Corporate Governance and Restructuring: Lessons from Transition Economies

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This article paints a synthetic picture of corporate governance in transition economies with an emphasis on its implications for efficiency, taking into account the heterogeneity of managers' skills, the diversity of firms' restructuring tasks and financial situations, and political constraints. The focus is on the efficiency effects of different privatization policies, with special emphasis on the broad dynamic effects of privatization. Different privatization policies have different effects on the distribution of economic power, with potentially far-reaching consequences for state capture, law enforcement, tax collection, stock market development, and private sector development. Moreover, legal reform is not an exogenous but an endogenous process influenced by the vested interests created by a country's initial privatization policy.

Corporate governance has recently become a hot topic in Western economies—one that is widely debated both in the business world and in academic research (for a survey, see Maher and Anderson 1999). Corporate governance is even more important in transition economies, where the initial situation was state governance and where approaches to corporate governance will likely affect overall economic performance.

Evolving Concepts of Corporate Governance in Transition

Achieving adequate corporate governance is no easy task in transition economies. Because almost the entire economy is involved, solutions must be matched to the varying conditions of firms. Simple recipes and slogans may attract a lot of attention,

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Annual World Bank Conference on Development Economics 2000
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but they are likely to give partial and sometimes misleading solutions. Early on in the transition, the slogan heard most often was "get the state out of the economy." This sounded reasonable.

More recently, the focus has been less on the inefficiency of state-owned enterprises and more on financial scandals—the various forms of asset stripping and looting in privatized firms. This focus is especially visible in the Czech Republic and Russia, where mass privatization programs transferred huge parts of the economy into private hands at dazzling speeds. Given the various forms of "tunneling" through which majority shareholders in mass-privatized firms were able to strip assets and cheat minority shareholders, the more recent slogan has been "introduce the common law system." In a celebrated series of papers, La Porta and others (1998a, b, 1999, 2000) have made an empirical connection between the type of legal system and the degree of shareholder protection. A key finding is that the common law systems in the United Kingdom and the United States protect minority shareholders more than the civil law systems in France, Germany, and other advanced economies of Western Europe.

This shift between such different slogans offers food for thought to those who have been uncritically espousing these slogans one after the other. When the emphasis was on getting the state out of the economy, fixing the law was a low-priority task and many legal loopholes were left open. In the Czech Republic, for example, former Prime Minister Václav Klaus put little emphasis on legal reform and financial sector regulation early in the transition. This was not necessarily because he believed that this approach would be good for tunneling but because he was wary of state intervention and thought that market development required as little state development as possible—a widely shared view in the early 1990s.

The current emphasis on corporate governance in transition is related to dissatisfaction with the simple dichotomy between state ownership and private ownership. The slogan "get the state out of the economy" partly relied on the idea that any form of privatization would always be much better than state ownership and that market mechanisms would lead to a more efficient distribution of assets among private owners.

But privatization has led to many disappointments. There is now extensive evidence on asset stripping by insiders to the detriment of minority shareholders (see Black, Kraakman, and Tarassova 2000; Coffee 1999). Other inefficiencies also persist, including soft budget constraints (Fox and Heller 1999; Schaffer 1998). And a large empirical literature has shown that in many privatized firms—especially firms privatized to insiders—there has been little restructuring or investment.

Moreover, the behavior of state enterprises has proven less apocalyptic than was initially predicted by many analysts, who foresaw massive asset stripping unless firms were privatized at great speed.[1] Early evidence on state enterprises actually showed cases of restructuring despite an absence of privatization (Belka, Krajewski, and Pinto 1993; Estrin, Schaffer, and Singh 1993).

The differences in enterprise behavior, whether privatized or not, can be related to the variety of approaches to corporate governance and to the variety of initial conditions facing enterprises. Is privatization to insiders always efficient? Under what conditions is it inefficient? Are inefficiencies of the same type, or do different

inefficiencies depend on specific conditions? How are these inefficiencies best corrected? These questions and others need to be answered to correctly assess situations and formulate policy recommendations. That is why this article draws a synthetic picture of corporate governance in transition economies with an emphasis on its implications for efficiency. The attention paid to scandals, frauds, and the like, especially in the legal literature, should not hide other inefficiencies that are perhaps less salient from a legal perspective but no less costly in terms of economic efficiency.

The main idea in this article is that the efficiency of corporate governance in transition economies is directly related to the privatization policies chosen and to the distribution of economic power and the economic environment generated by those policies. More broadly, the vested interests created by the initial distribution of economic power following various privatization policies are likely to have far-reaching consequences for state capture, law enforcement, tax collection, private sector development, and stock market development. In other words, privatization policies affect many variables that are important for overall economic performance.

Corporate Governance and Efficiency

Here corporate governance is defined as the control rights that influence the decisions of enterprise managers and ensure that outside funds can be raised to implement those decisions. (For closely related definitions, see Zingales 1998 and Williamson 1985.)

Problems with State Governance

Corporate governance in transition economies initially involved state governance—with many associated inefficiencies. A growing literature has tried to understand these inefficiencies.

A first strand of papers emphasized government intervention that imposes on managers political objectives such as the excess creation of jobs that offer political benefits but generate economic inefficiencies (Shleifer and Vishny 1994). State intervention also undermines commitment to incentive schemes. In contracts between private parties, governments (and courts) usually act as a third party to ensure contract enforcement and commitment. But in the relations between governments and enterprises, there is no such third party—so the question of government commitment to enterprises is important. Even if a government cares about efficiency, its inability to commit may lead it to intervene in enterprises, creating inefficiencies.

