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The Role of Employee Ownership in Privatisation of State Enterprises in Eastern and Central Europe

ŽELJKO BOGETIĆ*

WITHIN THE CURRENT REFORM EFFORTS in Eastern and Central Europe, private sector development, and particularly privatisation, stand out as mainstays of the overall reform strategy.¹ However, given the preponderance of state enterprises in these economies, it is clear that private sector development must be complemented with simultaneous restructuring of state enterprises remaining in the state sector. At the enterprise level, private sector development includes both privatisation of a substantial portion of state enterprise assets (divestiture),² and the removal of formal and informal impediments to the entry of new private firms. This article will argue that private sector development is of crucial importance for the stimulation of new sources of growth in these economies, and thus for the success of the overall reforms. In particular, this article is about tapping one such potential source: employee involvement in the process of privatisation of state enterprises.

Employee ownership is, however, regarded here neither as an end in itself nor as a means of developing fully cooperative enterprises combining both ownership and participation of employees in decision making.³ Rather, it is suggested as one of several pragmatic means for achieving an important end; privatising a substantial portion of the state sector and creating a truly mixed economy with competitive market structures.⁴ One of the main propositions of the article is that minority employee ownership combined with a free market for shares could be advantageous in the process of privatisation by lowering political resistance to, as well as transaction and information costs of privatisation. The basic reason is that employee ownership is based on clearly defined private property rights and, as such, enterprises practising some forms of minority employee ownership face a 'correct'⁵ structure of incentives. At the same time, a free market for shares would eliminate any danger of employee ownership turning into a lever for siphoning off profits into wages.

There appears to be no shortage of proposed methods and techniques to privatise socialist firms.⁶ These options mainly draw on the already voluminous literature and limited but growing experience with privatisation in developed countries (primarily the UK and France), some developing countries (e.g. Chile, Malaysia, Sri Lanka) and, in particular, in Eastern Europe (primarily the Czech and Slovak republics, Poland and Hungary). Yet the scanty empirical evidence that exists does not lend itself easily to generalisations about what works best, and in what circumstances. This intuitive observation that generalisations about privatisation strategies and techniques are hard

to come by is strongly supported by evidence: Eastern European countries which embarked on the design and implementation of major privatisation programmes employ very different views of the process itself and of appropriate techniques. What is clear is that privatisation is a highly politicised process which necessarily involves building a political consensus at all levels: the society, the industry and the firm. In multi-region, multi-nation societies similar to the CIS republics or republics of the former Yugoslavia, regional/national dimensions pose additional political constraints on the process. It follows that if privatisation is to work, methods applied need to be tailored to particular circumstances in a given country, region or industry, paying particular attention to 'the critical role of political will'.⁷ Furthermore, the same privatisation technique may yield very different outcomes in different firms, even within the same industry, because of a host of firm-specific factors that may influence the success of the process, e.g. firm size, internal labour-management relations, age and job-length structure of the workforce, monitoring costs, uncertainty, etc.⁸ Therefore an eclectic, flexible approach and learning from experience might prove superior to privatisation strategies which are based only on one privatisation method.

The purpose of this article is to provide a fresh look at one method of fostering the privatisation process—employee buy-outs or internal privatisation,⁹ with particular emphasis on the implications for the evolving firm ownership structure. First I set out some theoretical and pragmatic reasons why employee ownership in some state enterprises may be a powerful lever for fostering privatisation in the initial stage. In addition, some potential costs of employee ownership are discussed, and the section concludes by evaluating the relative costs and benefits of employee ownership in the context of privatisation. Then I analyse prospects for development of employee ownership schemes in Eastern and Central Europe with unfolding of the privatisation process; this section is based on current privatisation efforts in these countries and the emerging lessons. The article ends with concluding remarks.

Employee ownership as a lever for fostering privatisation

Benefits of employee involvement

The literature on privatisation abounds with detailed analyses of various privatisation methods; the arguments *pro et contra* need not be repeated here.¹⁰ Given what is known about various privatisation techniques, I argue that schemes that involve some employee ownership¹¹ will prove the least costly in terms of political, transaction and monitoring costs. This is *not* to argue for a uniformly sanctioned and protected system of compulsory employee ownership;¹² the latter is simply viewed as an instrument for speeding up the privatisation process in socialist economies along the lines of least socio-political resistance.

In contrast to external privatisation, which involves the sale (or free distribution of assets) of enterprises to external owners (i.e. individuals, institutions and foreigners), internal privatisation occurs through a buy-out of an enterprise by its own workers and/or managers. Obviously, mixed privatisations are likely: a suitable combination of internal and external privatisation, i.e. selling portions of an enterprise's shares to outsiders and to its own employees, may

prove superior on political and other grounds to 'pure' privatisation schemes. Recently, the UK and Chile successfully implemented 'mixed' privatisation of a number of major firms with a great deal of employee involvement in the process. Along with this general argument for blending employee ownership with external ownership, I argue that if the privatisation process is to work in socialist economies employees will have to have an opportunity to acquire some stake in enterprises in terms of a share of the firms' assets (and, consequently, profits). The size of the employees' share will necessarily differ across firms and industries to be privatised, but the bottom line is that, without this stake on the part of employees, the process is likely to break down mainly on political, but also on practical, efficiency grounds as discussed below.

As a prelude to the discussion, Table 1 summarises the critical ownership characteristics of various types of enterprises and compares firms practising employee ownership with other types of firms.

