

**Restructuring in Transition Economies:
Ownership, Competition and Regulation**

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Abstract: Transition requires the reallocation of resources across activities through closure of inefficient firms and the creation of new firms. It also requires restructuring of existing firms where improvements in performance are feasible. Both processes are closely tied together and are aimed at raising productivity. This paper examines experience to date in the transition economies on both counts and indeed shows that failures to restructure have generally been associated with failures to reallocate. For restructuring to occur requires imposition of hard budget constraints and increases in competition. These in turn will ensure that changes in ownership have the desired positive effect on governance. We find that progress in restructuring has varied substantially across countries. We identify a profound divide between the countries of Central Europe and those further east, particularly in the CIS. In the former, incentives for private agents to start businesses, restructure and invest have been largely set in place. This has promoted growth and has had the added advantage of facilitating dynamic adjustment to earlier inadequacies in policy. In the latter, soft budget constraints have been associated with privatisations that have strongly favoured incumbents. The web of non-transparent links connecting government, firms and banks has consequently not been broken. The failure to provide appropriate incentives and an environment for restructuring has passed through into low productivity growth and negligible structural change. Despite these differences across the region, there remain substantial and common regulatory and institutional weaknesses.

Keywords: Privatisation, Competition, Soft Budget Constraints, Restructuring, Transition

JEL classification: D21, G32, H2, L33, P52

1. INTRODUCTION

Change in ownership through privatisation, the entry of new firms and policies designed to stimulate competition in markets for both products and corporate control are central to a transition from a command to a market economy. This paper examines how these changes have taken place and their consequences for restructuring and for performance. We focus mainly on the restructuring of firms. The picture that emerges is of significant variation across countries and of a process that is still in its early stages, indeed one that has barely begun in a number of countries. Where radical changes in both resource use and the structure of output have not occurred, the evidence points to major failures in imposing hard budget constraints and raising competition. These in turn have limited any positive effects of changes in ownership on governance. We highlight policies that can take the process forward.

The simplest way of thinking about the complex interaction of ownership, competition and performance in transition is to think of two key elements, reallocation of resources across activities and restructuring of activities. The first requires the closure of inefficient producers and the creation of new firms; the second involves the restructuring of those firms with long run viability, with both processes leading to productivity growth ¹. Resource reallocation requires changes in government objectives and expenditure plans, as well as changes in rules and institutions affecting entry, exit, taxation and other variables influencing private decisions. Restructuring implies changes in the objectives of existing firms and in their financing constraints, which again requires regulations and institutional capabilities. From the perspective of those making restructuring decisions, in dynamic terms, restructuring choices will depend on the relative values –appropriately discounted– of being in a restructured or un-restructured firm, qualified by the distribution of control rights within the firm, outside factor market conditions and the availability of severance or other mechanisms for compensating losers. In addition, restructuring of firms will critically depend on the availability of finance – other than through retentions – and hence on the banking sector (given that equity markets are not yet very developed). And because banks in a

¹ This framework is common to a range of models of transition that include; Aghion and Blanchard (1994); Blanchard (1998); Commander and Tolstopiatenko (1998); Coricelli and Chadha (1995)

number of key respects are not the same as firms, the conditions under which they should operate and fail will be different.

While conceptually distinct, the processes of resource reallocation and restructuring are closely tied. The evidence suggests large variation with some countries, for example, placing greater emphasis on entry rather than restructuring. Further, reallocation and restructuring should not be viewed as tidy processes uncontaminated by politics or other disturbances. This is clearly far from being the case. The paper demonstrates, in line with theory, that where change in ownership has been combined with the imposition of hard budget constraints and increased competition, there have been associated improvements in corporate governance. This has generally facilitated restructuring. But in a significant number of cases, ownership changes have been made in a context where hard budget constraints and competition have not been effectively introduced or, indeed, in a way which has actively impeded any subsequent imposition of such effects. These failures in implementation can be shown to have long lasting and adverse consequences. This suggests that understanding the political economy of ownership change and competition as well as the resulting institutional and enforcement dynamics is essential if we are to isolate the factors driving the variation in outcomes across countries.

In Central Europe privatisation has been widely implemented, even if the balance between new entrants and privatised firms in the subsequent private sector has varied substantially ². Conditions for entry have generally been propitious. Trade liberalisation has provided a further and important competitive discipline on domestic producers. However, there are still significant steps to be taken for further restructuring and for the change in incentives at the level of firms and banks to feed through into entrepreneurship and better performance. In Russia, Ukraine and many other parts of the FSU, the picture is far less rosy. Even where large-scale privatisation has occurred – as in Russia – the subsequent effects have in several respects been contrary to original intentions. Incumbents effectively took control of the redistribution of ownership and control rights and have subsequently compounded the sorry legacy of connected lending, cronyism and rent seeking. As such, privatisation

² Poland has been an outlier in terms of the slow speed at which privatisation has occurred; by early 1999 over 40 percent of non-agricultural state-owned enterprises were still in the pipeline for

has contributed to and been influenced by the incestuous and undesirable links that run through government, firms and banks. These combined failures have imposed large costs – including sanctioning theft and corruption - and raised difficult questions as to how they can now be addressed.

The initial policy stance in some countries was that restructuring could be left to unfettered markets, no doubt a reaction to the rigidities of the former command system. In other countries, restructuring was postponed through ineffectual ownership and competition changes as a result of the prevailing patterns of control and the associated distribution of political bargaining power. The challenge ahead is to ensure through appropriate public policy decisions that the prevailing business environment become as conducive as possible to private restructuring decisions that are also desirable from the viewpoint of the economy as a whole. The obstacles that have blocked hard budget constraints and effective competition from being implemented need to be addressed. To do this effectively will require non-marginal changes in policy at both ends of the competitive process, with respect to both entry and exit. The task is complicated by the fact that some initial policy decisions are now difficult to alter.³ Moreover, the ability to construct and enforce good regulation is one of the scarcest resources.

The paper is organised as follows. Section 2 lays out some theoretical analysis of the influence of ownership and competition on restructuring and performance, and puts this in context by reviewing evidence from OECD countries on the nature and strength of these relationships. Section 3 then moves on to an empirical analysis of the transition economies. It surveys the evidence that has now accumulated regarding both the scale of reallocation and restructuring and their impact, alongside competition, on performance. We emphasise the importance of aligning incentives for both banks and firms in order to achieve sustained firm restructuring, and highlight how this does not yet appear to have happened for a large number of firms. We pay particular attention to the different effects of changes in ownership and control in the FSU relative to

privatisation. However, the Polish economy has benefited from a large volume of new starts and expansion of existing private enterprises. See Rapacki (1999).

³ This is another notable distinction between Central Europe and most FSU countries. In the former, a process is underway where it is possible to make important subsequent corrections, as witnessed by the recent attempt in the Czech Republic to strengthen corporate governance. In the latter, subsequent corrections now appear even more difficult.

Central Europe. Section 4 builds on these findings to identify the main policy challenges for the coming years – primarily with respect to regulation and institutional reform aimed at removing the obstacles that have prevented ownership change and competition from having their expected impact. Section 5 provides concluding remarks.

2. WHY DOES OWNERSHIP AND COMPETITION MATTER?

2.1 Restructuring and productivity

What is restructuring? Restructuring is a set of non-marginal changes in the structure of an existing firm's output mix, including the closure of some activities, which in turn requires significant non-marginal changes in resource use. The purpose of restructuring is both to save resources and to re-deploy resources to more efficient use. In market-oriented economies, such restructuring is usually motivated by an attempt to restore or regain competitiveness and enhance long-term shareholder value in response to a radical change in the business environment or to a gradual erosion of competitiveness. To promote the transition from command to market economies, restructuring requires profit orientation as the overriding objective of the enterprise. By definition, restructuring is a process of radical adjustment that will break some vested interests.

Restructuring encompasses both *survival-driven* cost-side changes aimed at reducing existing inefficiencies and *growth-oriented* revenue-side changes to re-orient the enterprise's processes and products to current market requirements and thereby achieve improvements in performance over the longer run.⁴ Survival-driven restructuring, which may involve labour shedding, plant closures and the search for new markets for existing products is commonly a necessary first step to deeper restructuring. However, those survival-driven restructuring decisions that are motivated by a desire to make the minimum defensive changes necessary to avoid either more radical changes in output mix or exit will generally not be sufficient or even desirable. Such decisions will tend to tie up resources that could be more productively employed elsewhere. Growth-oriented restructuring, in contrast, generally involves substantial new investment in fixed and human capital as well as

⁴ See Carlin (1998) for an overview of the two-stage approach to restructuring.

strategic changes in product mix. To be effective in a market economy context, such deeper restructuring generally requires the appropriate human capital expertise to identify profitable opportunities and sufficient financial resources to implement the associated investments.

