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Privatization as a Means to Property
Redistribution in Republic of Armenia
and in the Russian Federation



ACADEMIC DISSERTATION

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To my parents

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Chapter One

1.1 INTRODUCTION

Privatization is a popular economic movement in all over the world. Most developed, developing and transitional countries have demonstrated a great interest in privatization. It becomes one of the major reforms in the last decade. In recent years governments of all political stripes, at every level have embraced privatization. Market oriented and socialist governments are exploring the implications of converting state enterprises and services to private ownership. There is no surprise that transitional countries are choosing way of privatization and free market economy. The results of many empirical studies indicate that private sector is more efficient than public sector. The sweeping of global waves of privatization have occupied government and academic around the world since the 1980s. These global waves of privatization have forced many governments to adopt what is now considered as market-oriented reforms.

Initially privatization as public policy was originated by two ultraconservative and ideologically oriented capitalist governments. These were Margaret Thatcher's government in Great Britain and Ronald Reagan's in the United States. They have reached the entire domain of what has traditionally been considered government and public sector functions around the world for several millennia. By their effort privatization has become a much more comprehensive and expansive movement that has infiltrated deep into the core of governmental, public administration and private sector domains around the globe.

Privatization as a fuzzy concept evokes sharp political reactions. It formed a range of ideas and policies, varying from the eminently reasonable to the wildly impractical. Privatization as a policy has unambiguous political origins and objectives. It has emerged from the questions of movements against the growth of government costs in the Western countries, to represent the most serious conservative effort of our time to formulate a positive alternative. Privatization proposals do not concentrate only on return services and goods production to their original location-private sector, but also create new kinds of market relations based on free market attitudes. Thus it is incorrect to define and dismiss the privatization movement as a simple replay of traditional opposition to state intervention and expenditure. The current wave of privatization initiatives can be defined as conflict over the public-private balance.

The act of privatization is at least as symbolic as it is substantive. As an experience in symbolism, it signals the government's intention to respond to the challenges of change by strengthening the market at the expense of the state. As such, privatization initiatives field for the truly substantive elements of this policy set liberalization, and deregulation, as well symbolically it evidences governments' willingness to rethink economic tradition.

Structural re-engineering has meant structural changes and adjustments of the governmental sector in favor of the corporate business dominated market sector in the name of efficiency, decentralization and more. Behind these mega-global trends of qualitative structural transformation are the fundamental underpinnings shaping the phenomenon and process of globalization. A key demand of globalization has been the relentless call for privatization.

Privatization and transfer of government function to the corporate market have become the central strategic component of both globalization and ideological transformation of modern political and economic systems. At this moment, privatization has become pervasive and, at the same time, a

global fashion. Privatization is a fashionable movement, even though studies show mixed results, at the best, for the privatization experience around the world.

It is important to note that public enterprises have played a key role in economic development and industrialization in developed and transitional countries. In fact public enterprises grew throughout the last century up to the end of 80's ideologically oriented turnaround, due to market failures and other fundamental reasons that prompted governments to nationalize sectors of economic and social functions in the first place. Today, most governments of the world have experienced privatization.

The movement for privatization at the present time springs primarily from the concern that many corporations have not been well managed, that they don't have a policy function to fulfill that cannot be fulfilled at less cost to the taxpayer, by some other policy instrument. Also there is growing belief that the effectiveness of public sector corporations in dealing with broad, general economic problems of unemployment, inflation and economic losses, at least in developed countries has already demonstrated.

Privatization in Eastern European countries and Newly Independent States that have been established after USSR collapse is proceeding at a high speed. It has caused dramatic changes in social life, strong effect on the whole economy. Privatization can serve a variety of purposes, from reducing budget deficits to restructuring industries to compete in the European Common Market. Privatization deals with the distribution of property rights, which strongly affect the profitability of enterprises, physical capital and public sector restructuring. However, if developed countries usually use only one privatization method, the former socialist countries are demonstrating the most extensive privatization programs and adopting almost every privatization method available.

There are different points of view, why privatization is adopted by many countries. In some cases, like in former socialist countries, it is a method of rapid conversion of economy from "Plan" or in the end of 80-th unmanageable economy to free market. In developed countries like Canada and Britain it is seen as a way of reducing the cost of government.

In the United States, privatization debates focus on the more different forms of privatization, such as schools and prisons, or on private provisions of infrastructure. With the exception of few very large state enterprises, there are no real candidates for privatization. But despite of wide variance in political motivations, the results from privatizing tend to be similar across nations: higher productivity, a smaller public sector, and savings for the taxpayer.

Privatization reduces the size of government and leaves space for more private sector initiative that will promote market competition and more efficient allocation of resources. It improves company efficiency through market discipline by reducing political and bureaucratic impediments, also in some cases, privatization may encourage individuals to take part in the ownership of major corporations through equity investment.

Therefore, the expansion of privatization has become a central public policy issue in capitalist and former socialist countries for ideological, political, economical and organizational reasons. Like many key public issues, privatization has its advocates and opponents. Each side presents arguments and reasons that may be debated on various grounds. Consequently privatization has become the subject of extensive studies around the world.

The proponents of privatization usually are ascending on such benefits like the competitive market conditions, which are reducing costs of provided products and services. In opposite to public service system consumer and producer have the same access to resources, products and information. There is an ideological factor that makes people to believe that all of them will win in free market field. Privatization processes are increasing public sector and develop market by means of creation of new services and goods. In fact many of the developed countries and some of transitional ones have success in economic, social and political level.

The opponents tell that closer and more critical study of privatization experience in different countries shows conversely picture. They claim that there is no guarantee that private enterprises are always more efficient, they confirm that many of the privatized enterprises were already profitable before they were divested, that the very reason for creating public enterprises was market failure rather than government failure. The same privatization may not promote competition, because often the state enterprises are sold as intact monopolies. That is why concentration and merger are increasing within the private sector itself.

If compare privatization in developed and transitional countries we can see that there are big differences between them. In terms of internal economic implication, in transitional countries the privatization period characterized by worsening conditions of unemployment and declining wages caused by privatization related issues. Such as retrenchment of public employees, withdrawal of minimum wage legislation, price increases caused by market competition and also subsidy and welfare cuts.

And on the contrary developed countries mostly have successful privatization, accomplished by reforms in open markets, remove price and exchange rate distortions, and encourage the development of the private sector through free entry. For successful privatization revenue maximization should not be the primary goal. Far better to eliminate monopoly power and unleash potentially competitive activities than to boost the sales price by divesting into protected markets. Also far better to create regulations to protect consumer welfare than to maximize price by selling into an unregulated market.

Privatization is not a panacea for all economic problems as in developed as in transitional countries, but it can be big push for creating a new relationship between private and public sector. Privatization itself is not a competition, but it leads to create regulatory framework, which ends goal is free market, based on competitive origins.

Below is the explanation how the study has been done. The privatization process in Republic of Armenian and in the Russian Federation is the central point of the research. In order to address the central point properly by studying and analyzing the privatization process in focal countries, its problems and benefits, analyze of the above mentioned process in both countries based on the case study, empirical and statistical studies. The research is prepared and presented in the six chapters of this dissertation.

The first chapter gives a research description. The chapter presents introduction, basic choice, object of the study and research questions. It also includes the theoretical basis and gives a detailed description of the research. Methodologically the chapter clarifies different concepts and theoretically describes the research by reviewing and analyzing the existing literature in the field.

The second chapter pursues studies to pick from the existing stock of theories and models for the study of privatization. Utilize the result of previous researchers theoretical basis, reviewing and analyzing the existing literature and previous empirical research in the field.

The third chapter highlights privatization process in the Russian Federation. Prepared by extensive literature review and content analyses. Analyses are done on finding research cases in the concerned area. The empirical part of the chapter based on observation, content analysis and selected literature survey. Empirical information presented in the chapter reflects years 1990 - 2000.

The forth chapter presents the empirical research of Armenian privatization process. The empirical part of the chapter based mainly on first hand data, then on thematic interviews, field visits observation, content analysis and survey of the selected literature. Empirical information presented in the chapter reflects years 1990 - 2000. Gives the analyze of the Armenian privatization programs, their tasks and goals. Study of the legal and organizational measurements, the role of Western assistance. Exam the existing literature in the field and Armenian privatization process in viewpoint of empirical study. Definition of theory based model that is best explaining the Armenian privatization process.

The fifth chapter includes empirical case study comparisons, which will be carried out in following direction: Armenia and the Russian Federation privatization processes will be compared with each other. These analyses and findings of the fifth chapter estimate differences and similarities of privatization process in Armenia and the Russian Federation.

The sixth chapter summarizes thesis and makes conclusions. The most important cases and findings of the privatization process in Armenian Republic and in the Russian Federation will be shown in this chapter. Final conclusions of this study also will be presented.

1.2 BASIC CHOICE OF THE STUDY

1.2.1 Research problem

Initially, the development of the modern privatization process was related to the shifts in the reproduction mechanism and the structural reconstruction of developed Western economies launched in the second half of 1970s, which required a substantial review of the structure of government regulation of economy formed in the 1950s and 1960s. In the context of these processes a serious reevaluation of the place and the role of public property and state entrepreneurship in the economy took place as reflected via privatization processes developing in the 1980s and 1990s. This phenomenon spread over not only in the majority of Western European countries, where the role of the government was traditionally important, but also in the USA, Japan, and Switzerland, where the public sectors was comparatively small.

Neo-conservative shifts in the ideology, general economic theory, and economic policies of industrial nations were later exported to transitional and developing countries both as ideas spread within the world scientific community, and via direct Western pressure in the framework of international aid. In late 1980s and early 1990s over 80 industrial Western nations and developing countries in Asia, Africa, and Latin America completed or were carrying out various programs for the privatization of state property [Bizaguet, A (1988); Hanke, S.H (1987)]; [Kikeri, S; Nellis, J; Shirley, M (1992)]; [Nellis, J; Shirley, M (1991)]; [Shapiro, C; Willig, M (1990)]; [UNCTAD, (1993)]; [Vickers, J; Yarrow, G (1988)]; [Vuylsteke, Ch (19889)].

Modern works on economy interpret the clarity (definiteness), stability, and predictability of property rights as the key factors behind the economic growth and directly ties stable economic development to these factors [Coase R.H. (1960), pp. 1-44]; [Demsetz H. (1967), pp. 347-359]; [North D.C. (1981)]. At the same time, the role of clearly defined property rights may vary depending on the size of organizations, state or private property, access to information, etc. [Arrow K.J. (1974)]; [Stiglitz J.E. (1994)]; [World Development Report (1998/1999)]; [World Bank, (1998)].

Any concept of the ownership being the basis of any economic system (even in the most abstract terms and however interpreted) per se assumes that (1) transformations related to the ownership sphere in transition from one economic system to another shall be on systemic nature, (2) the reform in general in the framework of a transition economy must also be of the systemic nature. This, in particular, is the principal distinction of the privatization process as the quintessence of the ownership reform in the framework of transition economy from any privatization measures implemented in the Western and developing countries.

If in most capitalist countries privatization proceeds by using different but well known models, in former socialist countries transition to market relations by transformation of former socialist productive and economic bases began and prolonged to develop in different social and economic, political, historical and other conditions. Last largely determine this or that form selected by country, model of reforms and ways of their implementation, policy of transition and specific factors, determining it. During the transition central place is allocated to privatization that leads to prices and markets liberalization, appearance of new private firms and implementation of such economical programs, that will supply or will keep, already reached stable economical level.

The problems in former socialist world are connected with changes and development of the property right, frame of work motives and also private sector creation, which will dominate in economics. Launching conditions of the given country also important. In a number of countries with transient economics privatization can be more actual than in others.

The examination of available literature leads as to better understanding of the advantages and pitfalls of privatization process and its impact on enterprise efficiency help us to find the issues-subject for new research into case understanding of the processes in focal countries.

Several studies were carried out in industrial and developing countries in order to determine the impact of privatization empirically. According to the Sunita Kikeri and John Nellis in "Privatization in Competitive Sectors: The Record So Far" the impacts of privatization, and supporting studies, can be grouped into five categories:

§ First, most studies assessments of privatization have looked at financial and operational performance at the enterprise level, comparing productivity and profitability before and after sale, changes in output, investments and capacity utilization. These studies provide ample evidence that, when done right, privatization improves performance in many different settings in many different ways.

§ Second, there is a limited but growing quantity of work about the fiscal and macroeconomic effects of privatization showing positive fiscal benefits and a high correlation between privatization and growth.

- § Third, broader welfare and economic consequences of privatization are not as widely studied though the few rigorous evaluations' show that privatization has done well, and that the welfare effects when compared to realistic counterfactuals have been positive, often substantially so.
- § Fourth, growing analysis of the employment and broader labor market impacts shows that privatization does not always lead to unemployment, but that the outcomes are mixed, reflecting country and industry differences.
- § Fifth, the effects of privatization on income and wealth distribution are the least studied aspects of privatization though considerable work on these questions is now in progress.

The studies undertaken in industrial economies largely attributed superior efficiency of private over public firms to market structure rather than to ownership.

Dewenter, Kathryn, and Paul H. Malatesta. (1997). "Public Offerings of State-Owned and Privately-Owned Enterprises: An International Comparison." *Journal of Finance*. 52: 1659-1679 uses data from 8 countries (Canada, France, Hungary, Japan, Malaysia, Poland, Thailand and UK) to compare initial returns of 109 companies with national average returns. Also tested whether PIPOs are more or less under priced than private sector IPO's. Results vary according to the countries: the UK shows significantly higher initial returns on PIPOs than private sector IPO's, while Canada and Malaysia point to the opposite case. Also PIPOs in unregulated industries tend to be less than those for regulated industries. There is, therefore, no evidence that governments systematically under price PIPOs. Relatively primitive capital markets (in this case Hungary, Malaysia, Poland and Thailand) leads to the tendency of higher initial returns than offered in countries with more developed capital markets. The authors suggested that this is due to an increased uncertainty that about the value of privatization offers leading to lower offer prices. Another suggestion is that these countries with relatively primitive capital markets may try to broaden private share ownership by decreasing the initially offered price.

D'Souza, Juliet, and William L. Megginson. (1999). "The Financial and Operating Performance of Newly Privatized Firms in the 1990s." *Journal of Finance*. 54: 1397. The paper documents are offering terms, method of sale, and ownership structure resulting from privatization of 78 companies (mostly from telecommunications and other regulated industries) from 10 developing and 15 developed countries over the period 1990-1994. The study compares three-year average post-privatization financial and operating performance ratios to the three-year pre-privatization values for a sub-sample of 26 firms. It concludes that there were economically and statistically significant post-privatization increases in output (real sales), operating efficiency, and profitability, as well as significant decrease in leverage. Capital investments spending are slightly increased, while employment declined significantly.

Megginson, William, Robert Nash, and Matthias van Randenborgh. (1994). "The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis." *Journal of Finance*. 49: 403-452 compares both pre-and post-privatization 3-year average performance ratios of 61 firms in 18 countries over the period 1961-1989. Significant increases in output, operating efficiency, profitability, capital investment spending and dividend payments are found along with significant decreases in leverage. The changes in employment after privatization are found to be insignificant.

While few studies of developing countries revealed marginal efficiency differences between public and private firms [*Kikeri et al., (1994)*].

Boubakri, Narjess, and Jean-Claude Cosset. (1998). "The Financial and Operating Performance of Newly Privatized Firms: Evidence From Developing Countries." *Journal of Finance*. 53: 1081-1110. The study examines post-privatization financial and operating performance of 79 companies in 21 developing countries and 32 industries between 1980 and 1992. The study concludes that there are economically and statistically significant post-privatization increases in output (real sales), operating efficiency, profitability, capital investment spending, dividend payments, and employment as well as significant decreases in leverage. About 60 percent of sample firms showed an increase in employment of 5-10 percent after privatization. Real sales per employee increased by 27 percent. Unadjusted net income per employee increased on average by 63 percent.

Davis, Jeffrey, Rolando Ossowski, Thomas Richardson and Steven Barnett. (2000). "Fiscal and Macroeconomic Aspects of Privatization." IMF Occasional Paper No. 194. Washington D.C.: International Monetary Fund. This paper separates the possible fiscal and other macroeconomic impacts of privatization. The study finds that receipts of privatization are saved rather than spent. Over time the fiscal situation is improved by privatization with positive impacts upon revenue and for some countries a large decline in deficits. In terms of growth private firms are found to be more efficient than those run by the state, especially in competitive industries. The strong correlation that exists between growth and privatization may be because privatization is a proxy for the more general factor of 'favorable regime change'. The authors also find that unemployment falls after privatization, but that it may have detrimental impacts on particular groups of workers. Overall the positive effects of privatization on growth and employment hold for all countries examined, although to a lesser extent in transition economies.

Shirley, Mary M. (1998). "Why Performance Contracts for State-Owned Enterprises Haven't Worked." *Public Policy for the Private Sector Note 150*. Washington D.C.: The World Bank. A study of performance contracts, looking at 12 enterprises in 6 developing countries. This study shows that only few cases actually improved performance (in terms of labor productivity and total factor productivity) after signing performance contracts. On the whole performance was unchanged, with a few enterprises actually showing declining performance. The contracts are found to have many flaws in that they assign soft or inappropriate measures of economic performance (e.g. output – which takes no account for productivity and can therefore lead to inefficiency in achieving the goal).

To combat these problems contracts must reduce the information advantage of managers over owners, and thus lead to appropriate targets being set. Incentives provided to managers must also motivate them. Many contracts in the study do not include either bonuses or punishments for under-achievement. Lastly, the bonuses that are included must be enforceable. Contracts in the study that included bonuses did not allow the managers to take the state to court if they failed to pay. Once these three items are included in a contract it has been shown that performance improves.

<http://www.worldbank.org/html/fpd/notes/150/150shirl.pdf>

A number of studies were made for privatization in transition economies. As Frydman, Gray, Hessel & Rapaczynski (1997) point out, the post-communist transition environment, ripe with transition shocks and characterized by far from equilibrium conditions offers a unique testing ground for hypotheses concerning the role of ownership in corporate behavior and performance.

Barberis, Nicholas, Maxim Boycko, Andrei Shleifer, and Natalia Tsukanova. (1996). "How Does Privatization Work? Evidence From the Russian Shops." *Journal of Political Economy*. 104: 764-790. The study surveys 452 Russian firms that were sound at the beginning of the 1990s and attempts to measure the relative importance of the channels through which privatization can

promote restructuring. The authors find that new owners and managers increase the chance of restructuring that increases the value. They emphasize the importance of new human capital in the restructuring process and find that equity incentives do not improve performance.

Black, Bernard, Reinier Kraakman, and Anna Tarassova. Forthcoming. "Russian Privatization and Corporate Governance: What Went Wrong?" *Stanford Law Review*. A descriptive survey of the history of privatization in Russia. Several specific cases are analyzed in details. The authors find that privatization has created a "kleptocracy" and has failed. They emphasize the importance of decreasing incentives for self-dealing when programs of privatization are designed.

Brada, Josef C. (1996). "Privatization is Transition Or is It?" *Journal of Economic Perspectives*. 10: 67-86. This study sets out the different methods of privatization. Privatization can occur in a number of ways, through restitution, sale of state property, mass or voucher privatization. The author finds that there are two key lessons when take a look at privatization in transition economies. First the method of privatization must vary according to the specific SOE and no "grand design" can be drawn up for privatizing a host of enterprises. In some cases the majority of SOEs can only be realistically privatized by giving them away. The second lesson is that it is difficult to achieve ownership by outsiders.

Djankov, Simeon. (1999a). "Ownership Structure and Enterprise Restructuring in Six Newly Independent States." *Comparative Economic Studies*. 41(1): 75-95. The author examines the relationship between ownership structure and firm restructuring for Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia and Ukraine. The sample contains 960 firms privatized between 1995 and 1997 in these countries. It is found that when foreign ownership is significant (greater than 30 percent), it is positively related to restructuring. Managerial ownership is positively related to restructuring at low levels (less than 10 percent) and high levels of ownership, but is negative in between. Employee ownership is found to be insignificant except at low levels of ownership where it has a positive effect.

Djankov, Simeon, and Peter Murrell. (2000). *The Determinants of Enterprise Restructuring in Transition: An Assessment of the Evidence*. Washington D.C.: The World Bank [Djankov, Simeon, and Peter Murrell. (2000). "Enterprise Restructuring in Transition: A Quantitative Survey." Washington D.C.: The World Bank]. The authors identified more than 125 empirical studies that examine the determinants of enterprise restructuring. This paper provides a comprehensive review of the empirical results of privatization in transition economies using the data generated by these studies. Private ownership produces more restructuring than state-ownership in Central and Eastern Europe. On the contrary, evidence is mixed for the Common Wealth of Independent Sates (CIS) countries. The privatization effect in the non-CIS countries is more than twice the size of that in the CIS countries. Privatization for foreign owners is ten times as productive as privatization to diffuse individual owners. State ownership within traditional state firms is the least effective type of ownership. State ownership in commercialized enterprises, however, is quite effective. Product market competition has been a major force behind improvements in enterprise productivity in transition economies. Privatization, hardened budget constraints, and product market competition all appears to be important determinants of enterprise restructuring in non-CIS countries, while they are less obviously so in the CIS. The evidence suggests that the difference in impact is due to the varying degree of institutional development between the regions.

Earle, John. (1998). "Post-Privatization Ownership and Productivity in Russian Industrial Enterprises." SITE Working Paper 127. Stockholm, Sweden: Stockholm Institute of Transition Economics looks into the ownership structure and its impact upon labor productivity in Russian

industrial firms. The survey sample includes 86 firms that were 100% state-owned, 299 that were partially privatized and 45 that were newly created. The 1994 survey data examines the impacts of insider, outsider or state ownership upon the performance of the firm. The authors use ordinary least squares regression to show a positive effect of increased private ownership upon labor productivity. However only outsider ownership is significantly related with such changes. The authors conclude that placing insiders in control of a firm has negative long-run implications for restructuring.

Fischer, Stanley, and Ratna Sahay. (2000). "The Transition Economies After Ten Years." IMF Working Paper WP/00/30. Washington D.C.: International Monetary Fund. The paper summarizes the macro-economic performance of the transition economies, accounting for the widely differing outcomes in the 25 countries covered in the study. The most successful transition economies are those that have both stabilized and undertaken comprehensive reforms, and the more and faster reforms are better than less and slower reforms. The study concludes that both stabilization policies and structural reforms, in particular privatization, contribute to growth.

It is tempting to conclude that the general market and competitive environment is more important than the method of privatization. Eventually, evidence may support this, but the research so far does not permit such a conclusion. Two findings argue in favor of it: (I) start-up firms outperform no matter what privatization method is used; and (ii) the success of Central European private sector development relative to the former Soviet Union countries partly reflects a better property rights and business environment. Perhaps the most important lesson after a decade of transition in the centrally planned economies to market-oriented systems is that private sector development can surely be rated a success. Despite a handful of reversals as well as slowdown in 1998, most transition countries are now recording positive growth in output-the bottom line indicator of trends in efficiency. <http://www.imf.org/external/pubs/ft/wp/1999/wp9906.pdf>

Nellis, John. (1999). "Time to Rethink Privatization in Transition Economies?" IFC Discussion Paper 38. Washington D.C.: International Finance Corporation. The paper reviews the accomplishments and shortcomings of privatization in transition economies. Countries in Central and Eastern Europe and the Baltic States - closer geographically, historically and culturally to Western commercial traditions and markets - have generally privatized more swiftly and with much better results than their more Eastern counterparts. Too much was expected and promised of privatization in institutionally weak transition economies where the speedy, massive, insider-oriented forms of privatization have generally, so far, not led to the restructuring required to allow firms to survive and thrive in competitive market operations. Re-nationalization would be a desperate measure, with a high likelihood of failure because the forces and conditions that lead governments to fail in privatization are the same that prevent effective and efficient SOE management. <http://www.ifc.org/economics/pubs/dp38/dp38.pdf>

Sachs, Jeffrey, Clifford Zinnes, and Yair Eilat. (2000). "The Gains from Privatization in Transition Economies: Is Change of Ownership Enough?" CAER Discussion Paper 63. Cambridge, MA: Harvard Institute for International Development. The authors examine the empirical evidence across 24 countries to determine whether change-of-title alone has been sufficient to achieve economic performance gains or whether other factors (e.g. institutions to address agency issues, hardening budget constraints, market competitiveness, and depoliticization of firm objectives as well as the implementation challenge of developing institutions and a regulatory framework to address them) are important. Privatization involving change-of-title alone is not enough to generate economic performance improvements.

While reforms directed at prudential regulation, corporate governance, hardening of enterprise budget constraints, management objectives, and developing capital markets contribute to economic

performance on their own, the real gains to privatization come from complementing the above with change-of-title reforms. The higher the level of prerequisite reforms, the more positive is the economic performance impact from an increase in change-of-title privatization. In fact the study finds a threshold level of reforms in order for change-of-title privatization to have a positive economic performance response. The conclusion is that while ownership matters, institutions matter as much. <http://www.hiid.harvard.edu/caer2/htm/content/papers/confpubs/paper63/paper63.pdf>

Meggison, William L., and Jeffrey M. Netter. (2001). "From State to Market: A Survey of Empirical Studies of Privatization." Mimeo. Forthcoming in *Journal of Economic Literature*. The paper surveys the rapidly growing literature on privatization, attempts to frame and answer the key questions this stream of research has addressed, and then describes some of its lessons on the promise and perils of state-owned assets. The paper identifies the following main lessons from the literature on privatization: The privatization programs of the last 20 years have reduced the role of SOEs in the economic life of most countries. Most of this reduction in developing countries has taken place only in the 1990s. The SOE share of "global GDP" has declined from more than 10 percent in 1979 to less than 6 percent today.

Privately owned firms are more efficient and more profitable than comparable state-owned firms. There is limited empirical evidence, especially from China, that suggests that non-privatizing reform measures - such as price deregulation, market liberalization, and increased use of incentives - can improve the efficiency of SOEs, but it also seems likely that these reforms would be even more effective if coupled with privatization.

<http://www.aei.brookings.org/publications/related/privatization.pdf>

Sheshinski, Eytan and Luis Felipe Lopez-Calva. (1999). "Privatization and its Benefits: Theory and Evidence." Development Discussion Paper 698. Cambridge, MA: Harvard Institute for International Development. The paper reviews the micro and macroeconomic effects of privatization based on a survey of the empirical literature. The evidence shows that privatized firms improve their profitability after the sale, even controlling for macroeconomic and industry specific factors. This result holds for different market structures. Deregulation policies speed up the convergence process of firms to industry standards. Partial privatization has a lower effect on profitability when compared with full privatization. Microeconomic evidence confirms that the introduction of competition enhances productivity gains. Firms in more concentrated and regulated markets, though they also go through an important restructuring after the sale, show lower increases in productivity as compared to those that are under market discipline. Eliminating restrictions to foreign direct investment and trade barriers, and government controls on prices and quantities fuels the catch-up of firms to competitive standards. The budget deficit shows a positive trend, i.e., it declines during the reform period. <http://www.hiid.harvard.edu/projects/caer/papers/paper35.pdf>

Shirley, Mary, and Patrick Walsh. (2000). "Public vs. Private Ownership: The Current State of the Debate." World Bank Policy Research Working Paper 2420. Washington, D.C.: World Bank. The paper reviews the debate over state ownership by searching theoretical and empirical studies for answers to the following questions: (i) Does competition matter more than ownership? (ii) Are SOEs more subject to welfare reducing interventions by government than private firms? (iii) Do SOEs suffer more from corporate governance problems than private firms?

Theoretical studies are ambiguous about the effects of ownership. Empirical literature, however, suggests that while market structure has a positive impact on performance, this impact fails to dominate the ownership effect. The arguments that market-structure dominates rests on cases in which public and private firms in competitive environments perform equally well and these cases are rare. Both the theoretical and empirical literature is ambiguous about the effects of ownership

in monopoly markets. Theories that assume a welfare maximizing government suggest that SOEs can correct market failures, but public choice theories are skeptical of these type government models. Corporate governance theories suggest that even well intentioned governments may not be able to assure that SOE managers do their bidding. The empirical literature favors the latter view of SOEs. In studies of industrialized countries, where we might expect more developed political markets to motivate greater government concern with welfare maximization or better information and incentives to overcome corporate governance problems, private firms still have an advantage. Theoretical critiques of privatization suggest that distorted objectives, market failures and poor institutions will lead to costly failures. Some of these studies suffer from the absence of a realistic SOE counterfactual or are extrapolating from a few, prominent cases, such as Russia. The 21 empirical studies cited in this paper suggest that most firms do better and all firms at least as well after privatization. None of the studies find that performance would be better had they not been privatized. <http://econ.worldbank.org/files/1175wps2420.pdf>

In Ashot Markossian's, Ministry of Privatization of Armenia and David M. Spira's, International Business and Technical Consultants, Inc. (IBTCI) study "Mass privatization in Armenia" (February 1999) discussed the mass privatization program by extremely successful accounts and tradable vouchers, received by citizens which could be used in a variety of privatization mechanisms for the purchase of medium and large enterprises as well as small businesses. But they argue that in certain instances, privatization was completed without the appropriate industry-specific regulatory framework in place, leading to misunderstandings between the Government, the companies involved and the general population. Last, finally many privatization transactions have been based on investment commitments that the Government is unable or unwilling to ensure.

On the whole, the privatization (both large and small-scale), legislation (laws, legal institutions, their fullness and enforcement effectiveness), the soundness of the financial system (financial intermediaries), and the role of the government are analyzed as a rule in order to compare progress in the area of institutional transformations in a transition economy. Shifts in the ownership structure in a transition economy are traditionally classified as the core of institutional transformations. *[From plan to market. World Development Report (1996); Transition Report (1998)].*

Dr Stephen Fortescue (1998) in "Privatization, corporate governance and enterprise performance in Russia" has researched the following key issues: who as a result of privatization obtained ownership of Russian industrial assets, and are they appropriate owners; can new owners, particularly if they are appropriate owners, exercise their ownership rights; and has privatization led to improvements in enterprise performance? The paper dealt with privatization only within the industrial sector thereby ignoring the highly controversial privatization of the energy and utility sectors. The author find out that suggestion that the designers of privatization were somehow conned into handing ownership over to managers does not stand up. The research shows that managers-owners are improving their ability to exercise and enforce their ownership rights. Also author has found that there are some small indications, at both macro-and micro-levels, of a positive correlation between private ownership and good performance. With time that correlation could well become stronger and more evident.

Yuri Perevalov, Ilya Gimadii & Vladimir Dobradei in "Does Privatization Improve Performance of Industrial Enterprises? Empirical Evidence From Russia" conclude that privatization 'on average' produces little improvement in performance of Russian enterprises. However, desegregating the process, they reveal that methods of privatization do influence performance but the impact is not always positive. The state seems to be a passive shareholder. At the same time, they results suggest that majority state ownership is preferable to a state minority stockholding, possibly because the

absence of a monitoring shareholder in the latter case does not permit managers to achieve their own objectives at the expense of other shareholders. [*Post-Communist Economies, Vol. 12, No.3, (2000)*]

A different approach is used in another ongoing study on the impact of Russian privatization. Saul and Estrin analyze the ownership structure that emerged from that process using information from a July 1994 sample survey of over 400 states privately owned manufacturing companies.

They document the large fraction of shares transferred to insiders and also analyze the holdings of the state. In the study, Saul and Estrin are distinguishing among the following categories: the state, workers, managers, and different types of outside investors. Among other points, through multivariate techniques, they also explore the implications of alternative privatization methods for ownership structure and the effects of ownership structure on enterprise performance (measured by labor productivity).

They found that, while it is true that privatization in Russia has benefited mostly insiders, outsider shareholders may wield more clout than generally thought. The reasons are following: outsiders are unequally distributed across companies and, in a significant fraction of firms, their stakes are much higher than average; outsiders tend to invest in somewhat larger companies which raises the proportion of capital they may influence; non-voting shares limit the control rights of inside and state shareholders; that citizens ultimately placed a relatively large fraction of vouchers with Investment Funds and that, as the 10 percent limit on fund ownership in any one company is not being enforced, outsiders holding concentrated blocks of shares may have some measure of control over insiders.

In to controversial of that ideas in the framework of the technological paradigm, including the neo-classical theory (in terms of Williamson [*Williamson, O (1990)*]), it is assumed that the relationship between the type of ownership and the effectiveness (results of an activity) of an enterprise is of no substantial importance. It is also assumed that the market structure and competition are much more important for the effectiveness of an enterprise than who is the owner of assets. At the same time, Yarrow notes, “the competitive and regulatory environment is more important than the question of ownership per se. In competitive markets there is a presumption in favor of private ownership. [*Yarrow, G (1986)*].

Due to this fact, the evaluation of advantages private enterprises have over public ones became a separate principal problem. In more narrow terms, it is the problem of the positive impact privatization has on the effectiveness of enterprises. The majority of researchers tend to answer this question positively; however, the consensus has not been reached yet (there is a vast number of both theoretical and empirical studies of the problem). There are at least several approaches favoring private enterprises:

- social: public enterprises are the instrument aimed to “heal” market flaws by implementing price policies taking into account social marginal prices [*Shapiro, Willig, (1988)*]. These functions and costs adversely affect the effectiveness of enterprises;
- political: political (bureaucratic) interference in enterprises' activities results in over-employment, non-optimal choice of products, non-optimal placement of investments and their shortages, unclear incentives for managers. These enterprises are more susceptible to pressure exerted by interest groups to the detriment of profit maximization [*Shleifer, Vishny, (1994)*];

- competitive: privatization facilitates competition, which makes enterprises work more effectively. Private enterprises better accept the discipline of commercial financial markets [*Kikeri, Nellis, Shirley, (1992)*];

- stimulating: managers of public enterprises may lack necessary incentives of effective work, or may be poorly controlled [*Vickers, Yarrow, (1988)*];

In spite of the broad range of development levels, concrete motives of privatization (budgetary revenues, rehabilitation of state finances, higher effectiveness of economy, revival of competition, management reform, specialization and demonopolization, ideology (for instance, “people's capitalism”), attraction of foreign investment), legal and economic traditions, political and ideological doctrines, all these countries share a key feature requiring no comment: privatization is carried out in the framework of already existing market and competitive environment, when the private sector is already present (dominant), and in the course of progressive evolutionary development of the economy.

Until these days the Russian privatization program is considered as a highly controversial. Some allege that it has been purely cosmetic, at best meaningless and at worst contributing to the criminalization of Russia's economy. Besides the blatant corruption associated with some transactions, the most criticized aspect of the program regards the massive advantages given to enterprise managers and other employees in acquiring shares in firms in which they work. Indeed, the rate of employee ownership that has emerged from the privatization process is huge by any standard. Given most enterprises urgent need for extensive and painful restructuring, a program that has so actively promoted inside ownership and discouraged outsiders entry would hardly seem appropriate. [*John S. Earle (1999)*].

Other observers have defended Russian program as the best that was politically feasible. [for example, the views of Russia's securities commission chairman, Dmitry Vasiliev, in *Economic Reform Today*, No. 1, (1999)]. Taking into consideration continued communist domination of the Duma and the lack of an organized lobby for outsider privatization whether through sales to core investors or through a Czech-style voucher scheme the only alternative to continued state ownership could be to cede majority control to insiders. According to this view, the program has at least led to improved corporate governance and restructuring by “depoliticizing” the enterprise-state relationship. It has also created some openings for outside investors.

Only limited information has been available concerning the results of the privatization process for the structure of corporate ownership in Russia and Armenia. In Russia the State Property Committee (GKI) released data on the number of privatizations, including some of their characteristics, but little on the actual ownership results. In Armenia the same function carries out Ministry of Privatization. The State Statistics Committee (Goskomstat) records about 122,000 “changes of ownership type,” but the only published classification divides firms only into the very general categories of “state,” “mixed,” and “private.”

The Russian privatization program has benefited from relatively little systematic research. The Russian government has not published detailed information on the methods that were used or on the ownership structures that resulted. While a number of surveys have given a fairly consistent picture of the basic ownership structure most importantly the heavy tilt towards employee ownership the research was based on very small and usually non-random samples, and most of the information was collected while the privatization process was still well underway. [*Blasi (1994, 1995, 1996) Earle, Estrin, and Leshchenko (1996); Earle and Estrin (1997)*]

Such data problems have also greatly reduced the value of efforts to relate privatization to subsequent firm restructuring and efficiency performance. Yet the scarcity of information has not prevented a number of economists from passing quick judgement. [J. David Brown, John S. Earle (1999)]

Although there have been a number of studies of industrial enterprises in Russia, most of them used small, unrepresentative samples. They also have focused on the firms participating in the State Privatization Program (SPP). The World Bank conducted the largest and most representative survey in July 1994 at the close of the voucher privatization process. The World Bank's findings with respect to the SPP are generally consistent with other studies, and showed a clear predominance of insider ownership at 56.3% of all shares. Outsiders had 23.3% and the state had 20.4%. [John S. Earle (1999)].

About Armenian privatization process very less scientific literature is available and only some statistic data provided by State Statistic Committee and World Bank reports begin from 1994. Also some research made by USAID and CEPRA for interim use.

Privatization of state assets in any country is accomplishing with many problems. From the presented above data we see the problems were meet, superior efficiency in private over public firms to market structure, economic benefits from privatization of SOEs; government policies concerning competition and regulation in the context of economic and political objectives; role of ownership in corporate behavior and performance; the improvement of private ownership corporate revenue performance; labor productivity grow in privatized firms; privatization impact on enterprise efficiency; effects of private ownership on several types of restructuring behavior and on labor etc.

Keeping in mind the above researched problems we see that issues related privatization are many, in spite of the vast literature on privatization in transition economies, the previous researchers are indicative of the tentativeness of the basic conclusions reached through empirical research. There still is a long way to go in terms of ascertaining the impacts of different approaches to privatization and what the effects on the economies have been. Probably the situation could not be different.

There are many studies on privatization issues, however, these studies insufficiently cover the subject of this paper "*Privatization as a means to state property redistribution in Republic of Armenia and in the Russian Federation*".

Privatization is the logical starting point of an analysis of the transformation of property relations in a transition economy. The comparison between Russian and Armenian privatization implementation and post privatization enterprises performance will bring new ideas in the vast quantity of literature about privatization and property rights transformation. But at the same time it is necessary to regard the privatization process as a whole, i.e. not only as technical procedures of sales (transfers) of assets from the public sector to the private one, but also as a more fundamental process of the emergence of private property and the formation of institutional prerequisites for further development of market environment.

This study was conducted to understand *when* and *how* privatization works. This question is actual because many developing countries only began to undertake large-scale privatization in the 1990s [Ramamurti, (1999)]. The results of this study should, therefore, be of interest to investors, government policy makers as well as officials of international agencies, such as the World Bank and the International Monetary Fund, by providing insights on the way privatization works.

Over the last decade, many studies have attempted to explain the extent of variation and the conditions under which privatization programs will be implemented. Most of the research derives its findings from case studies that focus on a particular region or sector. As such, this thesis seeks to fill in the lacuna of understanding about privatization across time in transitional countries. The first question asked deals with the extent of privatization: When and what factors motivate a government to privatize? The second set of related questions addresses the quality or nature of privatization.

Distinct from the question of *when* governments privatize is the matter of *how* governments privatize. The most common methods of privatization are mass privatization, direct sales to strategic investors, public offerings of shares, mixed sales and concession agreements. The most significant distinction among these various methods is whether governments sell the enterprise through public means (share issue privatizations, vouchers or public auctions) or private means (joint ventures, direct sales to strategic investors, trade sells or book sales). The results suggest that poorer transitional countries with low levels of market capitalization but with higher rates of completed privatizations used public share offerings more than private sales. Governments headed by an “executive” (president or prime minister) whose party commands majority control of the legislature also preferred to privatize using share issue privatizations. In contrast, governments with higher levels of financing from the IMF chose to privatize a greater share of their privatizations with private sales.

Another little studied dimension of the quality and method of privatization is the amount or stake of the enterprise sold. Political and economic factors also influence a government’s decision to sell a majority stake of the state owned enterprises. Results derived from probability analysis suggest that on average, democratic governments with higher rates of completed privatization programs, higher levels of investment and consumption are more likely to sell a minority share (less than 50%) of any given state owned enterprise.

That seemed as excellent political reasons, the emphasis was usually on massive, speedy transactions with substantial ownership stakes awarded to “insider” stakeholders. The reason was that one needed to cut the links between the enterprises and the state and to create swiftly a mass of private property owners; and that the only feasible way to do this was offering substantial ownership stakes to workers and managers in the firms being privatized. If these powerful insiders were not rewarded, and quickly, it was thought they would block indefinitely the privatization and transition processes.

Is these instances, the speedy, massive, insider-oriented forms of privatization have generally so far, led to the restructuring required to allow firms to survive and thrive in competitive market environment.

Worldwide is increasing evidence, that privatization improves firm performance. But in some institutionally-weak transition economies, ownership change has so far not delivered on its promise. Why mass and rapid privatization schemes turned over mediocre assets to people lacking the incentives, skills and resources to manage them well. Because most of high-quality assets have ended up in the hands of the resourceful, agile and well-connected few, who for a variety of reasons have tended not to embark on the thorough restructuring that might have justified their acquisition of the assets. In an institutional vacuum privatization can and has led to stagnation and decapitalization rather than to better financial results and increased efficiency.

Several studies have recently documented a performance improvement of newly privatized firms in transitional countries. These studies have shown that the outcomes of privatization tend to vary with the level of country development. In my study I have been researching the determinants of performance changes in Armenia and Russia. I conjecture that, in order to explain how privatization works in such an environment, I need to account the ongoing economic reforms in transitional countries, such as stock market and trade liberalization policies, all of which could affect the outcome of privatization. The set of factors is particularly important as it fundamentally distinguishes privatization in transitional countries from that in developed ones since privatization in transitional countries is generally implemented as part of a broader program of structural adjustment involving other concomitant economic reforms. For example, stock market and trade liberalization could create stronger competition and higher growth rates likely to spur performance improvements.

Most technical assessments classify privatization as a success. But privatization, especially in transitional and developing economies, is seen as fundamentally unfair both in conception and execution, and it is widely and increasingly unpopular. I have studied about the distributional effects of privatization in focal countries, focusing on changes in asset ownership, employment and returns to citizens, access to and prices of utility/infrastructure services, and the selling government's fiscal position. I set out a simple framework for assessing the equity (or fairness) and efficiency gained from privatization, and for understanding any trade-off between the two.

This study does not attempt to address the entire range of concerns and criticisms of privatization. Not less ambitious objective is to study the accomplishments and shortcomings of privatization in transition economies where the scope and pace of privatization has been larger than elsewhere, where the expectations surrounding the concept were so great, and where some problems of magnitude have surfaced. The study looks into where and why unsatisfactory performance has been found, and discusses what the effected transition governments, and those who assist them, should do about it.

1.2.2 Research questions

Keeping in mind the above practical problems, the research problem in this study is “*How does privatization works in case of state property redistribution and what final result it has?*” The following research questions are raised in order to answer this problem:

- § When and how does privatization works?
- § The goals of privatization and various methods used to achieve them in Republic of Armenia and in the Russian Federation.
- § Economic and political effectiveness of various forms of privatization implemented in focal countries.
- § The determinants of performance changes of newly privatized firms by focusing on the specific environment of transitional countries.

1.2.3 The object of the study

In this thesis I have studied the goals of privatization and evaluated various methods used to achieve them in different transition settings. The task is not only to summarize the policy lessons of experience to date with privatization of small, medium and large enterprises in transforming socialist economies. It attempts to research the complex and intertwined goals of privatization of various methods used to privatize state enterprises and progress achieved to this date in Russia and Armenia.

This thesis focuses on the effectiveness and economic impacts of various forms of privatization, their political impacts including their perceived fairness, their political legitimacy, the extent to which they create new decentralized centers of political power, and their contribution toward creating a class of property owners who favor and support continued liberalization and reforms.

The purpose of this thesis is also to contribute to understanding of the impact of the Russian and Armenian privatization process through an empirical investigation of its effects on the performance of industrial enterprises.

It should be highlighted that the study was dealing with privatization mostly within the industrial sector thereby ignoring the highly controversial privatization of the energy and utility sectors.

1.2.4 Point of view

There are different points of view for privatization process. I have been choosing the citizens point of view on privatization in Armenia and Russia. The perception of many citizens, analysis and a number of leaders in transition settings, especially in the FSU, as well as a set of knowledgeable external observers, is something quite close to the following: So far too many privatization transactions, too many transition countries, mass and rapid privatization has turned over mediocre assets to large numbers of citizens who have neither the skills nor the financial resources to run them well. Most high-quality assets were sometimes by “spontaneous privatization” that preceded official schemes; sometimes by manipulation of the voucher schemes; perhaps most often and acutely in the non-voucher second phases or in secondary trading gone to the resourceful, agile and politically well-connected few. In many instances where ordinary citizens managed to obtain and hold minority blocks of shares in the high-quality firms, they have been induced to turn over these shares to others at modest prices, or sell them for daily expenses. I can conclude that while privatization may be generally beneficial from the viewpoint of the shareholders, and perhaps the selling state, it has not proved so from the standpoint of society, or at least from the standpoint of significant groups of generally poor and powerless actors in society. Ordinary citizens did not resave any visible wealth from privatization, in fact that the mass privatization with voucher scheme was made for equal access for all population.

1.3 THEORETICAL BACKGRPUND OF THE RESEARCH

At the present day there is well-known two terms “public ownership” and “private enterprise”. They suggest two discrete and very different ways of structuring economic activity and utilizing productive assets. The public enterprise government officials possess intimate knowledge of the working of the enterprise, and public enterprise is motivated to satisfy the goals of the public management. While private enterprises are subject to carefully crafted taxes, subsidies, controlled by private parties, and motivated to maximize profits, subject to whatever government regulation is imposed on it. It is possible to differ public and private enterprises by differentiation of goals, because the public enterprise could be subjected to various forms of regulation directed to serve entirely public goals, while private ones are entirely profit oriented. [*Carl Shapiro and Robert D. Willing pp. 1-3*].

Privatization is undertaken to increase the productive efficiency of the respective enterprises. Can this efficiency be achieved by divestiture or could be obtain the same results if the enterprise were to remain in public ownership were “adequately restructured.” This question has often been raised because empirical investigations comparing the performance of private and public firms typically fail to prove that it is ownership per se which reduces inefficiency rater than competition, a new

business environment, new active management, regulatory changes, or the reduction of trade union power. [Bös, D. (1991), pp.50-8]

Opponents to the sale of public property thus argue that all results from the sale of assets can be achieved by a package of measures, which restructure the public enterprise. Such a package typically consists of some of the following measures:

a) Change in legal form, from a departmental agency or public corporation to a state company established under normal company law, but controlled by the government by virtue of its share ownership, whether wholly or in part. [Bös, D. (1989), pp. 21-2]

b) The replacement of management. In the West, new managers can be enticed away from the private economy. In post-communist countries the politically incriminated first rank managers of the communist era have often been replaced by their former second-rank technocrats. Otherwise, in post-communist countries new managers would have to be recruited from abroad. [Bös, Dieter. (1992), vol. 9, no.1]

c) Reduction in the power of the trade unions, for instance, by splitting one large public enterprise into several smaller ones, consequently diluting the influence of the trade unions. [Bös, Dieter. 1992, vol. 9, no.1]

d) The establishment of competition by allowing market entry.

Often such a regulation is called “privatization” but this is a misnomer, used primarily for political reason. First, privatization by divestiture entitles individual shareholders to residual rights, to everything, which has not been deduced upon by contract. In the case of restructuring, the residual rights remain with the State, in other words, with government bureaucrats. The incentive effects of this change of entitlement are decisive for efficiency improvements. Second, ownership changes give a decisive signal, both to domestic markets and to foreign investors. Third ownership changes induce other policy measures. Once ownership is private, management even if it is the old one faces the same pressures as other private management. This not the case, however, if the old bureaucrats continue to run a restructured public enterprise. Investments in the privately owned firm are financed in just the same way as investments in other private firms, in the public “restructured” enterprise rules of governmental indebtedment often still hold (which could be wrong because the enterprise either gets credit too easily or with too much difficulty.) [Bös, Dieter. 1992, vol. 9, no.1]

So the above mentioned shows that the regulated market, or as in some former socialist countries economic establishments so called socialist market couldn’t work without private ownership and competition.

If privatization in developed countries is balancing the power between public and private sectors by means of reducing pie of government owned assets. In transitional countries and especially in FSU countries this process start to change centrally planned economic system to free market. All this means that there is a qualitative difference between privatization in capitalist countries and transitional countries, if privatization in developed countries only is reducing public sector in transitional countries it is changing of system. To develop privatization in post socialist countries is necessary to change and reestablish whole legal and institutional framework, to create stock exchange and capital market.

Post-communist privatization takes place in an environment of collapsing markets. That makes difficult to privatize public assets when after the collapse were broken almost all relationship between countries and many enterprises and services had lost their consumers. Hence requirements of restructuring in former communist countries are more actual than in capitalist world. The privatization in former communist countries distinguishes between small privatization, mass privatization and privatization of key sector enterprises. To privatize key sector enterprise it is necessary to apply policies which are diverse as their national characters. It is necessary to notice that starting position of the giving countries also important.

Even in capitalist economies it is possible to find distinctive differences across countries. The discussion of EC policies made very clear that nations follow different policies, because of differences in their national character. In the post communist countries, such difference leads to very different policies with respect to the privatization public enterprises. [Bös, Dieter. (1992), vol. 9, no.1]

There is considerable diversity in the interpretations of privatization owing to varying practical experiences, expert opinions and academic views in this regard. Thus, Terence Daintith (1994, 43) mentions "Privatization is coming to mean all things to all people as it is adopted in different countries as a conveniently topical and attractive label for a wide variety of steps in economic and social policy." However, while a narrower definition of privatization denotes mainly the divestiture of public assets to the private sector; a broader view of privatization tends to encompass processes such as denationalization, deregulation, liberalization, contracting out, competitive tendering, user changes, cuts in public provisions, increases in private ownership and so on [Hartley and Parker (1991), 11; Martin (1993), 11; Murie (1994), 105]. A simpler definition is offered by Jeremy Richardson "Privatization and Deregulation in Canada and Britain" in general and most obvious form it is the transfer of ownership and control of an existing enterprise, activity or service from the public sector to the private sector.

So what is the privatization? As we see, this is a complex question with no single answer. The sweeping global waves of privatization have occupied government and academic around the world since the 1980s. These global waves of privatization have forced many governments to adopt to what is now considered market-oriented reform and "new public management". In Ali Farazmand (2001, ix) opinion: "Nothing is new about this new reform movement; the old reform ideas have become repackaged by the crusaders of the new conservative, ideologically oriented market reforms that claim, rather presumptively, market superiority over governmental functions, public administration, and public management".

Is privatization a good public policy? The proponents answer "yes", while opponents reply "no". Comparative studies on privatization indicate mixed results as best [Farazmand (1996b); Letwin (1988); Aharoni (1988), 23-25].

The complication in answering this question arises when we face a third question that has to do with the meaning of privatization, different perspectives reflect different ideological underpinnings. As a result, privatization conveys a broad range of meanings, from vague to clear definitions, showing exceedingly divers and occasionally contradictory constructs in both intend and impact. [Farazmand Ali (2001), 1-5].

While many views on privatization as on the sale of state-owned assets and public enterprises, it has also been regarded as deregulation, application of user fees, contracting out public services to private sector providers, marketization, corporatization, and a host of similar reforms intended to

introduce market forces into the public sector [Henig, Hamnett and Feingenbaum (1988); Starr (1989); Suleiman and Waterbury (1990); Farazmand (1996a; 1996b)].

Observation of worldwide experience and case studies could provide at list three formal types of privatization Farazmand (1996b): practical or programmatic, tactical, and strategic. Feingenbaum and Henig (1993) have called this programmatic, tactical, and systemic.

Practical Privatization

Practical privatization usually carried out by bureaucrats and high-level public administrators at different levels of governance. Practical privatization is a programmatic way of doing the business of public affairs. Constructing out is as old as human civilization, but its new surge has attracted many high level administrators, political as well as career, around the globe. It is a practical tool of public management for many governments [Donahue (1989); Feingenbaum and Henig (1993)]. This type of privatization is growing at a fast pace.

Tactical Privatization

Tactical Privatization is usually a product of short-term goal of a political party or actor that often tends to change. Its tactical characteristic reflects temporaries and short terms orientation to reflect the priority of a particular part or interest group pressures. These tactical privatization programs usually aim at serving certain political goals by, for example, winning a particular group or class of voters in an election [Feingenbaum and Henig (1993)]. Tactical privatization policies may serve temporal political objectives, but their impact on and consequences for society and people can be serious and devastating. For instance, a policy may create instability and discontinuity in the governance process and public administration. It also may cause all sorts of environmental, political and managerial as well as economic problems. [Ali Farazmand (2001), 10-11].

Strategic Privatization

Strategic Privatization is the most systematic, ideological, and long-term strategic change in the public-private sector configurations, in political and economic power structures, and in the ensuing consequences. This type of privatization is strategically aimed at reshaping and altering the fundamental spheres of public interests and of the institutions of the whole society, its power structure and economic bases. It is aimed at lowering people's expectations from governments, at promoting the corporate state dominated by corporate elite's, and at identifying privatization opponents as radical communists. [Heilbroner (1991); Macpherson (1987)].

Thus Farazmand (2001) mentions that privatization has taken many forms, mostly for the same strategic purpose, even through tactical and practical approaches may have been applied and promoted. The systematic, strategic change and reconfiguration in the power structure and in the public-private sector relations have been meant to fundamentally alter the organizational arrangement of society and economy and governance in favor of the private corporate elite's who already dominate the public policy realm. Framing privatization as a technical tool for "achieving efficiency allows proponents to pursue broader support that would be feasible with a direct challenge to the program and principles of the welfare state" [Feingenbaum and Henig (1993), 440].

In transitional countries, the market-oriented policies such as deregulation, privatization, liberalization, and rationalization, were adopted or imposed largely under programs known as stabilization and structural adjustment. Among these policies, however, the privatization of public assets, programs, and services, has been one of the most influential and noticeable changes in the recent history of policy reform. In James Waddell's opinion privatization process is fundamentally a political process as well as a commercial and economic process. Privatization changes the

distribution of power within a society, as it diminishes control of the economy by the state and insider managers.

In general, privatization has often undertaken in the name of increasing economic efficiency, streamlining an expansive public sector, reducing government borrowing, widening share ownership, enhancing competition, encouraging market forces, generating government revenues, expanding customers choices, and improving service quality [*Asmerom (1994), p.381; Pitiless and Clarke (1993), p. 7*].

The similar question that different authors are explaining in different ways is the process of privatization. James Waddell sees that in certain way: “Regardless of the privatization technique that is selected, the process of privatization is relatively standardized. Governments generally follow several steps in privatizing enterprises. First, the target companies are reviewed to understand, in a very general way, their characteristics, markets, and prospects. Second, a privatization plan is prepared to guide the implementation. This plan should match the goals of the government and the characteristics of the enterprise(s) to determine the approach that will be taken. Third, the company is marketed, whether to core investors or the public, depending on the path chosen. Fourth, if necessary, the terms of the transaction are negotiated and the legal documentation prepared. Finally, the transaction is closed.

Throughout this process, several factors are critically important to the success of privatization program. First, speed is absolutely essential. During the period that governments are deciding to privatize, until the point that new owners are recognized, the enterprise is essentially under the control of its management. Few true ownership interests are represented and the interest of capital is whether of maintaining existing capital or investing new capital are ignored. Great potential exists for asset-stripping or other misappropriation of assets. In worldwide experience, usually enterprises lose a substantial part of their value during this period. Speed in the privatization process is critical to ensure that any ownership vacuum is minimized. Second, the transparency of the privatization process must be preserved and publicized. Any questionable ethical conduct has the potential to destroy the integrity of the process and erode political support. Finally, the privatization program must be implemented professionally. If it is not, the enterprises, investors, and the public could be discouraged from participating with disastrous consequences”.

To proceed towards an understanding of what takes place in Armenian Republic and in the Russian Federation and other countries involved in privatization process, is necessary to study theories and models that render accounts of the processes and their conditions, their stages and their conceivable future directions.

Successful privatization leads to liberalization. So in point of view of normative theory I can also speak about liberal theory. Free markets combined with evidence of functioning formal elements of democracy are frequent elements of the liberal theories. There are also theories that include more hesitation as to the believed virtues of the free markets.

The privatization models-in-use is several. In some developed countries can be used only one of the models, for countries in transition could be used different models on different stages. For example, on initial stage usually takes place “small-scale privatization”, a normal procedure for privatizing small business. Then “mass privatization” or voucher-based mass privatization program model, which is designed to promote equity in the distribution of wealth, through widespread participation. But it is not always ensure efficiency because it may not generate revenues, bring in new capital or skills, or give shareholders control over managers. [*Goldberg; Jerdrzejczak; Fuchs., (1997)*].