In the literature this has been called the ratchet effect (Laffont and Tirole 1988; Roland and Sekkat 2000). In its most general form the ratchet effect means that government uses new information generated by firm behavior to renege on its past commitments and "ratchet up" its demands on enterprises. Well-known examples are the ratcheting up of plan targets for enterprises that fulfill the plan too easily or the cutting of budgets for enterprises or divisions that do not spend their entire budgets.

The perverse incentives generated by the ratchet effect are well understood: agents exhibit slack performance or overspend their budgets.

A second strand of papers has emphasized inefficiencies associated with state governance through efforts by enterprises to secure soft budgets (Kornai 1980; Dewatripont and Maskin 1995) and to seek rents.

The important question is, how does privatization solve these problems? The question is not trivial. Indeed, all these problems can exist with private firms. For example, the state can impose on private firms objectives that deviate from efficiency—as when inefficient regulations are enforced. Similarly, government can renege on its commitment not only to state enterprises but also to private enterprises. An obvious example comes from taxation: governments rarely commit to tax rates. And soft budget constraints and rent seeking are not unique to state enterprises. Private firms also lobby to get subsidies and to seek rents.

Economic theory has been trying to understand why these problems are less prevalent in private firms than in state-owned firms. Shleifer and Vishny (1994) show that state intervention is more costly in private firms than in state-owned firms because in private firms, deviations from efficiency imply profit losses for the owners. The managers of state enterprises, by contrast, depend on the state for their livelihood anyway and do not face such high opportunity costs from accepting state intervention. Thus private owners must be paid more to deviate from profit objectives.

Similarly, government's commitment problem can be made less severe through markets and free mobility. Roland and Sekkat (2000) show how the existence of a managerial labor market due to the presence of a private sector can break government's monopsony power over managers and so make managers less dependent on government. The literature also shows that entry and competition harden budget constraints because they reduce the opportunity cost to government of not bailing out firms in terms of job losses and other costs of hard budget constraints (Dewatripont, Maskin, and Roland 2000; Maskin and Xu 1999; Roland 2000). Finally, the profit incentives of private firms can be stronger than the rent-seeking incentives (and so discourage the latter) when the profit opportunities are big enough.

These are just a few examples. Much research still needs to be done to better understand the deeper reasons for inefficiencies in state enterprises. But the current literature goes beyond the simple dichotomy between private and state ownership, seeking to understand the exact mechanisms through which private firms can be more efficient.

Problems with Dispersed Share Ownership

It has long been known, at least since Grossman and Hart (1980), that dispersed share ownership is associated with a free-rider problem in monitoring. Dispersed outside ownership has been an inherent feature of voucher privatization in transition economies. In the Czech Republic all citizens were given vouchers to buy shares

of enterprises, and no mechanism was put in place to encourage the emergence of strong block-holders. Poland's mass privatization program tried to avoid the dispersed share ownership of the Czech plan by having large investment funds hold shares of enterprises. But that did not solve the problem: dispersed share ownership simply emerged in the ownership of the investment funds, because citizens were given vouchers to buy shares in the funds instead of in firms.

If firms have dispersed ownership, even the best legal environment will not eliminate the free-rider problem and so improve management. Thus efforts to perfect the law can be misguided when dispersed ownership is widespread—as during mass privatization. The law can still be useful in protecting minority shareholders from abuse by management. But that will only happen if the law can be enforced, a fundamental issue discussed below.

Complete concentration of assets among shareholders also has its costs, because excessive monitoring may stifle initiative by management (Burkart, Gromb, and Pannunzi 1997). Some mix of concentrated and dispersed ownership trades off optimally the costs of free riding with the costs of excessive monitoring.

Problems with Lack of Minority Shareholder Protection

Minority shareholder protection has become an important issue in transition economies—especially in the Czech Republic and Russia, which relied on mass privatization. As noted, the term tunneling was coined to denote the ways in which managers (as majority shareholders) can strip assets to the detriment of minority shareholders.

Mass privatization tends to enhance the benefits of asset stripping. Managers or owners who have received an asset nearly for free can reap immense gains from asset stripping, even when doing so is not optimal from an economic perspective. Two questions arise. Why would managers want to engage in inefficient asset stripping once they own part of a firm? And why would mass privatization lead to more asset stripping than would sales, since the price paid for assets is a sunk cost?

The basic answer lies in the selection effects that result from different forms of privatization. Under competitive sales (like auctions and tender sales), assets are allocated to the owner with the greatest willingness to pay.[2] The selected owner is thus the most likely to maximize the value of the firm and not to engage in inefficient asset stripping. Such owners will never want to engage in actions that reduce the value of the assets below their purchase price. In other words, they will not be interested in purchasing firms whose value they could only reduce.

Under mass privatization, incumbent managers get control and are not necessarily likely to maximize the value of the assets. Whereas an outside owner might prefer to restructure the firm, an incumbent owner may prefer to engage in asset stripping. Such owners have stronger incentives to strip assets if the general economic environment is uncertain. Incumbents who become owners through mass privatization may then prefer to reap the sure gains from stripping assets rather than the uncertain benefits from investing in restructuring. Such uncertainty can even be

endogenous and lead to multiple equilibria. Managers who believe that there may be renationalization or political instability may engage in asset stripping, reinforcing political instability.