Why is restructuring important? Those growth-oriented restructuring decisions that lead to the highest feasible value of the enterprise (net of the cost of required resources) raise the level and rate of growth of enterprise-level productivity through both static efficiency effects and dynamic innovation. Even more important from an economy-wide perspective, the restructured firms will have a new mix of resources that better meets the requirements of downstream firms and final consumers. Resources which may have been subsidising inefficient production can in turn be released and re-allocated to growing new and restructured enterprises, allowing over time better economy-wide resource allocation, higher employment, income and consumption levels.

Who makes decisions? In practice, restructuring decisions that are most desirable from an economy-, sector- or even enterprise-wide perspective will generally *not* be chosen. The social benefits and costs of restructuring will almost always differ from the private net benefits as perceived by the key decision makers who are authorised and entrusted to make restructuring decisions.⁵ Invariably, these decision makers make up a small proportion of the parties that will be affected by such decisions. The policy challenge is to *construct the existing business environment*, including regulations, institutions, capabilities and resources in such a way as to *narrow divergences between private and social returns*.⁶ Ideally, the private decision-maker should face incentives that lead to a set of actions that provides gains for society as a whole.

⁵ Restructuring authority typically may lie with a ministry official (whose interests may be personal or political), managers or worker councils (whose interests may conflict with shareholders), external owners (whose interest may conflict with creditors), or creditors (whose interests may conflict between creditors and with all of the preceding). None of these interests are necessarily aligned with social welfare.

⁶ See Atiyas, Dutz and Frischtak (1992).

2.2 Ownership and competition with relatively well-functioning markets

In general, ownership and competition are important and mutually-reinforcing discipline devices to move private incentives towards restructuring that is socially desirable. What matters with respect to ownership and market-based restructuring is whether the key decision-maker entrusted to make restructuring decisions is motivated by the objective of maximising the firm's profit. Where the owner is not the manager, this depends on whether the owner is able to establish control, which in turn depends on the distribution of control rights among shareholders and creditors. In such situations, there are at least four main channels through which effective corporate governance can affect restructuring ⁷.

- by identifying appropriate restructuring/turnaround agents.
- by ensuring managers take appropriate restructuring decisions.
- by attracting and retaining external finance needed for restructuring.
- by facilitating a broader social and political legitimacy for the restructuring process.

There is no debate regarding the importance of competition for resource allocation in general and restructuring in particular. Intensity of rivalry is the engine that makes market economies work. There at least four channels through which product market competition affects restructuring:

- by ensuring that appropriate restructuring takes place as price and profit signals reflect relative scarcities.
- by accelerating the decision to restructure through the closure of poorly managed firms, the reduction of managerial slack within firms and through spurring innovation ⁸.
- by reducing the extent of political involvement in restructuring decisions ⁹.
- by reducing the scope for corruption and thereby improving the overall social and political legitimacy of any restructuring.

The empirical evidence from relatively well-functioning markets suggests that privatisation significantly improves the operating and financial performance of divested

⁷ See Dutz and Vagliasindi (1999a) for a more detailed description of these four restructuring-related roles of corporate governance.

⁸ The persistence of monopoly rents, both from internally-driven higher costs and prices above those costs, raises the net benefit of *not* restructuring. For an overview of how competition can improve selection, reduce managerial slack, and spur innovation, see Armstrong, Cowan and Vickers (1994).

⁹ See Vishny and Shleifer (1994).

firms. Although there is continuing debate regarding the extent to which improvements in performance have been exclusively driven by ownership change or associated increases in competition, the empirical evidence points to the joint importance of strong and well-enforced ownership and control structures coupled with effective competition ¹⁰.

2.3 Ownership and competition in transition economies

The transition economies continue to be characterised by the presence of major capital and product market imperfections, as well as weak regulatory and institutional regimes. These features have implied more severe, underlying problems with both incumbent monopolists and incumbent managers.

For these reasons, changes in ownership without adequate attention to market structure can result in longer-term negative effects. While restructuring consistent with improved competition prior to privatisation is challenging at best ¹¹, it becomes next-to-impossible once ownership rights to a stream of monopoly rents have been transferred and paid for by new private owners. A powerful new set of lobbying interests will have been created ¹².

Changes in ownership without adequate attention to the distribution and subsequent exchange of control rights can also impede restructuring ¹³. For instance, transferring ownership to incumbent insiders without sufficiently constraining their ability to appropriate resources can be worse than continued state ownership, especially if it results in capital flight and a reduced political consensus for reform. Similarly, the absence of minority shareholder protection will make it more attractive for insiders to divert resources and strip assets even if they are core owners, since they will then not need to share these resources with other shareholders or creditors.

The case for promoting competition becomes even stronger when corporate control through shareholder and creditor monitoring is weak. Product market competition can substitute for capital market discipline and will generally act through

¹⁰ See Megginson and Netter (1998) and the evidence surveyed in Nellis (1999). La Porta and Lopez-de-Silanes (1997) provide evidence of the positive interaction of privatisation and increased product market competition on restructuring.

¹¹ See Van Sicten (1992).

¹² Attempts by the state to change the conditions of sale ex post are likely to have very negative consequences for investment.

¹³ See Dutz and Vagliasindi (1999a) from which this section and others on this topic heavily draws.

two main channels. First, to the extent that competition increases the sensitivity of profits to unit costs, more competition directly creates stronger incentives for cost-reducing or revenue-increasing restructuring changes¹⁴. Second, competition can reduce agency problems and improve corporate control by moving managers closer to profit maximisation, diminishing incentive problems between managers and owners or directly between managers and the market. When there are more competitors, there are more opportunities for benchmarking or other types of comparison that can lead to sharper incentives¹⁵. Product market competition can act as a substitute for debt-related financial pressure and external shareholder control¹⁶.

Finally, the importance of the social and political legitimacy of both the restructuring and overall reform process should be emphasised. By definition, restructuring involves winners and losers. Without a process that is perceived as legitimate, it will be difficult to attract outsiders as well as to avoid backtracking. Without sufficient competition, especially via unencumbered new entry and expansion possibilities, it becomes almost impossible to accommodate the downsizing and social dislocations that accompany restructuring. There is also some initial evidence that increases in product market competition reduce corruption in the bureaucracy¹⁷. To the extent that decreased corruption in institutions leads to better enforcement of regulations, there will be a further strong link between competition and improved corporate incentives.

3. REVIEW OF EXPERIENCE IN TRANSITION ECONOMIES

We now turn to an extended review of the experience in transition economies with respect to both resource reallocation and restructuring. We make a distinction between firms and banks.

3.1 Initial conditions in transition economies

The joint need for restructuring and reallocation has emerged from a number of common initial conditions.

¹⁴ See Willig (1987).

¹⁵ See Rey (1998).

¹⁶ Nickell, Nicolitsas and Dryden (1997) based on UK enterprise data. When financial pressure is low or when firms have no dominant external shareholder, competition tends to have more impact on productivity growth.

- Ownership of firms and banks was concentrated in the hands of the state. State owned firms largely operated with non profit-maximising objectives. The banking system was dominated by mono-banks.
- Firms were configured in ways – including overstaffing and choice of technology – that did not necessarily suit well the needs of a market economy. These problems were amplified by declining investment pre-transition that commonly resulted in the inheritance of dilapidated capital stock.
- Managerial and entrepreneurial skills were honed to working the networks of the planned economy -- including lobbying for soft supports -- and were hence in short supply relative to the needs of a market system. Human capital of both workers and managers tended to be highly firm specific.
- The dominance of the mono-bank meant that expertise in selecting and monitoring projects was very limited; banking technology was primitive and connected lending endemic.
- The structure of production was driven by political objectives that resulted in a systematic bias toward manufacturing alongside strong restrictions on competition.
- Foreign trade was largely organised through the CMEA and at artificial prices.
- Firms tended to be both larger and to possess more market power than in market economies. For example, the Soviet economy was striking for the almost complete absence of small manufacturing firms. In Poland in 1990/91, the leading firm had more than 30 percent of the market in over 60 percent of markets at a 3 digit level and over 60 percent of the market in 25 percent of markets ¹⁸. While concentration in the FSU was not necessarily that large, there is clear evidence of market power being present in regional markets ¹⁹.
- Planned economies were not necessarily characterised by lack of infrastructure per se, but by lack of appropriate business infrastructure. This ranged from inadequate distribution systems to constraints on entry and access to services for firms ²⁰.

