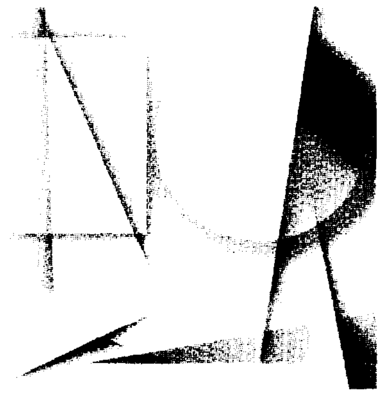
Property Rights and Enterprise Reform



At the heart of transition lies a change in incentives, none more important than those for managers of enterprises. Managers in centrally planned economies faced distorted incentives that sooner or later led to poor enterprise performance. Transition requires changes that introduce financial discipline and increase entry of new firms, exit of unviable firms, and competition. These spur needed restructuring, even in state enterprises. Ownership change, preferably to private ownership, in a large share of the economy is also important. Once markets have been liberalized, governments cannot indefinitely control large parts of a dynamic, changing economy. Decentralizing ownership is the best way to increase competition and improve performance.

There are two ways to move to an economy dominated by the private sector: through privatization of existing state assets and through the entry of new private businesses. The two are equally important. New private firms, spurred by liberalization, give quick returns and can accomplish a great deal by themselves; but the mass of state assets in transition economies makes some degree of privatization unavoidable.

The question is not merely how much to privatize, but how and when. Transition economies all experience problems in managing state-owned firms. In some countries, market-oriented reforms short of a massive shift in ownership can bring improvements, even though these may be difficult to sustain over the longer term. In others, rapid and widespread privatization is the only feasible course. All, however, face a dilemma: privatization done incorrectly can produce negative outcomes. Is "bad" privatization then better than none at all? There is no simple answer; it depends on the strength of the state and the capacity of its administrative institutions. The dilemma does not always arise: smaller assets are easy to privatize, and the outcomes are generally good. But larger transactions are more problematic on both counts, and the tradeoffs among the different ends and means of privatizing these assets are intricate and intensely political. Some of the forms of ownership first produced by privatization do not and should not last. The way to think of privatization, therefore, is not as a once-and-for-all transformation, but as the start of a process of reorganizing ownership, shifting over time to respond to the needs of the market economy.

The legacy of central planning

The principal objective of the "socialist firm"—developed in the Soviet Union and later emulated throughout the transition economies—was to meet physical production targets set by central planners. Under central planning, firms did not emphasize profits, quality, variety, or customer service, still less innovation. They were protected from competitive pressures and operated in shortage economies, where everything they produced was snapped up instantly. Managers, most of them production engineers, were judged in terms of output rather than client satisfaction. Financial performance was irrelevant because profits and losses were redistributed among firms. Lacking a bottom line, managers combated frequent input shortages by hoarding labor and inventories. The plan allocated output targets, inputs, and investment. It typically emphasized heavy industry, energy, and investment goods at the expense of consumption goods and services.

For a time the combination of massive investment and ideological commitment forced industrial growth in many centrally planned economies. In the late 1950s, however, evidence of declining Soviet productivity became more apparent (see Figure 1 in the Introduction). Productivity also lagged in China's state enterprises; output growth through the 1960s and 1970s depended on extensive investment. Many countries—Hungary, Poland, the Soviet Union, and Yugoslavia in the past, China and Vietnam still today—tried to improve enterprise performance without resorting to privatization. "Reform socialism" aimed to decentralize decisionmaking to the enterprise level and to create incentives for improved technical and financial performance. Such reforms often yielded temporary improvements in productivity, but the Soviet Union and all the CEE countries eventually suffered reversals. Nor, as discussed below, are Chinese officials today satisfied with the results of their enterprise reform programs. Deeper reforms were required to increase competition, enforce financial discipline, and open capital markets—that is, to fundamentally reorient enterprises and their incentive systems. Thorough reform was also needed in the agricultural sector, which was particularly burdened with inefficient structures and distorted incentives. However, the structure of agriculture and the problems it faced in the planned East Asian economies were quite different from those in CEE and the NIS, as discussed later in this chapter.

The first step: Imposing financial discipline and competition

The first step in transition is to move from the centrally planned regime of transfers and subsidies to one that allows for risk, ensures financial discipline, and creates strong, profit-oriented incentives. This requires opening markets to competition and sharply cutting direct government subsidies. It also requires removing two other cushions: bank credits on easy terms and arrears on payments due to government for taxes, customs duties, and social security (see Chapter 2). Interenterprise arrears are another form of soft finance. Some governments have implemented complex programs for netting and clearing these arrears, but the best advice is to let market forces work out the problem (see Box 2.7).

Financial discipline spurs restructuring—regardless of ownership

Extensive empirical evidence from CEE and elsewhere indicates that most firms, whether state owned or private—or in between, as in the case of China's "nonstate" enterprises (see Box 3.4)—make efforts to restructure if their avenues for rescue close and competition increases. Shrinking subsidies combined with more open markets have universally resulted in labor shedding or falling real wages, or some combination of the two. For example, the largest 150 to 200 firms in the Czech Republic, Hungary, and Poland reduced their work forces by 32, 47, and 33 percent, respectively, between 1989 and 1993 as their sales fell by 40 to 60 percent on average. In addition to layoffs, the more advanced reformers have also seen sales of large amounts of excess inventory and surplus assets. Thousands of trucks sold from state firms, for example, formed the basis of Poland's large private transport fleet. Enterprises subjected to financial discipline show more aggressive collection of receivables, a closer link between profitability and investment, and a reorientation of goals from output targets to profits. Transition forces managers, for the first time, to focus on marketing and product quality.

Whether enterprises actually adjust will thus depend on government policies and, most important, the credibility of government's commitment to reform. Strong and credible macroeconomic stabilizations in the Czech Republic and Poland, for example, stimulated adjustment in many firms. Polish subsidies to enterprises and households shrank rapidly, from more than 16 percent of GDP in 1986 to 5 percent in 1992. Polish managers interviewed in 1990 had little doubt that if they failed to make their firms competitive, the firms would close—and indeed many Polish state enterprises that had existed in 1989 had disappeared by the end of 1995. Banks still had large and rather concentrated bad loan portfolios, but cleanup began in 1993 through a combination of enterprise liquidations, debt sales, and a new bank-led conciliation process (Box 3.1). Tax arrears, however, remain a problem. In Poland, as elsewhere, these have proved the most difficult "subsidy" to eliminate, in part because tax administration is weak (see Chapter 7).

Russian reforms, although extensive, were neither as coherent nor as credible. Total federal subsidies to enterprises (including directed credits) fell from 32 percent of GDP in 1992 to about 6 percent in 1994, but tax arrears and ad hoc tax exemptions increased significantly. Also, local government subsidies to enterprises have increased. Russian firms have begun to adjust, but less than those in Central Europe and in a somewhat different mode. Formal layoffs have been fewer. Employees remain on the books and continue to draw benefits, but they have accepted large cuts in hours and cash compensation and have progressively shifted to informal activities (see Chapter 4).

Governments in the East Asian planned economies approached the problem differently, but even there reforms have sometimes been radical. Vietnam undertook swift and far-reaching state enterprise reforms in 1989. The government eliminated all budget subsidies, cut the number of firms by 5,000 (of which 3,000 were merged into other state firms, but 2,000 actually closed), and exposed some state firms to limited competition from a new private sector. Almost 900,000 workers (a third of the total) were dismissed without any promise of other public sector jobs. In response to this drastic surgery, the

Box 3.1 Innovative approaches to creditor-led restructuring in Hungary and Poland

Who should restructure problem firms in transition economies? In established market economies creditors are important agents of restructuring. Getting creditors to play that role takes financial incentives, adequate information, and strong legal powers in debt collection, debt workout, and liquidation processes.

Poland and Hungary are reforming their banking sectors and implementing creditor-led workout programs to help spur enterprise restructuring. In 1993 Poland adopted a bank-led "conciliation" process that empowers banks to negotiate workout agreements with problem debtors. An agreement reached among creditors holding more than half the value of a firm's outstanding debt is sufficient to bind all creditors. More than 400 such agreements have been successfully negotiated, involving primarily the nine large commercial banks and large state-owned firms.

Hungary took a somewhat different route. Its 1992 bankruptcy law required managers of firms with arrears of ninety days or more to file for reorganization or liquidation. Managers opting for the former retained their jobs and were given first right to present a reorganization plan to creditors. If creditors did not approve it unanimously, the firm was liquidated. The law led to 22,000 filings—17,000 liquidations and 5,000 reorganizations—in 1992 and 1993. The law was amended in late 1993 to eliminate the automatic ninety-day trigger and to reduce the creditor approval requirement to two-thirds of outstanding claims.

The two approaches have much in common. Both require management to put forward a reorganization plan (which should contain both financial and operational conditions) for creditors to negotiate and vote on, and the plan is binding on dissenting creditors if enough of the others approve. Both procedures rely on decentralized negotiations. Although the Hungarian reorganizations begin with a court filing, the courts have relatively little involvement thereafter. The Polish process is out of court, although courts may get involved in approving final agreements or handling appeals.

The new rules have had a significant impact in both countries. Hungarian reorganization cases have been concluded surprisingly quickly, with more than 90 percent of filings in 1992–93 completed during that period. The liquidation cases take much longer; most of those filed in 1992 and 1993 are still pending. Strong firms are more likely to enter and emerge successfully from reorganization, whereas weak firms are more likely to fail in reorganization or to file directly for liquidation. The same is true in Poland: firms entering conciliation have higher average operating profits than firms entering bankruptcy or liquidation. Equally important, both processes have stimulated critical institution building in the banks (particularly their debt workout departments), and the Hungarian scheme has helped build the capacity of the courts and the trustee-liquidator profession.

There is, however, considerable room for improvement. Weak collateral laws (see Chapter 5), poor financial information, and (particularly in Hungary) successive bank recapitalizations have undermined incentives for creditors to use the new procedures to impose strong financial discipline on firms. The reorganization plans that have emerged from the reforms have provided relief from debt service but contain few if any conditions on operational restructuring. Although a good start, it will be some time before the new regimes stimulate as much creditor-led restructuring as their equivalents in established market economies.

output of state enterprises rose and revenues from enterprises climbed from 6 to 11 percent of GDP in just three years. State enterprises—a category that includes joint ventures with private foreign or domestic partners—now provide about half of total government revenue. Managers and workers went along with this rapid reform for three reasons: firms retain their after-tax profits, distributing much of it in bonuses and higher wages; most of the dismissed workers were absorbed into the rapidly growing private sector; and state firms had never provided extensive social benefits. In contrast to most CEE countries and the NIS, however, Vietnam's state firms still benefit from a wide array of protective and distortionary measures (exchange controls and land policy, for example) that hinder free entry and competition and bias state firms toward capital-intensive production.