Detailed analyses of tunneling techniques have sometimes led to the conclusion that better laws could reduce tunneling. Indeed, every tunneling technique is associated with a loophole in the law—so it can be argued that closing those loopholes will reduce tunneling. But while good laws are necessary safeguards, they are not sufficient. Even if the law is improved, how can one be sure that it will be enforced, that insiders will not bribe regulators, and so on? For example, Russia has fairly good laws. But law enforcement is rather weak (see EBRD 1999; Berglöf and von Thadden 2000; and Black, Kraakman, and Tarassova 2000).

Access to Outside Funds

Control rights and their distribution change the incentives within firms, but access to outside funds is equally crucial to achieve efficiency. Usually, those with control rights over a firm bring outside funds or have the capacity to do so. This is not the case with mass privatization, whether to outsiders or insiders: the transfer of ownership is not linked to the financing of restructuring. As a result assets may be transferred into private hands that do not have easy access to outside funds.

Access to outside funds depends on the state and liquidity of the financial system and on whether corporate governance arrangements convince investors to put money in the firm. From that perspective, outside investors may ask for control rights in exchange for funds. This should be seen as a positive development because such a transfer of control rights may correct the initial allocation of assets achieved through privatization, reducing the possible insider bias. But situations differ, as discussed below. Not all firms need outside funds, even when outside control enhances efficiency. Nor will they necessarily relinquish control rights in exchange for outside funds.

Corporate Governance Systems

Let us now take a broader look at corporate governance systems. As noted, recent innovative work by La Porta and others (1998a, b, 1999, 2000) emphasizes the effects on corporate governance of different legal systems. The authors show that countries with civil law systems tend to have less protection of minority shareholders, leading to a higher concentration of shares and to less liquidity in the stock market.

This finding can be linked to previous research by Mayer (1990). He emphasized the difference between the Anglo-Saxon market-oriented financial system, based on the stock market and arm's-length banking, and the German or Japanese bank-oriented system, with less development of the stock market but with strong banks having long-term relationships with their clients. This research shows that corporate governance may be related to the structure of both the legal system and the financial system.

Scholars have recently tried to understand the institutional complementarities in various economic systems. For example, Pagano and Volpin (1999) find a negative correlation between shareholder protection and worker protection: low shareholder protection may be associated with high worker protection, and vice versa. The authors argue that a political coalition may form between managers and workers. Because managers benefit from low shareholder protection, they may offer higher worker protection in exchange for workers' support. This complementarity may explain why corporate governance institutions may not necessarily converge. This idea will be important for future research.

There may be not only institutional complementarities but also institutional substitutes. Berglöf and von Thadden (2000) note that in systems with less-developed stock markets, stronger competition and the presence of small investors may lead to the formation of business groups that substitute for the stock market. Such business groups are thus an alternative way of generating funds. But why is there a lack of institutional market development in the first place? What is the role of history and of newcomers and latecomers in the development of corporate governance systems?[3]

When thinking about corporate governance systems, one must ask how they emerge and how they evolve. Transition is an interesting opportunity for understanding this evolution because the initial conditions are visible. I return to this issue later in this article. The hypothesis is that different privatization policies have played an important role in explaining the differences in corporate governance in transition economies with similar initial economic and political conditions.

Determinants of Enterprise Restructuring in Transition Economies

There are two aspects of restructuring in transition economies: a sectoral aspect and an enterprise-level aspect. From a sectoral point of view, transition must lead to the shrinking of some sectors (steel, heavy industry) and the expansion of others (services). This implies that the entry of new firms is likely to play an important role, on par with the restructuring of existing enterprises. And given the importance of sectoral reallocation, investment based on retained earnings is not sufficient to reallocate resources across sectors—pointing to the importance of access to outside funds.

Restructuring at the enterprise level, as explained in Roland (1997), depends on four factors: the degree of product competition, the skills of incumbent managers, the need for external finance, and the degree of firm independence from government.

Degree of Product Competition

Carlin, Van Reenen, and Wolfe (1995) show that firms with a dominant position tend not to restructure. From a theoretical perspective, this finding is not self-evident. The Schumpeterian view may lead to the opposite conclusion. Monopoly power may provide stronger incentives for restructuring because of the monopoly rents extracted by incumbent managers when they restructure. The absence of restructuring may then

be explained by the fact that managers in monopolistic firms are not residual claimants. Here privatization—even to incumbent managers—will help achieve more restructuring.

But it is also possible that monopolies do not restructure because the profits from doing so would be lower than the government subsidies monopolies can extract by maintaining loss-making operations (Segal 1998). In this case privatization does not foster restructuring. Indeed, incentives for rent seeking will remain intact and may even be reinforced if managers are residual claimants of the government subsidies.

To boost efficiency, then, firms should be demonopolized and entry should be encouraged. From a political economy point of view, the task is to overcome resistance to demonopolization. Good arguments have been made for demonopolizing before privatization: resistance to demonopolization can be more intense after monopolies have been privatized than before (Newbery 1991; Tirole 1991). This is a sequencing mistake. Russia made this mistake and is suffering the consequences. The task of demonopolization is somewhat orthogonal to privatization and corporate governance. I will not pursue it further, but its policy importance should not be underestimated.

Skills of Incumbent Managers

It is important to distinguish between two types of restructuring: defensive restructuring and strategic restructuring (Grosfeld and Roland 1997). Defensive restructuring refers to the shedding of redundant workers to cut losses—a painful process that requires determined management. But it can be achieved by incumbent managers, in principle without further help, and especially without outside funds. Strategic restructuring refers to the creation of a business strategy for enterprise expansion. Defensive and strategic restructuring thus require different skills. Strategic restructuring also requires outside funds when the business strategy cannot be financed internally.