¹⁷ Ades and Di Tella (1994), Laffont and N'Guessan (1998)

¹⁸ Kattuman and Newbery (1992)

¹⁹ See Brown, Ickes and Ryterman (1996); Brown and Brown (1998)

²⁰ See EBRD (1996)

3.2 Evidence on reallocation

The linkages between reallocation and restructuring are fundamental. They arise through several channels. First, policies that promote entry and result in a dynamic new private sector will help attract resources away from less dynamic firms by raising the outside option to workers and managers in state firms. As in the Chinese case, this facilitates a smoother – and possibly more protracted – running down of the state sector. Second, for restructuring to be effective, attraction need be complemented by pressures on state firms through hardening the budget constraint, providing an exit mechanism and lowering the value of not restructuring and with it the incentive for insiders to block restructuring. Third, while private sector growth will facilitate restructuring, given the scale of adjustment, it is unlikely that restructuring can be feasible – including from a political angle – unless adequate fallbacks are provided outside of firms for those dislocated in the adjustment process.

Reallocation of resources across activities and firms requires a decline in soft supports, and, where relevant, closure of failing firms as well as the emergence of new private firms. This clearly implies a change in the competitive environment. Evidence regarding the contraction of subsidies to firms has been fairly unambiguous. There has been a large and fairly across-the-board decline in explicit subsidies in almost all countries ²¹. *Table 1* shows that by 1997 budgetary subsidies to firms in Central Europe ranged between 1-3 percent of GDP. A broadly similar picture appears to hold further east. But these numbers should not be taken at face value; they are often misleading. Soft supports have re-emerged, in the guise of non- or severely delayed payments, as well as through soft credits from the banking system ²². In Russia, for example, explicit subsidies and directed credits were replaced by roll-overs of bank loans, non-payments to government and utilities and, most recently, by a massive proliferation in barter and non-monetary transacting (see below). Quasi-fiscal transfers to firms have replaced on-budget subsidies with large scale net credit creation to firms being provided through utilities and other publicly controlled institutions.

At first approximation, however, we can think of the core Central European countries having imposed hard budget constraints on the bulk of firms relatively early in their transitions. Although the scale and speed of closure has varied widely,

²¹ See EBRD (1998)

bankruptcy rules have generally been introduced, if only selectively implemented, not least because of problems in the design of bankruptcy procedures, as well as institutional weakness²³. By contrast, in Bulgaria, Romania and most of the FSU, budget constraints have not been made hard, leading to slower restructuring and some ‘crowding-out’ of the new private sector. Bankruptcy and exit procedures have remained at best attenuated or, at worst, non-existent.

Available data do not allow disaggregation of the private sector into its new as against its privatised components. Nevertheless, *Table 2* shows that there has been a rapid growth in the size of the private sector; the unweighted mean share in GDP at mid-1998 was 65 percent in East and Central Europe and 45 percent in the FSU. While these numbers are far from exact and partly misleading, in that they ignore the continuing – and non-trivial – interference at firm level by the state²⁴, they show significant variation in the growth of the private sector. This variation can ultimately be traced to the difference in policies on subsidies and other supports to state and/or loss-making firms, to differences in the speed of privatisation, as well as to the basket of incentives facing new private sector agents.

The growth of new private firms has followed a clear pattern. Near the start of transition, such firms were small, often household operated, with curb or family finance and largely operating in services. Their sectoral attachment was primarily a function of the low level of services inherited from the planned economy and could hence be seen as ‘gap-filling’. Depending on the tax regime and other environmental factors largely exogenous to the firm, they worked both in and outside the tax net. Over time, new starts – and, to varying extents, spin-offs from existing firms – have grown and moved into other sectors, including manufacturing. Evidence from Hungary and Poland demonstrates this path most clearly. While gross flows of firms, not surprisingly, are large²⁵, there is some evidence that new firms increasingly have access to bank credit – often collateralised – and hence have moved on from the small-scale, retained finance

²² See Commander (1998); Schaffer (1997); Carlin and Landesmann (1997)

²³ For instance, Czech banks appear to have strong incentives for being passive with problem debtors and this, combined with the manner of privatisation, probably accounts for the low level of bankruptcy filings. See, Mitchell (1998); Balcerowicz, Gray and Hashi (1997)

²⁴ For example, Frydman et al (1998) find evidence of continuing interference by the state

²⁵ A feature common to developed economies, see Davis and Haltiwanger (1992). For the transition economies, see Konings, Lehmann and Schaffer (1996); Bilsen and Konings (1997), Faggio and Konings (1998)

model of the early years²⁶. This has clearly not been the case further east where firms have remained locked into small scale operations outside formal finance and, for the most part, outside the tax system²⁷. Entry barriers have remained significant and the incentives for remaining small and informal have been compelling. As such, the reallocation effect has been significantly weaker than in the more advanced Central European economies.

3.3 Evidence on ownership, competition and restructuring

A significant amount of empirical evidence has now been accumulated concerning the consequences of changes in ownership and control for performance as well as the effect of the choice of privatisation procedure. While the findings are necessarily provisional, some clear regularities have emerged.

- There has been significant variation in the pace and procedure by which privatisation has occurred across countries. Privatisation methods have ranged from management and employee buy-outs (MEBOs) to a series of mass privatisation schemes involving equity distributions to the public and direct sales to outsiders. *Table 2* shows that the most common primary privatisation procedures have been management and employee buy-outs and voucher based mass privatisations. The latter have been particularly widely used in the FSU where large concessions to insiders have generally been granted, but the broad approach has also been applied in the Czech Republic, as well as the Baltic states.
- In terms of the policy and legal environment for governance and economic restructuring, *Figure 1* reports the appropriate EBRD transition indicator broken down by sub-region²⁸. What is readily visible is a clear decrease when moving from west to east. In general, the scores registered by the states of the CIS are notably lower than for Eastern Europe and the Baltics.
- While there has been rapid progress in terms of small firm privatisation in almost all countries, medium and large firm privatisation has generally been implemented to a significantly greater extent in Central Europe than in the FSU. The growth in labour productivity in industry – a coarse measure of restructuring - has generally

²⁶ See Bratkowski, Grosfeld and Rostowski (1998)

²⁷ See Kaufmann and Kaliberda (1996); also Aslund, Johnson and Kaufmann (1997)

²⁸ See EBRD (1998)

been substantial in Central Europe, a clear contrast with the experience further east. There, firms have adjusted employment only partially, preferring instead to vary working hours and/or impose wage arrears on workers. Labour hoarding has not been eliminated; a consequence of the fact that firms have generally been privatised to insiders with continuing interference in decision-making by government.

- Based on simple cross-country regressions relating changes in several measures of restructuring – including change in industrial labour productivity - to privatisation procedure and a set of controls, including initial income, a statistically significant link between the primary privatisation method adopted and subsequent restructuring can be found. Relative to MEBOs, mass privatisation and direct sales more than double the productivity changes recorded over the subsequent two years, with the effect slightly stronger for direct sales ²⁹.
- Despite the variation in methods used to privatise, there have been large gains in the majority of countries by incumbents, commonly comprising coalitions of workers and managers. While this evidence is hard to organise synthetically, enterprise survey data and case studies show that incumbency has particularly tended to dominate privatisation in most of the states of the FSU and that this has been true independent of the privatisation procedure that has been followed.
- Insider dominated privatisations have been associated with a wide range of ultimate distributions of control rights. In general, while they have been based on coalitions of interest within the firm, the impression is that managers have for the most part dominated. There is some weak evidence that firms privatised to managers have performed better than those privatised with dominant worker ownership ³⁰.
- Predictably, insider privatisations have mostly been associated with low investment, limited managerial change and product innovation. Such investment that has occurred has mostly come from retentions. Although there is some

²⁹ In contrast to a mean labour productivity change of 5.6 percent where MEBOs have been the primary privatisation method, the values for MPP and direct sales are 11.2 and 11.7 percent respectively. See Dutz and Vagliasindi (1999a).

