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Keynote Address

WHITHER REFORM?
Ten Years of the Transition

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Table of Contents

Introduction
Part I: Misunderstandings of Market Economies
- **Competition and Privatization**
- **Privatization Alternatives**
- **Creative Destruction**
- **Social and Organizational Capital**
- **The Post-Socialist Separation of Ownership and Control**
- **Reducing Agency Chains: Stakeholder Privatization**
- **Restructuring and Bankruptcy**
- **Restructuring through Decentralization, Reconstitution, and Recombination**

Part II: Misunderstandings of the Reform Process
- **Sequencing and Pacing of Reforms**
- **The Grabbing Hand of the State; the Velvet Glove of Privatization**
- **The Modern Debate: Shock Therapy versus Incrementalism**
- **The CDF and The Presumption for Participation**

Conclusion
References

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WHITHER REFORM?

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Abstract

Ten years after the beginning of the transition, what are the lessons to be learned? Broadly speaking, most observers would conclude that China's path to the transition has been a success so far, while Russia's path has not been. I argue that the failures of the reforms in Russia and most of the former Soviet Union are not just due to sound policies being poorly implemented. I argue that the failures go deeper, to a misunderstanding of the foundations of a market economy as well as a misunderstanding of the basics of an institutional reform process. For instance, reform models based on conventional neoclassical economics are likely to under-estimate the importance of informational problems, including those arising from the problems of corporate governance; of social and organizational capital; and of the institutional and legal infrastructure required to make an effective market economy. They are also likely to underestimate the importance of the creation of new enterprises—and the difficulties of doing so. The promise, for instance, of quick economic transformation, and the creation of a "people's capitalism," based on voucher privatization with investment funds has proven illusory. An alternative strategy of decentralization, pushing economic decision-making down to the level where the stakeholders can protect their own interests without presupposing elaborate legal machinery that will take much longer to evolve, may under the circumstances prove to be more effective. Given the choice between the momentum of bottom-up popular involvement in "flawed" reforms and top-down imposition of what reformers see as "clean model institutions," an argument can be made in favor of using our knowledge and experience to work to improve the bottom-up approach to transformation.

The varied experiences of the countries going through the process of transition represents one of the most important set of economic and social experiments ever conducted, and should provide a rich opportunity for researchers both to understand the process of reform and to gain insights into the workings of economies. The limited success in so many of the countries means that their remain many opportunities for applying the lessons of such studies.

WHITHER REFORM?: Ten Years of the Transition

Joseph E. Stiglitz

Introduction

This century has been marked by two great economic experiments. The outcome of the first set, the socialist experiment that began, in its more extreme form, in the Soviet Union in 1917, is now clear. The second experiment is the movement back from a socialist economy to a market economy. Ten years after the beginning of the transition in Eastern Europe and the Former Soviet Union: How do we assess what has happened ? What are the lessons to be learned? Surely, this is one of the most important experiments in economics ever to have occurred, a massive and relatively sudden change in the rules of the game. As rapidly as the countries announced the abandonment of communism, so too did western advisers march in with their sure-fire recipes for a quick transition to a market economy.

A decade after the beginning of the transition in Eastern Europe and the Former Soviet Union (FSU), and two decades after the beginning of the transition in China, the picture is mixed. Each country started the course of transition with a different history, a different set of human and physical endowments. Some had lived under the yoke of central planning and authoritarianism for most of the century, while in others it was imposed only in the aftermath of World War II. Those countries bordering Western Europe with encouraging prospects of European Union integration were clearly in a different position than the land-locked countries of Mongolia and the former Soviet republics in Central Asia.[1] Counterfactual history—what would have been but for the policies that were pursued—is always problematic, and no more so than when there are so many variables with which to contend. Yet, the disparity between the successes and failures is so large that it calls out for interpretation and explanation, and in any case, the public debate has already begun.

The contrast between the strategies—and results—of the two largest countries, Russia and China, may be instructive. Figure 1 shows that over the decade beginning in 1989, while China's GDP nearly doubled, Russia's GDP almost halved; so that while at the beginning of the period, Russia's GDP was more than twice that of China's, at the end, it was a third smaller.[2] Not only did Russia stagnate during this past decade, but Figure 2 shows how it succeeded in turning the theoretical tradeoffs of inequality and growth on its head – in the process of shrinking its GDP, Russia also doubled its inequality (as measured by the Gini coefficient). Recent data contained in the 1999 *World Development Indicators* paint an even bleaker picture, with poverty—defined as $4 a day—rising from 2 million to over 60 million by the middle of the decade.

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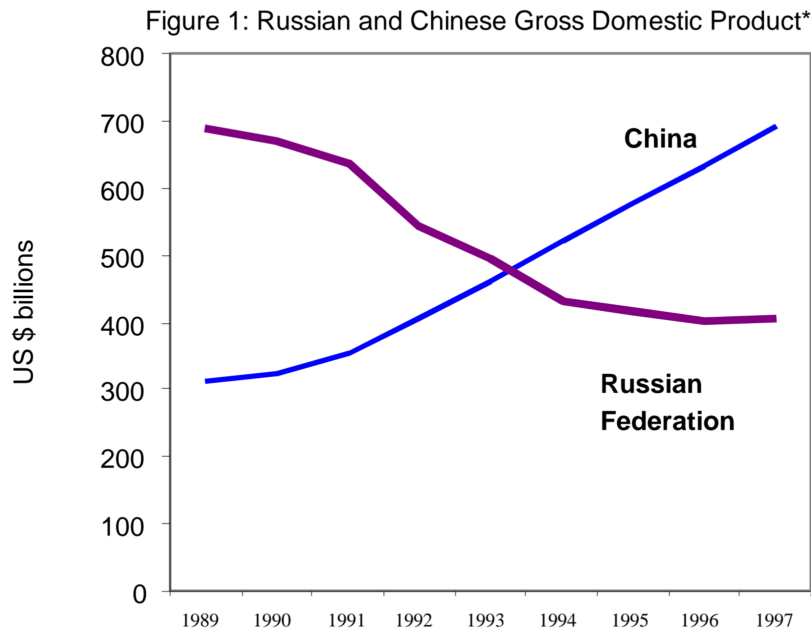
[1] Gallup and Sachs 1999, in the paper presented to last year's ABCDE Conference, has emphasized the importance of geography as a determinant of a country's economic prospects. See Figure 3 at the end of the text for a comparison of various countries' 1997 GDP relative to 1989.

[2] To be sure, by some accounts, this is a slight overstatement of the decline, since some informal sector activity is not included, while by other accounts, this is a significant understatement of the decline, since market prices, not the shadow barter prices, are used to value output. Social indicators (which again must be taken with a grain of salt) do not show a rosier picture.

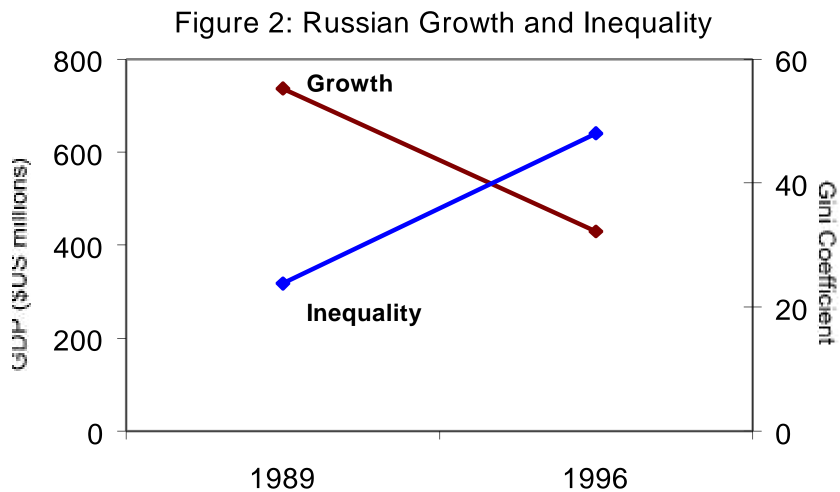
The titles of some recent books by leading advisors in the transition process are telling—*How Russia became a Market Economy* or *The Coming Boom in Russia*. While those who had advised Russia on its transition path constantly predicted that it was on the verge of success—virtually declaring victory just a short while before its recent crash—the shortfall should have been apparent. Yes, Russia had succeeded in "privatizing" much of its industry and natural resources, but the level of gross fixed investment—a far more important sign of a burgeoning market economy—has fallen dramatically over the last five years [EBRD 1998]. Russia was fast becoming an extractive economy, rather than a modern industrial economy.

Figure 1: Russian and Chinese Gross Domestic Product*



*Measured in constant 1987 US$.
Source: Statistical Information and Management Analysis (SIMA) database.

Figure 2: Russian Growth and Inequality



Source: World Development Indicators, 1999. The GDP is measured in constant 1987$US and chart represents generated trendline between 1989 and 1996 data points.

Standing in marked contrast with these failures has been the enormous success of China, which created its own path of transition (rather than just using a 'blueprint' or 'recipe' from western advisors). It succeeded not only in growing rapidly, but in creating a vibrant, non-State-owned collective enterprise sector. While investment in manufacturing in Russia stagnated, that in China was growing by leaps and bounds. Critics of such comparisons point out the marked difference in starting points—China's income was far lower, and so there were more opportunities for catch-up. On the contrary however, I would argue that China's challenges were greater, for it had to manage the challenges of transition and of development simultaneously. China did better than countries of comparably low income, while the countries of the FSU and Eastern Europe, by and large, did worse than countries of comparable income.