TABLE 1
ORGANISATION OF FIRMS AND MARKET FOR SHARES

Ownership type	Market for shares		
	Free	Restricted	Non-existent
<i>Privately owned firms</i>			
Corporation with minority employee ownership		X	
Partnership		X	
Sole proprietorship		X	
Mondragon (100% employee-owned firm)		X	
<i>Non-private firms</i>			
Socialist state firms			X
Collective firms (e.g., <i>Kolkhozy</i> , Chinese TVEs, Kibbutzim)			X
Social firms (e.g., OALs in the former Yugoslavia, before 1990)			X

Although Table 1 abstracts from numerous other characteristics which might define the specific organisational type of firm, it serves to highlight the main idea that there is a fundamental difference in terms of market for shares between the *privately owned* firms practising minority ownership on the one hand, and *non-private* types of enterprises practising various forms of *collective ownership* on the other. An example of the former is a corporation with an employee-ownership plan for part of its labour force, while an extreme example would be a Mondragon-type enterprise where there are no external owners. Both firms face a correct¹³ set of microeconomic incentives, arising from private ownership.

A corporation is the type of firm frequently owned by a combination of external owners and some minority group of employees such as managers. The market for shares is free in the sense that anyone can buy the corporation's shares. In the case of a partnership or Mondragon-type employee-owned enterprise, there are restrictions on sale of shares, which is basically limited to membership (partners, or worker-members). However, in the case of non-private firms, the market for shares is non-existent:

not only does no *individual* own shares, but no one can buy them either. An example not presented in the table but possible to imagine is a corporation with majority employee ownership, which would fall between a corporation and other forms of privately held firms. It seems that this may not be a stable form of organisation in a situation where the market for shares is free: over time, it would probably slide into the corporation type of firm or into the more restricted forms such as partnership or Mondragon-type firms. Given that the Mondragon experience is exceptional and can be expected to emerge spontaneously only in truly market economies, it seems that the privatisation of state enterprises in Eastern and Central Europe can benefit from striving towards a standard corporate structure which is found in modern market economies, with the qualification that some initial involvement of workers in this process will be needed. However, the importance of creating a capital market in these economies suggests that it should be created relatively early in the process. Also, it should be free from arbitrary restrictions limiting participation in the share market to specific groups of potential investors (e.g. employees). This way, privatisation will not be impeded by worker opposition because of their direct involvement in the privatisation process from the very beginning. At the same time, the early creation of the free market for shares will speed up the development of a market economy.

The politics of privatisation. Privatisation is an essentially *political process* that has many powerful adversaries at all levels: society, industry and firm.

Employed labour opposes divestiture for fear of job loss. Government officials may resent it because their jurisdiction becomes restricted. And the intellectual community may oppose it because privatisation tends to be perceived as primarily benefitting the rich and the privileged.¹⁴

In the socialist economies, even more than in other developing economies, employed labour will typically appear as the most prominent opponent of the process. Government officials and the intellectual community are usually divided along ideological lines, but the workers' immediate interests necessarily make them a major opponent, as they have most at stake: secure jobs and salaries which were ubiquitously guaranteed by the state or social enterprises. An army of managers of state enterprises,¹⁵ on the other hand, have least at stake (at any rate until a truly functioning market for managers is formed), despite the added uncertainty concerning their jobs posed by prospects of 'hardening' the budget constraint and privatisation. Because of decades of adverse political selection of managers by the state and/or party at federal, state and local levels, the market for corporate control in socialist countries has been effectively crippled; the invisible hand of competition for managerial jobs was replaced by the 'visible' hand of the state and the party.¹⁶ Thanks to their accumulated individual and professional contacts, even managers who are dismissed will probably be able to find re-employment relatively easily: they will not bear most of the burden of the labour market adjustment in the period of transition.

The fact that employees of state firms represent a powerful political constituency which can bring the privatisation process to a halt encouraged some countries to try

various employee ownership schemes. This was in part due to the recognition of the political nature of the process.

In Britain, the two most successful examples are the divestiture of the British National Freight Corporation in 1982 and Vickers shipyard in 1986. Both divestitures were good examples of a blend of internal and external privatisation and the benefits that can be reaped from such an eclectic approach; both involved a substantial number of employees while allowing external ownership as well. Commentators noted immediate improvements in labour-management relations and productivity.¹⁷ The shares of the British National Freight Corporation which were sold to employees and external investors for £1.00 in 1982 were worth £70.00 only five years later.

In developing countries, the Chilean privatisation programme (over 400 enterprises privatised since 1973) has, particularly in the latter stage, emphasised the twin objectives of spreading ownership while providing 'at least one group with a relatively high stake in it, to make monitoring of management a worthwhile effort'.¹⁸ In Poland, on the other hand, an attempted employee (worker-management) buy-out under the Rakowski government resulted in a management only or *nomenklatura*¹⁹ buy-out, which immediately provoked public opposition and effectively halted the process. Privatisation in Hungary and the former Yugoslavia also stalled for different but essentially political reasons. This shows how privatisation in socialist economies is a delicate political process which requires careful balancing of interests among parties involved: employees, managers, external investors and the state. The point to be emphasised is that employees are a key 'player' in this game and their role must be carefully defined.

Minimising the agency problem. Political feasibility is not the only argument in favour of combining employee ownership with other forms of external privatisation (e.g. sale to citizens, banks, pension funds, foreigners). It has already been argued convincingly by Demsetz & Lehn (1985) that in an environment characterised by a high degree of uncertainty and imperfect functioning of the market for corporate control (owing, for example, to transaction or information costs), it will pay owners to exercise tighter control over management by more concentrated ownership.²⁰ In their words, 'the profit potential from exercising a... degree of owner control is, we believe, correlated with the instability of the firm's environment'.²¹ Furthermore, in their empirical test on a sample of over 500 US firms, Demsetz & Lehn find that *inter alia* ownership concentration varies positively with uncertainty²² and negatively with firm size. This was exactly one of the economic arguments for the involvement of employees in the aforementioned privatisation in Chile.