³⁰ Earle and Estrin (1998)

evidence of resale -- or at least realignments in equity distributions – this appears mostly to have been among insiders rather than through disposal to outsiders³¹.

- Depoliticisation of firm level decision making has been widely achieved in Central Europe. Among other consequences, large order employment reductions have resulted, although continued over-manning could be expected – even with depoliticisation – if managers continued to need the cooperation of workers to maximise their returns from control over a firm’s assets³². In much of the FSU, despite privatisation, depoliticisation has not for the most part occurred. This has been associated with continued labour hoarding and soft supports to firms.
- In terms of both relative cost or revenue performance, the evidence suggests that privatised firms have generally out-performed firms remaining in state ownership, but the finding is as yet far from robust³³. Part of this can be attributed to lags; part to selection and endogeneity problems. Selection bias -- possibly contingent on the privatisation procedure -- makes comparison difficult.
- Where controls for selection have been implemented, there is mixed evidence on the ability of the privatisation procedure to sort firms by quality. While in the Czech Republic seemingly better firms were voucher-privatised with concentrated ownership, this was clearly not the case in Russia³⁴.
- Firms privatised to outsiders – particularly to foreigners – have tended to perform best, whether measured in terms of total factor or labour productivity or over other restructuring dimensions, including investment³⁵. This can be explained not only by changes in investment and technology but also by associated changes in management³⁶.
- Privatised firms tend to show a greater variance in performance relative to state firms, which may be indicative of differences in their approach to decision-making, including attitudes to risk. Further, some evidence of superior product

³¹ For instance, managers appear to have systematically acquired worker shares.

³² This would, of course, still point to an agency problem.

³³ See Earle and Estrin (1998); Frydman et al (1998); Carlin and Landesmann (1997); Commander (1998); Grosfeld and Nivet (1997); Lizal and Svejnar (1998); Jones (1998)

³⁴ For the Czech Republic, see Marcincin and van Wijnbergen (1997); for Russia, Earle and Estrin (1998)

³⁵ Claessens et al (1997); Frydman et al (1998); Carlin and Landesmann (1997)

³⁶ See Barberis et al (1996); Estrin et al (1997)

restructuring by privatised relative to state firms possibly reflects not only a difference in the degree of risk aversion but also better incentives for innovation ³⁷.

- Capital market imperfections have remained significant, while disciplinary mechanisms exogenous to the firm -- such as bankruptcy laws – have rarely been effective. There has been little protection of shareholder rights, particularly outside the more advanced Central European countries.
- Competition in the product market from both domestic and foreign competitors appears to have been important in driving restructuring in Poland and Hungary ³⁸. There is some weak evidence for Russia that the extent of import competition has been positively associated with product restructuring and negatively with industry profitability ³⁹. However, these conclusions are derived largely from surveys of managerial perceptions rather than from any robust estimation of the appropriate measure; namely the effects of competition on productivity.
- Remaining in state control has in some contexts – such as Poland – been consistent with imposition of hard budget constraints, but, more commonly, it has been associated with a perpetuation of soft credits, whether from government or banks. Part of this can be accounted for by declining industries with few or no prospects; part by decapitalisation and stealing prompted by uncertainty over ownership and control rights. Ownership ‘in limbo’ -- as Bulgaria between 1992-97 indicates -- has been particularly susceptible to resource diversion and subsidies.

In conclusion, where privatisation has brought in outside owners – particularly foreign owners -- infusions of capital and new management have promoted restructuring and resulted in large, relative productivity gains. There is evidence, as would be expected, that concentrated equity holdings have been associated with improved performance but with some important restrictions, as in the Czech Republic, where concentration of ownership in the hands of investment funds has not been associated with improved performance ⁴⁰. While privatisation favouring incumbents

³⁷ See Frydman, Hessel and Rapaczynski (1998)

³⁸ Carlin and Landesmann (1997); Pinto and van Wijnbergen (1995)

³⁹ Earle and Estrin (1998); Brown and Brown (1998)

⁴⁰ Nikitin and Weiss (1998) who attribute this in part to the closed-end design of the funds. Note that in Poland, the way funds were set up involved an explicit mechanism for restructuring as well as eventual change of ownership.

has also aligned ownership and control, lack of new investment and managerial skills has held back restructuring. In too many cases, it has also facilitated looting from firms by managers, particularly where there has been continuing uncertainty over the viability of the firm and when monitoring of managers – including by other insiders – has been incomplete. In addition, mass privatisations biased to incumbents have tended to be associated with continuing state interference in decision-making and/or in the maintenance of soft budget constraints, not least because of the inability to change incentives and the underlying bargaining power of those incumbents with respect to government. Further, it is very striking that although an important argument for the use of mass or voucher privatisation has been fairness, available evidence suggests no such association, at least when measured over a conventional measure of income inequality. With the important exception of the Czech Republic, countries pursuing voucher privatisation have generally experienced the largest increases in income inequality⁴¹.

Finally, competitive pressures on firms to restructure have come through the very process of reallocation itself – primarily through entry – but also through trade liberalisation. Given that initially most new entry was small scale and in services, a more effective, proximate source of discipline on manufacturing firms has been through import competition. Levels of import penetration have risen substantially throughout, but most significantly in Central Europe and the Baltics⁴². Some available evidence points to a strong and positive effect of import penetration on total factor productivity⁴³.

3.4 Restructuring and banks

In principle, banks should clearly be important players when determining the scale and pace of firm restructuring. Aside from their general function of intermediation and payments, banks can generally be expected to provide short and long run financing to firms. They also play a critical monitoring role vis-à-vis the firm sector and hence are an important link not only in enforcing hard budget constraints but also in improving corporate governance. When firms are unable to meet their obligations, banks can

⁴¹ Aghion and Commander (1999). Unfortunately, there is no solid evidence available on the distribution of wealth.

⁴² See EBRD (1997)

initiate bankruptcy proceedings⁴⁴. For these mechanisms to function requires, however, a framework in which contract and other enforcement of rules is feasible. Further, insofar as financing and monitoring promote restructuring by firms, this in turn should promote further restructuring as a result of the positive impact on the profitability of the banks. Greater profitability will tend to be associated with entry of more banks which in turn will tend to lower financing costs for firms, thereby facilitating additional restructuring. In short, the efficiency and stability of the banking system is likely to be key to effective restructuring among firms.

Available evidence suggests, however, that the ability of banks to promote restructuring has been quite limited in the transition economies. Part of this can be attributed to the inheritance, but also to subsequent decisions regarding ownership and competition.

The obvious starting point is the financing that banks have provided to the firm sector. *Figure 2* relates credit to the private sector normalised by GDP to the share of non-performing loans in total loans for 1997⁴⁵. What is clear is that there has been large variation in both the scale of lending to the private sector and loan performance. In Croatia, the Czech and Slovak Republics credit to the private sector ranged between 40-60 percent. By contrast, credit to the private sector in Ukraine, Kazakhstan and Russia was very low, between 2-8 percent of GDP. In general, lending by banks to private firms has been quite restricted, particularly in the FSU. While countries with the highest lending exposures have also tended to be those with the highest non-performing rates, it is also the case that for very low given exposures, several of the FSU countries have relatively high non-performing loan ratios.

In sum, financial systems in the transition economies have been characterised by low loan to GDP ratios. Private sector borrowers have found access to credit difficult and there has been a decline in long term lending. Part of the reason lies with the scale of government borrowing – bank credit to government relative to firms has increased significantly - as well as the inherent risk associated with lending to the private sector. But part of the reason lies with the way in which bank privatisation – or lack of it – has

⁴³ Falk, Raiser and Brauer (1996)

⁴⁴ Banks can, of course, also play a governance role through holding equity. For this to be effective requires not only adequate supervision of banks themselves but also competition among banks and freedom from political interference.

⁴⁵ Note broadly the same distributions hold for earlier years.

proceeded and the way in which competition among banks has occurred. We now look in some more detail at both ownership and competition among banks.

Ownership of banks. Bank privatisation has generally proceeded at a slower pace than for firms. It has been held back by a combination of factors, including the scale of bad debts in the portfolios of state banks, opposition by vested interests - including incumbent personnel and favoured debtors - as well as a lack of clarity in legal rules and oversight.