The question that we need to ask is, why the failures? Not surprisingly, those who advocated shock therapy and rapid privatization argue that the problem was not too much shock and too little therapy, but that there was too little shock. The reforms were not pursued aggressively enough. The medicine was right; it was only that the patient failed to follow the doctor's orders! Other defenders of the recommended reform programs argue that the failures were not in the design of the reforms, but in their implementation. One of the Russian reformers recently quipped that there was nothing wrong with the laws they enacted except non-enforcement.

I want to argue here however, that the failures of the reforms that were widely advocated go far deeper—to a misunderstanding of the very foundations of a market economy, as well as a failure to grasp the fundamentals of reform processes. I will argue below that at least part of the problem was an excessive reliance on textbook models of economics. Textbook economics may be fine for teaching students, but not for advising governments trying to establish from anew a market economy—especially since the typical American style textbook relies so heavily on a particular intellectual tradition, the neoclassical model, leaving out other traditions (such as those put forward by Schumpeter and Hayek) which might have provided more insights into the situations facing the economies in transition. (But, as I shall argument below, the failings of textbook economics are far greater: with few exceptions, they fail even to incorporate insights concerning corporate governance, a concern of mainstream economics from Marshall [1897] to Berle and Means [1932] and a major focus of modern information and transactions costs economics)
A part of the problem also rose from confusing means with ends: taking, for instance, privatization or the opening of capital accounts as a mark of success rather than means to the more fundamental ends. Even the creation of a market economy should be viewed as a means to broader ends. It is not just the creation of market economy that matters, but the improvement of living standards and the establishment of the foundations of sustainable, equitable, and democratic development.

Finally, while due obeisance was paid to "political processes"—and insights into the political process were often put forward in justification of particular courses for reform—in fact, little understanding of these political processes was evidenced. In hindsight, it is clear that many of the political forecasts of those involved in the reform process were far from clairvoyant; many worries seem, by and large, not to have materialized, while political developments which should have been of concern were not anticipated. Nor can one separate "principles" from how they are, or are

likely to be implemented. Policy advisers put forth policy prescriptions in the context of a particular society—a society with a particular history, with a certain level of social capital, with a particular set of political institutions, and with political processes affected by (if not determined by) the existence of particular political forces. Interventions do not occur in a vacuum. How those recommendations are used, or abused, is not an issue from which economists can simply walk away. And this is especially so in those instances where one of the arguments for the economic reforms is either failures in the political process or their impact on the political process itself.[3] It is time for the doctors to rethink the prescription.[4] But in doing so, they will have to take the patient as he is today, not as he might have been had history taken a different course. The point is not to refight the old battles, but to learn the lessons of the past, to help guide the future.

Part I: Misunderstandings of Market Economies

In my book, *Whither Socialism?* [1994], I argued that the failure of market socialism arose in part from a failure to understand what makes a actual market economy function—a failure arising in part from the neoclassical model itself. If the Arrow-Debreu (AD) model [1954] had been correct, then market socialism might have fared far better. But while the AD models capture one essential aspect of a market economy—the information conveyed by price signals, and the role that those price signals serve in coordinating production—the information problems addressed by the economy are far richer. Prices do not convey all the relevant information. I want to suggest here that those advocating shock therapy, with its focus on privatization, similarly failed because they failed to understand modern capitalism; they too were overly influenced by the excessively simplistic textbook models of the market economy. But we should be less forgiving of those failures. While Hayek and Schumpeter had earlier in the century developed alternative paradigms, views that had not been well integrated into the mainstream of the Anglo-American tradition, by the time the post-socialist economies faced their transition, the modern theory of information economics had shown the striking limitations of the AD model, and used the tools of modern economic analysis to illustrate forcefully the problems of corporate governance that Marshall [1897], Keynes [1963 (1926)], Berle and Means [1932], Galbraith [1952], March and Simon [1958], Baumol [1959], Marris [1964], and many others had written about over the course of the twentieth century.

In the following paragraphs, I want to review what I see as the major ways in which, for want of a better term, I shall refer to as the "Washington Consensus" doctrines of transition, failed in their

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[3] "Grand privatization are likely to be frustrated by: quarrelsome members of parliament, foot-dragging ministries, stubborn local politicians, cautious and/or confused law enforcement authorities, opportunistic managers, entrenched unions, rebellious workers, sullen and resentful citizens, bankrupt companies, illiquid banks, revolving-door governments, and the general chaotic nature of post-socialism, plus an occasional *deus ex machina*.... How robust is a privatization plan against such distortions? If the plan's implementation is distorted, will the plan lose only a small amount of effectiveness or will the plan dissolve into a mess? This design criterion of robustness-against-chaos is quite important in Eastern Europe, but it is even more crucial in the former USSR." [Ellerman 1993, 25-6]

[4] The *Transition* newsletter sponsored by the World Bank and several other institutions has been one forum for this discussion, debate, and rethinking. http://www.worldbank.org/html/prddr/trans/WEB/trans.htm

understandings of the core elements of a market economy.[5] In the second section of this talk, I shall focus more sharply on the *reform strategy*, that is, on views about sequencing and pacing.

Competition and Privatization

Standard neoclassical theory argues that for a market economy to work well (to be Pareto efficient), there must be both competition and private property (the "Siamese twins" of efficient wealth creation). Both are required, and clearly, if one could wave a magic wand and instantaneously institute both, one would presumably do that. The issue however, concerns choices: if one cannot have both, should one proceed with privatization alone?

While those pushing for privatization pointed with pride to the large fraction of state enterprises that were turned over to private hands, these were dubious achievements. After all, it is easy to simply give away state assets, especially to one's friends and cronies; and the incentives for doing so are especially strong if the politicians conducting the privatization exercise can get a kickback, either directly or indirectly as campaign contributions. Indeed, if privatization is conducted in ways that are widely viewed as illegitimate and in an environment which lacks the necessary institutional infrastructure, the longer-run prospects of a market economy may actually be undermined. Worse still, the private property interests that are created contribute to the weakening of the state and the undermining of the social order, through corruption and regulatory capture.

Consider the incentives facing the so-called oligarchs in Russia. They might well have reasoned: democratic elections will eventually conclude that their wealth was ill-begotten, and there will thus be attempts to recapture it. They might have been induced to pursue a two-fold strategy: on the one hand, to use their financial power to gain sufficient political influence to reduce the likelihood of such an event; but, assuming that that strategy is inherently risky, to use the other hand to take at least a significant part of their wealth out of the country to a safe haven. Indeed, the "reform" advisors facilitated this process by encouraging—in some cases even insisting—on the opening of capital accounts.[6] Thus, the failure of privatization to provide the basis of a market economy was not an accident, but a predictable consequence of the manner in which privatization occurred.

Privatization Alternatives

Those advocating rapid privatization faced the quandary that there were no legitimate sources of private wealth within the country with which privatization could be accomplished. Governments thus faced essentially four alternatives—a sale of national assets abroad; voucher privatization; taming "spontaneous" privatization; or what I shall call for want of a better term, "illegitimate" privatization. The latter was the route Russia chose after 1995 in the notorious "loans-for-shares"

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[5] To be sure, in many cases, lip service was paid to these points, but the points were certainly not stressed—they were not, for instance, part of the key "conditionalities"—and, as always, actions spoke louder than words.

[6] Yingi Qian, in the paper presented to this conference, argues forcefully that the closed capital accounts in China played a critical role in its success, not only enabling the financial system to provide a major source of income for the government (which it could not have done with full openness), but also in limiting the incentives and scope for asset stripping.

scheme.[7] The government can allow private entrepreneurs to create banks, which can lend these private parties money with which to buy the enterprises (or in the loans-for-shares deal, lend to the government, with the shares of government enterprises as collateral). Whoever got the banking license got a license to print money, and the license to print money is a license to acquire government enterprises. While the corruption was somewhat roundabout—and the process was less transparent than if the government had simply given the nation's assets to its friends—there is in fact little distinction between the two processes.

Since the whole process was widely viewed as illegitimate, this "robber baron" privatization put market capitalism to even greater disrepute than perhaps the indoctrination of the Communist era. And since there was no presumption that those who thereby acquired the assets were particularly good managers, there was no reason to hope that the assets would be better deployed than they had previously been. To be sure, some who advocated this process worried little about either the political impact or the managerial incompetence: they believed that there were strong incentives in play for an "aftermarket"—so that the assets would eventually be sold to those who could best manage these enterprises. The hope was that these new "robber barons" would at least conduct a good auction. But this process failed for several reasons: first, there remained the underlying problem—where were the internal managerial teams with the requisite capital? Worse still, the declining confidence in the economy and the government made the country even less attractive to foreign investors. The oligarchs found that they could extract more wealth from asset stripping than from redeploying assets in way that would provide the foundations of wealth creation.

The voucher schemes proved little more successful, with the Czech Republic (at first taken as a model) providing the clearest illustration of the underlying problem of corporate governance, the public good of corporate management, which I will consider later.

Perhaps trying to discipline spontaneous privatization might have offered the greatest hope: breaking up the large enterprises into smaller units which might have provided a basis for more effective governance by the stakeholders, a possibility I turn to later in this essay.