The other one is the case-by-case privatization. Many transition countries, most of which recently completed voucher-mass privatization now start to privatize medium-size and large enterprises using case-by-case method. Case-by-case privatization model involves selling government shares in state-owned firms through public share offerings, trade sales, or mixed sales. The case-by-case privatization allows governments to resolve the policy issues, such as regulation and labor concerns firms for their fair market value, surrounding privatization, lets governments sell firms for their market value, provides a transparent sales process, can improve corporate governance and attenuate insiders influence, and where required, can bring foreign management, skills, capital, and marketing know-how to privatized firm. [Iskander, M., (1999)].

One of the innovations in privatization techniques during the last few years is the IPO-Plus privatization model which is combines the efficiency of case-by-case privatization with the equity of mass privatization. IPO-Plus promotes equity widespread, but not mass participation in privatization. It promotes efficiency by making privatization transparent, by fostering capital market development, and by creating independent financial institutions that would press companies to improve their financial performance. [Goldberg; Jerdrzejczak; Fuchs., (1997)].

The disadvantages of IPO's are that they don't bring new capital to the enterprise and don't bring in new managerial talent or resources. As a result IPO's should only be used if the performance of existing management is satisfactory. In addition, IPO's are very time-consuming, and they generally require the existence of a formal stock exchange and broker network or other distribution mechanism to be implemented effectively. [Waddell's James]

Although the privatization process vary both between transitional and developed countries, among the countries within each groups particular futures of privatization in these countries rather same, of course if the privatization will be done in correct way, will apply structures changes, market liberalization and established strong private sector with competitive origins.

1.4 THE RESEARCH METHODOLOGY AND THECHNIQUES

No scientific research can be conducted purely by following only one method. The methods of social research are often interrelated, and thus inseparable in nature. The main method of this study is analytical cum descriptive, but for different part of study different methods have been used. Both secondary analyses based on previous studies and primary analysis drawing upon first-hand research materials has been pursued. Data from secondary sources have been collected as well. The study has been prepared in empirical manner. As to the former, the study involves working to establish familiarity with each case included in the study. As to research design, first is necessary to pursue theoretical study to have strong knowledge of privatization. Second step is presenting case study research of focal countries privatization policy. Third, once sufficiently achieved, those studies have been put into each other's comparative context to compare aspects of Armenian and the Russian privatization policies. To a suitable extent, the study of the two focal countries supplemented with statistical and other analyses covering further transitional countries.

By using comparative methodology have been examine patterns of similarities and differences across a moderate number of cases. Have been studied how the different parts of each case-those aspects that are relevant to the research fit together. The goal of this research was to analyze the particular set of cases. The research emphasizes diversity of cases and focuses on the similarities within a category of cases with the same outcome. In other words, I have examined patterns of similarities and differences of privatization policy within the given set of cases and try to come to terms within their diversity. The comparative method also has been used to study configurations-

specific combination of attributes that is common to a number of cases. The examination of patterns of diversity had been essentially involved in the research for combination of conditions that distinguishes categories of cases. Thus the research looks for uniformity within categories and contrasts between categories in combinations of conditions. The emphases on comparative research of diversity and of familiarity with each case make this especially well-suited for the goals of exploring privatization process and policy in Armenia and Russia.

One of the main methods used in this research is the case study. The case study is one of the several methods of scientific research in the field of social science, political science, economics and management, public policy and public administration. In Robert K. Yin (1994, 1) opinion it could be used also as a method of qualitative analyze and preferred strategy when to “how” and “why”. As a research strategy, the case study is used in many situations, including dissertations and theses in the social sciences. [*Robert K. Yin, (1994, p. 1)*].

Case study like other research strategies, is a way of investigating an empirical topic by following a set of specific procedures. Case study research can include both single and multiple-case studies. In the fifth chapter of this theses so called comparative case method will be used as a distinctive form of multi-case studies. [*Agranoff & Radin, (1991)*]. Some of case studies can be limited to quantitative evidence. But in fact, the contrast between quantitative and qualitative evidence doesn't distinguish the various research strategies. [*Robert K. Yin, (1994), pp. 14-15*]. As a further, some investigators distinguish between quantitative research and qualitative research not on the basis of the type of evidence but on the basis of wholly different philosophical belief. [*Guba & Lincoln, (1989); Lincoln, (1991); Sechrest, (1991); Smith & Heshusius, (1986)*].

Single cases are common for doing case studies, and two types can be described: using holistic design and using embedded units of analysis. A major step in designing and conducting a single case is defining the unit of analysis or the case itself. Multiple-case designs have advantages and disadvantages in comparison with single-case designs. [*Herriott & Firestone, (1983)*]. In some fields, multiple-case studies have been considered a different “methodology” than single-case studies. For example in political science one set of rationales for doing single-case studies, and other set for doing “comparative “ or multiple-case studies [*Eckstein, (1975); George, (1979)*]. As it mentioned above both and single-case, and multiple-case will use for research.

In the forth chapter of this study also used SWOT (Strengths, Weaknesses, Opportunities, Threats) analysis method. SWOT method divides the general analysis into two subsections. First, internal analysis reveals strengths and weaknesses with the privatized companies, related to management, marketing production process itself and analyzing the external environment gives the business organization the scope of various opportunities and threats existing in the market in general. The SWOT analysis based on systematic and careful collection. There where used information list for quantitative assessment of enterprises.

The topic “privatization” was chosen because of its major importance within Armenian and the Russian Federation economies in the 1990-2002s. Indeed, privatization and deregulation have now reached global proportion with the concepts having been adopted in both developed and developing countries and even in the Eastern bloc, as the grip of Communism is relaxed. [*Richardson, Jeremy, (1990)*].

Selection of Study Area

For collecting primary information two countries Republic of Armenia and the Russian Federation were selected by the researcher himself.

These countries were selected taking into consideration the fact that both of them were a part of the FSU and now they become NIS. They have long history of economic and political relationship, the same start point in the political view, and most similarities in economic condition. That is why it was interesting to make analyze of the models of privatization implemented in focal countries and as a final result see what they achieve on that way and make a comparison of the process.

Primary Information

Primary information was collected from the local authorities, Ministry of Privatization, USAID office in Armenia, CEPRA, UNDP in Armenia, non-governmental employees, some researchers and writers in the field who tried to find out strength and weakness of the privatization. Governmental executes such of those working at the Ministry of Economics and Ministry of privatization.

Secondary Information

Apart from the primary information secondary information was also collected from different sources, journals, magazines, published and unpublished information, planning reports, and other relevant materials were collected.

Data Collection Procedure

Primary data were collected at various time intervals by different methods and tools such as survey, interviews, discussion, filed observation. Survey was conducted by visiting the managers and directors of privatized enterprises and interviewing them, discussions with the politicians and administrators who conduct privatization process in Armenia. Reviewing and analyzing the existing literature and previous empirical research in the field help to understand Russian privatization process. The empirical part of the research is based on observation, content analysis and selected literature survey, thematic interviews, field visits observation, content analysis and survey of the selected literature.

Analysis of Data

After collecting primarily and secondary information, data were analyzed mostly in an analytical and descriptive way while the quantitative data are presented in tables, figures and percentages. Case study method was used for analyzing two country case studies. SWOT (Strengths, Weaknesses, Opportunities, Threats) analysis method was used for making analyze of firms performance in chapter four.

1.5 THE STRUCTURE OF THE STUDY

The present study has six chapters. *Chapter one* gives research descriptions, which includes background, task, objectives and research questions. The chapter also presents a theoretical basis for the research and gives a detailed description of the study methodologies used in this research as well as describes how the study have been implemented, also this chapter gives the structure of the study.

1.1 Introduction

1.2 Basic choice of the study.

1.3. Theoretical Background of the Research

1.4 The research Methodology and Technique

1.5 The Structure of the Study

Chapter two discusses the theoretical standpoint of privatization. The chapter studies types and kinds of theories and models available for the study of privatization phenomena, explaining how we should grade those theories and models from the viewpoint of the present study and its objectives. How do we have to utilize research in studying privatization, which techniques and methods do we have for study? Highlights the concepts of privatization function and valued aspects of privatization as positive and negative.

2.1. Selecting, study and analysis of theories and models of privatization

2.2 Utilization of research in studying privatization

2.3 The research methods and techniques: one case study, comparative studies, many-country statistical studies

2.4 Mass privatization, case-by-case privatization, IPO privatization

2.5 The concept of a “function“: positive and normative

2.5.1 Positive functions: economic, political, social, and other functions of privatization

2.5.2 Normative functions: aspects of privatization valued positively or negatively

Chapter three provide analyze of privatization process in the Russian Federation. Analyze are made on the finding research cases in the concerned area, on the base of extensive literature review and content analysis. The empirical part of the chapter based on observation, content analysis and selected literature survey.

3.1 Russian privatization program, task and goals

3.2 Russian privatization, legal and organizational measurements

3.3 Russian privatization process, stages and present situation

3.4 Successes and problems of Russian privatization process

3.5 Russian national privatization policies

3.6 The role of Western assistance in the Russian privatization process

3.7 Which privatization theories and models explain best the Russian privatization experiences?

Chapter four presents a whole picture of Armenian privatization process, in concrete terms, how has the privatization process evolved from pre-privatization stages and through the various privatization stages where the research country is now. What are the tasks and goals has Armenian privatization program, and what legal and organizational means necessary for privatization program realization. The chapter include analyze of western assistance in Armenian privatization process. It also highlights successes and problems of Armenian privatization process, and Armenian privatization policy. Exam what type of theory-based model regard to Armenian privatization and which type of research approach capable of derivation on the basis of such a model can we use for the purpose of studying privatization process in the focal country.

4.1 Armenian privatization program, task and goals

4.2 Armenian privatization, legal and organizational measurements.

4.3 Armenian privatization process, stages and present situation

4.4 Successes and problems of Armenian privatization process

4.5 Armenian national privatization policies

4.6 The role of Western assistance and guidance in the Armenian privatization process

4.7 Which privatization theories and models explain best the Armenian privatization experiences?

In Chapter five, research cases in the concerned area will be put into each other’s comparative context for comparing Armenian and the Russian Federation privatization methods.

5.1 Armenian and the Russian Federation privatization methods will be compared to each other.

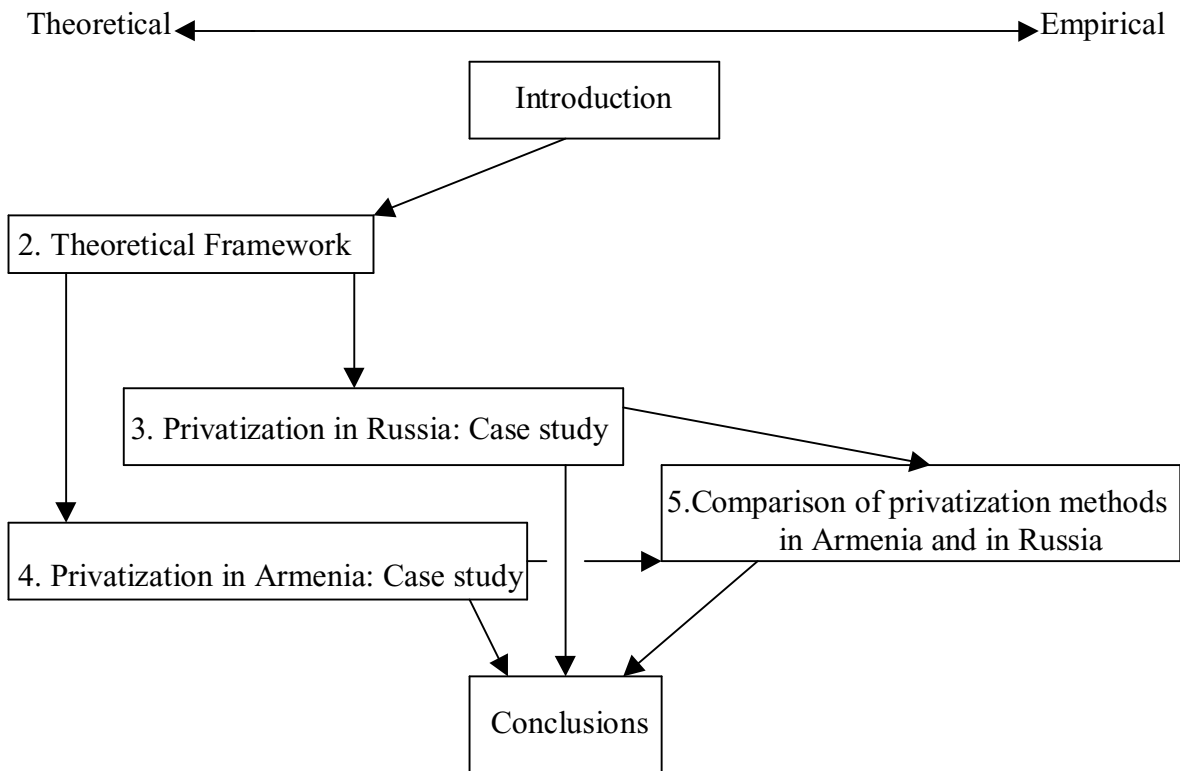
Chapter six presents conclusions. The chapter also includes list of research materials.

6.1 Conclusion

6.2 Research materials

The whole thesis is designed in a coherent way. The structure of the thesis is figured and presented in figure 1.1.

Figure 1.1: Proceeding of the study



Chapter Two

THEORETICAL FRAMEWORK OF THE STUDY

2.1 INTRODUCTION

From the classical viewpoint, the issue of transition is closely connected with that of growth. In particular, the classical school emphasizes the static technical features of economic systems. Trade and labor specialization, together with higher capital endowment and improved (maritime) transportation. As a consequence, the classical case for transition implies a strong plea in favor of free trade, limited governmental intervention, and especially in the case of poor countries foreign aid to enhance capital formation. [*Colombatto, Enrico (2001), pp. 271-272*].

From a normative perspective, the classical school, therefore, spells out the desirable policies to enhance growth in relatively poor countries, whereas, from a positive standpoint, classical transition applies to a country that complies with the appropriate set of sound economic rules but has not yet secured the full benefits they are supposed to generate. In a nutshell, classical transition theory turns out to be the analysis of the minimum conditions for growth and of how they can be obtained. [*Rodriguez, F and Rodrik, D (1999)*].

Neoclassical economics has surely led to major analytical results and has allowed scholars to study in sophisticated detail the features of the allegedly perfect machine known as an economy. The cultural and institutional incentives that drive individual behavior, however, have been, by and large, overlooked. Similar to the classical teaching, neoclassical modeling describes a static world where exogenous transaction costs prevent it from functioning flawlessly. Time and learning play a limited role and so does institutional dynamics. As suggested by Hodgson, it is no coincidence that neoclassical economics is cherished throughout the political spectrum. [*Hodgson, G (2000), pp. 317-29*].

The neoclassical perception of transition thus remains inadequate. A transition economy is still perceived as a machine that for some reasons ignorance or market imperfections runs below its full potential. Developed and transitional economies do differ. Agents need time to adapt to the new rules of the game. There is no doubt, however, that all these rules allow the reproduction of the allegedly ideal system and are to be introduced as quickly as possible. [*Winiecki, J (1998), pp. 3-265*].

Growth, then, becomes the inescapable consequence of transition; hence, the role of the so-called “Western expert” who is to explain and adapt a well-known prototype to an unknown but supposedly easy-to model reality. Furthermore, they are supposed to suggest suitable aid packages in order to reduce the cost of transition and make transaction costs acceptable. *Transition is the name of this experiment in social engineering.* [*Colombatto, Enrico (2001), pp. 270-271*].

According to the orthodox view the difference between development and transition economics is a matter of human capital and in earlier times infrastructure. Developing countries are those where both these variables are poor, while the problem with transition countries is the past system of centralized planning, which prevented the economy from benefiting from consumer sovereignty and specialization.

In both cases, foreign aid is believed to play a crucial role. In transition countries, foreign aid is to soften the adjustment-cost problems that the institutional shocks generate. [*Colombatto, Enrico (2001), p. 271*].

From a practical viewpoint, the failures of mainstream development and transition economics are apparent. They are apparent, due to their disregard, vis-à-vis, for the institutional framework and the variables that interact both formal and informal rules and organizations. Attempts to go back to classical economics and stress the role and the dynamics of factor endowments (be it fixed capital or human capital) did provide answers to some of the neoclassical riddles, but their overall predictive power remained modest. [*Olson, M. (1996), pp. 3–24; Arrow, K (1962). pp. 155–73*].

The public-choice addition deserves credit, for it surely fills the gap between positive and normative orthodox theory by showing why good theories are not necessarily put into practice by rational and omniscient policymakers. Nevertheless, the fundamental weaknesses of the orthodox vision persist. Since no theory is put forward regarding the development of social and institutional variables, the enriched mechanics offered by the political-economy approach assumes that the rules of the game are constant and that they can hardly be changed by the agents. [*Colombatto, Enrico (2001), p. 272*].

In addition, the dynamics of transaction costs are indeed mentioned to explain the birth of and the interaction among interest groups. But the essence of growth, as a competitive process among different institutional solutions aimed at reducing transaction costs and disequilibria, is systematically disregarded. [*Alchian, A (1950). pp. 211–21; North, D (1994), pp. 359–68*].

Yet, social-justice criteria are not likely to produce noteworthy results, unless one provides a satisfactory definition of social justice itself and is ready to accept the concept of society as being distinct from a system of interacting individuals. Unfortunately, the advocates of social justice fail on both accounts. As a matter of fact, growth with a human face has been another experiment in free-market constructivism, whereby expert and scholars have tried to solve the public-choice problem (interest-group resistance), preserve the bureaucracies, and overcome the market failures generated by a static free-market theory. In short, growth and development have been transformed into an instrument functional to vaguely defined social-justice policies. Transition can still be defined as the change in the rules of the game. Such a change, however, is not necessarily aimed at starting some kind of a mechanical catch-up process, but, rather, at reducing transaction costs and providing better opportunities to meet individual objectives. This has important consequences, since it implies that the issue of transition may clearly apply to the so-called developed world as well, and to Western Europe in particular. [*Colombatto, Enrico (2001), p. 273*].

The persistence of missed opportunities in large areas of the West over the last two centuries calls for a deeper investigation of the role of institutions and on the driving forces that have affected the evolution of the rules of the game in Western societies. [*Maddison, A (1995)*].

The essential economic-policy question in today's Western Europe can be formulated in two steps, which are related to each other. First, although public opinion is not particularly unhappy with living standards, there exists a prevailing feeling of dissatisfaction. Second, there is widespread agreement about what should be done to attain a better result that is, improve the institutional framework. Nevertheless, the demand for better rules of the game has been developing rather slowly. It has gone from a situation when disappointing performance was attributed to lack of governmental intervention along Keynesian guidelines to one where governmental intervention needed to be improved and made more efficient, following technocratic rule, to one where efforts

were required to reduce the size of the government machine altogether. Still, the role of government has remained intact, by and large, as the political space for truly free-market parties has remained rather modest. [Colombatto, Enrico (2001), p. 274].

The general framework is usually explained in public choice terms, whereby policymakers are subject to pressure from rent-seeking interest groups. When these are effective enough, they secure rents from politicians even when such rents negatively affect overall welfare and growth. Those who suffer from such rent-seeking activities are too weak to resist pressure or to respond. [Colombatto, Enrico (2001), p. 275].

The possibility that rent-seeking groups affect the institutional environment is not ruled out, either. However, although they do explain how today's illiberal democracies work. These theories do not even attempt to ask why and how illiberal democracies became so successful. As a consequence, they shed no light on their future developments. [Zakaria, F (1977), pp. 22–43].

It is plausible to claim that individuals generally accept or indeed advocate governmental intervention for three reasons. They might believe that governmental action can at least partially compensate market failures. In this case the state is then required to play an active role as a producer. In addition, the state, instead of individuals, is often asked to intervene and make decisions even when there is no *a priori* reason to believe that such decisions are preferable to those taken by individuals themselves. In this particular situation, the state relieves the individual from the strains and challenges involved in the decision-making process. Finally, the state may be required to perform a redistribution policy, according to some kind of allegedly agreed-upon social-justice criterion. [Colombatto, Enrico (2001), pp. 275-276].

The first set of cases regards the provision of rule-of-law, that is, the quasi monopoly of violence as a way to guarantee and defend individual liberties against external aggression and domestic turmoil. By and large, this role is accepted as a general principle, but frequent deviations tend to be tolerated whenever rule-of-law obstructs democratically approved redistributive or collective-welfare goals.

Relief from personal responsibilities the second source of legitimacy for state action is not only important, *per se*, but also because it allows people to understand when redistribution and/or collective-welfare policies are more important than rule-of-law. Of course, in most cases, this attitude turns out to affect the degree of governmental intervention, rather than being a clear-cut, yes-or-no decision. This is, perhaps, apparent today, when the role of the state beyond law-and-order, personal freedom, and sometimes even constitutional guarantees is taken for granted. [President Clinton, J. William (1993)].

The transfer of personal responsibilities is closely associated with the issue of redistribution. This becomes apparent if one observes that redistribution is seldom justified by referring to the principle of transferring income but, rather, to the need to finance governmental intervention according to principles of equity. In other words, fairness is not usually justified by the need to define *ex ante* the desirable net income (or purchasing power) of each individual, but rather by the need to finance governmental activity according to each individual's capacity to contribute. This leads to the concept whereby the idea of social justice is not deemed to be acceptable, *per se*, but only as a guideline for expenditure financing, and this concept sheds light on the fact that although direct taxation is clearly progressive, in fact, the net result of governmental action is much closer to neutrality than public opinion is induced to believe. [Colombatto, Enrico (2001), p. 277].

As is known from the public-choice and institutional literature, redistribution also plays two additional roles. It is the instrument through which social tensions are allegedly softened and through which politicians strive to obtain power. In this thesis also studied one more role of the redistribution that is can be found especially in transitional countries- wealth redistribution.

Borrowing in part from Quigley, it is here claimed that path-dependent processes give rise to public-choice mechanisms that involve political as well as economic pressure groups. In turn, the relative weight of the economic and political variables depends on the rules of the path-dependent game and on the transaction costs that characterize both sets of activities. The role of exogenous factors cannot be excluded. Contrary to the institutional view, however, it is here argued that such shocks do affect the timing and sometimes also the features of the institutional breaks but not their necessity; that is, the fact that sooner or later a given path-dependent process breaks down. [Quigley, C (1979)].

In the light of the preceding discussion, transition might now seem to be little more than an empty term. On the one hand, it is hard to maintain that there exists a period of time during which the old path-dependent process is finished but the new one has not yet started. The fact that we are not able to see what the new process consists of does not mean that the new process is absent. In fact, it may happen that the new rules go together with old rules, and those different layers of the populations move at different speeds, according to the different rules. Stated differently, the key argument here is that societies seldom change their path-dependence process overnight. [Colombatto, Enrico (2001), p. 283].

On the other hand, transition might be used to describe and analyze what happened to an economy (or a more-or-less-defined social structure) when the interplay of rent-seeking coalitions ends up generating a path-dependent process, eventually leading or contributing to its downfall. [Quigley, C (1979)]. In this light, transition would become some kind of a dynamic, public-choice investigation. Though acceptable, however, this notion of transition would probably not be of great use, either. After all, the terms of the rent-seeking game change continuously whenever coalitions are allowed to interact. In other words, all countries are almost always in transition unless a totalitarian regime stops rival pressure groups from coming to the surface. [Colombatto, Enrico (2001), p. 284].

In short, looking for new or emerging models of economic activity may be an interesting speculative exercise but unlikely to be of great use unless one understands how those models are going to be incorporated in actual economic activity and give birth to new assignments of property rights. For example, it is widely thought that today's Western economies are following a free-market pattern and that East-European countries have accepted such a model to shape their own economic institutions. Yet, a quick look at the data on the size of the governmental sector, of taxation, of regulation, or at the respect for rule-of-law should make it clear to anybody that the Western world today is not at all near the free-market paradigm and that Eastern European leaders do not actually pursue free-market models. Indeed, in both cases the political elite's would easily lose consensus if they were to act otherwise. [Colombatto, Enrico (2001), p. 284].

In a stable society, freedom may be more important than additional stability but becomes a questionable target if accompanied by less security. This concept can also be rather easily extended to the role of ideology, for a socializing ideology can be highly effective in creating political support, since it promises security within a large social group. [Miller, G. (1998), pp. 764–73].

Whereas, an ideology enhancing individual freedom and protection against social infringements is more likely to meet failure. By delegitimizing the notion of society or coalitions as political entities

prevailing on personal interests, individuals feel more vulnerable. In this light, freedom or personal economic interest, in the neoclassical sense, become marginal issues. Therefore, it seems that the change in the rules of the game in today's allegedly free-market societies is to be considered a cultural issue rather than a mere technical one. If so, transition should then be concerned with the change in individual perceptions, preferences, and attitudes, both in Western economies and in the East-European and Former Soviet areas. [*Colombatto, Enrico (2001), p. 284*].

The idea of transition embraces changes in a state's political and administrative structures, as well as changes of an economic and social kind in the wider society [*Salminen and Temmes (2000)*]. Markku Temmes explains for post-communist states the problem of transition connected to the complicated relationships between liberal democracy, a market economy and the rule of law. He provides an analytical framework containing the key factors in transition theory and he concludes that any effort to seek some kind of compromise between communism and the European welfare state will slow down the processes of transition and render them unsuccessful.

Unlike revolutions, peaceful transitions seek to achieve change by means of controlled development. In these circumstances, political support and the legitimation of reform measures require that transition costs be controlled and especially that some balance be achieved between the negative social costs for citizens and the delayed benefits of the changes being made. Realistic societal changes are normally based on long-term experiences and step-by-step development. The transition countries lack in their economies, politics and administration the resources and knowledge necessary to ensure the success of reforms. The level of implementation is low, especially when the economic resources are severely restricted. Although transition is mainly a national question, the EU must work for transition policies, which it prefers as a donor organization and as a key political actor. In fact, in transition there are elements of both the Eastern enlargement of the EU and the expansion of the European welfare state model. The activities of SIGMA and NISPAcee have been organized mainly around this idea of mutual cooperation and support. The development and ongoing refinement of transition theory have a significant role to play here. [*Temmes Markku (2000), pp. 258-259*].

The role of the state is crucial in transition and raises questions about politics, administration and justice, which all have links to civil society. The breadth of state intervention is one of the most important elements of transition. Maximum privatization and a minimalist role for the state do not guarantee the swift development of economies in circumstances in which state intervention is necessary in order to direct and regulate development. The role of those organizations, which are responsible for preparing administrative reforms, is crucial in the procedural implementation of transition. In fact, it is important that such organizations be constituted as a central component of a national administrative reform policy. A concrete approach to transition theory is to clarify the connections between political and economic changes brought about in transition. The tension between politics and the economy is a special feature of transition processes. In practice, politics and the economy are not in balance. [*Temmes Markku (2000), p. 260*].

European-based comparative administrative studies had been quite scarce until the 1980s and the 1990s. The main focus has been on different administrative systems as targets of evolutionary development and modernization. Traditional institutional comparisons are still being made, but they usually include wider selections of countries and more detailed arguments concerning research frameworks. Other, neo-institutional studies have sought to connect the institutional view to analyses of policy sectors in order to get a more comprehensive picture of the relevant policy arrangements. The problems of the transition countries have prompted the collection of comparative data and the exchange of research results and experiences. [*Temmes Markku (2000), p. 261*].

The resulting publications taking a comparative view have until now been mainly collections of articles concerning administrative policies in transition countries, as well as consultant reports [*Holl & Plokker, (1995)*]. This is why the real analysis of the theoretical frameworks has been left to one side. The few truly empirical comparative researchers have concentrated on economic and political changes, including the mapping of party relationships. The transition countries are indisputably a very interesting and important target group for comparative research in politics, economics and administration. When it develops further, this research will probably constitute the 'third generation' of comparative studies. [*Temmes Markku (2000), p. 261*].

Institutional arrangements are of particular relevance to the success of reform in the transition countries. At present, there is insufficient information available on specific organizations. Detailed information and comparative data on their structures and activities are necessary to the development of sound transition theory. The conceptualization of administrative policy in transition countries can be proactive or reactive depending on the nature of the policy and its level of support in the government. Some of the problems encountered in transition processes can be the result of donor policies and practices. Donors are often competing with one another and this can cause coordination difficulties and the adoption of short-term approaches, which can hinder development. The theory needed to support transition is naturally interested in the substantive content of reform policies, the institutions for designing and implementing these policies, and the actual achievements of reform. The success stories and failures and the problems in structuring and managing development processes are especially relevant. [*Temmes Markku (2000), pp. 262-263*].

The contents and related elements of reform programm have theoretical importance which should not be underestimated. The action plans and the schedules of reforms are good examples of this. If, for instance, the process of reform begins with the structural reorganization of sectoral ministries and is then extended to civil service law and the position of the civil service, it is clear that institutional economic theory and the neutral bureaucracy model have had an immediate impact on the formulation of the reform policy. With the tools of comparative research, there are good possibilities of developing knowledge which can in a very definite way benefit the work of reformers in transition countries. [*Temmes Markku (2000), p. 263*].

First, the process of transition has a core which comprises administrative machinery developed in line with Weber's (1978) ideal-type model of bureaucracy. In this connection, bureaucratic theory is used in its wide form to explain relationships between a capitalist market economy, politics and administration [*Vartola, J (1979)*]. The other part of the core consists of the most relevant institutions of a market economy which have key roles to play in state-market relations. The structure and operation of these institutions are explained by the theory of institutional economics together with related ideas in political science. This all enables a bridge to be built between politics and the economy [*Galbraith, (1974)*].

Second, the theoretical elements of the figure are connected to the general principles of liberal democracy: the political-administrative system, the market economy and the rule of law and its institutions. These principles form the general framework directing all theoretical angles and views. They can, of course, be implemented in many variations, and that is why it is important to analyze such variations. The third threat is based on the procedural viewpoint. The tasks of political and administrative development in transition countries will always be difficult. Because of this, it is realistic to be ready to meet failures and bad results in most development projects in transition countries. Considerable coordination problems increase the chances of failure. It is also clear that the design, planning, monitoring and evaluation of projects can encounter major problems. The

fourth threat concerns the dangers of either under- or over-organizing the political-administrative systems of transition countries. In practice, the extent of under-organization has been so significant that it is difficult to conceive of the threat of over-organization. [Temmes Markku (2000), pp.265-266].

The most difficult questions in transition concern the probability of transition countries reaching the level of developed countries and the length of the schedules involved. The sights ought to be set high. The model of the European welfare state is an important political choice for transition countries. The extent to which it can be adopted is related to the starting point of each country in terms of the existing economic, political and administrative arrangements. There are differences especially in the economic potential of each transition country. The geographic size of the country and the structure of its population also have an impact, as do the relationship to European legislative and administrative traditions, cultural life, and so on. These factors will all affect the nature of reforms and the intensity of their implementation. [Temmes Markku (2000), p. 266].

Privatization has become a popular movement around the world in the last two decade. Both developed and transitional countries had shown a grate interest in privatization. It is hard to find a country without a privatization program, or a sector of activity not susceptible to private management if not ownership. In the non-transitional countries of the world, in the period 1980 to 1991, some 6.800 firms were privatized. In fifteen countries of Central and Eastern Europe and the former Soviet Union by the end of 1994 estimated 30.740 medium size and large enterprises had changed ownership. Privatization is often adopted because it seen as a method of quickly converts to a market economy. Nowhere has this been demonstrated better than in the former socialist countries Central and Eastern Europe.

Privatization in most transitional economies of Central and Eastern Europe and former Soviet Union has proceeded in an unforeseeable speed. For a large share of productive assets private ownership has replaced public and collective ownership. It is obvious that this change in the ownership forms of most enterprises has caused dramatic changes in the economy. In transitional economies privatization has had a strong effect on the profitability of enterprises, on incentives and managerial effort, physical capital restructuring, public sector budget balance, unemployment and inequality. The reasoning behind and the consequences of privatization have been probably the most debated issue in the economics of transition. Furthermore, recent sweeping changes in post Soviet, and other socialist countries have related that a command economy system can not be exists any more and reform movements indicated that they realized the importance of a free market economy.

Why privatization?

It could be rise a question why privatization? Many scholars offers evidence that privatization aids in the development process. [Jayasankaran (1995)]. The answer can be viewed that under competitive market conditions the private organization is believed to provide products or service at lower cost than the public organizations. [Ostrom and Ostrom (1971); DeGregory (1974)]. The key underlying assumption is that a more or less free market where perfect competition, or something reasonably resembling perfect competition, describes economy. [Gianaris (1996)]. In such an economy, producers and consumers have equal access to information, resources, and products. Factor prices and customer preferences are the only constraints. Both the nations as whole and individual consumers are believed to be the winners in a free market. [Hampden-Turner, Charles (1995)].

Producers are forced to innovate on a continuous basis in order to maintain or create a competitive advantage over alternative suppliers of the product. To get profit is possible only under a condition of market disequilibrium. [Gilad (1984)]. Also other view that many public services are monopolies and the common belief is that the public sector will always tend toward inefficiency since it has no competition, cannot go bankrupt, and lacks an incentive to excel [The Economist (1985)].

Transitional countries may have many motivations behind its decision to privatize public assets and services. Internal motivations include costs of subsidizing public sector enterprises; keeping tax rates down by profiting from the sale of enterprises; an expanding bureaucracy, or general dissatisfaction with the performance of public organizations, creating competition and free market. [Adam, Cavedish and Mistry (1992), Cowan (1990)]. External motivations for privatization revolve two aspects of one central issue: debt. Many developing and transitional nations have enormous debt and expect privatization to raise revenue to relieve this burden [Marber (1997)]. The international Monetary Fund (IMF), the World Bank, and United States may pressure transitional nations to privatize in order to receive aid or loans [Knight (1992)].

Of course governments able to control all of the goods and services production available. But the problem is that governments do some things well some things not so well. Many of the developing countries in the 1940-1950s adopted the goal of increasing the capacity of government to manage change. [Douglass C. North (1990)]. Often the public sector increased in size and capacity only at the expense of the private sector. Because the fusion of economic and political decision making replace entrepreneurial interest with bureaucratic incentives, the expansion in the public sector often gave rise to corruption and increase in bureaucratic impediments to prosperity. Key industries were taken over by the state, and governments controlled and managed wealth “in the public interest” trough the control of licenses, franchises, and concessions. [G. Gleason (2000)]. In former socialist countries had belief that the central planning system can prove economic efficiency brought the countries to bureaucracy and self-isolation from the capitalist world, to state budget deficit and absence of competition, as inside of countries as well in foreign trade.

Realizing that the state sector was expanding at the expense of the private sector many international organizations began to focus their efforts on persuading states to seek more balanced relations between the private and public sector. By the early 1980’s, pressure by the multinational lending institutions such as the World Bank, many of transitional countries moved away from state management of resources to strengthening private property conventions and programs of privatization become a central feature. [G. Gleason (2000)].

The balance between the public and private sectors in societies is often determined less by theoretical principles than be contingencies of politics and circumstance. For instance, in some societies the inability of private sector enterprises to satisfy wide public demand has motivated nationalization of the industries. Critics of the private sector, claiming “failure” of the market, have urged that the state assume direct ownership and responsibility for operating the enterprises. Conversely, in some societies the inability of the government to satisfy public demand has led to denationalization and privatization of industries, services and utilities to increase their efficiency of operation. [G. Gleason (2000)].

The argument that private enterprise delivers goods and services efficiently and effectively assumes clear institutional boundaries between public and private sector and an absence of collusion among producers. These assumptions some time hold in developed countries, but in transitional countries markets often operate poorly due to:

- 1) lack of institutional boundaries between public and private sectors,

- 2) informal collusion among producers,
- 3) interconnectedness among elite's or oligarch, [Kurtz, W., Cunningham, R., and Adwan, Y.]

Most developing countries have a limited constitutional history and minimal delineation between private and public sectors. [Berg (1987); Manasan (1988)]. Public and private are blurred in the minds of citizens, and the private property does not strike a responsive chord in the public consciousness, as it can in the West. The softness of legal protections for private investment increases the risks to potential entrepreneurs, who fear market interference by the government either in the form of direct takeover or legislation that affects factor and product prices or arbitrary regulation by the state officials. [A. Farazmand (2001)]. Despite the fact that a market economy may not exist fully in developing countries, privatization is often used as a tool for economic development. [Pelikan (1997)].

The collapse of the Soviet Union and its headlong rush to private ownership property created a situation in which rules, laws, and implementers lacked widespread understanding or legitimacy among the public. Not only institutional boundaries are between public and private difficult to discern, in many cases they may not exist. Property rights are prerequisite to private enterprise [Hill and Karner (1996)] and must be formalized so that property can be exchanged. [de Soto (1996)]. The establishment of property right encourages rational and sustainable use of the resources of the society. Theories of property conventions argue a well-known proposition first articulated by Aristotle, that “*property that belongs to everyone belongs to no one*”. Property conventions have had an important role in the development of the theory of liberal democracy because private property separates the land from the government and limits the power of the government in the process. Private property, in the expression of a distinguished legal tradition, serves as the “guardian of other rights.” [James, W. Ely (1992)].

The major objective of privatization is to improve economic efficiency, competitiveness and sustainability of the whole private sector of an economy. The World Bank reports makes possible to see that the return on equity invested in public sector enterprises is around one third that in the private sector. Thus, mobilizing capital for investment will modernize the private sector and free up resources by reducing the financial burden of loss-making public sector enterprises to more socially beneficial projects such as health and education. Important also removes enterprises from the political arena.

However, it is important to note that privatization is also a political process and has important economic and social implications that not only effect enterprise performance, but also social welfare and stability. The social effects have to be considered in any impact assessment, particularly those related to employment, social safety net measures, social privatization that result from the extension of share ownership to small investors and employees, and the role of public utilities and services in economic and social development. It is therefore important that the framework for evaluation policy developments, including all forms of privatization, is clearly set in advance. [Piesse, J (2001)].

Privatization becomes a popular method for solving the organizational, financial, managerial and other problems of transitional countries by reducing the state assets portion and improving the growth of the private sector enterprises. However, privatization takes a number of forms and has been approached in various ways during the move away from state control to other forms of ownership.

The transition to market economy in transitional countries or reform process in developed countries has involved restructuring and privatization of state enterprises. The actual mechanism varied

between countries, in part reflected the degree to which population involving in reform process, the cultural and historical specific and of course it varies between industrial capitalist and ex-socialist countries [Piesse, J (2001) p.8-9]. Also one of forms of privatization is liberalization or deregulation that allows activities that were previously restricted to the public sector to be undertaken by others.

Privatization's essential contributions are to lock in the gains achieved earlier in reforming public ownership or in preparing a firm for sale, to distance the firm from the political process, and to inoculate it against the recurrence of the common and deadly ailment of public enterprises: the interference by owner who have more than profit on their minds. It is clear that ownership matters that it is a significant determinant of the profitability and productivity of an enterprise. Political and organizational factors are fundamental to the reason why. [Nellis, J (1999)].

2.2 THEORETICAL BACKGROUND OF PRIVATIZATION

Among economists, debates on privatization now spans many areas including welfare economics, public choice, public finance, industrial organization, law and economics, corporate finance, and macroeconomics. In this section, I summarize some of the important theoretical issues that arise in the study of privatization and that are needed to analyze the empirical evidence that reviewed in the 3 and 4-th chapter of this thesis. I concentrate on empirical evidence because, as Jean-Jacques Laffont and Jean Tirole (1993) say after presenting their model analyzing tradeoffs between government and private ownership in promoting efficiency, "theory alone is thus unlikely to be conclusive in this respect."

There are also several excellent articles that discuss the theory of privatization and review the literature, including Anthony Boardman and Aidan Vining (1989), John Vickers and George Yarrow (1991), Laffont and Tirole (1993), Andrei Shleifer (1998), Oleh Havrylyshyn and Donald McGettigan (2000), John Nellis (1999, 2000), and many others.

Developing a theoretical framework

Lets me move beyond criticism and on to the task of building a more relevant and robust economic science, one challenge is to develop a theoretical framework that will guide pluralistic borrowing from a variety of cases and approaches.

Regularities in the organization of both production and distribution are the same as all other social regularities in that they are human creations and are subject to change by human intervention. In other words, there is no "natural economy" and there is no reason to assume that an idealized market system is historically or morally prior to other social systems.

This understanding of the social and inquiring nature of humans is crucial for two tasks that must confront this economic analysis: the understanding of variation in economic organization across time and space, and variation in human understanding and behavior across the lifetime of individuals. The idea that we all start with a set of inherited ideas and perceptions is crucial for explaining economic and all other forms of social behavior.

It follows from above mentioned that as humans create their economies, they can change those economies to solve perceived problems. A central part of economic analysis should therefore be the identification of problems, which is to say to patterns of production and distribution that do not accord with the goals of society. This analysis should lead to reasoned advocacy of reform through normal political, economical and social processes.

Post rationalization rather than prediction

This theoretical framework is mainly ex post rationalization rather than prediction or explanation. Is modern economic theory just a morass of special cases? It is important that some alternative framework be found to allow valid generalization to once again characterize economic theory, and this time, not fail to provide robust empirical results in the absence of ad hoc auxiliaries. Is there such an alternative?

The Adam Smith theory of free market and liberalization

One of the founders of privatization concept Adam Smith in his “Wealth of Nations” believed that part of the duties of a sovereign may be privatized. He wrote that: *“It does not seem necessary that the expense of those public works should be defrayed from the public revenue, as it is commonly called, of which the collection and application are in the most countries assigned to the executive power. The greater part of such public works may easily be so managed, as to afford particular revenue sufficient for defraying their own expense, without bringing any burden upon the general revenues of the society.”* [Smith, A. (1976), p.245]

The New Right (also called “economic rationalism”) is a classical liberal movement. It began in the 18th century as a reaction against the control of the government by the king, church and landed gentry, and the way that such control stifled personal enterprise in the emerging Industrial Revolution. People like Adam Smith were the revolutionaries of their day - Adam Smith's “The Wealth of Nations” was coincidentally published in the year of the US Declaration of Independence: 1776. The New Right wants the least possible amount of government-including involvement in economic activities. They want individuals to have as much power as possible to run their own lives.

Smith was an opponent of mercantilism. He was an advocate of the policy of laissez faire, both nationally and internationally. His advocacy of the free market (to give the greatest scope to the division of labor), of competition (which would always assert itself provided monopolistic positions were not supported by the State), and of unimpeded international commerce all gained support.

Smith also criticized mercantilism's policy of exporting as much as a country could and importing as little as possible. He was an advocate of free trade and did not support ideas of national self-sufficiency. He argued that countries should specialize in what they were best at doing. International free trade would not only benefit consumers but also reduce the risk of war since trade would bring countries together.

To conclude, with the acceptance by governments of Adam Smith's ideas and the reliance on the market, a new era emerged. Governments - unlike the thinking of the thousand years of church influence - now accepted that they had little role in economic activities.

Frederick List as an opponent to Adam Smith

On the level of industrial and international trade liberalization Adam Smith theory has some opponents one of them is Frederick List. Here presented some arguments of Frederick List surrounding the industry. List recommended selective, rather than across-the-board, protection of industries and he was against neither international trade nor export expansion. In fact, he emphasizes the importance of trade and envisages free trade as an ultimate aim of all nations; he regards protection as an instrument for achieving development, massive export expansion and ultimately free trade. List's theory was a dynamic one, with dimensions of time and geography. Making a distinction between “universal association” and national interest, he argues that industry

protection is necessary for countries at early stages of industrialization if some countries “outdistanced others in manufactures”. [Shafaeddin, M (2000)].

Nevertheless, protection should be temporary, targeted and not excessive. Domestic competition should in due course be introduced, preceded by planned, gradual and targeted trade liberalization. List guards, however, against premature liberalization. He is aware of the limitation of size for industry protection but claims that in most cases this obstacle could be overcome through collaboration with other countries. To List, trade policy is not a panacea; it is an element in his general theory of “productive power” (development); industrial development also requires a host of other socioeconomic measures. It is emphasized, however, that, as List maintained, after a point in time trade should be liberalized selectively and gradually, aiming at the ultimate goal of free trade when all nations have reached the same level of development.

According to List (1856: 69–70), Adam Smith (1776) developed his universal theory of international trade having mainly the interests of Great Britain in mind. His followers developed his theory, which also advocated universal free trade. It should be mentioned, however, that even Adam Smith regarded restoration of free trade as a utopia because of the opposition by the private sector. Furthermore, Smith was in favor of protecting defense industries, and approved the Navigation Acts to develop the English merchant navy so as to compete with the Dutch commercial supremacy [Panic, M (1988), p.125]. Moreover, Smith recommended various sorts of government intervention in the domestic economy with their impact on foreign trade. Goldsmith (1995) and Panic (1988) argued that the classical theory of international trade is as sound as any theory based on a certain number of assumptions. The problem with it is that its assumptions are unrealistic. [Shafaeddin, M (2000)].

List’s infant industry argument is very comprehensive, and as a basic theoretical framework extremely relevant to problems of trade and industrialization of transitional countries. To justify his theory List emphasizes the differences between national and universal interests, introduces the theory of productive power (development), as against the theory of universal free trade, and concentrates on the differences in the levels of industrialization of various countries.

The main point of List’s departure from Adam Smith in his theory of international trade is philosophical. Adam Smith does not make any distinction among the interests of individuals, nations and mankind at large [1776, Book II, chap. V]. According to Smith, by seeking their own interests, individuals also preserve the interests of society as a whole. To List, the sum of individual interests is not necessarily equal to the national interest [p. 74,10] i.e. social interests may diverge from private interests [pp. 245, 261]. Moreover, Adam Smith “overlooks nationality and national interest by arguing for maximization of the global welfare” [p. vi]. According to List, some nations may give more weight to their own welfare than to the collective interests of humanity; if so, that nation would be interested more in the expansion of productive forces of the country through infant industry protection than in maximizing the welfare of humanity at large through free trade [p. 2–61]. The economy of individuals is different from the national economy, which is in turn different from the cosmopolitan economy, i.e. the economy of mankind. [Shafaeddin, M (2000)].

Galbraith John Kenneth theory.

Other than his main trilogy, and perhaps *The Theory of Price Control*, Galbraith's *American Capitalism: The Concept of Countervailing Power* (1952) stands out in importance. The central argument of this book is that the growth of economic power in one economic sector tends to induce countervailing power from those who must bargain with the powerful. Hence, unionized labor and

politically organized farmers rose in response to powerful manufacturers. The government is often involved in supporting the rise of this countervailing power and, in Galbraith's view, should be.

With its characteristic emphasis on the reality of economic concentration on the microeconomics background of stabilization issues, Galbraith's has position as a continuing spokesperson for the New Deal perspective in economics. Galbraith coupled the new economics of John Maynard Keynes with the New Deal corporatist view, as did other Institutionalists of the time, notably C.E. Ayres and Allan G. Gruchy. With this book Galbraith's interest in power and his strong dissent from the neoclassical synthesis which was maturing at that time were set. The competitive modes so often used in economics textbooks, which had then been resurrected in the neoclassical synthesis which combined neoclassical microeconomics with Keynesian macroeconomics, maintain that good results follow from certain assumptions about the structure of the economy. Galbraith argued that such assumptions are not met in the actual economy, are unlikely to ever be met, and probably should not be met. He recognized power as an essential element of economic life and argued that only by examining the power of corporations, unions, and others could economists address the vital issues of social control and economic policy.

In *The New Industrial State* Galbraith expanded his analysis of the role of power in economic life. A central concept of the book is the *revised sequence*. The conventional wisdom in economic thought portrays economic life as a set of competitive markets governed ultimately by the decisions of sovereign consumers. In this original sequence, the control of the production process flows from consumers of commodities to the organizations that produce those commodities. In the revised sequence, this flow is reversed and businesses exercise control over consumers by advertising and related salesmanship activities.

The revised sequence concept applies only to the industrial system that is, the manufacturing core of the economy in which each industry contains only a handful of very powerful corporations. It does not apply to the market system in the Galbraithian dual economy. In the market system, comprised of the vast majority of business organizations, price competition remains the dominant form of social control. In the industrial system, however, comprised of the 1,000 or so largest corporations, competitive price theory obscures the relation to the price system of these large and powerful corporations. In Galbraith's view, the principal function of market relations in this industrial system is not to constrain the power of the corporate behemoths but to serve as an instrument for the implementation of their power. Moreover, the power of these corporations extends into commercial culture and politics, allowing them to exercise considerable influence upon popular social attitudes and value judgments. That this power is exercised in the shortsighted interest of expanding commodity production and the status of the few is both inconsistent with democracy and a barrier to achieving the quality of life which the new industrial state with its affluence could provide.

The New Industrial State extended once again the currency of Institutional economic thought. The conventional theory of monopoly power in economic life maintains that the monopolist will attempt to restrict supply in order to maintain price above its competitive level. The social cost of this monopoly power is a decrease in both allocative efficiency and the equity of income distribution. This conventional economic analysis of the role of monopoly power did not adequately address popular concern about the large corporation in the late 1960s. The growing concern focused on the role of the corporation in politics, the damage done to the natural environment by an unmitigated commitment to economic growth, and the perversion of advertising and other pecuniary aspects of culture.

Economics and the Public Purpose, the last work in Galbraith's major trilogy, continued the characteristic insistence on the role of power in economic life and the inability of conventional economic thought to deal adequately with this power. Conventional economic thought, with its competitive model and presumptions of scarcity and consumer sovereignty what Galbraith called the "imagery of choice" serves to hide the power structure. This obscurantism prevents economists from coming to grips with this governing structure and its untoward effects on the quality of life. Galbraith employed what he called "the test of anxiety" in this attack on conventional economics. He argued that any system of economic ideas should be evaluated by the test of anxiety--that is, by its ability to relate to popular concern about the economic system and to resolve or allay this anxiety. Galbraith contended that conventional economic thought failed the test of anxiety and again offered his basic model from *The New Industrial State* as an alternative approach to understanding the contemporary economy.

Institutional Economists

While the Institutional economists saw their role as one of criticism and advocacy, they did not purport to offer permanent solutions or design of utopias. They were reformers, not revolutionaries who could advocate permanent solutions. Instead, the pragmatic solutions to problems were offered with the sure knowledge that these solutions would create new problems. Central to institutionalist thought was the perception that the advent of industrial as opposed to craft production had altered the relationship of producers of products and producers to consumers. New rules, regulations and patterns of interaction were required and those very rules, regulations and patterns of interaction themselves created new conflicts that would lead to more change via a process of cumulative causation. Not only the path of change difficult to predict, but it is impossible to formulate an idea toward which such change tended. In other words, it was futile to speculate on the conditions that would prevail in an ideal economy.

In order to understand the processes of ongoing change, and in order to understand the human organization of production and distribution, a variety of tools were found to be useful. Wesley Mitchell, one of the most active of institutionalists and founder of the National Bureau of Economic Research was a strong advocate of descriptive statistics and statistical analysis as a way of discovering the actual (as opposed to idealized) patterns of economic behavior. Others borrowed the methods of anthropology and sociology to discover patterns of behavior through rough observation and participation. Studies of the legal system, as a working system of evolving human rules was central to the approach taken by John R. Commons and his students. The study of economic history was vital for understanding patterns and processes of change. In all of the institutionalist work, the tools were just that: ways to achieve the goal of understanding the patterns of human behavior and how they changed. The tools did not define the discipline. [Anne, M (2001), p. 7]

The New Evolutionary Microeconomics

In *The New Evolutionary Microeconomics*, Jason Potts (2000) argues that all heterodox thought shares a common ontological foundation in the view that the dynamics of evolving economic systems are in the space of connections. Economy is a complex system of interactions, and the dynamics of an economic system involve change in the connective structure of the system. Three main themes can be found to share this common foundation.

The first is the evolutionary economics revived by Nelson and Winter (1982). This builds on Book IV of Marshall's *Principles*, and on Schumpeter's theories of cycles and innovation, creative destruction and greed for monopoly profit. Market capitalism is a restless system of experimentation in pursuit of sustainable rents based on private knowledge. This is fundamentally a neo-Darwinian approach. It has been argued in Nightingale and Laurent [*Darwinism and*

Evolutionary Economics, Edward Elgar, (2001)], that social and cultural theory is ultimately swallowed by Darwin's 'universal acid', as Dennett so tellingly put it [Dennett, *Darwin's Dangerous Idea*, (1995)]. Complexity and self-organisation theory is the most recent advance of the neo-Darwinian project [Foster and Metcalfe, *Frontiers of Evolutionary Economics*, (2001)].

The second is the New "Old Institutionalism", which is about how agents with minds construct and use complex systems of rules. Current research on Veblen's themes often ignores his contribution, but continuity of ideas remains clear. Organisational ecology, and other resource and systems based views of the firm, is one such well-defined field on inquiry. Evolutionary psychology is another [L. Cosmides and J. Tooby, (1994) 'Better than Rational' *AER*, 84: 327–32]. Both these are converging in the economist's sphere, seeking explanations of selection processes and system regularities in habits, routines and the causes for organizations' and other institutions' persistence as well as entry and exit.

The third is the complex systems view of economic systems. Methodological Individualism is one of the principles on which modern orthodox economics is based, as an article of faith, and a justification for the reductionism that has bedeviled areas such as macroeconomics.

There is sociology and discursive social theory but here there is a huge gap between its thorough and detailed observation and its abstract theoretical terms. I suggest that the way forward is not to abandon all types of formal modeling but rather to use expressive quantitative and qualitative systems to build descriptive models of observed dynamic processes. This aims to combine the relevance and realism of social observation with the rigor of formal quantitative models. This is a bottom-up attempt to bridge the gap and move towards a science of social phenomena.

Modeling complex study systems

Complex systems are precisely those for which it is extremely difficult to deduce its behavior from first principles. With complex systems, observation and description must come first and only much later is it sometimes possible to encapsulate some of these in a predictive model. It seems likely that much economic behavior is complex in this way. This would not be surprising since it arises as the consequence of the intricate interactions between members of a species that is characterized by the variety and contingency of its behavior.

But if we are to give up the chimera of numerical predictive models built using a priori principles, doesn't that mean we have to give up formal models and rigor? I would say that we do not. What it does mean, however, is that we have to use formal and quantitative models that are capable of capturing the detailed process as it is observed. We then need to constrain these models as much as possible using observations of the relevant phenomena, both in terms of the trajectories of the causal processes as well as the outcomes; in terms of qualitative information as well as quantitative data. Pinning down models using only the verification of predictive outcomes and an insistence on formal simplicity will not be enough. We will need to capture the workings of the process stage by stage as they are observed.

In order to perform this feat I will need systems that are up to the task of expressing the qualitative cognitive and social processes of economic phenomena like privatization. These more expressive systems come at a price, they are not simple and they allow for multiple representations of the same outcomes. However there is no need for them to be any less formal than a set of differential equations.

I am suggesting that I should attempt to construct models of quite specific sets of observations that are more akin to a description than a theory. It is, of course, impossible to lose all assumptions in the construction of any model, but the point is to move towards using fewer and less drastic a priori assumptions and use more qualitative and quantitative constraints derived from observation the processes under study. The purpose is to provide an unambiguous framework for the exploration of the possible processes within these constraints so as to inform the direction of further observation and modeling.

Monetarism

The pioneer of the “*Monetarism*”, Milton Friedman, wrote in his “Free Market Economy” or in his own words, “*Competitive Capitalism*”: “The scope of government must be limited. Its major function must be to protect our freedom both from the enemies outside our gates and from our fellow citizens; to preserve law and order, to enforce private contracts, to foster competitive markets. By relying, primarily on voluntary cooperation and private enterprise, in both economic and other activities, we can insure that private sector is a Check on the powers of the governmental sector and an effective protection of freedom of speech, of religion and of thought.” [*Friedman, M (1962)1*].

About governmental intervention in economy Friedman said: “The existence of a free market does not of course, eliminate the need for government. On the contrary, government is essential both as a form for determining the “rules of the game” and as an umpire to interpret and enforce the rules decided on.” [*Friedman, M (1962)2*].

The monetarists are not is new; they are simply a modern variation of the neoclassical school of economics which dominated the field from the 1870s to the Keynesian revolution of the 1930s and 1940s. Monetarists share the same essential view as the neoclassical school, that is, they reject theories of macro demand deficiencies and emphasize the efficiency of free markets; for instance, they believe that market forces act quickly to eliminate unemployment. Monetarists are new only in the sense that their theory is more sophisticated than that of their ancestors and that their doctrine has reasserted itself after a long period following 1945 in which Keynesians dominated both economics and economic policy.

The modern term “monetarist” derives from the debate of the 1960s and 1970s concerning the role of money in determining aggregate demand. It is seen by many as a relatively narrow argument to motivate specific monetary reform, in particular, a “fine-tuning” of measures to deal with inflation. While, its critics say, ignoring everything else-well being in particular.