To understand the heterogeneity in managerial skills, make a basic distinction between "good" and "bad" managers. Bad managers do not have the skills required for successful restructuring and are not competent enough to acquire them. Thus they are expected to lose their jobs and so lose from strategic restructuring. Good managers possess enough managerial or learning skills. Thus they are expected to gain from strategic restructuring. Of course, there is asymmetric information on managerial skills, and different privatization policies may screen good managers from bad (see below).

Because bad managers are assumed to lose from strategic restructuring, they have no incentive to engage in defensive restructuring. Early privatization may even encourage bad managers to strip the assets of state enterprises (Aghion, Blanchard, and Burgess 1994). To boost efficiency, such managers must be replaced. The political economy constraint that must be overcome is resistance to layoffs within firms.

Good managers are expected to gain from strategic restructuring, but they may face different costs from defensive restructuring. These costs may be low enough for

some managers to perform defensive restructuring without being given formal incentives. Other managers may need such incentives. For efficiency, such managers must be given incentives for defensive restructuring.

Due to asymmetric information, there may be resistance to defensive restructuring both from bad managers and from good managers who face high costs from it. How can the good managers be encouraged to engage in defensive restructuring? Either by imposing negative incentives (such as the credible threat of closing the firm if it does not restructure) or by giving managers equity in the privatized firm. Both instruments screen good managers from bad.

Need for External Finance

An additional distinction should be made between firms with no retained earnings and firms with retained earnings. As noted, firms without retained earnings in which incumbent managers are expected to gain from strategic restructuring will need to raise outside funds. By doing so, they may give up control rights to investors. This may enhance economic efficiency within the firm because the transfer of control rights can lead to better decisions.

Firms with retained earnings have no need to raise outside funds. But giving away control rights can increase efficiency in such firms. This would be especially likely when incumbent managers engage in empire building and make excessive investments in the firm instead of diversifying investments.

In both cases efficiency requires securing outside finance and control. The political economy constraint is overcoming resistance from empire builders in firms with retained earnings.

Degree of Firm Independence from Government

As noted, major problems with state governance include inefficient government intervention in firms (the ratchet effect) and rent seeking by firms (the soft budget constraint). Here efficiency requires finding mechanisms for government commitment. It is necessary to overcome both forms of inefficiency, but one must think carefully about how to achieve that goal. For example, weakening the government will reduce intervention in firms—but possibly at the expense of increasing soft budget constraints. One must go beyond the simple dichotomy between a weaker and a stronger government and think of specific mechanisms to establish government commitment.

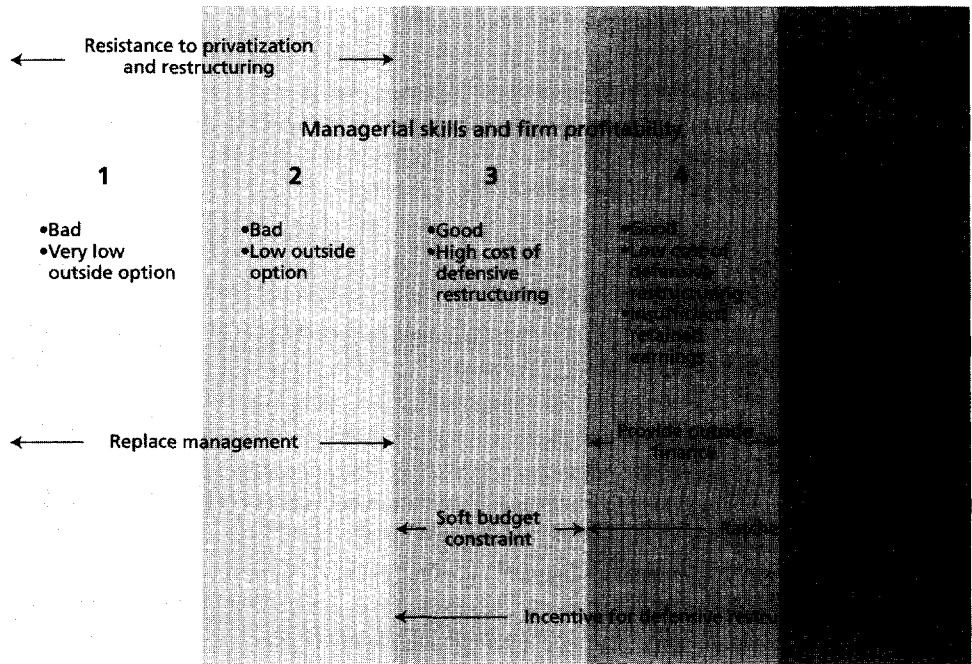
Summary

The preceding analysis holds for a given set of enterprise and sector characteristics. Controlling for those characteristics, it is reasonable to assume that there is a positive correlation between managerial skills and firm profitability. Figure 1 summarizes this in what I believe is the most comprehensive framework yet offered to explain the links between corporate governance and restructuring.

Thus there are various types of asymmetric information. There is the difference between bad and good managers: bad managers differ in their outside options, while good managers differ in their costs for defensive restructuring and in their need for outside funds. Overall, there are five types of managers. Type 1 are bad managers who are expected to lose from strategic restructuring and who have very few outside options. Type 2 managers are also bad but have more outside options. Thus these two types differ only in their outside options—a useful distinction. Indeed, because there is a political economy task of overcoming resistance to privatization and restructuring, it may be useful to develop tactics that prevent the joint resistance of the two groups (Dewatripont and Roland 1992, 1995). For efficiency, both types of managers should be replaced.

