Reforms in other areas crucial for the successful transformation include creating a workable legal system, achieving macroeconomic control, privatizing small-scale business and growing new private enterprises, reducing industrial concentration, developing the financial sector, and improving the functioning of labor markets and the government.

Creating a workable legal system based on recognized property rights is a prerequisite for the transformation. Until investors can be sure of their ownership rights, privatization will not yield improved economic performance.

Achieving macroeconomic control requires fiscal and monetary discipline, which, in turn, depend on privatization. Inflation has often resulted from monetization of deficit government spending on subsidies to loss-making state-owned enterprises. On the other hand, macroeconomic control is a prerequisite for successful privatization in that no investor can determine the viability of the firm in a highly inflationary environment and where relative prices are distorted.

Growing new private enterprises and small-scale privatization are as important as large-scale privatization for achieving the objectives of a private market economy and constituency for further reforms. New private firms and small-scale privatized firms play very important roles in increasing the efficiency of production and in the creation and distribution of wealth in a private market economy. Moreover, these firms offer employment opportunities at a time when the larger firms are being restructured and shedding labor.

Reducing industry concentration in the economy can affect the success of privatization and the overall reform process. Monopolies at key points in the production or distribution chain can offset increasingly competitive and efficient behavior in other sectors, and can choke-off development of small and medium-sized enterprises.

Developing the financial sector is intimately related to macroeconomic control, growth of the new private sector, and successful large-scale privatization. Difficulties in the financial systems of the East and Central European economies are hampering the pace of the overall transformation. The history of lending without question to loss-making, large-scale enterprises means that banks not only do not know how to evaluate credits, but also that their ability to extend credit to the sectors of emerging comparative advantage is limited by balance sheets full of bad debts.

Improving labor mobility goes hand-in-hand with successful large-scale privatization. If labor is not mobile, enterprises will not be able to restructure production, and privatization will not have the hoped-for effect on economic performance.

Finally, clarifying government priorities and improving fiscal policy are important for the success of the transformation. New tax and spending instruments can increase efficiency, reduce distortions, and maintain macroeconomic discipline. These policies must balance the need to preserve economic incentives with the need to redistribute the gains from economic reforms.

IV. Privatization strategies face multiple objectives

Even as privatization depends on other reforms to achieve a private market economy, in practice, these programs have been charged with achieving objectives beyond simply a change in ownership. These other objectives include developing equity markets, raising government revenue, distributing wealth equitably among the population, and ensuring enterprise viability. Speed, transparency, and administrative feasibility are also important attributes of the programs. The programs' success will be measured by multiple and occasionally conflicting yardsticks.

Many believe that equity market development is a critical component of the overall economic transformation because private owners realize the full value of their shares only if they can buy and sell them. However, which comes first, large private firms or capital markets? Without private ownership, equity markets and institutions are unnecessary: Stock markets have no listings, analysts have no stocks to follow, and pension funds have no investment opportunities. Yet, without operational equity markets and institutions, newly-privatized firms cannot raise funds, their shares cannot be traded, and institutional investors cannot provide discipline to enterprise management. This dilemma over sequencing has not been resolved by any of the privatization programs.

Initially, a second objective of privatization was to recify fiscal imbalances. Revenue from asset sales was to be used to reduce outstanding government debt, while privatization was supposed to reduce state subsidies and help close the budget deficit. However, most East and Central European governments have downgraded their hopes for raising significant revenues through privatization, in part because of the administrative difficulties of valuing the assets and in part because raising significant revenue would depend largely on selling assets to foreign investors, which might lead to an anti-foreign backlash. Moreover, governments have become more circumspect of the ability of newly privatized enterprises to survive without government support, given limited labor mobility and the extended period of economic decline.

Thirdly, consistent with socialist ideals, the privatization process must offer equitable participation and outcome. Privatization "returns" government assets to their rightful owners, the general public. Initial "spontaneous" privatizations, while expedient, lacked transparency and fueled public resentment over a process widely believed to favor the "nomenklatura," or former communist party members. The mass voucher programs are a direct result of the desire to promote a more egalitarian distribution of wealth.

A fourth objective of the privatization process is to improve the long-term viability and international competitiveness of large enterprises by injecting capital, technology, and management "know-how," as well as by restructuring and downsizing. Generally, a strategic foreign partner offers the best hope because of its financial resources and business acumen. But, foreign sales conflict with the domestic-investor focus of some of the privatization programs. In the mass voucher programs, investment funds are charged with these tasks, although their capability is unknown. The size of the problem, the delays in large-scale privatizations, and the virtual economic freefall have led some to suggest that the government should restructure an enterprise before trying to sell the pieces. Without restructuring, the government risks having nothing of value to privatize. But, it is doubtful that the governments have the management expertise, technological knowledge, political leeway, or funds necessary.

A final objective in crafting a privatization program is that it must be both politically and administratively feasible. Speed is important, since proceeding slowly risks allowing political opposition to develop that could weaken and perhaps unravel progress achieved to date. Yet, "spontaneous" privatizations violate the requirements of transparency and perceived fairness of the process which affect the degree to which the public is willing to support privatizations and endure the extended hardships accompanying the transition. Careful valuation of assets helps broaden political support, but is costly and time-consuming. Any strategy must consider the severe administrative constraints that limited funding and personnel create.