Creative Destruction

An essential part of the transition to a more efficient economy is the redeployment of resources from less productive to more productive uses. Moving workers from low productive employment to unemployment does not, by itself, increase productivity. Indeed, productivity is lowered, and some productivity is better than none. The movement into unemployment is a costly and inefficient intermediate stage—one could only defend it if there were no better way of moving workers directly from a low productivity job to a higher productivity job. A crude form of Say's law (with little empirical basis) was often put forward: a large supply of idle workers will create a demand, partly by facilitating downward pressure on wages.

But any student of the process of enterprise creation and entrepreneurship would have expressed concerns, especially in regions like FSU, where there was little history of market-oriented entrepreneurship. For entrepreneurship to succeed, certain skills need to be developed in practice,

[7] See Lieberman and Veimetra 1996.

skills which those in the FSU had no opportunity to develop. They had acquired skills in evading government regulations, in arbitraging away some of the inefficiencies in government regulations for private profit, and in operating at the interstices between the legal and illegal world. But that is a far different kind of enterprise that creating new businesses and competing in the international market place.

Entrepreneurship also requires capital. As noted above, few had the necessary capital—especially after inflation eroded what little savings people had accumulated. The banking system had no experience in screening and monitoring loans, it was wrong even to think of these banks as "banks" in the western sense. The language here confused both those in the country and western advisers. But in any case, few of the enterprises actually got into the business of providing funds to new, small enterprises, and thus, even under the best of conditions, entrepreneurship was stifled. Where then, were the new jobs for those forced out of existing employment?

Bankruptcy, or the credible threat of it, is a crucial part of a market economy. The institution of bankruptcy, like its inverse of entrepreneurship, had little or no precedent in the socialist countries. The institution of bankruptcy had to be created. A variety of available models for bankruptcy codes had evolved over centuries in the market economies, and each was integrated into the specifics of its economy. A transplant to an alien environment could hardly be expected to quickly take root – particularly in the absence of an independent and competent judiciary, trained in and sympathetic to the basic tenets of bankruptcy. Those who hoped that newly drafted and "installed" bankruptcy codes would drive industrial restructuring have been much disappointed.

Moreover, as is so often the case, there is no "one best way"; all bankruptcy systems involve genuine tradeoffs between creditor and debtor rights. Systems need to be tailored to the local environment.[8] For instance, one relevant feature is the speed with which assets can be re-engaged in productive use. In countries with little entrepreneurship, poor social safety nets, and little tradition of labor mobility, we must expect a tilt towards debtor-oriented bankruptcy.[9] Moreover, we should not think that much industrial restructuring will come out of bankruptcy courts; the real restructuring is usually done to keep companies out of formal bankruptcy. I will later consider a range of such restructuring actions.

Entrepreneurship and bankruptcy, entry and exit, must be seen as two sides of the same coin of economic change. The advice to "just enforce the bankruptcy laws" or "just harden the budget constraint" is not good advice where there is little culture of new business creation. Both parts of

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[8] See Balcerowicz et al. 1998 for a discussion of the variety of exit procedures in the leading transition economies.

[9] There is a long legal tradition that sees courts as evolving gradually and falteringly towards principles of (rough) efficiency, or at least "perceived" efficiency. In this perspective, then, one should expect independent courts in an economy with a large underutilization of resources to be sympathetic to "solutions" that provide for the continued utilization of resources. Supreme Court Justice William O. Douglas noted that: "Underlying all of our bankruptcy laws is the philosophy expressed by Henry Clay in 1840: 'I maintain that the public right of the State in all the faculties of its members, moral and physical, is paramount to any supposed rights which appertain to a private creditor.'" [1954, 289]

Schumpeter's phrase "creative destruction" must be remembered.[10] Even long-standing market economies do not get out of deep depressions, where many firms qualify as bankrupt, by forcing large numbers of firms into bankruptcy. Vigorous programs of employment creation and maintenance, through promotion of entrepreneurship and/or by Keynesian stimuli, must go hand in hand, if not precede, bankruptcy-induced restructuring.

Social and Organizational Capital

It has long been recognized that a market system cannot operate solely on the basis of narrow self-interest. The informational problems in market interactions offer many chances for opportunistic behavior. Without some minimal amount of social trust and civil norms, social interaction would be reduced to a minimum of tentative and distrustful commodity trades. Behind these social norms stands the machinery of the law which itself stands apart from the market.

> Property systems are in general not completely self-enforcing. They depend for their definition upon a constellation of legal procedures, both civil and criminal. The course of the law itself cannot be regarded as subject to the price system. The judges and the police may indeed be paid, but the system itself would disappear if on each occasion they were to sell their services and decisions. Thus the definition of property rights based on the price system depends precisely on the lack of universality of private property and the price system. ... The price system is not, and perhaps in some basic sense cannot be, universal. To the extent that it is incomplete, it must be supplemented by an implicit or explicit social contract. [Arrow 1972, 357]

The information requirements for, and transactions costs involved in, implicit and explicit contract enforcement are typically different, so that the two should best be thought of as complements rather than substitutes. The problem in the economies in transition was that both enforcement mechanisms were weak: the state's legal and judicial capacities were limited, while the very process of transition—high institutional turnover, high shadow interest rates, and short time horizons—impairs the effectiveness of implicit contracts. Thus, even if institutions did not need to be created, the very process of transition provides impediments to the workings of a market economy.

Arrow, Hirschman [1992], Putnam [1993], Fukuyama [1995], and others have argued that the success of a market economy cannot be understood in terms of narrow *economic* incentives: norms, social institutions, social capital, and trust play critical roles.[11] It is this implicit social contract, necessary to a market society, that cannot be simply legislated, decreed, or installed by a reform government. Some such "social glue" is necessary in any society. One of the most

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[10] See Spicer et al. 1998 for a discussion of the processes of creation and destruction in the Czech Republic.

[11] On the other hand, one must guard against the fallacy that social institutions that arise to address the market failures from imperfections of information are *necessarily* welfare enhancing. The conditions under which decentralized social institutions lead to Pareto efficient allocations [see Arnott and Stiglitz, 1991] are as restrictive as those under which decentralized economic institutions lead to Pareto efficiency [Greenwald and Stiglitz, 1986]. For a non-technical discussion of these points in the context of privatization and the transition, see Stiglitz 1993, 1994 (and for a more technical treatment, Sappington and Stiglitz 1987).

difficult parts of a transformation, such as the transition from socialism to a market economy, is the transformation of the old "implicit social contract" to a new one. If "reformers" simply destroy the old norms and constraints in order to "clean the slate" without allowing for the time-consuming processes of reconstructing new norms, then the new legislated institutions may well not take hold. Then the reforms will be discredited and the "reformers" will blame the victims for not correctly implementing their ill-considered designs.

One variation on this theme is to blame the failure of the shock therapy reforms on corruption and rent-seeking at every turn (e.g., Åslund 1999 this conference. But while rent seeking and corruption were important, there was more to the failure than that (and indeed, if rent-seeking were the sole problem, then the reductions in rents asserted by Åslund should have been accompanied by a soaring of national output.) Moreover, corruption and rent seeking may itself have been increased by the manner in which the reforms were conducted, which both destroyed the already weak social capital and which enhanced opportunities and incentives for such activities.[12]

The social and organizational capital needed for the transition cannot be legislated, decreed, or in some other way imposed from above. [13] People need to take an active and constructive role in their self-transformation; to a large extent, they need to be in the driver's seat. Otherwise the reform regime is only using bribes and threats to induce outward changes in behavior insofar as behavior can be monitored—but that is not transformation.[14]

In market economies, firms may be seen as local non-market solutions to collective action problems where transaction costs inhibit coordination by market contracts [Coase 1937]. In the new post-socialist market economies, as in the established market economies, the primary example of extensive (i.e., beyond the family) social cooperation in daily life is found in the workplace. Thus entrepreneurial efforts that arise out of or spin off from existing enterprises may be particularly effective in post-socialist societies in preserving "lumps" of social and organizational capital. Once dissipated, organizational capital is hard to reassemble, particularly in environments with little entrepreneurial experience. Other social organizations that might incubate and support entrepreneurial efforts include local township governments,[15] unions, schools, colleges, cooperatives (housing, consumer, credit, and producer co-ops), mutual aid associations, guilds, professional associations, churches, veterans' associations, clubs, and extended family groups. Creativity and experimentation should be the order of the day to remobilize social resources particularly in the slow-starting transitional economies of the former Soviet Union.[16]

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[12] One colleague quipped: "The institutional blitzkrieg destroyed without replacing the old social norms—removing the last restraints against society-threatening levels of corruption. This is like using a flame-thrower to burn off an old coat of housepaint, and then lamenting that you couldn't finish the new paint job because the house burned down."

[13] See, for instance, Knack and Keefer 1997 for recent research and for a review of the extensive literature on social capital, see Woolcock (forthcoming).

[14] See Wolfensohn 1997, 1998, and 1999 on the Comprehensive Development Framework (CDF).

[15] See the township-village enterprises in China as in Weitzman and Xu 1994, Lin et al. 1996, and Qian 1999.

[16] See Blanchard and Kremer 1997 and Gaddy and Ickes 1998 for current descriptions.

The Post-Socialist Separation of Ownership and Control

Given the difficulties in reassembling organizational capital once it is dissipated or destroyed, it is particularly important to promote entrepreneurial restructuring in existing enterprises. The need for fundamental enterprise restructuring has not been lost on the swarms of western advisors, but their advice has sometimes contributed as much to the problem as to the solution.