Type 3 managers are good but face a high cost for defensive restructuring. Types 4 and 5 are good and have a low cost for defensive restructuring. The difference is that type 4 managers do not have enough retained earnings to finance strategic restructuring, while type 5 managers do. Type 3, 4, and 5 managers need to be given incentives for defensive restructuring. But type 3 managers may need to be given stronger incentives. Under socialism, type 4 and 5 managers were more likely to suffer from the ratchet effect, while type 3 managers (as well as types 1 and 2) were more likely to be subject to soft budget constraints. For type 4 managers, efficiency requires securing outside finance. But for type 5 managers, it is also important to provide outsider control, though for a different reason: to avoid empire building. Type 5 managers also face the political economy constraint of overcoming resistance to outsider control.

Figure 1. Managerial Heterogeneity and Restructuring



Before analyzing the effects of different privatization policies on corporate governance and restructuring, one can use the framework of figure 1 to think about the different initial conditions in various countries. For example, some countries may have had more type 1 and 2 managers. Because proportions of manager types may differ across sectors and countries, policy priorities may not be the same everywhere.

Effects of Privatization Policies on Corporate Governance and Restructuring

Instead of discussing the optimal responses to the issues raised in the previous section, I will analyze the effects of different privatization policies on the five types of managers. There are four types of privatization policies:

- Fast giveaways (mass privatization) to dispersed outsiders (as happened in the Czech Republic).
- Fast giveaways to insiders (as in Russia).
- Top-down sales to outsiders (as in East Germany).
- Bottom-up gradual sales to outsiders (as in Hungary and Poland).

By top-down sales I mean those initiated primarily by the government. By bottom-up sales I mean those initiated through decentralized initiatives emanating from potential buyers or from managers seeking a buyer or major investor.

Fast Giveaways to Dispersed Outsiders

When there is a fast giveaway to dispersed outsiders, the free-rider problem in monitoring means that bad managers are unlikely to be replaced because dispersed shareholders are likely to be passive. In addition, type 4 managers are unlikely to get outside finance, and type 5 managers are unlikely to face outsider control. But the reasons are not exactly the same. Because the transfer of ownership and the provision of outside funds are decoupled in mass privatization, it may not be easy for a privatized firm to get outside funds for strategic restructuring. Small outside owners may lack the necessary capital, or dispersed ownership may discourage investors unless they gain control. On the other hand, type 5 managers will be left to engage in empire building because of the free-rider problem in monitoring.

But this type of privatization does give type 4 and 5 managers incentives for defensive restructuring because they will be residual claimants of the effort put into it. Similarly, this form of privatization eliminates the ratchet effect because the state loses control over managers. Type 3 managers will not necessarily have incentives for defensive restructuring because its cost is high relative to the uncertain benefits of future participation in a firm with outside finance. But the soft budget constraint may be partly solved for such firms. Indeed, mass privatization deprives the government of much of its wealth and so raises the cost of public funds, increasing the cost of bailing out firms.

Though this privatization policy may not achieve efficiency objectives, it is likely to ease political constraints. Bad managers will not be threatened by dispersed share-

owners and so will be less resistant to this form of privatization. The same reasoning applies to type 5 managers who do not need to fear outsider control.

Fast Giveaways to Insiders

A fast giveaway to insiders is likely to be have effects quite similar to those of a fast giveaway to outsiders. The only difference is in terms of formal ownership. Under dispersed ownership, managers do not have ownership, but they have control. A fast giveaway to insiders gives managers real ownership on top of real control.

Top-Down Sales to Outsiders

Top-down sales to outsiders are likely to achieve all the efficiency objectives of privatization. New owners will replace type 1 and 2 managers and provide outside finance and outside control to type 4 and 5 managers. But political constraints will likely be a problem. Type 1, 2, and 5 managers will strongly resist this privatization policy, though for different reasons. Type 1 and 2 managers will resist because they want to avoid being ousted, while type 5 managers will resist in order to continue empire building.

It would be wrong to analyze privatization policies without taking into account political constraints. It is not by chance that top-down sales to outsiders were used only in East Germany, where political constraints were least important because the country was being merged with the bigger and powerful West Germany. In unified Germany, East Germans have had, until recently at least, little influence on political decisionmaking. Because of the differences in political constraints, it would be wrong to compare fast giveaways that achieve fewer efficiency objectives with top-down sales to outsiders.

Bottom-Up Gradual Sales to Outsiders

Bottom-up gradual sales to outsiders are easier to compare with mass privatization (see Bolton and Roland 1992). Under gradual sales, good firms with better managers tend to be privatized first. This is in line with political economy analysis (Roland 1994a, 1994b; Dewatripont and Roland 1997). In addition, better managers try to signal themselves to potential investors by engaging in defensive restructuring (Roland and Sekkat 2000). This is consistent with the observation that firms restructure to attract the attention of private investors (Estrin, Schaffer, and Singh 1993). Gradual sales are more likely to ease political constraints because type 1 and 2 managers will, at least during the early stages, not be the object of privatization. The efficiency objective of replacing them will thus not be obtained in the first stage. So, there will be no resistance to privatization and restructuring as long as those managers do not feel threatened and are not facing a direct privatization prospect. The problem of replacing bad managers will be tackled only later, after reformers have grown stronger.

But gradual sales are still likely to encounter resistance to outside control. The level of resistance will depend on initial conditions. Walsh and Whelan (1999) show

that Polish firms producing exports for the EU market are less subject to privatization than firms exporting to the former Council of Mutual Economic Assistance (CMEA) market. This seems to indicate that the first group of firms is more resistant to privatization and is exploiting the opportunities provided by the booming EU export market.