In the core Central European countries, privatisation has largely proceeded in an orderly manner with varying weights given to the interests of incumbents and outsiders. Drawing in foreign strategic investment has only been a major feature in the Hungarian bank privatisations. However, even when privatisation has gone ahead, governments have often retained strategic stakes in privatised banks. The design of the privatisation, as with firms, has also mattered. Thus, the accumulation of significant holdings in privatised banks by investment funds in the Czech Republic appears to have exerted little beneficial influence on governance. Part of the reason lies with the fact that with ownership of the investment funds dispersed, an incentive problem involving the behaviour of managers of both the fund and the bank has arisen ⁴⁶.

Further east, the privatisations that have occurred have generally been led by incumbent bank managers who have successfully exploited the inability of the government to organise an orderly transfer of ownership rights. A distinctive feature - in common with firm privatisation - has been the importance of securing the participation not only of insiders - the managers and employees of banks - but also the participation of borrowers that have historically benefited from loans granted in a regime of soft budget constraints.

Evidence from Russia shows that not only have managers been key in driving privatisation but there has been a systematic creation of cross-holding patterns between the newly privatised banks and their main debtor enterprises. In addition post-privatisation, managers have also commonly issued new equity to dilute holdings and to ensure dispersed ownership structures ⁴⁷. As a result, managers have privately benefited but to the detriment of efficiency and other shareholders' interests. Moreover, as insider-led privatisations have not usually facilitated access to debt

⁴⁶ The design of the funds has also contributed.

finance - since there cannot generally be a credible commitment to pay back investors - while issuing capital is costly, such banks have proven more liable to rely on government rescue, including partial renationalisation.

Although in general – as with firms – concentrated rather than dispersed ownership of banks is preferable, experience with privatisation in the transition context has raised several important caveats. The first is that there is a risk of perpetuating connected lending in cases where bank shareholders are at the same time borrowers from the bank. This will mitigate against efficient restructuring and good corporate governance as lending practices may primarily respond to the private interests of the dominant shareholders, rather than to the interests of the bank or minority shareholders. When banks and their main shareholders form part of the same group, experience suggests that shareholders tend to be ineffectual in restraining risky investments undertaken by managers⁴⁸.

Concentrated ownership of banks can also raise the scope for collusion. This appears to be particularly the case where government has retained a significant ownership stake in newly privatised banks, as in Hungary. This can easily translate into inefficient lending practices and the continuing politicisation of lending decisions. In addition, there is the danger that minority shareholders will be expropriated or their interests ignored⁴⁹.

Competition among banks. Robust competition among banks requires new entry and the expansion of the more efficient institutions, but also the contraction and exit of inefficient institutions. Yet, transition economies have continued to face major problems in imposing financial discipline and limiting the generosity of bail-outs for distressed banks. Among the main reasons are the following;

- Bank managers have continued to pursue objectives other than the strict enforcement of financial discipline. Their interests have often remained more closely aligned with those of their employees than those of shareholders and depositors. As a result, managers have tended to be very reluctant to close down projects when no longer viable.

⁴⁷ See the case study of Zhilotsbank in Abarbanell and Meyendorff (1997).

⁴⁸ A proposition confirmed by evidence from Japanese lending in the 1980s, see Dinc (1998) and illustrated by Russian experience with Financial and Industrial Groups.

⁴⁹ In most transition economies, minority shareholders remain poorly protected not least by the continuing absence of international accounting standards in consolidated accounts.

- Political pressures – particularly at regional level - on bank managers to keep alive large state and, in the FSU, privatised firms have been significant, for governments have remained very sensitive to changes in the level of unemployment.
- Inherited as well as subsequent accumulations of bad debt have distorted the allocation of capital, crowding out lending to the private sector and placing pressure on banks' balance sheets.
- There has only been limited progress in implementing workable bankruptcy procedures. In most transition economies procedures have been too lenient and the courts have been too slow and too friendly to debtors.
- Strict and fair bank closure rules have rarely been enforced on the larger banks, as they have been deemed 'too big to fail'. Regulators have generally opted for bailing out large troubled banks, as in Estonia in 1997 or Bulgaria in 1996.
- Finally, the problem of regulatory forbearance has been exacerbated by technical incapacity and lack of adequate accountability.

There is a clear range of options for reducing these constraints – including capital adequacy rules, limits on explicit deposit insurance and breaking-up banks to avoid the 'too-big-to-fail' problem⁵⁰. However, efficient exit depends critically on the way entry is handled, given the joint importance of both stability and efficiency in the banking system. Because of regulatory shortcomings and the importance of stability, the quality of entrants will be critical. Increasing competition can arise through combinations of domestic and foreign entry, as well as through break-ups of existing banks.

Recent experience in Russia and the FSU demonstrates that relatively unconstrained entry leads to a proliferation of under-capitalised banks and to greater instability. In Central Europe – where bank concentration ratios have remained notably higher than in OECD countries – a combination of break-ups and further entry would be more appropriate. In general, given the need to mesh superior banking technology with knowledge of local markets while reducing the risks of connected lending, foreign entry appears particularly attractive.

⁵⁰ See EBRD (1998), Chapter 8.

3.5 Paths of transition

Our overview of ownership change and competition points to significant variation across the region with respect to reallocation and restructuring. However, at risk of simplification, two broad paths can be identified⁵¹.

Large reallocation, large restructuring. The first path - which embraces the major Central European economies - has been associated with very significant new entry, relatively rapid privatisation – with outsiders increasingly taking major stakes – and a generally hard budget constraint imposed on state sector firms. Employment reductions and declining rent appropriation by insiders were achieved at a relatively early stage⁵². Increases in productivity have mostly been translated into profits rather than wages. Depoliticisation was also mostly achieved early in the transition and interference by the state in decision-making among privatised firms, while far from absent, has been restricted. Incumbents have in general been unable to lobby for large order state supports, capture other rents and otherwise block reforms. Over time, exit mechanisms have been developed and increasingly implemented.

The combination of new private firms expanding both in size and across sector with privatised firms investing and restructuring has fuelled innovation leading to growth and structural change. Bank lending to the firm sector has been maintained, limiting the adverse effects of a prolonged credit squeeze. In addition, the evidence suggests improved lending decisions by banks as their technology capacity to screen projects has developed. Foreign direct investment has also expanded, often dramatically, as in Hungary and, more recently, in Poland. Trade data generally show some diminution in quality gaps in trade with the European Union⁵³. The stimulus to this process has been a combination of domestic policies and competitive pressures unleashed by trade liberalisation.

Entry of new firms has been accelerated by both institutional factors – affecting set-up costs – and by infrastructure. Indicators both for institutional and physical infrastructure in Central Europe show significant convergence toward OECD levels.

⁵¹ Of course, this distinction may obscure some similarities, such as the persistence of governance problems in privatised firms, a feature as relevant in the Czech or Slovak Republics, as in much of the FSU.

⁵² See findings in: Kollo (1998); Commander and Dhar (1998); Estrin and Svejnar (1998); Grosfeld and Nivet (1997)

⁵³ Landesmann and Burgstaller (1997)

By reducing transaction costs, these combined infrastructure effects have put pressure on high cost firms and stimulated product market competition⁵⁴.

One consequence of large entry has been that new firms have attracted workers from low productivity firms further raising the pressure to restructure among the latter. The unemployed have been provided with relatively generous benefits – the replacement ratio has ranged around 0.3 - and working systems of social assistance outside firms have been put in place. These outside options have been key to ensuring that insiders have not systematically attempted to block restructuring, as the value of remaining in unrestructured firms has been relatively low and the ability to loot has been restricted.

Little reallocation, little restructuring. By contrast, the second path -- which encompasses to varying degrees much of the FSU, as well as Bulgaria and Romania -- has been characterised by limited reallocation and little restructuring despite, in several cases, seemingly radical changes in ownership regimes⁵⁵. Privatisation – whether through vouchers (as in Russia) or MEBOs (as in Ukraine) – has been conducted largely on terms that favoured incumbents, both in the allocation of ownership and control rights and with respect to their bargaining power with public agency. Depoliticisation has mostly failed. The incentive effects of privatisation – muddied by this failure and by low protection of property, contract and shareholder rights – have been limited. Insider privatisation has thus delivered few, if any, of the requirements for improved performance – whether through investment in plant or through managerial change – or the conditions for a credible snapping of links between public resources and firms. Credit to the private sector from the banking system has declined, while connected lending and other inefficiencies in the allocation of credit have persisted. Permissive entry, alongside entrenched branch banking networks, has resulted in both instability and rent appropriation. Foreign investment has been very restricted and volatile⁵⁶. Not surprisingly, the EBRD transition indicators for governance and restructuring have scores that remain low relative to Central Europe (see *Figure 1*).