In retrospect, one of the remarkable features of the body of western advice given to post-socialist economies ("Washington Consensus"), especially as they approached the issue of privatization (see above), is the absence of attention to the separation of ownership and control. The intellectual framework often seems to be a curious pre-Berle-Means[17] world where "private ownership" and control of the enterprise are essentially the same thing—as if the small or medium-sized closely-held corporation was the norm. Yet the salient feature of the large companies in the Anglo-American economies has been what Berle and Means called the "separation of ownership and control." Keynes, even earlier, made the same point.

> One of the most interesting and unnoticed developments of recent decades [written in 1926] has been the tendency of big enterprise to socialize itself. A point arrives in the growth of a big institution—particularly a big railroad or big public utility enterprise, but also a big bank or a big insurance company—at which the owners of the capital, i.e., the shareholders, are almost entirely dissociated from the management, with the result that the direct personal interest of the latter in the making of the great profit becomes quite secondary. [Keynes 1963, 314]

The divergence of interests between the managers and shareholders in large publicly-traded corporations has been a major source of the economics of agency contracts.[18] Yet the hard lessons of the separation of ownership and control, and the resulting agency problems, have received insufficient attention in the standard western advice in spite of much discussion of "the corporate governance problem." Let me give you a few examples of "fine phrases."

"Clearly Defined Private Property Rights"

Instead of trying to control managers in state-owned companies with better incentive contracts, the standard advice is to privatize and let "private property rights" provide the natural incentives—"like in the West." Yet the separation of ownership and control in large western companies means that the control function is not allocated on the basis of "clearly defined private property rights." The ownership of shares, like the ownership of bonds, is indeed clearly defined; the shareholder can buy, sell, or hold those rights. But those rights do not "add up" to a real ownership-based control of the company when the shareholders are atomized and dispersed. One way to express this point is to recognize that the management of a publicly held company with

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[17] See Berle and Means 1932 and the huge literature following it. See Roe 1994, Kaufman et al. 1995, Stiglitz and Edlin 1995, and Stiglitz 1982, 1985, and 1994 for recent treatments.

[18] An enormous literature has grown out of the early work such as Ross 1973 and Stiglitz 1974. See Stiglitz 1987 for an overview.

disperse ownership is a public good[19]—and as in the case of any public good, there will be an undersupply. Another way of putting the same point is that the market for managers—the process of take-overs—is highly imperfect, and does not in general ensure that the company will be managed by those who will ensure that the assets yield the highest returns.[20]

"Controlling Private Owner"

When the problems of dispersed shareholding were recognized in operating companies, then the suggested solution was usually to have a "controlling private owner" in the form of an investment fund—as in the standard form of voucher privatization promoted by the Washington Consensus and modeled essentially on the Czech voucher privatization program. One obvious problem with this "solution" is that the voucher investment funds had an even greater "corporate governance" problem than the companies in their portfolio. The funds' shares were held by a broad cross-section of the entire population of citizens. Thus the shareholders' influence on the fund management was essentially nil. Yet the controlling investment fund idea was "sold" by the standard Washington Consensus as a "solution" (rather than a worsening) of the corporate governance problem.

"Natural Incentives of Private Ownership"

In economics, as in politics, it is a good idea to "follow the money." Who has the economic interests ("cashflow rights") normally associated with corporate ownership? The standard theory is that the economic interests are attached to share ownership. The shareholder enjoys the economic return to ownership in two ways: dividends on shares and capital gains on shares when sold. But when there is a separation of ownership and control, then the controlling agent is partly or almost wholly disconnected from those "natural incentives of ownership." The effects of the separation are aggravated when there is pyramiding.

An actual case is point is the Czech voucher privatization scheme. The voucher investment funds were limited to at most a 20% stake in a portfolio company, and the funds were controlled by fund management companies receiving 2% of the asset value under management. That fund management company's economic interest in the portfolio company is 0.4 % (20% x 2%). If two funds with the same management company each have a 20% interest, then we have a 0.8% economic interest. Other variations allowed 30% maximum holdings and 3% fund management fees for a 0.9% economic interest. Moreover, these returns are gross to the fund manager. If the fund manager must expend any costs, say in devising and implementing a restructuring plan for a portfolio company, then those costs would have to be subtracted to get the net return to the fund management company.

[19] See Stiglitz 1982.

[20] For an early discussion of the theory of takeovers, see Stiglitz 1972. Perhaps the most dramatic illustration of this was provided by Grossman and Hart's [1980] analysis of take-overs: take-overs by value-enhancing management teams would never be successful, since each shareholder has an incentive to retain his shares, so as to fully participate in the increased returns; while, if each shareholder believes that others will tender their shares, value reducing, asset stripping, take-overs will be successful.

Let me ask you. If you had control of an economic asset but could only extract say 0.9% through a certain channel, would you tend to use that channel or to find a more "efficient" channel for extracting value? At least in retrospect, no one should be surprised that the Czech investment funds found other channels to extract or "tunnel" value out of the portfolio companies.[21] After all, one does not need a lot of sophisticated economics to figure out that if the controlling interest must pay over 99% tax on money taken out one door, then there will be a determined search for another door to get the money out.

"Better Management Contracts"

It will be said, perhaps the answer lies with better regulations and well-designed incentive contracts for the controlling fund managers. But let us now step back and take stock. If a government had such incredible monitoring and enforcement powers to overcome such disincentives, why not apply those powers directly in corporatized state-owned enterprises and then privatize later in a better thought-out way?

One of the main points of "privatization" was to use the "natural incentives of private ownership" *instead of* the more contrived incentives of management contracts (e.g., in SOEs). Yet we have come full circle. We have seen that the rapid privatization schemes promoted by the standard western advice (voucher privatization with investment funds) did not establish or lead to controlling owners motivated to restructure enterprises towards long-term economic success. The current advice has ended up focusing on better regulations and management contracts to try to get those in control (e.g., the Czech fund management companies) to act like "private owners"—since the standard form of privatization didn't do that job. It is time to rethink that "standard" type of privatization.

Reducing Agency Chains: Stakeholder Privatization

A modern market economy is based on highly developed agency relationships. One of the most important ways in which real economies diverge from textbook models is in the problems of asymmetric information, imperfect monitoring, and opportunistic behavior. Accordingly some of the most important economic institutions arise to alleviate agency problems (e.g., the legal machinery to enforce shareholder rights and other stakeholder rights, liquid stock markets and open-end investment funds (so investors can "vote with their feet"), the legal framework of competition policy, the entire monitoring system of accounting and auditing, and lastly the ethos of managerial professionalism). In the more stable and developed market economies, long multi-stage chains of agency relationships have developed (e.g., workers are agents for managers who are agents for shareholders such as mutual funds whose shares are held by pension funds which act as agents for their beneficiaries such as workers). But in earlier stages of development, market economies had much shorter agency chains.

These agency institutions need to incrementally grow and evolve over decades. If one tries to just set up a market economy overnight with such extended and concatenated agency relationships, then the superstructure may collapse in dysfunction. That is what has happened in Russia and the former Soviet Union. The elites who have had the roles of institutional agents representing broad

[21] See Ellerman 1998 for an institutional analysis and Weiss and Nikitin 1998 for econometric analysis.

constituencies in the FSU have, in many cases, not been able resist grabbing what they can.[22] The elites have betrayed society's trust in them on a massive scale. Those who would enforce the agency relationships and other legal obligations are too often themselves part of the problem.

That is why it is time to rethink the elaborate agency chains we have been trying to "install" in the former Soviet Union. Think for a moment why we condemn oligarchs and managers for asset stripping and looting that leads to the demise of an enterprise. One might say that they are within their legal rights as shareholders. Yet we nonetheless condemn them because of the direct impact on the livelihoods of workers and indirect impact on the economic life of the local community and on the prospects for related parties such as suppliers and customers. By bringing in the interests of these other parties in evaluating the looting, we are in effect identifying these other parties as *stakeholders* in the enterprise. The stakeholders all have implicit contracts signifying long term relationships with the enterprise. It is these stakeholders who are ultimately harmed as an "externality" by the agents' betrayal of the extended agency relationships in the transitional economies.

If the pyramided agency relationships are not functioning and it will take many years to build the supporting institutions, then perhaps it is best to shorten the relationships so that those who are monitoring are the ultimate stakeholders who are hurt by the looting and malfeasance. Instead of A trying to get B to get C to do something for A, the pyramided agency relationships should be shortened as much as possible. Shortening one stage means A trying to get B to do something for A. The most dramatic and self-enforcing arrangement is the unification of principal and agent so that A helps him- or herself directly. Then "corporate governance" becomes a more manageable problem, if not a solved problem. There is no corporate governance problem with unified principal and agent in the family farm or small owner-operated business. In general, we might reason that the shorter the agency chain, the easier it is to resolve the corporate governance problem.[23]

This is a strategy of *privatization to stakeholders* which could be seen as a way to generalize the owner-operated business or family farm to medium-sized and larger firms [see below on decentralizing large firms].[24] Since the stakeholders, by definition, have a long-term economic

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[22] See Shleifer and Vishny 1998 and Wedel 1998.