Gradual sales have definite efficiency advantages over mass privatization. Indeed, the need for outside financing and control is not decoupled from the transfer of ownership because the investors who buy firms have the means to restructure them. Otherwise they would not be buying them. And the fact that firms get privatized gradually allows for harder budget constraints—to the extent that negative incentives can be used against managers. Indeed, because type 1 and 2 managers are not threatened at an early stage, it is more credible for government to be hard on type 3 managers, in order to avoid soft budget constraints in those firms.

Summary

The effects on restructuring of the four privatization policies are summarized in table 1. The table includes a row on the policies' effects on asset stripping. As noted, firms privatized to dispersed outsiders or to insiders may encounter asset stripping. Gradual sales can prevent asset stripping in privatized firms but not necessarily in firms left under state control—especially those controlled by type 1 and 2 managers. A policy like East Germany's, with fast top-down sales to outsiders, prevents asset stripping more fully.

Although fast giveaways (mass privatization) take into account political constraints, they achieve only some of the efficiency objectives associated with privatization. This is also the case for gradual sales in their early stages. Though there are differences between the two methods—especially the better outside finance and control under gradual sales—the static analysis presented above indi-

Table 1. Outcomes of Privatization Policies

Outcome	*Fast giveaways (mass privatization) to dispersed outsiders*	*Fast giveaways (mass privatization) to insiders*	*Top-down sales to outsiders*	*Gradual bottom-up sales to outsiders*
Efficiency objectives				
Replace management	No	No	Yes	Yes
Engage in defensive restructuring	Partial	Partial	Yes	Gradual
Secure outside funds and control	No	No	Yes	Gradual
Harden budget constraints	Partial	Partial	Yes	Gradual
Prevent asset stripping	No	No	Yes	Partial
Political constraints satisfied				
Resistance to redundancies	Yes	Yes	No	Yes
Resistance of empire builders to outside control	Yes	Yes	No	No

cates that they should have similar outcomes in their early stages. Whether the differences become smaller or larger depends on a dynamic analysis of the effects of the various privatization policies.

Dynamic Effects of Different Initial Allocations of Economic Power

The most common argument about the dynamic effects of privatization policies used to be that the efficiency shortcomings of mass privatization would quickly disappear because of market forces. Firms privatized to incompetent insiders would soon be taken over by more efficient owners, and entrepreneurial insiders would soon find outside finance for strategic restructuring. But that has not happened. Insider entrenchment has occurred, preventing takeovers. Moreover, insiders who were expected to become powerful advocates for reform have become powerful interest groups, defending the rents they received through mass privatization.

Thus this section places more emphasis on the dynamic effects of the initial allocation of economic power generated by privatization policies. These dynamic effects shed light on the divergence between countries that used mass privatization as their main privatization policy and countries that relied on gradual sales. I am not claiming that different privatization policies have necessarily been the main determinant of different performance across transition economies. Rather, I want to highlight some of the implications of the distribution of economic power created by privatization policies.

As a starting point, note the big difference between the economic power of individuals under state and private ownership. Under state ownership in the socialist economy, the state was extremely powerful, holding nearly all political, military, and economic power. On their own, people like enterprise managers did not have much economic power: they were dependent on the planning system's chain of orders and commands. Under private ownership managers have far more economic power. Given that socialist enterprises were larger than capitalist firms, the person who gains economic power over a formerly socialist firm will have an enormous amount of power.

So, mass privatization creates a sudden and strong concentration of economic power among insider managers. In one move, managers are freed from the commands and constraints of a planned economy.

Gradual sales do not lead to such a sudden and strong concentration of power, because control over firms can be acquired only through sales and asset purchases (though that can occur through noncash sales such as leases or loans; see Bolton and Roland 1992). On the other hand, managers of state enterprises that have not been privatized do not have as much power as managers in insider-privatized firms—especially when the government reinstates its control rights over them, as in Poland (Belka, Krajewski, and Pinto 1993).

Given the powerful shift in economic power created by mass privatization, there is considerable scope for abuse of minority shareholders. Such abuse is especially likely if minority shareholders are voucher-holders who have no previous experience with stock markets and have fewer incentives to protect the value of their assets than normal small shareholders who have accumulated private savings.

This abuse of power will lead to low stock market confidence and low liquidity, shrinking the stock market. Between 1995 and 1999 the number of listings on the Prague (Czech Republic) stock exchange fell by more than 80 percent, from 1,716 to 301. Over the same period there was a 60 percent drop in the value of an index of the exchange's top 50 stocks (Coffee 1999).

When stock markets lack liquidity, insider-managed firms will try to form large business groups to pool financial resources and benefit from possible cross-subsidies. The formation of such groups can only lead to a further concentration of economic power.

The sudden shift of economic power to insider managers may also make it easier for them to capture the state. Insider managers can bribe politicians or use the threat of reducing economic activity and destroying jobs to extract subsidies or favorable legislation. Politicians tend to be more responsive to such influences when they emanate from those in control of large, visible firms. These influences will lead to more corruption within the state, weak tax enforcement (especially for large firms, a situation unique to transition economies; see Campos 1999), weak law enforcement, the development of mafia networks, and so on. Large insider interest groups may block legal reform that would reduce their power or undermine their interests. All these developments aggravate inflationary dangers in the economy.

One should not underestimate the economic power created by insider privatization. This power is greater than the private wealth of those insiders. For example, Russian oligarchs like Boris Berezovsky are said to have few direct stakes in firms but exercise strong control over them through control over their managers.