Consider the analogy of this finding with the privatisation process in socialist economies. It is a matter of fact that the economic environment during the period of transition is highly uncertain, giving rise to very erratic profit rates of different firms. In addition, the market for corporate control,²³ even more than other markets in socialist economies, is non-existent or highly distorted and inefficient in the informational sense. In this situation, it seems that the only way managers will indeed work in the interest of the owners is if the latter exercise stronger control over the former;²⁴ a logical way to achieve this in practice is by relatively more concentrated ownership. In the absence of owners monitoring managers, there will be no mechanism to ensure

that the principal (owner) will get the agent (manager) to do the job: it is a case of the agency problem.²⁵ Under these circumstances the question remains who is to take on the role of a majority owner in privatised firms. Since foreign investors are certainly not major candidates, except for a limited number of privatised firms, the majority owners must be found among employees and domestic external investors (individuals and institutions). In the initial phase of the privatisation process employees, being the largest and politically most vocal group, may be the natural candidate to consider in fostering the privatisation process. To be sure, this does not mean that the government should seek to sell all firms exclusively or mostly to employees, which would lead to a sort of worker capitalism on a countrywide basis. It simply means that where employees' interests and labour-management relations allow, internal privatisation in the broad sense (i.e. pure or combined with partial sale to external investors) appears advantageous to jumpstart the process in specific companies.

Establishing a closer relationship between owners and workers via a partial (or even full) employee-ownership scheme seems to avoid a twin problem:

- (a) it creates some concentration of ownership in the hands of employees, which alleviates the monitoring problem and harmonises the inherent interest conflicts between owners and workers as separate individuals; and
- (b) it lengthens the employees' time horizon by providing them with capital income arising from the investment in their own enterprise; this *ceteris paribus* may improve the incentive structure within the firm.

By making (all or some) employees capitalists, the famous Furubotn-Pejovich effect is significantly diminished, if not entirely eliminated. Employee-owners will adopt a longer time horizon than in the case when they are not owners, because of the presence of capital income. Related to this, though less tangible, one can argue that this symbiosis of labour and capital owners would enhance motivation, work effort and/or productivity (see Blinder, 1990).

Taking advantage of informational asymmetry. Employees are, by virtue of their position, most knowledgeable about the internal slack, market and technological constraints and opportunities facing a firm. In cases where employees express sufficient interest to invest their own capital in their firm, allowing them to do so taps the important informational advantage that employees possess with regard to production possibilities. In a recent theoretical paper, Minkler (1990) shows that in cases where employees possess superior knowledge over production possibilities, the horizontal form of organisation (such as a franchise, or even a participatory firm) will be least costly in terms of monitoring and other costs, and will be chosen by a principal over the vertical (or hierarchical) organisational structure. The same reasoning applies here. Where employees (agent) have an advantage in terms of information and/or knowledge over the external owners (principal), the latter will not be able to direct the agent in profitable activities, even in the case of zero monitoring costs. The larger the knowledge/information asymmetry between the principal and the agent, the greater potential profitability from making employees co-owners, franchisees or cooperateurs. The practical questions, however, concern the extent of jobs and/or

activities where the employees indeed possess superior knowledge, as well as the issue of *relevant* knowledge of the principal.

On a more practical level, privatisation of small establishments (i.e. retail outlets, restaurants, kiosks, etc.) could mean more involvement of employees than in the case of large enterprise privatisations, for at least two reasons. Employees in these small firms are in the best position to assess whether the buy-out is worthwhile and whether the firm is potentially profitable. The demand constraint working through the limited purchasing power of employees, while certainly present, may not be as binding as it seems *prima facie* for small establishments in countries like Hungary and the Czech republic, because of the small size and value of small firms. The practical importance of the informational asymmetry is well understood by professional investors in developed market economies. One of the investment analysts' rules of thumb for determining whether the firm's prospects are good is whether managers or employees are buying or selling their company's stock;²⁶ the former is generally interpreted as a sign of good prospects, while the latter suggests 'exit' before new financial difficulties.

Minimising administrative and time costs. From the perspective of administrative and time costs, employee buy-outs (100% or in combination with external sale) are clearly simpler and faster: they involve a readily identifiable group of interested buyers, and the problem boils down to finding the appropriate mode of financing the buy-out. It seems particularly easy in the case of small firms (say, employing less than 100 workers) where employees (with the likely consent of the government) may decide to buy a controlling share in their enterprise, while floating the rest for external buyers; the smaller the firm, the more transparent the administrative and financial issues that need to be resolved in the process of divestiture. In addition, relatively young firms with few or no pensioners or ex-workers who otherwise would also be interested in the buy-out may have additional incentives to go private internally because of a clear distinction between interest groups (employees and outside investors).

Costs of employee involvement

Inequity of employee buy-out. One caveat to the employee buy-out as a method of privatisation is that it introduces *ex ante* inequities *vis-à-vis* retired employees, workers in non-profit enterprises and the unemployed. However, where the employee buy-outs are combined with an external sale, initial inequities would not be as strong as might be perceived. Moreover, it can be dealt with *ex ante* by reserving a portion of shares for adversely affected groups. After all, a Pareto neutral position for all 'players' *ex ante* privatisation is impossible in a world of uncertainties, uneven distribution of knowledge and, particularly, costly information;²⁷ individuals with more knowledge or less costly access to information will be *ex ante* favoured even in a perfectly egalitarian distribution of shares to all citizens, as advocated in the Czech and Slovak republics. More strongly, capitalism is not necessarily an egalitarian system although it is the most dynamic and the most efficient in a standard economic sense. Therefore, claims by some privatisation schemes that 'equality' in the process of privatisation should be an important criterion simply promise more than

is realistically possible to expect, while giving grounds to populist politics to halt the process exactly on grounds of 'unfulfilled promises' of egalitarian and smooth transition. Finally, what matters is the public perception of the appropriate degree of equity in the process, not the elusive, 'ideal' equity that may be unattainable.