China has not taken equally dramatic steps to end the flow of subsidies to state-owned firms, but officials are increasingly concerned with their poor performance relative to the nonstate sector. State enterprises remain important financial and economic actors in China. Although their share of industrial output has declined considerably since the early 1980s, they still accounted for three-quarters of investment and 70 percent of bank credit in 1994. Efforts to improve state enterprise performance have focused on improving corporate governance and management through contracts for managers, new accounting standards, the shifting of supervisory control to the provinces, leasing, corporatization, and the selling of minority shares on domestic and foreign stock exchanges. Hundreds of smaller, unprofitable state enterprises have been closed or merged with other firms. The efficiency of some state enterprises has risen, although by how much is hotly debated. What is not disputed is that the benefits have been largest where enterprises are most exposed to competition and market incentives.

Overall, however, the number of unprofitable state enterprises in China has been growing steadily, because these firms invest too much and earn too little. They face onerous problems of excessive employment, unfunded pensions, and obligations to provide social services they cannot afford. Forty percent of state firms reported losses in 1995, despite paying interest on their borrowings at rates well below inflation. To the extent that they result from increased financial discipline, losses could be a mark of progress. But losses cannot be allowed to continue indefinitely; persistent money-losers must be forced to restructure or close. The frequency with which the government has announced new state enterprise reform programs suggests how difficult reform really is. This is not surprising; a wealth of international experience, from economies as diverse as Japan, New Zealand, Pakistan, and the Republic of Korea, indicates that state enterprise performance can indeed be improved, but improvement is hard to accomplish and even harder to sustain.

In sum, one of the strongest messages to emerge from transition to date is that governments that enforce financial discipline and foster competition will stimulate restructuring in enterprises, regardless of ownership. But many firms get stuck in the early stages. Most adjustments have involved downsizing—of output, employment, and assets. Managers have been survival-oriented; like turnaround managers everywhere, they have focused on sustaining current cash flow. It will take time, and in many cases a clarification and reallocation of property rights, to move from this defensive reaction to a deeper strategic restructuring that involves new and innovative business strategies and investment.

Direct government intervention: Alluring but risky

In addition to—or sometimes instead of—policies to introduce competition and increase financial discipline, some transition governments intervene directly to carry out targeted, top-down programs to restructure enterprises. The problem here is not with the near-universal practice of partial or complete public ownership of certain firms in infrastructure industries with natural monopoly characteristics. Transition economies' interventions in these sectors are generally in line with those in industrial market economies, and indeed in some cases ahead of them: Estonia and Hungary, for example, have sought to exploit the new wave of opportunities for private sector involvement in infrastructure provision. Rather the concern is with cases where governments extend their reach far beyond infrastructure firms to engage in so-called industrial policy, arguing that transition justifies direct government intervention to give industrial enterprises, public or private, the time, protection, and resources to become competitive.

Advocates claim that without state direction and assistance many high-potential firms and thousands of jobs will be swept away by the imperfect functioning of half-developed markets. In some cases the explicit goal is to improve performance without changing state ownership. For private (usually privatized) firms the typical goal is to select companies with good prospects and improve their chances of survival. Proposed interventions include free or subsidized technical assistance in preparing business plans and bankable projects, management training, loans at below-market interest rates, debt forgiveness, and protection from import competition. Similar policies have been associated with good results in several high-growth Asian economies, and it is natural for officials and observers in depressed transition economies to look longingly at activist measures that might offer hope. However, the countries that have had some success with this approach possess advantages that some CEE countries and most NIS lack: disciplined and well-trained bureaucracies, stable and prudent macroeconomic policies, and a long-standing emphasis on export promotion and international competitiveness. In their absence, a proactive industrial policy runs the risk of continuing the costly subsidization of those firms with political clout while shutting out others with greater potential to succeed.

For some enterprises the objective of government intervention is to restructure and add value, to raise the price they can command upon sale. Few would disagree that the state in transition economies can play a legitimate role in breaking up large state enterprises prior to sale, in assisting enterprises and communities in dealing with "social" assets (schools, clinics, housing, day care centers), and in helping fund severance pay. But going beyond this is likely to be wasteful if not counterproductive. New physical investments under public ownership almost never raise the sale price by the cost of the investment. And a continuation of straight subsidies to cover wage bills and working capital compounds the pain and heightens the severity of the eventual cure.

A number of transition economies have developed what are termed isolation exercises for problem enterprises. A set of poor performers, often the biggest money-losers, are put into a "jail" and examined to determine which are potentially competitive and which merit liquidation. Early experience with jails was not promising. Inmates tended to view their isolation units more as rest homes than as prisons, since they provided both relief from creditors and exceptional resources to meet the wage bill. More-recent isolation exercises, for example in Armenia, the Kyrgyz Republic, the former Yugoslav Republic of (FYR) Macedonia, and Uzbekistan, have tried to overcome these problems by assuring prisoners that governments are indeed committed to their sale or closure, and are not simply using the device to delay the day of reckoning. For example, of twenty-nine firms assigned to the Kyrgyz "restructuring agency," over a twenty-four-month period eight have been liquidated (including a 5,000-employee agricultural machinery plant that the government had regarded as strategic), two have been sold, six more are for sale, eleven are being downsized in hopes of rendering them salable, and two are still in the diagnostic stage. So far the exercise has cost around $20 million, of which half went to cover arrears on energy payments and much of the remainder to provide severance payments for more than 40,000 dismissed workers. Proponents argue that both the information supplied by external consultants and the provision of money to pay for severance costs have been crucial in persuading the Kyrgyz authorities to act. As always, however, the deciding factor is the government's willingness to accept the painful reality that downsizing and closures must occur (Box 3.2).

A 1995 study of the 400 to 500 largest firms in Bulgaria, the Czech and Slovak Republics, and Poland points to the key problem with direct government involvement: the difficulty of picking winners based on past performance. Variation in performance among firms in transition economies is much greater than that in established market economies, and as Chapter 2 noted, neither the past performance of a firm nor its inherited debt structure is a good guide to future viability. Even more than elsewhere, transition governments that try to pick winners are likely to choose poorly.

In sum, avoiding direct government intervention is likely to be the best approach in most cases. Tight, sustained macroeconomic policies can significantly reduce the scale of enterprise losses without direct intervention. They force money-losers to downsize and redundant workers to seek jobs in new private firms. To the extent that governments must subsidize—for political or other reasons—subsidies should be targeted and transparent. The key is to avoid the perception that persistent poor performance is somehow socially justified and entails no painful consequences.

The second step: Creating and allocating property rights

Property rights are at the heart of the incentive structure of market economies. They determine who bears risk and who gains or loses from transactions. In so doing they spur worthwhile investment, encourage careful monitor-

Box 3.2 Coal restructuring in Ukraine

Ukraine's coal industry, which employs about 800,000 people, is in deep crisis. Output has fallen by over 40 percent in the past five years. A Ukrainian miner produces an average of 112 tons of coal a year, compared with 250 tons in Russia, 420 tons in Poland, 2,000 tons in the United Kingdom, and 4,000 to 6,000 tons in the United States. Up to half of Ukraine's 250 mines need to be closed in the next decade if the industry is to regain competitiveness. Coal enterprises provide a wide variety of social services, including kindergartens and housing. These are often overstaffed as well: kindergartens, for example, often have one employee for every three children.

Any plan to restructure the coal industry will need to use market incentives, minimize social costs, and have a well-defined role for fiscal support. One approach would involve corporatizing existing mines, excluding those identified as uneconomic, into joint-stock companies as a first step toward privatization or liquidation. Profit-oriented managers rather than the government would decide on the reallocation of investments. Resulting mergers would make it easier for managers to transfer workers from unproductive to productive mines rather than having layoffs at one mine and new hires at another, and thus would allow natural attrition to take care of a substantial part of downsizing. Fiscal support would be needed to fund closing costs, but all new investment would be financed from retained earnings and bank loans. A second element of the plan would involve divesting social assets. Some can be privatized, but others would have to be turned over to municipalities, which, to smooth the transition, would need support, as cost recovery ratios are increased from their present levels of less than 20 percent.

Mine closures can yield significant fiscal savings. A four-year program would require about $250 million to support local governments, $150 million for severance pay, retraining, and temporary employment assistance, and $300 million for closures and environmental costs. But closing uneconomic mines would save $200 million a year, and the benefits of restructuring would be even greater if the remaining mines could reinvest profits to increase productivity. It is cheaper to close uneconomic mines than to cover their losses indefinitely.

ing and supervision, promote work effort, and create a constituency for enforceable contracts. In short, fully specified property rights reward effort and good judgment, thereby assisting economic growth and wealth creation. In addition, a wide distribution of property rights can counteract any concentration of power in the political system and contribute to social stability.

What are property rights?

Property rights include the right to use an asset, to permit or exclude its use by others, to collect the income generated by the asset, and to sell or otherwise dispose of the asset. In market economies these rights are defined in law, usually in great detail (see Chapter 5). Ownership rights to an asset may be split—for example, a widow may have rights to the income from property left by her deceased spouse to her children—but this division is also clearly specified. In transition economies these rights are not at first clearly defined or allocated. Indeed, often such distinctions are not even recognized.

In mature market economies the distribution of property rights across the population and the legal forms through which they are exercised are relatively stable, having evolved over centuries. In most transition economies the initial assignment of property rights is both rapid and partial; it could well be inefficient. Many buildings and plots of land, for example, have been restored to precommunist owners who are neither willing nor able to care for them. Similarly, most former state farms in Russia were privatized as large joint-stock corporations—typically not the most efficient ownership form for agriculture. Thus, for property rights to become fully effective, it is especially important that they be tradable and free to evolve.

Is privatization necessary?

Does it matter whether property is public, private, or something in between? The first obvious test is whether privatization improves performance. An extensive empirical literature (mainly from the 1980s) comparing public and private enterprises in industrial market economies concludes generally, but not uniformly, that private firms exhibit higher productivity and better performance than public enterprises. More recent analyses of performance before and after privatization in industrial and developing countries reach stronger conclusions in favor of private ownership. For example, an analysis of sixty-one privatized companies in eighteen countries (six developing and twelve industrial) showed, in at least two-thirds of the divestitures, postprivatization increases in profitability, sales, operating efficiency, and capital investment—all this, surprisingly, with no evidence of falling employment. In established market economies and middle- to high-income developing economies there is little doubt that private ownership is a significant determinant of economic performance.