Over time this strong economic power is likely to lead to enormous wealth inequality (Alexeev 1999) because of asset stripping and capital evasion. Capital evasion will likely increase political instability given the high inequality in the distribution of wealth. This political instability will likely reinforce the short-term perspectives of managers and insider owners: they will prefer to strip assets rather than invest in the long-term future of the enterprises they control. At the same time, increased asset stripping will likely reinforce political instability—creating a vicious circle (Polishchuk 1999). Thus mass privatization can create a corporate governance system with no stock market liquidity, large business groups, weak law enforcement, and political instability.

In the Czech Republic these negative effects can be partly offset by prospects for joining the European Union. Those prospects may help generate a minimum of discipline in law enforcement and focus expectations in the right direction (Roland and Verdier 1999). But in Russia and other mass-privatizing countries with little hope of joining the European Union, the dynamic effects of mass privatization will likely have negative long-term effects.

Gradual sales, on the other hand, create a less sudden concentration of economic power. Because it takes money to acquire control, private capital must accumulate before more concentrated control over firms can be achieved. Much of this private accumulation is based on the new private sector and the small and medium-size enterprises that emerged at the start of the transition.

With gradual sales, the capital accumulated in small and medium-size enterprises will provide much of the new liquidity in the stock market. Thus these enterprises

become the small investors who have stakes in defending minority shareholder protection and who will lobby to change laws in that direction. Small and medium-size enterprises will also be the main constituency for further reform and for further shrinking of the state.

At the same time, under gradual sales state enterprises will continue to push for soft budget constraints. But these pressures can be eased through the growing strength of the private sector, which will increasingly oppose such practices as it grows in size and strength. Thus there may be a virtuous process leading to increased stock market liquidity, better minority shareholder protection, more law enforcement, real transparency in securities markets, further private capital accumulation, and stronger constituencies in favor of further reforms.

Empirical Evidence on Restructuring

There is an extensive empirical literature on the effects of the privatization form on enterprise performance. Before assessing that literature, it is worth noting that early studies on enterprise behavior found that the main difference was between existing firms (state-owned and privatized) and new enterprises (see Konings, Lehmann, and Schaffer 1996, Konings 1997, and Bilsen and Konings 1997). Controlling for factors such as size and capital intensity, new enterprises performed better on measures such as productivity growth. But such exercises are not easy to conduct because of a potential sample selection bias. The new enterprises generally survived early competition, which tends to overstate their performance relative to existing enterprises.

Another problem is the endogeneity that occurs when analyzing the effect of ownership form on enterprise performance by regressing performance on ownership. Causality may run the other way, with performance determining ownership—as when stronger enterprises are privatized first or privatized primarily to insiders who have superior information about them. In the Czech Republic the more profitable firms were privatized first to create support and political goodwill, in line with the political economy analysis mentioned above (Gupta, Ham, and Svejnar 1999).

Barberis and others (1996) provide an interesting empirical analysis of retail shops in Russia. Their study aims to provide evidence on the relative importance of the two channels mentioned earlier through which privatization increases efficiency: better matching of managers and assets, and better incentives. The authors find that restructuring occurred far less often when a shop was privatized to managers than when there were new owners who differed from incumbent managers. These findings suggest that matching managerial skills with assets is more important than improving incentives for incumbent managers. Incentives were found to have less effect than replacing management. The authors used an instrumental variable approach to control for endogeneity when using the method of privatization as an instrument. But while the study is interesting and well done, Russian shops provide limited evidence on the effects of privatization—especially the privatization of large firms.

Earle and Estrin (1997) surveyed 300 Russian enterprises after mass privatization was completed in mid-1994. The authors found first that the state remained a dom-

inant owner—holding more than 40 percent of shares—in 38 percent of the firms. More than 70 percent of the firms with a dominant private owner were privatized to insiders. The general finding from the authors' ordinary least squares regressions is that private ownership has a small positive impact on enterprise performance. The impact is big in cases of ownership by insiders and investment funds but insignificant for other forms of outside ownership.

The authors then correct for endogeneity (better firms being selected for privatization) using the privatization method as their instrument, as in Barberis and others (1996). The main difference obtained in the instrumental variable approach was that outside ownership has a significant positive effect on enterprise performance—except dispersed ownership, which has a negative effect. Thus the difference between the instrumental variable approach and the ordinary least squares approach suggests that better firms were privatized to managers and weaker ones to outside owners. But the performance measures relate to the period immediately after privatization, and further studies on Russia are needed—especially given subsequent events such as the generalization of barter and big increases in payment arrears.

Frydman and others (1999a) use panel data for 209 medium-size manufacturing firms (100–1,500 employees) in the Czech Republic, Hungary, and Poland in the fall of 1994. About 25 percent of the firms were owned by insiders, 25 percent by foreigners, 20 percent by investment funds, and 15 percent predominantly by the state. Using a fixed effect estimation, the authors find that outsider privatization had a positive effect on revenue and productivity growth and that insider privatization helped reduce layoffs. Among outside owners, foreigners contributed significantly to revenue and employment growth, while domestic financial firms and large minority state ownership increased revenue and productivity growth. The latter result is rather astonishing and suggests state passivity in those firms. Ownership by domestic outsiders as individuals had no effect on performance. Privatization had no effect on cost cutting, which suggests that privatization is more important for strategic restructuring than for defensive restructuring and that defensive restructuring can occur before privatization.