⁵⁴ Aghion and Schankerman (1999)

⁵⁵ One measure of this is relatively low job reallocation rates when comparing Bulgaria or Romania with Poland; see Faggio and Konings (1998) and Konings, Lehmann and Schaffer (1996)

⁵⁶ Meyer (1999)

Further, while there has been significant trade liberalisation, the consequences have been rather different from Central Europe. In general, trade has filled out gaps – primarily in consumer goods markets – rather than necessarily disciplining existing producers. The growing use of barter and other non-monetary transactions has further impeded any trade disciplining effect.

New private firms have emerged but have remained largely small-scale and informal. With compensation in the formal sector composed of wages and firm-specific non-monetary benefits (such as housing), workers have been reluctant to separate explicitly, leading to allocation of time across formal and informal sectors with moonlighting (and tax avoidance) being key components in these decisions⁵⁷. This contemporaneous allocation of effort across formal and informal sectors has been sanctioned by formal sector firms – both state and privatised firms - including allowing the use of firm resources for informal activity. Maintaining employment – even in the face of large, acknowledged levels of labour hoarding – has remained a key objective of both firms and government⁵⁸. Part of this can be explained by the absence of adequate fallbacks for the unemployed – the replacement rate for benefits has remained at around 0.1 - while much of the available social assistance has continued to be provided through firms. It seems unlikely that any acceleration in restructuring can occur without simultaneous measures to lower set-up costs and facilitate entry, while providing compensation for losers in restructuring. The combination of mafia⁵⁹ and a predatory bureaucracy have been important in lowering the rate of entry of new firms.

The consequence of these choices has been little pull from the private sector and, just as importantly, little push from the side of privatised and state firms. The value of staying in formal – and unstructured – firms has remained relatively high, not least because insiders have continued to capture large resource flows from both fiscal and quasi-fiscal institutions.

The complexity and range of actions taken to limit restructuring is best illustrated by the growth in barter. By way of evidence, a recent Ukrainian firm survey has shown that use of barter has become widespread – over 75 percent of sampled firms had some

⁵⁷ This is modelled in Commander and Tolstopyatenko (1998)

⁵⁸ For evidence on labour hoarding see; Estrin and Rosevear (1998), Earle and Estrin (1998), Commander, Dhar and Yemtsov (1994), Djankov and Kreacic (1998)

⁵⁹ Cohen (1995)

form of barter transacting accounting for over 45 percent of trades at mid-1998⁶⁰. A large survey of Russian firms at the end of 1998 found not only that roughly two-thirds of firms had some exposure to non-monetary transacting but that for those that did, the mean barter share in sales exceeded 60 percent⁶¹. Further, there was little significant difference in barter shares across ownership forms in both countries; indeed privatised firms tended to have higher exposures in Russia.

Barter represents a set of responses by both firms and public institutions to a credit crunch and should generally be seen within the context of the larger problem of non-payments. The accumulation of arrears and innovation in non-money has been sanctioned fiscally and quasi-fiscally. This has aggravated underlying fiscal tensions. However, it has also permitted unambiguously higher output and employment levels than would have been sanctioned in the monetary and fiscal mix notionally avowed by government. This - combined with the absence of an effective exit procedure - has been central to the propagation and perpetuation of non-monetary transactions. The distortions that have resulted have further locked firms into low restructuring equilibria (see *Box 1*)⁶². It has made it hard - if not impossible - to separate good from bad firms and has acted to limit restructuring and exit, but at great fiscal and other cost.

Box 1: Barter and Restructuring

Barter postpones or impedes restructuring in the firm sector through a variety of channels. These include:

- Reinforcing existing inter-firm relationships. With manufacturing in the FSU commonly operating with strong vertical links and market power, it might be rational for suppliers to grant trade credits through barter to their customers in order to survive.
- Weakening product market competition. Many firms rely on a few key customers or suppliers. Dual monopolies are common and firms tend to get locked into barter chains with limited outside options, resulting in market segmentation and weaker competition.
- Complicating monitoring of managers of firms by reducing overall transparency in accounting and transactions.
- Barter chains – a common phenomenon – may reflect an inefficient matching of partners, where matches are primarily dictated by access to barter instruments or deals.

⁶⁰ Estrin and Rosevear (1998). See also, Marin and Kaufmann (1998)

⁶¹ Commander and Mumssen (1999) from which this section draws heavily.

⁶² Box 1 is based on the findings reported in Commander, Dolinskaya and Mumssen (1999) using a large – 350 - firm EBRD survey of Russian firms implemented in November 1998.

- Barter deals tend to create ‘artificial’ demand, creating a market for goods that may otherwise not be competitive. This restrains restructuring, including product innovation.
- Barter camouflages the underlying financial position of a given firm, making it harder for banks or other creditors to screen efficiently, while also facilitating corruption.
- By limiting cash transactions, barter reduces firm flexibility in the face of shocks, whether through trade credits or use of cash reserves.
- At a macroeconomic level, barter has exacerbated the fiscal crisis by cutting into monetary revenue flows and prompting further rounds of non- or partial payments.

Insofar as Russian and Ukrainian firms transact largely outside money, this has also tended to spill over into the markets of their trading partners with downstream costs in other countries.

The proliferation of these survival mechanisms begs the question of why *both* government and firms are reluctant to sanction restructuring, including exit? An important part of the answer – already indicated above – is the aversion to large, explicit unemployment and any associated political unrest. Yet few actions have been taken to address this constraint, whether through financing a workable system of fallbacks for losers in the adjustment process or equally through the development of enabling institutions for delivery of benefits and/or other ancillary supports. Instead, excessive reliance – particularly in Russia and Ukraine - has been placed on wage flexibility.

4. PROMOTING RESTRUCTURING

We have seen that while there has been significant variation in the way in which countries have proceeded with restructuring, several common obstacles have been present.

First, capital market imperfections have remained significant resulting in weak discipline and, in some cases, highly non-transparent dealing.

Second, while privatisation may in principle have aligned ownership and control, inadequate minority shareholder protection and other regulatory failures have limited effective discipline on managers. Where insider privatisation has been dominant, these factors have combined to restrict the extent of restructuring while also helping perpetuate connected lending and cronyism. In this context, outsider privatisation – particularly through the participation of foreigners – may have offered

major benefits but has been sensitive to the criticism that foreigners have acquired assets cheaply and unjustly.

Third, competitive discipline – given capital market shortcomings – has largely been through the product market, with external trade liberalisation apparently acting as the most significant competitive impulse. Even so – and particularly in the FSU – there is continuing evidence of significant pockets of market power. Part of this is due to geographic factors and the importance of regional markets; part to the unwillingness of foreigners to enter markets; and part to the unwillingness or inability of governments to remove remaining publicly imposed, or sanctioned, entry and expansion barriers. This has resulted in limiting the ability of a new private sector to emerge as competitors to incumbent firms.

Given these limitations, what are the factors likely to promote better corporate governance and appropriate competition for firms? Further, given the importance of political economy constraints, how can these objectives be achieved in a realistic manner? For it is also important to recognise the profound technical limitations on the part of government agencies, including regulation and competition agencies. This points to the need for simplicity in design. We pay particular attention to facilitating entry and managing firms in distress.

4.1 Facilitating entry and expansion of firms

In the first years of transition, policy towards enterprise restructuring was characterised by a ‘pendulum effect’. As a reaction to direct government controls of industry under the planned economy, restructuring was largely left to market forces. Rather than regulatory reform, emphasis was almost exclusively put on deregulation. This led to insufficient attention being paid to creating supportive regulations and institutional capacity required to overcome market failures and to ensure that restructuring decisions approximate socially desirable ones.