So what is “monetarism” which formed the world view of this group? “Monetarism” is usually understood as an economic theory, or a loose array of economic approaches which challenged mainstream Keynesian theory in the early 70's. Additionally, the term could also stand for a set of economic policies associated with the neo-conservative revolution (from Reaganism and Thatcherism to Gingrichism), and with the recommendations of world economic supervisory agencies [*IMF, World Bank*].

The most important of these policies were: 1) to strictly control and reduce inflation (since it distorts the work of the market as an information machine), even at the expense of permanent unemployment; 2) to reduce the government’s discretionary jurisdiction in favor of fixed policy rules, which are known to all and guarantee stable expectation-formation; 3) to keep a tight-fisted fiscal policy and a “monetary rule of steady growth in the money stock”; 4) to establish flexible

exchange rates, and open up to international competition [*Mankiw, G (1990); Harvey, D (1989); Frieden, J (1991)*].

My usage of the term, however, will be somewhat different, though connected in important ways to both monetarist theory and monetarist policies. By “monetarism” I mean a technology for governing economic life, and by extension also social life in transition period and especially in time of privatization. The term “technology” is used advisedly: to produce a governable population is a technical task specified by an art of government. In such a task, concepts, theories, forms of measurement and inscription, are not simply “ideas” representing reality, but tools for constituting this reality and rendering it calculable, knowable and hence governable [*Miller, P and N, Rose (1990)*].

To understand this point, we need simply to remember that the term “economy” itself, only recently came to mean a “sphere of society”. Early in the 18th century, it still referred to an economizing art of government, a way of putting things in right order. We retain this sense when we say that someone does something “with economy”, i.e. orderly, frugally, rationally. “The economy” begun to mean a sphere of society only with liberalism, but this was precisely because liberalism thought of the “economy” as a naturally arising order, i.e. we can think of liberalism itself as an “economizing” art of government, which exploits the capacities for natural order inherent in what it rules [*Foucault, Michel (1991)*].

Monetarism is such a liberal art of government. It proceeds by imposing monetary representations on social phenomena, which it then expects to become self-regulating. They never really do, but the monetarist art of government consists in carefully cultivating their natural tendency to self-regulation, avoiding as much as possible gross interferences. Monetary representations, like all other representations - maps, charts, statistics, reports and forms - open the possibility for regulating the conduct of individuals and populations “from afar”, because they can mobilize distant phenomena, and bring them closer into “centers of calculation” [*Latour, B (1987)*].

Monetary devices representing a population (for example, “the money stock”) or an individual (for example, “human capital”) have the added advantage that they afford precise calculation, and they exploit a tendency of markets to self-regulate. Thus it is possible to regulate and pacify social problems without direct intervention. Supply and demand will determine what gets defined as “accident” and what is worth. This is not necessarily what happens in actuality, but this is the “governmentality” behind its introduction, and this is why I say that monetarism is a technology of government [*Ewald, F (1991); Defert, D (1991)*].

One could distinguish two phases in the development of monetarism. In the first one, mostly represented by the work of Milton Friedman, the emphasis was on using money and control over the money stock to control and shape an “economy” especially economy in transition. Money, for Friedman (1962, 38-39), is the ideal means for action at a distance. “Control over money can be a potent tool for controlling and shaping the economy”, and in this respect it is superior to fiscal interventions, about which he says, “we simply do not know enough to be able to use [them]...as a sensitive stabilizing mechanism.” For all his emphasis on “freedom”, Friedman’s over-riding concern is one of “governing”: the question is how to “establish a monetary system that is stable and at the same time free from irresponsible government tinkering.”

Now, Friedman’s approach is based on what, from the vantage point of the second phase, is a rather crude instrument. He constructs a monetary representation of the workings of an “economy”, encapsulated in the notion of the “money stock”, a global index of the amount of currency outside

and inside banks. His goal is to show that changes in the money stock lead to changes in income and business conditions, and he constructs specific monetary indicators (“the monetary base”, “bank reserve ratio”) to represent the behavior of important actors-the monetary authorities, commercial banks, the public [*Thygesen, N (1984)*].

The concept of “the money stock” removes the actions of the governing authority one step further from the natural order of the economy. Money is a “nominal” value, not a “real” one, hence manipulation of money would not mean government intervention in any real economic processes, or in the real lives of economic actors. By shaping the money stock, the governor merely shapes the nominal environment in which agents’ choices are made. Additionally, the government is to be limited by a set of binding rules resembling a constitution. In fiscal terms, the government will be limited to a balanced budget, while as a monetary authority it will be rendered effective yet limited, by a rule of fixed slow (3-5% annually) growth in the money stock. In this way, the government of the economy will be free from human errors and abuse of power. At the same time, a nominal environment of “growth” will be created, comforting and re-assuring actors about the health of the economy, and thus guiding their actions in a positive direction [*Friedman, M (1962), pp. 54, 79; Thygesen, N (1984), pp. 229, 240-243; Mankiw, G (1990), 165*].

The major limitation of this technology of government was that, to use economists’ language, it was formulated on the macro-economic level of aggregate indicators, and lacked “micro-foundations”. From the point of view of governmentality, I should note that Friedman’s technology remains peculiarly limited to the relation between “population” and the state. The “money stock”, a veritable monetary representation of the national economy, serves to limit and prescribe the role of the state in the economy, but the potentialities of money to serve as a medium of government have not been explored.

For a moment, Friedman envisions a new possibility for an efficient government of the social. If these activities could be dealt with in “organized financial markets”, or at least in something, which will simulate the workings of these markets, the conduct of households and individuals in a variety of domains-birth, immigration, crime and leisure-could be tied to stringent calculations of profit and loss, and hence led in the desired direction. Even more important, it could be “mobilized”, in the sense that it could be quantified, calculated and represented. But Friedman rejects this possibility as not very realistic, I would argue, precisely because it is beyond the reach of his technology. The “money stock” is a product of a technology which is focused on the population as composed of concrete individuals, and thus is limited in its application by a strict boundary-line separating reasonable individuals, activities, and spheres of life from non-reasonable ones: “Freedom is a tenable objective only for responsible individuals.

We should understand these economic theories not so much as scientific models of “the economy”, but as proposals for governing society on the way from socialist economy to free market. Only in this way it is possible to appreciate their appeal and novelty. For example, the analysis of expectation-formation, as suggested by Robert Luckas, validates Friedman’s preference for fixed monetary rules over discretionary policies. The Keynesians understood discretionary policies as “interventions” in the economy, i.e. as a means of stabilizing a delicate machine liable to get out of hand. But from the point of view of “rational expectations” theory, discretionary policy should be understood not as policy intervention, but as a risky form of governing; not as manipulating “real” quantities to restore order, but as distorting information. Introducing systematic expectation errors, in short, disrupt the means of “action at a distance”. Even if policy-makers promise low levels of inflation (as against being bound by a fixed rule), individuals are likely to expect them to renege on their promises, create inflationary strains, and thus be “justified” in their expectations. Which means

that a systematic distortion of information will be created, and with it “perverse effects” such as inflation [Mankiw, G (1990), pp. 1649-1650)].

With the move away from concrete individuals to a combinatory of factors (such as “risk” or “choice”), the project of governing a privatization process in transition becomes at least in part a matter of governing information (represented by money). This can explain the revival of interest in Hayek, and in his view of markets as (albeit imperfect) the most efficient means for mobilizing, distributing and calculating information. It is in this field that monetarism has been the most successful up till now. Between the crude devices suggested by Friedman and Becker’s economic government of the social there stretches a whole range of financial instruments for the compression, manipulation, evaluation and translation of information, that is most affect on privatization and totally transformed the government of economic life in period of transition.

Rational Expectation Theory

Rational Expectation Theory was developed in the 1970’s by a group of neoliberal economists, notably Robert E. Lucas, Thomas J. Sargent, Neil Wallace. The theory is also based on Classical Economics and focuses particularly on the inflationary expectations of individuals. The Rational Expectation Theory challenged and amended the Adaptive Expectation Hypothesis, which claims that present price expectations about the future are adopted from the previous or the most recent prices. [Aktan, C (1992) p.6-7]. Individuals can make systematic forecasting errors period after period. However, the point of departure for rational expectations is that individuals should not make systematic errors. This does not imply that individuals invariably forecast accurately in a world in which some random movements are inevitable; rather the assertion is that guesses about the future must be correct on the average if individuals are to remain satisfied with their mechanism of expectations formation. According to rational expectations economists, when uncertainty is absent and information complete, individuals make “rational” decisions and approach the “perfect foresight.” [Begg, D(1982)].

Individuals are rational in that they do not throw useful information away. After a time, individuals begin to understand the workings of the economy. Decision-makers with rational expectations are not always right, but they learn over time, and are able to predict outcomes over the long run. The result is that, when the discretionary decisions of policymakers are perfectly anticipated, monetary and fiscal policy will have no effect on aggregate demand. [Ekelund, R and D. Tollison (1986) p.693] In sum, rational expectation economists propose that government should only determine the rules of the game in the marketplace and then let the market forces operate themselves. They, like classical economists, believe that the market is able to solve economic problems automatically over time. They strongly oppose government interference with the economy. [Aktan, C (1992) p.7-8].

Neoliberals were not only had capitalism proved superior to communism, but the economic theory of the market economy had, it seemed, proved superior to Marxism. A task of transition did lie at “the end of history” though not from capitalism to communism as Marx had expected, but from state socialism back to the market economy.

Such a transition was clearly necessary. In addition to the clear political and humanitarian failures of centralized Soviet regime, economic growth under central planning had failed to maintain its initial promise. Once impressive performances gave way to stagnant economies producing dated goods, whereas the market economies of the West had grown more rapidly and with far greater product innovation.

As the most prominent intellectual advocates for the free market over central planning, neoclassical economists presented themselves as the authorities for how this transition should occur. Above all else, they endorsed haste. In a typical statement, Murray Wolfson argued that “market systems are much more stable than most people who have been brought up in a command economy can imagine. The flexibility of market systems permits them to absorb a great deal of abuse and error that a rigidly planned system cannot endure. [Wolfson, M (1992), p. 42].

The terms “abuse” and “error” were unfortunately prophetic for the rapid transition imposed a great deal of abuse and error on the peoples of Eastern Europe. A decade later, incomes have collapsed, unemployment is at Great Depression levels, poverty is endemic. The transition has in general been not from Socialism to Capitalism but from Socialism to Third World.

Wolfson is far from being a leading light of neoliberal economics. But his arguments in favor of a rapid transition are indicative of the naivety of those whom Joseph Stiglitz would eventually blame for abetting the theft and destruction of Russia’s wealth. Their key failing was a simplistic belief in the ability of market economies even proto-market economies to rapidly achieve equilibrium. This led them to recommend haste in the transition and especially in privatization of state assets a haste, which effectively handed over state assets to those in a position to move quickly, the old Party officials and organized crime.

Reading these pro-haste papers one-decade after the privatization debacle, one can take little comfort in realizing how different the outcome of this rapid privatization was to the expectations economists held: “Even though we favor rapid privatization, we doubt that privatization will produce immediate, large increases in productivity... Nonetheless, we believe that in order to enjoy these enormous long-term gains, it is necessary to proceed rapidly and comprehensively on creating a privately-owned, corporate-based economy in Eastern Europe” [Lipton & Sachs (1990), p. 295]

It might be thought that, since speed was such a key aspect of the recommendations economists gave for the privatization, they must have modeled the impact of slow versus fast privatization and shown that the latter were, in model terms at least superior. But in fact the models economists took their guidance from completely ignored time: they were equilibrium models that presumed the system could rapidly move to a new equilibrium once disturbed.

The period of transition coincided with the peak influence of the concept of “rational expectations” in economic theory. This theory argues that a market economy is inhabited by “rational agents” who have, by some presumably evolutionary or iterative learning process, developed complete knowledge of the work of the market economy and who can therefore confidently predict the future (at the very least, they know what will happen in response to any policy change by the government). The workings of the market economy happen to coincide with the behavior of a conventional neoclassical model, so that the economy is always in full employment equilibrium.

These perspectives on individual behavior, the formation of expectations, and the behavior of a market economy, are dubious enough in their own right. Rational expectations “logic” is truly worthy of the moniker autistic, since it is based on a proposition that, if properly handled, negates its own predictions. This is the proposition that, as Muth put it: “Information is scarce, and the economic system generally does not waste it. [John Muth, “Rational Expectations and the Theory of Price Movements”]

Since in neoclassical economics, scarcity is the basis of value, then information should according to this theory have a cost. If it has a cost, then agents should economize on its use they will not use

“all available information” but only the subset of information that they can afford, given their preferences for knowledge. Therefore individual agents will not know the full character of the economy, and most will certainly not know its “stable manifold”.

Rational agents therefore cannot be expected to jump immediately to the equilibrium path of the economy unless they are irrational enough to expend the enormous amount of revenue that would be necessary to buy all the scarce information.

The foundations of “rational expectations” economics are thus internally inconsistent, and the fact that they were taken seriously in the first place is a clear sign of how truly autistic economic theory has become.

But if it was autistic to give this theory credence in the West, how much more so was it to apply this model to the behavior of people in an economic system in transition between central planning and market capitalism?

How can the “agents” in a transitional system develop a mental model of a market economy with which they predict the future behavior of the actual economy, if they have not previously lived in a market economy? Are we to presume instead that people can instantly develop the understanding of something as complex as a market economy and are we to grace this belief with the adjective “rational”?

Let’ this seem an overly harsh rhetorical flourish, consider the following discussion of how fast the transition should be from Wolfson’s (1992) paper. He begins with a statement that a sensible person might expect the conclusion that people must be given time to learn how to react to market signals: “Indeed, when government actions become so large that their effect on prices causes wide divergence from individual choices, one cannot determine what those choices would have been. As a result, no reliable guidelines exist for government choice. Even with the best of intentions, unlimited collective choice destroys the very information base for rational decisions.” [Wolfson (1992), p. 37].

“Rational and reasonably knowledgeable economic agents”? Where did they come from, and how did they acquire so profound a knowledge of the market system they have not as yet lived in that they can predict its behavior (and prices in it a year into the future) before they experience it? Yet presuming their existence and their intimate knowledge of the behavior of an economic system that does not yet exist, Wolfson advises that:

A rational expectations conclusion is that quitting communism Cold Turkey is the only way to get from A to B. In practice, governments must make the national currency convertible and allow it to float on legal as well as black markets, abolish the system of subsidies and direct plans and quotas, close plants that cannot compete, come quickly to a privatization of industry even if some inequities result, strictly control the money supply, and allow goods and services to find their own price on national and international markets. [Wolfson, M (1992), p. 39]. Wolfson does qualify his arguments with some concessions to reality, but in the end his recommendations are all for speed on the basis of a belief in the self-adjusting properties of the market economy

As Janos Kornai details so well the soft budget constraints of the Soviet system had resulted in “cashed up” consumers on the one hand, and technologically backward and shortage-afflicted factories on the other. The consumer financial surpluses, accumulated during the long wait between placing orders for consumer durables under the Soviet system and actually receiving the goods,

were rapidly dissipated on Western consumer goods. The Eastern businesses, now forced to compete with technologically far superior Western firms, were rapidly destroyed, throwing their workers into unemployment. With accumulated buying power dissipated and freely floating currencies, exchange rates collapsed.

A sensible dynamic analysis of the plight of the ex-socialist economies is one that really did take time into account would have predicted this outcome from a too rapid privatization. Even if the technological advantages of the market system over Soviet-style industrialization had amounted to just a one percentage difference per annum in productivity, the forty five year period of socialism would have given market economy firms a 55 per cent cost advantage over their socialist counterparts. And of course, the product development aspect of technological innovation had made far greater differences than this merely quantitative measure of costs Western firms would have decimated socialist ones on product quality alone, even without a cost advantage.

A time-based analysis would therefore have supported a gradual privatization, with substantial aid as well to assist Eastern factories to introduce modern production technology and process control methods. It should also have been obvious that for a market economy to develop one needs the minimum distributive systems of a market: systems of wholesale and retail distribution, respect for written contracts, systems for consumer protection, laws of exchange all things which take a substantial time to put in to place.

With the obscene haste with which the actual transition was implemented, the only non-market systems that could rapidly develop were those that were already in place in the preceding socialist system, the systems of organized crime that had always been there to lubricate the wheels of the shortage-afflicted Soviet system, just as market intrusions once permeated the feudal systems out of which capitalism itself evolved in Europe.

It is of course too late now to suggest any alternative path from socialism to the market for these no longer socialist economies. The new transition they must make is from a de-industrialized Third World state back to a developed one, and that transition will clearly take time.

Property Rights Theory

Thus the perspective that unequivocally points to privatization as desirable policy holds that property ownership is the fulcrum of political economy. From the Chicago tradition come two closely related clusters of work: the theory of property rights and the theory of public choice. Both attempt to enlarge the conventional economic paradigm by treating the classical firm and modern package of property rights as only one of various possible institutional forms.

As developed by economists such as Armen Alchian and Harold Demsetz, the theory of property rights explains differences in organizational behavior solely on the basis of the individual incentives created by the structure of property rights [Alchian, (1965)p. 816; Demsetz, (1967)p. 347]. A right of ownership actually comprises several rights, chiefly the rights to use an asset, to change it in form, substance, or location, and to transfer all or some of these rights.

First the theory holds that the form of ownership is the predominant explanation for the varying performance of different organizations. The theory gives no importance whatsoever to organizational characteristics such as size, centralization, hierarchy, or leadership.

Second, the theory takes the market as the standard for judging value and finds public institutions deficient because they fail to measure up to that standard, e.g., their “shareholders” cannot sell

stock. Survival in the market, of course, depends on the capacity of organizations to produce a residual reward for the owners a profit. This is not the standard that public institutions generally need to meet. The property rights approach says that society would be better off if, instead of meeting approval in the political process, public organizations or their assets were privately owned and had to meet the test of profitability.

Third, the property rights theory assumes that the market for corporate control is highly efficient and that the chief reason corporations are acquired is their management's poor performance. Virtue is not always rewarded in the market for corporate control; nonetheless, according to the property rights view, market discipline forces managers of private firms to be more efficient than public managers. The theory gives no weight at all to the monitoring capacities of the state, the public at large, and the various institutions of a liberal democracy, such as the press, that routinely scrutinize the performance of public institutions. The reasons for this dim view of public monitoring are spelled out in the theory of public choice. [Paul, Starr (1988), pp.21-22].

Well-defined property rights are widely viewed as a source of improved economic performance. A system of property rights is "a method of assigning to particular individuals the 'authority' to select, for specific goods, any use from an unprohibited class of uses. " It is common to distinguish three categories of property rights: First, there are the rights to use an asset user rights which define the potential uses of an asset that are legitimate for an individual, including the right to transform physically or even destroy an asset. We should note that restrictions of rights that shrink the set of permissible uses would lower the economic value of an asset if highly valued uses were excluded. Second, there is the right to earn income from an asset and contract over the terms with other individuals. Third, there is the right to transfer permanently to another party ownership rights over an asset that is, to alienate or sell an asset.

Ronald Coase (1960) provided a fundamental insight into the role of the determinants of property rights. He showed that in a hypothetical world in which it is castles to measure and monitor goods, to ascertain ownership, and to transfer goods, initial ownership would have no effect on the efficient allocation of goods. In that world, no matter what the initial allocation, property rights will flow to their highest valued use.

Improving the clarity of ownership is valuable in that it permits owners and potential owners to seek out more highly valued uses across a wider set of individuals and over a longer time horizon. For example, clarity of ownership allows the owners of assets to access capital markets by using those assets as collateral. Land reform that prevents the sale of land will eliminate land as collateral, greatly diminish the capital markets, and limit development. This argument for increasing the gains from trade by increasing clarity of ownership is the central economic argument for privatization, efficient court systems, stable rules, stable prices, low taxes, and the elimination of barriers to trade.

Constitutionally enforced property rights can be viewed in this context as "...an attempt to remove issues from the domain of politics so as to reduce the opportunities to create unstable social outcomes" [Ordeshook, P (1993), p. 216]. This view implies that placing more property under the direct control of the state will lead to greater instability of the polity because coalitions will form to compete for property in the public domain. This competition takes many forms. In systems with extensive state ownership of enterprises, controversies frequently arise concerning the amount and allocation of state subsidies. The budget deficits, capital market distortions, and inflation engendered by these subsidies add instability to the rights individuals hold over private property. [Riker and Weimer (1995)].

Property rights may be enforced in a variety of ways, through self-help, through vigilante groups, through mercenaries. But in most cases, the least expensive and most feasible way is to have the state provide this service. The state, with its sole monopoly on the legitimate use of ultimate sanctions, can most cheaply do this. But the state may find that the protection of revenues or the privilege of a hereditary bureaucracy for instance is critical to its own well being. At the same time, the state mitigates property rights in the public interest through rights of appropriation, eminent domain, and through the exercise of police powers.

Property rights are a legal construct. The theory of private property is based upon the idea that “property is the right, and not the object over which the right extends.” [Richard T. Ely (1914), p. 108]. There are four basic types of ownership: 1) private ownership; 2) communal ownership; 3) common ownership (or open access); and 4) state ownership. Private ownership of an asset implies the right to use the asset, the right to earn income from the asset, and the right of alienation, that is, the right to transfer all the other rights associated with the property (including the right of alienation) to another party. [Eggertsson, T (1990). pp. 33-57].

The goal of privatization is to establish ownership rights. Privatization involves identifying a specific set of property rights that were exercised previously by the state and transferring these as ownership rights to individuals or entities in the private sector. In the circumstances of the former Soviet countries, privatization is basically denationalization and it takes central place in discussions concerning transformation in Central and Eastern Europe and the former Soviet Union.

Privatization is the transfer of property rights from the public to the private sector. Privatization has far-reaching normative implications because it effects the transfer of enormous amount of wealth. Moreover, privatization has wider social and political consequences. Privatization encourages the growth of the non-state sector by under girding operational autonomy of non-governmental organizations. In the view of some democratic theorists, the right to private property is the “guardian” of all other rights, a pillar of civil society, and a fundamental element of every modern democracy.

Public Choice Theory

Thus, like the theory of property rights, the public choice perspective indicts public ownership and management across the board. In short, starting with an individualistic model of human behavior, the public choice school makes a series of empirical claims: (1) that democratic polities have inherent tendencies toward government growth and excessive budgets; (2) that expenditure growth is due to self-interested coalitions of voters, politicians, and bureaucrats; and (3) that public enterprises necessarily perform less efficiently than private enterprises.

Together, the property rights and public choice schools show only that, if you start by assuming a purely individualistic model of human behavior and treat politics as if it were a pale imitation of the market, democracy will, indeed, make no sense. [Starr, P (1988)pp.22-23].

Throughout history, scholars, including economists, have debated the role of government in the economy. For example, Friedrich von Hayek’s (1994) passionate critiques of the welfare state and collectivism, exemplified in the 1944 book *The Road to Serfdom*, had a direct impact on policymakers in developing a motive for privatization. Yergin and Stanislaw (1998) write how Hayek’s work was the intellectual basis for Keith Joseph and then Margaret Thatcher and the Tory politicians who began the intellectual campaign against statism in the U.K. that triggered the worldwide privatization movement.

The economic theory of privatization is a subset of the large literature on the economics of ownership and the role for government ownership (or regulation) of productive resources. An initial question to be asked is “what is the proper role of government?” Implicitly, we assume that the goal of government is to promote efficiency.

Thus, we discuss the efficiency implications of government ownership and more importantly, the movement from government ownership to privatization.

One of the major contributions to the development of the contemporary privatization movement which has also been called “Economic of Politics” or “Collective Choice Theory” deals with the issues of how economic resources are allocated by the political decision making process. In other words, public choice may be defined as the application of economic concepts, assumptions and tools to politics. The most important contribution of the Public Choice Theory to the economics is that it developed a “Theory of Governmental Failure” as opposed to a “Theory of Market Failure” developed by Welfare Economics. It has been argued that market failure, due to external economies, public goods, scale of economies necessitates government interference with the economy. For many years, some economists have advocated government intervention in order to correct market failures. [*Aktan, C (1992) p.8-10*].

However, it is only in recent years how public choice economists have argued that the concept of “government failure” also exists. By this advocate government enacted policies produce inefficient and inequitable consequences as a result of the traditional behavior of participants in the political process. Public choice economists argued that the fact that the market is inefficient does not imply that government will do any better. [*Browning, E and J. Browning (1983)p. 74-76*].

There are two themes in the broader privatization debate: a “political economy” consideration of the role and size of government in an economy, which focuses on whether or not there is a failure of private markets; and, secondly, an expressed need to reduce government outlays. First we should note that both governments and markets do the same thing: they exchange goods and services for money. But if they both do the same thing, then why not let the market do it all? Or why not let the government do it all? The answer is because it depends on the goods and services being offered. Governments and markets are better suited for providing different things.

To better understand how the markets and governments are making transactions I am offering go through Steve Kangas model.

The General Model: A group (A) delegates power to individual providers (B) within an institution (C) to provide goods and services in exchange for money (D). The group has their choice of many providers competing to provide them goods, and they give consumer satisfaction units (E) to their preferred choice. Those providers receiving a sufficient number of units will be delegated to power (F), and those that do not will be denied power (G). This competition keeps prices down, quality high, and incompetent providers out of the system.

The Market: Customers (A) delegate power to individual companies (B) within the market (C) to provide goods and services in exchange for money (D). Customers have their choice of many companies competing to provide them goods, and they give money (E) to their preferred choice. Those companies receiving a sufficient number of moneys will stay in business (F), and those that do not will go bankrupt (G). This competition keeps prices down, quality high and incompetent companies out of the market.

Government: Citizens (A) delegate power to individual representative's (B) within government (C) to provide goods and services in exchange for taxes (D). Citizens have their choice of many candidates competing to provide them goods, and they give votes (E) to their preferred choice. Those candidates receiving a sufficient number of votes will be elected to office (F), and those that do not will be denied office (G). This competition keeps prices down, quality high, and incompetent representatives out of government.

This is a model of non mixed economy with ideal market and ideal government. The prevailing economic justification for government involvement in an activity is because of market failure, whereby the market mechanism alone cannot perform all economic functions for appropriate resource allocation. "Market failure" may arise because some goods or services are public goods which can be consumed in a non-rival fashion by all members of society without any individual's consumption reducing the amount available for other individuals. Because individuals cannot appropriate the benefit of providing such goods, individuals generally will not provide such goods in a society even though there may be significant gains for producers and consumers. Some extension activities are clearly concerned with public goods subject to market failure; other confers appropriable private benefits which could be adequately supplied by private markets.

Although competitive markets are the best way yet found for efficiently organizing the production and distribution of goods and services, the state must provide an appropriate institutional framework and must step in where markets prove inadequate or fail altogether. There is also a complementarily aspect of market being encouraged to work and judicious intervention by the government in cases of failure. Adam Smith argued that as each individual pursued their own self-interest, in market economy, they would also serve the common good. Therefor if markets are complete, so that no transaction are missed, and if there are so many buyers and sellers that none can alone influence prices, then the market outcome will be efficient. In addition, efficient markets also depend on assuming perfect information, as the provision of information is itself subject to market failure. Monopoly control of information leads to market failure, just as much as monopoly over resources. It is clear to, that achieving fully competitive markets is difficult, so it is the nature and extent of the imperfection that is important. Interventions by government may also be justified where resources are not fully employed, or the efficient market outcome is unacceptable on distributional grounds. Therefor, although this too is closely linked to regulation and enterprise development, it is so central to privatization and restructuring. [*Piessse, J (2001)p.4-6*].

The theoretical arguments for the advantages of private ownership of the means of production are based on a fundamental theorem of welfare economics: Under strong assumptions, a competitive equilibrium is Pareto optimal. However, the assumptions include requirements that there are no externalities in production or consumption, that the product is not a public good, that the market is not monopolistic in structure, and that information costs are low. Thus, a theoretical argument for government intervention based on efficiency grounds rests on an argument that markets have failed in some way, one or more of these assumptions do not hold, and that the government can resolve the market failure.

Markets Failure.

Markets fail for some main reasons. The first is *Market power* when there is market structure with no competition, because there are too few participants in the market or there is a *natural monopoly*. The second is that markets may not exist, or they may be incomplete or fragmented, this allows transactions have non-market spillover effects or externalities. Second *Externalities* result when the production or consumption activities of one economic group impinge on those of another and the effect is not resolved by the price system. Also it is necessary to distinguish between a public and

private good. Third the public good that is non-exclusive and non-rival. Non-exclusive means that it's difficult to keep non-payers from consuming the good. Non-rival means that one person's consumption doesn't subtract from another person's consumption of the same good.

A public good is something that provides a benefit to people, but because of its nature, we can't exclude people from consuming it, whether they pay for it or not. This means that a person or firm will not be able to make a profit because they can't effectively control who gets the product so a free market will not make the product in the first place. Private goods sometimes are subject to market failure whereby the operation of private markets does not provide certain services at a socially optimal level or where external costs or benefits are accrued by others rather than the provider of the goods. All these problems are likely to be more severe at lower levels of development. Furthermore, although monopoly and externalities are conceptually separate, they tend to interact to cause market failure. [*Piessse, J (2001)p.5*].

Intellectual arguments for government intervention based on efficiency considerations have been made in many areas. Governments perceive the need to regulate (or own) natural monopolies or other monopolies, intervene in the case of externalities (such as regulating pollution), and help provide public goods (such as providing national defense and education, or in areas where there is a public good aspect to providing information).

The arguments for government intervention become more complicated when they extend to distributional concerns. For example, some argue that the role of government is to act as a "welfare state" Briggs, A (1961), using state intervention in the market economy to modify the actions of the market. Thus, the arguments for state ownership or control rest on some market failure or perceived market failure, and countries have often responded to market failure with state ownership. Privatization, in turn, is a response to the failings of state ownership.

As noted above, welfare theory would argue that privatization tends to have the greatest positive impact in those cases where the role for the government in lessening a market failure is the weakest, i.e., for SOEs in competitive markets, or markets that can become readily competitive. Sheshinski and Lopez-Calva (1999), in summarizing the theoretical literature, argue that there should be "... *important efficiency gains from changes to private ownership in competitive structures.*" In fact, the effects of competition can be so strong that SOEs, in an increasingly global environment, may be forced to respond to pressures that maximize productive efficiency without the ownership change of privatization. Shirley and Walsh (2000) provide additional discussion of the effects of competition on the privatization decision.

In contrast, the justification for privatization is less compelling in markets for public goods and natural monopolies where competitive considerations are weaker. However, even in those markets, Andrei Shleifer (1998) and others have argued that government-owned firms are rarely the appropriate solution for many of the reasons discussed below.

Government ownership of firms results in problems in defining the goals of the firm. While the shareholder-wealth-maximizing model of corporate organization is becoming increasingly dominant in part because of the advantages of having a well-defined corporate goal governments have many objectives other than profit or shareholder-wealth maximization. [*Hansmann, Hand Kraakman, R (2000)*].

Further, government objectives can change from one administration to the next. The inability of the government to credibly commit to a policy can significantly reduce the efficiency of a firm's

operations and governance. Even if the government does attempt to maximize social welfare, for example, welfare is a difficult thing to measure and use in guiding policy. In addition, the government's goals can be inconsistent with efficiency, inconsistent with maximizing social welfare, or even malevolent [*Laffont and Tirole, (1993) and Shleifer, (1998)*].

In addition, even if the government and the nation's citizens agree that profit maximizing is the goal of the firm, it is difficult to write complete contracts that adequately tie managers' incentives to that goal. Shleifer (1998) argues that the owners of public firms (the nation's citizens) are less able to write complete contracts with their managers because of their diffuse nature, making it difficult to tie the managers' incentives to the returns from their decisions. This is a subset of the broader arguments based in property rights and agency costs that there will be differences in performance between government and privately held firms because there are a broader range of monitoring devices under private ownership.

Governments can intervene in the operations of any firm, either public or private. However, the government's transaction costs of intervening in production arrangements and other decisions of the firm are greater when firms are privately owned. Thus, to the extent that government intervention has greater costs than benefits, private ownership is preferred to public ownership [*Sappington and Stiglitz, (1987)*].

Theoretical work that examines privatization offers many reasons why, even in the case of market failure, state ownership has important weaknesses. Shleifer (1998) sums up much of the literature with, "... a good government that wants to further 'social goals,' would rarely own producers to meet its objectives." A question for the post-privatization world is the role of the public sector in the economy and in the regulation of firms. The alternative to state ownership is rarely purely private, unregulated firms. State ownership is only one form of the continuum of governance structures that reflect the level of state regulation of public and privately owned firms [*Laffont and Tirole, (1993)*].

Government Failure.

Market failure is a necessary but not a sufficient condition for government intervention since this assumes that existing imperfect institutional arrangements can be compared with an ideal norm. The appropriate comparative institutions approach compares the existing arrangements with an alternative real set of arrangements, raising the possibility that government failure may lead to a less efficient outcome than market failure. Outcomes from government intervention include a lack of incentives, corruption, discrimination and rent seeking. Furthermore, there is no reason for the state does better than the private sector where information deficiencies are the cause of market failure, unless the government has access to superior information. The extent of government failure is well established. It is not difficult to cite examples of chronic over-staffing of public institutions, which have grown alarmingly fast and yet produce less. In many countries the public sector is disproportionately large. Rather than attempting to assist in the development of market institutions, government policies have been antagonistic to private activity and have stifled what existed. Private enterprise has been actively discouraged as nearly every perceived problem has prompted a new government intervention. Structural adjustment lending and conditionality in program aid have led to changes in the public-private balance in many countries. This may be temporary, as compliance has been the result of coercion, rather than because governments have changed their ideologies, or dealt with corruption. Institutional changes, that take time, may be necessary for a better balance between public and private activities to be achieved. [*Piessse, J (2001)p.6*].

Many of the theoretical arguments for privatization are based on the premise that the harmful effects of state intervention have a greater impact under state ownership than under state regulation,

not that the harmful effects can be eliminated through privatization. However, in this paper I leave to others the continuing debate on the proper role of regulation in a market-oriented economy.

Community Empowerment Theory

The view of privatization as community empowerment stands in sharp contrast to the conception of privatization as an extension of property rights. Berger and Neuhaus emphatically reject a narrowly individualistic view of human motivation. Indeed, they criticize liberalism precisely for defending individual rights over the rights of social groups to assert their own values; for example, they defend the capacity of neighborhoods to sustain "democratically determined values in the public sphere" by exhibiting religious symbols in public places. [*P. Berger and R. Neuhaus (1977).p.11*].

They also suggest that attacks on the ideals of voluntary service "aid the expansion of the kind of capitalist mentality that would put a dollar sign on everything on the grounds that only that which has a price tag has worth." [*P. Berger and R. Neuhaus (1977) pp.36-7*]. Their concern is not to expand the domain of the profit motive but rather to strengthen local, small-scale forms of social provision. This is privatization with a human face, and it bears some resemblance to left-wing interest in community organizations and cooperatives. [*Donnison (1984)*].

Many nonprofit community organizations have depended for their survival on government subsidies. Moreover, today there is often a division of labor between the public and voluntary sectors. Some of them, like the national chains of nursing homes, are every bit as alienating as other corporate "megastructures." It is probably an illusion to think that a major shift toward private social services would lead to a proliferation of community organizations, if only because the private institutions would need much more capital than they traditionally have had available. If not supplied by the state, the capital must be supplied by the financial markets. In health care, the demand of capital formation is one of the principal pressures producing a shift from nonprofit to commercial organization, often national in scale. Community empowerment might be a good idea, but if it is to come at all, it will come from more government intervention, not from privatization. [*Starr, P (1982)*].

Government Overload Theory

This theory justifying privatization holds that privatization is desirable for its likely political effect in deflecting and reducing demands on the state. In the 1970s, some critics suggested that the Western democracies were suffering from an "overload" of pressure, responsible for excessive spending and poor economic performance. [*Willey 1970, at 57-71*]. In that framework privatization represents one of several policies encouraging a counterrevolution of declining expectations. In a similar vein, Stuart Butler of the Heritage Foundation has argued that privatization can cure budget deficits by breaking up the kind of public spending coalitions described by public choice theory. Privatizing government enterprises and public services, in this view, will redirect aspirations into the market and encourage a more entrepreneurial consciousness. [*Butler, S (1985) pp. 43-62*]

The political theory of privatization has several different, overlapping elements. First, the privatization of enterprises is a privatization of employment relations. The advocates of privatization hope to divert employees' wage claims from the public treasury, with its vast capacity for taxing and borrowing, to private employers, who presumably will have more spines in resisting wage demands. Moreover, the proponents hope for a trickle-down of entrepreneurship from the newly privatized managers to the workers; for that very reason, privatizes often are perfectly willing to sell to the workers, at an advantageous price, whole enterprises or at least some proportion of the shares. In addition, by shifting to private contractors even in a few selected areas, government might

signal a harder line on wage concessions and thereby weaken public employee unions. [Starr, P (1988)pp.21-28].

Second, the advocates of privatization hope also for a privatization of beneficiaries' claims. Instead of marching outside of government offices when things go wrong, the privatizes want them to direct their ire to private service providers or better yet, simply to switch to other providers. In other words, privatization could mean a wholesale shift, in Hirschman's terms, from "voice" to "exit" as the usual and preferred tactic of coping with dissatisfaction. [Hirschman, A. (1970)].

Third, the privatization of public assets and enterprises is also a privatization of wealth. "People's capitalism" is an old idea, but using privatization of public assets to bring it about is new. Moreover, by privatizing other assets such as public housing and Social Security trust funds, privatizes hope to turn public claimants into property owners and engender in them a deeper identification with capitalism. [Starr, P (1988) pp.21-28].

This political theory of privatization, like the economic and sociological theories, contains empirical predictions as well as normative judgments. The predictions concern the probable effects of privatization on political consciousness and action; the normative judgments concern the desirability of weakening the political foundations of public provision. Empirically, it seems unlikely that contracting-out, vouchers, and other arrangements for paying private providers will reduce pressure on government spending; the contractors are as likely as public employees to lobby for larger budgets. [Starr, P.pp.124, 128 in S. Hanke ed. (1987)].

Liberalism

If one wants to know what liberalism is and what it aims at, one cannot simply turn to history for the information and inquire what the liberal politicians stood for and what they accomplished. For liberalism nowhere succeeded in carrying out its program as it had intended. And just as economics, sociology, and philosophy have not stood still since the days of David Hume, Adam Smith, David Ricardo, Jeremy Bentham, and Wilhelm Humboldt, so the doctrine of liberalism is different today from what it was in their day. [von Mises, L(1985) p.xv].

Historically, liberalism was the first political movement that aimed at promoting the welfare of all, not that of special groups. A society in which liberal principles are put into effect is usually called a capitalist society, and the condition of that society, capitalism. It is wrong to assert that the entrepreneurs and capitalist have special interest in supporting liberalism. The interest in championing the liberal program is exactly the same as that of everyone else. We call the social apparatus of compulsion and coercion that includes people to abide by the rules of life in society, the state; the rules according to which the state proceeds, law and the organs charged with the responsibility of administering the apparatus of compulsion, government. The function that liberal doctrine assigns to the state the protection of property, liberty, and peace. The stand liberalism takes in regard to the problem of the function of the state is the necessary consequence of its advocacy of private ownership of the means of production. [von Mises, L(1985), pp.1-68].

The rise of the liberal state specifically entailed a sharpening of the public-private distinction: on the one hand, the privatizing of religious and moral belief and practice and of economic activity formerly regulated by the state; on the other, a commitment to public law and public political discussion. Classical liberalism is often represented as a purely privatizing ideology, but liberals were committed to suppressing markets in votes, offices, and tax collection, not to mention human beings. Strengthening the public character of the state is continuity in liberal thought from its classical to contemporary phases. Moreover, as Stephen Holmes argues, the liberal effort to

privatize otherwise rancorous religious differences promoted a civilized public order. [Holmes, S (1984), pp. 241-52].

In liberal democratic thought, public and private are central terms in the language of claims-making. In particular, they provide a deeply resonant vocabulary for making claims against the state. These are of two kinds. First, the concept of a public government implies an elaborate structure of rules limiting the exercise of state power. Those who wield power are to be held publicly accountable that is, answerable to the citizens--for their performance. Government decisions and deliberations must be publicly reported and open to general participation. In short, the citizens of a liberal state are understood to have a right to expect their government to be public not only in its ends but also in its processes. Second, when the members of a liberal society think of their homes, businesses, churches, and myriad other forms of association as lying in a private sphere, they are claiming limits to the power of that democratic state. The limits are not absolute private property rights, for example, are not an insuperable barrier to public control or regulation but when crossing from public to private the presumptions shift away from the state and any state intervention must meet more stringent tests of the public interest. [Starr, P. (1988), pp.8-11].

Privatization should not automatically be equated with increased competition. Two related processes, privatization and liberalization, need to be carefully distinguished. By liberalization one generally means a reduction of government control; in this context, it refers to the opening up of an industry to competitive pressures. Entry deregulation of public monopolies is a form of privatization that is also liberalizing. However, it is entirely possible to privatize without liberalizing. When the Thatcher government sold shares of British Telecom and British Gas, it substituted private monopolies for public ones and introduced new regulatory agencies to perform some of the functions previously undertaken through public ownership. The option of putting liberalization first that is, encouraging greater competition was expressly rejected, perhaps for fear that it would reduce the share price of the companies. [J. Kay & D. Thompson. (1984), pp.116-21].

Conversely, it is also possible to liberalize without privatizing that is, to introduce competition into the public sector without transferring ownership. For example, governments may allocate funds to schools according to student enrollments where families are free to choose among competing public schools; or they may require public enterprises or operating agencies to compete for capital or contracts from higher level authorities. Indeed, it is even possible to nationalize and liberalize at the same time, as the French socialists demonstrated in the early 1980s when they first nationalized banks and later liberalized financial markets. [Francls, (1985), at 21].

Libertarianism

Libertarianism is one of the many theories about economic freedom. The central idea of Libertarianism is that people should be permitted to run their own life as they wish. As defined by John Hospers, libertarianism is a philosophy of personal liberty of each person to live according to his own choices; provided that he does not attempt to coerce others and this prevent them from living according to their choices. [Hospers, J(1971)p. 27].

Libertarianists notably Murray Rothbard, Robert Nozick, David Friedman and Ayn Rand believe that government interference with the economy distorts both political economic and political freedom. According to libertarianists, “a government is an agency of legitimized coercion.” Some extreme libertarianists, called anarcho-capitalists, go even further, saying that government is not necessary in society even in providing services such as defense, law and other etc. They argue that even those public services may be privatized. [Friedman, D(1978)p.155-64; Rothbard, M(1982)p. 185-97].

Libertarianism, as usually understood, is a theory about the permissible use of non-consensual force. It holds that agents at least initially, fully own themselves and have moral powers to acquire property rights in external things under certain conditions. These property rights (in their own person and in other things) set the limits of permissible non-consensual force against a person: such force is permissible only when it is necessary to prevent that person from violating someone's rights or to impose rectification for such violation (e.g., compensation or punishment). The use of force against an innocent person is thus not permissible to benefit that person (paternalism), to benefit others (e.g., compulsory military service), or even to prevent third parties from violating the rights of others (e.g., killing innocents when necessary to prevent a terrorist attack). These limits on the use of force thus radically limit the legitimate powers of government.

Libertarians generally believe that government intervention in the lives of private citizens has a corrosive effect on personal liberties and freedom, and should therefore be contained. This laissez-faire attitude extends to all spheres of governmental policy: the economy, civil liberty, trade and foreign policy. The state, they believe, should be limited in duty to protecting rights and any action beyond that has the opposite effect. Only a limited government can unleash the freedom and creativity naturally granted to individuals, they say.

"Libertarians defend each person's right to life, liberty, and property rights that people possess naturally, before governments are created," writes David Boaz, author of *Libertarianism*:

"Governments should exist to protect rights, to protect us from others who might use force against us. When governments use force against people who have not violated the rights of others, then governments themselves become the violators. Thus libertarians condemn such government actions as censorship, the draft, price controls, confiscation of property, and regulation of our personal and economic lives."

What do libertarians believe in? In a few words, they believe that individual freedom is the fundamental value that must underlie all social relations, economic exchanges and the political system. They believe that voluntary co-operation between individuals in a free market is always preferable to coercion exerted by the state. They believe that the role of the state is not to pursue goals in the name of the community. The state is not there to redistribute wealth, "promote" culture, "support" the agricultural sector, or "help" small firms, but should limit itself to the protection of individual rights and let citizens pursue their own goals in a peaceful way.

Like all philosophical movements, libertarianism is varied, containing several schools and sub-groups, and one will find no unanimity about its theoretical justifications, its goals or the strategy that it should adopt to reach them. In North America, a majority of those who call themselves libertarians would like to see the state brought back to a few essential functions: in particular defense, foreign relations, justice, the protection of private property and individual rights, and some other minor responsibilities. All remaining functions should be privatized. In the context of a much decentralized federal state, libertarians accept however that local authorities (constituent States, provinces, regions or municipalities) can intervene in other fields and offer various types of social and economic arrangements, insofar as dissatisfied citizens can easily move to other jurisdictions.

Some libertarians of the "anarcho-capitalist" school advocate the complete disappearance of the state and the privatization of even the basic functions mentioned above. This goal may appear extreme or ridiculous at first sight, but it is based on a theoretically plausible argument. It is for example easy to imagine that one could replace provincial, State or municipal police forces (with

the corruption, abuses of power, the incompetence and favoritism which usually characterize them, all done often with impunity) with private security agencies. These would make profits only insofar as they really protect citizens and fight real criminals. Anarcho-capitalists use the same type of arguments to support the privatization of the army and the courts, which would leave nothing for a state to do. Private firms would then provide all the services that individuals might need in a pure free market. [Masse, M (2000), pp 1-4].

Carlton Hobbs recently challenged the tendency of mainstream libertarians, free marketers and anarcho-capitalists to favor the capitalist corporation as the primary model of ownership and economic activity, and to assume that any future free market society will be organized on the pattern of corporate capitalism. As one alternative to such forms of organisation, Hobbs proposed "stateless common property," with usufructuary right possessed by the inhabitants of a given area, coming about "without any prior formal agreements incorporating a potentially imprecise owning group."

Libertarians and anarcho-capitalists, in calling for the abolition of state property and services, typically call for a process of "privatization" that relies heavily on the corporate capitalist model of ownership. The property of the State should be auctioned off and its services performed by, say citizens. And the picture of the future market economy, so far as business enterprise is concerned, is simply the present corporate economy minus the regulatory and welfare state an idealized version of Nineteenth Century "robber baron capitalism. The latter tendency ignores the issue of state capitalism, of the extent to which the giant corporations that have received the lion's share of their profits from the State can be regarded either as legitimate private property or the result of theft.

In challenging this aesthetic affinity for the corporation as the dominant form of economic organization, Karl Hess denounced those who simply identified libertarianism "with those who want to create a society in which super capitalists are free to amass vast holdings..." Writing in The Libertarian Forum in 1969, Hess argued instead that:

Libertarianism is a people's movement and a liberation movement. It seeks the sort of open, non-coercive society in which the people, the living, free, distinct people, may voluntarily associate, disassociate, and, as they see fit, participate in the decisions affecting their lives. This means a truly free market in everything from ideas to idiosyncrasies. It means people free collectively to organize the resources of their immediate community or individualistically to organize them; it means the freedom to have a community-based and supported judiciary where wanted, none where not, or private arbitration services where that is seen as most desirable. The same with police. The same with schools, hospitals, factories, farms, laboratories, parks, and pensions. Liberty means the right to shape your own institutions. It opposes the right of those institutions to shape you simply because of accreted power or gerontological status.

Libertarianism in Post-Socialist Societies.

Murray Rothbard and Hans-Herman Hoppe have attempted to apply the same homestead principle to state property in post-communist societies.

Although Rothbard's assessment of the libertarian potential of Yugoslavia's combination of worker self-management and market socialism was over-optimistic and naive, his statement of principle for post-Communist societies was quite sound: "*land to the peasants and the factories to the workers, thereby getting the property out of the hands of the State and into private, homesteading hands.*"

The fall of the Soviet Union and its satrapies in 1989-91 transformed this from a theoretical to a very practical issue. The course generally followed in the ensuing period involved issuing equal, marketable shares in State enterprises to all citizens, and then allowing subsequent ownership to develop through the buying and selling of such shares. Rothbard proposed, instead, a ‘syndicalist’ solution:

It would be far better to enshrine the venerable homesteading principle at the base of the new dissocialized property system. Or, to revive the old Marxist slogan: “all land to the peasants, all factories to the workers!” This would establish the basic Lockean principle that ownership of owned property is to be acquired by "mixing one's labor with the soil" or with other unowned resources.

Desocialization is a process of depriving the government of its existing “ownership” or control, and devolving it upon private individuals. In a sense, abolishing government ownership of assets puts them immediately and implicitly into an unowned status, out of which previous homesteading can quickly convert them into private ownership.

Hoppe made a similar proposal specifically regarding East Germany, albeit more hesitantly and with more qualifications.

Of course, the term “syndicalist” was used mainly for color, since Rothbard and Hoppe were both adamant that such “syndicalist” property be devolved to individual workers and peasants as marketable shares, and not to the members of production units collectively. The ideal, as Hoppe expressed it, would be for share-ownership and labor to become separated as quickly as possible. But there is no reason in principle, as Carlton Hobbs showed in regard to the commons, that such production units should not remain the joint and indivisible property of their labor force, with a usufructuary right in the wages and pensions derived from it. Such a system would by no means necessarily prevent a market in factors of production.

Worker collectives would buy new capital equipment on the market; but their property claims to any industrial production unit would be collective so long as the enterprise maintained organizational and spatial continuity.

Privatization of state property, as it is actually carried out is just another form of state capitalist subsidy. In the first state, transnational capital promotes infrastructure projects in Third World countries that are essential to returns on Western capital in those countries, as a way of subsidizing foreign investment there at the expense of native taxpayers. Next, the resulting debt load is used to discipline the country's government into carrying out policies favorable to Western capital. Finally, under the "structural adjustment" regime imposed by the IMF and World Bank, the country is forced to sell assets (previously paid for in the sweat of the native producing classes) to Western capital at pennies on the dollar.

Privatization also commonly involves a phenomenon known as “tunneling” in which politically connected elite’s have an advantage in acquiring rights to the former state property. For example, besides Western capital, the other group that had funds available for buying up former Soviet enterprises was the Party nomenklatura, which had accumulated ill-gotten gains from decades of graft and corruption.

2.3 PRIVATIZATION

The idea of turning over government-owned enterprises to the private sector is sweeping and changing the developing world. The transitional countries get an idea that market economies have greater diversity and resilience than controlled economies. Privatization has finally come into the development mainstream as a result of gradual but profound shift in attitudes worldwide concerning the beneficial role of the free market and private sector. Privatization increases the quality of goods and service available in the market while keeping it responsive to consumer needs and demands. Usually if privatization going right it leads to open competitive economies that produce higher incomes and more permanent jobs. *In short, privatization can be the right step at the right time to liberate the economies of transitional countries from the slow growth or stagnation that has plagued so many of them for so long.* Essentials to successful privatization are macroeconomic policies such as extending credit to private borrowers, developing capital market structures, and reducing government regulation. [McPherson, P (1986)].

In short the *general aims of privatization* are:

1. Promote competition, improve efficiency and increase the productivity of the service;
2. Accelerate the rate of growth of the market economy through private entrepreneurship and investment;
3. Assist in reducing the size and presence of the public sector, with its monopolistic tendencies and bureaucratic support, in the economy. [Ragunathan, A (1990) pp. 203-205].

The Concept of Privatization

Paul Starr in his “The Meaning of Privatization” confirms that privatization is a fuzzy concept that evokes political reactions. It covers a grate range of ideas and policies, varying from the eminently reasonable to the impractical. Privatization has unambiguous political origins and objectives. It emerges from the counter movement against the growth of government in the West to the changing economic structures in the East. Privatization proposals do not aim merely to return services to their original location in the private sector. Some proposals seek to create new kind of market relations and promise results comparable or superior to conventional public programs. The current wave of privatization in former Soviet, and some less developed countries opens a new chapter in the conflict over the public-private balance. [Starr, P. (1988). p 6].

The concept of “privatization” has not been yet clarified in both theory and practice [Bailey, R(1987); Kolderie, T(1986); Kay, J and Thompson. D(1986)]. “One of the concepts in vogue is privatization, although the concepts itself is unclear, it might be tentatively defined as a general effort to relieve the disincentives toward efficiency in public organizations by subjecting them to the incentives of the private market. There are in fact several different concepts of privatization” [Bailey, R (1987), p.138]. “Privatization is a term which is used to cover several distinct, and possibly alternative means of changing the relationship between the government and private sector” [Kay, J and Thompson. D (1986), p.18-32].

The terms public and private are fundamental to the language of our politics, economics and social life, but they are the source of continual frustration. The different contrasts between public and private lead to some apparent conflict in defining what lies on each side of the boundary. One such conflict concerns the location of the market. To economists, the marketplace is quintessentially private. But to a sociologist or anthropologist concerned with culture, the market place is quintessentially public share open to utter strangers who nonetheless are able to understand the same rules and gestures in what may be a highly ritualized process of exchange. [Imray, L. and A. Middleton (1983),.pp12-13]

From these varying uses of the categories come several contrasting conceptions of the public share. The public share also may be conceived of as that which applies to the whole people or, the general public or the public at large, in which case the public may consist of an aggregate or a mass who have no direct contact or social relation the very opposite of a share of sociability. Or the public share may be conceived specifically as the domain circumscribed by the state, although exactly where to draw the state's boundaries may be difficult indeed. [Starr, P. (1988), p 6-7].

The general meaning of privatization, then, correspond to withdrawals from any of these variously conceived public shares. Richard Sennett suggests that since the eighteenth century modern society has seen a decline of public culture and sociability, a deadening of public life and public space, a privatization of emotion. [Sennett, R (1977), pp. 16-24]. Such arguments shade into a second meaning of privatization: a shift of individual involvement's from the whole to the part that is, from public action to private concerns the kind of privatization that Hirschman describes as one swing in a public-private cycle of individual action. [Hirschman, A (1982), pp.121-22].

Privatization can also signify another kind of withdrawal from the whole to the part: an appropriation by an individual or a particular group of some good formerly available to the entire public or community. Like the withdrawal of involvement, privatization in the sense of private appropriation has obvious implications for the distribution of welfare. From these meanings it is but a short step to the sense of privatization as a withdrawal from the state, not of individual involvement's, but of assets, functions, indeed entire institutions. Public policy is concerned with privatization at this level. But the two forms, the privatization of individual involvements and the privatization of social functions and assets, are certainly related, at least by ideological kinship. A confidence that pursuit of private gain serves the larger social order leads to approval for both self-interested behavior and private enterprise. [Starr, P. (1988), p 8].

With the rise of conservative governments in Great Britain, the United States, and France, privatization has come primarily to mean two things: (1) any shift of activities or functions from the state to the private sector; and, more specifically, (2) any shift of the production of goods and services from public to private. [Savas, S.(1987), p.3].

Besides directly producing services, governments establish the legal framework of societies and regulate social and economic life, and they finance services that are privately produced and consumed. The first, broader definition of privatization includes all reductions in the regulatory and spending activity of the state. The second, more specific definition of privatization excludes deregulation and spending cuts except when they result in a shift from public to private in the production of goods and services. The conversion of a state agency into an autonomous public authority or state-owned enterprise is not privatization, though it may well put the enterprise on a commercial footing. [Glade, W (1987), pp. 12-13]. Similarly, the conversion of a private nonprofit organization into a profit-making firm also is not privatization, though it, too, may orient the firm toward the market. Both of these intrasectoral changes might be described as commercialization; in the case of public agencies, commercialization is sometimes a preliminary stage to privatization. [Starr, P. (1988), p 8].

The meaning of privatization depends in practice on a nation's position in the world economy. In the wealthier countries it is easy to treat privatization purely as a question of domestic policy. But where the likely buyers are foreign, as in the Third World, privatization of state-owned enterprises often means denationalization, a transfer of control to foreign investors or managers. Since state ownership often originally came about in an act of national self-assertion, privatization appears to

be a retreat in the face of international pressure. In that sense, national memory colors the meaning of privatization. Privatization will raise the prospect of diminished sovereignty and excite the passions of nationalism. Where privatization raises such issues, it is often blocked, or citizens and domestic firms are reserved exclusive rights to publicly offered assets, shares, or contracts. In many Western countries, state ownership owed more in the first place to nationalist than to socialist sentiment; hence it is scarcely surprising that nationalism is liable to derail or distort privatization plans. [Starr, P. (1988), p 20].