Because most privatizations in CEE and the NIS are quite recent, judgments on their impact are just beginning to emerge. The first signs are encouraging in many cases, less so in others. A recent study of Hungarian firms found that new private companies in the sample were quicker than state firms to adjust their labor forces as demand changed. Privatized firms at first resembled state firms, but, encouragingly, after a year or two their behavior looked more like that of new private firms. Enterprise surveys in Poland in 1993 and Russia in 1994 concur that new private firms behave differently from, and better than, state firms, exhibiting more dynamism and generating higher profits. In the Polish survey (and a similar one in Slovenia) privatized firms also outperformed state companies, although this may in part reflect the fact that the better state firms were the first to be privatized.

Other research supports the positive effects of privatization but suggests that these vary by type of private owner. In Russia and Ukraine owners who had bought their small business units at competitive auctions invested more and realized better performance than insiders who had obtained their shops at near-giveaway prices (although even the insider-owned firms did better than state-owned shops). The likely impact of the mode of privatization and of the identity of the new owner is discussed further below.

Poland has been slower to privatize than many other transition economies. Some argue that its 6 percent average annual growth since 1994 shows that privatization is unnecessary. But this assessment is incomplete; what Poland's experience illustrates is rather the importance of determined macroeconomic reforms imposing financial discipline on companies, the emergence of large numbers of new private firms, and managerial expectations of eventual privatization in state firms themselves. Most of Poland's growth has been fueled by expansion of the new private sector, not by well-performing state firms. Also, the turnaround in some Polish state firms in the early 1990s was stimulated in part by managers' belief that privatization was just around the corner. New Zealand's experience (Box 3.3) applies in transition economies: a state with the will to impose a hard budget and expose its enterprises to competition can expect performance in some firms to improve without changing ownership. But the gains from hard budget constraints will be larger and more likely to endure if ownership change accompanies or closely follows these reforms.

Widespread formal privatization of majority stakes in the larger state firms is not presently on China's agenda. Still, much of the Chinese economy has moved away from state ownership, some into private hands but most into intermediate forms of ownership. The nonstate sector has

Box 3.3 Locking in the gains of enterprise reform in New Zealand

In 1986 the government of New Zealand launched a major reform of its poorly performing public corporations. Commercial profitability was set as the main goal; any remaining social objectives had to be agreed by parliament and paid for from the government budget. State-owned firms were placed on the same legal footing as private companies, exposed to competition wherever possible, and required to seek any new financing on commercial capital markets without government guarantees. A new Ministry of State Enterprises shared the ownership function with the Treasury, replacing the involvement of line ministries. Together they appointed each firm's board of directors, drawing almost exclusively from the private sector. The board, in turn, appointed the top management of the firm and set and administered annual performance targets. Managers who achieved their objectives were rewarded; those who did not were subject to sanctions, possibly including dismissal. If the government owners were dissatisfied, they could—and sometimes did—dismiss the board of directors.

Results were impressive. After four years sales, profits, and output per employee had increased in ten of eleven companies examined. Even so, successive governments went on to privatize a number of the companies and contemplated privatizing several others. Why, if the reformed state firms were so successful?

They did so because they recognized the intense difficulty of sustaining reforms over time. In time of crisis governments admit the priority of commercial objectives, impose harder budgets, and grant managers autonomy. But as the crisis fades or a major political claim arises, commitment to managerial autonomy also fades. For example, the postal service was pressured to reopen small, rural post offices, and the electric power company was pushed to buy locally produced coal despite its higher cost. The conclusion of many in New Zealand, both in the firms and in the government, was that privatization was required, not necessarily to improve performance in the short run but to lock in the gains of earlier reforms.

grown much faster than China's state enterprises despite an imprecise property rights framework that is quite alien to Western legal traditions. What accounts for the differences in performance? Box 3.4 offers an answer.

Ownership matters. But the need to privatize is not equally urgent in all settings. Slower privatization is viable (although not necessarily optimal) if the government, or workers themselves, are strong enough to assert control over enterprises and prevent managers from stealing assets, and if saving and growth in the nonstate sector are high. But where governments are weak and enterprise managers strong, or where restructuring needs dwarf available funds, privatization is urgent. Indeed, in these settings the likely and less desirable alternative is "spontaneous" privatization, in which managers purchase assets cheaply or seize them outright, often in collusion with the political elite. In many countries before the privatization process is formalized (such as Hungary and Russia in 1988–91), in several where privatization has been accepted in theory but stalled in practice (Belarus, Bulgaria, Ukraine), and even to some extent in the East Asian transition economies that have eschewed formal privatization, assets or income flows have slipped out of state hands and into private control, if not outright ownership, through a variety of methods. These transfers are often illegal and widely resented. Indeed, in some cases privatization has been delayed less because of political philosophy or uncertainty about the optimal approach than because continued state ownership preserves the ambiguous property rights that allow profit shifting, tax evasion, and asset looting, largely for the benefit of incumbent managers.

Bulgaria's experience illustrates the point. A coalition government liberalized extensively and early and implemented a determined stabilization program. Swift privatization was anticipated. But a new administration in 1991 diluted the emphasis on reform and blocked adoption of a privatization program until mid-1995. During these four years the Bulgarian state lost much of its capacity to monitor enterprise performance and management. Managers channeled enterprise assets and cash flow to themselves, leaving little to the state but liabilities. Losses of Bulgarian state enterprises, which averaged more than 12 percent of GDP between 1992 and 1994, were covered by loans from an increasingly insolvent banking system. Bulgarian observers concluded that "unclear property rights [are] turning from a legal to a major macroeconomic problem."

Privatizing larger enterprises

Privatizing large and medium-size enterprises has proved far more difficult than originally thought. Policymakers have to weigh complex and often competing goals, satisfy a multitude of competing stakeholders, and cope with the administrative difficulty of privatizing thousands of firms in a relatively short time and without mature, functioning

Box 3.4 China's township and village enterprises

China has developed several halfway forms of industrial enterprise that are neither state owned in the classic sense nor privately owned in the capitalist sense. One important configuration is the township and village enterprise (TVE), owned by local governments and citizens. These mainly produce consumer goods for domestic and international markets. TVEs are generally of two types. The first, owned by the local government, acts like a holding company, reinvesting profits in existing or new ventures as well as in local infrastructure. The second, more recently developed type is much closer to private enterprise in that most are effectively controlled if not formally owned by an individual. Still, they too maintain close fiscal ties to the local government.

The growth and performance of TVEs have been extraordinary. Their share in GDP rose from 13 percent in 1985 to 31 percent in 1994. Output has grown by about 25 percent a year since the mid-1980s; TVEs now account for a third of total industrial growth in China. The nonstate share of industrial output in China climbed from 22 percent in 1978 to a startling 66 percent in 1995. TVEs have created 95 million jobs in the past fifteen years. Capital-labor ratios in collective industry in China are only 25 percent of those in the state sector. Yet labor productivity (output per capita) is close to 80 percent of the level in state enterprises—and rising at more than 10 percent a year. Total factor productivity in TVEs is higher than in the state sector and is growing at 5 percent a year, more than twice the rate in state enterprises.

Several factors explain this remarkable growth and superior record of efficiency:

- *Kinship and implicit property rights.* Strong kinship links among rural Chinese villagers encourage responsibility in entrepreneurs. The sharing of implicit, if fuzzy, property rights leads to a productive combination of risk and reward sharing between entrepreneurs and local governments. Nonetheless, incentives facing TVEs are more like those of private firms in that the residual profits accrue to a limited group: a traditionally stable local community and, in particular, its government and TVE managers. Studies show the enormous importance of TVE profits in local budgets and the close links between local economic performance and the status, income, and career prospects of local officials.
- *Decentralization plus financial discipline.* The 1984 decentralization of fiscal power in China allowed subnational governments to retain locally generated revenues, creating powerful incentives for the development of local industry. Under this system a nonperforming TVE becomes an unaffordable drain on a limited local budget. In the end persistent money-losers are closed and the work force is shifted to more profitable lines.
- *Competition.* Studies also show intense competition for investment (including foreign investment) among communities with TVEs. Success in attracting investment is affected by reputation and local economic performance.
- *Market opportunities and rural saving.* A past bias against light industry and services has created vast market opportunities, buttressed by high rural saving and demand following the agricultural reforms of 1978 and by the limited scope for emigration from rural areas.
- *Links with the state enterprise sector.* The large state-owned industrial sector provides a natural source of demand, technology, and raw materials for many TVEs. Foreign investment from Hong Kong and Taiwan (China) plays the same role for many others.

TVEs will continue to grow, but they must also evolve. As their demands for finance increase and extend beyond their communities, and as people become more mobile, the TVEs' limited and implicit property rights will need to be better defined and made more transferable. Aspects of the TVE phenomenon are specific to China, but the experience holds important lessons for other transition economies: the importance of liberal entry, competition, hard budget constraints, and appropriate fiscal incentives for local governments.

capital markets. Approaches to privatization abound, from extensive efforts at sales to strategic owners, to insider buyouts, to innovative voucher programs involving the creation of large and powerful new financial intermediaries. These efforts are often complemented by extensive programs of restitution to pretransition owners and by smaller programs of debt-equity conversion or public offering of shares on newly emerging stock markets.

Each approach to privatization creates tradeoffs among various goals (Table 3.1). Privatizing countries typically want many things: to increase efficiency of asset use by improving corporate governance; to depoliticize firms by

Table 3.1 Tradeoffs among privatization routes for large firms

	Objective				
Method	Better corporate governance	Speed and feasibility	Better access to capital and skills	More government revenue	Greater fairness
Sale to outside owners	+	–	+	+	–
Management-employee buyout	–	+	–	–	–
Equal-access voucher privatization	?	+	?	–	+
Spontaneous privatization	?	?	–	–	–

cutting links to the state; to move quickly to create owners who will support further reform; to increase firms' access to capital and expertise; to bolster government revenues; and to ensure a fair distribution of benefits. Within this range countries have different priorities, and some want to proceed more quickly than others. Hungary, with its large foreign debt, has always viewed revenues as critical, the Czechs and the Romanians less so. To Russian reformers a speedy break with the past was paramount, while the Poles have forgone speed and entered into long debates over fairness. The Czechs have consistently stressed privatization's depoliticizing role, while Estonia's privatization program sought out "real" owners capable of bringing new money and management skills to bear.

Table 3.1 presents only a partial view of these tradeoffs. A key additional objective in all transition settings is long-term institution building. Privatization can spur development of such fundamental market institutions as capital markets, legal systems, and business-related professions. By the same token, each approach to privatization sets off a complex process of institutional and ownership change whose long-run results may differ considerably from the shorter-run picture. For example, mass privatization may not produce the best owners in the short run, but it might lead to better corporate governance in the long run if it promotes the development of capital markets (and subsequent rearrangements of ownership) and of intermediary monitoring institutions for the economy as a whole.