[23] In a recent book, one of the pioneers in employee stock ownership plans, Jeff Gates, has argued for a similar notion of "up-close capitalism." "As an example of the benefits of such 'up-close capitalism,' Nobel laureate economist Myron Scholes touts the positive effect that employee stock ownership can have on corporate decision-making. In his view, such 'inside' ownership improves performance both directly (by encouraging insider challenges to poorly conceived management decisions) and indirectly—by influencing managers who know that the firm's owners are now working among them.[1991] Similarly, by including a component of *consumer* ownership [of utilities], the utility's managers (and their families) would live among shareholders who are also neighbors, schoolmates and teammates. Such a community-focused ownership stake could change the quality of business relationships across a broad spectrum because local, up-close capitalists have more at stake than do remote investors." [1998, 13-4]

[24] Two examples of stakeholder privatization are the Polish privatization by liquidation (mostly leasing management and employee buyouts or MEBOs) and the Chinese township-village enterprises (TVEs). The fact that some would object to the TVEs being considered as "private" shows what a surreal fetish "privatization" has become. The Chinese managers and workers are immobilized in their TVE so these "barriers to exit" lead to a

relationship to the enterprise, they have broader interests in the firm and another channel through which to exert their corporate governance on the management.[25] Their cooperation is necessary for the firm to function so this "hold-up power" gives the stakeholders a way to exercise "corporate governance" as part of their day-to-day business relationships rather than through external legal machinery. They are not unrelated absentee shareholders who see the enterprise only as a "property" (perhaps to be quickly harvested) or who are dependent on agency chains and intermediary institutions to exert their influence.[26]

This general strategy would push towards decentralization. The idea is to push decision-making responsibility down to the levels where people can more directly control their agents or where peer-monitoring can operate—without presupposing the elaborate institutions of monitoring and enforcement that will take many years to develop. There is usually corruption also at decentralized levels but centralization keeps control too removed from the discontents that can lead to change. As David Lilienthal, past Chairman of the Tennessee Valley Authority, put it:

> [C]entralization to avoid unsavory local influences surely deprives the people of the chance to draw their issues locally and to clean up their own local inadequacies. The fundamental solution is to crowd more, not less responsibility into the community. Only as the consequences of administrational errors become more localized, can we expect citizens to know which rabbit to shoot. [Lilienthal 1949, 89-90]

This strategy would also entail energizing some of the more subdued segments of the population such as the workers and their unions. If oligarchs and/or managers are looting an enterprise and

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"logic of commitment" [see Kagono and Kobayashi 1994] and "loyalty" [Hirschman 1970] which together with a hard budget constraint yields a *de facto* private firm. In contrast, Polish firms held by the national investment funds (in effect, parastatal holding companies) are considered "private" simply because the parastatal holding companies themselves floated their shares on the stock market and thus were "privatized."

[25] This is reminiscent of the Japanese pattern of taking shareholding as symbolic of an underlying business relationship rather than being itself the relationship. "A high proportion of the holders of Japanese equity have more to gain from the other business they do with the company whose shares they hold than from profits or capital gains on the shares themselves. They are 'committed' in interest terms because they have a stake in the actual long-term growth of the company." [Dore 1987, 113] Thus "corporate governance" has a natural economic basis. See Blinder 1995 for a suggestion that the former socialist countries look towards Japan and East Asia for some ideas.

[26] Perhaps the main stakeholder group is the workers and managers in an enterprise. In a perceptive paper early in the decade, Martin Weitzman (who, unlike the most prominent western advisors, was a scholar of Soviet-style economies) gave the pragmatic argument for the worker ownership version of stakeholder privatization. "Under worker ownership, the workers themselves, or their agents, will have to control pay and negotiate plant shutdowns. The most acute 'us vs. them' stalemates may be avoided. Ownership is more concentrated relatively close to management decisions and can put more immediate pressure on performance. Regulatory capture may be avoided. Hard budget constraints may be more acceptable. There is less opportunity for financial manipulation." [1993, 267] But it should be noted that concentrated ownership in the hands of an old manager may, in the FSU context, still lead to looting. With no eventual exit in sight to a strategic investor or a public market, the manager-owner's time horizon may collapse and lead, in the absence of constraint, to grabbing what he can rather than long-term wealth creation. Thus stakeholder ownership needs to be spread to a broad enough coalition that firm-threatening looting is prevented and each stakeholder is then constrained to "doing business" instead of "making a killing."

destroying people's future jobs, then any national pride in being "long suffering and enduring" is quite misplaced. Those who are being hurt should have the information and the organizational capacity to vigorously protect their interests, not just to depend on some reform elite to act in their best interest.[27] The same holds for local governments as well as suppliers and customers—all of whom are stakeholders in the enterprise being looted. The cooperation of the stakeholders is necessary for the enterprise to function and the interests of the stakeholders are harmed when the enterprise is looted. Therefore stakeholder privatization coupled with stakeholder empowerment will tend to reunite the *de facto* control rights and *de jure* ownership rights in a self-enforcing system of corporate governance. Since the strategy of shortening agency chains leads in the direction of devolution to ultimate stakeholders, let us step back and look at the role of bankruptcy and decentralization in restructuring—particularly in the larger firms.

Restructuring and Bankruptcy

Industrial restructuring to improve competitiveness has proven one of the most difficult and intractable parts of the transition process. Hopes that privatization would lead to restructuring "by the market" have been widely disappointed. Part of the blame, as I have noted, should be assigned to privatization methods that created little incentive for restructuring as opposed to "tunneling" value out of firms. But part of the blame should also be assigned to a failure to understand the nature of the restructuring process in the context of economies in transition.

One fundamental error (similar to one which we have encountered in the past couple of years in East Asia) is a failure to distinguish between what is required in the case of restructuring a single firm within a well functioning market economy, and restructuring virtually an entire economy, or at least the manufacturing sector of an economy.

Systemic reorganization is different from reorganization when a single firm has a problem. When a single firm is restructured in an economy operating at full employment, firing underemployed workers has beneficial effects, partly because those workers get quickly redeployed to more productive uses. When, however, there already is massive unemployment, firing workers moves them for a situation of underemployment to no employment—not necessarily a transfer that leads to an overall increase in the productivity of the economy, though it may improve the balance sheet of a particular firm. In the economies in transition, many bad investment decisions had been made. The issue facing a country, *given its capital stock,* was not, in the short run, whether it wished it had a different capital stock; there was no magic wand by which it could convert its inefficient steel mills into efficient aluminum smelters. The question was, given its capital stock, what was the best way to employ its workers. To be sure, even in the short run some rearrangements in the labor force were desirable; some firms should be hiring workers, some firing workers: this is an on-going part of the process of any dynamic economy. But it cannot be

[27] In other words, in large corporations, all stakeholders, not just shareholders, face public good-management problems: each feels powerless to affect outcomes, and to the extent that they can affect outcomes, most of the benefits accrue to others.

the case that all firms are overstaffed—except if at the same time new firms can be *and are being* created to absorb the workers let go.[28]

It is particularly important to recognize that there was no reason to believe that the inherited financial structure of the firms in the economy in transition at the beginning of the process had any inherent "merit," simply because finance under the socialist regime played a completely different role. Banks did not have the job of screening and monitoring. A high debt-equity ratio—leading a firm to a situation where it could not meet its obligations—thus had no informational value; it did not convey information even about the incompetence of the chief financial officer.[29]

By the same token, when there is systemic bankruptcy, selling off assets may make little sense: who is there to buy them? And even when it is possible that some firm could more effectively utilize the asset, if capital market imperfections are rampant—so that the firm that should be expanding does not have access to capital—it may not find it possible to obtain the funds to purchase the asset. The rearrangement of assets in the presence of a systemic problem is thus far more difficult than in the case of an isolated weak firm.

Thus, financial restructuring was necessary, but a weak financial position had far different implications than in an ongoing market economy; and the prospects of fundamental improvements in the underlying structure of the economy from disposing of assets, in the presence of systemic bankruptcy, were far bleaker.

Restructuring through Decentralization, Reconstitution, and Recombination

There was a form of restructuring that was important—but unfortunately, with few exceptions, such restructuring was not the focus of attention—and that is restructuring to decentralize decision-making. Indeed, it seems to me that there is a rather general model of restructuring which suitably describes successes in a wide variety of contexts. Consider a centralized organization that is encountering consistent failure in its tasks. It could be a unit of government or an economic enterprise. The "iron law of oligarchy"[30] has done its work so the organization is centralized, ossified, and stagnant. Those who have power in the organization want to maintain its structure to preserve their power and perquisites.

New and complex situations call for experiments; not one but many experiments. The need for many parallel experiments to see "what works" implies decentralization so that the smaller units can operate with some independence.[31] Risk is diversified since a bad decision by one unit does

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[28] To be sure, all firms in a sector can face a financial crisis, if the sector has been receiving a subsidy from other sectors, or has accumulated liabilities (debts) on which interest is due, and such financial crises require financial adjustments.

[29] This is doubly so in those cases where interest rates increased in ways that could not have been anticipated. By contrast, in some cases, firms were left with too little debt, so that the inefficiencies arising from excessive managerial discretion were given free reign. The role of debt as an incentive device has been emphasized in much of the literature on corporate governance of the past quarter century. See Jensen and Meckling 1976.

[30] See Michels 1962 (1915).