Using the same data, Frydman and others (1999b) show that major product restructuring has an important positive effect on revenue for outsider-owned firms but not for insider- and state-owned firms. This effect was strong even in outsider-privatized firms where management was not replaced. More broadly, the two papers by Frydman and others confirm the importance of the distinction made by Grosfeld and Roland (1997) between defensive and strategic restructuring. Defensive restructuring is as effective in privatized enterprises as in state enterprises. But strategic restructuring (as measured by revenue growth) is affected by ownership. Outsider-privatized firms are much better at strategic restructuring than state enterprises or insider-privatized firms.

Grosfeld and Nivet (1997) examine the impact of defensive and strategic restructuring on a large panel of Polish firms through 1994. The authors find that privatized firms invested a lot more and grew faster, confirming the effect of privatization on strategic restructuring. The authors do not distinguish between types of privatization. But in their sample, privatization occurred through sales to strategic investors.

Marcincin and van Wijnbergen (1997) find that in the Czech Republic, firms privatized entirely through vouchers tended to be of lower initial quality than firms privatized through sales or partial sales. Controlling for the selection effect, the authors find that privatization to outsiders had a positive but small impact on performance and that firms privatized entirely through vouchers exhibited weaker performance.

Weiss and Nikitin (1998) also analyze privatization in the Czech Republic. They find that concentrated outside ownership improves enterprise performance only under outside ownership other than investment funds. This result is even stronger when changes in performance are regressed against changes in ownership. Doing so eliminates any initial selection effect but is a noisy measure of control because dominant owners may reduce their ownership stakes after having secured control. The authors partly attribute the weak performance of firms owned by investment funds to perverse corporate governance arrangements and to asset stripping.

Prasnikar and Svejnar (1998) use data from Slovenia to test whether asset stripping was occurring. They test whether managers of state enterprises who also owned private firms underinvested in the state enterprises—and find that was not the case. They find that outside ownership had a positive effect on investment but no effect on wage setting. This suggests that privatization has not reduced the bargaining power of workers.

The European Bank for Reconstruction and Development's Transition Report 1999 provides preliminary evidence on the broader rent-seeking environment of privatization by examining the link between state governance, the degree of state capture, and the results of privatization. Businesses were surveyed to get an indirect measure of state capture by powerful interests. Firms were asked whether the sale to private interests of parliamentary votes and presidential decrees had affected their business. More than 40 percent of the firms in Azerbaijan, Moldova, Russia, and Ukraine cited a significant impact, but less than 10 percent in Slovenia and Uzbekistan did so. Thus there are "high capture" and "low capture" countries.

The influence on government appears to be concentrated in a small number of firms: in general less than 5 percent of the firms surveyed reported having a significant influence on policy. There is a negative correlation between the degree of capture and a general measure of governance (the effectiveness, as perceived by firms, of state governance in terms of regulation, taxation, inflation, policy stability, physical infrastructure, and law and order). Moreover, privatization's effect on governance differs according to the degree of capture. In low-capture states, progress on large-scale privatization is associated with better governance—while in high-capture states, progress on privatization is associated with worse governance. The second group is made up of Azerbaijan, Bulgaria, Croatia, Georgia, Moldova, Kyrgyz Republic, Romania, Russia, and Ukraine.

The evidence from transition economies tends to confirm prior analyses of privatization, indicating that privatization can enhance enterprise performance if corporate governance is sound. It is not true that any form of privatization is always better than state ownership. In particular, insider privatization in Central Europe and privatization to investment funds in the Czech Republic show disappointing results. And dispersed outside ownership can even hurt performance.

The empirical literature tends to show the importance of using privatization to better match managerial skills with assets. But many of these analyses were conducted just after privatization was completed. Empirical analysis over an extended period will improve our understanding of the policies followed. Comparative analyses across countries, like those of Frydman and others (1999a, b), are useful for assessing the overall process. Further research is needed to better assess the impact of the privatization policies followed in various countries, controlling for country-specific characteristics. Such cross-country analysis is also needed to understand the impact of the legal, financial, and political environment. Finally, research is needed to understand channels for hardening budget constraints through privatization. For example, has insider privatization helped harden budget constraints? If so, how?

Conclusion

A country's privatization policy appears to play a crucial role in determining restructuring outcomes within firms. Privatization policies also affect economic performance and the evolution of institutions and of reform. Differences between privatization policies matter because they affect the distribution of economic power among economic agents.

Mass privatization creates a sudden and strong concentration of economic power in the hands of insider managers. This sudden transfer of power creates opportunities for asset stripping and abuse of power to the detriment of minority shareholders. These abuses lead to low stock market liquidity and low confidence. When financial markets are weak, large business groups tend to form—reinforcing the concentration of economic power and leading to captured governments and potential political instability.

Gradual sales yield a lower initial concentration of economic power and rely on the entry of new entrepreneurs, learning of entrepreneurial skills, and accumulation of private capital. Small and medium-size enterprises and middle-class citizens become constituencies in favor of further reform and stable democracy. Their growing economic and political power makes them advocate for legal safeguards against asset stripping. Capitalism evolves naturally instead of by jumpstart.

Notes

1. The implicit assumption behind such reasoning was that all managers were bad and had to be replaced. Seen from today's perspective, this is clearly a sweeping generalization.

2. In transition economies those with the greatest willingness to pay are not necessarily those with the greatest ability to pay. Thus cash sales may allocate assets only to those with the greatest ability to pay. Solutions to overcome that problem have been put forward, particularly the concept of noncash sales (Bolton and Roland 1992) such as payment by installments, various leasing formulas, sales on credit, and gradual sales of stocks. Such noncash bids have been used extensively in Hungary and Poland; for a formal analysis, see Bolton, Pivetta, and Roland (1997).

3. This question was first raised by Gerschenkron (1962).

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