What is effective corporate governance? A primary economic rationale behind privatization is to create owners who are motivated to use resources efficiently. But changes in ownership will not change managerial behavior if the new owners lack the power, incentives, and capability to monitor the managers and ensure that they act in the firm's best interest. Owners must also have the power to change managers, since it often takes a shake-up at the top to spur deep restructuring. For small firms such corporate governance is straightforward: usually the owners are themselves the managers. It is with large firms that the separation of ownership and management creates a need for monitoring. Direct monitoring by shareholders is one way to supervise managers. Another is to sell shares when performance is weak and let falling stock prices discipline managers. In the early stages of transition, direct monitoring is likely to be particularly important, because markets for capital and managerial labor are not sufficiently developed to exert strong competitive pressures on managers.

Political feasibility is a *sine qua non* of any privatization program. There is a profound tension between the need to reward stakeholders—managers, workers, officials in the former branch ministries—and the desire for good economic outcomes that contribute to economic restructuring and institution building and reinforce the benefits of reform in the public eye. Competition among stakeholders has affected the design of most privatization programs. The former Czechoslovakia and the former East Germany, with their centralized power structures and well-developed administrative capacity, could design and implement top-down privatization programs. Poland, Slovenia, and Russia, with more decentralized power structures, well-organized employees (in Poland and Slovenia), and strong managers (in Russia), had no such option. Yet accommodating stakeholder interests is risky and often conflicts with longer-run economic and political goals. Newly privatized entities may fail to restructure because of inappropriate corporate governance. Poorly managed privatization, even if it delivers short-term revenue or performance gains, may be seen as corrupt or highly inequitable, concentrating economic and political power in the hands of a domestic elite or foreign investors rather than expanding an independent and decentralized middle class. The various routes and illustrative country experiences are outlined below and in Table 3.2.

Sales to outsiders

In the early days of transition most CEE countries hoped to privatize by selling state enterprises case by case as going concerns. This was the best-known model, which had been very successful in established market economies like the United Kingdom and in middle-income developing countries like Chile. Sales to outside "strategic" or "core" investors were also favored because they would bring in revenue and turn the firm over to "real" owners possessing the knowledge and incentives to govern the company efficiently and the capital to restructure it.

Sales to outside investors have largely fulfilled expectations about performance improvements. But they have proved costly and slow, far more difficult to implement than anticipated, and most important, few in number. One reason is the limited amount of domestic capital, combined with the political tensions that can accompany a large dependence on foreign capital. Even where domestic capital is sufficient, insiders (managers and other

Table 3.2 Methods of privatization for medium-size and large enterprises in seven transition economies
(percentages of total)

Country	Sale to outside owners	Management-employee buyout	Equal-access voucher privatization	Restitution	Other[a]	Still in state hands
Czech Republic						
By number[b]	32	0	$\boxed{22^c}$	9	28	10
By value[d]	5	0	$\boxed{50}$	2	3	40
Estonia[e]						
By number	$\boxed{64}$	30	0	0	2	4
By value	$\boxed{60}$	12	3	10	0	15
Hungary						
By number	$\boxed{38}$	7	0	0	33	22
By value	$\boxed{40}$	2	0	4	12	42
Lithuania						
By number	<1	5	$\boxed{70}$	0	0	25
By value	<1	5	$\boxed{60}$	0	0	35
Mongolia						
By number	0	0	$\boxed{70}$	0	0	30
By value	0	0	$\boxed{55}$	0	0	45
Poland						
By number	3	14	6	0	$\boxed{23}$	54
Russia[c]						
By number	0	$\boxed{55}$	11	0	0	34

Note: *Boxed numbers show the dominant method in each country. Data are as of the end of 1995.*

a. Includes transfers to municipalities or social insurance organizations, debt-equity swaps, and sales through insolvency proceedings.

b. Number of privatized firms as a share of all formerly state-owned firms. Includes parts of firms restructured prior to privatization.

c. Includes assets sold for cash as part of the voucher privatization program through June 1994.

d. Value of firms privatized as a share of the value of all formerly state-owned firms. Data for Poland and Russia are unavailable.

e. Does not include some infrastructure firms. All management buyouts were part of competitive, open tenders. In thirteen cases citizens could exchange vouchers for minority shares in firms sold to a core investor.

Source: Gray, background paper; World Bank data.

employees) in some countries have been able to block sales. More generally, the process is held back by the sheer magnitude of the job of evaluating and negotiating deals one by one, and then of following up to be sure that the buyers fulfill contract provisions. For example, in Germany it is reported that 20 percent of the thousands of privatization contracts signed by the Treuhandanstalt (the privatization agency) are in dispute.

Placing a value on firms to be offered for sale is particularly problematic. The issue is only partly one of inadequate accounting. Economic and political turbulence often make it impossible to estimate a firm's eventual value. Appraising and assigning responsibility for past environmental damage is also a thorny issue (Box 3.5). Governments that insist on high minimum prices (as has occurred in Hungary and more recently in Ukraine) may find no takers. A final disadvantage of the sales approach is its perceived unfairness. Many ordinary citizens cannot participate and find the process nontransparent and arbitrary, if not corrupt.

These obstacles have been even more debilitating than expected. The German Treuhandanstalt was able to privatize (or liquidate) its 8,500 state enterprises relatively quickly, but at an enormous cost in terms of both skilled personnel and explicit or implicit subsidies to buyers. Among other transition economies, only Hungary and Estonia have privatized a significant share of their state enterprises through direct sales. No other country has even come close to these achievements. In Poland the power of workers to block privatization has slowed progress: five years of effort by various administrations has produced about 200 sales. The conclusion is that sales, although a useful element in the privatization process, cannot in most circumstances be the sole or even the primary method.

A second form of sale to outsiders involves floating shares on public stock exchanges. The infancy of stock exchanges (see Chapter 6) limits this approach in all the transition economies. Furthermore, the method works only for firms with good financial prospects and strong reputations. Even Poland, which has had the most success with this approach, has privatized fewer than thirty firms in this manner. Hungary has had no greater success.. Initial public offerings are clearly not the answer to the need for rapid, large-scale privatization, although at the margin they can help develop capital markets and share trading.

Management-employee buyouts

Management-employee buyouts are a widely used alternative to sales, notably in Croatia, Poland, Romania, and Slovenia. Many of the firms privatized through Lithuania's and Mongolia's voucher programs effectively became management-employee buyouts as employees and their families used vouchers and cash to buy major stakes in their own firms. In addition, several voucher-based programs, such as those of Georgia and Russia, gave such large preferences to insiders that most privatized firms were initially owned primarily by managers and employees.

Buyouts are relatively fast and easy to implement, both politically and technically. In theory they might also be

Box 3.5 Is environmental liability a serious barrier to privatization?

A prospective investor sizing up an industrial plant in a transition economy wants clear agreement in advance on how responsibility for environmental damage caused by the plant will be allocated. Without such an agreement, the assumption is that the environmental authorities will impose hefty cleanup costs on the company down the line. The Treuhandanstalt's sales procedures included an assessment of environmental liabilities, followed by an agreement on corrective measures, whose cost was taken into account in the final sale price. Other countries, however, lack the skills, financial resources, and even the desire to imitate the German model. Environmental liabilities have usually been ignored. Transferring them with the plant—the philosophy underpinning Czech and Polish legislation—is one solution. But after a sale the new owners may claim, often with some justification, that they were unable to assess environmental liabilities properly because of insufficient time or information, or because regulators have since tightened the relevant standards. The result is often a prolonged period of conflict. In the Czech case it is increasingly clear that the strict transfers of environmental liabilities to companies during the early rounds of voucher privatization will not stick. Discussions are under way to come up with ways for the state and the new owners to share cleanup costs. An alternative approach is for the state to retain responsibility for some or all environmental liabilities, usually defined on the basis of an environmental audit prior to sale. But it can be difficult to make the agreement credible: what prevents the government from later reneging? Setting up a special cleanup fund to discharge the government's commitments might be one way to make them more believable.

better for corporate governance if insiders have better access than outsiders to the information needed to monitor managers. In the early stages of privatization in Slovenia, for example, insiders voluntarily purchased a number of successful firms, which have generally continued to perform quite well.

However, the risks and disadvantages are many, particularly in large-scale buyout programs that include many unprofitable firms in need of restructuring. One disadvantage is that the benefits are unevenly distributed: employees in good firms get valuable assets while those in money-losers get little or nothing of value. Another is that governments typically charge low prices to insiders and thus realize little revenue. Most important, management-employee buyouts may weaken corporate governance, particularly in transition economies, where controls on managers are less developed than in a fully fledged market economy and product and capital markets cannot be counted on to enforce discipline. Insiders are generally unable to bring in new skills and new capital, yet may deter outsiders who can from investing. Managers or employees may simply prevent outsiders from buying shares. Or outsiders may hesitate to invest in firms with significant insider ownership—legally or illegally acquired—because of potential conflicts of interest between inside and outside owners. For example, inside shareholders may vote to pay themselves higher salaries even if doing so reduces profits and share value. The bottom line is that management-employee buyouts can lead to managerial and worker entrenchment that blocks further reform.

Russia's mass privatization program of 1992–94, although it used vouchers, was basically a management-employee buyout program because of its preferential treatment of managers and workers. These insiders could choose between receiving a minority of shares at no cost and purchasing a majority of shares at a large discount. They chose the second option in about 70 percent of cases. These transfers were handled in "closed subscriptions" in advance of open voucher auctions, at which managers and workers could use their vouchers to add to their ownership. In the end insiders acquired about two-thirds of the shares in the 15,000 privatized firms. Outsiders obtained 20 to 30 percent (about 10 to 15 percent each went to investment funds and individual investors), and the rest remained in government hands.

In many respects Russia's mass privatization was a major achievement, particularly in light of the political and economic turmoil that confronted Russian policymakers in the early 1990s. But the program well illustrates the drawbacks of management-employee buyouts and, more broadly, the serious tensions between political feasibility and economic desirability. The extensive preferences given to managers and workers to garner their support, and the inability to install procedures to protect minority shareholder rights and to promote secondary trading, are now proving costly. Managers control their insider-owned firms with little if any employee-shareholder influence. Some managers have tried, often illegally, to prohibit workers from selling their shares to outsiders. Some have used even less transparent means to block participation by either employees or outsiders or to transfer assets or profits to other firms they control. Given the weakness of laws and institutions, the scarcity of information, and in some cases the laxity of competitive pressures (due in part to the incomplete macroeconomic stabilization before 1995), few if any outside controls existed to thwart such behavior. This is as much a problem of efficiency as of transparency: behavior of privatized Russian firms is so far hard to distinguish from that of state firms.