Legal protection for minority shareholders. The role of corporate governance rules and entry is key here. One of the strongest lessons emerging from privatisation and experience post-privatisation is the critical importance of mechanisms to ensure sufficient legal protection of investor rights, especially smaller investors. In addition to helping ensure a broader legitimacy for the reform process and preventing managers from asset stripping, strong protection of minority shareholders is essential

for promoting entry of new investors. Without safeguards for transparent secondary trading and protection of new investors, the scope for outsider participation and re-allocation of control rights will be drastically diminished.

There is a need throughout the transition economies for strengthening the rules and enforcement practices concerning internal mechanisms of corporate governance. There is a strong argument that to build investor confidence there will be a need for applying relatively stringent and mandatory rules, at least for a period of time. Such rules should include; an obligation for enterprises to disclose financial statements – ideally on the Internet - with minimum standards of quality and completeness; strict requirements for prior shareholder approval of purchases or disposals of significant assets, and a clear duty for directors to act in the best interest of the company and to avoid self-dealing⁶³. It would then be desirable to publicise widely such rules, facilitate the reporting of transgressors and ensure swift adjudication, with clearly stipulated and consistently applied sanctions for companies which fail to comply.

Although adequate protection for minority shareholders and contracts is important in facilitating the resale of ownership rights, complementary measures may also be needed. Barriers to foreign participation in such transactions should generally be lifted. In addition, rules for investment fund managers should be closely scrutinised and modified wherever possible to ensure that the rewards strongly favour both active management to promote restructuring and the sale of controlling stakes to interested strategic investors. For example, recent efforts by the Czech government in this area have been aimed at changing the design of funds as well as the incentives of fund managers consistent with restructuring⁶⁴.

Competition policy. Turning to competition policy, the appropriate emphasis for most transition economies differs from the traditional emphasis of antitrust on reducing price-cost margins. Instead, competition agencies should focus in a much more active manner on eliminating barriers to grass-roots entry and facilitating access to essential business services, especially those that reduce economy-wide transactions

⁶³ Even in countries which have made recent changes, improvements are still required. For example, although amendments to the Commercial Code in 1996 strengthened minority shareholder protection in the Czech Republic, the law still says nothing about the responsibility of board directors to act in the interest of the company and to avoid self-dealing. See World Bank (1999).

⁶⁴ Ellerman (1998) argues that incentives were originally inhibiting rather than promoting restructuring. See also World Bank (1999)

costs such as telecommunications and transportation. Competition policy in transition economies should focus on supply-side stimulus and innovation ⁶⁵.

Effective competition policy also requires advocacy and the reduction of both public and private barriers to entry. These barriers are often likely to reside in less traditional, but easier to address, areas of the business environment. These include introducing a movable assets registry, liens on motor vehicles as well as simplification of the tax code. Competition agencies have an important role to play in forcefully advocating reforms in areas where contact between an enforcement official and each individual firm is necessary, as with regard to entry regulations and tax collection. Surveys of firms have found significant variation across countries and regions in the level of regulation. For example, in Russia on average it took shopkeepers almost four months of permission-seeking to set up in business. Further, regulatory interference was often arbitrary and restrictive ⁶⁶. Simpler tax and other administrative rules provide less opportunity for arbitrary implementation.

One of the most important tasks for competition agencies is to prevent other executive bodies at the state and local levels from maintaining or introducing new public barriers, such as through restricting goods and investment flows between countries, regions or even localities, or obstructing the entry of new domestic or foreign enterprises, and granting privileges to favoured existing enterprises ⁶⁷. Here as with other regulations, there is need for clear, well-disseminated rules, sanctions for non-compliance and adequate resources for enforcement signalling strong political support. Political support will in turn be strengthened through public support, which depends on developing constituencies, such as small business organisations, export associations and consumer groups.

Finally, an emphasis on promotion of entry also calls for much stronger collaboration between competition and other government officials, especially those responsible for privatisation and infrastructure regulation. Thus, competition agencies should monitor larger transactions during the privatisation process. Competition is a

⁶⁵ See Romer (1994) on the larger overall welfare impact from new products arising from international trade competition, and Dutz (1999) on a similar argument arising from increased competition through domestic regulatory reform.

⁶⁶ See World Bank (1997); Frye and Zhuravskaya (1998)

⁶⁷ In Russia, the share of cases where executive bodies restricted competition in all cases concerning infringements of the Antimonopoly Law rose from 27% in 1995 to more than 40% in 1997. See Yachestova (1998).

complement to regulation, and less concentrated markets can often allow imperfect competition to do a better job than imperfect regulation. Horizontal and vertical separation of dominant enterprises that are clearly over-dimensioned by market standards should occur prior to privatisation. In addition, competition agencies have an important role to play in giving opinions regarding competition-related entry and operating conditions in the provision of infrastructure services, ideally leaving pricing and technical regulation to a specialised agency⁶⁸.

4.2 Managing firms in distress

Several complementary regulatory approaches have emerged towards the largest firms that remain in financial distress and that continue to be supported by subsidies, explicit or implicit. The main resistance to downsizing has understandably come from workers, often allied with managers, who have also stood to lose jobs and other benefits. In turn, this resistance has often been buttressed by local and centrally elected officials who have increasingly reflected the views of their most vocal or locally powerful constituencies. Any successful approach must directly deal with these stakeholders. The magnitude of the problem in much of the FSU is such that specific targeted programs facilitating restructuring and exit will be required.

Turnaround. A significant number of large firms will have an existing or new core activity that could eventually return to profitability, subject to some labour downsizing and financial restructuring. Such restructuring is best undertaken by outsiders who have sufficient finance, skills and determination, and not by the state prior to privatisation. This approach also requires a supportive business environment for the necessary downsizing, in particular the absence of restrictive labour regulations prohibiting layoffs and relocation.

A useful example of the relatively resource-intensive nature of such restructuring is given by the Polish National Investment Funds, where fifteen funds with foreign management were each given a controlling investor position in some thirty-five large firms. Of all transition economies, Poland is the only country that so far has administratively structured its investment funds in a manner consistent with improved corporate governance. Although the complexity of the scheme resulted in

⁶⁸ A good example is the Polish competition agency's support for increased competition in the

some delay and costs arising from firms left in limbo for too long, a longer gestation period has also permitted learning from other experience and has allowed the stock market to develop sufficiently for the flotation of the shares of firms in the portfolio. The fund managers, who brought in finance and expertise, were given sufficient incentives to act as the main restructuring agent – even though the program only amounted to a privatisation of the managerial function without an immediate transfer of ownership title. Although it is too early to judge fully the performance of the National Investment Funds - they began only in mid 1995 – deep restructuring to varying degrees was carried out in all firms, new technology and products have already been introduced by roughly 90 percent of firms, and new private owners (mostly strategic investors) have been found for half⁶⁹.

Ring-fencing with relatively rapid exit. Large firms whose asset configuration is no longer viable in the new market environment may require liquidation. In localities where the number and employment impact of such firms is relatively small, rapid exit will generally be feasible provided that there is sufficient new entry, alongside growth coming from restructured enterprises. This approach puts a premium on policies to promote entry and expansion of viable firms. Ideally, a relatively rapid bankruptcy procedure that minimises delays in legal procedures should complement policies for promotion of entry by facilitating the rapid sale of those firm assets that can be redeployed in more efficient alternative use.

Ring-fencing where relatively rapid exit presents prohibitive costs. In localities where the number and employment impact of non-viable firms is large, it will generally be politically too difficult to force closure unless there are sufficient alternate employment opportunities either locally or elsewhere.

In addition to policies promoting entry and expansion of viable firms, targeted social assistance, together with a working system of unemployment benefits, will generally be a precondition for removing existing barriers to reform. In much of the FSU, implicit subsidies to employment need be translated into explicit subsidies declining over time. There needs to be far greater emphasis on the provision of retraining opportunities as well as job placement services for accelerating the re-entry of displaced workers into the labour force. While some external financial assistance

provision of telecom services.

might be forthcoming, it is important to appreciate that the explicit fiscal costs of targeted supports would not necessarily dominate the current preference for implicit and open-ended fiscal and quasi-fiscal supports to failing firms.