[31] See Stiglitz 1994 for an extended discussion of decentralization in various contexts and for a discussion of the related principle of subsidiarity in government, see Begg et al. 1993, and in a company, see Handy 1996 (next fn.).

not entail the same for the other units. Decentralization means vertically and/or horizontally dis-integrating a large firm into separate semi-autonomous teams or profit centers within a federal structure[32]—or perhaps a split into more independent business units (e.g., spin-offs which could be confederated and/or partly owned by the mother firm). Decentralization can improve incentives (by linking actions of individuals and smaller units to rewards) and accountability, and harden budget constraints—eliminating the cross subsidies that often exist in large organizations.

New managers are needed in the decentralized parts. This devolution is the hardest part of the process since it entails the central management giving up a good part of its power to the decentralized or spun off units under younger middle managers. Yet it is key. Restructuring for a market economy entails a sea-change away from the strategy of keeping or conglomerating together the largest units possible to be more successful in lobbying for subsidies. Instead of the slogan "United we stand; divided we fall," the slogan might be "Centralized, we go to the ministry; decentralized, we go to the market."

One can argue that it is best if the pressure for the center to cede power to the decentralized units to begin the process of re-constitution come from the constituent stakeholders (e.g., workers, creditors, and other parties with stable relationships to the enterprise), those who will lose if the organization is not successfully restructured. Their participation and involvement in the restructuring decisions will lead to better execution of the restructuring plans (since the stakeholders will have more "buy-in" and "ownership" of a plan they helped devise).

The fundamental fact is that much of the relevant knowledge is, in fact, decentralized; that the well recognized failures of central planning—having at least in part to do with the inability of the central planner to gather and disseminate relevant information—can apply with equal force within a large organization; and that simply calling the organization a "firm" does not by itself provide the constituent parts with incentives to transmit information to the center, nor does it endow the "firm" with the ability to process that information, nor does it provide a clear mechanism for the central headquarters to convey instructions to its constituent parts, nor does it provide the incentives for those parts (and the individuals within them) to respond in the desired manner.

Following the decentralization, the new units can experiment to probe their environment, to test their capabilities, and to accumulate local knowledge. The connection or loop between experiment and feedback is, under decentralization, now much tighter so the learning process can proceed apace. Benchmarking and world quality standards provide a Hirschmanian pacing mechanism to drive the learning.[33] Real decentralization within an enterprise means that the units can now buy supplies and sell outputs outside the firm whereas before they were in effect restricted to a monopoly supplier or buyer within the firm. It also means the new units should bear the costs of their failure just as they may reap the fruits of their success. These competitive possibilities will expose vulnerabilities within the various units to induce learning and change.

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[32] See, for example, "Balancing Corporate Power: A New Federalist Paper" in Handy 1996.

[33] See "bootstrapping reforms" in Sabel [1995] and "experimental decentralization" in Sabel and Prokop [1996] for similar approaches. See Hirschman 1958 for the original discussion of low-fault-tolerance technologies (e.g., running an airline) as mechanisms to induce or pace social learning.

Thus decentralization along with the benchmarking and outside competition (like "export promotion" in the international arena) could be seen as social learning mechanisms to drive the process of recombination and restructuring.[34] Thus, the horizontal discussions between the units should be seen not simply as "best practice fora" but as part of the "constitutional" process of rebuilding the organizational relationships from the ground up.[35] This is the process of rebuilding social capital, to which so little attention was paid in the process of transition.

We have so far illustrated the general model of restructuring through decentralization, reconstitution, and recombination by applying it to a large and presumably distressed firm. The model helps to explain why successful restructuring is so rare in post-socialist countries (as well as elsewhere). The center refuses to decentralize power to start the new process of learning and reconstitution. The center clings to the hope that some new master restructuring plan (coupled no doubt with "new machinery" as a technological fix) will solve the problem. If the government is to foster restructuring in troubled firms, then it needs to find ways to promote restructuring through decentralization, reconstitution. Where enough constituent units have the leadership (e.g., middle managers) and initiative to strike out on the restructuring path, then the government can help to devise ways to lift the dead hand of the center (i.e., the failed managers clinging to centralized power) so the process of renewal can go forward.[36]

Part II: Misunderstandings of the Reform Process

Early in the decade, there was much discussion about the proper pacing and sequencing of reforms in the transition economies. In both cases, political and economic considerations were invoked to justify alternative strategies. I have already referred to some of the debates concerning key economic issues—like corporate governance—where the neoclassical model had been found wanting; and the lacuna had only been grasped in the last fifteen years, and evidently, not even then by many of the reformers. But traditional economic theory has even less to say about the dynamics of transition than it has to say about equilibrium states; and yet it was issues of dynamics of transition that were central to the debate over pacing and sequencing.

In the next sections, I will take up the issues of sequencing and pacing in turn.

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[34] See McDermott 1998 for a description of examples in Czech Republic, Stark 1996 for Hungary, and Stark and Bruszt 1998 for East Europe generally.

[35] This process of "government by discussion" in the state and other social organizations has been emphasized by John Stuart Mill, Walter Bagehot, James Bryce, John Dewey, Frank Knight, and Charles Lindblom [see Lindblom 1990].

[36] How the government can best do this is not always obvious. Devising appropriate “rules of the game” – bankruptcy laws which provide some clarity about what will happen if the firm does not restructure itself—are surely part of the overall incentive structure. Government provided safety nets are important, since in most of the economies in transition, individuals depended on firms for many essential services; any corporate reorganization thus not only put at risk their jobs, but also these social services. Government assistance to spun off units has to be carefully managed; providing such assistance only to firms going through bankruptcy gives an incentive to postpone reorganization, or at least to force the reorganization to occur through bankruptcy proceedings.

Sequencing and Pacing of Reforms

There was always the facile recommendation that "everything is important" and "everything should be done at once." But real choices are always necessary given the real limitations on any government's time, focus, and resources. One of the theories was to start with the "low hanging fruit"—the easy pieces—to build up the momentum of reform before taking on the harder pieces. Even if there were no other theories, governments will tend to take the easy pieces first anyway. In any case, this approach was widely used.

The particular context in which I will look at the issue of sequencing is *privatization*. There were three different perspectives: (a) Proceed with privatization as fast as one can; it is more important that privatization occurs than how it occurs; (b) Proceed with privatization as soon as one has put into place an appropriate framework for privatization itself, but do not wait for an appropriate legal structure, including a regulatory and competition framework, to be in place (since government failure is much more important than market failure); and (c) Only proceed with full privatization when there is the appropriate legal framework in place.

There were, in fact, arguments put forward in favor of each of these strategies. Consider the first approach. Underlying it was the Coasian idea that the initial private owners didn't matter too much as "the market" would soon reallocate the assets to the efficient owners. One of the strong arguments for rapid privatization was that it would create powerful political forces that would move forward the broader agenda of economic reform. Fearing a reversion to a Communist state, one needed not only to lock up what successes one could, but to create a political force in favor of the market economy. Still another argument was that waiting until a legal structure was in place would result in long delays. Privatization, at least in a formal sense, can be done quickly while it will take years to build up the regulatory framework for competition and the legal system to enforce it. One needed to "grab" the low hanging fruit, "take advantage of the window of opportunity" in every way that one could.

In contrast to the argument that one should take the "low hanging fruit" is the view that reforms have strong complementarities. Privatization is no great achievement—it can occur whenever one wants—if only by giving away property to one's friends. Achieving a private, competitive market economy, on the other hand, is a great achievement, but this requires an institutional framework, a set of credible and enforced laws and regulations. Do this, and the larger politically-sensitive privatizations can be attended to when the needed institutional infrastructure was ready, while in the meantime stakeholder-oriented privatization of small and medium-sized firms (which have less potential for abuse and require simpler regulatory structures) could go forward apace.

Those who worried about the sequencing and pacing of reforms were also concerned that without the appropriate reform strategy the likelihood of success was limited; and a failure of reform could indeed undermine its sustainability. Success, rather than speed, was of the essence. Indeed, failures could be reinforcing: if reforms were not viewed to be sustainable, then investors would not have an incentive to make the long term commitments required for growth; one could get caught in a low level equilibrium trap. Successful transition strategies had to have the property of time consistency, including political sustainability.

What have we learned? Some of the most telling lessons relate to the political process itself. One of the problems in the theory is that the interest groups do not sit still in the midst of the reform process. And the reform can create new political forces. The early reforms, the "low hanging fruit," can—and in many cases did-- create new interest groups, often associated with the "reformers," that would then add their decisive weight to block the later reforms. Several examples might be cited.

- It is not doubt easier to start the process of privatizing banks by privatizing the early ones to domestic groups. The new domestic private banks would then be able to stabilize themselves before allowing foreign competition by selling other banks to foreigners or by allowing direct entry of foreign banks. The problem in the strategy is that the private groups owning the first privatized banks will use their political clout to prevent the foreign sales or entry.

- Many countries, in effect, adopted the policy to "privatize now, regulate later." Here again, the early privatizations into an essentially unregulated environment created a strong vested interest to block the later attempts at regulation in the case of natural monopolies, or to create a competitive market, in the case of those industries where competition was viable.[37]

While privatization was supposed to "tame" political intrusion in market processes, privatization provided an additional instrument by which special interests, and political powers, could maintain their power. For instance, in a variety of dubious arrangements, political allies of the reformers "bought" assets (e.g., with money borrowed from the government or from the banks to which the government gave charters), with part of the "profits" generated thereby being recycled to support the political campaigns of the reformers.