V. Corporate governance affects economic incentives, firm performance, and development of the reform constituencies

Patterns of corporate governance, defined as shareholdership, and monitoring and control of management decisions, affect economic incentives within a firm and therefore the economic performance of the firm. Other stakeholders in the firm, such as employees or local townships, also signal to managers their objectives for firm performance. Moreover, the government specifies some parameters of the environment, such as regulations, in which the firm operates. Along with overall economic activity, this collection of incentives determine firm performance, which means that performance may depart from what any of the individual stakeholder groups might have preferred. The relative abilities to affect management decisions across stakeholder groups will importantly determine who gains from successul firm performance. Consequently, patterns of corporate governance will affect the development of the reform consitituency. Chart 1 shows a schematic outline of these arguments.

The top panel of Chart 1 outlines the types of stakeholders and their objective functions. Owners are the residual claimants to the profits of the firm. Accordingly, their objective is to maximize the value of the firm. But, economic performance is a function of management decisions (such as wages and hiring practices, pricing and marketing strategies, production techniques, strategic planning, and so on) as well as the structure of the marketplace and overall level of economic activity. Since owners have little ability to affect the latter forces, they can only hope to achieve their objective of value maximization if they can affect management decisions.

How shareholders affect control over managers becomes a question of shareholder concentration and/or cooperation. In a small firm, the owner and manager are one, so there is no confusion over the objective of value maximization. If ownership of the firm is sufficiently concentrated, a single large shareholder can press her right as residual claimant and change management if necessary to achieve superior firm performance as measured by value maximization. However, if shareholdings are diffused across many people, controlling management requires collective shareholder action. This requires a common evaluation of a firm's economic performance and then shareholder cooperation to change management and redirect the firm towards value maximization. Obtaining information on the performance of the firm that is interpreted in the same way by various shareholders, and then orchestrating collective action may be difficult.

Thus, the second important figure in the corporate governance framework is the monitor. Monitors, such as stock analysts and Board Directors, vary by the degree and directness whereby they channel the objective functions of shareholders to influence management decisions and firm performance. Monitors, such as banks and institutional investors, may act like other stakeholders with objectives for the firm that are different from the value-maximizing objective of the owners. Therefore the monitor's affect on manangement incentives and economic performance may be complex.

Shareholders and monitors are not the only influence on management decisions and firm performance. Other stakeholders in the performance of the firm can influence managerial decisions directly. For example, labor can threaten to strike if management cuts jobs to maximize firm value. Townships can offer special tax breaks to lure business. In some cases (and as discussed more below), the objectives of the other stakeholders may conflict with the shareholder objective of value maximization.

Moreover, government policies also influence management decisions. In general terms, government policies set parameters, such as the regulatory climate, in which all firms operate. Firm-specific actions, such as trade protection, also will affect management decisions and a specific firm's economic performance. In some cases, government policies are designed to balance the objectives of the shareholders against the objectives of the other stakeholders or to redistribute the gains from shareholders to other stakeholders.

Shareholders, other stakeholders, and government may have different objectives for the firm, and therefore may send conflicting messages to management. The relative power of the different owners and stakeholders will affect management incentives. Even so, and the issue will not be adequately addressed here, there may be little relationship between the incentives set-up for management and the economic performance of the firm. First, there is no recipe whereby the right incentives are sure to yield optimal firm performance. Moreover, even if there were, management competancy is a key issue, as is the role of the overall economic environment in which the firm is operating.

The middle part of Chart 1 offers a stylized relationship between firm performance and the incentives of the various stakeholders as derived from their objective functions. The concentrated owner of a firm employing only herself cares only about maximizing the value of the firm. Therefore the link between ownership, management incentives, and firm performance is relatively tight. So too would be the case of a concentrated owner or a diffuse ownership situation with an effective monitor. In the context of East and Central Europe, with the lopsided structure of the large-scale enterprises, value maximization is likely to be achieved through significant restructuring, such as downsizing of the firm and a reduction in labor input.

Suppose, however, that other stakeholders are sufficiently concentrated to affect management incentives. Examining the objectives of the concentrated or powerful group yields insight into how a firm's performance might deviate from value maximization. In the context of East and Central Europe, the large-scale privatization strategies empower to differing degrees the shareholders, the monitors, and the other stakeholders. Section VII discusses in more specific terms the impact of these strategies on the incentives created for management, but in general, value may not be maximized and firm restructuring may be slowed. As indicated by the double arrows in the middle of the Chart, actual firm performance lies somewhere along the spectrum from value maximization with significant restucturing to zero valuation with no restructuring.

The bottom panel of Chart 1 combines firm performance with corporate governance to indicate the pattern of stakeholder gains, which is an important influence on the development of the reform constituency. At one extreme (shown by the line with open dots), concentrated shareholder power enables greater emphasis on value maximization and firm restructuring which yields concentrated gains to the shareholders, but, potentially, concentrated losses to the other stakeholders, such as labor, management and townships that may hurt by substantial restucturing. With diffuse shareholder power and effective monitors (shown by the line with squares), value is maximized and firms are restructured; but because the shareholders are diffuse, gains are diffuse while losses remain concentrated and firm-specific. At the other end of the spectrum (shown by the line with triangles), signficant power of the other stakeholders could slow enterprise restructuring, reducing gains to shareholders and redistributing them to the other stakeholders.

How does the distribution of outcomes affect the development of the reform constituency? As shown at the very bottom of the chart, in general, concentrated gains or losses fuel the development of pro- or anti-reform constituencies because the costs of orgainizing a political coalition are small in comparison to the possible benefit of affecting the legislative outcome. In the context of the corporate governance framework, stakeholder characteristics and power combined with the achievement of their objectives yields a distribution and concentration of gains which suggest how political constituencies might develop.