I do not want to suggest, however, that the view of politics as pure self-interest capture all that is going on, even in the case of privatization. Privatization is a worldwide policy movement carried along by a combination of objective forces, imitative processes, and international financial sponsorship. Many countries whose public sectors expanded sharply in recent decades now find themselves confronted by rising debt and strong resistance to higher taxes. Privatizing state-owned firms promises to bring some fiscal relief, particularly where the treasury has been heavily subsidizing unprofitable enterprises. Privatization may help both to cut expenditures and boost revenues, and, by converting debt to equity, states may improve the overall financial structure of their economies and reduce pressure for even less palatable austerity measures. Privatization is not the only possible response, but as in other institution-shaping movements, like the postwar spread of public enterprises, organizational forms spread by imitation. Institutional models are disseminated through a variety of political networks and the direct influence of international lending organizations. Privatization is now one of the policies that the International Monetary Fund promotes in negotiating loans with transitional countries. [IMF Survey (1987)].

Dimension of privatization

A vast literature on privatization has emerged in scientific world, but many of the empirical studies are descriptive rather than analytical, methodological weak or narrowly focused on economic factors [Collyer F.M (1996)]. Up to the present knowledge we can distinguish privatization as:

- § a shifting of function from the public to the private sector that represents a “deliberate effort by governments to increase reliance on market mechanisms as a means of pursuing public goals” [Henig, J; C.Hamnett and H.B. Feigenbaum (1988), p.442].
- § a fiscal technique for managing public sector finances [Piggott, J (1987)].
- § “a cultural and political mission, aiming to alter consciousness and effect changes in power relationships.” [Samson, C (1994), p.79].

The first dimension sees privatization as a political strategy in which assets and functions are shifted from the public to the private sector, so reordering the political landscape [Henig (1988); Feigenbaum and Henig (1994), pp.190-1].

It is an intensely political process since it redistributes power (economic and political) and involves conflict resolution between net winners and losers. Furthermore, privatization is intensive in public communication requirements and sensitive to public opinion trends. These include: initiatives prior to privatization; assuring the presence of enabling legal and institutional conditions; institutionalization of the privatization process; providing for supporting institutional requirements; and organizing privatization execution in terms of preparation, implementation and monitoring. [UNCTAD (1995), and World Bank (1997)]. From theoretical perspective, privatization is understood as a strategy that employed by political actors that privileges some groups over others. It recognizes also that a systematic and sustained privatization program may be designed to transform institutions or economic and political interest [Feigenbaum and Henig (1994), pp. 190-1].

The second dimension sees privatization as a fiscal technique for meeting the expenditure needs of government more effectively, is problematic. Case studies are demonstrating that privatization does not necessarily result in more efficient enterprises and that it does not necessarily provide a better return to the public sector [Collyer (1997), p 32; White and Collyer (1997)]. What it can do is to provide governments temporarily with injections of capital, it is thus an indirect means of obtaining funds which must be paid back by future generations with interest.

Of course privatization is also seen as a strategy to provide government with private capital for undertaking public infrastructure projects. The shortage of available capital and search for more cost-efficient means to provide service has been stated publicly as the motivation behind several recent privatizations. [Collyer (1997), p 29].

The third, or sociological, dimension theories about the cultural and power-shifting effects of privatization on established relationship between groups and classes. In this dimension, privatization can be understood as a “hegemonic project” in which powerful ideologies are used to manipulate public attitudes [Samson, C (1994), p.79]. These ideologies broadcast specific “truth” about privatization for public consumption, shaping public debates and determining political agendas.

Government Objectives

Let’s consider first why government wants to privatize a state-owned enterprise. First, it wishes to effectively allocate ownership rights. In a competitive market economy a firm to be privatized should be given to those who value it most, or who can put it to most profitable use, and who therefore have strongest incentives to restructure, to modernize production and reduce risk. Second probably the most important objective of the government is the maximizing revenues from privatization. Economists often argue that revenues affect only the income distribution and should be of no concern for government welfare maximization. But for transitional countries privatization is the important instrument to reduce the burden of taxation and of an excessive budget deficit.

Process of Privatization

Privatization without policy, procedures, and a competent, committed staff is doomed to failure. We can divide the process of privatization on three broad phases. 1. Preparing for privatization; 2. Implementing a privatization program and project; 3. Monitoring and enforcing agreement and applicable laws and regulation. The preparatory phase is extremely important, when it done properly it sets the stage for successful privatization, it’s turns on four central components.

Examination of governmental organization and staff performance (organization productivity issues.)

§ Selection of a responsible private sector replacement (investment, business analysis, and finance issues.)

§ Redefinition of where and how the affected employees work and their stake in the privatization (human resource issues.)

§ Management of privatization process and /or specific actions (management issues.) [Marston, L (1987)].

Preparing for privatization requires education, organization, and mobilization of four groups that must work together. The groups that can make or break a privatization program are:

§ Political: the executive and legislative (parliamentary) political leadership;

§ Public: the consumers and recipients of public products and services;

§ Government employers and managers: the group outside political leadership, typically civil service professionals, supervisors, and unskilled workers.

§ Business community: the local and expatriate commercial interests most willing and able to acquire, lease. Or manage a government-owned and /or operated activity. recipients of public products and services [Marston, L (1987)].

The key to privatization is understand and being responsive to the problems and needs of the major interests groups.

Preparing for privatization

Privatization can be conducted in four phases:

- § Institutional development.
- § Target selection
- § Privatization transfer
- § Monitoring end results

First Phase

Institutional development

- § Organize for privatization
- § Assess political situation
- § Create private sector coalition
- § Develop strategies and guidelines

Second Phase

Selecting targets

- § Policy review
- § Organizational survey
- § Business evaluation
- § Strategic analysis

Third Phase

Privatization transfer

- § Estimate value
- § Issue conditions and solicitation for transfer
- § Evaluate and select successful bidder
- § Negotiate and execute transfer

Forth Phase

Monitoring and results

- § Establish regulatory and oversight mechanism
- § Monitor performance [Marston, L (1987)].

2.4 ROUTS TO PRIVATIZATION

However, while a narrower definition of privatization denotes mainly the divestiture of public assets to the private sector; a broader view of privatization tends to encompass processes such as denationalization, deregulation, liberalization, contracting out, competitive tendering, user changes, cuts in public provisions, increases in private ownership and so on [Hartley and Parker (1991), p. 11; Martin (1993), p. 11; Murie (1994), p. 105].

Denationalization

Denationalization consists in the sale to private subject of public property. It may take place through the sale of shares at a price that is either preestablished or arrived at through bargaining between demand and supply. This type of privatization secures substantial revenues for the state, but in itself it is unable to bring improvements in productive efficiency, understood as the minimization in all cases of the unit costs of production, to the privatized firm. Neither is allocative efficiency-which entails that production takes place according to the needs of consumers and at prices, which reflect the costs, sustained-ensured by the privatization. If the privatized firms find itself in a situation of monopoly and provided that the market is not contestable and the sale is made without concomitant regulation, the firms continue to be protected against competition while it is simultaneously freed from the obligation to comply with government directives. However, an even regulation is defective and sometimes counter-productive. [Dollago, B (1993)].

Denationalization is a timing issue. It is necessary to make a time schedule in order to reach a successful outcome. [Aktan, C (1991), p.5-6]. For that reason, the following stages should be taken in consideration. 1. Promotion of the denationalization program and strategy to the public. Denationalization may create an antagonistic reaction, and some political parties may oppose the policy. This make a sense to promote denationalization objectives to the public and explain that it is not a “the sale of the government.” 2 Preliminary studies. At this stage, is necessary to create the knowledge and strategy of future program. 3. Legal framework. Should be created a new law and institutions that will promote efficiency and effectiveness of denationalization program. 4. The gradually implementation of program. To have the best effect it is necessary to realizing denationalization program step by step, high speed in this case brings more trouble than benefits.

There are three main barriers to successful denationalization process:

Political Instability and Uncertainty. The notion of democracy and freedom has not yet been institutionalized in those transitional countries. As Roger Leeds noted: ”For a variety of reasons the achievement of a set of privatization objectives is extraordinarily difficult, and in the best of circumstances will take many years to implement. It is imperative that political leadership has the time to build a solid foundation to support for the privatization program both with the government itself and in the electorate. [Leeds, R (1988), p.169].

Economic Instability and Uncertainty. Economic instability and uncertainty are mostly the result of political instability. The economists believe that the politicians are the major source of economic problem. Up to Leeds “there is an inextricable linkage between the prospects for a successful privatization program and attractiveness of the macro economic environment to the private sector generally. A need exists, for price stability, positive but not exorbitant real interest rates, a policy framework that encourages competition and realistic exchange rates. If this ingredients are absent, or their future in doubt, privatization plans will be more difficult to implement” [Leeds, R (1988), p.170].

Weak and Not Developed Capital Market. Capital market in developing market or very weak or not exist, it is necessary to create a legal capital market before implementation of denationalization. As a matter of fact, development of a formal indigenous capital market is not an automatic or simple process. In brief, development of a capital market is likely to be a slow process. [Alyen, J (1987,) p.25].

Deregulation

Deregulation and privatization are bound together by the economic, political and intellectual underpinnings that gave rise to their implementation. They are also linked in that for both there is a residual regulation, particularly where the privatization or deregulation involves elements of natural monopoly [Yarrow. G (1988), pp324-77; and A. Friedlaender (1992), pp. 376-94]. Perhaps the chief benefit of deregulation and privatization is a substantial increase in efficiency [Winston, C (1993), pp.1263-89]. Under Public ownership or regulation, there was little incentive to plan or to pinpoint the sources of the markets that were successful and that were failures, or to keep costs under control and be responsive to consumer demand. In contrast deregulation and privatization are in the most cases leading to substantially more efficient industries in which cross-subsidy is disappearing, a diversity of price-service operations is present, and cost-minimizing behavior is prevalent, both in delivery system and in order operating costs.

From a macroeconomic point of view, deregulation and privatization have essentially meant lower inflation and higher productivity, although the overall impact is difficult to quantify precisely. With regard to wage and price formation, there is no doubt that the economy as a whole has benefited. Producers have undergone significant and long-lived structural adjustment. Labor work rules and pay are less generous. Most of the welfare gains have been to consumers, through lower costs, greater varieties of services and increased productivity. [Bailey. E and Pack. J (1995)].

Stigler George (1981) interprets economic deregulation as the state's withdrawal of its legal powers to direct the economic conduct (pricing, entry, and exit) of non-governmental bodies. [Stigler, G(1981), pp. 73-77]. Although an industries regulatory status is commonly characterized as either regulated or deregulated, in fact neither characterization is ever completely accurate. Regulatory policy is multidimensional encompassing an industry's economic conduct-pricing, entry, and exit and social conduct-health and safety of its workplace and products, noise and pollution externalities from the production of its products, and the accuracy of the information it disseminates about its products. In addition, the economic conduct among firms is governed by antitrust laws. Firms can be deregulated in one sphere but regulated in another. Study of the effects of deregulation have primary based on empirical studies of the effects of regulation. The traditional theory of regulation is that it serves the public interest by correcting some form of market failure, typically natural monopoly. [Bailey. E and Pack. J(1995,)pp.590-592].

Although the Chicago theory, as fully evolved and explained by Sam Peltzman, argues that regulation is sensitive to deadweight losses, it still predicts that social welfare will be enhanced by deregulation because the losses to the well-organized groups that benefited from and support regulation fall short of the gains to groups that supports deregulation and to less formally organized members o society [Peltzman, Sam (1989)1-59].

Theories of regulation therefore tend to suggest that deregulation would enhance efficiency in one of two ways. First, inefficient operations that developed because of regulation and because firms were insulated from actual and potential competition would be curtailed. Second, rents that accrued to well-organized groups benefiting from regulation (generally producers and labor), would be dissipated by unregulated competition. Thus, the belief is that deregulation would generate broad consumer gains, partially offset with lower producer profits and lower rents to labor. Any assessment of the effects of deregulation must overcome a fundamental problem: regulation and deregulation never occurred simultaneously at the national level. In some instances regulated and fully deregulated environments are separating in several years. [Winston, C (1993)pp.1263-12].

White Lawrence (1991) argues that economists' analyses deregulation of airlines, transports, and telecommunication but not emphasize the importance of supplementing banking deregulation with a strengthened safety and soundless regulatory regime, especially for saving and loans, which would institute minimum capital standards based on market rather than book value and intensify supervisions of bank call reports. Tax regulatory surveillance contributed significantly to the savings and loan crisis and may have undermined public support for deregulation. [*White, L (1991)*].

A Complete counterfactual analysis must recognize that industry performance under deregulation influenced not only by technical change and external economic events but also by public policies unrelated to economic regulatory reform. Because all the influences are interdependent, each must operate in accord with the others or performance will become disrupted.

One of important role of deregulation is the changing the corporate governance structure. Deregulation increases the importance of the managerial function in the firm. Incentives to develop low-cost methods of production are muted under price and entry regulation. Price regulation and insulation from product-market competition also discourage firms from developing innovative pricing and distribution strategies. [*Stacey, K and Kenneth, L (1997), p.428*].

Cragg and Dyck (1998) in their study on managerial turnover in British privatized firms, reach the conclusion that the effect of privatization on incentives was more pronounced after four years in the private sector and in sectors not subject to price regulation. They suggest that work needs to be done to see if the speed of introduction of changes is linked to restriction in corporate governance activity (golden shares, share allocation in public offers or asset sales, etc.) and if ownership change also leads to incentive change in countries with weak markets for corporate control.

Kole and Lehn (1997) predict that "Deregulation provides a unique opportunity to observe the Darwinian process at work. It serves as a shock that requires firms to adapt their strategies and organizational structures to the new rules of the game." Managerial discretion increases under deregulation, as does the sensitivity of firm value to the quality of managerial decisions. This room of maneuver should lead to cost cutting operational changes, to pricing and marketing innovations (new products, more aggressive publicity), as well as to an increased number of mergers and acquisitions. In addition to increasing the importance of the managerial function, deregulation increases the costs of observing managerial performance. Greater business instability makes it harder to distinguish the effects of management decisions on firm performance from the effects of other factors. Consequently, the value of actions that better align the incentives between managers and shareholders increases (better monitoring, incentive schemes in compensation.).

The Kole and Lehn in their study admit that managers must have different skills: in regulated firms "public relations" and "political" skills are more valued due to the need for company to play the regulatory game. According to them deregulation would in part remove these constraints and would make regulated managers resemble more their colleagues in non-regulated firms. [*Kole and Lehn (1997), pp.424-427*].

Restructuring and its influence on corporate governance

Privatization has not always led to the kind of radical restructuring needed either to develop firms' comparative advantage and enable them to compete in global markets or alternatively to exit as efficiently as possible. The lack of appropriate restructuring has been particularly acute in the case of transition economies. This is partly due to insiders (existing management and/or employees) gaining control of enterprises and opposing restructuring to the extent that it implies loss of their

rents. More generally, it is due to the governance environment not being appropriate for decision-makers within firms to undertake socially-desirable decisions. The “growth-oriented” restructuring, defined as restructuring which increases revenues, was distinguished from “survival-driven” restructuring, which is concerned only with defensive cost-cutting for breaking even. [*United Nations Report (1999), pp.11-13*]

While in general restructuring should be left to new owners, there are two sets of interventions that may be desirable before privatization takes place. First, in the case of dominant enterprises with substantial market power, there is an important role for horizontal and/or vertical separation according to competition policy criteria. This competition-enhancing restructuring should take place prior to privatization. Second, legal/financial restructuring to clean up balance sheets, reduce excessive gearing, value contingent liabilities, resolve outstanding legal issues, convert the legal status of the enterprise to make it saleable and put its workforce under the same labor laws as the private sector—should also take place prior to privatization. [*United Nations Report (1999), pp.11-13*]

In the absence of sufficient legal protection for minority investors, new owners (especially if insiders) may find it more profitable to loot and divert assets rather than restructure. It is also important that the privatization process be perceived as legitimate. Otherwise, it becomes difficult to attract outsiders, as well as to sustain restructuring and avoid backtracking. To ensure an incentive structure favorable to restructuring, further regulatory changes are necessary to enhance flexibility and facilitate social changes. In particular, early introduction of competition and hard budget constraints put effective pressure on owners and managers not to postpone restructuring. [*Dutz, M and M. Vagliasindi (1999), pp.11-16*]

- a) The initial privatization methods should be designed to promote restructuring, including facilitation of post-privatization ownership changes that enhance restructuring.
- b) The recommended policy choice for restructuring is to combine transparent corporate governance rules with direct sales to strategic outsiders wherever possible.

Investors with a strategic share have comparatively stronger incentives to bring in appropriate restructuring agents. In addition, foreign outsiders bring new techniques of production and help implant new standards of corporate governance. Resistance to foreign ownership might be overcome by attaching greater visibility to appropriately sequenced secondary methods. [*Dutz, M and M. Vagliasindi (1999) pp.11-16*]

Improved corporate governance is a vehicle for a number of possible objectives. Let see how corporate governance interacts with growth-oriented restructuring at the enterprise level. Restructuring is characterized by radical, non-marginal changes in production techniques, implying non-marginal changes in factor mix and output mix. Market-based restructuring actions generally involve both survival-driven changes to reduce costs and growth-oriented changes to increase revenues. Restructuring requires: (1) profit/shareholder value maximization as the objective of owners; (2) human capital/expertise to identify profitable opportunities and (3) substantial new finance to implement the required changes [*Carlin, W (1998)*].

In those instances where the existing asset mix has a more desirable alternate use, this may require rapid enterprise exit and resource reallocation to other enterprises. While useful as a first step towards growth-oriented restructuring, survival-driven changes are harmful to the extent that they are motivated solely by a desire to postpone or block further socially-desirable adjustment.

Effective corporate governance affects growth-oriented restructuring by ensuring that appropriately skilled implementing agents are chosen and that appropriate actions are implemented while respecting the finance constraint (sufficient finance) and the political economy constraint (socially legitimate process). [Dutz, M and M. Vagliasindi (1999) pp.11-16].

There are four main channels. First, corporate governance ensures the selection of the appropriate restructuring/turnaround agents. Owners should be able to replace managers if necessary, and appoint individuals most skilled at the specific restructuring challenges that the enterprise faces (having industry-specific knowledge, together with marketing, accounting and finance skills). A second channel is ensuring that managers take appropriate restructuring decisions. Owners should be able to leave sufficient discretion to managers in their technical decisions regarding changes in resource use and the structure of outputs, but require managers to report periodically and relatively frequently initially regarding the technical bases for decisions and ongoing results. A third channel is attracting and retaining sufficient external finance needed for restructuring. In addition to helping enterprises get access to funds beyond internally-generated sources, protection of investors helps insulate the enterprise from sudden outflows. A fourth channel is ensuring a broad social legitimacy for the restructuring process. Restructuring generally involves winners and losers, or at least a non-uniform distribution of gains. Without governance mechanism widely perceived as appropriate, with stakeholders adequately protected, unavoidable resistance by the potential losers may become impossible to overcome. [Atiyas, Izak, Mark Dutz and Claudio Frischtak (1992)].

The first two channels ensure that a desirable ownership and control structure is put in place, whereas the last two ensure the sustainability of the restructuring process. In practice, successful growth-oriented restructuring across a number of enterprises throughout the economy should be reflected in increased productivity, increased foreign direct investment flows (reflecting profitable investment opportunities), and more gradually in increased export earnings in tradable sectors. Over time, as resources are reallocated to growing new and restructured enterprises, expected outcomes include higher employment, income, consumption levels and sustainable growth. Improved alignment of the interests of owners, managers and other stakeholders within the enterprise is only one of a number of areas of the prevailing business environment that can stimulate appropriate restructuring. [Atiyas, Izak, Mark Dutz and Claudio Frischtak (1992)].

A number of features related to corporate governance and restructuring, prevalent in many developing economies, are particularly significant in the transition economies. First, due to a legacy of relative isolation from international best-practice and underdeveloped financial markets, there is a greater scarcity of expertise and new finance available to individual enterprises, precisely the two main inputs required for restructuring. Second, the institutional infrastructure required for effective restructuring, in terms of product, capital and labor market regulations and enforcement capabilities, together with respect for the rule of law, is much weaker. Third, the magnitude of the problem in terms of the number of enterprises requiring restructuring and in terms of the mismatch between the prevailing asset mix and market requirements is much larger. This in turn often makes it politically more difficult to effectively harden budget constraints. Fourth, there is a much broader lack of understanding within concerned enterprises and civil society at large regarding the requirements and benefits of effective restructuring, in particular with the role of corporate governance in that process. [R. Shyam Khemani (1999) pp.65-70].

2.5 PRIVATIZATION GOALS

Privatization in its various forms has been used to pursue a wide variety of goals. The consequences set out by theoretical analyses and empirical research appear to show that, in practice, this excess of

ambition or of confusion and compromises has achieved rather modest result compared with the effort and resource involved; result that are sometimes counter productive and in any case inferior to those expected by its promoters. We can consider three main categories of privatization goals:

- I. Social, Political and Ideological goals,
- II. Financial goals,
- III. Micro and macroeconomic goals. [*Dallago, B, (1993), pp12-13*].

The first group of goals attempts:

- a) to reduce political interference in firms activities and to restrict the governments political responsibility for the management of specific sectors and forms or its responsibility for certain functions;
- b) to weaken unions;
- c) to increase the number of shareholders in order to “democratize” the economy and to boost support for the political parties in power;
- d) to attract foreign economic and political support for the governments policy, especially in the form of the inflow of the foreign capital;
- e) to use privatization such as large scale as to convert it into a fundamental means for overturning the [central administrated (in post-socialist countries)] economic system and the lay the ground for the development of a market economy. [*Dallago, B, (1993), pp12-13*].

Social, Political and Ideological goals,

a) The government may utilize privatization, especially denationalization, to reduce political interference in firms activities if it is able to resolves so called “paradox” of privatization. This goal is of particular importance for the privatization’s currently under way in the economies in transition. One of the reason for the poor performance of the old system, in fact, was political interference in the activities of enterprises and, as a consequence, the scant financial discipline imposed on them. [*Kornai, J (1993), pp 315-336*].

b) A further objective that government may pursue through privatization is the reduction of its involvement’s in the management of economic activity and in labor conflicts. Important here may be the goal of reducing the unions bargaining power if managers and politics have weak incentives to reduce unitary labor cost. However, the opposite case is equally plausible: if the government has decided to impose a rigid wage policy, privatization may actually increase trade union power. In the economies in transition this goal is critical, in that an important precondition for the success of transition is a substantial change in industrial relations and break with previous trade union tradition in order to increase productivity, to improve workplace discipline and reduce absenteeism, to introduce unemployment as a way to increase flexibility in enterprises to bring wage in line with productivity, and to restructure the wages system. [*Dallago, B, (1993), pp12-13*].

c) A government may also use privatization with the direct goal to introduce some form of “popular capitalism”, in order, that is, to increase the number of people owning property rights, to encourage the spread of schemes for worker share–holding in their firms, and to redistribute income and wealth. Although these goals can be more efficiently accomplished through the use of, for example, tax incentives to encourage individual share–holding, they may be dictated by political and social considerations, such as strengthening certain pressure groups, increasing the government parties electoral base, promoting the propensity to save. In the economies in transition the importance attributed to the growth of broad–scale share–owning varies considerably from country to country. In these countries pursuit of this goal has involved much of the population through the free distribution of vouchers convertible into shares. Or other solutions are still at an early stage the

intention is to open a line of city-rate credit for those wishing to purchase shares in denationalized enterprises. [Dallago, B, (1993), pp14-15].

d) Next goal of privatization is to attract foreign economic and political support for government policy from international and national organizations, foreign governments, and private investors. The particular importance is denationalization designed to encourage the inflow of foreign capital. Nevertheless, privatization is only one of the factors determine the decisions of foreign investors and, on its own, it is not enough to induce foreign governments and international organizations to lend their concrete support to government policy. The current experience of the economies in transition is instructive: despite the ample supply of enterprises for sale, the positive attitude of the governments of these countries, and numerous opportunities available, the inflow of foreign capital has so far been either small or negligible. [Dallago, B, (1993), pp15-16].

e) The first group of goals discussed so far is relevant in both market and transitional economies. However, in the latter group of countries changes are much wider and deeper at least in relative terms. The greatest difference concerns the attitudes towards change in the economic system and its operation. For the market economies, the objective of privatization is not to change the economic system but, at most, to improve it, in the sense of giving greater efficiency to the economy and reducing the public debt. Moreover macroeconomic goals are often secondary to microeconomic ones. In the economies in transition, by contrast, privatization is only one item, albeit a crucial one, in a more general policy of change in the economic, social and political systems. [Dallago, B, (1993), pp15-16].

Financial goals,

Financing the state budget and public debt through the sale of public assets form the second group of goals pursued through privatization. However, this is a rather weak strategy because it is difficult to privatize loss-making public firms, and the earning accruing to the state from the sale of public owned assets is illusory. [Bos, D (1991), pp.15-16]. This is born out by the experience of both the market and the transition economies. Sometimes, in order to get rid of loss-making firms, the government may decide to sell them at an extremely low or even negative price, usually in exchange for an undertaking by the purchaser to restructure the firm and to maintain employment level.

However if privatization increases competition and this leads to a greater productive efficiency, the sale price will be higher than should the firms continue in public ownership, and this will increase the net value of the public sector. [Dallago, B, (1993), pp16-17].

It is also worth nothing if a government pursues this goal, the temptation to exclude competition is very strong and this would prevent the economy from enjoying the advantages discussed in the following point. In fact, if the government deregulates the market in order to increase its efficiency, the firm to be privatized inevitably loses its market power. Its value diminishes and consequently also the income earned by the state from privatization. [Andreff, W (1992), pp. 147-8; Yarrow, G (1986), pp. 345-54].

These problems are particularly evident in the economies in transition. Various countries have begun the transition process with large budget deficits and rapidly growing public debt. The privatization of enterprises makes the continued centralization of enterprise profit impossible and in this new situation they cannot continue to be punitively taxed. The government must find large sums to finance the welfare programs required to cushion the effects of transition, above all growing unemployment. The only respite for the economies in transition is the fact that the

productivity of many enterprises is so low that it is relatively easy to improve simply by increasing labor discipline and effort. These various factors strengthen the temptation to use denationalization to contain or reduce current budget problems without paying due attention to the promotion of competition. [Dallago, B, (1993), pp16-17].

Micro and macroeconomic goals

Privatization can be used to pursue micro and macroeconomic goals in particular efficiency, distribution, and stabilization as well as goals tied to the development of the economy. It is usually stressed that public firms do not minimize costs because they assign the profit motive low priority, they are frequently assign divers often not economic, and conflicting objectives, and finally, the incentives offered to public managers are not compatible with the pursuit of productive efficiency. By contrast, privately owned firms are subject to incentives which promote productive efficiency and the threat of failure forces them to operate efficiently. They are less prone to political interference, the pursuit of profit sets a clearly easily identifiable objective, and the price of the firms' shares on the stock market is an unequivocal indicator of its performance, while the threat of takeover by other private subjects compels private firms to efficient behavior. [Dallago, B, (1993), pp18-19].

The benefits of privatization for allocative efficiency are even more dubious. Unless the market is contestable or competition can be introduced by opening the market, the pursuit of allocative efficiency requires the distribution of monopolies before privatization or the regulation of prices, of quantities, of quality, of profit rates and also of safety and quality standards. In fact privatization may induce a worsening of quality, especially when it results from social or political obligations imposed on the state owned firm. Privatization also changes the functional and personal distribution of income. A net transfer of income from public to private sector occurs when the sale takes place at a price lower than the market price, and when the privatization method favors certain social groups workers or managers. But if privatization yields greater efficiency and therefore higher profits and income from the overall capital in the economy increases while the income from work probably diminishes, in so far as privatization usually reduces employment and pay levels. Considering the stabilization and the development of the economy, privatization may prove useful in reducing political interference in the economy, and it may also dissuade the public authorities from sustaining and defending obsolete industries. A future argument to support privatization concerns the development process: when the private sector is sufficiently strong, the development process is managed better by the market, and hence privatization is useful for this purpose as well. [Dallago, B, (1993), pp20-30].

2.6 PRIVATIZATION METHODS

Consider a government that wants to privatize a state-owned enterprise. What method of privatization should it use if it wants to achieve an efficient allocation of ownership rights and generate as much revenues as possible? Most western countries employed various kinds of auctions to sell state-owned enterprises to the highest bidder. Some transition countries in Eastern Europe give away for free a substantial fraction of the shares of all firms to the general population. In Eastern Germany the Treuhandanstalt bargained on the terms of trade with predetermined buyers and negotiated detailed employment and investment guarantees. Most privatization programs combined several elements of these or other basic methods.

Restitution

Privatization through restitution is the return of nationalized properties to their former owners in situations where the government's original acquisition is seen as unjust, such as uncompensated

seizure. Redressing the worst examples of past injustices, it is argued, is essential on moral grounds. It has been especially relevant in Central and Eastern Europe. Outside the transition economies, restitution has played an important role. Under restitution, the adverse effects on workers and consumers are likely to be as large and as rapid as in the case of public sales and auctions. Given the automaticity of the approach, the possibilities for reprivatization restructuring and for incorporating social concerns in the transfer of ownership to the private sector are quite limited. Moreover, restitution does not generate any revenues, but in the case of a loss-making enterprise, the budget no longer has to cover the losses. Opponents of restitution counter that the process is necessarily selective, and therefore an unsatisfactory way of achieving justice retroactively. As a practical matter, private claims can often be complicated and drawn out, bogging down privatization unnecessarily. In practice, the transition countries have seldom used restitution, except for Estonia and, to a lesser extent, the Czech Republic. [*Havrylyshyn, O. and McGettigan, D (1999), pp. 1-2; Sanjeev, G; Ma, H; Schiller, C. p.47*].

Contracting-Out

Under this arrangement, the government contracts out with the for-profit as well as not-for-profit organizations for the delivery of goods and services. In other words, the government purchases services from a private firm or a non-profit organization. Contracting out is common especially in such services as public works and transportation, public safety services, health and human services, parks and recreations services etc. Especially municipal governments are interested in contracting such goods and services with private firms, increasingly. At the local level, refuse collection and cleaning are very common practices of contracting-out in many countries. In addition to this, roads, schools and government offices are generally constructed for governments by private contractors under contractual arrangements and pencils, desks, fire hoses, uniforms, food (for pupils, patients, and prisoners), ferry boats, automobiles, guns, garbage trucks and computers are bought from private vendors. Furthermore, governments both central government and local government contract-out for a wide variety of services; grounds maintenance, custodial functions, cafeterias, secretarial and clerical work, libraries, laundries etc. [*Savas, E.S. (1987, p 69)*].

For carrying on contracting-out procedure it is necessary divide it in better manageable parts. 1. The planning process is meaning that the planning for a given privatization is essential that there are questions should be answered. 2. The bid process that meaning the most basic rule underlying the solicitation of proposals or bids from the private sector is that the statement of desires and requirements should be as widespread, transparent, and accurate as possible. 3. The evaluation and selection process. As bids are shaped on the basis of stated criteria, there should be no deviation from this statement at any time, or the government opens itself up to legal challenge. In a complex technical contracting situation, the legal requirements might prove overwhelming in a one-step process. In such cases, two-step procurement might be used, in which technical responses are sought and evaluated before business and financial presentations. 4. Monitoring framework should be built into the contract to oversee all contract schedules and other terms and conditions. 5. Disputes and terminations. No matter how well structured a contract, disputes may arise or the government may wish to terminate. Clearly stated rules are necessary so that all parties will know their right and obligations. [*Thomas, P (1986), pp.5-7*].

There are many arguments in favor of contracting-out for public goods and services. But also, there are some disadvantages of the contracting-out system. Advocates of this method claim that contracting-out has the following superiority's [*Savas, E.S. (1987), pp.105- 110; Hartley, K (1986); De Hoog, Ruth (1984), pp.1-16; Moore, S (1987); Ascher, K (1987)*].

(i) Contracting-out is efficient and effective, because it fosters and initiates competition. The competition among firms bidding for a service contract drives the cost down. Empirical studies clearly prove that the cost of the services provided by government is much higher than when the services are provided by private contractors.

(ii) Contracting-out also provides better management than the public management. Because decision making under contracting-out is directly related to the costs and benefits. In other words, this method fosters good management because the cost of the service is usually obscured.

(iii) Contracting-out would help to limit the size of government at least in terms of the number of employees.

On the other hand, opponents of contracting-out method argue that this system mainly has the following deficiencies:

(i) Corruption may be widespread in the process awarding contracts to the individuals or private firms.

(ii) Contracting may limit the flexibility of government in response to emergencies because contractors are liable to default and go bankrupt in their activities.

(iii) Contractors may hire inexperienced transient personnel at low wages and this decrease the quality of the service.

(iv) Contracting-out involves laying off public employees. As a result of this, government has to pay unemployment compensation to the laid off public employees.

Although, there are some drawbacks to the contracting-out system, it has been alleged that, taking some precautionary measures can eliminate them. For example, a genuine rivalry is important for improving efficiency. There is a danger that competition will be restricted to members of established trade associations, with the possibility that collusion may result in private monopolies replacing state monopolies. On the other hand, regular re-contracting should also be required, so that competition occurs. Regular re-contracting also forces contractors to work efficiently so they can renew the contract [Hartley, K (1986)]. Long-term contracting also should be avoided to obtain maximum cost savings, bidding requests should be publicized as broadly as possible. And finally, upon completion of the bidding process, performance of the contractor should be monitored and evaluated regularly.

Franchising

Under a franchise agreement, the government gives a special monopoly privilege to private firms to produce and supply some part of a particular service. Besides this exclusive right given to private firms, the government may also award multiple franchises. Mass transit is an example of franchising. The government either makes a contract with a single private firm or several firms to provide the service. The former is an "exclusive franchise" and the latter is called "multiple franchise". It should be pointed out that a franchise contract usually involves a price resolution right of government. [Aktan, C. C (1992), p.9]

Franchising method is especially common for the delivery of toll goods, which have natural monopoly characteristics. In the macroeconomic theory, it is argued that a firm would become a "natural monopoly" in time, if there are economies of scale in industry. In other words, natural

monopoly exists if the average cost of producing a product constantly decreases while output is increased. [Ekelund, R.B and Tollison, R.D (1986), p. 171].

The reasons why the long-run unit cost of production fall as output increases are due to several factors:

1. A larger operation means more specialized processes are possible in the firm. Workers can concentrate and become more proficient at narrowly defined tasks.
2. As the operation enlarges workers and managers gain valuable experience in production processes. In other words, since workers and managers of a larger firm produce more output, they acquire more experience can lead to lower unit costs.
3. Large firms can take advantage of mass production techniques, which require large setup costs. Setup costs are more economical when they are spread over a large amount of output. Production techniques such as the assembly line used by large automobile manufacturers would result in very high unit costs used by small producer of specialized cars. [Ekelund and Tollison, (1986), p. 171].

In this range of outputs, the firms have become too large to be controlled effectively. Here the cost rises due to inefficiencies. As noted earlier, if there are economies of scale industry, a natural monopoly exists finally. Because, if there is more than one firm supplying the total market, each firm must be producing, at an average cost level that would exist if only one firm supplied the entire market. As a result of this, each firm increase its market share and reduce its average costs. At last, a hard competition would occur among firms and finally, there will be one firm that is a natural monopolist to dominate the market [Hanke, S.H (1985), p. 9].

Economies of scale are most common for such goods as power supply, gas and water distribution, communications services, broadcasting TV, railways, etc. For many years, economists especially theoretical welfare economists argued that these goods and services ought to be provided by public monopolist, who tends to increase the prices by limiting the production. However, in recent years, it has been argued that these goods and services can be privatized under a franchising agreement. It is possible to obtain maximum benefit via a competitive bidding process. Some economists argue that franchising is an effective solution for the privatization of natural monopolies [Hanke, S.H (1985); Domberger, S (1985)].

On the other hand, opponents of this method argue that franchising is not cost less. Some problems may occur during the operating phase of a franchise. Franchises typically last for a considerable length of time in some cases. During this period, significant changes would happen in consumer choices, costs and production technologies. These factors require that original bidding contract ought to be properly evaluated. Moreover, the government needs to monitor the activities of the franchise carefully and regularly. [Aktan, C. C (1992), p.10]

Another problem concerning the operating phase of a franchise occurs toward the end of the contract. It is argued, when there is chances that the franchisee may under invest in fixed assets reduce maintenance expenditures [Hanke, S.H (1985), p. 13].

Sale of State Ownership

Direct sales or sales to outsiders.

In the early 1990s, many of the former socialist countries planned to privatize through direct sales, emulating successes elsewhere, such as in the United Kingdom and Chile. At first some of them pursued this approach vigorously, but political and practical drawbacks quickly emerged. The initial

goal was to sell state assets to outside investors in view of the underdeveloped state of domestic capital markets. Policymakers expected three gains: revenue earnings for the state, the rapid infusion of outside expertise, and the likelihood that management by outside owners would be more effective. Among the practical drawbacks, the inadequacy of national stock markets and the lack of domestic capital proved to be greater handicaps than expected, and foreign investors, unable to obtain sound on the enterprises offered, lacked sufficient interest. Furthermore, the direct sales approach was costly and slow, owing to the complexity of preparing each state asset for sale individually, and then ensuring that buyers lived up to contract provisions. Politically, direct sales and equity offerings could be stalled when the general public saw the process as unfair. Powerful local interests, such as workers and managers, sometimes blocked consideration of direct sale privatization. [*Havrylyshyn, O and McGettigan, D (1999), p. 2*].

Sales may be: negotiated enterprise-by-enterprise (Hungary has made extensive use of this approach); by multi-enterprise tender whereby several enterprises are offered for sale as a single package (used by Estonia, Germany, and Latvia, for example); or through a public offering of shares (has been used in Poland and in Hungary). In principle, direct sales to outsiders improve corporate governance, help increase access to new capital and skills, and raises government revenues. The disadvantage has been that, due to difficulty in evaluating firms, negotiation, and follow up, it is a slower costly process, and may be perceived as unfair, as not everybody can enter into the negotiations. In fact, because of these factors, coupled with lack of domestic capital, and reluctance to sell to foreigners, it has been relatively little used. On the other hand, relying on initial public offerings has not been an effective tool due to the underdevelopment of stock exchanges. [*Buttari, J.J (1997), pp.2-3*]

Public sales and auctions

Public share offerings on stock markets can be used for large, profitable, relatively well-known state enterprises. In addition to transferring ownership, share offers often raise additional capital for an enterprise through the issue of new shares. Share offers can also meet a government's objective of broadening share ownership by allocating a portion of shares to small investors. Shares can be offered on the domestic market as well as in international markets using American depository receipts (ADRs) or global depository receipts (GDRs). Shares are offered to retail and institutional investors, usually at a fixed price. In most cases shares are sold by stockbrokers overseen by government regulators. Public share offers are generally transparent because of advertising (if permitted) and disclosure requirements. This approach is especially suitable if the size of the sale justifies the costs involved. [*Welch and Frémond (1998), p.24*].

Public sales and auctions are most often employed when enterprises are divested singly. Methods include initial public offerings, sales of shares of already corporatized or publicly traded enterprises, or public auctions (the prevalent method for privatizing small businesses in Central and Eastern Europe). To the extent that these transactions are transparent and efficiently conducted, the government collects maximum revenue. But to make the price worthwhile, the new owner must undertake a broad and rapid restructuring; hence, the impact on workers and consumers tends to be large under this method. Furthermore, the government has little leverage in terms of incorporating its social concerns in the sales contracts, unless such provisions are explicitly incorporated in the terms of the sale (perhaps reducing the sale price). However, since the enterprises also benefit from getting fresh capital and, in many cases, new ideas, chances are also best for a quick move up the U-curve in terms of employment and compensation. [*Sanjeev, G; Ma, H; Schiller, C. p.45*].

Secondary Offerings

The sales process for a secondary offer that is, a public offering of shares already traded on domestic or foreign markets-is less complex than the process for an initial public offering. Setting a price for shares is less difficult because the shares are already trading and have a market price. Brokers sell a secondary issue to individuals and institutional investors in much the same way as an initial public offering. [Welch and Frémond (1998), p.28].

There are two types of trade sales for privatization: auctions (open bidding) and negotiated sales. [Welch and Frémond (1998), p.28]. Auctions are more common and more transparent than negotiated sales. First, the financial advisers or sales agents, working with state enterprise managers and government officials, prepare an information memorandum containing general information for potential investors. The memorandum is sent to potentially interested parties. In most cases the financial advisers or sales agents will have compiled a list of potential investors and will discuss it with the government prior to use. Then, nonbinding expressions of interest are received from interested buyers. Based on these expressions of interest and a review of the financial capacity of potential bidders, a short list of potential buyers is selected. These bidders then move to the second stage of the process.

During the second stage the government signs confidentiality agreements with the short-listed bidders gives them much more detailed, commercially confidential information on the state enterprise, access to management, and a draft sales agreement. Bidders that wish to proceed then submit a binding offer (bid) and a deposit. Finally, the government and its advisers choose the best offer, and the sale closes with payment for the shares (or in special cases, assets) of the state enterprise. [Welch and Frémond (1998), p.28].

Negotiated sales to strategic investors

Negotiated sales are a variant of the open bidding process. Once the government has chosen a buyer, it negotiates an agreement that is attractive to the buyer and protects the government's interests. Negotiated sales are used when there is only one bidder or a bidder has a marked advantage over other bidders in the government's eyes. It is difficult to get the highest price in such sales, however, and they are less transparent than open bidding. In contrast to public auctions and sales, negotiated sales enable the government to influence the divestiture to achieve its social objectives or to exclude unwanted buyers (e.g. foreign investors). However, these constraints on the new owner can lead to a lower sale price, reducing the revenues that the government can use to finance social safety nets. [Welch and Frémond (1998), p.33].

Also once the employment guarantees expire, the government has little leverage for protecting workers. And due to their decreased transparency, negotiated sales give rise to fiscal and distributional concerns; that is, the enterprises can be under priced during the negotiations, causing a negative effect on the budget, as well as benefiting the favored buyers. This risk of an adverse distributional impact via the capital income channel is greater than in the case of public sales and auctions. [Sanjeev, G; Ma, H; Schiller, C. p.45].

Mixed sales

Mixed sales combine two or three sale methods to transfer the state's shareholdings to the private sector. These sales allow several types of investors to participate in the privatization transaction. Trade sales are usually used when an enterprise is sold to a strategic investor bringing capital, know-how, and market connections to the privatized firm. Depending on the objectives of the government and the requirements of potential investors, the level of control offered for sale may range from a super majority (66 percent of voting rights), to an absolute majority (51 percent of

voting rights), to a relative majority (the strategic investor becomes principal shareholder with, say, 35 percent of shares). [Welch and Frémond (1998), p.33].

Initial public offerings are often used to allow the public, together with domestic and international institutional investors, to participate in privatization. The shares reserved for the stock market can be sold in several tranches, depending on the absorption capacity of domestic and international markets at the time of the offering. In addition, in developed markets the share price offered to retail investors is often slightly lower than the price offered to institutional investors, which is lower than the price paid by the strategic investor.

Finally, negotiated sales or private placements are used to transfer shares to the employees of the privatized entity, including retirees and former employees who worked for the company for a minimum cumulative period of, say, five years. The shares reserved for employees are generally sold at a discount to the offer price for retail investors at the time of the initial public offering—provided the shares are not sold in the secondary market for, say, 18 months to three years. [Welch and Frémond (1998), p.35].

MEBO

Management/employee buyouts (MEBOs) have played a major role in a number of Eastern European countries. [Nutti, D (1995)]. Management-employee buyout (also referred to as insider buyout). Under this approach, shares of an enterprise are sold or given to some combination of managers and other employees. The powerful positions of employees as, for example, in Poland, and of managers, as in Russia give this approach the twin advantages of feasibility and political popularity. The main advantage is that it is faster and relatively easy to implement. Well-structured management-employee buyouts can sometimes lead to efficient results, since they align the incentives of workers and owners. [Havrylyshyn, O and McGettigan, D (1999), p. 2; Buttari, J.J (1997), pp.2-3]

However, on the downside, by and large, it is not regarded as leading to better corporate governance, increase in new capital, skills or government revenues. Nevertheless, experience shows that these buyouts suffer serious disadvantages. Yielding to insider interests often entails large costs in inefficiency and poor management. The process may be inequitable, handing employees, rather than the population at large, most of the benefits. The record of labor-managed firms suggests that they may grant excessive wage increases, maintain excessively high employment, and undertake insufficient investment. In the transitional economies, insiders may also lack many of the skills necessary to function in a market-oriented economy. [Havrylyshyn, O and McGettigan, D (1999), p. 2].

Another disadvantage is that it entails an element of arbitrariness and unfairness a worker loses or gains depending on whether he happens to be in a “bad” or “good” firm. Moreover, use of this method may block further reforms if insiders prevent access to ownership by outsiders (who would bring new capital and skills) or the latter are reluctant to invest (because of insider control). One should note that, the other most frequently approach used, "equal access" voucher programs (see below), may de facto become management-employee buyouts, if managers, employees, and their families use the vouchers and other resources to buy stakes in their own companies (as in Lithuania). A fortiori, voucher programs which give preferential access to managers and employees are also de facto insider buyouts Russia is an example. [Buttari, J.J (1997), pp.2-3]

Despite its many disadvantages, management-employee buyouts have been popular in several transition countries, including Croatia, the Former Yugoslav Republic of Macedonia, Poland,

Romania, the Slovak Republic, Slovenia and Russia. [Havrylyshyn, O. and McGettigan, D (1999), p. 2].

Management or lease contracts

Under management or lease contracts, the government retains ownership but delegates the management functions. Thus, there is no transfer of assets to the private sector. Instead, private sector technology and skills are provided for an agreed time and for a fee. Under a management contract, the private company earns a fee for managing the enterprise; the government keeps the profits. [Sanjeev, G; Ma, H; Schiller, C. p.48]

The rationale for management contract can be summed up as follows: Management contract would be the first step to achieving privatized ownership. In other words, management contract is more important when government wants to transfer the ownership to a private firm, but also wants to return the state owned enterprise (SOE) to a reasonable level of performance in order to attract private investors. It is a fact that SOEs are operated within financial and management troubles, therefore the productivity is very low in those enterprises. In this context, management contract is a rational solution to rehabilitate the enterprise and prepare it for full divestiture. Secondly, government may want to undertake a rehabilitation effort, the benefits of which can only be derived with improved managerial efficiency. In this case, the purpose of the government is not to sell enterprise, rather its purpose is to address managerial, technical and financial difficulties through an injection of advanced management and other skills. Third, it would be necessary to improve management capacity, system and expertise in the enterprise in order to reach a new and advanced technology. Management contract is common in such areas as the hotel industry, hospitals, homes for aged, day-care centers, city bus and subway operation and some industries such as steel, fertilizer, chemical, textile etc. [Aktan, C. C (1992), p.12]

Under a lease contract, the private company pays a rent to the government and assumes full commercial risk. Lease contracts are relatively rare in industrialized countries, but more usual in developing countries. [UNCTAD, (1995)].

The impact of these two types of contracts on the budget should be rather similar. If the private company manages the enterprise efficiently, then either contract can produce a steady stream of revenues for the government. The impact, however, could differ in terms of the workforce and consumers. Management contracts typically provide for cost-plus payments to the manager; hence, so long as the manager earns the fee, he/she would have little motivation to change the prices charged by the enterprise or the workforce. In the case of a lease contract, the lessor has an incentive to raise prices and cut the workforce, since he/she can keep all extra proceeds net of the lease payment. [Sanjeev, G; Ma, H; Schiller, C. p.48]

User Charges

Some public goods and services are supplied free of charge and financed by general fund revenues. In fact this is something of a requirement because of the "indivisibility" and "non-exclusion" characteristics of some goods and services. National defense and judiciary are two typical examples of these kinds of services. However, there are some other types of public goods and services, whose benefits can easily be divided and whose users can be excluded from its consumption. Higher education, health services, cable TV, electric power and mass transit are the main examples. These types of goods and services can be either provided free of charge and financed by taxes or by the imposition of a fee or user charge to the individuals who receive benefits. User charges can be imposed on exclusive club goods, which includes "toll" and "quasi-public" goods. These goods have both exclusion and joint consumption features. The main purpose of the user charges, or fees,

is to reveal the true cost of the services provided. In other words, those who want to get benefit from some particular services should contribute to their full cost. Here we should note that user charges are an application of the “Benefit Approach of Taxation”. Only those, who receive benefits from public goods and services, are required to pay or share its cost. User charges apply to a wide range of goods and services that are provided by local government in particular. Public utilities usually charge a fee to local inhabitants for their use of goods. Examples of services financed by user charges include swimming pools, parks, museums, hospitals, electricity, gas and water supply, education etc. [Aktan, C. Can (1992), p. 18].

Some conditions are necessary for a successful implementation of user charges [Wagner, R (1973), p. 128]. First, the goods and services must be divisible among the users. That is, different people must be able to consume different amounts of the service. The user pricing of “divisible” goods and services thus stands in contrast to the tax pricing of indivisible goods and services. In brief, user charges should be implemented to the consumption of the divisible goods and services.

There are some important benefits that can be obtained through the implementation of the user charges. When user charges are substituted for general fund financing, taxes, it is possible to get immediate and clear responses to the price changes. Hence, producer's output choices transmit stronger signals concerning desired rates of supply. Consumer purchases convey information about relative preferences, and this information is an ingredient in the process by which resources become allocated to more highly valued uses. If a single service is sold via user charges, the information generated by consumer preferences is clear. Thus, the earning of a profit indicates that a service is valued more highly than other services. However, if several services are sold jointly through a general budget, information concerns profit or loss reveals little about which services to expand or contract. Thus, price is a less sensitive conveyor of information when several prices are jointly supplied by a general budget that when a single service is supplied by user changes [Wagner, R. (1973), p. 132].

Note that, user charges are not the same thing as “earmarked taxes”. Earmarking is a method by which specific government revenues are designated or dedicated to the financing of specific government expenditures [Buchanan, J (1972)].

Joint Venture

As noted earlier, privatization encompasses all practices aiming to reduce the role and scope of the public sector and to increase private sector activities in the national economy. Within this framework, joint venture can be considered a privatization method. Joint venture is a partnership of two or more firms. Joint venture firms, that is, partners agree to a common business target and to share accruing profits, losses and any other risks. Joint venture can be established in various fields such as; general trade, commodity exchange, technology development and exchange, constancy services, training, product development, oil, gas and mineral exploration, international marketing, construction etc. However, industrial joint venture is the most common type of partnership [Jafri, S.S.1(987), p.1].

Partnership could be done between two or more private firms; however, it may be established between a private enterprise and public enterprise. The former can be named as a “private sector joint venture agreement” and the latter as a “public and private joint venture agreement” or simply as a “mixed enterprise”. Both types of joint venture agreements can be made within the country or at the international levels. Domestic joint venture is a partnership of two or more firms operating within a country. However, international joint venture exists when a domestic public and/or private firm is involved in business collaboration with a foreign public or private firm. International joint

venture is especially popular within developing countries. It has been proved that developing countries suffer for lack of capital accumulation, technical know-how etc to boost the economy. [Aktan, C. C (1992), p.19]

Therefore, international joint venture agreements are a reasonable means to achieve economic development in these countries. An international joint venture agreement is usually made between two firms where usually one operates in a relatively developed country and the other in a developing country. A joint venture agreement covers almost all stages of industrial activity such as joint planning, production and marketing, thus enjoying the blessing of research and development in managerial and technological fields, copyrights and trademarks, experience, expertise, modern plants and machinery as provided by the partner in the developed country. On the other side, cheap labor, raw materials, geographical advantage, better market incentives are offered by the partner in the developing country [Jafri, S.S.(1987), p. 2].

It seems that the main rationale of international joint venture investments is to help underdeveloped countries achieve economic growth and development. However, firms operating in developed countries also gain from this type of business collaboration, because there is a high probability for a reasonably good rate of return on investments. One of the problems with this type of arrangement is that political and economic uncertainty and instability sometimes discourages a foreign private firm from participating in international joint venture agreements. [Aktan, C. C (1992), p.20]

Grant System

Grants or subsidies are financial or in-kind contributions to individuals or private firms by government. In other words, grants are awarded to encourage the production of particular classes or producers. The Aktan Coskun argued the grant may be in the form of a cash subsidy, tax incentives, low cost loans and loan guarantees.

Grant in the form of Cash Subsidy: Government offers money to a particular type of producer or supplier of goods and services. The most important feature of this form of grant is that recipient of the subsidy is not required to pay the money back to the government. There is also no interest payment requirement.

Grant in the form of Direct Loans: Government provides low cost loans, in other words, “subsidized credit” to many different type of borrowers. Agricultural credit to farmers is a common example of direct loans. The primary type of a direct loan is the disbursement of funds by a single government agency or via different departments or ministries. Under the terms of a loan contract, the borrower agrees to repay the loan principal to the government with or without interest. Direct loans are financed from a variety of sources, including repayment of previous loans, appropriated funds derived from taxation and borrowings.

Grant in the form of Loan Guarantees: Through loan guarantees, government guarantees the payment of the principal and the interest in whole or in part in the event of borrower default. Note that, under this type of grant, government itself does not extend credits or loans to the individuals or the businesses. The loan is obtained from private lenders. Loan guarantees are contingent liabilities of the government. In the case of default by borrowers, government makes payment. Consequently, a loan guarantee transfers some or all of the default risk of the loan from the private lender to the government.

Grant in the form of Tax Incentives: Tax incentives take many forms:

§ Low rate of taxes for particular types of activities.

§ Through an Investment Credit System, government permits individuals and private firms to deduct each year from their tax liability a certain amount/percent of their total current investment outlays on equipment. Thus, in effect, the government pays a subsidy on investments by giving back to firms a fraction of the investment cost through this special tax credit. [Aktan, C. C (1992), p.21].

Subsidies are used most frequently to provide merit goods. Profit as well as non-profit organizations is generally the recipients of subsidies. For example, government may award a cash subsidy to a non-profit organization to encourage their activity in the field of culture or the performing arts, such as the theater, opera, symphony orchestra etc. The primary benefit of using subsidies is that it can be an inexpensive way to encourage private firms to provide services that are in the public interest and that could not be provided as inexpensively or as well by government [Valente, C.F. and Manchester, D. L. (1984), p. xviii].

Non-Profit Organization

Non-profit organizations, which are sometimes called “Voluntary Organizations” or “Philanthropic Organization”, also provide some public goods and services. A non-profit firm is an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, and directors of trustees. In addition to this main characteristic, which is called “nondistribution constraint”, a non-profit organization has some other features:

- § They are often granted a variety of tax subsidies such as tax-deductible donations, special postal rates and exemption from income and property taxation.
- § They usually have no access to tax revenues for financial support; however, they sometimes get grants from government.
- § They generally receive only a minority of their total revenues through donations from either private or public sources. Overall, their revenue is even more dependent on user charges largely involving sales of services or dues from members [Hansmann, (1986), p. 58-59; Weisbrod, (1987)].

According to this last characteristic, a non-profit organization is either “donative” or “commercial”. A donative non-profit organization receives most or all of its income in the form of grants or donations from individuals, private firms as well as from government. By contrast, a “commercial non-profit organization” receives the bulk of its income from fee charges for its services. Non-profit organizations donative or commercial generally provide merit and club goods such as rehabilitation and sanitation centers, elderly housing, drug-alcohol prevention and treatment centers, cultural activities (museums, private libraries, art galleries, symphony orchestra, theaters, etc), hospitals, environmental protection centers, blood banks, child-care, nursing homes etc. So the government is able to transfer some of its functions to those non-profit or voluntary organizations. However, a non-profit economy may exist only if government provides a great many incentive to those voluntary organizations. [Aktan, C. C (1992), pp.22-23].

Build-Operate-Transfer (BOT) System

Build-Operate-Transfer (BOT) has been a popular method in some developing countries in recent years. The system is quite simple and seeks to attract foreign capital. Direct foreign investments are encouraged to build infrastructure facilities, petroleum exploration stations, entertainment centers, recreation facilities etc within the developing or host country. Upon completion of construction, the foreign private firm has the right to operate the facilities for a certain period of time agreed upon via contract. At the end of the contract, the facilities and establishments are transferred to the government. [Aktan, C. C (1992), p24].

Foreign private capital, particularly in the form of direct investment, plays an important role in economic development within developing countries. Domestic private capital investment could be insufficient due to such factors as lack of private capital accumulation, reluctance to undertake risk and uncertainty by private individuals and firms etc. In this case, government usually establishes public economic enterprises in various sectors. Lack of modern technology, availability of sufficient capital, managerial and technical know-how is factors that may hinder public enterprise's ability to work efficiently. However, foreign direct investment can contribute to developing countries a great deal. General economic conditions in many developing and underdeveloped countries offer a challenge to the private sectors of more developed countries to explore the significant opportunities that exist in the developing world. On the other hand, there is a high probability for a reasonable rate of return on investment. Despite political and economic instability and uncertainty in the developing countries, foreign investors can be offered some guarantees to attract investment. [Aktan, C. C (1992), p.25].