The problem of majority employee ownership. The potential problem that arises from majority employee ownership is that it could develop into a labour-managed form of enterprise similar to that in the former Yugoslavia. This possibility is present in almost all former centrally planned economies, where some kind of labour-management enterprise structure has been formally constituted. Given the well known problems related to undefined property rights and distorted incentives, large-scale conversion of former state firms into labour-managed firms would create a serious impediment to the entire process of privatisation and the development of a truly market economy. This problem could be avoided by stimulating minority employee ownership and the legal institution of non-voting shares. The institutional environment for new entry must of course be entirely non-discriminating across various firm types. The key issue is to avoid the potential organisational deadlock of the uniformly organised labour-managed firms as known in the former Yugoslavia, and to speed up the process of creation of privately owned enterprises from the ashes of state firms as well as through new entry.

The approach I advocate here, that employee buy-outs and external sales be combined when possible, implies a subtle distinction from the 'Big Bang' approach. In the former, the initial distribution of political power and resources (labour and capital primarily) matters and will necessarily influence the success of privatisation because '... intra-firm relations and firm structures are significantly historical in character'.²⁸ In the latter, privatisation is viewed as a radical break with the previous firm structure, one which establishes a new set of rules governing a new allocation of power and resources. Both, however, have the same aim: achieving privatisation in the fastest and least costly way. The type of limited 'squatter sovereignty',²⁹ where employees have *some* right to ownership of their enterprises, will probably minimise the political resistance to the process and contribute substantially to a speedy creation of a market economy. In this approach, I suggest that this initial distribution of political power could be exploited to speed up the process of privatisation along the lines of least political resistance. Well defined minority employee ownership combined with the emerging free market for shares are the key in such an approach.

Balancing the costs and benefits: minority employee ownership with free market for shares

In a nutshell, the approach suggested in this article is to allow employees to acquire minority ownership in their enterprise (along with other interested parties), while the shares would be freely marketed on the equity market, allowing individuals, foreigners, institutions or employees to acquire a majority stake. The initial restriction on minority employee ownership would serve to overcome potential transformation of state enterprises into labour-managed firms, which would impede the process of privatisation. However, once the firms are privatised (with minority employee

ownership), the market for shares will quickly develop majority owners in specific enterprises, which is necessary for the owner-manager relationship to function properly. There should be no restrictions on who should take on this majority owner's role in specific enterprises: these could be external individuals, institutions, groups of citizens or even employees. As long as new owners are true, *individual*, private owners, there will be no adverse incentives effects.

It is often argued that, if the market for shares is allowed to function freely, the evidence of employee ownership in Western countries suggests that employees will sell their shares and so their initial stake in enterprises will necessarily diminish over time. For those who favour employee ownership over other types of firms, this is a reason for concern, while for others it is a natural product of the functioning of the capital market. If the employees will indeed behave in this way in the immediate aftermath of privatisation, majority employee ownership will not emerge in Eastern Europe to a significant extent. The emerging ownership structure will therefore probably mimic that of developed Western countries from several decades ago.

But although this is the prevailing opinion, this outcome is by no means certain. Specifically, East European economies during transition are different from developed market economies in two important respects: the scope of different investment opportunities and information costs regarding those investment opportunities. In transitional economies the diversity of stable, promising investment opportunities will be lower and costs of information about those opportunities will be higher than in a developed market economy. Coupled with the generally lower mobility of people in these countries, and self-interest, these factors provide powerful incentives to employees of promising enterprises to stick with them for at least a period of time, rather than sell their stake for a quick profit. If that is what they do, privatisation through forms of employee ownership will not necessarily result in decline in employee ownership in its immediate aftermath.

It is of interest that this approach, using employee ownership, is consistent with the Lipton & Sachs (1990) proposal which formed the basis for the early privatisation plans in Poland. In their paper, the recognition of political reality is, however, the main reason for advocating a limited role for employee ownership in privatisation. In contrast, I argue that, in addition to the argument of political feasibility, there are fundamental *economic* reasons why employee ownership should be an element of any viable privatisation strategy. Privately owned firms with a degree of employee ownership are but another type of privately owned firms which face correct micro-economic incentives, can maintain the delicate owner-manager balance and contribute to the spread of ownership among the population. In addition, this approach is consistent with a large number of privatisation strategies based on sale of shares which include varying roles for mutual funds, external investors, the general public and former owners.³⁰

Progress with privatisation and implications for employee ownership

The striking fact about the progress with privatisation in Eastern Europe to date is the diversity of approaches and methods and, therefore, the pace and success with privatisation across countries.

Former East Germany. At one end of the spectrum lies the experience of the German Treuhandanstalt (THA) which has been an absolute champion of speed: it managed to sell over 6000 large and medium-size enterprises or more than 50% of the planned total.³¹ Although these results are impressive in themselves and attracted considerable academic and political attention, the German experience seems to have limited relevance for other East European countries. There are two main characteristics of the THA which at least partly account for its relative success, but are largely absent in other countries. The first is the strong centralised power of the THA, backed by political consensus, to execute rapid privatisation and shut down and/or restructure state enterprises. The second is the borrowed funds which the THA has at its disposal to enable it to intervene and, when needed, subsidise ailing enterprises before they can be successfully privatised. In contrast, East European countries are much more subject to domestic political constraints and are reluctant to resort to fully centralised forms of privatisation which are all too reminiscent of the old ways of managing the economy and society. In addition, the continued subsidisation of state enterprises, apart from the obvious negative fiscal and incentive effects, is bound to delay the painful decisions; those decisions can then easily get bogged down in a political deadlock. The protracted Polish debates on privatisation and the political difficulties are a case in point. Therefore, decentralised forms of privatisation which involve a multitude of agents who can initiate and/or execute privatisation, including employees (managers and workers) and local governments, appear to offer more promising avenues for deepening the process.

The progress in countries other than Germany has been considerably more modest. Privatisation of small establishments (e.g. retail outlets, restaurants etc.) has been proceeding apace through spontaneous and other forms of privatisation, but the fact remains that the privatisation of large and medium-size enterprises has been slower than the rhetoric was suggesting at the outset of reforms. Even in Poland and the Czech and Slovak republics, which advocate mass privatisation programmes, the number of privatisations of large enterprises has been limited.