Concentrated shareholder power and achievement of value maximixation pits concentrated shareholder gains against the firm-specific and concentrated losses of the other stakeholders with the development of opposing political constituencies a possible outcome. Diffuse shareholders, even with effective monitors, are unlikely to organize in favor of continued reforms because the individual benefits appear small. At the same time, the concentrated losers are likely to organize to slow down the reform process.

The following Sections VI and VII describe and then put into this framework the privatization programs of Poland, Hungary, and the Czech Republic. The various strategies differ in the type and concentration of stakeholder power. Thus, they are likely to yield a different amount of enterprise restructuring, and consequent improvements in economic performance of the firm. The strategies will also differ in terms of the distribution of gains across stakeholder groups. Together, these will affect the development of the pro-reform constituency.

VI. Sketches of the large-scale privatization strategies[2]

This section briefly outlines and stylistically characterizes the different approaches to large-scale privatization being undertaken by Poland, Hungary, and the Czech Republic. The point is not to review every detail, in part because some of these programs are still in flux, but to set the stage for comparing the programs in the next sections.

While the focus is on large-scale privatization, each of these countries also have privatization programs for small-scale enterprises, such as retail shops and small factories. These programs are more similar across the countries and emphasize the auction method. All have been relatively successful at transferring ownership from the state to the public, and, as noted in Section III, are a very important part of the overall transformation of the economies.

Moreover, even for the large-scale firms, none of the countries is exclusively using one method of privatization. Some other methods include:

-- Public offering of stock

-- Private offering or direct sale of the firm to a single or small group of strategic investors, which might include a foreign partner.

-- Direct sale to managers (management buy-out) or employees (ESOP)

-- Sale of some of the assets (sometimes called privatization by liquidation) to a single or small group of owners, managers, or employees.

[2] This section draws heavily on each country's presentation at the Third Annual Conference on Privatization in Central and Eastern Europe held December 4-5, 1992 in Ljublijana, Slovenia. In general, the authors of these papers were top officials in the Ministries of Privatization. The conference was sponsored by the Economic Development Institute of the World Bank, the United Nations Development Program, and the Commission of the European Communities PHARE Program. Additional information on the Czech program comes from Leeds, and for the Hungarian program from Gatsios.

-- Leasing of assets from the State where ownership is retained by the State.

-- Management incentives contracts where ownership is retained by the State, but the State explicitly negotiates performance contracts with management.

Poland is using mutual fund shares as the main vehicle for transferring ownership of the large state-owned firms to the public. The essential characteristics of the draft law on the Mass Privatization Program (MPP) are as follows.

-- About 400-600 firms will be participating in the MPP (about 200 in the first round).

-- The State is analysing each firm for its appropriateness for the MPP, or for other types of privatization or restructuring. Participation by a firm will be decided in part by the State and in part by its employees.

-- Shares of firms designated to participate in the MPP will be allocated as follows: 60 percent of each firms' shares will be allocated to one of 27 National Investment Funds (NIF), 10 percent will be distributed free to the firms' employees, and 30 percent will be retained by the State Treasury.

-- The 60 percent of the shares allocated to the NIFs will be distributed 33 percent to a single NIF as a "lead shareholding" with the other 27 percent equally allocated to the other 26 NIFs as "minority shareholdings".

-- Each citizen will have the opportunity to purchase at a very low price one share in the whole Mass Privatization Program. Or, the MPP share can be exchanged at the Ministry of Privatization for one share in each of 27 National Investment Funds.

-- The MPP share will be tradable on the Warsaw Stock Exchange. Similarly the shares of the NIFs will be tradable on the WSE.

-- Shares in individual firms can be traded by NIFs, employees, or other shareholders, but will not initially be quoted on the WSE.

-- Employee representatives and representatives of the lead NIF will sit on a firm's Board of Directors.

-- NIF mangers will be compensated in cash and shares dependent on the performance of the constituent companies. However, the NIF managers cannot vote their shares, which the State holds on their behalf.

The Czech Republic initially based its large-scale privatization program on the direct share voucher as the main tool for transferring ownership of the SOEs to the public. Almost immediately, however, Investment Privatization Funds (IPFs) developed.

-- All firms submitted at least one privatization plan to the Fund for National Property (FNP). Plans for firms could be submitted by employees, management, and former owners. The FNP decided which plan to approve.

-- One form of privatization plan issued some or all of the shares in the firm to the public pool that was to be allocated to citizens via the Voucher Privatization Scheme (VPS).

-- For those firms participating in the VPS, a maximum of 10 percent of the shares could be purchased at preferential rates by employees, or held in reserve for future distribution to employees, perhaps at preferential rates. The employee shares could be voting or non-voting stock.

-- Each citizen could purchase for a nominal fee one voucher booklet worth 1000 points to bid directly on shares in firms. Or, individuals could entrust some or all of their points to an IPF that would bid on shares on their behalf.

-- In direct bidding, points could be used to bid on shares in firms at least some of whose stock had been entered into the VPS. Following the completion of bidding, the individual holds some number of shares of each firm that they bid on.

-- In mutual fund bidding, the individual entrusted all or some share of his voucher points to one of about 450 IPFs. The IPF bid on shares on behalf of the individual. After the completion of the bidding, the individual held shares in the IPF, and the IPF held shares in the firms.

-- If, during the course of the rounds of bidding, demand for shares exceeded supply by less than 25 percent, demand and supply were equated by reducing pro-rata the bids by IPFs.