This kind of insider ownership has not been stable on such a large scale elsewhere in the world and almost certainly will not be in Russia. It is likely eventually to evolve at least in part into ownership by outside investors (banks, investment funds, or other domestic or foreign investors), although an intermediate stage is likely to see increased ownership by managers as they buy up employee shares or divert assets to other companies they own. How long this evolution will take, however, depends largely on the government. If enterprises cannot rely on either open or hidden subsidies to cover their losses, and if price and trade liberalization intensifies competition, some managers will be forced to turn outside for financing. Some evidence indicates that outsiders are finding ways to acquire significant stakes in some privatized firms. A recent survey found that insider ownership in a sample of 142 firms fell from 65 percent in 1993 to 56 percent in 1995—a modest move in the right direction.

On the other hand, lax Russian macroeconomic and competition policies could combine with deficiencies in law enforcement to prolong insider control, further delay restructuring, and permit unfair and fraudulent transactions. In some of the largest and richest firms—in the oil and gas sectors, for example—initial privatizations were particularly murky, and sales of remaining shares have been far from regular. And the "shares for loans" schemes carried out in 1995 generated less revenue than expected and were decidedly opaque. Overall, many Russians resent the way privatization has been conducted, feeling they have received a pittance while some managers—and their high-placed political supporters—gained fortunes. One study estimated that the 19 percent of adult Russians employed in privatized firms obtained 56 percent of equity sold through June 1994; the remaining 81 percent who received only vouchers ended up with 15 percent of the divested assets. Transactions in 1995 almost certainly added to the disparity.

Ukraine presents another case of insider entrenchment. Although generally slow to privatize, the government has implemented some management-employee buyouts. It introduced a voucher privatization program in 1994–95 but has so far failed to carry it through effectively. Macroeconomic reforms have been slower than in Russia, and some firms still have ready access to state subsidies. A recent survey of privatized companies in both countries indicated that Russian insider-owners, facing somewhat greater financial discipline, had taken more steps to improve efficiency and were less hostile to outsiders than their Ukrainian counterparts. These results point once again to the importance of financial discipline in promoting restructuring and ownership change in firms privatized through management-employee buyouts.

Equal-access voucher privatization

A third form of privatization distributes vouchers across the population and attempts to allocate assets approximately evenly among voucher holders. Such programs excel in speed and fairness. But they raise no revenue for the government, and they have unclear implications for corporate governance. Mongolia, Lithuania, and the former Czechoslovakia were the first to implement this form of privatization. Albania, Armenia, Kazakstan, Moldova, Poland, Romania (in its 1995 program), and Ukraine have followed, and Bulgaria is now preparing such a program. Some countries (such as Georgia and Russia) have used vouchers but given strong preference to insiders, as discussed above. A few countries (Estonia and Romania in its 1991 program) have used vouchers to transfer only minority stakes in certain firms. Hungary, FYR Macedonia, and Uzbekistan are among the few privatizing transition economies that have specifically rejected vouchers, arguing that shares given away are perceived by recipients to have no value, and that voucher programs merely delay the arrival of "real" owners.

The Czech Republic's mass privatization program has been the most successful to date. In two successive waves (the first while part of Czechoslovakia), the Czechs transferred more than half the assets of state enterprises into private hands. Citizens were free to invest their vouchers directly in the firms being auctioned. However, to encourage more concentrated ownership and so create incentives for more active corporate governance, the program allowed the free entry of intermediary investment funds to pool vouchers and invest them on the original holders' behalf. More than two-thirds of voucher holders chose to place their vouchers with these competing funds. The ten largest obtained more than 40 percent of all vouchers in both waves (about 72 percent of all vouchers held by such funds), leading to concentrated ownership of the Czech industrial sector in these large funds. This is in stark contrast to the experience of Mongolia, which forbade the entry of intermediary funds and ended up with heavy insider ownership.

Are the Czech funds active owners, capable of exercising good corporate governance? Although it is too early to judge definitively, some funds are developing both hands-on shareholder monitoring (as practiced in Germany and Japan) and active share trading (more common in the United States) as tools for monitoring managerial performance. These funds are putting representatives on company boards, demanding better financial information, and imposing financial discipline on the firms they own. They are trading large blocks of shares among themselves or selling them to new strategic investors, and a moderately active share market has developed, on the Prague Stock Exchange and in the much larger over-the-counter system. Clearly, however, patterns of ownership in the Czech Republic are still in flux. Some observers hope that the funds, together with banks or in place of them, will become the cornerstone of the financial infrastructure essential for capital allocation and corporate governance in a market economy. Others expect the funds' influence to dwindle rapidly as strategic investors pick up controlling blocks of shares. In either case the goal of institution building appears to be well served by this approach.

The Czech experience illustrates how a well-designed voucher privatization program can overcome many problems. It can depoliticize restructuring, stimulate development of capital markets, and quickly create new stakeholders with an interest in reform. But plenty of obstacles lie along the road from mass privatization to efficient capitalism. Governments need to implement complementary reforms—for example, regarding the supervision of financial intermediaries and the regulation of natural monopolies (Box 3.6). The former Czechoslovakia and Russia allowed free entry of investment funds, whereas Poland and Romania called for the top-down creation by government of a predetermined number of funds. Each approach has its risks. A particularly vexing question is: who monitors the monitors? Supervising financial agents, difficult enough in established market economies, is even more problematic in transition economies, where norms of disclosure and fiduciary responsibility are weak, and watchdog institutions and oversight mechanisms are in their infancy. Policymakers need to think carefully about how to regulate funds to protect individual investors in the funds and other minority shareholders in firms partly owned by the funds.

Privatizing small firms

Small firms have proved much easier to privatize than large ones. Most small firms were engaged in trade and services, activities with simple technology and easy entry.

Box 3.6 Do's and don'ts in privatizing natural monopolies

Privatizing public utilities and infrastructure industries, such as electricity, telecommunications, natural gas, oil pipelines, water supply, ports, airports, and railroads, raises complex issues that do not apply to other industries. These industries are typically large and capital-intensive. They are critical to the functioning of the economy and hence often viewed as strategic. Parts of some of them are natural monopolies in which competition is technically impossible. And for largely political reasons they often charge low, controlled prices that result in financial losses. Privatizing them involves at least four steps:

- Introducing competition by separating the monopoly parts from the competitive parts, allowing new firms to enter the competitive parts, and possibly restructuring the monopoly parts
- Establishing laws and institutions to regulate price and quality in the monopoly parts
- "Commercializing" the enterprises and
- Attracting private sector participation through concession arrangements or privatization (whether sales to strategic investors, mass privatization, or a mixture of both).

Commercialization involves creating enterprises that, although still public, are similar in structure and operation to private enterprises. Enterprises should be removed from the control of ministries and converted into joint-stock companies reporting to a board of directors. Prices should be increased to efficient levels and subsidies reduced and targeted (see Chapter 2). The financial structure of these enterprises should be similar to that of private companies: assets may need to be revalued and debt (initially owed to the government) may need to be added to the balance sheet as a liability.

A growing number of transition economies—most notably the Czech Republic, Estonia, Hungary, and Russia—are joining the worldwide trend toward infrastructure privatization. Others are considering doing so. In the energy sector Hungary has gone the furthest in privatizing through sales. It has adopted a regulatory framework, raised average prices to near world levels, and split companies into smaller entities. It has sold majority stakes in its oil and gas production company and several power generation and gas and power distribution companies to strategic investors. This desire to sell firms for cash, motivated in part by the need to raise revenues, has spurred price and regulatory reforms because prospective buyers need the assurance these reforms provide. Hungary has learned from its 1992 and 1993 attempts to sell electric power and gas distribution companies, which failed because of a lack of proper pricing and regulatory policies.

The Czech Republic and Russia provide an interesting contrast to Hungary's sales approach. They included partial stakes in their large, integrated energy companies (such as 30 percent of the Czech power company and 50 percent of Russian power and gas companies) in their voucher privatizations. These stakes were essentially given away, and so generated no demand for price and regulatory reform. Household energy prices remain low, and neither country has made much progress in developing effective regulatory systems. Any future increases in government-controlled prices will generate huge windfalls for the new owners. Because of their low initial levels of debt, the companies are building large cash surpluses as industrial energy prices approach world levels. In the meantime there is little corporate governance from outside owners, creditors, or government. Although in other ways these voucher privatization programs (particularly the Czech one) were impressive, the government's lack of attention to complementary reforms in the area of natural monopolies is problematic.

None of the major obstacles to privatizing larger entities —high capital requirements, major restructuring needs, and regulatory and governance weaknesses—apply to small firms. Local authorities can take charge of transferring small units, and because they are easier to value, many parties can gain access to enough information for open auctions to succeed. Even where insiders are given strong preference (as in Russia), assets can be quickly transferred to higher-value uses through secondary markets. Governments, however, must resist the temptation to impose artificial limits on property transfers, by setting minimum prices, for example, or by forcing buyers to stay in the same line of business.

Small sales are also easier politically. Organized opposition has been weak. Services had been neglected under central planning, resulting in shortages, queuing, drab stores, and limited variety. Privatization has led to quick improvements in quantity and quality. Progress in this area can also provide an impetus for reforms elsewhere in the economy. Privatized small businesses can serve as schools for entrepreneurs and investors and can absorb labor being shed from large-scale enterprises.

The former Czechoslovakia, Hungary, and Poland were the first countries to achieve widespread ownership of small businesses, using very different approaches. The Czechs implemented a centrally conceived but locally administered system of open, competitive auctions. Poland's program, like its large-scale privatization program, was somewhat ad hoc and gave large concessions to employees. Hungary had a reasonably sized trade and services sector even under central planning, with strong, decentralized managerial control through leasehold. This sector grew less through widespread privatization than through the entry of private competitors. Following these leaders, most other transition economies have carried out substantial small-scale privatization, and Albania, the Baltic states, Croatia, Russia, and Slovenia have caught up with the early starters in terms of the percentage of small firms divested.

Russia has divested most of its small units, but as was true of large-scale privatization, insiders have ended up with much of the ownership. This is worrisome. Studies of small privatization in Central Europe, Russia, and Ukraine show the need to bring in outsiders, who tend to invest more and supply services better. Czech-style auctions result in a more competitive structure of ownership than other privatization methods and bring in the largest number of outside investors. But political realities cannot be ignored. Where insiders are strong enough to block outsider participation, privatization to insiders is still better than keeping the assets under state ownership, especially in the case of small firms, where competition can quite easily force subsequent restructuring and reshuffling of ownership.