Poland. In Poland, for example, despite high expectations and the legal framework in place, by June 1992 only 26 large enterprises had been privatised by way of the restructuring-valuation-sale method,³² which was mandated in the first Law on Privatisation (July 1990). As a result of the apparently slow pace of implementation, and after much political debate, the Ministry for Privatisation has worked out the Mass Privatisation Act which, if approved by the parliament, would considerably speed the process of implementation. This new programme, which marks a second attempt at mass privatisation, is based on national investment funds. The Ministry for Privatisation would select enterprises for privatisation, appoint their management boards, including international professionals, and allocate shares in the enterprises to these funds. According to this plan, the shares of each firm would be allocated as follows: 27% of the shares would be allocated equally to investment funds as a 'small shareholding stake'; 33% of the shares of each individual enterprise would go to a single fund as a 'lead shareholding stake'; finally, 10% would be allocated to the enterprise employees and 30% would remain state-owned. This privatisation programme is similar to (and perhaps influenced by) the proposal by Lipton & Sachs (1990), who argue for a privatisation strategy which gives a 'slice' of ownership to

each major interest group (i.e. pension plans, employees, banks, the general population), making sure that a 'stable core' of owners is established in each case.

The role envisaged for employees is that of minority owners (10%) while the working of the stock market in the aftermath of privatisation will determine the future ownership pattern. Also, given the history and the presence of strong union power in Poland, it is quite likely that outright sale of firms to external owners, under the conditions of high uncertainty, would lead to a political impasse and that an additional role for employees as participants in the privatisation may be necessary. Although the exact ownership pattern in Poland in the medium term is not possible to predict, it is almost certain that it will contain an element of employee ownership in forms similar to those that at present exist in Western countries (e.g. ESOPs in the US).

The Czech and Slovak republics. The mainstay of the privatisation strategy in the Czech and Slovak republics is the voucher scheme, which simulates the Walrasian auctioneer in determining equilibrium price for enterprises. The scheme works as follows. Citizens may voluntarily participate in the process by paying the equivalent of \$37.00 for voucher booklets to buy shares. Each booklet has a value of 1000 points which can be used to pay for shares in state enterprises. The government offered shares for sale in 1446 state enterprises in the so-called 'first wave', initially priced at 33.3 points per share (or 3 shares for 100 points), while each share has a book value of 1000 crowns. Here is how the Walrasian auctioneer comes into the picture: if an enterprise receives bids for more shares than it has, it is an indication of excess demand, so no shares are distributed at that time and they are offered again later at a higher price; the objective is not to undersell promising enterprises before a 'market' price is established by bringing the demand of bidders into balance with the existing supply of shares. If the opposite happens—if the company has more shares than the initial bidders demand—shares are distributed to the bidders, and the remaining shares are later offered at a lower price. The auction process continues until the shares are sold. In the second 'wave' new enterprises can go through essentially the same process.

So far this scheme is unfolding relatively well: at the time of writing the first two rounds of auctions had been completed and the third was underway and planned to be completed by October 1992. In mid 1992 about 56% of all shares had already been allocated. Of the total of 8.6 million vouchers bought by the population, over 70% were entrusted to private investment funds, which are emerging as an important player in this process. The remaining 30% of vouchers (2.9 million) are being used by individual bidders.

It is not clear whether and in what way the political split of the former CSFR into independent Czech and Slovak republics will affect the process, beyond the official statement that the second wave of the programme will be carried out separately in the two countries. Yet the scope of the scheme was somewhat reduced relative to the original proposal, so that not all the firms' equity will be sold by this method: in all 1400 firms participating in the process the average stake to be sold by vouchers is only 50%,³³ while the actual volume of equity sold via the voucher scheme in individual enterprises varies widely from 10% to 97% (3% is reserved for restitution claims). This must reflect the growing realisation that there is no one best way to

privatise and that a multi-pronged approach and flexibility are likely to yield better results than a single all-encompassing scheme.³⁴

The Czech-Slovak privatisation programme is also unique in the relatively large role that the stock market will play in the process of privatisation and subsequent trading of privatised enterprises. As discussed earlier, stock market and employee ownership are mutually consistent and are likely to grow in co-existence. If developments in the West are any guide, the employee-owned firm should be expected to emerge spontaneously in the Czech and Slovak republics as a competitive form of enterprise. In addition, it is likely that those enterprises which do not fully participate in the voucher process will also involve employees in the process of privatisation although, at present, it is too early to assess its extent.

Hungary. Hungarian privatisation has, perhaps, been the most pragmatic, seeking solutions that work subject to political constraints of the moment. It has also been rather successful, particularly in the area of small and medium-size enterprise privatisation.³⁵ An interesting specific feature of Hungary's privatisation is the recent return to forms of 'spontaneous' privatisation, 'self-privatisation' or 'privatisation from below', where enterprise employees (managers and workers) can initiate the process. In fact this was the first method Hungary tried before it was deemed 'unfair' in the explosion of public opposition to a few poorly managed deals which blocked spontaneous privatisation for some time. As the Minister, Tamas Szabo, explains, '... it turned out that the centrally managed privatisation programmes bring only modest results ... on the other hand, self-privatisation (previously called spontaneous privatisation), in which state companies initiate their own transformation and look for new owners, proved very successful'.³⁶ As a result, the Minister reported, the Hungarian government had already launched a second programme of these types of privatisation involving some 300 small and medium-size enterprises.

This all suggests that Hungarian privatisation may well use more employee ownership as a lever for fostering privatisation than was commonly held in the early days of the privatisation debate when emotional overtones and talk of 'unfair' privatisation dominated. The shift we observe in Hungary may be simply due to the passage of time and the realisation that no privatisation is fair³⁷ and that what is important is to get the process going, subject to an acceptable level of inevitable inequity.