-- An IPF must hold shares in more than 10 companies, and can hold a maxmimum of 20 percent of the value of its portfolio in a single firm.

-- IPF managers that hold more than 10 percent of the stock of a firm can participate actively in management, can vote in stockholders meetings, and trade shares.

-- The stock exchange opened in April 1993, and shares in two mutual funds are tradable. In addition, off-market trading without brokers allows trading between individuals and IPFs.

Hungary's flagship approach depends heavily on auction and direct sales methods and emphasizes a case-by-case strategy. Voucher schemes are not, at this time, part of the privatization strategy.

-- Privatization can be initiated by the enterprise management and employees, by an outside investor, or by the State Property Agency (SPA). In general, the largest firms have SPA-initiated privatizations.

-- In SPA-initiated privatizations, consulting companies help value the assets, suggest ways to privatize (including the options noted above), and advise as to the quality of bidders. The foreign or strategic investor is the target of the SPA-initiated privatizations.

-- In self-initiated privatizations, enterprise management and employees work with a consulting company on an offer for the firm that is acceptable to all parties and the SPA. 15 percent of the capital must be made available to employees. The SPA must approve or deny a privatization proposal within a specific timeframe.

-- In investor-initiated privatization, a foreign or domestic investor bids on the firm. In theory, the strategic investor could work without the assistance of management or employees. In fact, the investor-initiated and self-initiated privatizations are complementary.

-- The SPA will consider the effect of the privatization proposal on competition in the economy, employment and other factors, as well as the effect on the operation of the individual firm.

-- Maximizing revenue from the sale is not the over-riding consideration. However, a higher offer price is an important signal for determining the level of interest and commitment from potential investors.

-- Consulting companies receive 5 percent of the value of the revenue or 10 percent of the privatization as a fee for service.

-- Two funds have been set up within the banking system for private domestic investors. A "mortgage capital" fund lends at preferential rates to purchase firms. A "working capital" fund lends at market rates.

-- The SPA may play an active role by restructuring the firm to increase its value or to make it easier to sell to a single or small group of investors and may solicit investor groups to participate in the bidding.

VII. Privatization and the Development of the Market Economy and the Reform Constituency

The framework of Section V related corporate governance to economic incentives and the performance of the firm. This section puts into this framework key aspects of the privatization programs of Poland, Hungary, and the Czech Republic described in Section VI. These various strategies differ in the type and concentration of stakeholder power. Thus, they are likely to lead to different degrees of enterprise restructuring and improvement in economic performance of the firm.

The distribution of gains and losses across stakeholder groups is also likely to differ, which will affect the development of the reform constituency. In general, concentrated gains or losses fuel the development of pro- or anti-reform constituencies. Far more likely in the context of East and Central Europe is a balance of gains and losses with the key issues being the degree of diffuseness or concentration of gains and losses, and the balance in gains and losses between shareholders and other stakeholders. The different strategies may create situations whereby concentrated but relatively firm-specific losses must be balanced against diffuse but relatively large economy-wide gains.

Government policy in response to demands by shareholders or other stakeholders may be an important factor linking the development of the reform constituency and the continued reforms in favor of the market economy. That is, given the distribution of gains and losses between shareholders and other stakeholders that are implied by privatization and economic reforms, the government could be pressured into legislating changes in the economic environment for all firms (such as minimum wage laws or price ceilings) or pressured into providing specific protection for individual firms to avoid labor layoffs, bank failures, or collapse of the equity markets. Or, government intervention could take the form of taxation and spending that would redistribute some of the gains, which might allow the reform process to continue.

The **Polish** privatization strategy described in Section VI represents the most recent effort to balance shareholder and other stakeholder (principally labor) interests, and to monitor and affect control over state-enterprise managers. The socialist legacy and the power of the Worker's Councils in the state enterprises have been important forces leading to the nearly free and universal distribution of shares in the whole economy (the MPP share) and to the preferential treatment of labor in the allocation of shares of the firms.

However, the mass privatization program alone would yield too diffuse an ownership of firms to monitor performance or affect enterprise managers. Moreover, from the standpoint of the individual, the MPP share is a completely diversified portfolio of shares in the domestic economy. There is, therefore, no incentive for an individual to obtain information about specific industries or to consider concentrating her shares in a few firms to try to achieve gains in excess of this "market portfolio". Accordingly, the Polish program depends importantly on the National Investment Funds and their managers to create these monitoring, control, and incentive structures.

The NIF lead shareholding was designed to create a concentrated stakeholder in whose interest it is to monitor the firm and control enterprise management. As mutual fund managers, the lead NIF manager should act as a concentrated stakeholder on behalf of the fund's shareholders to maximize the value of the NIF share. As an added incentive, the lead NIF's compensation is related to the performance of the firms in its portfolio. Finally, since there are multiple NIFs whose shares are supposed to trade on the Warsaw Stock Exchange, individual shareholders can discipline NIF managers to maximize the value of the NIF share.

While these mechanisms help direct and discipline NIF management, it is unclear to what extent NIF managers can change enterprise management. While apparently the lead NIF will sit on the Board of Directors of the firm in which it has a lead shareholding, it may be that the NIF manager cannot vote its shares. Moreover, the NIF's ability to affect management incentives by trading away shares in poor performers in the portfolio may be hampered since shares of individual firms will trade only in an informal market, not on the Warsaw Exchange.