Privatizing and restructuring farms

Chinese agriculture was collectivized in the 1950s, effectively stifling individual incentive. Agriculture was then heavily taxed through price and marketing controls until 1978, when the household responsibility system was introduced. This broke up collective farms and vested households with use rights over the land they worked. It also relaxed discriminatory price policies and controls over marketing. The result was a dramatic increase in agricultural production. Higher rural incomes followed, raising local demand for food, while the government continued to subsidize food in urban areas. The boom in agriculture helped propel growth throughout the economy. Vietnam went through a similar process in the mid-1980s, passing from importing to exporting rice in a very few years. In both countries market forces now mainly determine agricultural prices and production.

Agricultural reform has been harder in CEE and especially the NIS. In contrast to China, agriculture in these countries was both highly mechanized and heavily subsidized under central planning. Collective and state farms were too large to be managed effectively. Like large state-owned industrial firms, they were kept alive through easy access to bank credit and extensive subsidies to both farms and consumers. Coexisting with these large farms was a stunted private sector of small, individually owned farms and household plots. This dual structure deprived the state sector of efficient labor and the private sector of efficient technology. Reforms in the early 1990s cut consumer subsidies and other transfers to agriculture. The demise of the protected markets of the CMEA was an additional severe blow. Demand plummeted, particularly for meat and milk, and overall agricultural output fell by a quarter to a third. Some governments then squeezed agriculture even harder by retaining partial price controls on output while easing controls on inputs. Agriculture suffered a sharp fall in profitability.

Clear property rights, assigned to people rather than collectives, are as important in agriculture as in industry. Much of China's success can be attributed to its move toward more individualized land rights through explicit or implicit long-term leases. Commitment to full private ownership of agricultural land has been strong in Central Europe but partial in Belarus, Moldova, Russia, Ukraine, and the Transcaucasus. In Central Asia Turkmenistan allows private land ownership—with no right of transfer. (The constitutions of some other Central Asian republics forbid private landholding.) Where memory and documentation of prior ownership are strong, as in much of CEE and the Baltics, restitution of land has prevailed (Box 3.7). Elsewhere land rights have been distributed to employees of state farms and other rural residents through in-kind transfers, as in Albania and Armenia, or through paper entitlements (legal recognition that the holder owns a part of a cooperatively farmed unit), as in Belarus, Moldova, Russia, and Ukraine.

Privatizing farms is different from privatizing industries. For two reasons, reorganizing—or restructuring—has to be an integral part of the privatization program. The first relates to economies of scale: these are limited in farming, and supervising large numbers of workers is costly. Yet central planning left farms that are gigantic by world standards. Russian farms still average 6,000 hectares; in 1987 only 3 percent of U.S. farms exceeded 840 hectares. Russia has corporatized many former collective farms and divided ownership shares among members, but this does little to improve labor incentives. On the other hand, restitution and distribution in kind have in some cases gone too far in the other direction, creating many new owners of small holdings (often less than 2 hectares) that may be too fragmented to take full advantage of the limited economies of scale that do exist.

The second reason why reorganization needs to accompany privatization is that farms are poorly suited to the

Box 3.7 The pros and cons of restitution

Most communist regimes seized large amounts of private property. Restitution of this property to precommunist owners or their heirs is appealing—but fraught with difficulties. The Baltic countries and most of the CEE countries have taken steps to reverse earlier confiscations by paying compensation or returning property to former owners. Among the most aggressive efforts (besides those in the former East Germany) have been those of Bulgaria, the former Czechoslovakia, and Slovenia. All three passed laws providing for extensive restitution of land, housing, and enterprises, either in kind (if possible) or through substitute property, securities, or money. Estonia, Latvia, and Lithuania passed laws providing for restitution of urban and rural land; about 1 million people have filed claims in the three countries. Romania has aggressively pursued in-kind restitution of agricultural land, through which about 2.4 million private farms have been created. Hungary is one of the few holdouts: it has opted against in-kind restitution in favor of coupons that can be used to purchase privatized property (including land).

Restitution in kind can certainly contribute to private sector development, particularly in retail trade and services. However, it can be complex and sometimes arbitrary, creating uncertainty that may interfere with other privatization methods and clog the judicial system. In the Czech Republic, for example, tenants in restituted apartments have clashed with new owners over rights and responsibilities. Some interested private parties have been afraid to purchase businesses for fear of restitution claims. In Romania land often could not be returned to its former owners because it had been converted to nonagricultural uses; the allocation of alternative plots resulted in more than 300,000 court actions. Restitution of agricultural land was complicated and slowed in the Czech Republic by lack of proper title documentation.

Hungary's program of compensation coupons has been less disruptive but also less far-reaching. Privatization transactions have not been burdened by the uncertainty of potential compensation claims, and conflicts between competing claimants have not overburdened the courts. Compensation coupons are traded on the Budapest Stock Exchange and provide a useful source of domestic capital to purchase privatized firms. From an economic perspective Hungary's approach appears sensible, although some see it as less fair, and it contributes less to privatization and private sector development in the short run.

corporate form. Most corporate farms in North America, for example, are family farms incorporated for tax purposes, not companies with many shareholders. Secondary markets in shares of farm corporations are virtually unheard of. Corporatizing collective and state farms therefore creates farm structures with no counterpart in market economies and no ready mechanism for their evolution and reorganization, since share trading on secondary markets is unlikely to develop.

The reorganization of farmholdings should concentrate on establishing and documenting individual ownership of land and nonland assets and on creating markets through which owners can adjust farm size and capital intensity. Where owners choose to farm jointly, they should retain individual ownership of their parcels and not be required to transfer title to the group or enterprise in common. Nonetheless, over sixty years of nonprivate farming in parts of the NIS has instilled a view that land is not a commodity like any other, and that land markets should be highly constrained. This has created considerable resistance to change.

Varying share systems for farmland and other farm assets have been adopted in much of the NIS. But reorganization through share allotment brings little or no change to traditional farms. Shareholders need a mechanism for converting their stock into real assets such as land, farm equipment, and buildings. One of the few specific mechanisms that has been implemented (on a pilot scale in Nizhniy Novgorod, Russia) is the internal auction. After an initial period of share distribution, public education, and asset valuation, participants bid their shares in auctions against the farm's real assets. The farm is then liquidated, and the new enterprises created through the auction are registered. By mid-1995 sixty-eight farm enterprises had gone through this process. Out of five farms in the earliest stage of the program (1993–94), twenty collective enterprises, seventeen family farms, and six individual businesses were created. This is a promising beginning.

Whatever mechanism of initial privatization is adopted, the critical need is for freely functioning land markets. Such markets provide flexible mechanisms for reorganization, preventing resources from being locked into the forms created in the early stages of reform. Until late 1992, for example, Hungary allowed shareholders to propose a package of assets to trade for their shares and then to withdraw to form a new unit. If the remaining shareholders did not agree, the entire farm underwent an internal auction against shares. Although a natural tension exists between the stability needed for operation and the ease of exit needed for flexible evolution, the latter is critical in the transition environment.

Privatizing commercial real estate

Commercial real estate was considered to have no productive value under central planning. In market economies, however, commercial real estate is a vast store of wealth, often larger than industrial plant and equipment. Real estate is also a critical factor in new business entry; start-ups need access to premises or, equally important (given the poor state of many existing buildings), access to vacant land and permits to construct new buildings. Both are hard to come by in many cities in transition economies; the result is a severe shortage of commercial space, which is blocking private sector development.

Reformers had have meager success in privatizing commercial real estate: no transition economy has yet embarked on a systematic program. What progress some countries and cities have achieved has come as a side effect of other privatization initiatives. Bulgaria, the Czech and Slovak Republics, and Slovenia included substantial amounts of commercial real estate in their restitution programs (see Box 3.7). Many countries have transferred rights to commercial real estate—but often only lease rights—to occupants or to the highest bidders through small privatization programs. In both restitutions and small privatizations new owners have had to deal with the strong tenancy rights of current occupants. For example, one external investor gave up efforts to purchase a hotel site in Prague in 1994 when it could not reach agreement with the site's three tenants. In Bulgaria owners by restitution must continue to rent to the current tenants for three years. These conflicts between former occupiers and new owners are unavoidable. The key is to establish clear rules so that transactions can proceed and markets can develop. Some countries have included the real estate occupied by large state firms in enterprise privatization programs. (Poland and Russia are notable exceptions.) Furthermore, state enterprises in almost all transition economies have leased or otherwise transferred unneeded land and buildings when squeezed by hardening budget constraints or when tempted by opportunities for "spontaneous" privatization. However, because state enterprises typically hold only use rights, such transfers are often not legally valid.

The result of these partial efforts to privatize commercial real estate in most transition economies is a patchwork of confused property rights and continued widespread public ownership. Even in Bulgaria, the Czech and Slovak Republics, and Slovenia local governments still own large amounts of retail and office space and vacant land. Hungary has managed to free up the commercial rental market even though it has neither privatized extensively nor raised rents to market-clearing levels. Occupants (generally with long-term lease rights at below-market rents) are assured the right to sublet, provided they pay 20 percent of the "profit" (the difference between the rent they charge and the rent they pay) to local authorities. A large part of the market for commercial space operates in this manner. The Baltic countries and Poland, despite advances in adopting commercial management practices, have not transferred much commercial real estate to private hands. Other NIS and Romania have made little progress on paper or in practice, although some cities and regions are clearly ahead of others.

A major reason for the slow pace of privatization and new private construction is the conflicting incentives of local governments that control most commercial real estate. The more progressive and honest local governments realize that allocating this real estate efficiently can spur rapid private sector growth and increase their revenues. But other local governments hold on to their monopoly power to allocate scarce space (often at below-market rents) and to develop new space, to some extent because of the irregular income that can be derived. Ownership is not their only source of power. Local governments also provide the services that make commercial space usable, including power, water, sanitation, and fire protection. They also regulate development. Some governments enter into direct competition with private businesses by developing land themselves or by setting up joint ventures in commercial activities, using real estate as their contribution. The conflicts of interest among these many public roles lead to the creation and maintenance of artificial monopolies, complex regulations, arbitrary enforcement, and high costs for new private firms. Struggles among municipal agencies to play the lucrative role of owner-manager are commonplace. Some districts of Warsaw have been very progressive in making land and commercial real estate available to private investors, while others have been slow. The difference is clearly evident in the distribution of commercial activity in the city today.

These deficiencies of commercial real estate markets are a major barrier to private sector development. The problems will not solve themselves, and they invite corruption. Local governments must act forcefully (or be prodded into action by reformers at other levels of government) to privatize, loosen regulatory and zoning constraints on new development, and open up infrastructure and service provision to private competition. For buildings that remain in state hands, local governments should promote commercial management practices, including leasing with transparent rules and at market rents, and respect for contractual obligations. National governments may be able to spur the reform of local governments by financially rewarding those that make the most efficient and transparent use of their assets.