2.7 PRIVATIZATION TECHNIQUES

There are a variety of techniques that can be selected to use in privatizing state owned enterprises and activities. They are Small-Scale or Spontaneous privatization technique, Mass, Voucher or Give Away Privatization technique, Case-by-Case privatization technique and offered in theory as a privatization technique Initial Public Offering Plus (IPO-Plus) privatization technique. The developed countries usually privatizing state assets by case privatization. In opposite them developing or in most cases transitional countries going through all this techniques begins with spontaneous privatization and finish by case-by-case.

2.7.1 Spontaneous privatization

Spontaneous privatization very typical for former Soviet Union and East European ex-socialist countries. Spontaneous privatization is the result of managers and in some cases workers, greater control over their enterprises. This type of privatization involves fundamental changes in the organization and operations of enterprises and is rapidly rendering existing theories of social managerial behavior out-of-date. These changes are not the result of coherent government policy, and nor do they appear to be unambiguously in the interest of any political group. The process is truly spontaneous privatization because the critical decisions are made by the enterprise managers and by lower level supervisory bureaucrats and these individuals obtain rights that were previously held by the state.

In many cases, the new property forms are motivated by the desire for new contracts between the firm and the suppliers, customers, workers, and implicitly bureaucrats. But at the same time, another motivation behind this process is the desire of state managers, members of the bureaucracy, and in some cases workers, to seize property rights that mean control over what was previously state property [Johnson, S (1991). p.1].

It is rarely complete privatization, because private individuals do not become the *de jure* owners of assets, but all levels of government definitely end up with property rights [IMF (1991), p.2].

Spontaneous privatization often also involves an important element of reorganization for firm's contract. Because managers are acquiring the right to decide how assets are used, they are also devising novel ways to deal with the current economic problems of their firms. Many of these reorganizations are merely the rational response to macroeconomic imbalance and pervasive shortages, but some new contracts help to create new physical and human capital. It must be

stressed that while much of spontaneous privatization appears to be beyond the control of government, it is not usually illegal. [Johnson, S (1991). p.2].

Gradually state enterprises were allowed a wide range of property form, they were authorized to issue non-voting shares, began to sign leases with ministries and in former Soviet Union they become independent from sectoral ministries after August 1989. [Hansen, P (1990), pp. 95-124]. Other form of property is cooperative were formed become fully legal in 1988. The most important form of new property is probably the joint stock company, first seen in 1989. [Economist (1991), p.78; Shatalev, S (1991)].

These enterprises are not strictly a new property form, but just rather small units of production usually within a state enterprise. In some cases an individual entrepreneur persuades a state manager to allow an autonomous small enterprise within a state firm. For these new firms can be detected at list six new forms of contract.

1) Contracts With The State. New property forms provide numerous legal ways to avoid wage and price controls there are, in effect, fundamental changes in firms' contracts with all levels of government. The creation of new property forms and new contracts also provides opportunities to transfer money from tightly controlled accounts which cannot be used to pay wages, into cash or other bank deposits which are not so restricted. It is now quite common for firms to establish joint stock banks which are not effectively regulated, and to use these banks as a way to avoid wage controls and probably also to evade their taxes. In these ways spontaneous privatization increases the nominal purchasing power in the economy [Rutland, Peter (1991)].

2) Contracts With Individual Bureaucrats. Managers and their former bureaucratic bosses also may explicitly establish a new property form together, combining their economic and political skills, and with the shares officially held by their organizations. Effectively, parts of the nomenklatura are engaged in leveraged quasi-buyouts of former state assets, always on extremely favorable terms often involving no initial cash payment. At the same time these deals are carefully constructed so they do not break any law. [Johnson, S (1991), p.7].

3) Contracts With New Firms. There appears to be a significant number of start-up firms in the Soviet Union. Any new firm would be very vulnerable if it tried to operate by itself, buying and selling for money. The key to success is to obtain resources (material inputs, food, transportation services) through established and emerging networks of barter between existing state firms. Many new firms are therefore organized with an equity stake, either implicit or explicit, for a "protecting" state firm. Existing state firms may provide to new firms four main forms of protection and support: financial, logistical, people, and political [Johnson, S (1991), p.7].

4) Contracts With Suppliers. Some new contracts are designed to reorganize supply relations. There are at least two distinct forms of reorganization. First, there may be reintegration of an input supply chain inside a new firm. The collapse of planning and central control over supplies means that the old system of vertical integration under individual ministries is breaking down. This breakdown has been exacerbated by ethnic conflicts, because supply chains were often stretched across several republics and inter-republic trade is now frequently disrupted. Therefore some managers were seek to rebuild input supply chains on a narrower geographic basis preferably within one republic. These managers have been arguing that all stages of production need to be placed within one firm, because this is the only way to monitor whether everyone complies with their supply agreements. Second, the whole supply chain of agricultural goods may be reintegrated within one firm, in reaction to the increasing problems of obtaining food in markets or through stable barter deals. In this case the

manager seeks to achieve autarchy for his firm. Some trade with other firms remains desirable but the goal is to have the capacity to survive primarily through long-term implicit contracts, relying as little as possible on trade in unstable markets. [Johnson, S (1991), p.7].

5) Contracts With Other Enterprises. Some new property forms are designed to create a holding company, which will facilitate expansion, by enterprising managers. This is horizontal rather than vertical integration. Pervasive shortages mean there are opportunities to produce new goods and services, but in a very unstable economy it makes sense to diversify the risks by operating in a variety of different sectors. Therefore a holding company may be established, running a conglomeration of different enterprises or organizing an effective monopoly. The lack of effective antitrust measures must make the formation of monopolies attractive [Kroll, H (1991), pp.143-174].

6) Contracts With Workers. Types of contracts also motivate some of the new property forms with workers. For example, some cooperatives have been established within state firms either as subcontractors or simply as ways for workers to earn a higher wage. The state enterprise provides protection, and in return workers turn over part of their output to managers, who may then use it to barter for consumer goods for the enterprise as a whole. The rise of subcontracting cooperatives probably also involves an increase in contingent payments to workers. [Johnson, S (1991), p.10].

The Winners and Losers in spontaneous privatization

Winners

The principal winners are therefore people who work in the firm being privatised and their immediate supervisors in the bureaucracy. But at the same time there may be gains for suppliers and customers. The state supply system is disintegrating, and all the traditional problems of obtaining goods have been greatly exacerbated. The move to market relations with western-type contracts between parties is complicated by the lack of a legal system that can enforce contracts and by the absence of stable money. Therefore new institutional forms that may seem bizarre from a western perspective, such as complicated cross-holdings of shares, which are not underpinned by any ultimate private ownership, can be interpreted as contracts that are designed to ensure stable access to supplies. [Johnson, S (1991), p.12].

Losers

There must also be some losers. For people who rely on deliveries of consumer goods to state stores at official prices, living standards may fall due to spontaneous privatisation to the extent it helps divert goods onto the free market. It is very difficult to identify exactly who are such people, because they do not form a single homogeneous group. For example, it might be reasonable to think that pensioners would be losers. But some pensioners have personal connections to family or friends who are gaining from spontaneous privatisation and they will likely share in these gains. The critical issue that is whether an individual is connected to an organisation in which managers are gaining autonomy and property rights and this varies considerably between individuals [Johnson, S (1991), p.12].

The social and political implications of spontaneous privatization.

The social and political implications are enormous: the old control structure, which worked through the self-interest of party careerists, has disappeared. The best bureaucratic career move now is to promote new enterprises, and get an implicit equity stake. Of course, if too many of the nomenklatura make too much money there will be popular outrage against this form of privatisation. [Johnson, S (1991), p.16].

At the same time state sector managers and private entrepreneurs are learning how to do business, how to tailor products for consumers, and occasionally how to export. The products, production processes and physical capital which result from spontaneous privatisation may all be totally unsuited to a free market economy operating with more nearly world relative prices. Most likely some of the human capital which is being created will remain useful. Private entrepreneurs need the time and the opportunity to develop their own skills, organisations and networks. [Dabrowski, J; Federowicz, M and A. Levitas (1991)].

2.7.2 Mass Privatization Model

Introduction

There are a few models that transient countries use to privatize the state ownership. "Mass Privatization" one of innovative models which was adopted in Czech Republic, the Russian Federation, Armenian Republic and etc. Mass Privatization model mean rapid privatization with involving of large mass of population. For a country which is just starts transition and therefore privatization can have good beginning it is quite well choice but on the other side this model can be exceedingly complex, hold many danger tropes, and if it not develop carefully could bring to delay and undermine public support for privatization. It is very important at the beginning to examine the various options consider to country specific and take in to account the experience of other countries which are already involved in this process.

I can confirm Mass Privatization as a complex of important reforms, which is become a tool to create a new economics system and find solution for problems of old system in connected to planed economies. What is mean Mass Privatization Program? It is mean system of voucher distribution to citizens. The Russian Federation, Czech Republic, Armenian Republic has chosen direct form of distributing. Citizens could invest them direct in to companies or trough investment funds. But it does not mean that they have to use only this privatization method. It is possible to combine this method with others, how it took place in the Russian Federation and Armenian Republic where direct sales was predominantly combined with insiders sales to managers and employers and then was used case-by-case technique. Mass privatization approach has proved to be very efficient for the rapid privatization of a large number of state owned enterprises. However it cold decide only very limited part of problems of enterprises and corporate government restricting.

Usually direct MPPs don't address to problems of corporate governance and enterprise restructuring as well. It is more like precondition for restructuring than restructuring itself. Restructuring basically affects pre-privatization process by combining direct voucher sales with traditional one such as goods on the market. Moreover, the existence of investment founds or voucher markets might to mitigate the negative effects of widely dispersed share-ownership and the ensuing lack of effective corporate control mechanisms. But of course there is an expectation that these mechanisms will work through post-privatization secondary markets.

Voucher in different countries depends of there system of MPP could play a different role. Voucher is a means for bidding companies shares. For example in Czech Republic that was done through voucher investments founds or direct investment. But the voucher could not be a good, which is mater to sale. It is so cold non-tradable vouchers. They have no nominal value established by government and they have not been subject for sale on the market. These kinds of politics involve whole layers of population in process of privatization until they become shareholders. This system of vouchers distributing makes easier question about amount of vouchers to be issued. But it seems that it can be implemented effectively only in countries with a rather small number of population and state-owned enterprises.

On the other hands there is a tradable voucher system which was used in Armenian Republic and in the Russian Federation. This system can be valued both positively and negatively. The positive that in general this system mach more sensitive to shifts in public confidence and require careful management by government. It not requires the establishment of complicated bidding procedure for voucher implementation and might be beneficial in creating concentration of ownership through voucher market. Negative it has low credibility for the MPP and in this case might result in a large-scale sell of vouchers for cash and consequent loss of political support for the MPP. Also vouchers sale by cash brings to corruption. All that might provide to period of transition between privatization and the emergence of restructuring effective corporate governance.

Financial intermediaries play a critical role in the success of any MPP. The countries that have cozened compulsory intermediaries in the context of MPP are faced with the task of creating a real private sector structure and supervision for these state-created institutions. First of all this implies means privatization of their management and establishment of an appropriate set of incentives for the private managers. The second step is creating a framework for complete transfer of property rights from state “old owners” to citizens their “new shareholders”. Private intermediaries are playing a predominant role in countries with direct voucher systems. For example in the Russian Federation more than 50% of shares sold in voucher auctions have been acquired by investment funds, the corresponding percentage for Armenia is bit more than 18%.

The most complicated issue regarding voucher funds is their dual and a great degree conflicting nature. They are, on one hand mutual investment institution, in which thousands of small voucher holders have invested their future rights to property. An effective regulatory framework for the protection of these investors would require the maintenance by these funds of highly liquid asset structures. On other hand they are under the circumstances, the only institutions capable of playing in the immediate future an important role in corporate governance of the newly privatized SOEs and, thus of facilitating their rapid restructuring.

Fulfilling such a holding function, however, requires extensive, exposure to risk and much lower liquidity levels on the asset side of their balance sheets. Combination of the two functions might, at a first stage be unavoidable. However, regulation is needed for adequate protection of investor interests. Also there is another problem it is relation ship between the bunking sectors and founds. A captive relationship between them might rise to a rapid restructuring of the corporate sector. A widespread combination of the lending and shareholding function in the bank might create conflicts of interests and delay the enforcement of market discipline, including bankruptcy procedures, on the newly privatized enterprises.

To get success with mass privatization model is necessary to inform the people through mass media TV and etc. about contents and benefits of the program. Furthermore, the program has to be attractive for the population at large. Thus, even though stakeholders should get some preferential treatment, the program must be regarded as equitable and fair. Furthermore, in order to sustain the political momentum for privatization, it is important to get the population excited about the program. *[Boycko, M., A. Shleifer, and R. Vishny. (1994b), pp. 249-266].*

Very important role playing such establishments as a stock exchange they help to establish effective corporate control structures for newly privatized firms. In most Central and Eastern European countries an initial stage they has very impressive growth. Exchanges were created, as an immediate consequence of mass privatization in Russia and Armenia at the same time regional exchanges with little or no regulation becomes very active.

Although the development of exchanges is an important step in consolidating post privatization ownership structures, most block transfers of shares in privatized entities have taken place outside of exchanges. These forms of ownership consolidation become predominant in countries, which stock exchanges are in the incipient stages. The existence of such markets is an indication that corporate control mechanisms for the newly privatized firms are starting to emerge. However it could affect to further development of orderly equity markets. Some times asymmetries on share prices may result in unrealistic price formation in the exchanges that exacerbate liquidity problems. To avoid such problems it is necessary to put into place a framework for disclosure of price-sensitive information that would promote transparency in the marketplace.

For ensure effective corporate governance and restructuring privatized enterprises at the post privatization phase is necessary good functioning secondary market. Obstacles that prevent the operation of secondary markets should be identified and removed. Usually role of obstacles playing enterprise insiders through variety of mechanisms. Specific transitory rules for privatized companies as it has place in Russia might need to be developed and enforced by the governmental institution responsible for privatization.

The important role in secondary market development playing State Property Funds, which retain considerable minority interests in a large number of privatized enterprises. These institutions should work to facilitate the involvement of outside shareholders in exercising management control, but in the same time should being as neutral as possible in term of company policy.

Background of mass privatization technique.

Mass privatisation technique can best be described as non-cash share distribution technique. These techniques have enjoyed the advantage of being relatively more transparent, with initial share values usually set at nominal book values which are instinctively understood by most governments. A centralised auction of shares is then conducted, what permits the simultaneous sale of a large number of companies. By providing management, employees and the general public an opportunity to acquire ownership of former State companies easily (and cheaply), these programmes have encouraged support of the privatisation process and the larger landscape of market-based reforms. They have helped to create a new class of investors and owners in countries where the idea of private property and ownership had not existed for decades [*Tessie S. M (1999), p.87*].

MPPs are starting from decision about universe of firms to be included in the program. MPPs usually implements in countries with large scope of firms because mass privatization requires a critical mass of firms to be privatized, to create the supply side for the program. The other peculiarity that makes difference between mass privatization from classical one (case-by-case) is speed. MPP creates the basis for a market economy by privatizing SOEs as quickly as it possible. On the other side, mass privatization usually includes the wide distribution of shares of SOEs to the public, either free or for a minimum charge, generally though a voucher allocation scheme. [*Lieberman, I. W (1994), p. 14*]

Most discusses about dilemma of MPPs included development of financial intermediaries, voucher investment funds to accumulate and invest vouchers, to allow the public to diversify it risk, to strengthen governance over the newly privatized firms and to establish the basis for a capital market, a secondary trading market for the newly created shareholders.

Finally it has become apparent that for real working MMP is necessary formation of a capital share market. It will allow the newly created shareholders to buy and sell shares, offering potential for a

real return on their vouchers, reward companies and management, which restructure and perform well. By contrast they provide some degree of discipline over those managers and firms that perform poorly. Capital market will allow ownership structures to change over time and provide the basis for the entry of foreign capital.

On MPPs affect not only critical components like portfolio selection, mass corporatisation, vouchers investment funds, state property agencies, but also such issues as political will, property rights, corporate governance and restructuring.

General condition for all ex-socialist countries is absence of private ownership, limit for foreigners to participate in auctions and buying firms to own, desire to involve citizens in the process of economic transformations through widely distributed ownership. The main goals of this kind privatization are attempting to involve and commit population at large economic transformation process. Look for distributive equity through the distribution of shares to the citizens. Quickly privatizing a large number of companies to deepen market forces and competition within the economy [*Lieberman, I. W (1994), p. 14*]

Objectives of mass privatisation

The overall objectives are several:

- a) political: attempting to involve and commit the population at large to the economic transformation process;
- b) social: seeking some form of distributive equity through the distribution of shares to the general public; and
- c) economic: quickly privatising a large number of firms to deepen market forces and competition within the economy. [*Lieberman, I. W(1994), p. 16*]

Definition of mass privatization components or selection of firms for privatization.

Another characteristic that varies among voucher privatization program is the locus of decision-making power regarding whether and in what form a particular firm will participate. The initial problem is to selection or segmentation pervades the entire privatization process. Some of enterprises should be privatized first, others after time, some enterprises will stay in state property. The experience of other countries shown that implementation of only one method or technique of privatization is not a best way. But unlike other methods of privatization, mass privatization requires a huge quantity of firms to be privatized. The government maintained full authority to choose which firms would participate in the first wave of its voucher privatization, and government continued to apply this principle in the second wave. To what extent a particular firm would participate the mix in each individual case between voucher auctions and other forms of transfer, it is decided centrally but based on bids submitted from competing bidders and prepared by them with little government involvement. Thus, the design process is decentralized in framework, but the final decision process is controlled by the top. This approach, attractive both economically and practically appears to have working well in the politically centralized environment where strong inside shareholders were absent. The first step is, therefore to choose which enterprise are to be included in the mass privatization program. [*Lieberman, I. W (1994), p. 16-17*]

For examples deferent countries creating a differ framework of privatization alternatives such as: small scale privatization for retail shops and service establishments, privatization through liquidation, form of managers or insiders buy out, capital privatization, sectional privatization, privatization through renting and contracting out, and finally mass privatization. It is possible to delay mass privatization because sometime it is not clear which firms would be slotted into one privatization alternative versus another.

In all cases development of any MPPs extremely need to decide deadline of program, how many and what kind of firms involved in process, supply them to match the demand generated from the distribution of vouchers to the population and creation of investment funds as intermediaries. For examples it could be in two or four year's period, as it was in Armenia. Every two years was accepted new program with new framework, or as it was in Russia the leaders have kept the pressure on to maintain a high rate of regional voucher auctions. The MPP program in Russia was completed in June 1994, some two years from its inception and about 18 months from initial pilot voucher auctions. [Boycko, M., Shleifer, A and. Vislinsky R. W, (1994), p. 163].

Corporatisation

Corporatization is a main part of mass privatization process, or in other words any mass privatization needs a critical mass of firms which will be supply to MPPs. Usually corporatization process proceed simple and automatic. In Russia it was compulsory. Firms were given some quantity days for corporatization, and even some of them didn't corporatise in time, compulsory nature of the process created critical mass of firms necessary to launch the auction program. This process has only administrative nature. All SOEs get standard set of corporatization documents, procedures and regulations. Also this set of documents publishing in mass media for any company has no excuse to evade the exercise. The standard documents included a charter, a method to value the firm, using book value, valuation basis and a procedure for choosing options for distributing shares to managers and workers. Tying the closed subscription to corporatization induced firms to corporatise rapidly [Lieberman, I. W (1994), p. 18].

Voucher

Voucher in Practice

Vouchers are certificates or scrip that are distributed to the population that they can to convert shares in SOEs through some form of auction process, investment funds, and stock market. Voucher also can be means for direct sales, or in some countries sales on the market. Mass privatization schemas not strait linked to voucher, they are associated with each other. In some NIS countries vouchers have been used to speed up privatization process and to assure more fair and equitable distribution of the wealth previously held by the state. By wide-scale distribution to the population, vouchers are intended to generate both popular supports for the MPP and demand for shares in SOEs being privatized. Russia and Armenia introduced a nation wide voucher scheme and vouchers were distributed to all citizens.

Voucher Funds and Stock Market.

Will the voucher funds jump-start the stock market? Expectations in the East about the importance of public stock markets as a net source of funds have been grossly exaggerated. In fact, stock markets in the developed market economies play a rather modest role as a net source of investment finance. One primary purpose of a public capital market is to provide a bridge so that personal savings can flow into the investments of businesses.

To large extent equity markets are an interesting and fun sideshow, but they are not at the heart of the action. Relatively little capital is raised in equity markets, even in the United States and the United Kingdom. One cannot expect equity markets to play an important role in raising funds in the newly emerging democracies. [Stiglitz (1994), p. 228]

Furthermore the voucher privatization process does not "jump-start the capital market" since the whole process of distributing vouchers to citizens and firms distributing shares in return for

vouchers does not move one ducat of capital from savings into investment. An ersatz "stock market" in a transitional economy for the secondary trading of voucher-based shares does not perform that most basic function of a capital market in spite of the strong symbolism of the "stock market" in the popular mind. If public stock markets in the West play such a small role in net finance and if the stock markets in the transitional countries don't even have that role, and then it is difficult to explain the enormous attention and resources devoted to stock markets in the transitional countries by western advisors and domestic reformers. [Ellerman, D (1998), p.5]

Voucher economics

What voucher doing, it is replacing cash in the auction process and it seems that using vouchers will help to reduce total cash proceeds to the state from the sale of SOEs. However a case can be made that the proceeds to the state will not be reduced so much as issued vouchers, or not reduced at all. Because vouchers may stimulate privatization process and incomes in state budget will be much more than it was provided by initial privatization program. Information and other materials related with privatization and vouchers to promote interest of large layers of population to participate in this process. But unfortunately wide mass of population has not enough money or other financial sources to bid for SOEs shares. In most cases price reserved for this shares much lower than justified by demand when taking place cash payment. Issuing vouchers could increase financial resources available for purchasing these shares, thus increasing the sale price and the overall proceeds to the state in the form of vouchers and cash [Lieberman, I. W (1994), p. 19]

Vouchers using could bring to inflation, because it is high liquidity form of wealth that can easily to be sold for cash to finance consumption. The magnetization of vouchers and velocity of their turnover are, therefore likely to have some impact on inflation, the magnitude of which must be estimated when the system is designed. For examples in Poland voucher was a bearer document and will become immediately tradable off-line. [Jan Winięcki (1994)].

There are systems for avoiding inflation effects. Each of countries that is doing MPP choosing some of them, for examples valuing vouchers nominative price, limiting their use to bidding shares in auctions, converting for shares in funds, into shares in privatized companies and denominating them into points, not in currency. The Russians vouchers an initial stage have been assigned a monetary equivalent of 10 000 rubles. All that makes voucher immediately tradable and of course very popular in large mass of population but that also leads to inflation. [Boycko, M., Shleifer, A and. Vislinsky R. W, (1993b)].

The complex of voucher schemes

The design of voucher system and associated system for auctioning enterprises to voucher holders is complex, requiring a series of decisions all of which affect the cost and complexity of the system. The key considerations are noted below:

- *Who is eligible to receive vouchers?* - all citizens, resident as of a specific date, all citizens above a given age..
- *How to voucher issued?* One or a series of vouchers, tied to the auctioning of firms in a series of tranches..
- *Should voucher be assigned a monetary value?* - this affects issue such inflationary effects of vouchers, their tradability, controls and security printing..
- *Who issues of vouchers?* - which institutions should control the physical issuance or distribution of vouchers, for example the voter registration system, the saving banks, the social security, or pension system..
- *Are voucher immediately tradable?* What other rules should govern trading of vouchers.

- *What are the roles of financial intermediaries?* How will they be registered, regulated and supervised? - their linkage to the development of capital markets and standards for financial institutions..
- *How the vouchers converted into shares?* - via an auction system and inter related futures of the system for voucher cancellation, share registration and trading..
- *Can voucher using for anything other than SOE shares?* - to buy lands, apartments..
- *How are vouchers and distribution of preference shares to employees linked?* [Lieberman, I. W (1994), p. 20]

Investment Funds

The quickest and most politically popular technique is mass voucher privatization. While voucher privatization gives away for free the bulk of the assets on the asset side of the public balance sheet, one needs to consider the liabilities side of the balance sheet, which includes:

- § funding the daunting pension liabilities and health care needs of the aging population,
- § meeting the interest and principal payments of the public and foreign debt,
- § funding the social safety net and other economic dislocation costs,
- § modernizing the education system to face the new challenges of a competitive market economy,
- § paying to clean up after the environmental neglect of the past,
- § rebuilding the infrastructure needed for a modern economy. [Ellerman, D; Vahcic, A and Petrin, T (1991), pp. 283-298.]

However without intermediaries, this would spread the ownership too wide and would thus create the problem of "corporate governance." Therefore voucher privatization needs to be augmented by voucher investment funds to provide the necessary corporate governance for the restructuring of the privatized enterprises. [Ellerman, D (1998), pp.1-8].

Mutual Funds or Holding Companies?

The main line of the conventional argument is that the investment funds are needed to provide corporate governance for the restructuring of privatized enterprises. But what are the options for a voucher investment fund in a transitional economy? Is it the post-socialist analogue of a mutual fund or a holding company or is it perhaps some new creation socially engineered especially for the transition?

In a developed market economy such as the United States or United Kingdom where economic institutions have had time to evolve, one finds two extremes, the mutual fund (unit trust in the UK) and the (venture capital) holding company, which have rather opposite institutional logic's.

- § Mutual funds hold a diversified portfolio of shares with only a small percentage from any given publicly traded company. Mutual funds exercise no direct corporate governance over companies. They are the model of the passive institutional owner that lives by the "Wall Street Rule" of voting with one's feet. Exit is preferred to voice [Hirschman, A (1970)].
- § Holding companies operate in a diametrically opposite way (voice). They hold all or almost all the shares in a portfolio company so that they will reap most of the capital gains from the development and restructuring of the company. They epitomize the active owner that exercises voice rather than exit.

The voucher investment funds have been envisioned by post-socialist reformers as a mixture of mutual funds and holding companies, a chimera with no direct counterpart in an evolved market economy. Western-style legislation restricting any mutual fund's share in a single company (e.g., a 20% maximum) has been enacted in most voucher investment fund regulations as if the funds were mutual funds. But then in the next moment, the voucher funds are described as the vehicles for

restructuring the voucherized enterprises as if the funds were holding companies. [Ellerman, D (1998), p. 3]

There are substantive reasons why the voucher funds will have trouble functioning as mutual funds operate in the West. Most of the shares owned by the voucher funds have no real market. In the West only a small percentage of the companies qualify to be publicly traded and even a smaller percent would qualify in the transitional economies. Yet the voucher privatization programs corporatized medium to large socialist enterprises of most any quality, and issued their shares in return for vouchers. Then the voucher funds have a portfolio full of shares, which are essentially illiquid at any significant price “junk shares”. Can the funds operate as restructuring holding companies rather than as illiquid mutual funds? There seem to be formidable obstacles in the way of the funds operating in that manner. I shall argue that the funds typically lack the economic incentive, power, expertise, and capital to carry out the restructuring function of a holding company. [Ellerman, D (1998), p. 4]

The intermediaries playing very important role in MPP process in any country, their basic duties are intermediation and vouchers accumulation. They are also important source of corporate power, providing transitional governance of the newly privatized firms are expected to deepen incipient capital market. Some funds were developed to be turnaround or restructuring funds, and role of these funds in corporate governance is particularly critical. [Lieberman, I. W (1994), p. 22]

State Property Agencies

When we are examining MPPs in several countries we see that they all have some similar aspect concerned with residual shares. What is lead to this phenomenon, first of all it could be government’s decision itself not to sell all the shares enterprises to be privatized, to hold control in some significant companies. The second it could be specific class of enterprises, something like military or defense companies. Third the shares can be simply unsold, because of price or other specific auction condition, and fourth, not all companies selling in the same time, it could be in too or three wave like in Armenia and Russia. All that leads to condition when until almost end of MPP there is enough large portfolio unsold shares.

This continuation shares keeping by state leads to some problems, such as how to manage this large residual portfolio and what strategy it should apply to disposal rapid divestiture, revenue maximization, finding core investors, domestic or foreign, or deepening of incipient capital markets.

The important question how the government will execute management over it portfolio. Will it take passive role and waiting privatization, or actively using companies actives for receipt profit. For many companies interim governance has provided very difficult and is a major factor favoring speed in the process of privatization. But there is also other approach, where some of the portfolio holdings in the federal portfolio have been utilized to resolve specific problem in the transition from state to privatized enterprises. It cold go by two way, first some of this companies can be transferred to municipalities, were revenue from shares sales will be utilized to cover potential indemnities for environmental liabilities faced by these municipalities.

In the case of newly created capital market state will play role of largest potential seller of shares with visible influence over market results. Its mean that government needs to act prudently in selling residual shareholdings to allow capital markets to develop and deepen. [Lieberman, I. W (1994), p. 23]

Capital Market Development

A major and important benefit of mass privatization is the development of secondary capital markets. Well-regulated and efficient capital markets will play a critical role in providing corporate governance to the newly privatized SOEs. MPP created quite rapidly scope of privatized firms. Many of these firms have widespread share ownership through financial intermediaries or via direct shareholders. The development of secondary markets is therefore natural outgrowth of the MPP. [Lieberman, I. W (1994), p. 23]

The Czech MPP has supported the development of an over-the-counter market in which many of the enterprises privatized through vouchers are now being traded. A second, more classical equity market has also developed, the Prague Stock Exchange, which currently lists the major banks, a few larger industrial enterprises and utilities and the major investment funds. The Prague Exchange also allows over the counter or off-market trading of some of the smaller issues resulting from the MPP. [Triska, D (1994)].

The Russian program is developing supporting intermediaries (transfer agents, registrars, custodians and a Russian Securities Exchange Commission) and, in the course of 1995, expects to develop a series of regional exchanges. Already, shares of a number of the recently privatized firms are trading actively on the commodity and share exchanges in Moscow, Saint Petersburg and other major municipalities in Russia. In the Polish MPP, it is anticipated that shares will be floated in the financial intermediaries, National Investment Funds (NIFs), on the Warsaw Stock Exchange. It is expected that many of the enterprises held by the NIFs, once restructured, should be floated publicly. Indeed, this is the principal exit strategy for the Investment Funds. [Boycko, M., A. Shleifer, and R. Vishny. (1994b), pp. 249-266].

Usually any increasing leads to changes and capital market changes make easier to gradual changes in capital and ownership structures of firms. Taking place redistribution of shares, workers and managers sell them to core investors. The market to start companies change their structures, makes them more successful and able to competition. It means that investors or shareholders, invest more money in companies for modernization. At the same moment starts to increase new information and marketing services, which should support capital market operations and creating information field for investors. Consequently one of most important step in MPP is the capital market development. It "closes the loop" that is bringing closure to the voucher process by creating a liquidity market for the newly created shareholders and intermediaries. [Lieberman, I. W (1994), p. 24]

The supporting environment for mass privatization.

Very important for mass privatization is two component, first is the support of wide layers of population and the second one and not less important is the political support. It means that for successful privatization is necessary strong commitment at the highest political level, such kind as Prime Minister or Country President. Mass privatization failure rarely could be attributed by technical reason. For example in the Russian Federation MPP has continuously support by President Yeltsin, he has made enable the program to move against determined parliamentary leadership. In Armenia it was President Levon Ter-Petrosjan, who was started MPP and prolong it almost until end.

The widespread distribution of vouchers and subsequently shares in newly privatized enterprises or investment funds to the population, supported by public information campaigns designed to educate the population about privatization and free markets, is intended to produce popular support for the transition to a market economy. [Lieberman, I. W (1995), p. 25].

So it means that mass privatization is a highly political process, which will have a favorable future only in case of strong support of politics and population. In Russia, where the politics of reform have been bitterly debated, the MPP has resulted in the Parliament creating its own privatization institution, the Federal Property Fund, created to manage and control the activities of the more reformist government institution, the GKI. The MPP change through parliament course of privatization, it became an instrument for widespread distribution of vouchers, to the public and their ownership of shares in thousands of newly privatized firms, unlike the program where workers and managers have been collecting 51% of vouchers. [Boycko, M., A. Shleifer, and R. Vishny. (1994b), pp. 249-266].

Therefore MPP can become a debatable subject between reformists and anti-reformists due to the role in rapidly creating irreversible conditions for market economy and is a focal point for market reforms. But it is not necessary to forget that weak government or poorly conceptual MPP could lead to stop any reform and delay privatization itself.

Property rights

Mass Privatization is not viable in the absence of the unequivocal creation of property rights. The goal of privatization is to establish ownership rights. Privatization involves identifying a specific set of property rights that were exercised previously by the state and transferring these as ownership rights to individuals or entities in the private sector. Privatization is the transfer of property rights from the public to the private sector. Privatization has far-reaching normative implications because it affects the transfer of enormous amounts of wealth. Moreover, privatization has wider social and political consequences. Privatization encourages the growth of the non-state sector by undergirding operational autonomy of non-governmental organizations. In the view of some democratic theorists, the right to private property is the "guardian" of all other rights, a pillar of civil society, and a fundamental element of every modern democracy. [Gleason, G (2000), pp.1-5].

The principles must be established by law and supported by institutions to safeguard and enforce them. New private owners need to know that through their shares they have proportionate ownership of all of the underlying assets that they have acquired in the newly privatized enterprise. They must have the right to buy and sell, otherwise dispose of assets and these rights must be upheld by the legal system. In addition, new owners need to understand property responsibilities that they can benefit from the success, and will be economically hurt by the failure of their investment, in short, that there are winners and losers in the process. [Lieberman, I. W (1994), pp. 1-26].

Governance and Restructuring

Some of the most interesting questions about privatization are:

What actions can the government take prior to the sale to raise the price? Or should the government sell as fast as it can without attempting to restructure the SOEs?

Restructuring before privatization can take place at the company, industry or country levels, requiring the intervention and coordination of other authorities beyond those in the office of privatization. Specific areas of prior restructuring include change in management and board of directors, workers contract renegotiations, absorption of either outsiders debt, cross-liabilities among SOEs or past-due fiscal debt. Legal restructuring, including the solution of legal disputes or creation operation permits. Change in domestic regulation, trade barriers or entry and exit rules. [Lieberman, I. W (1993), p. 23].

Corporate governance is an important issue for the firms which are in process of privatization until their full and final privatization. Also, governments in the CEECs and NIS have demonstrated

incapacity to restructure more than a handful of SOEs at a time. All that leads to conclusion that necessary attributes are speed of privatization and decentralizing process, replacing governance and passing responsibilities in the hands of new private owners. Corporate restructuring requires much effort and time, often years of intensive, single-minded concentration of resources. It cannot be imposed successfully from the outside (by shareholders, governments, or the public). It can only be instigated by managers able to carry the organization with them [Wilson, H (1994), p. 167].

One of the favorites models for that is the mass privatization model. This model include and speed which is made the firms responsible for preparing their own privatization plans and strategies, and responsibilities for their own governance pursuant to preparing for privatization. If we will follow privatization in the Russian Federation we will see that important players, among new owners who are responsible for governance and restructuring are investment funds. [Boycko, M., A. Shleifer, and R. Vishny. (1994b), pp. 249-266].

Very important is initial strong privatization, in any countries, MPP could be implemented quickly, but there is a weakly side of this process, interim governance has very scant attention by the reformers. Some time interim governance has no enough resources to provide restructuring during privatization process. A lesson from the experience to date is that firms which are part of an MPP need to be brought into the process at the earliest stage and their commitment to privatization obtained. Moreover, given the fact that governance is difficult to establish speed in privatization is essential. Restructuring with the exception of limited passive restructuring, for example to clear excessive indebtedness, should be handled by new private owners. [Lieberman, I. W (1994), p. 23].

Pro-competition policy

Central planning left a legacy of heavy concentrated industrial sectors, market by an absence of competition at all levels of production and distribution. This creates lots of problem in contest of MPP, necessity to create new pro-competition policy, anti monopoly law and commitment, which is carry out market monitoring.

The Czech and Slovak MPP partially dealt with this issue by prior review and approval of all submitted privatization projects. But it did not make anti-trust review a prior condition for privatization. The Polish program anticipates a review of all enterprises entering the MPP and has a number of post-privatization checks on the activities of the investment funds and their acquisition of shares in private enterprises. There are trigger points at which the Anti-Monopoly Agency needs to be notified of potential share purchases or acquisition of a firm by one of the NIFs. [Mladek, J]

The Russian MPP seeks to prevent any cartels, associations or concerns from being privatized intact. It also required that the lowest legal entity of an enterprise be corporatised and allows for plants or units of an enterprise to break away from a large multi-plant enterprise and privatize themselves. Nevertheless, with the Russian Anti-Monopoly Agency basically focused on price controls and given the reformers desire for speed, the Russian MPP has clearly not made anti-trust considerations a first priority. [Boycko, M., A. Shleifer, and R. Vishny. (1994b), pp. 249-266].

In discussion about restructuring and governing we haven't forget about privatizing without first engaging in intensive anti-trust efforts. Part of the problem is the complexity of such programs, the different approaches to pro-competition policies, the capacity of any agency required to undertake such a program. So it is better have any kind of competition than good central planning, regulation or monopolies system. Also economic reforms needed in modern law, which will reduce trade barriers, leads companies to competition, consequently reducing monopolies. [Lieberman, I. W (1994), pp. 1-26].

Environment

One of the basic problems connected with privatization is the environmental legacy of central planning. The Russian MPP has also generally ignored environmental concerns. While mass privatization is basically a matter for the national governments, environmental issues are basically dealt on a local or regional basis. [Boycko, M., A. Shleifer, and R. Vishny. (1994b), pp. 249-266].

Therefore, environmental problems may loom as an open issue for the newly privatized firms, as local authorities seek to enforce environmental standards in the future.

Institutional support for the MPP

Despite the fact that a market economy may not exist fully in developing countries, privatization is often used as a tool for economic development [Pelikan, P (1997)]. Although privatization has been pursued by many market economies since the early 1980s, the task of privatization in formerly socialist economies is so much larger that it's very nature changes. Its headlong rush to private ownership of property, created a situation in which rules, laws, and implementers lacked wide-spread understanding or legitimacy among the public. Not only the institutional boundaries between public and private difficult to discern, in many cases they may not exist. Property rights are prerequisite to private enterprise [Hill, P and M. Karner (1996)] and must be formulised so that property can be exchanged [de Soto, H (1996)].

In some former communist states, which have moved rapidly from state ownership to private ownership without institutional regulation of property, legitimacy and legality are major concerns.

Indeed, the ultimate goal in the transition economies is more than simply changing ownership or governance per se, rather, it is to establish the institutions of a private market economy. Definitions of property rights and the rules, professions, and organizations that support property ownership must be created, either before or in tandem with the transfer of property rights to private owners. The enormous magnitude of this privatization task results from the complex and multifaceted legacy of socialism. Private ownership was not the only institution compromised, if never completely abolished, by socialism. The institutions that support private ownership also largely disappeared. Legal frameworks defining property rights, private contract regimes, fiduciary liability, dispute resolution mechanisms and rules of entry and exit for private firms atrophied. Courts lost much if not all of their independence as well as their role as adjudicators of commercial disputes and enforcers of commercial laws. Banks lost their independent monitoring role over firms and became instead passive funnels for channeling state funds. Monitor institutions that provide critical information for markets to function, such as credit-rating and consumer protection services, accounting and legal professions had no reason or permission to exist. [Lieberman, I. W (1994), pp. 1-25].

In Armenia the Ministry of Privatization monitoring privatization process. Russia has established the Russian Privatization Center, as a way of recruiting advisers for the program paying market wages to retain them. The Russian MPP has also been supported by substantial advisory assistance to make up for the relatively small staff and thin budgetary resources of the GKI.

MPP is a complex of the policy implementation and logistical reforms. In theory any countries ministries should design, implement and render support for privatization program to reach success. It is necessary top level policy, staff and advisors familiar with the operation on the market, good knowledge of market economy, laws and regulation for assist implementation of privatization program, create modules for voucher systems, corporatization, investment funds and auction centers. Also very important is training and public information companies. The required

qualification, support and other are often trivial relative to the importance of program implementation and value of assets to be privatized. But the important think is the necessity to provide human and financial resources required to implement the MPP. [*Lieberman, I. W (1995), pp. 27*].

Financial sector

All of the transitional countries have learned that privatization must proceed in tandem with the reform of the financial sector. The central credit allocation mechanisms and the weak banking system of the former socialist system are unsuited to a market economy.

At the first stage of MPP important role playing commercial banks, they are helping to survive newly privatized firms, giving them soft and direct credits, which is quite problematic for the governments in transition. They are also potentially important sours for long term restructuring credit, day-to-day operations. If the commercial banks could not carry out such support, there is a possibility that firms will revert to government support. There is a direct linkage between commercial banks and MPP. In many cases banks become equity holders of the newly privatized enterprises, and correspondingly play a major role in the newly emerging capital market. It should be noted however that concentration of newly privatized firms in banks hand could result to fragility of the banking sector. [*Lieberman, I. W (1994), pp. 28*].

The Russian MPP has tried to keep the banks, particularly state-owned banks, at the distance from equity holdings in investment funds or the newly privatized enterprises. Actually the opposite is occurring with so called “pocket” banks banks-owned by SOEs being privatized. A new phenomenon is emerging as increasingly new and private banks in Russia are owned by a number of enterprises in an industry or by a diversified group of enterprises in a region. The formation of these bank-industrial holding companies, modeled after the Korean “chaebol”, is being actively discussed in Russia as an alternative form of industrial policy to supplant or augment present reform efforts. Extension of these holdings are anti-competitive, they represent a significant problem for pro-market reforms. [*Boycko, M., A. Shleifer, and R. Vishny. (1994b), pp. 249-266*].

Privatization and structural reform

Structural change and adjustment in the CEE countries will be a long drawn-out process and both political and public supports are limited in term of time. Privatization is an essential but not a sufficient element of structural reform. Even where mass privatization occurs and the process is accelerated, as in the Czech Republic, there is clear recognition that this is only the first phase of structural reform. Where privatization occurs with little else in the way of structural reform, as in Russia, this leaves privatization open to charges that it has failed. Extensive restructuring will need to occur and assuredly ownership structures will change substantially after the initial privatization has occurred. The last lesson to be drawn is that privatization needs to be viewed as a part of comprehensive reform programs. [*Lieberman, I. W (1994), p. 1-26*].

Although most countries in contest of structural reforms have sharply reduced fiscal deficits, tax and public expenditure reform remains critical. With Bank support, Russia are improving tax administration and budget management, took several major steps to improve tax collection, including the termination of non-cash arrangements for clearing arrears and actions against large high-profile tax debtors. Bank financed adjustment operations in Armenia and Russia are increasing payment rates in power and energy sector public utilities.

Accelerating privatization and financial sector reform continues to be a regional priority. Introducing more flexible pricing mechanisms in auctions has speeded up privatization in some

countries where it had stalled. Adjustment loans are supporting small-scale privatization in Moldova and accelerating privatization of medium-and large-scale enterprises in Armenia and Russia. Also in Armenia and Russia, a structural adjustment loan is facilitating more transparent, open, and competitive case-by-case privatization transactions. The loan is complemented by analytical work examining ways to improve corporate governance, enhance enterprise restructuring, and increase competition in the industrial sector. With Bank support, Armenia and Russia are privatizing or liquidating troubled banks and improving accounting practices, prudential regulation, and supervision of the banking sector.

2.7.3 Case-by-case Privatisation

Introduction

Case-by-case privatisation is a technique best suited to privatising medium-size and large enterprises. It has been used world-wide extensively in industrial countries and in transition economies, most of them recently completed voucher (mass) privatisation, have started to privatise medium-size and large state enterprises use case-by-case privatization technique.

Case-by-case privatization involves selling government shares in state-owned firms through public share offerings, trade (third-party) sales, or mixed sales. In the process the ownership and management of state firms are shifted to the private sector. The case-by-case approach allows governments increase efficiency, expose state enterprises to market discipline and best practices, promote wider share ownership and entrepreneurship, reduce government interference in the economy, strengthen competition and weaken monopolies, develop domestic capital markets, cut budget deficits, and reduce public and external debt.

Many countries adopt privatization programs as part of structural reforms and to alleviate budget problems. Selling state enterprises to the private sector can substantially reduce the flow of public funds to these firms. It also can generate significant revenue for government in the form of sales proceeds and future tax revenues from the newly privatised firms.

Many Central and Eastern European countries are starting to move beyond their initial privatization programs, which focused on small-scale privatization and mass (voucher) privatization. Thus case-by-case privatization of major infrastructure and medium-size and large (strategic) enterprises is taking hold there as well. Most of the world's privatization programs have been implemented on a case-by-case basis. Following section is a brief description of case-by-case privatization technique offered by *Welch and Frémond* in *“The Case-by-Case Approach to Privatization: Techniques and Examples”* (1998), pp.1-51.

Transparency and Support

Transparency is crucial to successful case-by-case privatization. Financial advisers must carry out asset valuations to ensure that prices are realistic, fair, and consistent, as are procedures for calling for bids and evaluating offers. Privatisation must receive support from the highest levels of government to overcome inertia and resistance from the bureaucracy and special interests. A successful privatization program must be located at the centre of government, receive support from the highest levels of government, clearly define its objectives, develop institutional competence and experience, and overcome the commitment problem. Most privatization programs are at the centre of government, attached to the president's or prime minister's office, the ministry of finance or treasury, or some other powerful central ministry or department. Implementation should be the responsibility of pragmatic individuals with political clout, no vested interest in the status quo, and

access to world-class technical expertise. Government institutions responsible for privatization must gain experience and develop competence with the process.

Financial advisers

Specialists consultants-especially financial advisers have a clear role to play in case-by-case privatization. Although local experts can be used, governments should not hesitate to call on the growing body of foreign privatization experts. Foreign financial advisers are essential if the government expects participation by foreign investors or injections of foreign capital, or if it plans to sell shares on international markets. These advisers should work with domestic advisers, who should address more local issues. Investment banks, consulting firms, environmental experts, accountants, and lawyers are essential players in case-by-case programs. Many privatization programs have suffered because governments, lacking qualified personnel, could not manage the process.

Success of privatisation program

Governments should implement privatization programs within a framework of mutually reinforcing economic reforms, including macroeconomic stabilisation, trade liberalisation, financial sector reform, public sector reform, and regulatory reform. If other reforms lag, privatization will be unsustainable and unable to restructure the economy. Before privatising natural monopolies, governments should restructure the industry to promote competition, accompanied by clear regulations and credible enforcement. Although the privatisation agency has a duty to sell state assets for their fair market value, it must balance its desire to maximise sale proceeds with other priorities, such as broadening share ownership, deepening domestic capital markets, and promoting competition.

Case-by-case timing

Although constant pressure is needed for case-by-case privatization to proceed, unrealistic time constraints serve little purpose. One useful approach is to sequence several sales according to market conditions. Moreover, governments should bear in mind that not all transactions will be successful, and that it might be necessary to reject all bids and start the new bidding process or change the method of divestiture.

Privatisation Law

Countries with a civil law tradition tend to approach privatization by preparing a general privatization law. Such laws define the rules of the privatization program and establish and empower the institutions charged with executing it. Countries with weaker institutions and law enforcement, however, may not be able to ensure the transparency of privatization. Such countries should draft a privatization law that clearly defines privatization procedures. Privatisation laws offer both advantages and disadvantages. When carefully drafted, they strengthen the state's capacity to carry out structural reforms. They also help make more transparent the transfer of state property to the private sector. Once ratified, however, a law cannot easily be changed. If procedures need to be revised in response to market conditions, an amended law or new regulations may be required.

Selecting companies for privatisation

In selecting companies for privatization, many countries have drafted a list containing enterprises that can be privatised and list containing enterprises that cannot be privatized, because they are deemed strategic. A positive list is useful because it has the full power of the law behind it. Companies are committed to privatization within the deadline for the program, and can be privatized at any time by the institution in charge of executing the transfers. Such arrangements make it harder if not impossible for enterprise managers to stack privatization.

Five steps of case-by-case privatization

Case-by-case privatization is a five-step process. Many case-by-case practitioners separate these steps into two phases both for conceptual reasons and for ease of contracting when designing terms of reference and hiring financial advisers and sales agents.

Step one: Identification and Selection candidates for privatization

This section deals with the first phase of case-by-case privatization-getting ready. This phase begins with the government identifying potential privatization candidates. It ends with the completion of a feasibility study and the government's decision on the privatization option and sale. Selection criteria depend on a country's privatization objectives and legal framework.

Step two: Feasibility study

During the second step the government and its financial advisers analyse the feasibility of and options for privatising the enterprises identified in step one. This analysis should examine:

- § The enterprise's economic performance, efficiency, profitability, and earning potential.
- § The enterprise's internal structure and management.
- § The need to corporatize the enterprise before privatization.
- § The need for restructuring and rationalization. As noted, governments should limit privatization restructuring to legal, accounting (balance sheet), and organizational changes. Any workforce reductions should take place before an enterprise is sold. Technology changes, capital investments, and major purchases should be left to the new owners.
- § The environmental aspects of the privatization, including past and future pollution and the need to establish environmental legislation or regulation.

The feasibility study should examine the policy issues surrounding the possible privatization and propose solutions that are compatible with the sale of the enterprise. It should, for example, address regulation and competition and if necessary, employee issues particularly downsizing and buyouts. It also should examine the need for restrictions on sale (golden share) and study the management of any residual shareholding.

As noted, the second phase of privatization involves three steps: preparing a privatization plan, obtaining legislative approval (if needed), and selling the enterprise.

Step three: Preparing a privatization plan

Once a government decides to privatise a state enterprise, it should prepare a privatization plan with its advisers. This plan should include a communications plan (to build public support and attract investors); a plan to resolve the public policy issues surrounding the privatization; a plan outlining the method of sale, the steps required to reach sale, and a timeline; and draft legislation or executive orders. In addition, if the government is using different financial advisers for the sale than it used to prepare for privatization, those advisers (sales agents) should be hired at this point. The government should develop a communications plan before it starts the sale process. The sales plan should state how the government and its financial advisers or sales agents will carry out the sale. The plan should contain the steps and timeline for the sale, covering the timing and method of sale, responsibilities of government officials and advisers.

Step four: The Legislative or approval phase

If legislative or government approval is required, the government should obtain it at this stage. Legislation should be passed before the sales transaction starts; the sales process becomes needlessly complex if legislation is pending when the company is brought to market. A

communications exercise is needed to provide parliamentarians with objective information on the aims of the government and the reasons for privatization.

Step five: Sale

The issues that arise during the sales transaction will vary according to whether the privatization is a public offering, trade sale, negotiated sale, or mixed sale. An initial public offering requires the enterprise being privatized to be of sufficient size and quality to justify a public sale of shares. (in addition, the markets in which the shares are being sold must be mature enough to absorb them.) Enterprises that do not meet these requirements are sold through a trade sale (third-party sale) of assets or shares using an open bidding (auction) process. A negotiated sale to a strategic buyer is another alternative, though in most cases the government will receive less than it would through an active, open bidding process. Finally, governments can use a mixed sale, combining a trade sale with a public share offering, particularly if a strategic buyer is being sought for a significant block of shares. In addition, attention must be paid to any conditions attached to privatisation, to the role of foreign investors, and to the steps involved in privatising natural monopolies. Governments often attach special conditions to privatization sales, demanding a special or golden share to protect the enterprise from an unwelcome take-over (usually aimed at preventing a foreign take-over) or to give the government influence on company matters it considers of national importance. Golden shares normally involve the government's right to approve major corporate actions such as the sale of the majority of shares to a third party, sale of major assets, and liquidation or reorganisation.

The role of foreign investors

Governments in many transition economies encourage foreign participation in privatization 'relying on foreign investors to bring capital, management skills, new technology, international links, and access to foreign markets. Foreign participation in trade sales, mixed sales, or public offerings ensures that government will receive a better price because of the increased competition for assets or shares. It also means that the company will move into the hands of a strong owner that can restructure the company. Foreign investors bring are particularly valuable to former state firms in transition economies that are manufacturing products that do not meet international standards, are outdated or technically obsolescent, and have no international brand awareness. Macroeconomic stability and a favourable business environment are required to attract foreign investment. Moreover, unnecessary restrictions on foreign investment should be lifted and discrimination between foreign and domestic investors eliminated.

Valuation

Valuation is of paramount importance because it establishes a market price range for the enterprise. Valuations based on market principles are essential to stifle criticisms that the state is not receiving a fair price and to ensure that there is sufficient investor interest. In Western market economies valuation is based on discounted cash-flow projections of future earnings and comparisons of similar firms' market prices (when sold through trade or negotiated sales) or stock market offer valuations (if publicly traded). A valuation starts with a financial audit and a method of sale. The audit is important because certain valuation calculations cannot be completed without it. The method of sale determines the weight and level of detail that should be applied to the valuation methods used to estimate the assets' fair market value.

Next is the selection of the financial adviser who will carry out the valuation. The adviser should be selected by competitive tender from among several independent and reputable companies based on their terms of reference for various valuation methods. The financial adviser should be selected before the auditor so that the adviser can help prepare the terms of reference for the audit, which besides a financial review normally includes an operational and legal review. Once appointed, the

financial adviser undertakes due diligence—an exercise that differs from but complements the audit. Due diligence consists of gathering and verifying information about the privatization candidate, its organization, its finances and balance sheet, its national and (if relevant) international standing, and any other information that may be relevant to a valuation, such as a likely change in taxation or regulation. At the end of the due diligence process, the financial adviser should be able to submit a first valuation report to the government. A valuation report is highly confidential. It is prepared for the exclusive use of the seller (or buyer) and under no circumstances should be disclosed to third parties.

All valuation methods estimate market value. Some methods are appropriate if the company is to be divested through an initial public offering; others if control is to be sold to a strategic investor. Whatever the method of sale, no valuation method is infallible. The market value of a company is best estimated by combining, in different proportions, six methods of valuation: the adjusted net assets method, the discounted cash-flow method, the comparable companies method, the comparable transactions method, the book building method, and the replacement value method. Combining these methods allows a range of probable values to be established, a process known as triangulation.

2.7.4 IPO Privatization

As acknowledged in the World Development Report, “From Plan to Market” [*The World Development Report, (1996), p 3-12 published by the World Bank.*] each approach to privatization creates trade-off among various goals. IPO Plus a new form of privatization, which includes central features of both case-by-case privatization and mass privatization in order to promote both efficiency and equity. [*Goldberg, I., Jedrzejczak, G., Fuch, M. (1997).*]

Selection of suitable methods for privatization is still a timely issue in many countries. Several transition economies have completed MPP's, but are left with undigested state holdings in partially privatized companies and with large non-privatized sectors such as the infrastructure sector (transport, energy and telecommunications) and the financial sector (banks and insurance). The potential role of cash sales or IPO's is also limited, because private sector purchasing power is small and the financial infrastructure for conducting public share offerings is insufficiently developed. [*Goldberg, I., Jedrzejczak, G., Fuch, M. (1997).*]

The IPO-Plus method of privatization is designed to achieve I. Equity through widespread public, but not mass participation in the privatization process, and II. Efficiency through transparent privatization and capital market development creating independent financial institutions with responsibility for putting pressure on companies to improve their financial performance. Instead of vouchers as under an MPP, the IPO-Plus relies on (a) the sale of low-priced public participation shares, (b) incentives for the purchase of company shares by allowing deferred payment, and (c) downward flexibility in share prices. This method is not using in Armenia or in the Russian Federation that is why it is not discussed in more detail.