Another key determinant of the incentive structure created by the Polish privatization strategy is whether employees who hold shares in their own firm will act as a concentrated owner. As proposed, labor has direct control over management both as owners and through seats on the Board of Directors. How might concentrated employee ownership affect management incentives and performance of the firm? In general, a firm owned and controlled by employees is likely to have higher wages and less restructuring and capital investment compared to firms owned and controlled by non-employees. Employee-owners see the benefit of higher wages immediately and discount the uncertain higher future value of their investment (that is, shares in the firm) that would come from the higher profits that should result from lower wages, lower employment, more restucturing, and greater capital investment. The future value of their investment is uncertain because the link between restructuring and future value is imperfect, in part because future value depends on the overall economic environment. Moreover, in the absense of a market for shares, employee-shareholders cannot extract the capital gain associated with successful restructuring. Since shares of individual firms will not trade on the Warsaw Exchange, employees-shareholders may have a greater incentives to limit restructuring and investment than would non-employee shareholders. Thus, if the employee group is powerful in Poland, it may be difficult to restructure firms to make them profitable and competitive in domestic and international markets.

Will a pro-reform constituency develop in Poland? If the privatization strategy can affect managerial control and improve firm performance, the MPP and NIF programs assure a wide distribution of economic gains. However, since no individual owns much of any firm, those gains will appear quite small to individual shareholders, and moreover, until individual shares trade on the stock market, these gains will be unrealized. On the other hand, to the extent that improved firm performance depends on restructuring and reducing employment, labor would tend to bear concentrated and realized losses. Consequently, the relatively greater power of labor in the privatization strategy may lead to opposition to further reforms. The diffuse and unrealized distribution of gains to shareholders and concentrated and realized losses to labor may delay the development of a constituency in favor of reforms.

In theory, the government could use economy-wide tax and transfer policies to redistribute some of the economy-wide gains to the firm-specifc losers. However, this would be difficult until the gains could be realized through trading shares. One possible outcome is government intervention on a case-by-case basis to support firms in which the voice of the concentrated losers is the loudest. If only one or two firms are so supported, the overall development of the market economy would not be seriously impaired. If, however, many firms receive special support, overall eonomic reform could be seriously undermined.

As originally conceived, the Czech voucher program would have distributed state assets directly to the people. In contrast to the even distribution of all shares in Poland, the Czech scheme used a bidding method to try to induce people to learn about firms and markets and perhaps take sufficient interest in a particular firm to try for a concentrated ownership position. In fact, however, in the first wave of bidding, about three-quarters of the voucher points were entrusted to mutual funds. Perhaps the information requirements for direct bidding on firms were too high for most people. In fact, until the mutual funds advertized, only about 50 percent of the population had purchased voucher books. By the time bidding took place, more than 75 percent of those eligible were participating. Many people may have preferred the more diversified wealth portfolio that should be associated with mutual funds. Finally, people may have been attracted by some mutual fund assurances of quick capital appreciation.

Unlike in Poland, where the NIFs were carefully designed to create a controlling interest, the Czech mutual funds initially developed on their own without government intervention or legitimacy, although subsequently some guidelines were put into place. Can these mutual funds overcome the coordination problems of diffuse ownership and affect control over managers? As in Poland, the IPFs mitigate to some extent the dispersion of poorly informed owners that would have resulted from direct sale of the state assets to the population. Based on preliminary results of the first wave, some of the IPFs hold controlling interest in some firms. Total voucher points may have been so concentrated in several of the IPFs that the 20 percent limit on the concentration of shares in a single firm in the portfolio might have been binding. This does imply, however, that hundreds of IPFs do not hold controlling shares in any firms.

While not as carefully codified as in the case of Polish legislation, the IPF managers do appear to have some direct control over firm management in that they can vote their shares as well as sit on the Board of Directors of the firm. On the other hand, the stock exchange lists shares of very few firms and only two of the mutual funds. The off-market exchange allows trade, but this market may be very illiquid and prices may not be public or clearing. Thus, the IPFs may not be able to influence manager behavior directly by selling shares in poorly performing firms.

Moreover, there appear to be few channels for IPF shareholders to communicate their objective to or discipline fund managment. The lack of transparency in off-market transactions would be worse for the private investor, thus severely limiting his ability to sell shares in poorly performing funds. Consequently, examining the objectives of the mutual fund managers could be very important in terms of what incentives they might communicate to firm mananagement.

Some of the mutual funds touted short-term stock appreciation as their objective. This may be inconsistent with the kind of long-term restructuring necessary in the Czech economy. For example, a fund might choose to liquidate a firm and sell its assets to achieve a quick return on the whole portfolio. Alternatively, an IPF holding a concentrated interest in a particular firm could become a strong advocate of massive restructuring so as to achieve the desired rate of return.

The role of banks as owners deserves special mention. Banks have played an important role so far in the IPFs. Banks can discipline the behavior of employees and managers by requiring adequate performance to repay debt. Even if not an owner, banks exert disicpline on enterprise management since employee and management jobs are at stake if the bank forces the firm into bankruptcy. Moreover, banks, as owners, can encourage restructuring in pursuit of value maxmization. However, if a firm's debt or negative equity position becomes large with respect to the bank's capital, the ability to discipline management is lost and the performance of both the bank and the firm would deteriorte. Moreover, if the bank is only a lender and not an owner, the length of maturity of the debt might be too short, and the time horizon of firm restructuring would also be sub-optimal.