Former Yugoslavia. The disintegration of the former Yugoslavia adds to the diversity of patterns of privatisation we observe in other countries since its former republics now all have their own plans for privatisation. However, the implementation of these plans has stalled because of the civil war. It is of some interest, though, to mention the old federal government's programme which had employee ownership at its core, particularly since some privatisation actually occurred under this scheme before the civil war accelerated. Specifically, the government of the former Yugoslavia advocated a privatisation strategy in which employees and other citizens were able to acquire shares in the formerly 'social' enterprises. The emphasis, however, was on transferring most of the ownership to employees. For this purpose, the Law on Social Capital allows employees to buy shares of their enterprises at 30% discount plus 1% for each year of work in the firm, with the maximum discount to any particular employee being 70%. Former employees and pensioners enjoy the

same discounts, while other citizens and institutions can buy shares at a flat 30% discount.³⁸

Apparently, the intention of law makers in the former Yugoslavia was to complete the ownership transfer in profitable firms relatively fast, by passing the ownership primarily to employees. It seems that this plan has implicitly adopted ESOP or even Mondragon as a model towards which privatisation should strive. In addition, it was hoped that paying out part of salaries in shares or bonds instead of cash, would (a) partly contain new inflationary pressures which became apparent in the middle of 1990 and (b) increase the self-financing ability of firms.

Interestingly enough, the legal obligation of firms to pay a portion of salaries in the form of shares or bonds backfired on the government in the form of strong opposition from unions, which asked that this obligation be revoked.³⁹ Recently, some former Yugoslav republics challenged the idea of internal shares in favour of a free market in shares of the kind described above, and separate privatisation proposals at the level of republics began to emerge.

Examples of employee-led buy-outs included two large and previously successful firms—OHIS from Skopje (Macedonia) and Hemoform from Vrsac (Serbia).⁴⁰ The privatisation of OHIS was the first example of actual implementation of the government's initiative towards internal privatisation. It was carried out in the form of sale of internal, non-transferable shares to 3500 employees, which effectively turned OHIS into a partially employee-owned firm; it is reported, however, that the firm will issue external shares as well in the near future. The nominal price per share was 1000 dinars (approximately \$83.00 at the then existing exchange rate), and the total value of the shares sold was DM3.15 million (around \$US1.9 million). This is estimated to constitute 30% of the value of the firm. OHIS also offered guarantees to its employees of receiving an annual dividend of 10% with the possibility of a higher dividend depending on the firm's financial performance. Interestingly enough, OHIS, producing a variety of chemical products (detergents, pesticides, paints, etc.), is an example of a large,⁴¹ successful firm that has never reported financial losses since its formation.

Hemoform, an enterprise worth DM94 million (approximately \$US57 million) which employs 1000 employees, is also an example of a large, successful firm, said to have engaged in joint ventures with foreign investors. In the first issue shares were sold to 700 of its employees. The proceeds of sale are estimated at 260 million dinars (around \$US22 million). The minimum dividend was not determined, as in the case of OHIS, and will depend entirely on performance.

These examples from the former Yugoslavia suggest that this type of privatisation could gain momentum in successor republics where there still exists considerable employee influence on the political process. However, given the extreme uncertainties generated by the civil war, it is unclear when and in what form privatisation plans will be resumed in the two largest republics—Serbia and Croatia.

Russia. In Russia the complexity of the regional, ethnic and political tensions, as well as competing conservative and radical approaches to transition to a market economy, make privatisation an even more delicate task, which might well require additional flexibility and innovative thinking. A recent study of the Soviet economy⁴² by international organisations recommended that privatisation of small and medium-size enterprises be initially carried out through direct public auctions to individuals

and cooperatives; payment in instalments was seen as a means of accelerating the process. For large enterprises, two strategies were recommended: (a) privatisation via leasing parts of enterprises to private entrepreneurs, and (b) commercialisation into joint stock companies owned by a holding company, which would then be privatised by sale of shares. Only minority ownership for workers was recommended. As in the case of the former Yugoslavia, some former Soviet republics have been developing their own privatisation programmes, which suggests that privatisation modes and pace may well differ significantly across these countries.

The practice of privatisation, however, suggests some obvious ways out of a privatisation impasse. The story of the Moscow-based ventilator firm Moven illustrates the point. In May 1991 a successful employee buy-out of the firm, which had gradually evolved from state firm to cooperative and then to an employee-owned corporation, was reported.⁴³ The employees first struggled their way out of state control by reorganising the firm as a cooperative and leasing the equipment from the state. Soon thereafter the cooperative was transformed into an employee-owned joint stock company, as management borrowed some \$3.6 million (6.5 million rubles) from prospective client firms to complete the buy-out. Although the membership transfer was completed by the management, Moven soon offered 6500 shares (at a price of 1000 rubles per share) to its employees on favourable terms: only 20% downpayment was required, while the rest could be borrowed as a long-term loan. Interestingly enough, employees are free to sell their shares, which also suggests that *economic* rather than political incentives motivated the buy-out. The initial results in terms of output and profits in the aftermath of the buy-out were reported as positive and led to a joint venture with a Western firm. The case of Moven illustrates how entrepreneurial management/employees can turn a state socialist firm into a successful privately owned corporation ready to expose itself to international competition. The lesson for policy makers is clear. As long as employee buy-outs are motivated by economic, entrepreneurial incentives rather than ideological or purely job security considerations, they are serving the fundamental goal of privatisation: to place state assets in the hands of 'better owners' (Kornai, 1990).

The current Russian mass privatisation plan is certainly influenced by the aforementioned proposal, although it displays one important peculiarity in relation to other plans. Perhaps the most significant differences between the Russian and the other programmes are that the Russian plan provides more discounted equity for employees, as well as greater opportunities for employees to purchase shares at reduced prices.⁴⁴ In Russia, employees receive a gift of up to 25% of the shares in an enterprise that is corporatised and the right to buy another 10% of the shares on favourable terms. Managers may buy a further 5%. Alternatively, employees may decide to purchase a controlling interest in the enterprise (up to 51% of the shares) on terms which remain to be specified by the Russian property agency (the GKI).