2.8 TREUHANDANSTALT IN EASTERN GERMANY.

In the newly unified Germany, the Treuhandanstalt (or Trust Institution) has taken on the tremendous task of leading the former East Germany from a centrally planned economy to free enterprise. Entrusted with the privatization of formerly publicly owned property, the Treuhand (as it is commonly called) was more at the focal point of the economic and sociopolitical debate in Germany than any other institution. Its goal was to integrate the companies of the five new federal

states into the world economy along a path of performance and price competition. [Ulrike Grünrock (1993)]

The Treuhand was made the sole owner of all former state-owned companies, which were transformed into joint-stock companies. The Treuhand holds all shares of these companies. It is important to note that the firms were not been privatized. This helped avoid an ideological conflict by ensuring that the Treuhand was selling property that it owned and not selling the "property of the people". [Volksvermogen]

The Treuhandanstalt as a more or less independent agency - and not the political system - was given by legal mandate the responsibility for the privatization, restructuring and turnaround of the East German economy. [Colloquium, 29-30 June, 1 July 1994] Because of the planned economy and the division of labor under Comecon, East Germany was over-industrialized and stuck in old industrial structures when the Treuhand began its operations in July 1990. [Ulrike Grünrock (1993)]

Dr. Wolfgang Vehse was a Director of the Treuhandanstalt, the German organisation responsible for the privatization of East Germany's state-owned enterprises. Privatization is much more than selling companies to the highest bidder, says Wolfgang Vehse. Before choosing the ideal buyers for former-East German state-owned companies, Germany's Treuhandanstalt evaluates potential buyers following several criteria: the amount and targets of planned investment; ability to provide job guarantees; environmental clean-up policy; market analysis; turnaround strategy; future product strategy, and purchase price. The work of the Treuhandanstalt received international recognition. There is interest in how the Treuhand operates, what it has achieved and whether its experience can be applied to the reform process in Eastern and Western Europe. [Colloquium, 29-30 June, 1 July 1994]

The transition in East Germany has been characterized by an extremely rapid privatization of state-owned enterprises and by an equally rapid process of deindustrialization. The great majorities of East German SOEs has been privatized and are now genuine capitalist firms with an owner with the incentive and the power to change management behavior. Meanwhile East Germany has been deindustrialized with employment in mining and manufacturing falling to one quarter of its pre-unification level. The Treuhand had little choice given its mandate to privatize rapidly. Finding buyers for Treuhand enterprises has required single-minded focus on the issue of corporate governance and the matching of assets to management capabilities through the policy of selling to "competent outsiders" diverted attention from the possibility that such a policy would not guarantee the retention of a minimal core of industrial activity. Lately the Treuhand recognized that greater use had to be made of economies of scale in management and control to achieve the forward-looking restructuring of its remaining portfolio. [Carlin, Wendy (1993)]

A Learning Process During the period of upheaval in East Germany, no one was precisely sure how to approach restructuring on such a massive scale, and the Treuhand was no exception. [Ulrike Grünrock(1993)]

Some authors argue that Eastern German privatization and restructuring of firms is seen as a special case because of the peculiarities of reunification and the large transfers from Western Germany to finance it. A unique case of transition from a centrally planed to a market economy in Eastern Germany characterized by fact that it had "the assets of kinship: the advantage of having an 'a rich uncle' obliged and willing to support the 'poor nephew's' start of life". [Hagen, J (1995)] But the German government has faced the same problems as other countries in transition when privatizing and restructuring firms, it had to decide about the aims, methods and organization of privatization.

It had to take in to account politico-economic situation and tradition, have to find a general economic policy toward restructuring. Eastern Germany transition was “the big band with the big brother”. [Siebert, H (1993)]

The German system is totally different from the self-privatization methods used in Hungary or the Czech system under which companies develop their own proposals, using vouchers and other techniques. Germany has decided on a centralized form of privatization, in which a central organization decides which company is to be sold to which investor. [Ulrike Grünrock]

Consequently, Eastern German privatization and restructuring has been seen only in this light. Mass privatization proceeded fast compared to that in some other transitional countries. The basic political and institutional structure was imported immediately. The government provided the money for buying investors instead of selling firms to private owners that would restructure them. [Breuel, B (1992a), Schmidt, K. D. (1996a)]

In October 1990 the Treuhand began with 22,000 companies in the service sector (retail, wholesale, restaurants, hotels, travel agencies, pharmacies, bookstores, movie theaters, etc.) and approximately 8,500 industrial companies (often in the form of conglomerates). After three years the results were: All service sector industries have been privatized. More than 70% of these companies went into the hands of Eastern Germans. By breaking up the industrial conglomerates, the original 8,500 industries became 13,640 companies. The majority of these were sold to small and medium-sized investors as small and medium-sized companies. The Treuhand has realized over 2,65,200 Management-Buy-Outs/Management Buy-Ins. In 1992 the Treuhand privatized 500 to 600 companies or company divisions a month at a rate of 25 to 30 privatizations a day. [Colloquium, 29-30 June, 1 July 1994]

Eastern Germany had the advantage of known the future institutional system of its transition: the Social Market Economy of Western Germany. Thus firms and assets in Eastern Germany became private only to the same extent as in Western Germany. Only firms that could operate under competition became private. No other country in transition had such a shock approach to transition with external and internal liberalization at once. There was no time and no economic buffer such as an exchange rate or tariffs for step-by-step or gradual restructuring. In fact the idea of the Treuhand a trustee on behalf of the Eastern German citizens was born to prevent insider privatization, nomeklatura privatization, or giveaway to Western German businesses for free. [Uwe Siegmund (1997)]

Rapid privatization, decisive reorganization, cautious shutdowns: these tasks form the Treuhand's legal mission. Privatization and reorganization have never been separate issues for the Treuhand. Both of these steps are necessary components in the transformation of companies from state to private ownership. During the transition period between state and private ownership, the Treuhand owns the companies in Eastern Germany. Because its ownership rights were legally clear and unchallenged, the Treuhand had the final word in the privatization process. However, the Treuhand does not run the companies; it only supervises the decisions of their boards. The companies themselves were actively involved in establishing their own restructuring methods. Of course, if the companies need loan financing, the Treuhand had a say in negotiating and approving the terms of the loan. [Ulrike Grünrock(1993)]

Companies had to present the Treuhand with their balance sheets, business concepts for the future (including market research and technical data for investment), and a financial plan showing how to realize these concepts. A group of 60 experts (the so-called "Leitungsausschuss" or steering

committee) sits down and evaluates this package of information. After careful analysis, the steering committee groups the companies in categories with ratings from 1 to 6. The steering committee reports the results of its research to the board of managers, who then decide which measures to take. Without any restructuring by the Treuhand, there would have been little chance for swift privatization. Most companies have needed substantial restructuring; very few have needed little or no restructuring. Part of the restructuring was usually done before privatization. Major investment, however, was postponed until the company has been privatized. The Treuhand invests as much as necessary to keep the companies afloat and then supports them in their initial ventures into competitive western markets. The restructuring of these companies meant that well-established products and processes, markets and partnerships had to be re-examined. A lot of former practices survived, but plenty of them broke under the weight of the changes. [*Ulrike Grünrock (1993)*]

On July 1, 1990, East German companies were confronted with international competition from one day to the next. The companies were not prepared for such a change in terms of their operational and cost structure or their products. They no longer received any price subsidies, any help from advantageous exchange rates, nor benefits from artificially low wages; they received no protection from imports and no special export promotion; and for political reasons were not granted any structural adjustment measures in order to ease the transition into the Common Market, as Great Britain, Denmark, Spain, Greece and Portugal had previously received. The East German economy was left without any markets. Even its domestic market disappeared. Eastern European markets provided no hope and western markets were beyond reach. Even though it recognized the problem, the Treuhand could not help. [*Colloquium, 29-30 June, 1 July 1994*]

Thus, within a period of two and a half years, roughly 80 percent of the Treuhand's portfolio of companies was placed under the responsibility of private, enterprising owners. The Treuhand was counting on these new owners to lead their companies as soon as possible to competitiveness and as much as possible growth in their new markets. An important positive outcome of the restructuring program has been a dramatic increase in new investment in the five eastern German states. In 1992, a total of DM 90 billion in investments flowed into the region, an increase of about 25 percent over 1991. Even more significantly, foreign investors have accounted for about ten percent of the investments thus far and a similar share of the job commitments. [*Colloquium, 29-30 June, 1 July 1994*]

Of course, the major impetus for local development came from the people of Eastern Germany. More and more people were tackling problems, making decisions on their own, and taking risks in the economic conversion. Their new attitudes represent a sea-change compared to life under the old system, when the state took care of all of their needs. Perhaps the best example of their changing attitudes lies in the following statistic: Nearly 2,000 companies were privatized as management buy-outs as of January 1993. The Treuhand sees management buyouts as a good way to offer new opportunities to Eastern German managers, since hardly anyone knows a company better than its managers. Managers who were willing to take this step, demonstrating faith in their co-workers' efficiency, are supported by the Treuhand, provided certain conditions, such as a feasible business plan, readiness to invest, and the securing of jobs, were met. [*Colloquium, 29-30 June, 1 July 1994*]

In Germany the Treuhandanstalt put more than 10,000 enterprises in private hands between 1991 and 1994 an achievement that cannot and should not be minimized. But German privatization was a case of the integration of a formerly socialist economy into a functioning, indeed flourishing, market economy, an exercise that differs sharply from the total transition that Russia and Armenia confronted. In Germany an irreplaceable combination of West German legal and administrative

institutions, West German managers, and West German money eased many of the problems of the integration.

2.9 DANGERS OF PRIVATIZATION

Loss of Control

One danger lies in the fact that once privatized and turned over to the market, the enterprise is beyond direct government control, but the government is still held accountable for enterprise action. In fact, the government must make sure that the privatized enterprises operate responsibly. This is a very difficult task to accomplish. Regulatory and monitoring mechanisms must be strengthened in order to oversee market failures. Once a former public enterprise fails, the government is often forced to intervene to rescue the failing enterprise and bear the cost of bailout, which is an exercise of high inefficiency, or let it go bankrupt. If the enterprise fails and goes bankrupt, then the public is left unprotected. The government is the ultimate authority that must be accountable and responsible for enterprise and market failures. [Farazmand, A (2001), pp.195-196].

Corruption

Privatization often leads to more corruption in government, not to mention the loss of accountability and abuses of public funds and resources. With the increasing power of the business and corporate elites, the chances for corruption increase significantly. The ability to influence policy makers, to offer various kinds of bribes and incentives for favorable political and administrative actions, places corporate business elites in an advantageous position to entice government officials into corrupt activities. Since privatization has been a powerful strategy of globalization pursued by globalizing corporate elite's, corruption is likely to increase much more significantly [Bliss, C and Di Tella, R (1997); Gould, D (1991)].

Business Power Elites.

Privatization expands the power of the private sector in general, and the power of the corporate business elite's in particular, who can unfairly skew public policy choices by influencing the policy process from development to approval and implementation. It further shrinks the public sector and the public sphere in which citizens can promote public interests. Instead, it expands the private business sector, promotes inequality, and adds to negative externalities. [Farazmand, A (2001), pp.195-196].

Globalization

This is a phenomenon that is not unique to transitional countries; in fact, the industrialized nations of the West, including the United States, are now for the first time experiencing the bitter taste of globalization that their corporate and government elite's have pursued. Their communities, individuals, and citizen associations are losing their democratic rights in many ways [Farazmand, A (1999a); Korten, D (1995); Brecher, J and T. Costello (1994)].

All Western governments promote-directly and indirectly their own national public and private corporate interests in order to enhance their own interests. This should be a major policy lesson that developing and transitional countries' government elite's must consider very seriously. Growth without development rapes the national resources of a country in favor of the powerful globalizing corporate elite's interested in short term profit maximization through export-oriented consumer products [Korten, D (1995); Mander, J and E. Goldsmith, (1996)].

Shrinking Public Sphere.

Privatization shrinks the public sphere in favor of the private sector, therefore limiting the opportunity for private citizens to participate in public administration and governance. Public administration and public management in general, and public enterprise management in particular, will suffer from excessive privatization. The danger becomes more serious when poor planning, poor execution, and poor evaluation of privatization policy is the case. Very often the private sector is not well developed in developing countries, and privatization policy is likely to be captured by powerful business elites close to members of governing elites. This problem obscures the whole purpose of privatization in favor of developing broad-based private and cooperative sectors, and therefore contributes to further corruption, threatens democratic rights of communities and individual citizens, and weakens political legitimacy of the governance system. [Farazmand, A (2001), pp.195-196].

Loss of Public Interests.

Public interests may suffer, and even be lost, from massive privatization. Privatization turns over public assets, public administration functions, and government obligations of serving the public interests and common good to the private sector. But the unstable private sector has no obligation to serve such public interests; its prime and only motivation is to maximum profit, at any cost. Either through lack of incentive or because of market failure, privatized enterprises only seek profit maximization as their prime objective. They do not care for public interests, who gets hurt, who loses, or how society may lose [Burkhead, J and J. Miner, (1971)].

2.10 ALTERNATIVES TO PRIVATIZATION

Privatization is one of many approaches to the conduct of the public's business. There are others that also need to be considered seriously. Even the strongest proponents of privatization admit the negative consequences of privatization such as loss of quality in service delivery, potential abuse, lack of incentives for private firms to take on unprofitable functions of government, and loss of social equity [Savas, E. S (1987); Osborne, D and Gaebler, T (1992)].

In fact, David Osborne and Ted Gaebler (1992) note that privatization is one answer to problems of government, not the answer (emphasis is original). "Privatization is one arrow in government's quiver. But just as obviously, privatization is not the solution. Privatization is simply the wrong starting point for a discussion of the role of government. Services can be contracted out or turned over to the private sector. But governance cannot [Osborne, D and Gaebler, T (1992), p. 45]. Governance and government functions cannot be abandoned to the chaotic private sector filled with market failures and exploitation.

Effective performance of societal institutions, private and public, requires strong governance and government, not weak and subservient ones. Even Peter Drucker (1969) argued that we need more governance, not less. In short, privatization cannot replace governmental functions; indeed it cannot even replace a portion of these functions in society. There are areas in which government does better and best, such as in policy making and management, regulation, control, social equity, prevention of discrimination and exploitation, protection of individual rights and citizenship, provision of security and stability in governance and administration, social control and cohesion, and more [Rosenbloom, D (1993); Henry, N (1995)].

On the other hand, private businesses can do better in doing certain other things in the market, such as production and sale of foods, shoes, clothing, and material supplies for consumers [Osborne, D and Gaebler, T (1992)]. The market by no means can replace key governmental functions, many of

which are performed through public enterprises, and privatization of these enterprises without considering carefully the consequences and the viable alternatives is a wrong and bad starting approach to effective governance and administration.

Cooperative as an alternative

One alternative to privatization is development and expansion of cooperatives in town and country. Cooperatives are self-governing, democratic organizations with profit-seeking motives, but their primary mission is to serve stakeholders with common and shared interests. This is a true form of “public organization” with public functions and responsibilities. Selling certain public enterprises or turning over certain governmental functions to cooperatives is a democratic option. It is also an option that promotes efficiency, effectiveness, and self-governance. The role of government is to provide the enabling environment for them. [Farazmand, A (2001), pp.197, 15]

Public–Private alternative

Another alternative to privatization is building and sustaining public-private and other forms of partnerships with private and cooperative sectors for service delivery and promotion of public interests. This partnership can take many forms, from supervised to less controlled and free floating organizational arrangements, to co-production and co-provision of public services and goods in transportation, education, and health. However, governments must maintain the ultimate responsibility for the consequences of these organizational arrangements [Caiden, G (1994)].

Through partnership building, the government can share the management of public enterprises and similar but non-essential functions with private or cooperative sectors and allow these sectors to share the burden of public finance and contribute to the growth and development of economy. There are several models of partnership building [Farazmand, A (1999c)], but the government must maintain the ultimate control of the enterprises, because it is the government that shoulders the ultimate responsibility to the people and national interests.

Reforming the Public Enterprise Management

Finally, reforming and developing public enterprise management and other areas of public administration is another, and probably the best, alternative to privatization. Reforming government and administration, and especially public enterprise management, is both necessary and important. Reform and development can take many forms. Structural reorganization is an important starting point to alter the structural design of public enterprises for flexibility, transparency, and accountability. Redesign, redevelopment, and reform of public enterprises structurally are among the first steps to be taken before considering any form of privatization. Second, the processes of public enterprise management must be reformed and redeveloped. Innovative approaches to management and organizational performance must be adopted and organizational changes and adaptation should be at the top of the list of reforming criteria for public enterprise management improvement. Next, attitude and value changes must be adopted and implemented with measurable results. [Farazmand, A (2001), pp.198, 16]

Generally, three approaches to change and reform are noted in the organizational literature. One is the top-down purposive model of organizational change, in which organizational or political elite perceive certain problems and determine a need for organizational changes. This top-down approach can be genuine and effective, but limitation and deficiency are rooted in the lack of involvement and participation of members or outside stakeholders in the change process [Peters, Guy (1994)].

Another approach is the opposite, the bottom-up or environmentally determining model found in political science, economics, and organization theory. Here environmental changes dictate organizational responses for adaptation. Therefore, organizational changes must be adopted in order to survive; hence the adaptability to the environmental conditions. The third model of organization change is the institutional model found in political science, economics, and organization theory. Offering the advantages of both top-down and bottom-up approaches, the institutional models of change and development apply the very foundational values and structural underpinnings embedded in the institution subject to change. Institutional change also involves a fundamental review and reconsideration of the whole society and its political-economic institutions that shape the individual organizational institutions [Farazmand, (1997; 2000)].

Institutional change is a comprehensive and holistic approach to reform, reorganization, and development, which requires structural, process, and value changes [Peters, G (1994); Farazmand, A (1997; 2000)]. Public enterprises can be redesigned, reorganized, and reformed. Their management must be reformed to update them with highest efficiency and effectiveness criteria.

In another proposal, [Chilosi, A (1993a; 1993b)] describes pros and cons of alternatives schemes based on privatization of management and control without a corresponding privatization of ownership. The main scheme [Chilosi, A (1993b), pp. 13-14] delineates a non-discretionary privatization process based on depriving state-held shares of voting rights. State enterprises are first transformed into joint-stock companies, while a constitutional law deprives the shares that remain in state hands of voting rights. Then a certain percentage of the capital of the firm is sold through auctions to the highest bidder. The remaining state quotas are subsequently auctioned until the state share is reduced to the required proportion. Incentives for an efficient management of the enterprises can be devised, for instance, by means of option rights to existing private shareholders depending on the profitability of the company, or entitlement to appropriate residual income.

2.11 CONCLUSION ON THEORETICAL FRAMEWORK

This paper provides a discussion of the most important theoretical contributions to the literature on privatization, focusing on emerging economies, and gives a summary on recent research concerning the ways privatization might affect the development of economies. In addition, the paper provides a number of policy implications, emphasizing the trade-off between privatization and the reduction in social welfare and the possibility that the privatization process itself may have conflicting objectives (creation of incentive mechanisms, fairness, and fast privatization).

Above is an analyze of how privatization has become part of current public policy debates. It begins by discussing the theory of privatization, then moves to development and legitimation of the idea and discusses how theory appropriates practice. Finally, in the chapter discusses a possible backlash to privatization and looks to the future.

A theory of privatization, with its origins possibly as far back as Adam Smith, has played a key role in the emergence of it into current political debate. He points out that the privatization theory has indirectly helped the cause, but has not been married with actual implementation. Privatization movement has pointed to many local and state level measures, undertaken as managerial responses to fiscal constraints rather than pro-privatization experiments. The theory, as opposed to the practical implementation through government measures, has helped to both revive economic, laissez faire principles to explain government behavior, and to redefine preexisting government practices.

Privatization remained a fringe idea until last couple decades because had come to accept the welfare state and the necessity of government to protect poor people. Economist Milton Friedman helped push the idea that the government is a part of the economy (acting like a private monopoly) rather than a separate entity. He characterized government regulation as anti-consumer and helped create the distinction between government responsibility and government provision. Public-choice theorists helped to solidify the theory.

One of the results of the emergence of privatization theory to classify preexisting efforts by governments to privatize was a new emerging nature to the issue. “As privatization was brought to the national agenda in the 1980’s, it was invested with emerging content that undermined the atmosphere of pragmatic adjustment in which the practice initially took root”.

Theoretical literature on privatization in Former Socialist Countries focused on the question of how to design privatization process in order to reallocate ownership rights and maximize revenues for the budget. Some theoretical approach assumes a benevolent government, which focuses on the establishment of management incentives and the social cost of restructuring during the privatization process. Fast privatization creates more efficient incentives structures while brings about higher social costs than a low speed privatization program. Anticipating large restructuring cost several authors propose a graduate transition to new market type corporate government structures, argue that first intermediate governance structure should be introduced, with the participation of the government, and only later Western type incentive mechanisms can be applied. There are arguments that during privatization politicians and managers have conflicting interests, politicians allow inefficient enterprises operation since it is not leading to unemployment and may bring them political benefits, contrary managers do prefer self-benefits and efficiency of the company.

There is an opinion that in emerging economies, successful privatization requires that initial announced volume of sales by the state exceed the critical level like in mass privatization. Some authors argued that case-by-case privatization is the best decision. In both models, there is a positive externality attached to the size of the private sector: ones the number of privately owned companies has achieved a specific level, the economy converged to a full privatization equilibrium.

In political economy context, the governments using free share distribution technique to get the median voters at election. This technique has been applied in many privatization programs in Eastern European and CIS countries. Under pricing shares issue support right wing with government maximizing the utility of rich class to stay in power, by providing median class voters shareholding property. In an emerging economy political forces often hinder efficient transformation of property rights.

Different governance structure is differently impacts on the efficiency of restructuring. There are two main approaches to the establishment of new corporate governance structures the “market approach” and the “government approach”. The first refers to immediate and fast privatization at the very beginning of the transition process leaving restructuring of companies to new owners. Excluding the government's active participation, this approach considers mass privatization and the set up of holdings as first owners of the new private companies, in order to achieve the goals of fairness and efficiency in the privatization process.

The so-called “government approach” aims at restructuring and establishing competitive market structures before any ownership change. This method requires the government's active participation and allows for real-location of revenues up to some degree in order to reduce the social costs of restructuring. Both governance structures result in socially sub-optimal allocations: managers under

both regimes exert an inefficiently low amount of effort. However, a trade-off exists between the two ways: government control allows more reallocation of profits and therefore lowers the social costs of restructuring, but induces managers to spend less effort and therefore has detrimental effects on incentives.

There is opinion that short-term objective of privatization should be to create a stable ownership of firms through the setup of holding companies as temporary owners. The establishment of Western-type market structures requires competition oriented restructuring before the ownership change, especially in industries where monopolies had prevailed under socialism. In the process, foreign institutions should be used as a commitment device to counter-balance the influence of different interest groups on government's decision making.

If to concentrate on the incentive issue at the firm's level some authors shows superiority of selling shares to outside investors over insider privatization. Their argument is that, although insider privatization aligns control and property rights and therefore creates appropriate incentive structures, it might lead to inefficient restructuring. Also, after a failure to restructure by insiders (which is a realistic scenario in transition economies), a resale to outside investors can happen only with small probability. This may be because, worker-owners either extracts the surplus of restructuring by requiring an excessive price from an outside investor or, when the probability of becoming unemployed is high, they do not carry out restructuring at all. Under managerial ownership, when the probability of becoming unemployed and the size of private benefits are both high (which is typical in transition), the resale process is more likely if managers own small stakes.

In focus on the sustainability of the privatization process might arise changing of ownership structures. The rationale for this is the strong pressure for redistribution from previously favored interest groups after new owners take actions following the ownership change. Focusing on the long-term sustainability of privatization government should privatize a relatively large stake early in the transition process: when privatization is carried out in large scale, the possibility of a policy reversal becomes less realistic.

Some authors think that success of transformation of ownership structures substantially depends on the expected aggregate volume of privatization at the time when the privatization plan is announced. They argue that due to a positive externality related to the size of the private sector, if a certain amount of aggregate capital is to be privatized relatively early in the course of transition, a higher number of investors will choose to invest in buying state-owned property. Once a critical number of privatizations have been achieved, there is no further possibility for a policy change.

As a result of an endogenous probability of political continuation, several equilibrium might arise. On the condition that the critical (threshold) level of capital is privatized relatively early, a full-privatization equilibrium will be approached by the end of the transition process. In the opposite case, however, due to a coordination problem among agents, a low-privatization trap may occur, meaning that the total amount of capital given to private hands by the end of transition does not reach the threshold level. In the other opinion, however, a possible denationalization of privatized assets represents the way of ex-post expropriation by the government. The low privatization equilibrium might be brought along by investors' fear of a political backlash or high entry costs born by them when they enter the state-owned asset market. Therefore, a possible change in policy (political risk) drives the optimal design of privatization.

The policy of free distribution of shares applied in CIS countries is also considered as a means of stimulating privatization. Free share distribution eliminates government's incentives to renationalize

even below the critical mass, therefore it solves the problem of a potential policy reversal. At the same time, it raises entry costs for private investors engaging in buying state enterprises, by which it increases the costs of restructuring. Even though, the government's temptation to renationalize is eliminated, when entry costs are too high and privatization volume is below the threshold, there are still remains a coordination problem among private investors.

The possibility for a policy reversal serves as an explanation for the puzzle of partial sale and under pricing observed in many privatization programs. Initial equity retention and a discounted share price may help the government to signal its commitment to a long-term pro-privatization policy. In transition, to counter-balance the loss in popularity resulted by the general decrease in the country's welfare, at privatization, the government is often interested to ex-post reallocate value to its favored constituencies. Therefore, there is significant uncertainty for investors about government's interests concerning future interference.

When the efficient transfer of control requires selling a large stake of the company, equity retention may not serve as a signal of commitment. Instead, strategic under pricing can be a substituting device: when large sales are necessary, a committed government will offer shares at discount. A combination of under pricing and graduate selling can be the most efficient signaling method.

Political risk in privatization context is meant to measure the government's ability to adopt appropriate economic policies and its willingness to adjust decisions to people's expectations (credibility of its policy). In addition, it implies an evaluation by financial market experts and bankers, of the country's financial stability and ability to service its debts.

An important result is that in the period preceding the announcement of the privatization program and even at the time of the announcement, political risk indicators reflect a negative change in the countries' rating. This suggests that governments start to privatize in periods of declining credibility. When sales start and later when they are at the peak, the policy risk indicators show substantial improvements referring to a resolution of the uncertainty about government's future policy.

Chapter Three

PRIVATIZATION IN THE RUSSIAN FEDERATION

Privatization is a great historical development; it is a peaceful and civilized equivalent of a revolution. Previously in the history of Russia, as we know, it was not vouchers but Browning that was used to bring about change.

For bureaucracy the ideal formula is to add property to power. The idea is to achieve a restoration of property to private ownership in such a way that ultimately the production (production costs and risks) remains social but the appropriation private; to conduct privatization as was the case with Eastern despotic regimes without creating a full-fledged market, so that power would be free, independent of the administrative machinery, and in effect private property.

It was not done immediately, but gradually; we reached that kind of situation somewhere in 1990. But the path thus passed was a sweet one for bureaucrats. The landmarks are probably the law on cooperation and the election of directors and reduction of their responsibility to ministries (and the parallel total reduction of the so-called "party discipline" which was the backbone of everything the state had), and the change in rules which made it possible for enterprises to "whip up" the salaries as much as they wished and secretly jack up the prices of their products though on the official level prices were not "freed". In my view, the period of the last days of Ryzhkov and Pavlov in 1989-1991 may be called the "golden" period for the nomenclature, when they knew no limits. The 1990-1991, system with no set rules and procedures on property rights, no responsibility for whatever one did, could be seen as if created (was it, indeed, so created?) specifically to make it possible to get rich, fearing nothing, ashamed of nothing.

Prior to our coming to office, so-called nomenclature privatization that had been in progress for as long as three years was following a classic scenario of privatization under the "Asiatic mode of production". The privatization we had was reduced to the looting of satrapies by their satraps. Such privatization, which guaranteed maximum gains and minimum risks for the oligarchy which retained full administrative power in its hands and, moreover, added unearned wealth to it, would always end up (at least in Eastern societies) in one and the same way: with an explosion and a new dictatorship. The general cycle of development these societies follow is this: dictatorship-disintegration (privatization) - explosion - a new dictatorship. The first stage has split into two parts: a latent period (1953-1988) and an open period of disintegration in society (1988-1991). That period was coming to its end. One could see an explosion on the horizon. And the paradox is as follows: at the time when psychologically trust was in the democrats, and it was almost complete trust at that time, we came as close as possible to the dangerous edge of "impending catastrophe" and the period of fighting it using the already tried methods.

Without resorting to violent measures, without putting the economy into 'extreme circumstances', it became possible to change the catastrophic system of property relations that existed at the end of 1991. On the whole the course that was started at that time (and it was not possible to lead the government of the country astray, though there were quite a number of attempts of that kind), it seems to me, brought about vast changes and not only market-oriented changes, or changes toward capitalism but also changes toward a non-nomenclature market, non-nomenclature capitalism. Naturally, what we have today is an intermediate version that can develop in different directions but the general trend remains with all its inconsistencies, it is a non-nomenclature trend. Today a

non-bureaucratic market predominates. That kind of approach was made realistic (though not everything is done yet) in 1992-1993.

The main reason it became possible is that the political power of the nomenclature was destroyed. Trying to achieve the privatization they needed, the representatives of the party oligarchy went too far in the process of "democratization" that process became unruly, and democracy was already in place. And having lost their monopoly on power, the nomenclature was no longer capable of keeping the process of privatization under their complete control. The nomenclature-type privatization was being replaced with a democratic, market privatization.

Once the system is destroyed, the owners will bear financial responsibility on the market, which may spell bankruptcy, and that means that objectively it is an "anti-nomenclature" privatization that has been implemented. Change in the forms of property, change in the roles and not just the performers acting on the stage - this is a real economic revolution, a social and economic revolution which has occurred (which has been effected!) by means of evolution, but quite rapidly!

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September 1994

3.1 HISTORY OF RUSSIAN PRIVATIZATION.

The privatization movement started in Russia in the end of 1988 in beginning of 1989. In the beginning of the process priorities were price liberalization and control of the budget. Only in the middle of 1989 when the process of state democratization led to spontaneous acquisition of state assets, privatization came in agenda as a way of the legalizing ownership rights. 1990-1991 became years of preliminary preparation for privatization or period of more systematic concepts of pro-market transformation. The Russian privatization process officially began in mid-1991 when Russian President Boris Yeltsin signed a privatization law that created a state agency, known by its Russian abbreviation Ministry of State Property (then GKI), to oversee the transfer of state assets into private hands. 1992 enters the history of Russia as the year when a large-scale reform in the sphere of property relations on the basis of the privatization legislation just developed began at that time Russian economy was still centrally controlled by ministries or subministries, each running an industry. The GKI team realized these organizations could not easily or willingly give up their authority. The GKI team decided that tackling this network of entrenched bureaucrats would require decisive action. The reformers aimed to entice the red directors into supporting the privatization program by offering them ownership stakes in the enterprises they were already managing for the state. Another goal was quickly create a broad base of property owners who would be opposed to reversing the changes.

For small enterprises and assets, such as shops, restaurants, and apartments, the reformers chose to leave details of the privatization effort to local authorities. The most common approach was to auction small enterprises and assets for cash. Often the buyers were the workers themselves. The

approach proved successful, and by 1995 over two-thirds of all small businesses in Russia had been privatized. These small businesses have become the foundation for a growing middle class. For midsize and large enterprises, the GKI adopted a mass privatization strategy that utilized a voucher system. It was modeled after the system was used in the Czech Republic, the first step was transforms thousands of state enterprises into “corporatized” companies with shareholdings, with some portion of their shares to be slated for auction. The Russian government then issued vouchers, available from October 1992 to January 1993. For a fee of 25 rubles (then about 10 cents), each Russian was eligible to receive one voucher. About 144 million vouchers were given out in this way, meaning that about 97 percent of the population took up the offer. Each voucher had a face value of 10,000 rubles (i.e., about \$25). The voucher holder had three options: sell the voucher for cash (a lively market for vouchers soon developed); use the vouchers to bid at auctions for the shares in corporatized firms; or invest the vouchers in private mutual funds that would then purchase packets of shares. By mid 1995 Russia's private sector employed over 80 percent of the nation's non-agrarian work force, more than half of Russia's estimated 240,000 enterprises had been privatized, and some 40 million Russians owned shares in more than 15,000 mid and large scale enterprises. Then in 1995-1996 start the program so called “loans-for-share” involving banking sector privatization. And the finally in 1997 starts the case-by case privatization. Case-by-case privatization is especially applicable for the sale of large, economically important enterprises, where transparency and competition are critical to successful privatization.

The official privatization process in Russia can be divided into three major phases. The mass privatization program (1992-94) was the first, when vouchers were issued to all citizens. This actually resulted in most enterprises falling under the control of existing managers and other insiders. In the second phase (1995-97) the emphasis shifted to sales of larger, high-value enterprises to financial-industrial groups and included a "loan-for-shares" scheme. The likely result of this program is the transfer of share ownership at knockdown prices to a privileged few when the loans come due in the year 2000. As a result the third phase of privatization, from 1998 to 2000 has seen the government trying various measures to make the process more fair and transparent, including dropping restrictions on foreign participation and instituting the valuation of assets by international advisors. Even so, the Russian government has thus far met with little success in selling blue-chip companies at the targeted price through "case-by-case" privatization.

3.2 1989-1992 SPONTANEOUS PRIVATIZATION.

It is very important to classify research countries as belonging to one of four basic types of political order: liberal democracy, liberal autocracy, illiberal democracy, and illiberal autocracy. [F. Zakaria, (1997)]. Liberalism and democracy are two critical concepts underlying those four political arrangements. Democracy is about the right of individuals to organize into political parties, the holding of free and fair elections, and the process of selecting a government. Liberalism is concerned with the rule of law, stable and credible property rights, and civic and economic freedoms. While democracy is concerned with who has power, liberalism focuses on the limitation of government's power. The liberal state is one in which the law protects individual rights against the collective (majority) will. Thus, the liberal state creates incentives for individuals to pursue self-interest, self-determination, and self-responsibility.

A useful simplification for analyzing the transition in Eastern Europe is to refer to liberal democracies and liberal autocracies as rule of law states, and to illiberal democracies and simple dictatorships as arbitrary states. The former implies credible absence of arbitrary use of power on the part of the ruling group, while the latter means arbitrary use of power by the ruling group. With a few possible exceptions such as the Czech Republic, Estonia, Hungary, and Poland, all former

Communist countries in Eastern Europe and the Former Soviet Union should be considered as arbitrary states. [Pejovich, S (1999)].

After the collapse of socialism, Eastern Europeans and Former USSR needed stable rules for carrying out interactions among themselves and with the rest of the world. [Pejovich, S (1997)].

In a context of transition from command economic system to a free market based on the principles of competition, privatization plays very important role. In this context it is quite natural that privatization policy is the core of specific reforms affecting on legislative field, ownership rights and an economic structure as a whole. The condition of privatization policy basically depends on national specifics. In Eastern and Central Europe as in former Soviet Union this tendencies to changes starts late in 80's. The critical period for the Soviet Union in some expert's opinion was 1989-1991, the Gorbachev era. It was a time when the people understood that business is too complex for central planners to control and run it efficiently.

Instead, individuals allowed to freely pursue their own interests are better equipped to run businesses, because their performance is directly linked to their individual utilities. In doing so, they produce goods and services and pursue co-operative networks based on the free exchange of goods and services. The pressures of the marketplace direct the selfish activities of individuals as an invisible hand using Adam Smith's terminology into socially responsible paths. As he observed: *"It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest."*

Deregulation

Administrative regulation generates control over resource movement, produces a glut in one place and a short supply in another. Three corresponding main groups of beneficiaries emerge: those living on administrative rent, whose benefits depend on either the abundance or shortage of resources and the right to control resource movement. If such a regulation is institutionalized and is regarded as something natural, its elimination means a disruption of common property rights of the interest groups, listed below.

The economics argues, however, that a deregulation leads to an increase in the aggregate product. Therefore, even in case of a full compensation of all former administrative renters, the deregulation will all the same generate extra incomes. The problem, thus, consists in the way by which beneficiaries of deregulation will be paying former owners the administrative rent for the economic freedom.

A practical answer to this question may be supplied by a spontaneous deregulation, which in many countries forms illicit actions corruption, while in Russia and Armenia, it is a characteristic feature of the administrative market system. The rights of renters are being bought out by those who are interested in unhampered market transactions. This is a way a voluntary non-violent liberation of the economy is going on.

It is beyond doubt that during the Gorbachev era, a considerable economic deregulation has taken place. This is to a great deal connect with that period of legal environment, which gave a free hand to legal experiment-making. In this context the old exchange of rights, this was characteristic of the Brezhnev bureaucratic market, started to acquire legal forms. Formerly, regulatory restrictions used to be overcome by one-off authorizations (not free, of course). During Gorbachev era, a new legal status was stitched together from contradictional legislation to create maximum freedom of action

for a powerful and influential buyer of rights. Later, the new status was distributed among other customers willing to buy a “free life”.

Major obstacle standing in the way of a liberal economic reform is most likely the neglect of the common law. The legalization of the customs connected with the administrative regulations and so-called “state property” is especially hard from the moral point of view, because the state economic sector usually concentrates much scum around it, to get rid of which is probably one of the main tasks of the market reform. The legal recognition of the administrative rent, however, is the first step towards doing away with it.

The recognition of the common law in the sphere of administrative management makes the deregulation strongly advocated by mainstream economists beneficial for all sides concerned and needing no enforcement. It also enables to carry out a voluntary privatization of state enterprises. Vested interests, now hampering the economic reforms, will come to boos them.

Since the reforms are spontaneous, voluntary and to a great extent self-adjusting, they do not require well-balanced and high-quality state decision-making and as a result, no vast bureaucracy. This is extremely important for transitional countries, whose key problem is the shortage of skilled and non-corrupt government servants.

Deregulation effect on Russia and Armenia

In Russia and also in Armenia all this process started not at once and had been preceded by a series of fundamental changes in economic structure and what more important in ownership structure. It was a time of state control absence as the central government did not work, and former Soviet Republics were not independent states yet. That was a time of lack of rational market and competitive environment, difficulties in separation what is public and what is already private, it was first stage of capital accumulation, or in other words spontaneous transfer of public assets and services in other forms of ownership, like collective private, quasi private, or quasi public. That was a wave of spontaneous or nomenclature privatization, which took a variety of forms, from spontaneous-bureaucratic privatization to managerial privatization, and also employee lease-buyouts. The time of the end of communist period in Former Soviet Republics. The first stage of dividing “Big Cake” or the Soviet Union ownership. The state, which over the years has subsidized the economy, was the source of this late-Soviet enrichment as new capitalists rapidly pocketed the funds of the public sector.

Since the system of state control over enterprises was collapsed and there was not legal basis for private ownership (*see second chapter, privatization techniques, first law about cooperative was issued in 1989*) the control over enterprises was divided between managers and directors and not rear, it was done by force that involved criminal structures. Over this period were created a new ownership structures mostly in the form of cooperatives on the state enterprise basis, holdings, concerns associations. The main idea was by using public technical and material base to create money for new “owner”. The characteristic features of such kinds of new created firms were unclear ownership structure, highly centralized and ineffective management being the legacy of former communist structures.

On the example of Russian privatization, the real challenge for the reformers at the beginning stage lay neither in finding a technical solution to the problem of “sequencing” the various steps of the process, nor was the primary question one of dealing with the various political obstacles known as “feasibility constraints” or “backlash constraints” represented by the anticipated contrary behavior of well-placed insider actors.

The real challenge was not privatization per se, but the creation of the preconditions necessary for the introduction of private property as a basic parameter in the institutional matrix of Russian society.

Method for privatization analysis

To study privatization phenomenon in this research I am using fast growing method for analysis of economic and social issues, the new institutional economics, it is also a young method still in the process of creating its own mainstream. Some scholars view the new institutional economics as an attempt to enlarge the competence of neoclassical economics to explain a larger class of real-world events. Others consider neoclassical economics merely as a point of departure for redirecting economic analysis toward the effects of alternative institutions on economic behavior. Thus, according to G. Libecap, "*The new institutional economics retains its general attachment to neoclassical economics with its emphasis on individual maximization and marginal analysis, but with attention to transaction costs, information problems, and bounded rationality.*" [Libecap, G (1998), 4]. Many economists consider the new institutional economics to be a "sui generis" method of analysis with strong ties to the subjectivism of the Austrian School and Public Choice theory.

The new institutional economics

In their research the new institutional economics focuses on how alternative institutional arrangements facilitate economic stability and economic growth. Increases in knowledge, technological innovations, and other activities create new opportunities for gains. Those potential gains are realized through exchange, which, in a world of uncertainty and incomplete knowledge, are not without cost. By reducing the flow of resources into new and more valuable uses, positive transaction costs threaten to be a limiting factor on the rate of growth.

Rational expectation theory brings the new institutional economics and neoclassical economics into proximity but not to convergence. Furthermore, rational expectation theorists consider the process of adaptation to an optimal solution as a steady trial-and-error process in which the participants cease to acquire new knowledge. H. Simon wrote: "*New economic theories are not focused upon, or even much concerned with, how variables are equated at the margin, or how equilibrium is altered by marginal shifts in conditions. Rather, they are focused on qualitative and structural questions, typically, on the choice among a small number of discrete institutional alternatives*". [Simon, H (1978)]

Four principal concepts upon which the new institutional economics rests are: informal institutions, formal institutions, property rights, and transaction costs. Thus according to Pejovich, S (1999) they are:

I) Informal Institutions

Informal rules are traditions, customs, moral values, religious beliefs, and all other norms of behavior that have passed the test of time. Informal rules are often called the old ethos, the hand of the past, or the carriers of history. They embody the community's prevailing perceptions about the world, the accumulated wisdom of the past, and a current set of values. Thus, informal institutions are the part of a community's heritage that we call culture. [Gellner, P (1988), 14]

II) Formal Institutions

Formal rules are constitutions, statutes, common law, and other governmental regulations. They determine the political system (i.e., the governance structure and individual rights), the economic system (i.e., property rights and contracts), and the enforcement system (i.e., the judiciary and the

police). Governmental authorities enforce formal rules by means of sanctions such as fines, imprisonment, and execution.

III) Property Rights

Property rights are relationships among individuals that arise from the existence of scarce goods and pertain to their use. They are not about the relationship between individuals and objects. The most common types of property rights today are private property rights, communal property rights, and state or public property rights. Institutions, in this framework, can be seen as containers that hold property rights. The more property rights a person has in a good, the closer his or her private cost is to the social costs of using that good, and the more incentives that person has for seeking the highest-valued use for the asset. That is, different property rights in goods create their own incentives through the impact they have on the relationship between the private and social costs of using those goods, which, in turn, affect human behavior in specific and predictable ways.

IV) Transaction Costs

Transaction costs are the costs of all resources required to transfer property rights from one economic agent to another. They include the cost of making an exchange (i.e., discovering exchange opportunities, negotiating exchange, monitoring exchanges, and enforcing agreements) and the cost of maintaining and protecting the institutional structure (i.e., the judiciary, police, and armed forces).

Public Choice scholars have addressed the problem of evaluating the incentive structures of different political orders. However, the evidence for refutable implications of those effects on the behavior of public decision-makers is yet to be developed. Privatization programs in Russia and Armenia have made a major change in country's formal rules. However, if those rules are out of harmony with informal institutions, people view it with apprehension, uneasiness, and even outright hostility. The higher costs of integrating the rule into the prevailing framework of property relations should force public-policy makers to pass clarifying rules and regulations.

Formal and Informal Rules

Formal rules are enacted, changed, and enforced by legislators, judges, bureaucrats, and other rule-makers. That is, formal rules are a policy variable. New, formal rules may emerge in response to the requirements of the game, or rule-makers could pass new rules in order to change the game. The emerging convention is to refer to the former as spontaneous changes or changes from within the system, and to the latter as changes from without.

In light of formal rules changing, during Gorbachev era was used very innovative for that time method of ownership change, and in some authors opinion most innovative and effective method of privatization ever seen in Russia "lease-buy-outs." In the Soviet lease-buy-out model, the company made lease payments to the government over a period of years and then could exercise the final buy-out clause (much like an individual hire-purchase arrangement). The current workers were the members as in a collectively owned worker cooperative or were "shareholders" in Soviet versions of share-cooperatives. It was changing of old planing economic system and rules of the game to new rules of free entrepreneurship. Of course this model has its own problem us corruption, problem with collective ownership, because of absence of legal institutional field. But in any way it was wide spreading model that works well and was stopped in the reason according to Ellerman "to leave something to go in to the voucher program." [Ellerman, D (1999), p.2]

Cooperatives were very popular in the Soviet Union. Managers of state enterprises channeled economic activity to new cooperatives, which could sell at higher prices than the state enterprises

whose prices were centrally controlled. Cooperatives, small businesses and leased assets were also allowed, according to the new laws to undertake economic activities, which were forbidden to state enterprises. The directors established cooperatives, collectively owned entities, lease agreements and joint ventures, which became profit centers feeding off the assets of large state enterprises. In this way, cooperatives started the spontaneous privatization of state property. [*Nysten-Haarala, Soili (2001), p.8*]

The last scheme was especially widespread in the USSR law on leasing enacted in 1989 provided employees, worker collectives, managers and directors with the opportunity to lease state enterprises with the right of buy-out, the enterprises were then reestablished as 100% insider-owned closed corporations. Formally, the lease-buyout privatization was stopped in mid 1991 when the law on privatization was passed, however, it de facto continued through 1991 and even 1992. The incidence of the lease-buyout scheme was particularly large in the retail trade and consumer services sectors, in light industry and some others. By February 1992, 9451 of Russian state enterprises according for 8 percent of total employment were leased by their workers and managers [*Blasi et al., (1997)*].

Formal rules emerge spontaneously in response to changes in the economic conditions of life (e.g., new markets, new knowledge, new sources of supplies, and so on). Changes in the economic conditions of life create new opportunities for human interactions. To exploit those opportunities, individuals seek new contractual arrangements. Contractual arrangements that pass the market test create the demand for institutional change that promises to lower the transaction costs of exploiting new opportunities. New formal rules that emerge from this process should then be in tune with the prevailing informal institutions. Otherwise, voluntary contractual agreements leading to the demand for adjustments in the rules would not have happened. An implication is that the community that provides an environment conducive to spontaneous changes in formal rules should be both stable and growing. Formal rules that are imposed from without (in order to change the game) may or may not be in conflict with informal rules. A great deal depends on the incentive structures under which rule-makers operate and the effect of the prevailing political order upon those incentives.

Spontaneous privatization and Ownership rights

Spontaneous privatization has dramatically stepped up the process of formation of ownership rights. The former system of rights, in accord with the old administrative market, has started to transform into a new system, to match the barter market. The new, interim type of market, which stands close to the normal commodity and monetary market, has brought to life a system of rights, close to the normal system based on private ownership.

The disruption of vertical hierarchical relations led to powerful shifts in administrative rights towards grassroots hierarchical levels and a regrouping from industrial branches to regional power-centers. Ownership rights are being redistributed among former heads of different levels of different hierarchies and entrepreneurs of new commercial structures who also possess important rights to be free from many state restrictions, and possess spare money.

In its most ultimate form, the process is revealed in the form of spontaneous privatization of state property. The nomenclature, in particular, young and middle-aged; owners of cooperatives and joint ventures, newly elected deputies of local councils were used the new legislation on privatization to their benefit.

Nevertheless, spontaneous changes have been occurring in Eastern Europe and former USSR. Thousands of small private firms that have sprung up, many have failed, but many survive and

grow. They serve as the breeding ground for entrepreneurs, a work ethic, a capitalist exchange culture, and positive attitudes toward capitalism in general. They educate ordinary people to appreciate a way of life that rewards performance, promotes individual liberties, and places a high value on self-responsibility and self-determination.

From 1989 people in all former Socialist countries needed time to learn that capitalism is not merely an alternative mechanism for the allocation of resources, but a way of life, in which individuals voluntarily interact with one another in the pursuit of their private ends and in so doing, create a culture “sui generis”. Forcing former Socialists to accept the institutions of capitalism before they had become comfortable with the system’s culture inevitably created a conflict with the old ethos. The new leaders with considerable support from the West, used the strong hand of the state to build capitalism, they basically replaced the old conflict between Socialist institutions and the region’s ethos with a new one. The new conflict created an opportunity for two groups, former nomenclature (red directors) and new kleptocrats (oligarchs) (the attention on this conflict will be paid in mass and loans for share privatization parts).

Then the process passed to a new level, the new owners wanted legalize the control over their ownership. For that reason was necessary to create a new legislative field and legalize privatization not as a spontaneous process, but as a legal state controlled program.

All that was necessary precondition for the mass privatization in 1992-1994. At the same time creation of legal privatization program allow the state try to take control over the progressive plunder of state assets. It meant that state and state managers or new owners were interested in formalizing ownership rights, but de facto, we see that at the mentioned period legalization of this formal ownership rights become a tool to acquire more and more state assets and resources. In other words, the paradox of the situation was, that privatization was a strategic necessity to carry out market reforms, however, it needed the political will, consistent legal system, initially though enforcement in order to succeed. The red directors entice into supporting the privatization program by offering them ownership stakes in the enterprises were the same red directors who had presided over the poor management of the enterprises when they were state owned. That made no sense in meaning of new effective owner, but have reduced the resistance and made possible to involve critical mass of enterprises to start preparation of Mass Privatization.

Also former leaders had incentives to seek ways to preserve their power and privileges. Their human capital equipped them for seeking advantages in a bureaucratic environment therefore, the transition to the free-market, private-property system threatened their well-being. To preserve the value of their human capital, former Nomenclature, while paying lip service to free-market reforms, had to maintain or recreate a state centered system. They knew that encouraging the perception of an external threat to their respective ethnic groups would give them a good chance to stay in power. The imposition of new formal rules that were not in harmony with the prevailing informal institutions in Russia and Armenia has provided incentives for rent-seeking coalitions to be formed, and those coalitions have played a major role in subverting the transition from socialism to capitalism. Nomenclature have adroitly exploited the old ethos to their advantage and pushed former USSR, in the direction of arbitrary states.

It is ironic that the Communists of a decade ago, knew that central planning was a dead end, but not fully trusting markets either, likely built through enterprise leasing better means for enterprises to manage privatization than the privatize-now approach that Western advisors later promoted and Russian reformers enthusiastically followed. The Russians who blame Western advice for destroying their economy are not entirely wrong. [Black et al. (2000)].

3.3 1992-1994 MASS PRIVATIZATION.

Very often the so-called monetarist paradigm of economic transition is criticized on two grounds. First, the proponents of "gradualist" approach argue that step-by-step reforms help exclude the situation when institutions of the old system have been already dismantled whereas those of the new system have not yet evolved; such reforms are also believed to be much less traumatic than "Big Bang" transformation of the economic system. Second, the consistency of austerity policies with regard to aggregate demand in conditions of transformation recession is put under question. *[Nekipelov, A (2000), p.5]*

In general I share the gradualists point of view. The problem of institutions is extremely important because in case of absence or in case of their immaturity market mechanism cannot simply produce the expected results. The only important qualification refers to the transformation of the behavior of economic agents, which, in its turn, is conditional on property rights. To make economic agents to produce proper market signals as well as to adequately react to them it is not enough just to free economic units from commands issued by state bodies with regard to output levels, prices, suppliers, consumers etc. It is absolutely necessary to change their motivation (to reorient them on maximization of profit in the short run, and net worth of the company in the long run), which is possible only if relations between owners, management and hired labor force undergo radical transformation.

This transformation at a particular enterprise cannot be carried out in a gradual fashion because there is no smooth, evolutionary passage from old type of relations between the above-mentioned stakeholders to a new, market one. Monetarists believe that this testifies to the necessity of forced privatization. Russian experience eloquently demonstrated all the dangers of this approach.

3.3.1 Shock Therapy

When the Soviet Union collapsed, reformers or adherents of revolutionary transition (shock therapy) came into power in Russia with President Boris Yeltsin. Yegor Gaidar and many other economists had studied neoclassical economics in the United States in the neo-liberal form (Milton Friedman, James Buchanan and Friedrich Hayek), and were sure that the liberalization of prices and privatization of enterprises would lead to rapid economic growth and spontaneous generation of markets and market institutions.

It was a considerable change in the ideology of transition from state controlled gradual transition to liberalization and passive government theory. The main argument for shock therapy was that the bureaucratic state interference blocked reforms *[Sachs, (1993); Åslund, (1997), p. 454]*. According to *[Kornai (1990), p. 131]*, market socialist countries maintained the fundamental attributes of the socialist system. The state-owned sector still dominated the economy and the main coordinator of economic activities was the centralized bureaucracy. Shock therapy and liberalization, however, produced a shock with long lasting and unexpected effects without being able to rapidly turn Russia into a market economy. *[Nysten-Haarala, Soili (2001), p.9]*

The key elements of the stabilization program initiated by Russian economist Yegor Gaidar were the liberalization of prices, combined with tight-money, and the replacement of the turnover tax with a value-added tax and a profits tax. *[Ickes and Ryterman, 3519]*. Advocated by the International Monetary Fund (IMF), the idea was that the freeing of prices "would bring scarce goods back into shops, that the curbing of budget deficit and the slowing of monetary growth would bring stability to economy, and that the privatization process would encourage new

entrepreneurship and the restructuring of old ailing enterprises". [Weisskopf E. Thomas (1992)] In theory, the IMF may have been correct, but when applied these reforms did not obtain the expected results.

I study the domestic price liberalization first. To assess its own effects necessary to presuppose that after it is initiated economy begins to function in full conformity with free market laws, that is why necessary to ignore the problem of lacking or immature institutions as well as the fact that a significant part of modern market economy is characterized by imperfect competition. Taking into account the fact that deployment of the factors of production under centrally planned system was carried out in accordance with totally different criteria huge resource reallocation after one-time dismantling of command controls is unavoidable. In the short run it is necessarily produces a significant drop in production because of capital and, to a lesser extent, labor cannot be easily transferred from one use to another. Even if money supply is held constant drastic price hike is inevitable as a result of diminished output. That is why all post-communist economies faced a severe stagflation process in the initial phase of transition. [Nekipelov, A (2000), p.5-9]

The Gaidar policy had strong microeconomic ramifications on the creation of the virtual economy. It was very easy for the Russian government to “free” prices and holds a tight monetary policy de jure, but as critical error, the accompanying program of restructuring and privatization necessary for the success of these reforms was not developed and implemented together. The Russian government's failure to do so “enabled well-placed individuals traders and speculators who could dominate the emerging and largely unregulated markets, government officials whose authority was needed to approve various transactions, and enterprise managers with de facto control of important state assets-to enrich themselves handsomely at the expense of the general public”. The lining of pockets by the elite created a tremendous polarization between their small class of new capitalists and the rest of the population. [Bost, Christina (1999)].

The situation in the long run or the shock therapy depends on how short is the shock therapy run. The longer the initial recession the more widespread will be the situation when “temporarily” idle factors of production never get employed in future. The above described liberalization shock is further increased if domestic liberalization is accompanied by lifting obstacles in the way of international exchange of goods and services. The well-known negative value-added phenomenon supports this conclusion.

The privatization process thus allowed the old leaders to maintain their leadership role within Russian society, reconfigured as the financial-industrial elite. In June 1992, the Russian parliament passed a comprehensive new law on privatization, establishing a “voucher” system of mass privatization for medium-sized and large state enterprises. Under this scheme the enterprises would be transformed into joint-stock companies with shares, and every Russian citizen would receive a voucher that entitled the holder to buy shares in the new stock market. However, the Russians have little knowledge of how market economies work, so that most people had no idea what to do with their vouchers and sold them cheaply to those with useful insider information, i.e., the old Soviet nomenclature. [Bost, Christina (1999)].

The key assumption of the Gaidar reform program was that enterprises could be induced to behave like market-oriented firms. Subsidies were completely eliminated and enterprises were supposed to operate on hard budget constraints. [Ickes and Ryterman, 359]. But enterprise managers were never instilled with a drive to compete and make a profit. The undeveloped democratic and market institutions that allowed the virtual economy to establish itself rewarded many of the same skills that were called upon in the old system. For example, cultivating of relationships with key

individuals, payments of bribes or exchanges in favors of other people whose goods or services one needs, and a willingness to bend rules and engage in semi-legal if not illegal transactions were rewarded as the financial-industrial leaders were able to amass more and more cash as their enterprises became more and more insolvent. [Weisskopf, p. 4]

The process of market reallocation of resources without shock therapy produces two major challenges, both of normative nature. The first is of social character and results from emerging large-scale structural unemployment. The government has to decide whether it is ready to intervene or prefers to stay apart waiting until market mechanism settles the issue. In fact governments always intervene and it is much better when they do so in a planned manner. Otherwise, as the case was often met in Russia, government had to act as a fire brigade, on an ad-hoc basis, reacting to growing political tensions.

The second challenge is that people can perceive the results of the work of market forces as non-optimal. For instance, in the Russian case, probably, a big majority of population would prefer to bear additional hardships to preserve (restore) the status of the country resulting from possession of modern scientific and technological potential. Of course, this can be done if an adequate industrial policy is designed and implemented.

Governments have different levers to correct the work of market mechanism without undermining it. They include: gradual liberalization of economic activity; use of differentiated taxes and tariffs, which are then gradually reduced to normal levels; institution of social safety nets etc. Contrary to monetarist dogmas, their use can lead to increase in the level of satisfaction of democratically determined social needs. However, it is important to note that there is no direct link between shock therapy approaches to liberalization of prices and foreign exchange of goods and services, on the one hand, and financial crisis of the type Russia experienced in August 1998.

The aforementioned failure of Gaidar to stick to his shock therapy policy when pressured helped to reinforce the enterprise managers beliefs that Gaidar's policy regime was not credible. The managers did not believe the government would be willing to tolerate the unemployment consequences that would result if a large number of enterprises would be closed. [Bost, Christina (1999)].

Mass privatization (MP).