Some of the specific appoaches to the preferential treatment of employees may lead this bloc to be a strong voice for restructuring instead of a advocating less restructuring. As noted in the Polish case, the key difficulty with employee ownership is uncertainty over future value of shares. Thus giving employees stock options or non-voting stock instead of voting stock may make them advocates of restructuring since the value of the stock or option rises more as firm performance improves. A well-functioning stock exchange is key to this approach, however. And, for those employees laid off in the course of restructuring, assuring current income is another problem.

Finally, it is interesting how the Czech approach tried to limit the concentration of firm ownership by existing enterprise management. Some of the IPFs were initially constituted by enterprise management to pool voucher points to try to get a controlling interest in their firm. However, government guidelines were adjusted so that in order to be classified an IPF, and thus be able to sit of the Board and vote the shares, an IPF had to hold at least 10 percent of the shares of the single firm, as well as hold shares in at least 10 firms. This, in essense, may have put the firms out of reach of many of the management voucher pools.

What is wrong with manager owners? As discussed in more detail in the section on Hungary, manager owners may have the same myopia as employee owners. Or, they may strip the assets from the firm, liquidate them, leave the employees with no jobs, and use the money so obtained to buy other firms. Finally, to the extent that management was primarily nomeklatura, the view is that they should receive no preferential treatment.

The development of the pro-reform constituency in the Czech Republic faces some of the same problems as in Poland. The gains to economic reforms will be spread widely throughout the economy, but, for any individual investor, will likely be quite small. Although, the concentration of voucher points with only several IPFs may indicate more concentrated gains are a possibility. In the Czech privatization strategy, labor does not have so clear a shareholder voice, so the objective of value maximization may yield greater restructuring than in the Polish case, with consequently greater gains throughout the whole economy. Losses will still likely be concentrated, but gains may be somewhat greater and somewhat more concentrated.

Options for government intervention to further the economic reforms are similar to those in Poland. However, the Czech government also faces the possibility that the IPFs will not be able to make good on their guaranteed yields. Some of the funds could become bankrupt, and the government would have to decide whether to bail them out. Or, the value of IPF shares may decline, not become worthless. Bailing out the IPFs would send them the wrong signal, but an overall skeptical view of economic reform on the part of the population could tip the balance of power between the constituencies to the anti-reformers.

The principal approach that Hungary is taking to large-scale privatizations is significantly different from the approaches taken by Poland and the Czech Republic. The main objective is locating a strategic investor or investor group, which might include labor and management. This investor or investor group should have a sufficiently concentrated ownership position to control management directly without the intervention of monitors. Within the framework of Section V, the strategic investor with concentrated ownership is best able to change management incentives in favor of value maximization. A successful restructuring by a strategic investor could yield the greatest and the most concentrated gains to shareholders. However, as firms are restructured, firm-specific stakeholder losses are also likely to be concentrated. The development of the reform constituency in Hungary, therefore, may depend to a greater degree on which of the winners and losers from reform can better lobby the government.

Moreover, the Hungarian approach does allow management buy-outs and employee buy-outs. As noted in the case of employee-shareholdership in Poland, management incentives, restructuring, and firm performance could deviate from value maximization. Management buy-outs present a similarly mixed set of incentives. Managers as shareholders are likely to seek value maxmization. But managers as employees desire job retention and emoluments, both of which will affect restructuring for value maximization. Moreover, even if an outside strategic investor has joint ownership and direct control over management, the objectives of insiders, such as labor and management, are more likely to influence the pace of restructuring of the firm.

Hungary's search for strategic investors has exposed some difficulties not faced by the mass privatization approaches. Due diligence and pricing of the firm are more important when courting the strategic investor. These take time and may create the appearance of unfair deal-making.

In addition, the lack of domestic capital is a significant problem. Hungary has attempted to level the financial field by providing low-interest mortgages to domestic investor groups. It is trying to maintain the correct operational incentives by pricing working capital at market rates. Moreover, it is actively breaking-up firms to reduce their size to make them more financially accessable to domestic investors. An important question is whether the government is enhancing the likelihood of the firm's ultimate viability by breaking it into pieces in this way. Moreover, if an investor group that borrowed from the banking system bankrupts the firm, can the banking system survive the loss, or will further government involvement be necessary to support the banking system?

In contrast to the Czech and Polish programs, where there is virtually no role for foreigners, Hungary has actively courted the foreign investor. It would appear that Hungarian policy-makers view technology and capital infusions and foreign management know-how are more critical than ownership per se. However, if a successful restructuring of a firm is lead by a foreign investor who gains the most at the expense of domestic management and labor, the government may be faced with an anti-foreign backlash. Intervention, though taxes or some other means, may be required to balance the foreign gains against the domestic losses.

Another issue not addressed in the mass privatization approaches is that some firms in Hungary will remain owned by the State for some time. How will these firms interact with the privatized firms? As noted in Section III, pockets of monopoly power or inefficiency throughout the economy can undermine the overall reform effort.

VIII. Conclusions

Privatization strategies will have an important impact on the political and economic environments in the countries of East and Central Europe. From the standpoint of the economic environment, the development of the market economy and long-term growth depends on patterns of ownership, control, and monitoring that encourage long-term vision, efficient use of resources, and undistorted price signals. From the standpoint of the political environment, the power of a reform-minded constituency depends on the concentration of ownership that results from the privatization strategies, but also depends on the success of those strategies in yielding an economy where there are more winners than losers.

References

Berger, James. "After 55 years, Prague Stock Exchange Reopens Trading", in Michal Mejstrik, ed. Privatization Newsletter of the Czech Republic and Slovakia, No.14, March 1993.

Bolton, Patrick and Gerard Roland. "Privatization in Central and Eastern Europe", Economic Policy, October 1992.