Privatizing housing

Patterns of housing ownership differed greatly among the centrally planned economies (Figure 3.1). In China and Vietnam most urban housing was and is still owned by enterprises, whereas rural residents were responsible for their own housing and had informal property rights—but no formal title. In CEE private ownership of housing was never entirely eliminated, and it expanded considerably during the reform initiatives of the 1970s and 1980s. More than half the housing stock in most CEE countries (even more in rural areas) was already privately owned at the start of transition; local governments owned most of the rest. In the NIS local governments or enterprises owned most urban housing, although private housing was not uncommon, particularly in rural areas.

Privatizing housing is a high priority in transition economies, for social and economic reasons. Housing accounts for about 30 percent of wealth in market economies. Transferring housing to individuals and households and developing housing markets to realize its value can help compensate citizens for the loss of savings many have suffered due to hyperinflation. Because housing was relatively equally distributed under central planning (more so in terms of space than with regard to quality or location), converting tenancy rights into ownership rights is a simple and equitable way to privatize. Nearly all housing privatization to date has taken the form of giveaways or low-cost sales to current tenants, often subject to space limits. The Baltic states have issued vouchers to all citizens (the amount varying with age), one use of which is to purchase their apartments. Belarus gives away a set square footage.

Privatization can relieve governments and enterprises of the costly burden of subsidies, but only if responsibilities for utilities and maintenance are also shifted to the new owners. Giving away housing and the costs associated with it actually improves the fiscal position of governments. Rents for public housing were extremely low under central planning, and governments and enterprises bore most of the costs of construction, maintenance, and utilities. Soviet local governments typically spent up to 15 percent of their budgets maintaining the municipal housing stock. By 1993 this had risen to 25 percent. From 1927 to 1992 the basic monthly rent charged to households in the Soviet Union was frozen at 0.132 ruble per square meter. By the end of the Soviet era, households devoted just 2.4 percent of their cash income to housing (rent plus utilities)—less than they spent on liquor and cigarettes. This underpricing encouraged waste of energy and much else, discouraged proper maintenance, and led to high demand, long waiting lists, and a flourishing shadow economy.

The other high economic cost of these housing policies was the crushing effect on interregional labor mobility. Workers had little hope of finding housing if they took a job in another city. Developing housing markets is an essential adjunct to enterprise restructuring in transition economies, both to free firms to focus on productive activities and to facilitate labor mobility. This is particularly true in countries such as China, where enterprises own much urban housing.

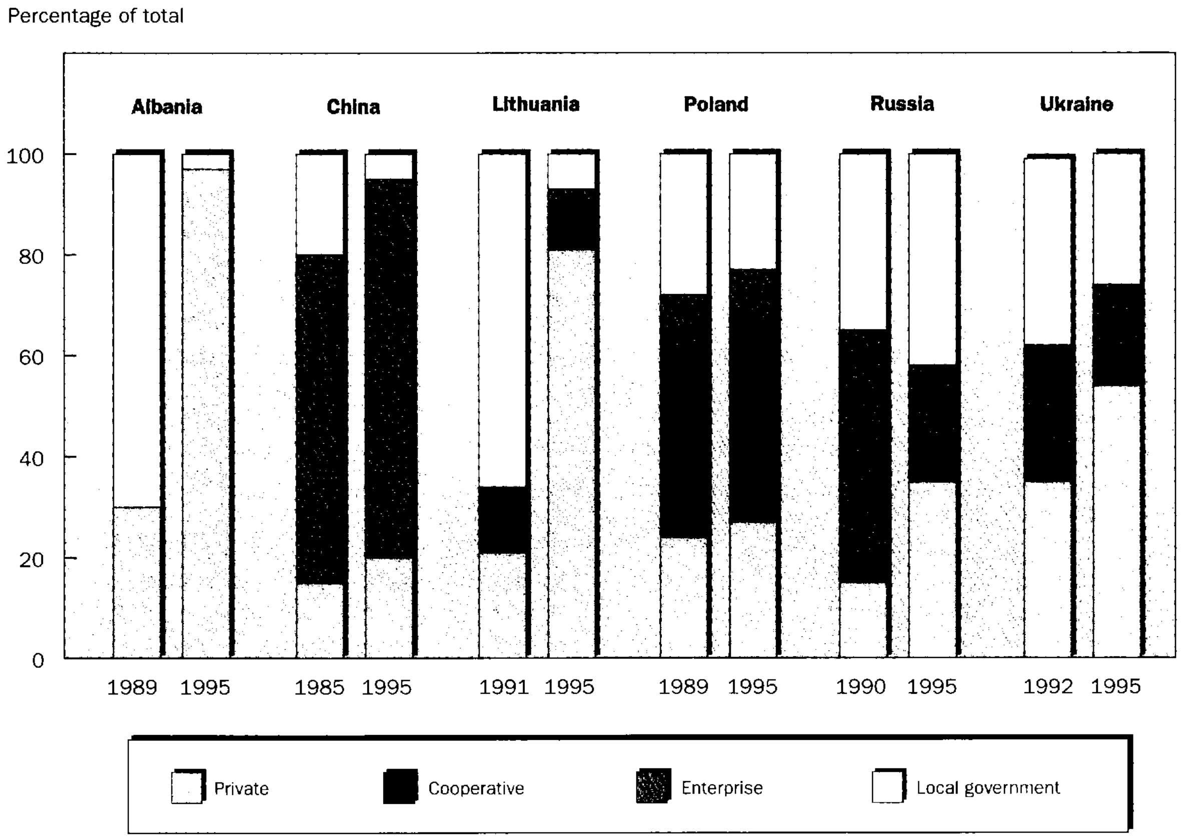
Several NIS have been at the forefront of housing privatization. Lithuania, the most successful, has reduced state ownership of housing from two-thirds of the total to less than one-tenth through a combination of voucher sales and restitution. Estonia started more slowly, but its program picked up speed as the end-1995 deadline for using vouchers approached. Seventy percent of its housing is now in private hands. Armenia and Moldova have been privatizing rapidly, too. Most CEE countries, initially in the vanguard, have moved more slowly since 1990, in part because they had much less public housing left to privatize—only Albania has matched the dramatic ownership changes of the leading NIS privatizers (Figure 3.1). Slovenia's program of low-cost sales in 1992 was instrumental in drawing foreign exchange from under the mattress (or from foreign bank accounts) and into the central bank's coffers. These growing foreign exchange reserves helped support the introduction of Slovenia's new currency, the tolar. On this score China and Vietnam are lagging; they have done little to separate housing from enterprises. In China enterprises own and manage about 75 percent of urban housing, and this share has actually increased in recent years as local governments have transferred housing to enterprises. It may be possible in the future to swap some of these assets against pension liabilities (see Box 4.6).

Building a strong housing market requires numerous reforms in addition to changing ownership. Tenant charges for rents, utilities, and maintenance in remaining state housing must be steadily increased. Tenancy rights inherited from central planning are much stronger than lease rights in some established market economies, and are de facto inheritable property rights. Moving from these to full ownership may have no meaning whatsoever unless the previous allocation of subsidies and responsibilities is altered as well.

Shifting the full economic costs of housing to households may not be possible overnight, particularly in economies that have suffered sharp drops in GDP and employment and sharp increases in poverty. To offset the short-term impact of higher rents in public housing and

Transition economies have contrasting patterns of housing ownership.

Figure 3.1 Housing ownership in urban areas in six transition economies



Note: "Enterprise" includes housing owned by government agencies other than local government. as well as state enterprise housing.
Source: Official data; World Bank 1995n; World Bank data.

higher maintenance and utility costs in all housing, governments might consider offering housing allowances to those hurt most by reforms, while at the same time raising cash wages to replace forgone subsidies. The critical point is that the true costs of housing—once hidden in repressed wages, budget deficits, inflation, and undersupply—need to be made explicit. Furthermore, new modes of finance are needed to help new private owners pay for housing as governments withdraw from housing construction and maintenance.

Local governments must also clarify property rights and zoning rules, improve real estate registries, and develop efficient property tax regimes and condominium-type laws, needed to allocate responsibility for common areas of buildings. New owners will not appreciate the value of their homes without active housing markets through which to measure and realize that value. And these markets will not develop unless owners have clear and readily tradable rights to both structures and underlying land. Finally, an often overlooked issue in housing privatization is the distribution of ownership rights within households. Ensuring that husbands and wives have equal rights to privatized housing is an important step toward gender equality in transition.

Properly privatized housing opens the way to a host of new products and services, including property insurance, real estate brokerage, housing maintenance, mortgage finance, and property development. These create new jobs and make private housing markets work by spreading risk, supplying information to buyers and sellers, and providing needed financing.

New firms and foreign investment

Privatizing state enterprises is crucial to the long-term development of transition economies. But just as important *is promoting the entry of new firms*. Given the delays in divesting larger firms, the quickest returns have come from new private entrants. The return to growth of Poland and Romania in 1993 and 1994, for example, cannot be attributed to their formal privatization programs, which have been slow, but rather to their strong record on new entry. Owners and investors in new firms bring new ideas and techniques, and they are less constrained by established routines and personnel. Throughout history more technical progress and improvements in productivity have come from new firms replacing old firms—from "creative destruction"—than from reforms in old firms. Most new firms in CEE and the NIS are privately owned; in the planned East Asian economies new entrants have been both private and "nonstate" in nature (see Box 3.4).

New entry and privatization are not entirely separable. Privatized small enterprises can be almost indistinguishable from new entrants, particularly when the privatized firm's only "asset" of any value is its access to commercial real estate. New private firms are often built on assets or labor released from downsizing state enterprises. Indeed, "asset privatization" has proceeded much faster than enterprise privatization in most transition economies. This helps explain, for example, why Poland's private sector now produces some 60 percent of GDP (up from 30 percent in 1990) despite the slow official privatization program. Economic reforms lead to rapid growth in legal private businesses. But even where reforms are slow, informal shadow economies of private firms will emerge—with help from spontaneous privatization. The shadow economy in Ukraine may account for as much as 40 percent of economic output, despite the slow pace of economic reform and privatization. Certainly, formal private sector growth is preferable to the growth of shadow economies, but either is preferable to no growth at all (see Chapter 2).

What does the new formal private sector need to succeed and grow? Macroeconomic stability is vital. Countries with large budget deficits have trouble resisting the confiscatory taxation that tends to quash an emerging private sector, and firms find it hard to set prices, negotiate contracts, and estimate investment needs in an environment of high inflation. Price and market liberalization is another must, along with freedom from overregulation. New private firms must be able to set prices for outputs, search for the best prices for inputs, change product lines, hire and fire workers, and get the foreign exchange they need if they are to adjust efficiently to changing market conditions. And they need clear and stable rules of the game that can be enforced at reasonable cost, as well as freedom from crime and corruption (see Chapter 5).