The principle of charge-free distribution of state ownership has not become general in Eastern Europe, therefore significance of the MP for consequent corporate governance of privatized enterprises was unequal in the various countries. This model was widely applied first in Czech and Russia after in Latvia, Lithuania, and Mongolia. In many other countries MP as the base model were conducted later Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, and Ukraine. In other countries this model was stipulated as additional to other methods of privatization or for a very small part of the shares of a narrow circle of the enterprises Albania, Bulgaria, Poland, Slovenia, Tajikistan, and Estonia. In a number of countries, nevertheless, its realization has stayed at the stage of acceptance of the appropriate legislation Romania or in connection with crisis of a 1997 Albania [Radygin, A (1995)].

Country	Privatization Methods		SOE total assets	Total private
	Main	Secondary	Privatized, %, 1997	sector share in GDP, %mid1998
Czech Republic	MP1	OS (DS)	More than 50	75
Poland	MEBO	MP1,OS(DS)	More than 50	65
Armenia	MP1	MP2, MEBO	Up to 50	60
Russia	MP2	OS, MEBO	More than 50	70
Ukraine	MP1	MEBO	Up to 25	55
Estonia	OS (DS)	MEBO, MP	More than 50	70

Sources: Boehm, ed., 1997; EBRD, 1997,1998; IET, 1998.

Abbreviations: MP1-mass (voucher) privatization with equal access of all citizens, MP2-mass (voucher) privatization with significant concessions to insiders, MEBO-management and employee buy-outs, OS-sale to the formally outside owners, DS-direct sales. Main and secondary privatization methods indicate the contribution (importance) of the concrete methods to the privatization of SOE assets.

Privatization program 1992

The Russian government has been trying to transform a centrally planned economy in which almost all-productive assets were owned by the state into a market economy. The main task has been the privatization of state owned enterprises. This process began in 1991, and by mid-1995 Russia's private sector employed over 80 percent of the nation's non-agrarian work force, more than half of Russia's estimated 240,000 enterprises had been privatized, and some 40 million Russians owned shares in more than 15,000 mid and large scale enterprises. However, it was too early to say whether the privatization process had a major success.

The Russian privatization process officially began in mid-1991 when Russian President Boris Yeltsin signed a privatization law that created a state agency, known by its Russian initials GKI, to oversee the transfer of state assets into private hands. Boris Yeltsin appointed a young politician from St. Petersburg, Anatoly Chubais, to head the GKI. Yeltsin gave Chubais free rein to devise a program for rapidly privatizing the Russian economy. Chubais quickly assembled a team of young and willing economists. To help to decide on a basic privatization strategy, Chubais and his team analyzed the privatization efforts, then being carried out in a number of other countries, including the gradual case-by-case approach to privatization pursued in Poland and the rapid mass privatization approach adopted by the Czech Republic.

Article 1 of the RSFSR law "On Privatization of State and Municipal Enterprises in the RSFSR" spells out that privatization is the acquisition by citizens, joint stock companies (partnerships) of various forms of property (as provided by the law) from the state and local soviets of the people's deputies as private property. The share of the state, a local soviet, public organization or charitable fund was limited to 25% in the authorized capital of the buying legal entity. The law provided for a sale of shares of the enterprise being privatized, by auction or tender and certain benefits for the workers, and in general a very wide range of methods of privatization as well as broad possibilities for their interpretation.

The administrative and bureaucratic aspect of privatization were entrusted to the State Committee of the RSFSR for the Management of State Property (GKI), a part of the government, while the actual selling or “holding” of property was a function of the Russian Federal property Fund, which operated under the aegis of the Supreme Soviet. Thus the element of dualism inserted into the diagram of control over the privatization process became one of the key elements that was a brake on the path of privatization and reinforced the confrontation at all levels of authority between the legislative and executive organs in 1991-1993.

From the very outset, having stated that privatization was one of the key elements of the economic reform, the Yeltsin and Gaidar government stepped up its efforts in the area of development of the legislation on privatization, but at the same time it had no real opportunity of operational monitoring of the process of privatization. That is why one of the specific features of the economic reform of that government was prices liberalization before a period of wide-scale privatization, which went beyond the dominating theoretical orthodoxy in the field of transition to the market and was in contradiction with the experience of some foreign countries.

According to the conventional wisdom of transient economies, it was necessary first to achieve macroeconomic stabilization, then or in parallel to liberalize domestic price and foreign trade, moving on finally to privatization and enterprise restructuring [*Portes, R (1991), Portes, R (1994)*].

According to Gaidar reformers, for that time there were quite sound reasons for liberalization and privatization. They are:

- impossibility to wait for the end of the “large-scale privatization” conducted in a classical way (i.e. over a number of years), because of the extreme shortage of goods prevailing in 1991;
- if prices were not liberalized, any state-owned enterprise actually became a state entity, so as to ensure administrative distribution of goods in short supply, which could ultimately grow (even without free prices) into a serious conflict;
- intensive spontaneous privatization.

Those measurements affected to future mass privatization process that passed with high inflation, losses in tax revenue, and substantial government deficits. [*OECD (1995, 2000); Leijonhufvud, A & E. Craver (2001)*]

On 29 of December 1991 the President of the Russian Federation signed a decree “On Speeding Up the Privatization of State and Municipal Enterprises”, in accordance with that approval was given to the “Fundamental Provisions of the Privatization Program of State and Municipal Enterprises in the RF for 1992”, these provisions being elaborated on the basis of the “Draft of the State Program of Privatization for 1991”. The implementation of these provisions was begun on 1 January 1992. So the Fundamental Provisions actually became the first document that provided practical regulation for the privatization process and gave a push to programmed privatization (as opposed to spontaneous privatization) in Russia. [*Radygin et al. (1998)*]

However, the experience of the first several months of practical implementation of the package showed, that all these regulations faced many problems. Delay was caused by poor operation (and poor co-ordination) of the privatization bodies at various levels, poor professional training of the personnel, local red tape, the dominance of political methods over democratic ones in other words,

bureaucrats tried to find out who was behind a privatization effort in each particular case and regarded that as decisive in taking a decision.

A final version of the first State Program of Privatization of State-owned and municipal Enterprises in the Russian Federation for the year 1992 was not adopted by a decree of the Supreme Soviet of the RF until 11 June 1992. This program, adopted after a series of delays, was actually a compromise, on the one hand between “paid” (for the active part of the population) and free (with vouchers given to the entire population and benefits given to work collectives) privatization and, on the other hand, between a model of privatization for all (GKI) and the division of property among the workers of enterprises (communists and workers unions). It also should be stressed that it was very document, which became a basic document for the subsequent large-scale privatization in 1992-1994. [*Radygin, A (1995)*]

Primary goals and Methods Envisaged by the Program

According to the program, the privatization objectives were as follows: (a) emergence of a socially oriented market economy on the basis of formation of the category of private owners; (b) enhancing the efficiency of enterprises; (c) social infrastructure development using the revenue from privatization; (d) contribution to financial stabilization; (e) contribution to a competitive economy and demonopolisation; (f) attraction of foreign investors. However, in autumn and winter 1992 the implementation of Russia's model of mass privatization became the primary goal of the privatization policy, for both and the President and the Russian government.

For 1992-1993, according to the program, the following privatization methods were envisaged:

1. Sale of ownership interests (shares) in the capital of corporatized state-owned enterprises, including private offering for the management and employees (MEBO) and going public through voucher and money auctions;
2. Sale of enterprises at auctions;
3. Sale of enterprises through commercial tenders (including those with a limited number of bidders);
4. Sale of enterprises through non-commercial investment tenders (investment bidding);
5. Sale of property (assets) of enterprises being liquidated and already liquidated;
6. Buy-out of rented assets (redemption of the property of enterprises leased out fully or partially).

At the same time direct bargaining was rejected in favor of auctions and tenders (although it is in conflict with world practice, according to which direct sales in 1991 covered 50% of all privatization transactions, amounting to \$50 billion). The top GKI officials thought that: 1) competition facilitated fair prices and simplified the valuation of enterprises, as the buyers determined the market value of enterprises. In the absence of competition, complex and contradictory methods of valuation had to be employed, which contributed to delays, arguments and corruption; 2) the highest bidders guaranteed the highest budget revenue to the seller. [*Radygin, A (1995)*]

All state-owned enterprises were divided into three categories, depending on the method of privatization used:

- § small businesses (with an average workforce of up to 200 employees and book value of fixed capital less than 1 million rubbles on 1 January 1992) would be sold at auctions and tenders (competitive bidding) and lease buy-out;

- § large enterprises (with an average workforce of more than 1000 employees or a book value of fixed capital of more than 50 million rubbles on 1 January 1992) would be privatized through mass privatization by being transformed into open joint stock companies (corporatization);
- § the remaining enterprises could be privatized by any method laid down in the program.

To understand correctly the adoption of the mass privatization course it is essential to take into account not only the above classification of enterprises from the point of view of the permissible methods of privatization but also the total number of enterprises that Russia had prior to the “programmed” privatization process.

As described in [*Blasi et al. (1997)*], in Russia in the late 1980s were dominated large and medium sized industrial enterprises that had more than 200 employees. These firms employed about 95 percent of the industrial workforce and produced 95 percent of production. Large firms with more than 1000 employees accounted for 75 per cent of employment and production. At the beginning of 1991 the Russian Federation had approximately 24.000 medium-sized and large industrial enterprises and about 170.000 smaller ones-astonishingly few businesses for such a large and diverse economy. Moreover, virtually all these businesses were in the state hands.

The small businesses were transferred in to municipal ownership in 1991 and took part in small privatization. To start mass privatization it was necessary to corporatized critical mass of enterprises that made about 5.000 large enterprises and over 15.000 medium sized ones.

By undertaking rapid mass privatization, Russia’s economic reformers believed they could achieve two goals at once. The most important task, obviously, was to achieve improved corporate governance, by shifting decision-making powers from the bureaucracy to private owners. In addition, however, there also was a political ambition. By turning the people into property owners the reforms would be made irreversible.

After the initial and failed attempts at financial stabilization, the privatization program increasingly came to be looked upon as perhaps the only real success of the "system change." Close to ten years later, even some of the most dedicated of the early optimists are beginning to have second thoughts in that respect.

The process of mass privatization in Russia combine too main techniques I.) management-employee buy-outs (or corporatization of medium sized and large state owned enterprises with subsequent sale or transfer of their shares in to the citizens and non-governmental legal entities) and II.) mass privatization itself (include providing to all of population with investment vouchers, which give a right to a part of the property be privatized through voucher privatization). Also were incorporated on that stage of privatization cash auctions and investment tenders. The techniques based on the mass privatization model combine the large-scale corporatization (supply side) and the distribution of privatization vouchers among the citizens (demand side). The important elements of this model were the offering of shares to insiders for closed subscription, the voucher auctions, and the system of voucher investment funds.

The major outcome from the standpoint of the prospects of development of the new ownership rights system was the emergence of new institutions: the corporate sector of the economy, the market of corporate securities, the system of corporate investors, and the mass privatization resulted in about 40million formal shareholders. [*Radygin, A (1994); Boyko, Shleifer, Vishny (1995)*].

Property Rights and Russian privatization

According to Radygin, Enotov, Malginov and etc. the real goal of mass privatization in Russia was the temporary massive redistribution and strengthening of private property rights in Russian society with a minimum of social conflicts and costs, hoping for further transactions in favor of efficient responsible owners.

Property rights are an important political and economic issue in Russia. A weak property rights system is a significant hindrance for economic growth and transition in Russia. Formal rules are complicated and blurred, because of the lack of consensus in society. Informal institutions prevail in spite of the privatization of enterprises.

Property rights have a great influence on the economy. The political nature of property rights is clearly visible in transforming economies. They are one of the most significant political issues in Russian transition, and an unclear property right is an obstacle for sustainable economic growth in Russia. However, neoclassical economics takes property rights as a given ready-made system. Property law is built on the assumption of the existence of a ready-made clear and precise system of property rights as well. Law is supposed to be neutral. Different property rights, such as ownership, leasing, possession or use, lead to a different set of legal rights and duties that do not depend on who is the holder of the right.

The lack of order in privatization has serious negative effects on the development of the Russian economy and society. The developing property rights system lacks credibility. It is therefore necessary to go beyond the legal system of property rights to understand property rights in transition.

According to Hohfeld (1919) rights can be understood as a combination of duties and claims, the content of which is what a right-holder can claim and what a duty-bearer should respect. It is not the resource itself that is owned it is a portion of the rights to use a resource that is owned [*Alchian and Demsetz, (1973)*]. Modern property law regards property rights as relations between the different right holders and analyses the legal positions and consequences in these relations.

The concept of property rights is wider in new institutional economics than in law because it attempts to go beyond the legal system. Property rights are relations among people concerning the use of things [*Furubotn and Pejovich, (1972)*]. Property rights specify relations among those who have various rights and duties to honour the rights, as well as mechanisms that are available to make the duty bearers comply with the rules. The property rights system includes the rights themselves, the formal and informal institutions that create the structure, and economic transactions including decisions concerning the exchange and accumulation.

Law and the legal system of property rights are the formal institutions. Even if modern property law sees property rights as relations, it concentrates on the formal legal effects of regulating these relations [*Zitting, (1951); Aarnio, (1989)*]. Informal institutions are excluded from legal studies, limiting law to neutral legal analysis. Laws are important on the condition that people expect that they are followed. When legal institutions are weak or incomplete, property rights are informal. Rights, which have been enforced informally, e.g., through self-help can, however, become legal in the course of time.

Changes in property rights are probably the most important factor that determines the evolution of economic and social performance for any country. In this sense, two major results are expected when there are changes in the ownership base that characterizes an economy [*Pejovich, S (1997a)*,

pp. 223-224]: (i) an increase of efficiency in the allocation of economic resources due to a reduction of transaction costs; and (ii) the conflict created between prevailing informal rules and the exogenously imposed formal rules. However, in the case of the Russian Federation, those changes brought about during the 1990s have shown all the problems that the property rights approach has always enunciated: (i) In the first place, the changes that have been occurring in the ownership of Russian enterprises during this decade are meant to lead the economic system towards a more efficient allocation of resources since transaction costs are expected to be reduced.

At least this is what all the actors involved in the process were expecting. But the final outcome has not followed this pattern. In fact, the exchange opportunities for individuals, as studied in this paper, have only been partially implemented. Even recently, an increase in transaction costs has been noticed, which makes the process of change even slower. (ii) In the second place, the process of change in Russian property rights has been imposed exogenously, which can create a conflict with the prevailing informal rules. This can lead to an unfavorable effect on transaction costs.

This second result is particularly appealing for justifying the process that has taken place in the Russian Federation. It is well known that the process of privatization implemented in Russia has been done by the legislators for favouring the ruling class (bureaucrats, political coalitions and so on). This is one of the most criticized consequences of the process: the rent-seeking effects inherent to changes in the property rights structure when politics and economics work together. As seen in this paper, the attempt to favour the workers through the program of privatization presents a final contradictory result. In other words, workers will not enjoy the benefits derived from the process implemented, since a collapse of the initial program of privatization is observed, thus these results put even more pressure on the rent-seeking effects that are discussed later in the paper. The necessary constitutional changes to adapt the game rules to the new economic framework are not completed in a satisfactory manner. There is not guarantee that all the individuals will be able to take advantage of the changes made in the system, especially in cases when the property rights are determined out of the State-planning realm. [*Julián I. Pla & Sobrecases F. García (2001)*]

Administrative development in Russia

Administrative development is critical for securing the prerequisites for democracy and a market economy in Russia. The change in the operational systems of administration is largely dependent on the change of the administrative environment, that is, the entire society. The framework for administrative reforms in Russia is the institutional establishment of "true" administration, that is, neutral bureaucracy.

The bureaucratization of administration in Russia is linked with the general consolidation of politics and the economy. A stronger civil society sets increasing claims for the content and efficiency of administration. [*Larjavaara (2001), p.2*].

The institutions of the state and administration have gradually become key issues in Russia and other country in transition clearly requires a holistic approach to the entire structure of the state and its institutions. The state administration is generally regarded as a major obstacle to development in Transitional countries. [*Larjavaara (2001), p.2*].

Sometimes an individual may seek to become a civil servant just to safeguard the interests of private business in administration. Officials are often involved in business enterprises, either personally or through relatives [*Linkola and Luhtala (2001), p. 20; Nozdrachev (1999), p. 308*]. This results in a sort of vertical integration in which officials fail to promote competition between businesses and other desirable values; instead, they establish personal relationships that are useful to individual officials and companies but detrimental to society at large [*Linkola and Luhtala (2001)*,

p.5]. Such administration fails to guide the private economy in the favour of the societal objectives [Nozdrachev (1999), pp. 303, 309]. Due to institutional weaknesses, development tools such as privatization, outsourcing, and competition, which may lead to positive results in institutionally strong contexts, often fails to work in Russia [Luhtala (2000), p. 15].

Politicians and high officials are not satisfied with being merely executors of policies working on a mandate issued by civil society and enjoying only their official salary; they wish to retain their opportunities for increasing personal wealth by keeping their connections to economic operators [Konseptsiya... (1998), p. 4].

The structure and authority of administration are largely adapted according to politics, that is, personal positions. In institutionally modern circumstances, decision-making in administration and organizational behavior in general are guided by legally formed rules and structures. The planned economy is being replaced by steering through norms and market dynamics. Due to the weakness of the new institutions, society partially operates by rather elementary mechanisms, such as hierarchies and networks. Under the institutional circumstances depicted above, the various markets become weaker and the efficiency of society diminishes due to individual loyalties and value exchange taking place in networks and hierarchies. Administration fails to be a mere institution executing policies and focusing the efficiency of its executive measures. [Larjavaara (2001), p.8-10].

- Politics is lobbying within administration to safeguard personal interests through personal relationships.
- Economy is not only based on markets in which the most efficient production competes best; instead, it is often the personally guaranteed agreements made between producers and authorities that apply. This results in monopolies and distorted competition.
- Administration is not so much about markets about the most qualified executors and tools. Appointments and procurements are often made without competition, based on personal relationships.
- Legal system. As everyone pursues his or her own interests without universal rules, everyone loses. [Larjavaara (2001), p.8-10].

Strategic planning to construct society and the serious execution of plans seem to be somewhat wanting in Russia [Bachilo (1998), pp.14, 23; Konseptsiya (1998), p. 15; Poslanie... (1997)]. Reasons for this include the weakening of the state as depicted above due to particularist interests [Bachilo (1998), pp. 34-35] and administrative instability caused by weakness of judicial rules [Luhtala (2000), p.15]. Focusing on individuals and instability makes long-term, constructive administration difficult [Linkola and Luhtala (2001), p. 20; Nozdrachev (1999), p. 313]. Policies in Russia tend to be more political than administrative in character [Linkola and Luhtala (2001), p. 20 and Luhtala (2000), p. 22].

Insufficient planning is related to both the functions of the state and their execution. Consequently, the development of administration is equally institutionally weak. Weak strategic planning and investments gradually erode the infrastructure. The weakness of civil society and administrative regulation combined with the Soviet tradition causes society to generate many social risks with consequences that need attention. [Larjavaara (2001), p.13].

Thus, there is neither time nor money left for planning, and administration only takes place as situational management. Insufficient planning leads to ever-worsening problems and a vicious circle. [Bachilo (1998), p. 23; Luhtala (2000), p.15; Linkola and Luhtala (2001), p. 20].

The generation of theoretical plans remains as popular an activity in Russia as ever in her history. Several plans for administrative reforms, for example, have been produced during the 1990s, but not much energy has been spent on their implementation. Thus, planning exists in theory but not in practice. This is partly explained by the fact that politics and administration are legitimized by programmes and plans, but these often fail to be institutionally feasible. [Larjavaara (2001), p.14].

During the post-Soviet era, administration has been overtaken by rapidly changing policies and partially by the personal objectives of high officials or unit-specific goals. There are few established practices in the planning, definition, management, and evaluation concerning the objectives and functions of the state, public offices, administrative units or individual officials [Luhtala (2000), p.15].

It has been similarly unclear who has the right to make decisions concerning the functions of the different administrative units. It naturally follows that the various political quarters within administration aim to decide which units are in charge of those fields which, either officially or unofficially, yield income to administration [Larjavaara (1999), p. 81].

Definition of the functions and tasks of administration would be necessary for reinforcing the structures and effectiveness of administration [Bachilo (1998), p.14], but institutional problems may prevent this. The activities of administration are less an administrative issue than a political one [Luhtala (2000), p.15].

The instability of state functions, the weakness of the steering and control of administration by civil society, and the particularistic interests prevailing in administration lead to annoying quasi-bureaucratic phenomena from the point of view of the civilians. One explanation for the quasi-bureaucracy is the tradition of Soviet administrative control. In the Soviet economy, successful management of the administrative production required strict administrative control. Nowadays, production is supposed to be privatized. It would be viable to support the activities of private production by light bureaucracy. Yet the control organizations dating from the Soviet era have survived, and in the new circumstances they aim at financing their existence by controlling and taxing private production. Partially this is due to the Soviet tradition of regarding private pursuit of financial profit as something dubious. "Management" of private business by authorities with detailed norms is considered necessary. [Konsepsiya (1998), p.11; Nozdrachev (1999), p. 20].

Like the legal system, administration is an institution deterministically subordinated to politics. Administration is an institution whose operational systems follow the political system. Only in established democracies with legalized, bureaucratic conditions can the legal system and administration independently guide and change politics and the economy. A classic example of the political nature of administration under transitional circumstances is recruitment. In a neutral bureaucracy, recruiting new staff is purely an administrative issue: the most qualified candidate is appointed to carry out state functions, as if a part in the machinery was being changed. The "machine" as such and its operation remains unchanged. Under a political administration, recruitment is political and not merely an administrative question. The candidate must be suitable from the point of view of the informal internal political objectives and relations of the administrative unit in question. [Larjavaara (2001), pp.16-17].

According to [Saline and Times (2000), pp. 10, 17]

- Political processes should be efficient and democratic. The values passing through the political system are not important for the efficiency of the system. In effect, it is disadvantageous for efficiency, democracy and other instrumental values if the system itself is subjected to the

contents of politics: in such a case, the efficiency and neutrality of machinery and, thus, the ability of society to change is endangered, as happened in the Soviet Union.

- With regard to the economy, markets are legally guided to operate in accordance with rules generating efficiency and other instrumental values. From the point of view of efficiency, it is irrelevant what the objects of supply and demand are.
- Administration conforms to established, legal procedures, but the legislation it executes varies to a great extent. Legislation depends on political decisions, but the neutral bureaucratic machine focuses on its efficient execution rather than the contents of policies.

There is no more efficient machine than administration: the machine is partially replaced whenever the contents are changed. If the machine was politically neutral, as neutral bureaucracy is, politics might change without administration changes, and the efficiency of administration would be retained. Nowadays, as the machine is not politically neutral, it must always be changed or wholly replaced when political changes take place. Thus, there is no permanent, accumulating efficiency and continuity in administrative structures. [*Linkola and Luhtala (2001), pp. 1, 8, 24; Luhtala (2000), p. 20.*]

While the institutional that is administrative, infrastructure is insufficient, activities are largely focused on redistribution instead of economic and political administrative production: distributing the existing value and wealth (the economy in the current situation) and struggle for political power (politics in the current situation). Only with the clarification of ownership relations can administration be established in the bureaucratic sense. This would include (i) private administration as the efficient employment of private property and (ii) public administration that is in charge of governance institutionally established private ownership and management, safeguarding the best interests of society. Today, it may be that officials are more interested in the personal privatization of the value produced by the economic units (possibly run by the said officials) or the units themselves, instead of solely creating politically neutral ownership and control of it by the state. [*Bachilo (1998), pp. 9, 37-39.*]

Administrative development in transition countries would mean replacing person-centred, particularist practices by neutral bureaucracy and universal rules of the game. [*Larjavaara (2001), p.8-10.*]

There are, roughly speaking, two kinds of development trends in the Russian society at large and its subsystems such as administration [*Obolonskii (1999), p.308*]. The dualism corresponds to the dilemma between the formal administrative processes, which also do have a presence in Russia, and the informal, particularist interests in administration. This opposition can also be seen as a simultaneous presence of the old and the new. The new is the gradually bureaucratizing administration; the old is the person-centred, hierarchical administration that operates irregularly. [*Riggs (1964); Salminen & Hyryläinen (1989) ; Salminen and Temmes (2000), pp. 48-49.*]

Typical negative trends acting as counter-forces for the positive development trends in transitional societies are caused by the weakness of governance in society, unbalanced institutions (such as weak politics vs. free economy) and the simultaneous presence of old and new etc. These include the corruption in administration depicted above, the instability of societal norms, decrease in production and the general stratification and dysfunctionality of social systems, and so on. One consequence is that financial resources and political power accumulate for small, rich and influential elite [*Konseptsiya... (1998), p. 20.*]

On a political level, some observers estimate that the wealth of the elite and the income disparities are reaching such dimensions in Russia that civil society is beginning to react, and that the elite might give up further attempts to gain wealth in the hope that what it has so far gained would remain intact. Fearing civil society and the politicians representing it (the emergence of politics as an objective process), the oligarchs are, under current conditions, willing to legalize their possessions. In fact, they have begun to voice their desire for a strong state to protect their assets (the emergence of the rule of law as an objective process), and, thus, a transition towards a “normal“ society based on private ownership and the rule of law. [Larjavaara (2001)]

Administrative reforms in transitional countries should be focused on creating the rules of the game, that is, creating and reinforcing administration. Administrative development should aim at the bureaucratization of administration and society: creating neutral, reliable administration. [Larjavaara (2001), p. 29]

The point of view of neutral bureaucracy in Russia means that the efficiency of governance is improved by reinforcing civil society, the rule of law, markets, and neutral bureaucracy while these are not yet fully functioning. Administrative development in Russia can be considered to be the so-called New Public Management (this will be discussed in detail below) as applied in Russian conditions. The functionality of administration can be approached from the point of view of the advantages of person-centred, particularistic practices. NPM doctrine, as interpreted in the Russian way, corresponds to, and supports, the existing economic and political institutions and their functionality in Russia. While the state remains weak, the informal powers that be have a lot of influence in administration. If results in public management are desired, general objectives must be actually connected to the private objectives of strong leaders. [Larjavaara (2001), p. 29-30]

While neutral bureaucracy remains non-existent and centralization has been dismantled in Russia, manager-centredness may be the only functional solution of management. If there are signs of bureaucratization in administration, manager-centredness may be a dysfunctional, particularist element promoting corruption. While political and economic institutions are unclear, but administration is subjected to reform, institutions should be the main focus. Institutional and technical reform must be linked. [Larjavaara (2001), p. 29-30]

A focal point in reforms is the interest system of the society that is the institutions through which political and economic objectives are pursued and the opportunities and needs for directing them. Administrative changes cannot be implemented against the existing institutions of the interest system. By definition, administration is the process and the arrangements within which political and economic objectives are being pursued – neutral bureaucracy executes this in its own way. This refers to, for example, redirecting entrepreneurship from redistribution activities towards productive ones: replacing the pursuit of quick profits in politics, the economy, and administration and the distribution of existing value by activities that produce political, economic, and administrative value. The institutional environment must change to motivate long-term administrative work that is beneficial for society. [Bachilo (1998), p. 21; Nozdrachev (1999), pp. 21, 304, 309; Vinogradova et al. (2000), p. 3].

Requiring efficiency and reinforcing institutions may result in the following consequences from the point of view of organizations that politically thrive under current conditions: (i) Reduced resources in order to increase the economy. (ii) Faster pace of work in order to increase productivity. (iii) Lower income owing to tighter competition. (iv) Genuinely reinforcing taxation while the state becomes stronger. (v) Requirements for reducing staff. (vi) Requirements for making the financial processes more transparent etc. [Sotsialno-ekonomicheskie... [1999], pp. 214-216].

The viewpoint of neutral bureaucracy represents a kind of objective modernization philosophy, according to which Russian society is becoming democratized, and the rule of law and the market economy stronger. Through the interaction of these factors, administration will gradually turn into a neutral bureaucracy, that is, administration legally controlled by civil society and providing stability for the market economy. In general, bureaucratization theories argue that while society becomes modernized it is also becomes objectively rationalized, that is secularized, bureaucratized, legalized, and commercialized. [Larjavaara (2001), p. 34-35]

Despite national differences in administrative models and some corruption, neutral bureaucracy is a major common institutional denominator of administrations in developed OECD countries. [Salminen and Temmes (2000), pp. 56-59].

New Public Management, the NPM doctrine, refers to development trends initiated and dominated the OECD countries since the 1980s: this aim at developing public management by bringing it closer to the methods of business management. NPM aims at reducing the dysfunctional features of neutral bureaucracy, such as excessive normative regulation, without undermining its legal basis. The NPM doctrine has involved increasing the market-orientation of administration and the freedom of managers, privatization, flexible organization structures, decentralization, dismantling of process control and, in general, all kinds of measures contributing to the “manageability“ of administration. [Larjavaara (2001), p. 35].

According to this line of thought, it is impossible to “bureaucratize” Russia, at least in the near future. The traditions of civil society and the rule of law are so weak in Russia that it is impossible to create neutral bureaucracy. If the reinforcement of administration is possible in the first place, NPM is the only way. [Yakobson (2000)].

The inapplicability of neutral bureaucracy is justified by the traditional weakness of democracy and the rule of law in Russia: neutral bureaucracy simply could not work. Neutral bureaucracy as an institution is essentially a creation of the rule of law, a certain type of Western democracy and market economy. As democracy, the rule of law and constructive capitalism could never be fully integrated in the Russian system, consequently neutral bureaucracy would be impossible, and any attempts to introduce of it are erroneous. [Salminen and Temmes (2000), p. 44].

The NPM doctrine has also been defended by arguing that it can be used to boost efficiency, at least to some extent, in the short run. Establishing bureaucracy cannot improve efficiency in a short time. Bureaucratization depends on many objective factors, which are beyond the reach of administrative reforms. Bureaucratization may become reality in the long run, but a NPM approach might yield some good short-term results, given the poor current standard of efficiency in administration in Russia. [Larjavaara (2001), p. 35-37].

It is interesting to what extent the popularity of NPM in Russia derives from the fact that it supports existing political and economic structures of power: hierarchies, manager-centredness, and unclear privatization of national assets. As public administration in Russia is also, more or less, private administration, development trends that favour the reduction of the legal regulation of management are naturally popular. [Larjavaara (2001), p. 37-38].

The idea of reinforcing neutral bureaucracy in Russia and development activities promoting this, such as the strengthening of civil society, can be seen as the most central framework for administrative development in Russia. Importing the NPM doctrine into Russia has chiefly been

found dubious, because it is feared it will reinforce dissolving, anti-legalist and person-centred trends [Salminen and Temmes (2000), pp. 64-65]. Russian experts in favour of bureaucratization argue that promotion of the NPM doctrine merely boost corruption. Those in favour of a strong state find that the liberation policy carried out by liberal economists in the early 1990s was clearly a mistake, if not a Western plot to make Russia weak. [Larjavaara (2001), p. 40-42].

The pursuit of neutral bureaucracy does not carry a special title in Russia; neither is it a coherent movement with a clearly defined group of supporters. The strengthening of civil society, legal order and the coherence of state organization principles are favoured and promoted by many, but there is no clear-cut, coherent theoretical trend. [Larjavaara (2001), p. 42-43].

Weberian neutral bureaucracy as a sociological institution and formal organization model are mixed up. Bureaucracy is primarily understood as an organization structure emphasizing hierarchy and discipline (again, this is not entirely unfamiliar in the West either), although this feature is hardly central in Weber's theories of modernization and bureaucratization, which are deplorably poorly known in Russia. [Pakulski (1986); Salminen and Temmes (2000), p. 56].

The direction and details of administrative reforms in Russia derive from the requirements of developing neutral bureaucracy. On the one hand, neutral bureaucracy develops alongside the modernization of society, but on the other, it can also be actively promoted. The central point is that the objectives and methods of administrative reforms in transitional countries are not the further development of existing neutral bureaucracy, as in the OECD countries: it is the creation of a neutral bureaucracy [Salminen and Temmes (2000), p. 56].

Several models are needed for a neutral bureaucracy to function, including all legislation so that administration as a legally formed entity could exist. The final level is the technical instruments such as management, budgeting, and information systems: these are required for the efficiency to become operational. The models may not suffice to improve administrative efficiency without the existence of a neutral bureaucracy. A neutral bureaucracy as a formal model, in turn, is of no use without the existence of a strong civil society. [Larjavaara (2001), p. 40-43].

The issue of fighting corruption well illustrates the field of administration theory in Russia. The "discipline school" argues that the problem can be tackled by increasing control; corruption emerged when the Soviet control weakened and disappeared. Anticorruption methods in Russia have largely represented this viewpoint [Konseptsiya... (1998), pp. 20]. The modernization school of thought find that to fight corruption, causes rather than symptoms need to be addressed: corruption is caused by the strong tradition of person-centredness in Russian administration, and it can be reduced by reinforcing structures and genuine bureaucratization. Russian supporters of NPM think that the problem is not corruption as such, blaming the artificial attempts to formalize administration, which force the system to try to operate through corruption [Salminen and Temmes (2000), p. 43].

The planning and implementation of administrative reforms has not been clearly assigned to a certain individual administrative unit. Several units have been involved and the power of execution has not been fully settled. [Nozdrachev (1999), p.107; Shkatulla (1999), p. 349].

The presidential administration decides which unit is to implement the programmes. Administrative policy clearly falls within the authority of the presidential administration, in particular when it comes to reforming the central administration. The division of labor between the president and the

government is such that while the former sees to administrative and legal policy and political governance of society. [Nozdrachev (1999), pp.102, 105; Shkatulla (1999), pp. 340, 347]

The presidential administration includes the Council of the Affairs of the State Administration. The Council investigates and assesses the state of the state administration and co-ordinates the preparation of laws for developing administration. [Larjavaara (2001), p. 45-50].

The operative tool of both councils has been the Department of the Affairs of the State Administration, which has executed the presidential ukases. In addition, there has been a Department of Human Resources Policy. At a later stage, these were combined into the Main Administration of Human Resources Policy and of the Affairs of the State Administration. [Nozdrachev (1999), pp. 104, 105, 300-301; Shkatulla (1999), p. 347].

The most significant ministry with regard to administrative development has been the Ministry of Labor Affairs and Social Development. It has executed administrative policies generated by the Government and it is mainly in charge of training officials. It is also responsible for recruiting, salaries, and social affairs. [Linkola and Luhtala (2001), p. 23; Nozdrachev (1999), p.107; Shkatulla (1999), p. 347.]

The Ministry of Justice and the Ministry of Finance implement tasks closely related to administrative policy issues. Regional and municipal administration development belongs to the Ministry of Federal Affairs, Nationality Policy and Immigration Policy. During the Putin term, strategic planning in general as well as administrative policy planning has been carried out in the Ministry of Economic Development and Trade. Administrative policy has also been planned in the Security Council of the presidential administration. If administrative reforms will be carried out during the Putin term, this council is likely to become a major executor. [Larjavaara (2001), p. 45-50].

It is generally thought that it would be desirable to have a single unit responsible for the planning and co-coordinating of administrative reform. The preparation and execution of administrative policy is not of best possible quality without a co-coordinating body. A state committee specializing in administrative development might be a viable solution for this. If the Putin term will see active measures in administrative reform, the formation of such a unit is possible. As administrative reform in Russia is, invariably, more or less a political activity, the power of execution and scope of the possible new unit remain unclear. [Larjavaara (2001), p. 45-50].

A mid-level unit would mostly be occupied with planning. It should have a permanent agenda to guarantee continuity. Administrative reform should be a continuous activity, instead of short-lived "programmes". [Linkola and Luhtala (2001), p. 26; Nozdrachev (1999), pp. 107, 108, 313; Salminen and Temmes (2000), p. 49].

3.3.2 Small-scale privatization

As far as small-scale privatisation is concerned, by 1 July 1994 as many as 75% of the enterprises were privatized in the field of trade (according to GKI statistics), 66% in public catering and 76% in consumer services. If we take the calculations, the figures are somewhat more modest: 55%, 47% and 55% of privatized enterprises respectively.

The most common method of small-scale privatisation in commerce and public catering is a lease with a buy-out right approximately 46% and 52%, while the numbers of units privatized by contest were 39% and 30%. In consumer services the prevailing form is sale through a contest (46%). Some

12% of all small enterprises were converted into joint stock companies, and other persons acquired 10% (not by the workers). And although the majority of buyers of the units in small-scale privatisation were the workers themselves (about 70% of all deals), nevertheless, as the estimates show [Rubleva, (1994)], only 10% of the work collectives in St. Petersburg could go about it without any “sponsor”. The latter actually means the appearance of a large co-owner at the majority of small-privatized enterprises.

The period of 1994-1995 was characterized with a general trend of a gradual slowdown of the small privatization that emerged since mid-1993. The trend can be attributed to a gradual exhaustion in the majority of the regions of the capacity of the enterprise subject to unquestionable privatization, and with the shift of the local authorities attention from the purely privatization problems to the matters of identifying a reasonable circle of objects in municipal property, post-privatization behavior of enterprises, their impact on the situation in terms of local markets for consumer goods and services, and the role of privatization revenues for regional budgets.

During the next years (1996 to 1997) the significance of the small privatization was increasingly declining, for the great majority of objects were privatized by that time. According to the 1st All-Russia Census of retail trade and public catering enterprises, as of November 1, 1994, throughout the country only 13.3 Thos. of retail trade objects and 2.2 those of public catering objects remained in government ownership, or 15% and 35%, respectively, of the overall number of economic agents in the noted sectors.

As a result, by early-1998, the proportion of private enterprises accounted for 85.9% of all the enterprises subject to the small privatization program, including 86.7% of those attributed to the trade sector, and 84.9% in public catering, and another 85% in the household services (in total over 81 Thos. enterprises).

Among the major problems typical of most of the objects of small-scale privatisation, it is important to note the requirement for retention of the profile of the business after privatisation, access to credits, optimization of the correlation between different channels of delivery of commodity resource, relations with the distribution warehouses, which became independent enterprises [Margolin, (1994)]. In many respects this caused disruption of the former supply links.

However the main problem remains the fact that most of the enterprises are being privatized without the premises, which are leased, and this is a kind of “hook” by which the local authorities hold these enterprises. The great majority of those are not at all inclined to ensure the companies’ full independence and apply a broad circle of economic and administrative mechanisms, including the rental status of real estate, price regulation for a certain circle of goods, control over the compliance with the privatization conditions.

In socialist economies, with large amounts of state and common property, less clear allocations of use rights than in market economies is typical. This fact is usually interpreted as causing inefficiency [Kornai, (1990); Moore, (1981)]. In post-communist countries, the collapse of the central political and economic planning institutions makes the allocations of use even less clear. This fact can provide an explanation for the immediate economic decline of post-communist countries [Olson, (1992)].

De jure allocation of rights to commodities and assets is typically precise. However, it is very seldom complete. De facto patterns of use complete the allocation, sometimes superseding de jure allocations. Since de facto alienation is typically imprecise, it prevents alienation and diminishes the

security from trespass and credibility of persistence. Therefore, neoclassical economics assumes a clear and precise allocation of private property rights to all commodities and productive assets. It is a precondition for Pareto efficiency of competitive equilibrium within a market economy. Markets fail to achieve Pareto efficiency when private property rights are not clearly defined. The use of private assets is generally more clearly allocated and therefore more efficient in terms of neoclassical economics. The reason is that it is assumed that principals using state-owned property have weaker incentives to specialize in monitoring than private principals [*De Alessi, (1983); Lott, (1987); Vining and Weimer, (1990)*].

3.3.3 MEBO

MEBO is an insider's model. The model is based on purchase of the enterprises and their assets by the employees and managers with the formal right of a consequent sale. Such practice has been rather widely applied in, Belarus, Poland, Romania, and Slovakia and on the second stage in Armenia. In Russia and Georgia this model as a matter of fact has become official "submodel" with large legal privileges to the employees in frameworks of MP.

The evaluations of actual participation of the employees and managers of enterprises in their privatization in various countries rather differ from each other. Nevertheless findings of many researches show, that the employees ownership has taken the certain niche within the framework of transitional economy. Influence of this model to corporate governance, as a rule, is relatively negative, though some contributors consider higher information possibilities of insiders to monitor activity of the managers. Obviously, that the last thesis in specific conditions of transitional economy is solvent only theoretically especially taking into account the fact that managers are the most influential insiders. [*Radygin, A (1995)*].

The management-employee buyout component stemmed from the substantial privileges given by the state to managers and employees of the enterprises offered for privatization. The program granted these groups the opportunity to receive a significant fraction of shares either for free or with substantial discounts.

Privatization of each enterprise started with a development of a privatization plan, which determined the procedures for the sale of shares various groups of potential investors, most importantly, employees and managers within the limits, allowed in the privatization program. The privatization program approves by the State Committee for the Management of State Property (GKI). The next step involved corporatization [*Primary goals and Methods Envisaged by the Program, ch.3*] which transformed state enterprises into open state joint-stock companies.

A Working Commission makes the property assessment on privatization. It is based on the balance sheet as of July 1, 1992. The fixed assets appraisal is based on the residual value (excluding depreciation) at 1985 prices. Beginning July 1992 all assets was re appraised for all cases other than privatization, the cost of re appraised assets now being 25-40 times higher. Therefore the value of privatized property is made up of two unequal elements: the cost of fixed assets at "old" prices, and the cost of current assets at "new" prices. Post privatization reappraisal of authorized capital is permitted, using unidentified coefficients approved by the Government for each type asset to adjust for current prices, if it does not change share participation. This may be accomplished either by increasing existing share per-value or distributing new issue of shares among all shareholders. Social, cultural and engineering infrastructure is not included in appraised property [*Johannevich van de Waal-Palms, P (1997)*].

Russian privatization program 1992-1994 was designed in way that offered the generous entitlements to managers and employees. These insiders were able to choose from among three options, or privatization methods, at a general meeting of their enterprise. Thus the insiders has the follow options [*P. Hare, A. Muravyev (2002) in "Privatization in Russia" and Pyotr Johannevich van de Waal-Palms (1997) in "The Objective of Privatization"*]

Option 1: Workers and managers could to receive 25% of equity in the form of preference (non-voting) shares for free, plus the right to purchase a further 10% of ordinary (voting) shares using cash or vouchers (at 30% discount on the January 1992 book value). In addition, senior managers of enterprises could purchase an additional 5% of the stock in the form of ordinary shares.

Option 2: Workers and managers could buy - for cash or vouchers - 51% of voting shares at 1.7 times the book value of the enterprise on January 1992.

Option 3: A managing group (that could include existing management and workers, or any other physical or legal person) that took responsibility for the execution of the privatization plan and the prevention of enterprise bankruptcy could buy 30% of the voting shares; a further 20% could be purchased by management and workers (regardless of whether they were part of the managing group) at a 30% discount.

In addition, employee shareholdings could be increased through so-called Employee Privatization Funds. Ordinary shares amounting to 10% of a firm's charter capital (if an enterprise followed the second option of privatization, the limit was 5%) could be assigned to these funds for subsequent sale to employees on preferential terms. These funds could be created only if the application for privatization was submitted before 1 February 1994.

Option 1 was first proposed as the main approach, but it met with strong resistance from managers who, through regional leaders and through their representatives in the State Duma, were able to put sufficient pressure on the government to have Option 2 included in the program [*Åslund, A (1995)*].

Managers, who preferred insider privatization, largely opposed the first model of the government. Industrial managers became the most influential lobby and were led by the Russian Union of Industrialists and Entrepreneurs. They found support both in the Supreme Soviet and in the government. Their position became even better, when Mr. Chernomyrdin became head of the government in December 1992 [*Frye, (1997)*].

The employees were also a lobby group. They had a vast number of votes and they could benefit from the attitudes and ideals of worker ownership, which were inherited from socialism. Because their union was weak and had always been dominated by managers, they decided to ally themselves with the latter to protect their interests against outsiders. Unemployment was the greatest threat to them. Employees were also under tight control of the managers because of Soviet authoritarian management. Soviet enterprises, especially in remote districts, took care of their employees including their social life and entertainment. The employees were actually not independent or ready to resist management taking over the property of the enterprises. The managers also knew how to propagate their own takeover in the name of the "labor collective" [*Clarke and Kabalina, (1995); Krüssmann, (1998)*].

This combined lobby group of managers and employees compromised a second option that allowed enterprise insiders to buy 51% of the shares at a closed auction prior to public sale. 29% of the

shares had to be left for voucher privatization and 20% for the government to be sold through cash auction or investment tenders [*Frye, (1997); Gurkov, (1998); Radygin, (1995)*].

Option 3 was also included due to pressure from the managerial lobby, but in practice the government banned its use at large enterprises and by imposing a “no bankruptcy” condition finally made it rather unattractive for the managers. In all three options, given the rapid inflation in Russia during the relevant period, the prices that insiders were asked to pay for enterprise shares were scarcely less than nominal. In this sense, the mass privatization really was a give-away operation.

As for the mass privatization component, the program envisaged that not less than 29 percent of shares of each firm would be sold at a voucher auction, though in reality the figure was closer to 20 percent. How people disposed of their vouchers was interesting: about half were invested by employees (and, as a rule, their relatives) in their own enterprises, either through closed subscription or through voucher auctions. A quarter of the vouchers were sold, and the remaining quarter was invested in voucher investment funds. These were closed-end funds that issued their own shares in exchange for vouchers invested by people; they were not obliged to repurchase the issued shares. The number of voucher funds peaked in 1994, amounting to 662. About 25 million people – over 16 percent of citizens – became shareholders in these funds, which acquired over 10 percent of the assets of the firms offered for privatization [*P. Hare & A. Muravyev (2002)*].

The last component of privatization – the competitive sale of shares at investment tenders or cash auctions – typically involved 10 to 20 percent of the shares of enterprises. In an investment tender, which was a competition between investors to buy a block of shares, bidders had to agree to provide the company with additional assistance in the form of capital investments or technology. Similarly, cash auctions also produced capital for enterprises.

In 1993 was destabilizing factor that we can consider the dominant one through mass privatization. Practically no responsibility to superior organizations, almost no responsibility for property, and an exceptionally thin line separating what is, from what is not one's own [*Galkin & Privalov, (1993)*]. So it was the interest of the former managers and directors made powerful attack on the principles of privatization within the government itself. They had tried the follow:

- 1) The desire of sectoral ministries to cancel decisions on privatization already taken;
- 2) Attempts to introduce limitations on incorporation and privatization from the sectoral point of view (estimates show that in the first half of 1993 the fuel and energy complex about 65% of state property removed from the process of privatization);
- 3) Unjustified attempts to secure ownership of federal property controlling blocks of shares of enterprises (as a rule, delegating the authority to run them to the appropriate department or agency); for instance, by the end of 1993 controlling blocks of shares in 305 enterprises were in federal ownership, while the authorized capital of 158 enterprises included a “golden share”;
- 4) Formation of giant holding structures including the delegation of the controlling block of shares in the parent company to the corresponding departments.

These attempts were made in 1993 and today we see that Russia has many unsolved problems because of creation big holdings-monopolist, and that creates new ownership class “Oligarchs.”

Another major factor is the legal environment. Twenty one decrees, laws, provisions, memorandums and directives have been issued between 1991 and 1993 by the Supreme Soviet, The President, Ministry of Finance, The Government, and State Committee of State Property, all having competence and jurisdiction and authority for their acts. By the time a full normative base for privatization was elaborated and adopted (over 200 key documents in 1992-1994) certain documents already became obsolete while the agenda had some new items associated with the post-privatization experience of many enterprises.

There are many problems associated with the mass violation of the privatisation legislation. In 1993 alone as many as 7000 violations were detected by the Office of the Public Prosecutor, all of them relating to the issue of privatisation, while the courts of arbitration received as many as 700 lawsuits. The most typical crimes are deliberate reduction of the book value of enterprises, forgery in lease contracts, sales of enterprises not authorized for privatisation (in the form of granting a lease with a subsequent buy-out right) and creation of close joint stock companies by-passing the law, use of the services of “dummies” at auctions and contests and so on. It is inevitable that citizens face a new wave of crimes and law violations in connection with a policy of property redistribution.

The above mentioned facts point to a key problem: creation of a favorable legal and economic environment for shaping a responsible and efficient owner, in the situation where the initial structure of the property for such owners is only just being formed, in the course of privatisation (and here I mean both domestic and foreign owners). This structure does not promote the shaping of such owners. That is why, while maintaining the stability of the current legislation, it is also essential to provide for reasonable revision of the current regulation base.

This is a typical example of privatization law: When 100% of an enterprise is sold by a commercial or investment tender, employment guarantees under Russian law continue to apply to the work force. When restructuring is to an OJSC (Open Joint Stock Company), general provisions of law subsequently apply to eventual termination of the work force and further employment of personnel. New owners must conclude a collective bargaining agreement within 6 months after acquiring ownership. Tender agreement may include provisions for extending the existing jobs, up to one year, including social guarantees and social programs such as schools and housing and hospitals, which are the obligation of the enterprise. There may also be requirements and commitments to maintain previous production levels of certain products and the obligation to maintain such requirements in subsequent resale of the business, unless it is agreed to close down the business or modernize it. [*Johannevich van de Waal-Palms, P (1997)*].

As a result, by September 1994 there were already 100,000 privatized enterprises in Russia that made 74% of all state enterprises with a separate balance sheet at the same period, while on January 1993 the corresponding figure was 10%(in this research is examining only industrial firms) [*OECD, (1995)*].

Most small enterprises had been privatized, and of the 24,000 or so medium and large enterprises, most had been corporatized and over 15,000 privatized by the end of 1994. Privatization then lost momentum to some extent, and continued at a much slower rate in subsequent years. Nevertheless, the main goal of separating the business sector from the state to limit the scope for state interference into enterprise activity was formally achieved.

The aggregate analytical data on the privatisation process in Russia in 1993-1994 on the whole exceeded the corresponding indicators for 1992. Although some indicators of the rates of

privatisation visibly fluctuated within the year, and this was especially noticeable in the regions, the rates of privatisation intensity went up significantly (the number of applications implemented the number of enterprises subject to privatisation rose to 0.820 in June 1994 and average figures were of the order of 0.369 and 0.582 in 1992 and 1993). It should be noted that such apparently successful results of privatisation can be accounted not only by the enthusiasm of the “micro level” and the activities of GKI but also by the build-up of certain counter trends: the rates of submission of applications diminished, which led to high implementation figures. In other words, by the end of 1993 we can say that the peak of the voluntary and initiative privatisation had been passed at the micro level, and those enterprises that were left can hardly be as active as in the period 1992-1993. [*Radygin, A (1995)*].

Secondly, the privatization program resulted in substantial ownership by managers and employees. Over 70 per cent of the firms offered for privatization chose Option 2, just over 21 per cent chose Option 1 for their privatization, giving insiders - managers and workers taken together an overwhelming degree of control at most enterprises [*Earle, J and Estrin, S (2001)*].

It is worth noting, however, that the incidence of employee ownership was much smaller in large enterprises, which represented the jewels of the economy. While, for example, 61 per cent of all enterprises that were privatized through corporatization in 1994 chose Option 2, their share in the total charter capital of all privatized firms was only 19 per cent [*IET, (2001)*]. In other words, in large, capital-intensive enterprises, insiders were unable to accumulate enough funds to buy 51 per cent of shares under Option 2; as a result, these firms mostly followed Option 1 privatization.

Thirdly, outsider control over firms was rare immediately after privatization. Outside ownership was typically spread among numerous investors so that none had enough votes to influence corporate decision-making processes significantly. In particular, the role of voucher investment funds, which were originally considered as a potentially important locus of outsider control and a vehicle of restructuring, was limited. The most visible manifestation of this was the sharp reduction in the number of funds, so by mid-1997, only 350 funds remained out of the 662 existing in 1994. More importantly, the funds only played a minor role in the governance of privatized firms, mostly because their shareholdings in individual companies were limited by privatization regulations. Even when they had enough shares, they often lacked the necessary expertise in managing industrial enterprises. [*P. Hare & A. Muravyev (2002)*].

Finally, the funds could not provide financial resources to enterprises as they often held relatively illiquid shares in poorly performing privatized firms that did not pay dividends. The Russian experience simply confirms many of the concerns regarding the role of voucher investment funds in privatization expressed [*Ellerman, D (1998)*].

3.3.3.1 MEBO Result

In the absence of foreign investors or domestic financial institutions able to invest, or interested to invest management-employee buy-out scheme are one of the few methods of privatization that result in a set of owners able to act as a coherent unit primarily in small and medium sized firms and bear the cost of their own actions or inaction's.

But it is asked, if MEBO was such a good idea, what about the substantial MEBO that resulted from the Russian voucher program [*Blasi et al. (1997)*]. The advisers favoring employee ownership did not pay any attention that using a worker ownership, as a part of voucher program would require a mechanism for collective decision-making. By the privatization law individuals were allowed to

sell-out their shares that met dilemma situation with the eventual non-cooperative solution of most workers to sell out their shares to the managers because of delay in salary.

The Russian MPP works to concentrate ownership in the hands of the top management. Even if the first idea was the equal distribution of property, the end result speaks for itself. Because the MPP was designed and implemented to undo insider social capital and to legally disempower the insider coalition of stakeholders with the collective interest in preserving and improving the enterprise as a going concern it is a bit disingenuous to picture the assets stripping by the top of managers. Was this incompetence or just planned redistribution of wealth we don't know, but I think any economist may do forecast that in absence of money on workers and citizens in all even for support normal level of life the wealth should be moved from whole population to hands of some limited number of person. In any way it can be counted as a failure of management-employee buy-out and accepted as a management and directors capture of wealth.

Also interesting the fact that in official statistics the enterprises repurchased by their labor collectives, bought by private person as well as transformed in joint-stock companies were considered as being privatized. In the later case, in dependence on distribution of shares, an enterprises may remain under the state control, under the control its managers and directors and the labor collective, or under the control of outside investor.

From the point of view of property rights a cursory glance at the writings of Adam Smith for example, would tell us that the invisible hand would lead the markets in the right direction, and that the initial distribution of property rights was of secondary importance. Freed from the state's heavy, possessive control, markets all by themselves would reallocate ownership titles and arrive by way of bargaining at an optimal configuration maximizing joint utility.

If we believe in Adam Smith theory Management and employee buyout method allows to accomplish rapid separation of hundreds even thousands of enterprises from state control when a country does not have massive technical assistance available and developed markets.

Management and employee buyouts under the rapid privatization model accomplish privatization quickly but ignore other issues. The real restructuring is coming after privatization for many firms. But the rapid model does not automatically restructure all company's activities. Boards of directors, core owners who can exert discipline on management, and public markets that can provide liquidity to investors and market information are not all created.

The practice shows that even if shares were not sold to managers that took place on about 60% of industrial enterprises that were privatized and transformed in joint-stock companies of an open type (by privatization law) in rough approximation are under joint control of managers and labor collectives. Out of them almost 40 % of enterprises the workers has the main pack of shares (it is necessary to remember that it was only on beginning stage) but the real control was in manager's hand. Thus not dependent do the workers have small or big package shareholders they are not organized, as a rule isolated and have no opportunities to realize the rights of owner even when control over enterprise formally belong to them.

The actual distribution of property rights considerably differs in the rates and nature from surface changes in the organizational and legal status of enterprises, in it turn determines the specific character of the shifts in economic motivation. The latter depends, however, not only on the redwing of property rights, but also on earlier forms of economic behavior adopted by various

social groups. The social psychology of people changes more slowly than the legal and institutional shifts do. [*Kolganov, A (1995), pp.1-3*]

But what is unfortunately the strangest thing that the majority of privatized enterprises without dependence in what way they have been privatized did not have at practice effectively acting owner. Motivation of managers and directors of privatized enterprises can not be characterized by positive shifts. The using by the state and privatized enterprises administration the capital of those enterprises for short term speculative operations in trade, on financial and stock markets has assumed a mass nature (of course at the first stage when they had wealth to sell) naturally that this operations were made not in interest of the strengthening of financial situation at given enterprises, but carried out for the purpose of personal enrichment. The transformation of the inefficient economic bureaucracy of the past to the modern, market oriented administrative elite is gradually formed not in the industrial sphere but in banking and financial sectors (that is also questionable subject because in present days they are belongs to oligarchs). The orientation to short term financial results, engaging basically in operations of a speculative nature slows down the formation of incentives for economic stability. The obvious disadvantage of long-term investment creates additional motives for fastening this negative tendency.

Of course, corporate governance is a component of modern economics. Just as classic economics like Adam Smith deals with the no benevolence of the firms toward their customers, corporate governance takes things one step further and deals with the no benevolence of corporate enterprise board members, and other agents toward the corporation.

But life is not so simple, that is why modern economic theory tries to balance the motivating factor of free enterprise with the role of governments and other mechanisms in bringing about efficient outcomes. Correspondingly, corporate governance tries to address the separation of ownership and management to bring the behavior of management as close as possible in line with that of its constituency, the shareholders. But unfortunately this world practice doesn't work in Russia.