Bonin, John P. "Privatization and Efficient Contracts: The Workers' Stake in the Transition", Journal of Comparative Economics, vol.16 (1992).

Csepi, Lajos and Erzsebet Lukacs. "Privatization in Hungary", presented at the Third Annual Conference on Privatization in Central and Eastern Europe, December 4-5, Ljubljana, Slovenia.

Ceska, Roman. "Czechsolovakia -- Czech Republic Country Privatization Report (1992)", presented at the Third Annual Conference on Privatization in Central and Eastern Europe, December 4-5, Ljubljana, Slovenia.

Demsetz, Harold and Kenneth Lehn. "The Structure of Corporate Ownership: Causes and Consequences", Journal of Political Economy, vol.93 no.6, 1985.

Fama, Eugene F. and Michael C. Jensen. "Separation of Ownership and Control", Journal of Law and Economics, vol. 26 (June 1983).

Gatsios, Konstantine. "Privatization in Hungary: Past, Present, and Future", Centre for Economic Policy Research Discussion Paper no. 642, March 1992.

Halama, Vladimir. "Privatization in the Second Wave: Revisiting the Issue of Employee Share Participation", in Michal Mejstrik, ed. Privatization Newsletter of the Czech Republic and Slovakia, No. 15, April 1993.

Jenkinson, Tim and Colin Mayer. "The Assessment: Corporate Governance and Corporate Control", Oxford Review of Economic Policy, vol.8, no.3.

Jensen, Michael C. "Eclipse of the Public Corporation", Harvard Business Review, September-October 1989.

__________ and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", Journal of Financial Economics, vol 3.

Klvacova, Eva. "The Role of the Fund National Property in the Privatization Process" in Michal Mejstrik, ed. Privatization Newsletter of the Czech Republic and Slovakia, No.15, April 1993.

Lastovicka, Radek. "Individual Investors versus Privatization Funds: A Comparison of Investment Behavior in Voucher Privatization", in Michal Mejstrik, ed. Privatization Newsletter of the Czech Republic and Slovakia, No.14, March 1993.

Leeds, Eva Marikova. "Voucher Privatization in Czechoslovakia", Franklin and Marshall College mimeo, February 1993.

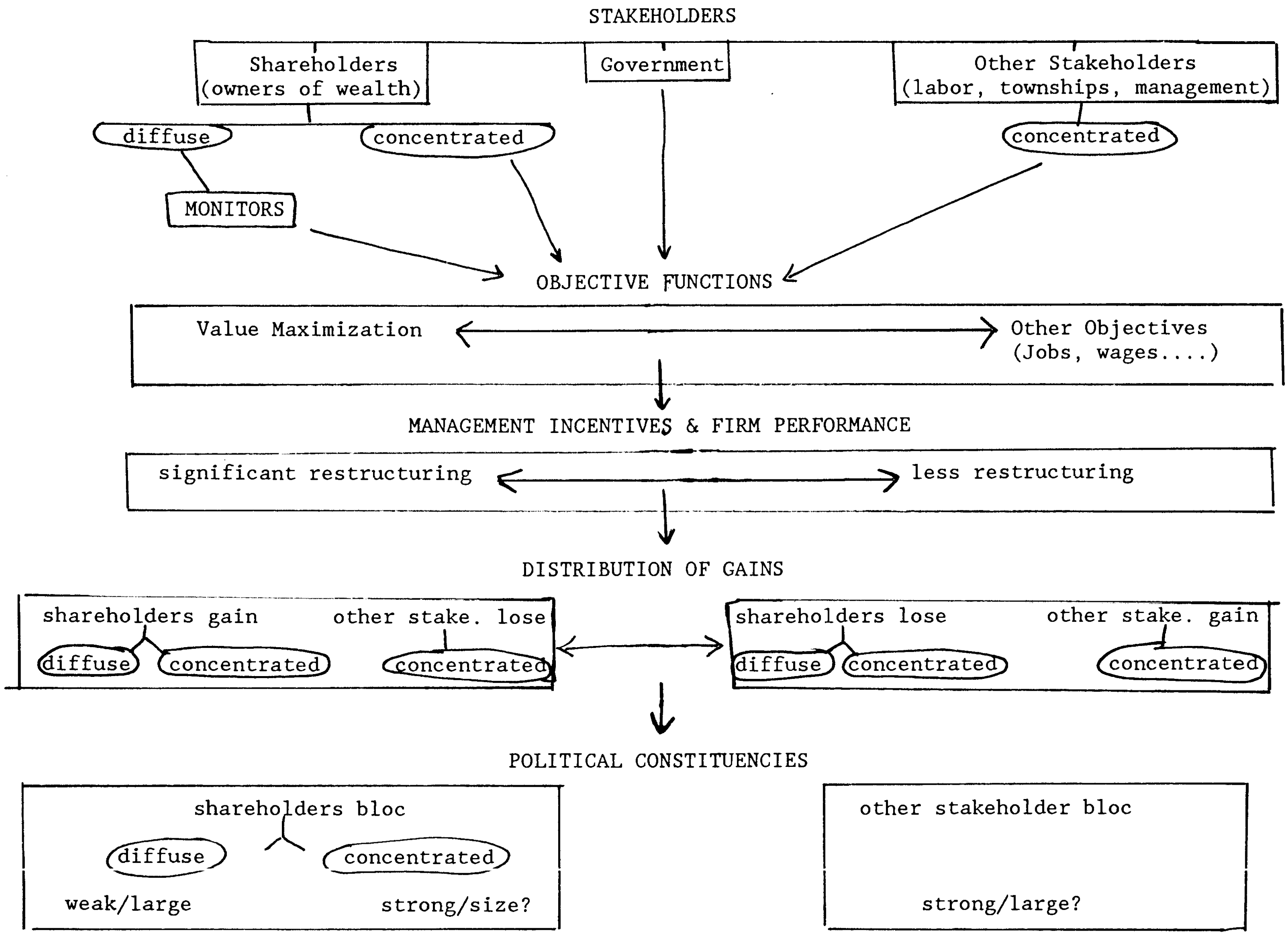
n.a. "Privatization in Poland, 1992", presented at the Third Annual Conference on Privatization in Central and Eastern Europe, December 4-5, Ljubljana, Slovenia.