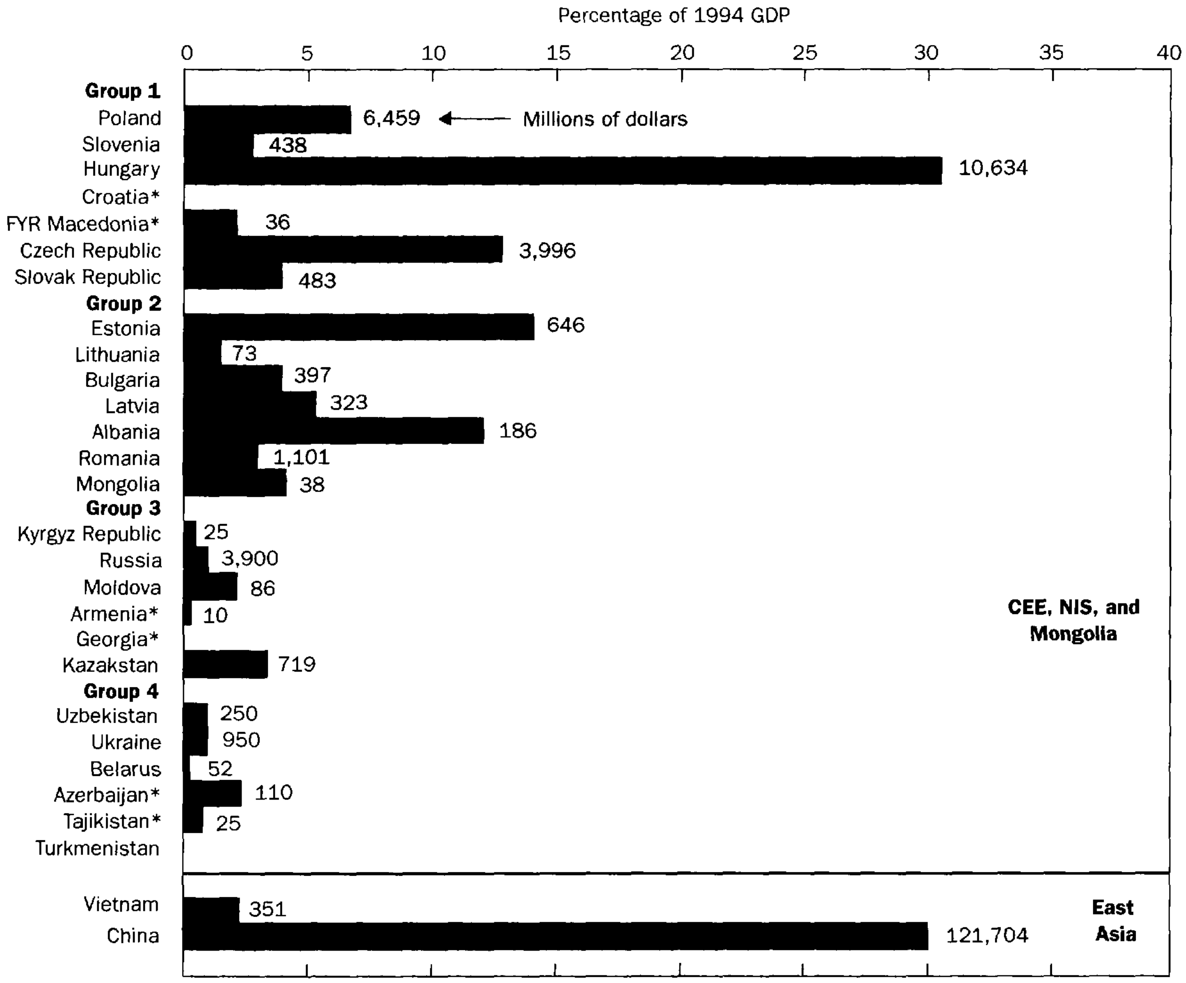
These preconditions have generally been met in Central Europe and to a somewhat lesser extent in Eastern Europe and the Baltics, where new private firms are free to operate in response to market forces (although they remain subject to high taxes, which many evade, and have some difficulty getting access to premises, as discussed above). Entrepreneurial freedom and access to inputs are more restricted in Russia and other non-Baltic NIS, yet many private firms manage to thrive in previously repressed sectors, such as trade and services, where pent-up demand is high. Entrepreneurs' biggest complaint in Poland in a 1992 survey was lack of financing, whereas in St. Petersburg and throughout Ukraine macroeconomic uncertainty, legal instability, and in many cases crime and corruption troubled entrepreneurs most, followed by high taxes and lack of finance.

Although domestic firms drive growth in all market economies, foreign investment also makes a highly valuable contribution. Foreigners bring capital, technology, management expertise, and access to markets—all critical to enterprise restructuring in transition economies. The less tangible effects of foreign investment, including the importation of new ideas and practices both through improved performance and support of policy change, are particularly important in transition settings. China has enjoyed rapid growth and has been a leader in foreign investment inflows, although much of this is thought to be domestic money recycled through Hong Kong, to take advantage of incentives offered only to foreign investors. Hungary shares the leadership title with China in foreign investment as a share of GDP (Figure 3.2).

Foreign investors can make an enormous difference. Consider the case of a Polish lighting company purchased by a Dutch businessman in 1991. The new owner invested heavily in technical and managerial training in such areas as cost accounting, computers, marketing, total quality management, and English-language training. He provided the Polish firm with technical know-how and state-of-the-art equipment that not only increased productivity but also reduced environmentally harmful emissions. He then modernized the company's offices and facilities. The results were startling. In three years the struggling company became a profitable and internationally competitive enterprise. Sales per employee almost doubled from 1991 to 1994 and are expected to double again by 2000. Polish

Some transition economies have proved much more attractive to foreign investment.

Figure 3.2 Cumulative foreign direct investment inflows



Note: Data are the sum of inflows during 1989–95: those for Croatia, Georgia, and Turkmenistan are unavailable. Data for 1995 are preliminary. Countries are ranked as in Figure 1.2. Asterisks indicate economies severely affected by regional tensions between 1989 and 1995. Source: World Bank 1996b; IMF and World Bank staff estimates.

consumers are paying 25 percent less for standard lighting products. Employment is stable at about 3,000, and salaries have risen by 10 percent a year. The company's operations have stimulated additional private employment within the community, engaged in transporting finished goods to domestic and foreign markets.

All foreign investors have the same concerns: political and economic stability and openness, laws and regulations that are fairly and transparently enforced, ready access to inputs at reasonable prices. All of these are heavily influenced by policy choices. Investors also look to the size and growth of domestic markets, which economic policy can influence, and closeness to major international markets, which it cannot. Foreign investment in natural resources is dictated by location—hence the interest of foreign energy companies in Kazakstan and Russia. Unique historical and cultural factors, such as the presence of a large diaspora, are also influential: Estonia has benefited from close ties with Finland and other Scandinavian countries, and most "foreign" investment in China has been made by overseas Chinese. But strong overseas ties are not enough. Armenia, Poland, Russia, and Vietnam have large émigré communities but have attracted relatively little investment from them, in part because of policies or privatization programs that are less than friendly to foreign investors (and in Armenia's case, because of blockade). The design of privatization programs heavily influences the amount of foreign involvement in privatized firms. Hungary and Estonia have both attracted foreign investment through sales of state enterprises, whereas Russia's insider privatization approach has kept foreign participation to just 2 percent of privatized equity.

Special foreign investment regimes create enclaves that benefit the rest of the economy little. These may be useful at the beginning of transition if they send the message that the country is serious about reform. But special tax breaks, exemptions from customs duties, and other incentives for foreigners can put domestic investors at a disadvantage and cost governments much-needed revenue. As quickly as possible, transition economies should dismantle these enclaves and put domestic and foreign investors on an equal footing. The Czech Republic took this step in 1992, for example, when it abolished specific foreign investment legislation in favor of a broad commercial code covering all investors.

The agenda

The lessons of experience from enterprise reform are quite clear and applicable across the range of transition economies, from the Czech Republic to China. Firms and farms surviving from central planning need major restructuring of their production and reorientation of their incentives. Entities that face strict financial discipline and competition and have clear owners are most likely to undertake the needed restructuring or to exit, leaving room for new and better firms. In the short run financial discipline can be fostered through the stabilization and liberalization measures outlined in Chapter 2. But in the longer run decentralized—preferably private—property rights and supporting institutions are needed to sustain financial discipline, to respond to market-oriented incentives, and to provide alternative forms of corporate finance and governance.

The patterns of ownership immediately resulting either from a shift to "nonstate" forms of enterprises or from privatization are unlikely to be optimal. This is particularly true for large firms and farms, but it may also apply to smaller firms, commercial real estate, and housing. Initial ownership may be too dispersed, as it was in Lithuania's mass privatization programs, or too entrenched in the hands of insiders, as in Russia's first-phase privatizations. Winners in the asset allocation process may try to construct barriers to secondary trading. Ownership can end up concentrated in entities that are either too large, like Russia's corporate farms, or too small, like Romania's fragmented landholdings. Ownership may be vested in entities, such as investment funds or absentee landlords, that are unable or unwilling to exercise efficient monitoring. A critical determinant of the longer-run success of any reform program is the extent to which ownership rights can evolve into more efficient forms. Programs that spur the growth of capital and asset markets, such as the Czech Republic's privatization program, have a distinct advantage. In all transition environments the evolution of ownership will also depend on tight macroeconomic policies, which force firms not only to restructure internally but also to turn to capital markets to raise needed finance.

But restructuring of the economy goes well beyond reform of existing enterprises. Entry and investment by new firms, both domestic and foreign, are at least as important for growth. Here the reformers in East Asia, CEE, and the NIS can learn from each other. China is increasingly concerned with the need to reform its state enterprises, which lag nonstate firms in financial performance and productivity growth but still consume the lion's share of investment resources. Reformers in CEE and the NIS have shown the importance of, and effective methods for, imposing financial discipline on state firms, allowing their downsizing and exit, developing debt workout mechanisms, and divesting housing, commercial real estate, and assets or shares of enterprises that the state no longer needs to own. In turn, some governments in CEE and the NIS can learn from China about the importance for growth and productivity of unrestricted new entry, the unleashing of competitive forces, and farm restructuring. In all transition economies the continued growth of new nonstate sectors, as well as the continued reform of enterprises that will stay in state hands, will depend on the development of institutions that sustain and deepen the reforms achieved to date. These include, among others, reforms in legal, financial, and government institutions. These are the subject of Part Two.