The Coasian argument that there would quickly be a reallocation of assets to "efficient" producers failed in part because there was no genuine secondary market for the same reasons that there was no real primary market—so the assets were more "looted" than resold.

But there was a further problem in the "Coasian" approach. It is not only important for sustainability that property rights are clarified but *how* they are clarified. Suppose there are several parties with ill-defined claims on "pieces of a pie." One strategy would be assign "clear property rights" to some party (probably on political grounds) and then let them trade. But the other parties would probably reject the assignment and sabotage the "solution." This "solution" ignored the whole process of discussion and agreement that could bring "buy-in" so that the resulting agreed-upon property rights might "stick" and be respected. In that alternative negotiated settlement between the stakeholders, the exact *ex ante* shares would be unclear, but all parties would have an incentive to come to some agreement that could then be sustained so that business could go forward. But when those who received the "clear" property rights by fiat or connivance did not view those rights as secure—and could not, since there was little perceived

[37] This problem went beyond sequencing to misunderstandings of market economics itself. Instead of seeing private property and competition as the "Siamese twins" of efficient wealth creation, privatization became a major fetish while competition policies and other market regulations were seen as minor afterthoughts. Policy advisors did note the need for competition policies but placed *emphases* on other issues such as the speed of privatization.

legitimacy to them—it made more sense for them to engage in asset stripping than in wealth creation, precisely the strategy that was in fact pursued.

The Grabbing Hand of the State; the Velvet Glove of Privatization

One of the theories that promotes privatization independently of a competitive or even regulated environment is the "grabbing hand" theory of the government.[38] The state is seen as the primary source of the problems: interfering in state firms and preying on private firms. The emphasis is on government failure, not market failure.[39] Privatization of enterprises and depoliticization of economic life are the overarching policy goals.

> The architects of the Russian privatization were aware of the dangers of poor enforcement of property rights. Yet because of the emphasis on politics, the reformers predicted that institutions would follow private property rather than the other way around. [Shleifer and Vishny 1998, 11]

Not only were regulatory and corporate governance institutions supposed to arise on their own account, but the proponents of this theory even saw it actually happening in Russia. "Institutions supporting corporate governance, such as the banking sector and capital markets, are also developing rapidly in part because of the profit opportunities made available by the privatized firms." [Shleifer and Vishny 1998, 254, note 4]

Historians may well wonder how the programs implemented by the architects of the Russian privatization could have led to the present system of economic oligarchy and disorganization. The grabbing hand theory sees the state as being irredeemably corrupt—while the private sector is viewed through rose-colored glasses. Yet the resulting program of transferring assets to the private sector without regulatory safeguards ("depoliticization") has only succeeded in putting the "grabbing hand" into the "velvet glove" of privatization. The "grabbing hand" keeps on grabbing with even less hope of public restraint. The rapid liberalization of capital accounts allowed the aforementioned "banking sector" to spirit tens of billions of dollars of loot out of Russia each year while the architects of capital account liberalization negotiated more billions of international debt. Economic and political forces—incentives—are at play, with far different outcomes than predicted by the proponents of the grabbing hand theory (some of whom are still arguing that, ten years after the beginning of the process, with output plummeting and inequality soaring, we are being too hasty in reaching a judgment). And why should we be surprised? It is not the first time that strong vested interests have used political processes to maintain and strengthen their economics interests. What is remarkable about this episode is that economists, who should have known better, had a hand in helping create these interests, believing somehow—in spite of the long history to the contrary—that Coasian forces would lead to efficient social outcomes.

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[38] See Shleifer and Vishny 1998.

[39] Indeed Schleifer and Vishny note that the Russian privatization program "de-emphasized corporate governance precisely because the intent was to reduce the damage from government failure rather than from market failure." [1998, 11] For a related discussion, see Dyck 1999.

Clothing the grabbing hand in a velvet glove does not solve the underlying problem of irresponsible power, public or private. That is why I have urged a strategy of decentralization to push power down to the levels where people can use local institutions (e.g., enterprises, associations, unions, and local governments) to protect their own interests and marshal their resources to incrementally rebuild functioning institutions on a broader scale.

This brings us to the larger debate about the methods and pace of institutional change.

The Modern Debate: Shock Therapy versus Incrementalism

The standard western advice, such as what I have called the "Washington consensus," took what Hirschman [1973, 248] called an ideological, fundamental, and root-and-branch approach to reform as opposed to an incremental, remedial, piecemeal, and adaptive approach. I have no great quarrel with "shock therapy" as a measure to quickly reset expectations say in an anti-inflation program. The controversy was more about the attempted use of a shock therapy approach to "install" institutions—where it might more aptly be called a "blitzkrieg" approach. Historically, the shock therapy approach to changing institutions is associated with Jacobinism in the French Revolution and (ironically) with Bolshevism in the Russian Revolution.

There is an "Austrian" tradition of criticism of the Jacobin-Bolshevik approach to institutional change. Karl Popper's criticism [1962] of utopian social engineering and Friedrich Hayek's critique [1979] of the Jacobinic ambitions of scientism gave this tradition its modern Austrian flavor but the roots go back at least to Edmund Burke's [1937 (1790)] attack on Jacobinism in the French Revolution. Peter Murrell [1992] has explicitly used that tradition in his critique of the shock therapy approach. A major theme in my own professional work is that informational problems coupled with human fallibility make the actual world we deal with strikingly different from the models of conventional neoclassical economic theory.[40] Indeed many of the intuitions and informal arguments of the Austrian school find their precise formulation in the new information economics. Thus it is no surprise that I have always had misgivings about the shock therapy component of the Washington consensus, at least as applied to institutional change.

The irony of it all is that the modern critique of utopian social engineering was based particularly on the Bolshevik approach to the transition from capitalism to communism, and the shock therapy approach tried to use many of the same principles for the reverse transition. It is almost as if many of the western advisors just thought the Bolsheviks had the wrong textbooks instead of the whole wrong approach. With the right textbooks in their briefcases, the "market Bolsheviks" would be able to fly into the post-socialist countries and use a peaceful version of Lenin's methods to make the opposite transition.

But we belittle the issue by seeing it only as an intellectual question of overlooking the Austrian or information economics critique of utopian social engineering. One deeper origin of what became known as the "shock therapy" approach to the transition was moral fervor and triumphialism left over from the Cold War. Some economic cold-warriors seem to have seen themselves on a mission to level the "evil" institutions of communism and to socially engineer in their place (using

[40] See Stiglitz 1994 and the references there.

the right textbooks this time) the new, clean, and pure "textbook institutions" of a private property market economy. From this cold-war perspective, those who showed any sympathy to transitional forms that had evolved out of the communist past and still bore traces of that evolution must themselves be guilty of "communist sympathies." Only a blitzkrieg approach during the "window of opportunity" provided by the "fog of transition" would get the changes made before the population had a chance to organize to protect its previous vested interests. This mentality is a reincarnation of the spirit and mindset of Bolshevism and Jacobinism.

Since, for better or for worse, much of the "great debate" has been carried on in metaphorical terms, I will summarize the "battle of the metaphors" in the following table 1.

Table 1: "Battle of Metaphors"

	Shock Therapy	Incrementalism
Continuity vs. Break	Discontinuous break or shock—razing the old social structure in order to build the new.	Continuous change—trying to preserve social capital that cannot be easily reconstructed.
Role of Initial Conditions	The first-best socially engineered solution that is not "distorted" by the initial conditions.	Piecemeal changes (continuous improvements) taking into account initial conditions.
Role of Knowledge	Emphasizes explicit or technical knowledge of end-state blueprint.	Emphasizes local practical knowledge that only yields local predictability and does not apply to large or global changes.
Knowledge Attitude	Knowing what you are doing.	Knowing that you don't know what you are doing.[41]
Chasm Metaphor	Jump across the chasm in one leap.	Build a bridge across the chasm.
Repairing the Ship Metaphor	Rebuilding the ship in dry dock. The dry dock provides the Archimedian point outside the water so the ship can be rebuilt without being disturbed by the conditions at sea.	Repairing the ship at sea. There is no "dry dock" or Archimedian fulcrum for changing social institutions from outside of society. Change always starts with the given historical institutions.
Transplanting the Tree Metaphor	All at once transplantation in a decisive manner to seize the benefits and get over the shock as quickly as possible.	Preparing and wrapping the major roots one at a time (*nemawashi*) to prevent shock to the whole system and improve chances of successful transplantation. [42]

The Chinese were not historically immune to this mentality but they seem to have "got it out of their system" in the Great Leap Forward and the Cultural Revolution. They learned the hard way where that Bolshevik mentality would lead. When they came to choose a path to a market economy, they chose the path of incrementalism (crossing the river by groping for the stones one at a time[43]) and non-ideological pragmatism (the question is not whether the cat is black or white, but whether or not it catches the mice). They had the wisdom to "know they didn't know what they were doing" so they didn't jump off a cliff after being assured by experts that they would be jumping over the chasm in just one more great leap forward.

[41] See Benziger 1996.

[42] See Elster et al. 1998 for the "rebuilding the ship at sea" metaphor and Morita 1986 about *nemawashi.*

[43] See Lin et al. 1996.

In contrast, the Russians have tended towards a more Jacobinic reform regime guided by prophets armed with clean textbook models. They have learned the hard way to appreciate the old saying: "It's not so much what you don't know that can hurt you—but what you know that ain't so."