Bulgaria. In Bulgaria substantial restitution to previous owners seems to be the specific feature of privatisation. The latest official estimates (June 1992) indicate that some 3600 shops, 2600 flats, 600 industrial sites and 130 restaurants have been returned to previous owners, amounting to a total of around 2.2 billion leva (2% of 1991 GDP). The process of land restitution is also underway.

The Privatisation Law of April 1992 specified a multitude of actors who can initiate

privatisation: the central government, the Privatisation Agency, municipalities, enterprises and investors. The Privatisation Agency has a supervisory role in the process and reports directly to the Council of Ministers. Under this law, the main method of privatisation is selling shares of state enterprises which have already been transformed into joint-stock companies, and selling non-transformed enterprises. Share prices will be determined by competitive bidding, but employees will have an option to buy up to 20% of transformed enterprises and up to 30% of non-transformed enterprises at a discount, but the discounted shares are non-voting. The government has recently adopted an action plan (which was already revised) to privatise a list of selected enterprises.

Small-scale privatisation was started in summer 1991 by auctions of several petrol stations and other small establishments but the process was soon bogged down in the politicised issues of state versus municipal ownership, preferences and the overall transparency of the process. After the slowdown during autumn 1991 associated with the election, the process was restarted on the passing of the Privatisation Law in April 1992. In August 1992 the necessary implementing regulations had been passed and an initial action plan had been developed, targeting enterprises selected by the relevant ministries.

Romania. In Romania the privatisation law passed in August 1991 set the basic framework. Under this law the ownership of the share capital will be allocated between the State Ownership Fund (70% of the share capital of each enterprise) and five Private Ownership Funds (30% of the share capital of each enterprise). From June 1992 the free distribution of ownership certificates of the Private Ownership Funds has been underway. The certificates could be traded on the stock market which is in the process of being established. At the same time, the State Ownership Fund has the obligation to sell its stake in enterprises so that its share of the capital is reduced by 10% each year.⁴⁵ In addition, a form of decentralised privatisation is allowed by which independently run hotels, restaurants and shops can sell up to 75% of the value of their assets. In practice, more than 6000 enterprises have already been commercialised and the sale of 4400 establishments was initiated in February 1992. In addition, approximately half of the arable land has been privatised and over half of the state-built houses were sold to their tenants.

Overall, there are significant differences across East European countries in their 'initial conditions' on the road to a market economy. In some countries (e.g. Russia, Poland, Bulgaria or some republics of the former Yugoslavia), the politics of change and employee power suggests that entrepreneurial, voluntary employee ownership could emerge as an important element in fostering the privatisation process. In other countries (e.g. Hungary), the role of employee ownership may be comparatively small. However, the bottom line is that without a stake for employees the privatisation process is likely to end in political deadlock. Combining employee ownership with a free market for shares, i.e. no discrimination against outside owners, would serve the early creation of a capital market and thus speed the creation of a market economy.

Concluding remarks

There are potential gains in terms of lowering political, economic, administrative and

time costs from fostering privatisation in Eastern Europe via various forms of minority employee ownership. This seems to be a fast and least costly way of creating a core class of owners, who are needed in the process of transformation. This is not to argue for a uniform system of employee-owned firms. On the contrary, modes of privatisation will necessarily differ across countries, and even across industries and firms within the same country. It is argued, however, that in the initial stage of privatisation, a political and bargaining impasse can be overcome via partial employee buy-outs in firms where employees choose to do so. Greater employee involvement could be expected in privatisation of small establishments where the small size and value of the firm could relax the demand constraint facing employees. In large firms, minority employee ownership could be combined with the emerging free market for shares, as a strategy which can accommodate a number of privatisation techniques, while overcoming the potential deadlocks in the privatisation process. Broadening of ownership among the population, building identification with the new private property-based economic system, necessary intra-firm concentration of ownership, and smoothing out interest conflicts in the process of transition are some reasons for this solution. A brief survey of different privatisation plans and experiences indicates that employee ownership is already emerging as an integral part of the newly created market economy in almost all the countries in transition. However, its scope and modalities will differ depending on the initial conditions, the nature of privatisation plans and the country-specific politics of transition.

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¹ For recent thorough analyses of problems of transition stressing the importance of privatisation see, for example, Hinds (1992), and Gelb & Grey (1991).

² See Berg & Shirley (1987) for a distinction between privatisation and a narrower concept of divestiture involving the transfer and/or liquidation of ownership of state firms. For an up-to-date survey of lessons of privatisation experiences in less developed countries, see Kikeri, Nellis & Shirley (1992).

³ For arguments supporting the extension of democratic community from the political sphere into the democratic, participatory (or cooperative) firm in the economic sphere see: Ellerman (1989); a similar view, albeit with different arguments, is held by Minkler (1989).

⁴ For a different view see Vanek (1990), who argues against employee ownership if not accompanied by participation in decision making. It should be noted that my argument for employee ownership does not exclude the possibility that some employee-owned firms, if they so choose, will indeed become truly cooperative in the participatory sense, but it does not impose this possibility *ex ante*.

⁵ It is important to understand a fundamental distinction between employee ownership as a form of private ownership on the one hand, and collective ownership such as that in, for example, *Kolkhozy* in the Soviet Union, and township and village industries in China, on the other. In the former, the link between private ownership and return on capital is clear, and the reward for labour is market-based, and in that sense the incentives are 'correct'. In the latter, neither is the case, thus giving rise to the set of incentives dominated by non-market stimuli such as the plan, peer pressure and effort minimisation.

⁶ For an up-to-date survey see Milanovic (1992), and Bogetić & Conte (1993).

⁷ Nankani (1990).

⁸ In a recent review of the World Bank experience with privatising public enterprises in developing countries, Nellis (1989) stresses the uncertainty surrounding privatisation and argues for

a careful and flexible handling of the Bank's conditionality. Arguably, rigid deadlines for sale of enterprises can be particularly counterproductive, because of the danger of undervaluation of state assets.