Even with a sufficiently generous social safety net, the conflicts of interest and externalities involved with restructuring large loss-makers will generally require a targeted approach. Without explicit programmes, it may be too difficult for the interested parties – the local municipality, the existing management and any potential outsider financier - to agree on acceptable terms of engagement. This is because of the likely inability of the parties to make credible long-term commitments in a contract that can be monitored and enforced. From the perspective of the external financier, the up-front costs of assessing the viability of assets and devising a feasible strategy, with some positive risk of non-compliance by all parties, may be prohibitive. From the perspective of the municipality and entrenched managers, the risks of ceding sufficient control may also be high if there is sufficient risk of the investor renegeing or incompletely fulfilling any up-front commitments. Introducing a workable system of benefits for job losers as well as ancillary supports – itself a major institutional challenge in the FSU - can help in these regards by lowering associated costs on both sides.

5. CONCLUSION

The reallocation of resources and the restructuring of both firms and banks are central to the challenge of transition. Both processes are closely tied together; failures to reallocate have generally been associated with failures to restructure. Our paper has mostly concentrated on restructuring and on the changes in incentives that are required for effective restructuring to proceed. Two main sets of changes were identified; changes in ownership and control and changes in competition. However, to be effective these are shown to require an appropriate regulatory framework.

While the approaches to privatisation and competition have varied substantially across the transition economies, we have identified a strong divide between the countries of Central Europe and those further east. In the latter, public policy has commonly been characterised by continued excess intervention or regulation alongside

⁶⁹ See Rapacki (1999)

the undue abandonment of the proper, or even minimal, functions of government. These have facilitated rent-seeking while limiting restructuring and the entry of new firms. Ultimately, this has translated into very weak, or even absent, output and productivity improvements. Despite considerable variation in the way privatisation has been implemented, some important similarities in outcomes can be observed. Incumbents have aligned ownership and control but in a way that has not brought new finance and skills consistent with restructuring. Furthermore, restructured firms have continued to command access to public resources, thereby limiting the incentives for restructuring and exacerbating underlying fiscal problems. The proliferation of barter and non-monetary transacting in Russia and Ukraine has been a manifestation of continuing soft budget constraints. The adverse feedback from restructuring to reallocation has further resulted in relatively small new private sectors. Bank lending and monitoring of firms has dried up or been mis-allocated. The fragility of the banking systems – most starkly illustrated in Russia - highlights not only the danger of permissive entry and inadequate regulation, but also continued rent-seeking and connected lending by incumbent branch banks. Without encouraging the entry of adequately capitalised outsiders, in part through providing access to branch networks, it is unlikely that the banking systems will intermediate effectively and hence act as efficient funders and monitors of firms that are in need of restructuring. In sum, there has been widespread failure to break the financial and other – often non-transparent -- links that connect government, firms and banks. The credibility of policies, such as privatisation, has, in some cases, been severely undermined.

By contrast, some other countries – particularly those in Central Europe – have charted a more balanced course, preserving the proper domain of government while also providing incentives for private agents to establish businesses, restructure and invest. This has facilitated dynamic adjustment to earlier inadequacies in, for example, the design of privatisation procedures. These features have duly led to acceleration in growth rates and structural transformation, spurred by competitive discipline coming not only from entry of new domestic firms and banks but also through trade liberalisation and imports.

Despite the differences in their relative experiences, there remain profound and common regulatory and institutional weaknesses. This implies that for ownership and competition to act as joint disciplinary devices on both firms and banks, the need is for

simple rules alongside additional resources for enforcement. Priority should be given to providing greater protection to minority shareholders and continuing steps toward the removal of entry barriers originating from government. For both firms and banks – the latter as key agents in promoting restructuring – continuing distortions at either end of the competitive process will need to be addressed. In much of the FSU barriers to entry and the dead hand of regulation have held down new firm growth and innovation while an unwillingness to sanction the exit of failing firms has limited restructuring potential and contributed to the persistence in soft budget constraints. It will take better targeted programmes and instruments – including explicit supports to displaced workers - to break out of this low restructuring trap.

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Table 1

| Budgetary subsidies to firms (% of GDP) | 1994 | 1995 | 1996 | 1997 |
|--|-------------|-------------|-------------|-------------|
| Eastern Europe and the Baltic States | | | | |
| Bulgaria | 1.3 | 1.2 | 0.8 | 0.8 |
| Croatia | 2.0 | 1.8 | 1.9 | 1.9 |
| Czech Republic | 3.1 | 2.7 | 2.2 | 2.4 |
| Estonia | 0.9 | 0.5 | 0.4 | 0.3 |
| Hungary | 4.5 | 3.8 | 3.9 | 3.3 |
| Latvia | 0.2 | 0.4 | 0.3 | 0.4 |
| Lithuania | 1.7 | 1.1 | 1.3 | 0.9 |
| Poland | 3.3 | 2.9 | 2.5 | 2.4 |
| Romania | 3.8 | 4.1 | 4.3 | 2.6 |
| Slovak Republic | 3.2 | 2.8 | 2.4 | 2.2 |
| Slovenia | 1.6 | 1.6 | 1.2 | 1.3 |
| CIS | | | | |
| Armenia | 12.8 | 0.9 | 0.1 | 0.4 |
| Azerbaijan | 5.4 | 2.2 | 2.1 | 0.7 |
| Belarus | 6.3 | 3.4 | 2.9 | 1.3 |
| Georgia | 13.8 | 1.1 | 1.0 | 1.5 |
| Russia | n.a. | n.a. | 6.2 | 6.4 |
| Uzbekistan | 1.9 | 3.4 | 4.0 | 3.2 |

Table 2***Ownership, Competition and Transition Indicators: 1998***

| | Privatisation procedures 1/ | | Transition indicators: Privatisation & Competition Policy | | | Labour productivity 2/ | Private sector share of GDP |
|--|--------------------------------|-----------|--|------------------------------|-----------------------|---------------------------------------|--------------------------------|
| | Primary | Secondary | Large-scale privatisation | Small-scale privatisation | Competition policy | Cumulative change 1994- 1997 | mid-1998 |
| <i>Eastern Europe and the Baltic States</i> | | | | | | | |
| Albania | M | V | 2 | 4 | 2 | na | 75 |
| Bulgaria | D | V | 3 | 3 | 2 | 18.7 | 50 |
| Croatia | M | V | 3 | 4+ | 2 | 34.1 | 55 |
| Czech Republic | V | D | 4 | 4+ | 3 | 39.3 | 75 |
| Estonia | D | V | 4 | 4+ | 3- | 30.8 | 70 |
| FYR Macedonia | M | D | 3 | 4 | 1 | 9.6 | 55 |
| Hungary | D | M | 4 | 4+ | 3 | 49.1 | 80 |
| Latvia | V | D | 3 | 4 | 3- | 50.7 | 60 |
| Lithuania | V | D | 3 | 4 | 2+ | 11.7 | 70 |
| Poland | D | M | 3+ | 4+ | 3 | 52.6 | 65 |
| Romania | M | D | 3- | 3+ | 2 | 49.7 | 60 |
| Slovak Republic | D | V | 4 | 4+ | 3 | 19.4 | 75 |
| Slovenia | M | V | 3+ | 4+ | 2 | 34.0 | 55 |
| <i>The Commonwealth of Independent States 3/</i> | | | | | | | |
| Armenia | V | M | 3 | 3 | 2 | 53.9 | 60 |
| Azerbaijan | V | D | 2 | 3 | 1 | -16.4 | 45 |
| Belarus | M | V | 1 | 2 | 2 | 14.7 | 20 |
| Georgia | V | D | 3+ | 4 | 2 | na | 60 |
| Kazakhstan | V | D | 3 | 4 | 2 | 15.8 | 55 |
| Kyrgyzstan | V | M | 3 | 4 | 2 | 49.0 | 60 |
| Moldova | V | D | 3 | 3+ | 2 | na | 45 |
| Russia | V | D | 3+ | 4 | 2+ | -3.9 | 70 |
| Tajikistan | M | V | 2 | 2+ | 1 | na | 30 |
| Turkmenistan | M | D | 2- | 2 | 1 | -39.1 | 25 |
| Ukraine | V | M | 2+ | 3+ | 2 | -18.0 | 55 |
| Uzbekistan | M | D | 3- | 3 | 2 | 20.2 | 45 |

1/ The primary and secondary privatisation methods are: V = vouchers (distribution of investment coupons at a symbolic price), D = direct sales (sales to outsiders), and M = MEBOs (management/employee buyouts).

2/ Labour productivity in industry is calculated as the ratio of industrial production to industrial employment.

3/ Here taken to include all countries of the former Soviet Union, except Estonia, Latvia and Lithuania.