Roe, Mark J. "Poltical and Legal Restraints on Ownership and Control of Public Companies", Journal of Financial Economics, vol. 27.

Triska, Dusan. "The 1992 Wave of the Voucher Privatization in Czechoslovakia", presented at the Third Annual Conference on Privatization in Central and Eastern Europe, December 4-5, Ljubljana, Slovenia.

Williamson, Oliver E. "Corporate Finance and Corporate Governance", Journal of Finance, vol.43 no.3 (July 1988).

CHART 1


STAKEHOLDERS
Shareholders (owners of wealth)
Government
Other Stakeholders (labor, townships, management)
diffuse
concentrated
MONITORS
concentrated
OBJECTIVE FUNCTIONS
Value Maximization
Other Objectives (Jobs, wages....)
MANAGEMENT INCENTIVES & FIRM PERFORMANCE
significant restructuring
less restructuring
DISTRIBUTION OF GAINS
shareholders gain
diffuse
concentrated
other stake. lose
concentrated
shareholders lose
diffuse
concentrated
other stake. gain
concentrated
POLITICAL CONSTITUENCIES
shareholders bloc
diffuse
concentrated
weak/large
strong/size?
other stakeholder bloc
strong/large?

International Finance Discussion Papers

IFDP Number	Titles	Author(s)
	1993	
455	Political and Economic Consequences of Alternative Privatization Strategies	Catherine L. Mann Stefanie Lenway Derek Utter
454	Is There a World Real Interest Rate?	Joseph E. Gagnon Mark D. Unferth
453	Macroeconomic Stabilization Through Monetary and Fiscal Policy Coordination Implications for Monetary Union	Jay H. Bryson
452	Long-term Banking Relationships in General Equilibrium	Michael S. Gibson
451	The Role of Fiscal Policy in an Incomplete Markets Framework	Charles P. Thomas
450	Internal Funds and the Investment Function	Guy V.G. Stevens
449	Measuring International Economic Linkage with Stock Data	John Ammer Jianping Mei
448	Macroeconomic Risk and Asset Pricing: Estimating the APT with Observable Factors	John Ammer
447	Near observational equivalence and unit root processes: formal concepts and implications	Jon Faust
446	Market Share and Exchange Rate Pass-Through in World Automobile Trade	Robert C. Feenstra Joseph E. Gagnon Michael M. Knetter
445	Industry Restructuring and Export Performance: Evidence on the Transition in Hungary	Valerie J. Chang Catherine L. Mann
444	Exchange Rates and Foreign Direct Investment: A Note	Guy V.G. Stevens
443	Global versus Country-Specific Productivity Shocks and the Current Account	Reuven Glick Kenneth Rogoff
442	The GATT's Contribution to Economic Recovery in Post-War Western Europe	Douglas A. Irwin

---

Please address requests for copies to International Finance Discussion Papers, Division of International Finance, Stop 24, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

International Finance Discussion Papers

IFDP Number	Titles	Author(s)
	1993	
441	A Utility Based Comparison of Some Models of Exchange Rate Volatility	Kenneth D. West Hali J. Edison Dongchul Cho
440	Cointegration Tests in the Presence of Structural Breaks	Julia Campos Neil R. Ericsson David F. Hendry
	1992	
439	Life Expectancy of International Cartels: An Empirical Analysis	Jaime Marquez
438	Daily Bundesbank and Federal Reserve Intervention and the Conditional Variance Tale in DM/$-Returns	Geert J. Almekinders Sylvester C.W. Eijffinger
437	War and Peace: Recovering the Market's Probability Distribution of Crude Oil Futures Prices During the Gulf Crisis	William R. Melick Charles P. Thomas
436	Growth, Political Instability, and the Defense Burden	Stephen Brock Blomberg
435	Foreign Exchange Policy, Monetary Policy, and Capital Market Liberalization in Korea	Deborah J. Lindner
434	The Political Economy of the Won: U.S.-Korean Bilateral Negotiations on Exchange Rates	Deborah J. Lindner
433	Import Demand and Supply with Relatively Few Theoretical or Empirical Puzzles	Andrew M. Warner
432	The Liquidity Premium in Average Interest Rates	Wilbur John Coleman II Christian Gilles Pamela Labadie
431	The Power of Cointegration Tests	Jeroen J.M. Kremers Neil R. Ericsson Juan J. Dolado
430	The Adequacy of the Data on U.S. International Financial Transactions: A Federal Reserve Perspective	Lois E. Stekler Edwin M. Truman
429	Whom can we trust to run the Fed? Theoretical support for the founders views	Jon Faust
428	Stochastic Behavior of the World Economy under Alternative Policy Regimes	Joseph E. Gagnon Ralph W. Tryon