⁹ The term 'employee' here encompasses both workers and managers, unless specified differently.

¹⁰ For surveys of advantages and disadvantages of various privatisation options see, for example, Milanovic (1992), and Vuylsteke (1988). Also, Pirie (1988) discusses as many as 21 different privatisation 'methods', primarily on the basis of the British experience in the past decade.

¹¹ The quantification of the word 'some' is left to the particular enterprise and/or industry being privatised.

¹² This was the case, for example, in Yugoslavia, where a restricted form of employee ownership (*ususfruct*), combined with labour-management, was the compulsory form of enterprise organisation, thus severely limiting the benefits of diverse organisational forms found in developed market economies.

¹³ See note 5.

¹⁴ Nankani (1990), p. 45.

¹⁵ I use the term state enterprises to denote both truly state firms in Eastern Europe as well as 'social' firms in the former Yugoslavia. These 'socially owned' firms can be regarded as a special case of state owned firms in the sense that the state in the former Yugoslavia appeared as a franchiser of the 'social' capital to worker collectives (or 'social' firms) at zero price, with the capital maintenance requirement.

¹⁶ One may argue that 'animal spirits' of entrepreneurship and managerial initiatives have been somewhat released in the former Yugoslav decentralised economy. Yet, even here, 'too much' entrepreneurship and initiative has been effectively condemned by (semi) official purges, as was the case with a number of successful managers of large firms in Serbia in the early 1970s.

¹⁷ See Pirie (1988), pp. 124-137.

¹⁸ Luders (1990). Also Nankani (1988) reports on the details of the sale of ECOM, the largest Chilean computer firm, to its employees. She notes that 'the only group that showed interest was its employees... This decision [to sell to employees] satisfied two other goals... in its privatisation programme: avoiding liquidation and redistributing ownership among a large group of investors'. (p.37).

¹⁹ See Walkowiak *et al.* (1990).

²⁰ By concentration of ownership I understand intra-firm ownership. It is useful to note that this is not necessarily incompatible with broadening of ownership of firms across the population. An example of perfect intra-firm concentration and perfect spread would be that society consists entirely of individual one-man businesses. Therefore, the argument for concentration of ownership within the firm is consistent with the spread of ownership among the population.

²¹ Demsetz & Lehn (1985), p. 1160.

²² Uncertainty was measured by the instability of profit rates.

²³ See Manne (1965).

²⁴ Control of managers does not necessarily imply an employee-run firm; only the power to appoint, reward, evaluate and dismiss managers in accordance with their performance.

²⁵ 'To turn a company around, some core group may need to have and use a large if not controlling stake in the enterprises. While perhaps not a serious issue with well managed firms, it is of concern where firms to be privatised are weak or underperforming, often the case in the developing countries'. Vuylsteke (1988), p. 125.

²⁶ Lynch (1989).

²⁷ Only in the case of free distribution of shares (or vouchers) to citizens will *ex ante* Pareto neutrality in privatisation be achieved. When the shares start selling in the market, no one will be worse off, and some people whose shares command a positive price will be better off. It is important to recognise that this method suffers from problems such as no concentration of ownership and *ex post* inequities, which may be even more substantial than under alternative methods of privatisation. Also, contrary to popular perceptions, the use of vouchers may *not* speed up the process (see Bogetic & Conte, 1993).

²⁸ Puttermann (1986), p. 9.

²⁹ See Weitzman (1991).

³⁰ In addition, elements of this approach can be modified to be included in a viable give-away privatisation scheme. See Bogetic & Conte (1993).

³¹ It is estimated that approximately 5000 more enterprises remain to be privatised.

³² *Transition*, May 1992, p. 4.

³³ *Ibid.*, p. 3.

³⁴ Bogetić & Conte (1993) stress this need for a multi-dimensional approach and flexibility, which imply considerable room for decentralised forms of privatisation.

³⁵ 'About half of the 1900 state enterprises selected for privatisation (representing about 35–40% of total state assets) were already involved somehow in the privatisation process—at least they were transformed into joint stock companies. Private owners have taken over about 10% of state assets . . .' *Transition*, 3, July–August, 1992, World Bank, Washington, DC, p. 9.

³⁶ Interview with the Hungarian Minister, Tamas Szabo, *Ibid.*, p. 10.

³⁷ Strictly speaking, all privatisation in which buyers pay some positive price for acquired assets is 'unfair' in an *ex post* Pareto sense; after it is completed and the market starts determining the value of shares, although some people will gain, some will definitely lose.

³⁸ Furthermore, the recently passed controversial Law on Personal Incomes obliges profitable firms to pay out a portion of salaries in the form of internal shares or bonds. The most controversial article 4 of this law requires that firms which paid 90% to 110% of the average (Republic average) monthly salaries, starting from 30 June 1991, pay 25% of the increase in personal incomes in the form of internal shares or bonds with a maturity of at least 1 year. Firms which manage to pay out more than 110% of the average monthly salaries will have to pay 50% of their future increase in salaries in the form of shares or 1-year bonds. Unprofitable firms are not under the obligation to sell shares to their employees.

³⁹ Dj. Simic, *Privredni Pregled*, 12 September, 1990, p. 12.

⁴⁰ *Ekomska politika* (Belgrade), 19 October, 1990.

⁴¹ OHIS has been among the 140 largest firms in the country for over twenty years, according to the annual review of the 200 largest firms by *Ekomska politika* (1988).

⁴² IMF, World Bank, OECD, EBRD (1990).

⁴³ *The Economist*, 13 May 1991.

⁴⁴ According to *Oxford Analytica*, 20 August 1992, the pilot privatisation programme launched in Nizhny Novgorod in December 1991 resulted in the auction of some 61 small establishments by May 1992; reportedly 21 of these were bought by employees at 30% discount.

⁴⁵ *IMF Survey*, Washington, DC, 22 June, 1992, p. 207.

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