The CDF and The Presumption for Participation

What is the alternative strategy for change? As social and organizational capital turns out to be so fragile and like Humpty-Dumpty, "hard to put back together again," one can argue that it is best to start with existing social institutions and try to induce their incremental transformation—rather than trying to eliminate them "root-and-branch" in order to start with "a clean sheet of paper."

> An unwillingness to start from where you are ranks as a fallacy of historic proportions;.... It is because the lesson of the past seems to be so clear on this score, because the nature of man so definitely confirms it, that there has been this perhaps tiresome repetition throughout this record: the people must be in on the planning; their existing institutions must be made part of it; self-education of the citizenry is more important than specific projects or physical changes. [Lilienthal 1944, 198]

Why were the reformers so unwilling to start from where they were? Perhaps the simplest explanation is that the post-Soviet reformers saw anything that grew organically out of Soviet or Russian reform attempts as still bearing the stigma of communism. They wanted to make a clean break by using the "window of opportunity" to jump over the abyss to an "advanced model" like in the western textbooks.

We should be clear: there were risks everywhere. The critics of gradual reform worried that the forces at play—the old vested interests—would somehow manage to reassert themselves, unless their power was broken. They worried, too, that the momentum—and the people's taste—for change was limited, and one had to seize the opportunity while one could. Alternatively, there is a long history of gridlock in democratic societies, and for a society in desperate need for change, such gridlock too would prove disastrous.

Perhaps nowhere did these conflicting fears and anxieties play out so much as in the debate over stake-holder (local) privatization, sometimes referred to as "spontaneous" privatization. The term spontaneous might have suggested a natural evolutionary process; a Hayekian might have seen these privatizations as a natural (efficient?) social response to the unfettering of central controls. For decades prior to the actual collapse of communism in 1989-90, reformers had worked in East Europe and in the Soviet Union itself to decentralize power away from the state. Various models of decentralized socialism were promoted starting in Yugoslavia in the early 50's and eventually in many of the countries within the Soviet bloc to a lesser degree. In the late 80's the "destatization" and decentralization spread to the Soviet Union. Some measures of independence and "self-accounting" were extended to state enterprises. New ownership forms such as cooperatives and collective ownership by work collectives were legalized. "The Law on Leasing set up a legal basis for gradual evolution of state ownership: work collectives could now lease enterprises from the state and run them as more or less private entities, according to the market logic." [Plekhanov

1995, 38] These ownership forms were not imposed on managers and workers by the state. They represented the results of experimentation and collective efforts to wrench more control over their lives from the state.[44] By the beginning of 1992, some ten thousand enterprises had become leasehold enterprises.[45] Reformers who recognize that real transformation requires participation and involvement would have welcomed this reform momentum and would have helped it push all the way to full privatization. Yet the western-oriented reformers took the opposite course. In Russia, the leasing movement was stopped dead in its tracks in favor of voucher privatization. Throughout the countries of the former Soviet Union, official announcements emphasized that voucher privatization was necessary to speed up the process—while there were unofficial and private admissions that the leasing movement had to be stopped in order to have something left to go into the voucher auctions.

The leasehold firms, like the TVEs in China or the self-managed firms in Yugoslavia, were far from "perfect" by western standards. A large literature had detailed both the strengths and weaknesses of the Yugoslavian model, and suggested reforms that would improve their performance. A priori, one would have thought that the chances of improving upon the flawed decentralized ownership forms were at least as good as the chances of designing new privatization schemes de novo. But rather than working to improve these ownership forms, to prevent abuses, and to channel these spontaneous energies, the reformers in country after country of the FSU tried to stop dead the "flawed" and "imperfect" bottom-up movements in favor of the top-down voucher programs based on textbook models of publicly traded joint stock companies. Why? Partly they feared that docile or naive workers would let local managers and party bosses strip the assets and weaken or destroy the firms. Partly they felt that reforms under the new political regime should be far more dramatic than the "constrained" evolution that the old structure had allowed. Some undoubtedly approached the reform process with a central planners mentality: how could one "control" a spontaneous privatization process?

Politics and political dynamics were discussed—but political dynamics are even harder to forecast than economic dynamics; the fact that so few foresaw the dynamics of the breakdown of the Soviet empire should have instilled a sense of humility; and the forecast record going from, in the process of transition, seems to have fared no better. Sustainable development requires widespread support; such support inevitably is engendered by a history of successes. Had the *economics* of reform fared better, perhaps so too would have the politics. But today, in Russia, there appears little support for the so-called reformers, and the reforms—at least in the form that they took in recent years. (This does not, however, mean that there is no support for the "market economy" or that the spirit of entrepreneurship has been quashed. The opposition seems to be to the particular manner in which the reforms were conducted.) The reformers claim, to be sure, that it was politics that hindered them: it inhibited the reforms from occurring at the pace and in the manner which they recommended. But this claim has a certain unconvincing ring to it: Remember, one of the key arguments for the pace and sequencing of reforms recommended was

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[44] To be sure, cooperative equilibrium among "local" players does not assure a "national" Pareto efficient outcome, if there are externalities extending beyond the players. But surely, these externality problems seem far smaller than the "free rider" corporate governance problems created under the alternative strategy.

[45] See Frydman et al. 1993.

that it was best *given the political situation.* Clearly, the advocates of shock therapy misjudged the politics.

In the first part of this paper, I also argued that they misjudged the economics. They underplayed the importance of social, organizational, and informational capital; they underestimated the impediments to the creation of new enterprises; and perhaps most importantly, they paid too little attention to the issues of corporate governance. For instance, on the voucher model, real "corporate governance" of the firms would reside in the voucher investment funds sometimes staffed by the political allies of the reformers. (With the later loans-for-shares scheme, this theme of privatizing to provide favors for political allies was "perfected" even if corporate governance was not.) But even when politics did not get involved (and the political involvement should itself be viewed as endogenous, a consequence of opportunities and incentives provided by the process itself), we have seen that there were strong a priori arguments to expect that voucher privatization schemes would face severe corporate governance problems. Stakeholder privatization too could have faced corporate governance problems—after all, "public good" and "free rider" problems arise at the local level as well as the national. But, if the local communities were provided with appropriate incentives (as they were in China), there is at least a prospect that local communities will evolve ways of addressing the issues (as they did in China).

The hardest questions concerning the reform process take us beyond economics, beyond politics, to issues concerning evolution and change in and of society—issues which were given shortshrift in the early debate, and about which we have insufficient evidence to make statements with the confidence that we would like. More research, particularly from the more dispassionate viewpoint of history, is needed to understand the turbulent decade we have just been through. But I do think we can draw some tentative lessons about the methods inducing institutional change—or at the very least, let me put forth some tentative hypotheses: There are certain areas of macro-economic management where central government-initiated action should be the norm. At the other extreme, there are vast domains of institutional transformation that are well outside the reach of central government dictates. And there are, of course, gray areas in between. But economic development and transition is more a matter of institutional transformation than of day-to-day economic management. To be sure, societal transformation inevitably entails *collective* action, but such collective action can take place both within and outside government, and both at the national and local levels. The central level will, inevitably play a large role, but perhaps most effectively by creating environments in which evolutionary processes—including local experimentation—can best occur.

Thus the Comprehensive Development Framework[46] argues for a presumption in favor of inclusion, popular participation, and involvement. Given a choice between the momentum of bottom-up involvement in "flawed" reforms and top-down imposition of what reformers see as "model" institutions, the CDF argues in favor of using our knowledge and experience to work to improve the bottom-up approach to transformation.[47]

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[46] See Wolfensohn 1997, 1998, and 1999.

[47] For instance, in Yingi Qian's study of the Chinese reforms presented at this conference, "the main lesson from the Chinese experience is that considerable growth is possible with sensible but not perfect institutions, and that some 'transitional institutions' can be more effective than the best practice institutions for a period of time because

Conclusion

I remarked at the beginning of this paper that the century coming to a close has been marked by two great economic experiments. The outcome of the first—the socialist/communist experiment that dominated much of the world scene during the century—is now virtually over, and the lessons from that experiment appear clear.

We are in the midst of the second great experiment—the transition from the socialist/communist economies to a market economy. That experiment has not proceeded in the way that many economists had predicted a short decade ago. To be sure, the process of transition is far from over. But it has not been an easy decade for most of the countries, and even China, with all of its successes, faces hard challenges ahead. Russia is a resource rich country, with enormous potential. We know that for societies to function, the State must provide a certain basic minimal level of services, and that it takes resources to provide those services. In all societies, taxes are collected only because governments enforce tax laws, through the right to seize property in the event of a failure to comply. Russia, and the other countries, must show a resolve to enforce the tax laws and to provide the basic services of the State. With compliance, government revenue problems will be resolved—and in doing so, one of the main challenges facing the countries would be effectively addressed. Without compliance, having through bankruptcy and other legal means taken control of assets previously privatized, the governments would face a new opportunity to address some of the key issues, e.g., associated with privatization, once again. Hopefully, this time, those issues would be faced with a better understanding of the broader principles of the market economy and the reform process. Hopefully, the countries—and their advisors—will have learned from the many bitter and disappointing failures—and the few successes—of the past decade.

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of the second-best principle: removing one distortion may be counter-productive in the presence of another distortion." [1999, 6]

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Figure 3: Transition Economies 1997 GDP (Percentage of 1989 GDP)