The ordinary scheme of getting enterprise under control looks the same and on voucher step and on the step of MEBO. The general director of the company with the closest managers get together and by all the vouchers (or the major block of shares) from their workers. They easily do this because they had grown rich or moderately wealthy by embezzling funds from the enterprise in the preceding years, and because of the market price and vouchers and shares were so low the directors and their managers would end up buying control of the company for almost nothing.

The problem with the mass privatized companies is that the only participants who influenced the creation of corporate contracts were the general directors and bureaucrats. They were not particularly interested in attracting shareholders, because shareholders or debt holders did not form the capital base of the corporations. Potential shareholders merely traded in their vouchers and had no freedom to choose any kind of alternative. There was no self-interest on the part of the bureaucrats or directors to collect more vouchers, and therefore no motivation to constrain themselves, or even to form viable businesses. Instead, they did everything possible to get control and perpetuate their entrenchment in collecting rents from the enterprises.

During the Soviet period, the development of a strategy for extensive growth and the implementation of economic regulations through planning justified the existence of a particular type of majority public ownership. However, since 1992 Russian authorities have established, as a prerequisite for the implementation of the market system in the Russian Federation, a change in ownership relationships, which should basically be of a private nature. The aim of denationalization

or, technically speaking, privatization was the end of the State's administrative activity and the eventual creation of a core of private entrepreneurs who would run enterprises efficiently [*Lipton & Sachs, (1990)*].

That is, the denationalization process did not only involve privatization of the ownership rights, which would become basically private, but also a management change on the macro and the micro economic levels. However, this change in managerial issues requires a long period of time to yield the desired result, given that actors would prefer to continue performing under a set of informal rules inherited from the former framework which is still more profitable for them. The fact that those actors are characterized as rent-seekers implies that an enormous amount of economic resources would be invested in arranging particular interests through collective choice mechanisms and, therefore, do not eliminate the supposedly existing transaction costs from which the new framework of property rights is built. [*Julián I. Pla & Sobrecases F. García (2001)*]

3.3.4 Foreign Direct Investment

Foreign involvement on this stage of Russian privatization was virtually negligible, and most of the FDI entering Russia whether for wholly new undertakings, or related to privatization and restructuring was heavily concentrated in just four areas: Moscow City, Moscow oblast, St. Petersburg, and Leningrad oblast' [*Broadman and Recanatini, (2001a)*].

More recently, it is clear that FDI inflows remain highly differentiated by region, being concentrated in those areas already relatively developed and in receipt of most western technical assistance [*Bradshaw, (2002)*].

The means of foreign investors were as a rule modest. For example, for the entire 1993 they comprised only 121 million dollars and 570 million rubles, with 70.8% going for federal enterprises. This should be considered against the total volume of investment in the Russian economy (together with credits) of the order of 6.6 billion dollars [*Efremova, (1994)*]. The major portion of foreign investment was from Germany and went into manufacturing industries, as well as from the USA and Italy in other fields of industry as well.

As reported by Goskomstat of RF, the sectoral structure of foreign investment in 1993 was: mechanical engineering and metal-working - 23.2%, fuel industry - 16.3%, commerce and the catering sector - 15.2%, construction - 5.3%, wood-working and paper and pulp industry - 4.5%, production of construction materials - 3.8% [*Delyagin, (1994)*]. The most attractive regions were Moscow (which is at the same time a zone of risk and uncertainty from the point of view of investment), Krasnoyarsk, Omsk and Archangelsk.

Experts estimates [*Bolmatova & Evseev, (1994)*] show that Russia could absorb some 10-12 billion dollars of private investment per year, and ideally the figure could be as high as 40-50 billion dollars annually. During 1992-2000 the investment climate for foreign capital in Russia deteriorated. The privileges and guarantees provided by the law on foreign investment were eliminated, there were no more tax holidays, and no right to dispose of currency gains freely. Duty-free export of goods of one's own production and customs benefits for the import of goods for one's own production needs were also abolished. Probably what is happening is that the 1992 policy of creating a favorable investment climate for foreign capital is giving way to a policy of protectionism with regard to domestic enterprises (major monopolists in production and state-owned enterprises).

It is a paradox but in these conditions practically all observers report a surge of foreign investment in the sphere of Russian privatization from the end of 1993. As the preliminary GKI data show, not

less than 10% of the stock of the enterprises privatized in 1992-1993 now belongs to foreign-owned companies. By various estimates the growth of foreign investment comprised from 138 to 400 million dollars in the first quarter of 1994

3.3.5 Voucher Privatization

Russia in 1992 was a huge country with a weak central government, that had neither will nor capacity to force privatization onto unwilling company managers. The prevailing Western advice called for “shock therapy” rapid decontrol of prices, freeing of markets, and privatization of industry. Speed was thought critical, both to revive the economy and to reduce the state’s role in the economy before popular tolerance for the dislocations that accompanied the shock was exhausted and reform lost its political momentum.

As shock therapist Jeffrey Sachs wrote: “The need to accelerate privatization is the paramount economic policy issue facing Eastern Europe. If there is no breakthrough in the privatization of large enterprises in the near future, the entire process could be stalled for years to come. Privatization is urgent and politically vulnerable”. [*Sachs, J (1992), p., 71*].

Privatization of state-owned enterprises in developed countries has proceeded primarily through one-company-at-a-time auctions, generally with reasonable transparency. [*Jones, S.L; Megginson, William. L; Nash, R.C & Jeffrey. M. Netter, (1999), p., 217*].

But countries attempting the transition from centrally planned to market economies had thousands of state-owned enterprises to dispose of, many of modest size, only, some of which were viable. One-at-a-time cash auctions couldn’t meet the shock therapists’ timetable and involved large transaction costs relative to enterprise value. Mass cash auctions were thought likely to exhaust the citizenry’s funds and to risk political backlash if companies were sold to wealthy crooks, ex-government officials, or foreigners. [*Boycko, M; Shleifer, A & Vishny, R.W (1995), pp. 71-72*]

Mass voucher privatization became the favored alternative. Citizens would be given vouchers, which they could use to buy shares of privatized companies. The Czech Republic showed the way. Czech voucher privatization began in 1991, was well underway in 1992 when Russia started up the same road, and was largely complete by 1994. Czech industry was mostly in private hands, and a new investment fund industry had sprung up to collect vouchers from citizens and invest in privatized firms. These “voucher investment funds” promised diversification, plus strong outside owners who could replace managers who couldn’t make the transition to a market economy. And the wealth giveaway from voucher auctions made them initially popular. [*Black, B; Kraakman, R; Tarassova, A (2000), p.1741*]

When we look at the most successful Czech and Slovak privatisation model we see that citizens had the choice of directly converting their vouchers into shares via auctions or placing them with investment funds, which in turn would bid for enterprise shares. For the first wave of the Czech and Slovak programme roughly 8.5 million citizens paid a nominal subscription fee to obtain vouchers. In Lithuania, subscription was virtually universal as vouchers were also used to purchase apartments. In Russia introduced a nation-wide voucher scheme on 1 October 1992 and vouchers were distributed to all Russian citizens for exclusive use in the MPP.

Vouchers are certificates or scrip that is distributed to the population that they can to convert into shares in SOEs through some form of auction process. Although mass privatisation schemes and vouchers are not inevitably linked, they are generally associated with each other. In at least ten NIS,

vouchers are being used to speed up the privatisation process and to assure a fairer and equitable distribution of the wealth previously held by the state. By wide-scale distribution to the population, vouchers are intended to generate both popular supports for the MPP and demand for shares in SOEs being privatised.

Russia followed in the Czech Republic's footsteps, with some important differences. In the Czech Republic, most of a company's shares were distributed in voucher auctions; only a limited number of shares were reserved for managers and employees. A small number of voucher investment funds accumulated most of the vouchers and bought large stakes in most major firms. This gave most Czech firms major outside owners.

The Russian government lacked the capacity to force privatization on unwilling managers. The political solution was to bribe them with cheap shares so they would pursue privatization voluntarily. Employees were also given large numbers of cheap shares, in a political bow to the Communist ideology of worker ownership of the means of production. The result: Most privatized firms were initially majority owned by workers and managers. A typical outcome was 60-65% manager and employee ownership, perhaps 20% ownership by individuals and voucher investment funds, with 15-20% still held by the state, which planned to sell its remaining shares for cash in the future. Given Russian workers' passivity and ignorance of free markets, this ownership structure led to manager control of most enterprises. [Black, B; Kraakman, R; Tarassova, A (2000), p.1742]

Russian managers' personal stake in their companies was often modest to begin with, but rose quickly. In Russia, vouchers were tradable. This let managers buy vouchers that they could trade for shares in their own companies. Managers often got the funds to buy vouchers by illegally "privatizing" company funds. They continued to accumulate shares after the voucher auctions were completed, by convincing or coercing employees to sell their shares cheaply. [Blasi, Kroumova & Kruse (1997)].

Voucher because of lack of cash

There is wide opinion that voucher privatization is necessary because of lack of cash. The basic argument is that citizens had no cash to buy shares. In Russia it was a method to correct previous mistake with the price liberalization program. After first privatization program implementation Russians had no wealth to buy any shares, and also other reason that assets to be privatised were so huge that it was not possible privatize them through cash auctions.

At first glance, it would seem that the use of vouchers would reduce the total cash proceeds to the state from the sale of SOEs, to the extent that vouchers displace cash in the auction process. However, a case can be made that the proceeds to the state will be reduced by much less than the amount of vouchers issued or not at all. Vouchers may stimulate the privatisation process as much as advertising and sales coupons stimulate purchase of consumer goods in the West. Information dissemination and educational materials related to vouchers and privatisation are likely to promote overall interest and willingness to participate in the process. Moreover, citizens of former socialist countries have a limited amount of cash or other financial resources to bid for shares in SOEs. In the absence of vouchers, the prices received for these shares may be lower than that justified by demand, reflecting the lack of cash. Issuing vouchers could increase the financial resources available for purchasing these shares, thus increasing the sale price and the overall proceeds to the state in the form of vouchers and cash.

But also is necessary to remember that use of vouchers may be inflationary. Vouchers are essentially an increase in the wealth of citizens and in most cases, a highly liquid form of wealth

that can easily be sold for cash to finance consumption. While the Czech and Slovak programme officially restricted trading, some citizens nonetheless traded their vouchers for cash. Moreover, the supply of shares (firms) available for privatisation and voucher conversion are likely to lag behind the demand created by the widespread distribution of vouchers, since it takes some time to organise a mechanism through which vouchers can be converted via auctions or bids for shares. This may increase the propensity to trade vouchers for cash and thereby increase current consumption and therefore inflation.

The magnetisation of vouchers and the velocity of their turnover are, therefore, likely to have some impact on inflation; the magnitude of which must be estimated when the system is designed. The Czech and Slovak voucher system sought to mitigate the inflationary effects of vouchers by making them nominative, limiting their use to conversion for shares in funds or into shares in privatised companies, and denominating the vouchers in points, not in currency.

Voucher distribution and its use in Russia

Between October 1992 and January 1993 150 million Russians could pick up their vouchers at their local Saving Banks. The fee for the voucher was only 25 roubles (5 cents at the prevailing exchange rate). That because privatisation in Russia was much more populist than privatisation in Czech and Slovak, the idea of charging a reasonable participation fee (US\$35 in Czechoslovakia) to eliminate marginally interested citizens was rejected. By the end of January 1993 almost 97 per cent of vouchers were distributed.

Shortly after its introduction, the voucher became the first liquid security in Russia. It is actively traded on dozens of organised exchanges throughout the country. On the largest exchange in Moscow, the Russian Commodity and Raw Material Exchange, the volume of trade easily reaches 60-100 000 vouchers per day (US\$600 000 --US\$1 000. 000 at prevailing prices).

The pace of voucher auctions

Voucher auctions began in December 1992, when 18 firms were sold in eight regions. By April, the pace of sales reached 613 enterprises in 58 regions. In June, sales reached almost 900 firms, which seem to be a sustainable monthly rate. Altogether, 8 292 firms have been privatised in voucher auctions by the end of 1993.

One of the options is to look at the sales in terms of the number of employees who work in privatised companies. By the end of 1994, almost 8.8 million employees worked in firms privatised in voucher auctions, which represents roughly 45 per cent of the manufacturing labour force in Russia. In June through December the privatisation rate averaged 900 000 employees per month, or about 4.5 per cent of industrial employment. This rate continues to 1 July 1994, when vouchers were set to expire, another 5.4 million Russian industrial workers end up in the private sector, so that the total will amount to over 70 per cent of manufacturing employment. This is rather fast for 18 months of mass privatisation in a country where no other reform has been worked.

Both the critics and the advocates of the voucher model, which expired on 30 June 1994, agree on one thing: the formal, quantitative success of the programme of mass privatisation is indisputable and evident. As to the results of the programme, which are beyond simple quantitative measurement, they always were and are now a subject of heated and meaningful discussions as well as of irrational speculations for political purposes. So to attempt to sum up the results let us go back to 1992 and try to understand the real situation and purposes of the privatisation voucher.

Let start research Russian voucher model (summer 1992) with the reminding of conditions in which has started privatisation process:

1. absence of effective demand of the population,
2. zero interest in privatisation in Russia on the part of foreign investors,
3. the presence of over 240,000 state-owned and municipal enterprises (which required standard procedures for privatisation),
4. the necessity of the highest possible rate of legal privatisation (at the first stage) to block intensive spontaneous privatisation and ensure an irreversible type of economic change,
5. the relatively favourable public opinion.

The Government of the RF on 11 of June 1992 approved the conception of Russia's voucher programme. The Russian Privatisation Vouchers were represented by state federal (and only federal) securities with a limited term of validity, each voucher with a face value of 10,000 rubbles, and were issued to the bearer, with the right of sale.

From 1 October to 31 January 1993 148 million vouchers was issued to citizens. There were no serious problems (such as the panic in Czechoslovakia when coupon books were issued during the last few days) in the course of handing out privatisation vouchers to individuals.

In the course of implementation of the voucher programme one of the key issues was the real purchasing power and market price of a voucher. The initial position of GKI was that it had to take into account the real value of state enterprises and other property that could be sold for vouchers (35% or 1.4 trillion rubbles in old balance sheet prices). It was stressed that vouchers were for use to acquire property at the old prices of the last balance sheet valuation and for that reason the actual purchasing power of the voucher should be considerably higher than the equivalent sum in roubles in 1992, and market price would therefore have a tendency to go up. So while in October 1992 representatives of GKI gave an optimistic purchasing power estimate of 200-300,000 roubles per voucher, in December that figure dropped to 12-13,000 roubles. [*Radygin, A et. al (2002)*].

On the first days of October 1992 an exchange and over-the-counter vouchers market was formed and it showed a price spread from 200 roubles to 70,000 roubles. The first stock exchange transactions were begun at the Russian Commodity and Raw Materials Exchange, with a voucher value of 5000 - 10,000 rubbles. During 1993 the rate went up from half to twice the nominal rate and on average it stayed at the level of 20,000 roubles during the first months of 1994 and finally, with all its fluctuations, reached some 40,000 roubles [*Radygin, A (1995)*].

To begin with, the current market price for the voucher was taken as the basis of the preliminary "market" valuation of shares and enterprises after voucher auctions. Obviously, however, the actual market price of the shares could only be determined on the secondary market, and this market, of course, was in a rudimentary stage.

Secondly, it was the current market price of the voucher (real expenditure for its purchase) that one considered to assess the profitability of purchase of any particular shares at voucher auctions. We don't have to forget that: the voucher price of shares was set not so much by the financial position of enterprises, but rather by the number of shares offered for sale. Thirdly, the current rate for the voucher influenced the volume of purchases of vouchers, especially by the enterprises themselves.

Many times the government took steps to support the voucher price on the market (considering it as a pledge of its prestige): these included increasing quotas for voucher payment for property up to 35-90%, bringing land, housing and municipal property into voucher sales, granting permission for

enterprises to purchase vouchers out of their privatisation funds, mandatory payment of 50% of the closed subscription by means of vouchers and so on. However, accelerating the incorporation process has always remained the key issue to ensure further voucher auctions.

Sale of Shares and Voucher Auctions

In accordance with the course established by GKI to ensure priority of the voucher privatisation, the regulations stipulated a rigid sequence in the sale of the shares of enterprises. They were closed subscription for workers, sale of shares (it should be stressed that here speaks about shares and not blocks of shares) at a voucher auction, and only then out of the fund for incorporation for the workers of enterprises and other techniques. All enterprises that were forced to effect incorporation were divided into 5 arbitrary groups, and for those that incorporated voluntarily the group depended on the period of registration as a stock company. Each group would have a time limit to conduct voucher auctions [*Radygin, A (1994)*].

The number of shares as subjects for sale at a voucher auction were determined as the total number of shares (from 35% to 90% depending on the level of property), minus the number of shares sold for vouchers via closed subscription and to the officials of the administration on preferential terms. Later a single mandatory quota of shares that were put up for voucher auction, 29% of the total number, was determined. The first type of application - without indication of the minimum of shares per voucher-should be satisfied completely, and the second type of application - with an indication of the price-should be satisfied depending on the demand for shares.

Taking into account the experience of the first auctions, provision was also made for splitting the nominal value of the shares to satisfy all the applications of the first type.

According to GKI estimates, the most popular (until the shares of the fuel and energy complex appeared) were certain types of enterprises in mechanical engineering, and in the food, tobacco, furniture and wood-working industries, as well as hotels, enterprises located in the most prestigious regions, the largest enterprises (in view of the liquidity of their shares) and small businesses (the hope here being that it would be easier to establish control). A marked spread of the rates can be observed, depending on the region, with the weighted average for all regions being. The “cheapest” shares were in enterprises in provincial areas (up to 405,000 rubbles in nominal value of shares per voucher) and the most expensive were in enterprises in the capital which were small in size and located in the centre. Here there was a direct relationship between the number of shares put up for sale (and accordingly the size of the authorised capital) and the auction rate. [*Malginov, G et. al (2002)*].

Analysis of the sectoral structure of the vouchers invested in the actions shows that enterprises of eight branches of industry accounted for 70% of the vouchers the distribution by sectors of industry was as follows: mechanical engineering (11.4%), metallurgy (11.1%), chemical industry (10.5%), oil and gas extraction (9.1%), oil-refining industry (8.9%), power industry (8.1%), postal services and communications (5.8%), transport engineering industry (5.0%) [*Privalov, Bessonov, Kalinichenko et al., (1994), p.61*].

Among participants in voucher auctions were not only enterprises themselves but also their intermediaries, voucher investment funds and large institutional and private investors. And if small investors tried, first of all, to invest their vouchers in those enterprises that seemed “reliable” from the point of view of the average person, the motives of funds and large investors are quite different, they are: a plot of land, a buildings, the actual profitability of an enterprise, resale of a large block of shares, the possibilities of reconstruction and increase of capacity and, finally, export potential.

For the enterprises that wanted to buy their own shares back had not any chance and they bought any block of shares to get controlling package. That types of enterprises were welcomed to auctions however, there were other advantages not to be overlooked: a possibility of becoming a full-fledged buyer (and thus trust-holder) in privatisation when the share of the state is reduced to 25% of the authorised capital, the buy-out of a plot of land (this being possible only after a voucher auction) and some other such considerations.

Naturally, in most of cases the initiative to buy back shares would come from the management, operating on the basis of the pattern tried out recently. A typical example of such activities is one of Russia's largest enterprises in the motor industry, JSC GAZ, which used 15 dummy companies and over 1 million vouchers to buy back shares at its "own" voucher auction [*Romanova, (1994)*].

In addition to the fact that such investment is not legally permitted (with an assigned state share GAZ cannot operate as a buyer in the course of privatisation), the funds used for these purposes are also probably state-owned. It is also evident that until the work of the Government Commission is completed the applications (and the funds) of all legitimate investors are frozen, especially if one takes into account the fact that the previous results of the auction may be cancelled and a new auction may be ordered. [*Radygin, A (1995)*].

Another trick designed to "cut out" unwanted investors that submit their applications at the very last minute is closing the place that receives the applications earlier than it should have been, as was done by AVTO-VAZ in Moscow [*Kalinichenko, (1994)*].

To attribute some appearance of legality to this trick it is necessary to obtain the right organiser of the auction for one's shares, a trick that was quite successful with the largest oil companies in Russia. Another trick is holding a formally open voucher auction but on the closed territory of an enterprise or at some other inaccessible place [*Ulyanov, (1994)*].

Some auctions were marked by other irregularities. Under the auction design, if fewer vouchers were bid for a company's shares, more shares would be distributed per voucher. This gave insiders an incentive to discourage others from bidding. There were various ways to achieve this result. The auction location could be hard to reach (Russia is a large country with limited transportation), or could be announced or changed at the last minute. In some cases, phone calls and air flights into the city where the auction took place were conveniently disrupted shortly before the auction, or armed guards excluded unwanted bidders from the auction. The more valuable the company, the more likely its managers (or well connected outside investors) were to use tactics like these. And perhaps 1000 of the 15,000 mass-privatized firms cut special privatization deals with the government.

Finally, the largest enterprises were held out of voucher privatization, with the government distributing at most a minority stake. In several important industries, the government created pyramid structures, bundling controlling stakes in a number of operating companies into a few holding companies, and later sold controlling stakes in the holding companies. The government created seven oil holding companies: Lukoil, Sidanko, Sibneft, Rosneft, Tyumen Oil, Yukos, and VNK. Electric power (with United Energy Systems as the principal holding company) and telecom (with Svyazinvest as the principal holding company) followed a similar pattern.

Pyramid structures everywhere are an invitation for controlling shareholders to siphon wealth from companies that they control, but have a limited economic stake in. [*Bebchuk, L, Kraakman, R & G. Triantis (2000)*].

This risk is controlled imperfectly in other countries because the pyramid commonly begins as a wholly-owned corporate group. The controlling family must develop a reputation for honesty, or no one will buy the non-controlling shares that it wants to sell. The risk from pyramid structures was magnified in Russia by weak enforcement, plus controllers' ability to acquire control of a pyramid without first developing a reputation for honesty.

The privatizers knew that the auctions wouldn't be perfectly clean, and that manager/worker control of privatized companies would limit shareholder oversight of managers. They saw this as an acceptable political price to pay for rapid privatization. Even bad private owners were better than state ownership. As Andrei Shleifer, a principal Western advisor to the Russian privatizers, and Dmitriy Vasiliev, a top Russian privatizer, explained: "Russian ownership structures have been to a large extent determined by the political imperative of accommodating managerial preferences in the privatization program, since without manager support firms would have remained under political control. We believe that the ownership structures emerging from Russian privatization, while far superior to state ownership, still give managers too much control relative to what is needed to speed up efficient restructuring". [Shleifer, A & Vasiliev, D (1996), pp., 76-77]

Foreign Investment and voucher privatization

In general the participation of foreign investors acting through intermediaries can be estimated rather roughly at around 10-12% of shares put up for auction. There are many reasons why the figure is not higher: in addition to the general climate for foreign investment, there is the difficult access to auctions of enterprises of the fuel and energy complex, the a priori indefinite nature of the results of auctions, the impossibility of buying a controlling interest at auctions, the desire not to make purchases public and other reasons. In addition to the recent problems with the acquisition of vouchers and their investment, it is the impossibility of buying a controlling block that is perhaps the weightiest reason for non-participation of foreign investors in auctions.

Today one of the main reasons for participation by foreign firms in an investment tender is to secure a certain segment of the Russian market. For example, the British Morgan Crucible Co., which controls 24% of the world market for electrical carbon, acquired 15% of the shares of Uralektrotugli on condition that it invests \$1.5 million and with the right to increase the authorised capital. At the same time a primary goal of the British firm today is just finding a place for itself in the Russian market. [Boreiko, (1994)].

From the point of view of some experts, one of the goals of those few foreign investors, which did directly participate in privatization bids, is just their desire to weaken potential Russian competitors in the promising Russian market. Thus, analyzing the policies of Proctor and Gamble Co. With reference to Tula Novomoskovskbytkhim, A. Kosorogov, Chairman of the Board of Directors of Alfa Capital investment fund, put it this way: "what they want is to absorb the plant and then brush it aside as a competitor on that market". Moreover, according to the same source, despite the apparently impressive volume of investment programmes, on the basis of the results of the tenders already held (as reported in May 1994), "not a single enterprise, when the investment bidding was won by foreign firms, has yet provided its money" [Privalov & Chernakov, (1994), p.4].

Investment Funds in voucher privatization

It is quite clear that when investment resources are dispersed (as is the case with the population's vouchers) and when the population lacks knowledge of securities markets and investments, the role of the voucher privatisation funds should be exclusively to carry out mass privatisation.

A major package of documents adopted in October-November 1992 (Decree of the President of the RF of 7 October 1992 “On Measures to Organise a Market for Securities in the Process of Privatisation of State-Owned and Municipal Enterprises” and other such documents) determined most of the required procedures for the institution and operation of investment funds in Russia. As a result, Russia's legislation provided for the creation of investment funds, known throughout the world, and specialised privatisation funds that would accumulate privatisation vouchers on behalf of the population.

In any case, any stock company of the open type that simultaneously carry out activities associated with the attraction of the funds of the population through the offer of their shares and investments of their resources in the securities of other issuers, as well as trading in such securities, were recognised as investment funds.

In contrast to all other investment funds, a voucher fund had exclusive rights to exchange its own shares for citizens' privatisation vouchers and as such could only be a closed-type fund and could obtain its license only from GKI. Although a closed-type voucher fund should, by its very nature, stimulate long-term investment, keeping in mind the gain in the market value of shares, and limit the possibilities of a manager to establish majority ownership and control, nevertheless the non-liquidity of the Russian fund market and the appearance of a considerable number of such funds (basically second-rate funds) considerably undercut shareholders' possibility of “voting with their feet”. In other words, having exchanged his privatisation voucher for shares in the privatisation fund, the shareholder becomes a hostage forever of the operations of this fund.

By the end of 1992 GKI had issued licences for 34 investment funds, and in June 1994 there were as many as 630 such funds. For 1993 and the first half of 1994 the funds acquired more than 45 million vouchers, and more than 25 million people became shareholders in them. By May 1994 all the funds together had invested as many as 27 million privatisation vouchers [*Funds Monitoring Report, (1994)*].

The most active stage in the process of setting up voucher funds was the first half of 1993. Then the number slowed down from 15% in August to 1% growth rate in December 1993. In 1994 there was no marked growth of funds. On the contrary, the number was already being reduced by reorganization or merger, as well as bankruptcy, because some funds were closed since they had not started operation.

On the example of differentiation of funds, using net assets as a criterion, 1% of funds, eg. Alfa-Capital, First Voucher Fund and MN-fund, may be included in the category of the largest ones (with net assets over 10 billion roubles), 10% of funds may then be regarded as large funds (net assets ranging from 1 to 10 billion roubles) and over 50% of funds are medium-size funds (with net assets from 200 million to 1 billion roubles) [*INIOR, 1994*]. First Voucher may be regarded as the largest fund in Russia by number of shareholders: 2,100,000 people. The funds may also be subdivided into regional, inter-regional, sectoral, inter sectoral, specialised social protection funds, funds for army personnel and so on.

There are also differences between funds by the structure of their investment portfolio. Some experts [*Gorbatova, (1994)*] distinguish the following types:

§ large funds that pay primary attention to regional enterprises when trying to buy packets of shares (the price of shares being less than in Moscow); their main goal is obtaining a large packet to get (in future) a controlling interest and manage the enterprise (growth funds);

- § purely speculative funds, usually small or medium-size funds, which do not hold shares on their balance sheet for a long time, i.e. for more than 1-3 months (it was speculation on the difference between the auction and post-auction prices that yielded maximum profits in 1993-1994);
- § agitation-type funds, with no strategy of their own, and trying to invest in the most popular enterprises;
- § funds with an extremely diversified portfolio, mainly regional funds that invest in local businesses without any strategy of their own; “privileged” funds that got all sorts of benefits from the local authorities to stimulate their privatization effort (access to closed auctions, obtaining state packets of shares for a trust form of ownership, and other such forms).

In 1993 it was the speculative activity of funds in the market that became their main source of income. And these activities were extremely intensive in May 1993, after a Decree of the President of the RF “On Guaranteeing the Rights of Citizens in the Course of Privatization” was issued. That Decree put an end to the funds' sale of accumulated vouchers and stipulated that funds should invest the vouchers only in shares that are put up for auction.

The main category of speculative activity was the purchase of shares at a voucher auction in order to resell them to a client not present, as well as to ensure the purchase of rather large packets of shares (5-15% of the authorised capital) of the enterprises being privatised for the sole purpose of future resale to the administration of the enterprises (through all sorts of “dummy firms” controlled by the management), and purchase of shares in privatised enterprises to the order of clients.

Yet a majority of funds are low-income yielding or even loss-making, so dividends may be received only by the shareholders of a very limited number of funds. For example, out of 150 funds analysed by the “Skif” association in 1993, less than 30% were making profits. GKI experts believe that on average each share in voucher funds carries 4 rubbles of losses. Even the largest funds recognise that they could not provide gains for their shareholders. More than half of the funds decided that they should pay no dividends after their 1993 results and for those funds which did make pay outs the dividend did not exceed 2000-5000 rubbles per share [*Shimov, 1994*].

One of the problems for the funds was the question of taxation. Actually the shareholders of the funds were subject to taxes indirectly, through the imposition of taxes on the profits of enterprises whose shares are in the portfolio of the fund (32%), dividend tax when the fund receives dividends as a legal entity (15%) and the tax imposed on natural persons (shareholders of the fund). The second State programme of privatization (December 1993) freed voucher funds (for the first two years from the time of registration) from the dividend tax when these dividends were paid out by enterprises on shares owned by these funds, from the transfer of the advance tax payments on profit, and the tax payable when a prospectus for the issue of securities is registered. Yet that programme was adopted by decree of the President of the RF, while according to the law, all questions relating to matters of taxation are within the province of the legislative branch. This makes it likely that the decisions may be reconsidered.

Many experts believe that one of the most acute medium-term problems waste illiquidity of the assets of voucher funds. There was practically no secondary market in the shares of the investment funds. And while at the early stage the voucher funds virtually faced no competitors in selling their shares for the population's vouchers, the secondary market means sale of the shares for cash and this changes the situation drastically. The point is that large investors may have no interest in such funds. There was a hard struggle for the free capital of the population and the funds face competition from commercial banks and certain companies whose efficiency from the point of investment is much higher, both in terms of the size of dividends paid and in terms of the liquidity

of their securities. It is quite clear that only some of the funds could ensure the liquidity of their shares [*INIOR, (1994)*].

Investment Contests and Other Methods of Initial Sale

In addition to closed subscription for shares and voucher auctions, the following types of privatization were likely in accordance with the second state program:

- § sale of blocks of shares through an investment tender;
- § auction for money of 10% of the shares from those sold for privatisation vouchers;
- § sale of enterprises that are not joint stock companies by auction or commercial tender (including a limited number of participants);
- § sale of property (assets) of active enterprises, those that are being liquidated and construction projects still in progress, by auction or tender (including an investment tender);
- § sale of defaulting debtor enterprises;
- § privatisation of leased property.

Though on the surface there were a number of ways to effect privatisation for a large investor who wants to have a controlling block or close to a controlling interest, the choice in fact is not too great. One may, of course, participate in auctions and tenders for the acquisition of an enterprise as a whole, primarily municipal ones, but in that case a permit must be obtained from the local authorities (for a foreign investor).

Moreover, as practice in 1993 showed, the main interest of large investors was concentrated on the items of federal property, which were incorporated. As to purchase of a defaulting enterprise as such, or a part of its assets, this was also hardly possible without considerable procedural and legal difficulties. As a rule, the workers of those enterprises themselves bought out leased enterprises. Finally, there was a money auction on the basis of the provisions of the order on selling shares at auction for roubles up to 10% of the total number of shares of the stock companies sold at a specialised voucher auction. Shares could be acquired there, but even the simplest calculation shows that one could not get more than 2-3% of the authorised capital.

In this connection, the most promising and actually the only means that made it possible to acquire a controlling interest or a packet of shares close to a controlling interest was an investment tender. Under the Russian law the tender can only be open, and the criterion for selection of the winner was the amount of investment, discounted over the entire period of investment at the rate of the Central Bank of Russia at the time the tender was held. The period for making investments shall not last more than 3 years, with the payment for the packet of shares acquired being on the basis of the nominal price.

By the beginning of 1994 privatisation plans in Russia provided for some 280 investment tenders, out of which 160 had been carried out by January 1994 (3.1% of the number of mandatory incorporated enterprises) the average size of the block of shares offered was 18-22% [*Isaac & Minaev, (1994)*].

Because the blocks offered were split, the number of tender winners reached 208, including a few foreign investors - 15 foreign companies proper and 7 joint ventures. One can also mention here the participation of two commercial banks. The total sums to be invested amount to 1.2 trillion roubles, \$1 billion and DM 35.6 million, with an average investment programme running for some 2-3 years. So in principle even this small experience has shown that this method could be applied quite efficiently from the point of view of the attraction of resources and for that reason it was thought

that in 1994-1995 the share of investment tenders among all methods of sale should be considerably increased.

Naturally, this kind of sale was not without problems. The first was that the tender winners may not carry out their investment commitments and to avoid this they resort to some techniques that were on the verge of legality. For example, a considerable problem for many regions (and the reason for the failure of many tenders) was the absence of investors and resources for investment. Many enterprises with a promising future were hoping for mobilisation of investment resources once they were privatised. For a serious investor the assigned period of one month was not enough to research the market and take a decision on participation in a tender.

It may also involve direct violation of the law, and the creators of the law may commit these violations themselves: the GKI instruction no. 255-p or 4 February 1994 was certainly against the law (it was issued when a voucher auction of Avtovaz was held). According to this instruction 7% of the shares of Avtovaz were to be transferred to the authorised capital of All-Russia Automobile Alliance (thus the share of the investment tender was effectively reduced from 22.5% to 15.5%). An amendment could be made to the privatization plan, which affects the second issue of shares for the winners of the tender. And all this is done despite a strict ban on changing a privatization plan in the process of a voucher auction for all other subjects.

[Radygin, A (1995)]

In a context of this system definition become more clear also the key stages of system transformation in sphere of attitudes of the property.

This stages presenting as external economical strong-willed act - technical privatization which success depends on conditions of the social compromise (counting of concerns balance). External economic character stipulated by two circumstances. At first already prior to the beginning official technical privatization and during it there was a spontaneous process of privatization in legal and non-legal forms and only criminal. Primary privatization only legalizes the former non-legal property rights for example within the framework of attitudes between the state and directors of state companies. Secondly impulse for the beginning of this stage was the political will of a state authority. In case of usage of mass models of privatization and formal dispersion of property right in scales of society as addition to the legalization available non-legal rights of properties.

For this stage the most important was the derivation of a critical mass private and quasiprivate companies and also intensive quantitative formation of new institutes. In this case as definite criterion of its completion it was possible to consider deboosting of process of quantitative transformations and appearance of the first signs of qualitative shifts in the already formed institutes and their relations.

At the second stage happened the following: 1) intensive reallocations of property right after primary technical privatization and 2) regulating still chaotic interference of the state in this process of reallocation on a micro level. Criterion of completion of this stage is the definite stabilization of a system of new property right (property relations), and also qualitative and quantitative stabilization of a new system of economic gears and types institutional structures as the premise for the subsequent economic implementation of new attitudes of the property. For the third stage was typical occurrence a stable property right system for what was necessary completely finished complex of other units of system reforms.

At last it is important to legibly understand the purposes of privatization at miscellaneous stages of this process and definite criteria of its efficiency. In general formulation of question of targets of privatization is base conditions for normal operation of the future market system. The privatization as the technical act conducts to constant reallocation of the control from bureaucrats to managers of corporations and outside shareholders. The privatization has very clear advantages to an economic efficiency because it establishes the initial rights private properties. In a context of the approach which has been set up above, the final goal of privatization as unit of system transformations is first of all: 1) maintenance of stability of a new system property relations (that appear in formation of steady structure of property right and accompanying infrastructure and gears); 2) creation of conditions (gears, institutes) for self-reproduction of this system; 3) economic efficiencies on micro and macro level.

The first program of privatization (1992) became the establishment of document for the subsequent scale privatization in 1992-1994 and was simultaneously the compromise on the one hand between paid (for a fissile part of the population) and gratuitous (vouchers to all population and privilege to labor collectives) privatization and on the other hand between model of privatization for all and divided property among the workers of firms. This compromise became so obvious - from economic point of view - disadvantages of implemented model as a residual technique of appraisal of property defiance of re-structuring (engaging of the investments) companies before and during technical privatization problem of social infrastructures of companies the defiance demopolisation in the same time with a problem of preservation of technological circuits, absence of the noticeable foreign investments and number others.

Both and opponents and supporters of check model the period of validity of which had expired in 30 of june1994 converge only in one: the formal quantitative success of the program of mass privatization is indisputable and is obvious. The totals of an implementation of a program of mass privatization lying behind frameworks of quantitative assessments were and remain a subject of controversies. From the point of view of the ideologists of the Russian privatization, the pragmatically substantiation of introduction of this model became the registration of real situation in the beginning of technical privatization: absence of possibility solvency demand of the population; zero concern of the foreign investors; the availability more than 240.000 state and municipal firms and companies (that required standard procedures of privatization); necessity of maximum high rates of legal privatization process (at the first stage(phase)) for blocking of intensive spontaneous privatization and series other.

From the qualitative standpoint the single most positive result of this stage was the birth of the new economic mechanisms and formation of institutional and legal environment for the post-privatization functioning of the Russian business. Corporate sector appeared stock exchange and over-the counter securities market and transitional system of the investment institutions were created. At the same time task which have not been accomplished with the framework of the 1992-1994 model primary restructuring of enterprises and attraction of investment-required such a privatization model which would at least partially compensate the enterprises for the virtually non-economic methods of sale during the first stage.

3.3.5.1 Voucher Privatization Results

Now days when the biggest part of Russian state owned enterprises have been privatized it is possible to analyze the result of each privatization stage. It is possible now to see whether the foreign advisers were right, while advising the shock therapy with the mass privatization, and which stage and model of privatization implemented in Russia was more successful.

The idea of voucher privatization in Russia implies equal distribution of vast majority of state industrial assets to every citizen. By means of voucher that gave to each citizen a proportional stake in privatizing assets government would promote equality in share ownership of those state owned assets. On the one hand it is very good idea, attempting to create owners of small business that could make a new middle class level which will be supporting ground for the growing democracy. But reality is bit different. At the first stage it was simply mismanagement and incompetence. In Yeltsin government two people responsible for that were: Anatoly Chubais and Yegor Gaidar. Joseph Stiglitz (1999) and Peter Reddaway & Dmitri Glinski (2001) have called their method of privatization as “Market Bolshevism”. They have decided with western advisers to carry out privatization very quickly or here we can use Kornai terminology “shock therapy”.

They made two fundamental mistakes, the first was the extraordinary speed of the reformation, and second the absence of solid legislative support and public understanding. Market reforms were simply equated with privatization, with no understanding of the necessary infrastructure required. Such fundamental reforms require time for society as a whole to understand the reforms psychologically and for government it was a time to pass a new law and new institutional infrastructures. There was no time for social adaptation and integration of privatization ideas and for most of population privatization meant nothing. But other picture for enterprise directors whom were given almost immediate possession and control of enterprises assets. Nothing changed in the methods and style of enterprises governance and nothing changed in the mentality of the directors and managers.

The biggest mistake was releasing of too much state owned industrial companies in to the market at once, and in condition that there was not ownership law and ownership security which make quite impossible for foreign investment and participation. The result of putting a huge quantity of products onto the market at once by privatization leaders the price became very low because of demand upset and moreover face value of the voucher was very low. The population was likewise deprived of effective participation there was no transparency or even reasonable time for participants to make serious decisions. All that meant that average citizens, after receiving the vouchers and didn't understand even how to use that voucher, they have sold their vouchers in the street for about seven dollars to meet daily expenses. At that price all Russian industrial and natural resource wealth was valued at \$5 billion. Unfortunately government understood what they were doing. One of the signs was the keeping entirely out of the voucher program the crown jewels of Russian industry the oil and metal companies, energy and communication giants. I mean that they kept trump in their hands as an economics and political force for the further election. Because in reality most of these assets were privatized later by “Loans-for-share” scheme for a fraction of their real value.

By Paul Klebnikov opinion “The young reformers were motivated neither by economic considerations, nor by considerations of how to get more money into the government's coffers, nor by a desire to promote the greatest efficiency of those enterprises that they were privatizing, but by purely political considerations, They saw that they need to move very quickly to “break the back” of the power of the “red directors” who controlled the state owned enterprises.”

As a result the value of enterprise offered for privatization shrank to almost meaningless amounts. The vast majority of Russian citizens got nothing out of voucher privatization. The people who did were benefiting the insiders and financial operators who bought up all the vouchers and got control of the main enterprises at unbelievable small price. The unhealthy privatization process likewise distorted the Russian securities market. It began as a mechanism of property redistribution among directors of enterprises that Chubais and Gaidar wanted to avoid and what had happened in the most

of the enterprises. Most newly privatized enterprises were not interested in issuing shares on the open market to attract new investors and investment funds. The managers primarily were motivated by a desire to retain control. The Russian securities market was further tilted towards foreign investors.

The ordinary citizens of the Russia did not get any wealth or profit from the Russian Mass huge and much accelerated privatization. Who did not invest vouchers in shares, or did not sell them in the streets they made even worst mistake, invested them in the voucher funds. On the moment of voucher privatization the government licensed 630 such kind of funds. The vast majority of those voucher funds worked by pyramid scheme that enriched the crooks that started up, while the citizens have lost everything.

So I am making a conclusion on what was done by the voucher program: first the redistribution of the property or simple juridical re-registration of the owners right on the enterprise assets without involvement of large private financial resources. Second, wide social disappointment with the results of privatization in the case of massive bankruptcies of joint-stock enterprises and investment funds, which accumulate up to 50 percent of issued vouchers. Third, the dreaming to get substantial revenues from privatization to cover budget deficit and finance the most acute social problems also has failed so far.

In Russia, in the first place, I can argue that although bureaucratic planning has been reduced, a large percentage of the power was still concentrated in the hands of bureaucrats. In particular, when we are dealing with industry, the bureaucrats have designed the process of privatization wielding considerable influence on the constitutional bills. This leads to situation that a significant number of rent-seeking effects have not been eliminated or reduced as required in a process that is aimed at increasing efficiency in the allocation of resources. That is what happened under a privatization program implemented initially in the industrial sector through checks. In fact, the data cited later in the paper confirms this result. As a consequence of this behavior, no major changes are observed in the final outcome of the *new private* enterprises compared to the *former public* ones. Obviously, the longer this process takes, the worse the results are in terms of efficiency. Therefore, the new structure of property rights has not added any net value to the total welfare. The expected final effect is that bureaucracy is taking control again.

As a result of the latter, informal institutions will dominate the scenario in which transition should take place. Fortunately, the evolution in the process of privatization and the separation from State finances seems to have altered entrepreneurial business ethic that prevailed initially under the informal rules. However, it is too early to reach a final conclusion.

In the second place, in accordance with the first condition, a narrowing in the gap between formal and informal rules is required if the final aim of the process is to succeed. Changes in property rights can be made in a relatively short period of time, but what has to be adjusted over time is the set of informal rules that dominate institutions at the early stages of the transition process. Stability of the political framework is a requirement for the success of the new formal institutional situation. This aim may be reached at a relatively low cost once the political framework is stable and, thus, a reduction in uncertainties as well as in transaction costs among all actors will lead to higher institutional reliance. However, this is a process that takes a long time in order to reach the desired result.

Failures in property rights reforms materialized in emergence of highly irrational corporate governance system at the majority of big and middle size enterprises. A situation when management

of these economic units has either found itself out of efficient control by the owners of capital or, vice versa, under overwhelming control of a small group of shareholders striving for outright looting of enterprise assets has become typical.

More intricate theory stresses the timing of the creation of regulatory capacity relative to privatization. When privatization outstripped the capacity to regulate corporations, outsider shareholders were unable to realize their rights, while giving insiders the chance to secure their position for the long term before regulations were enacted. Black et. al. argue that in Russia, the absence of effective regulation, rather than raising the rewards for a good reputation, instead of fostering the spread of majority owners willing to flout minority property rights, since such owners were able to extract more from the firms under their control. It was the prevalence of such unscrupulous majority shareholders that prompted their strongly worded, enforcement-oriented remarks quoted at the outset of this section. Earlier good enforcement would have avoided these problems, which now can be solved only through especially vigorous regulatory and enforcement activity. Thus although Black et. al. discuss incentives to contest property rights, they conceive them quite generally as the desire of majority shareholders is to expropriate minority shareholders portion of the profits, which must everywhere be reined in by enforcement.

The reasons of such situation of affairs are multiple. They include: deficiencies of voucher privatization, which provided wide dispersion of stock among numerous shareholders, slips in legislation (insufficient protection for minority shareholders), weakness of law-enforcing system. But one of the most important reasons of corporate governance inefficiency is a lack of well-designed system of management of stock belonging to the state. The very fact that the state does not avail of the rights resulting from its ownership of shares of privatized enterprises in many cases creates conditions for management of joint-stock companies to get out of efficient control by owners and to pursue their own interests. Even now the state remains the biggest owner of assets in general and shares of privatized enterprises, in particular.

If this is accepted then the aim becomes obvious: to make management of joint-stock companies oriented towards maximization of profit (in the short run) and companies' net worth (in the long run). Its achievement will provide basic foundations for adequate reaction of economic agents to market signals for efficient corporate governance system, accounting transparency of firms and thus for radical improvement of investment climate and efficient stock market.

The algorithm of achieving this aim includes efforts in two directions. The first one consists of completing the introduction of legal mechanisms ensuring for shareholders real opportunities to exercise their functions of owners. The second should provide for setting up of a system, which would guarantee a market-compatible control by the state over main part of its assets. Theoretically it was the second task, which is most challenging.

Concrete mechanisms have been demonstrated to direct the activity of this investment-and-holding company towards maximization of its net worth; it has also been shown that it should have a similar status as that of the Central Bank state institution which was not subordinated to the executive power. The role of the Ministry of state property would then be reduced to determining those state assets, which have to be transferred to the above-mentioned company. The investment-and-holding company would judge the expediency of selling out some assets to the private sector as well as of buying new ones from the private sector exclusively on the basis of market criteria. Thus processes of privatization and "nationalization" could be deprived of their arbitrary character.

3.4 1995 CASH OR POST VOUCHER PRIVATIZATION.

Most intensively privatization proceeded from 1993 through 1994. In 1994-1997s there was registered a stable and continuous decrease of the new enterprises participation. As per RF State Property Ministry data, about 130 thousand enterprises (58.9 percent of the total number of enterprises in the RF by the beginning of privatization) were privatized by January 1, 2000. At the same time, as a result of privatization in 1992 through 1999 the state was left with a considerable number of shareholdings in privatized enterprises. By 2000, the state still owned 3100 blocks of shares (via “golden shares”) and 7 to 8 thousand unsold ones. The sale of these shares was the key problem of privatization policy per se pursued in 1995 through 1999.

The State needed revenues in budget and investment in privatized enterprises, these goals were not achieved within the framework of 1992-1994 model. First of all restructuring of enterprises and mobilization of investments was needed and government demanded on formation of such a privatization model, which might at least partially compensate harm caused to enterprises for the methods used during the sale of their stocks at the first stage of privatization methods were not based on economic considerations.

As Mr. Chubais the “father” of Russian privatization said, *“First of all, the second stage of Russian privatization, which was begun in July 1994, should be qualitative in nature, in view of the real purpose of the previous stage. In its broadest sense this stage should be directed to ensuring effective and legally guaranteed passage of the property rights acquired in the course of the initial distribution to owners who bear real responsibility”*.

The cash stage of privatization based on the “Key Provisions of the State Program for Privatization of State and Municipal Enterprises in the RF after July 1, 1994” was approved by Presidential Decree No. 1535 of July 22, 1994.

Dilemma existing in 1995 through 2000 was settled in favor of budget. So maximization of federal budget revenues became the priority by the start of cash privatization. On the whole, it may be noted that in 1995 through 2000 the unified privatization policy was transformed into an essentially spontaneous process of residual privatization both at the federal and regional levels. This period is also characterized by the utilization of quasi-privatization instruments for the purpose of attracting political allies among the regional elite’s and major financial groups. The process of consolidation and further distribution of property among the major financial groups and natural monopolies was also still underway.

The new privatization program had many changes, from the system of free allocation of property to real sale, from accelerated privatization to a rather slow privatization designed to ensure restructuring and investment. In other words, the new privatization model should incorporate two key ideas determining the procedure of large privatization: investment orientation of sales and opportunity for an investor to get a major shareholding in the initial placement of shares.

As to the valuation of property in the course of privatization GKI retained its formal position: the final selling price had to be determined on the basis of auctions and tenders (i.e. through open bidding and money auctions). So the initial reserve price has been raised and it was based on one of the reevaluations carried out after 1 January 1992. Although in total (after all the revaluation’s that have been made) the book value of the enterprises has gone up approximately 800-1000 times, for the privatized enterprises it means that there was an increase in the book value of property of some 10-20 times. [Demchenko, I (1994)]. Such growth, in the opinion of the GKI management, reflects

the existing market conditions that have to be taken into account when selling property at auctions [Vasiliev, D (1994a)].

A new scheme of distribution of the privatization revenue was introduced. While earlier almost all privatization revenue went into the budgets of different levels, since July 1994 51% of the sale value of the enterprises (shares) were transferred to a special account of the enterprises itself for investment purposes. In practice this means that a potential buyer pays only half of the required price since the other half should be returned to restructure and develop production. Although such an approach does discriminate against the enterprises that have already gone through privatization at the first stage, nevertheless this was a powerful incentive for a potential investor to participate in privatization. [Radygin, A (1995)].

Originally it was planned that an absolutely new model of the benefits for workers and managers of enterprises would be adopted, with two possible options: receipt of 25% of privileged non-voting shares or purchase at face value of 10% of voting shares with a 30% discount and payment deferred for a year. The grounds for such an approach were the ending of vouchers (as a privilege for the entire population) and a new policy emphasis on the initial formation of large “external” holders of enterprises shares.

GKI did not manage to make such a drastic cut in benefits for the workers in a “pure” form, since, in line with the Fundamentals, the previous model remains in force. Yet in a veiled form there is a provision promoting use of the new model of privileges; as Chubais said, indexing the value of property when its value rose many times should mean that only new schemes will be adopted because most work collectives do not have the means to buy out 51% of shares valued using the new prices. [Karpenko, I (1994)].

In order to attract “strategic” investors who will improve control and management of an enterprise, and who are interested in its long-term progress, was planned that rather large blocks of shares, not less than 15-25% of the authorized capital of an enterprise, will be put up for auction and for investment tenders. It is especially important that this have been done with regard to the blocks of 10-20% secured as federal property but with practically no one being in charge. At the same time, on the basis of the infrastructure of the specialized voucher auctions, a system of special money auctions should be set up to sell retail shares to small investors.

Method of sale

(1.) Specialized auctions for share sales

It was modernized type of voucher auction that used instead of vouchers-cash. It is method of shares sailing through an open bidding; during that auctions all the winners get their shares at the same price. In order to participate to auction participant should present the application that include the total amount of payment and the number of shares to be purchased.

In Russia in 1995 were announced 831 share auctions. From June to October of 1995 14 such auctions were held and till the end of the year 30 auctions took place. In accounted period were sold on auctions shares of the following medium-size enterprises: Russian JSC “Energy system of Russia” Rostelekom, Uralmash, oil companies, Novorossiysk shipping company, Vyborg pulp and paper plant, Ust-Ilym wood-processing plant and others”. [According to Federal Stock Corporation].

Initially, with the starting price equal to 20 nominal values of shares, the average difference between the sales price and starting price was 2.5-3 times. This allowed reviewing the starting price and making it higher.

Although, according to the results of all the 1995 auctions the sales prices were on the average 3.3 times higher than the starting price (the maximum was registered in case of Medexport when the sales price was 35 times higher) investors have not demonstrated a noticeable interest towards these sales [*Malin, V (1996)*].

The following factors contributed to this situation:

- § competition from the state securities (including the state savings bonds and municipal bonds);
- § competition from the loans-for-shares auctions where significantly larger
- § shareholdings or controlling interests were offered (for instance, 51% of shares of Sidanco or Sibneft);
- § sales of "blue chips" in small shareholdings of 10-15% (15% of Sidanco's shares offered; 74, 79% of them bought);
- § in a number of cases the auctions did not take place at the initially announced time or were cancelled even after the start of the applications submission (YUKOS);
- § attempts to sell the shareholdings at prices higher than the market price
- § the special auctions for sale of shares of oil and some other companies actually turned into the primary placement of their shares which additionally complicated the setting of starting prices in the absence of the market quotations. [*Radygin, A (1996)*].

As it was expected the legal persons were predominant at these auctions, money-wise (84% of the total funds) although individuals submitted 89% of applications. According to the existing estimates the applications from physical persons for the amount of more than 100 million rubles can be attributed with the high degree of certainty to the managers of the companies which shares were sold [*Privalov, A (1995)*].

If the voucher was a method of large participation of citizens, the physical persons had not real opportunity to participate in the special auctions. At the same time it was practically the only way for a small investor to acquire shares since almost all the operators of the secondary market of corporate securities deal with large shareholdings. Comparison of shareholdings secondary sales with the primary sales from the standpoint of their market value can not be correct because during the primary sales were used voucher methods. Only the relationship between the sales price of a shareholding and the existence of a controlling interest owned by a non-state stockholder can be clearly traced.

(2.) Cash auctions

Shareholdings sale method was used very often 4052 auctions in 1995 its revenue to the budget was minimum as compared to the loans-for-shares schemes and specialized auctions.

The most common reason was that the auctions did not take place due to the different reasons including the following major ones:

- absence of applications during the sales of shares of "unattractive" enterprises;
- absence of applications due to the high starting price of shares;
- absence of applications because the controlling interest belonged to one investor [15];
- refusal of the auction's winner to conclude sales contract or to pay;
- insolvency of the company;

the necessary documents were not submitted to the property fund either by the company or by the local property management committee (82 cases in St. Petersburg, 73 cases in the Krasnoyarsk territory); conflicts were presented to the arbitration courts for resolution, privatization plans were changed, etc. [*According to GKI, (1996)*]

In number of cases the cash auctions (usually in the form of closed tenders) became the final stages of specialized auctions during which not all the offered shares has been sold. Thus, for instance, in January of 1996 0.022% of shares of Rostelecom were offered for sale in 14 lots. The selling price was 3.800 rubles per share (20% lower than the secondary market price) with the starting price of 3.200 rubles. [*Radygin, A (1996), p.10*].

(3.) Investment tenders

According to the Russian privatization law the criterion of selection of the winner was the total amount of investment counted for the duration of the investment period at the refinancing rate of the RF Central Bank on the date when the results of the tender are decided.

The following list reflecting conditions of tender:

- § the period of investment should not exceed 3 years period or should be determined by the privatization plan;
- § the purchased shareholdings should be paid for their nominal value (at that moment shareholdings have been reevaluated by the GKI methodology);
- § not less than 20% of investment total amount should be transferred to the issuer's bank account within one month upon the condition of a contract;
- § the issuer's debts should be repaid. [*RF privatization law*].

The debts payment condition was one of the most often used method. For example, the conditions of the repeated investment tender for 18.5% of shares of the Yaroslavl mineral processing plant announced in March of 1996 envisage that the total amount should include investment (lowered from 100 bln. rubles to 60 bln rubles) and the sum of the enterprise's debts to the budgets of all levels (36.8 bln rubles). Similar conditions were put forward at a number of commercial tenders. Another condition used during the tenders was moratorium for the sale of shares purchased at investment tender until the investment program is fully executed. Such condition, in particular, was attached during the sale of 16.7% shares of Lukoil in December of 1995. [*Radygin, A (1996), p.12*].

In 1995, 556 shareholdings of the Russian enterprises were offered for investment tenders. As in case with the cash auctions (and largely because of the same reasons) a large part of them did not take place. For instance, out of 19 investment tenders announced by the Penza Regional property fund ten did not take place because of the absence of applications [*Kozak, N (1995)*].

The main problem with this situation when the investment tenders had not taken place was the lack of local investors, long-term nature of pay back of investments, unclear legislation, and common tendency to invest in short term projects.

There are many legal ways to get a shareholding in an enterprise without fulfilling investment obligations: the shareholding may be redeemed by the issuer itself through an affiliate; several affiliated companies may participate in a tender and the winning company would reject the transaction in favour of its partner-company which offered a much lower price; there may be manipulations with the timing of bringing in investment etc. All this created potential ground for a subsequent cancellation of transactions by courts. It was not a secret that system of investment tenders (even open) hardly veiled form of direct sale to a particular investor who was known much

earlier than tender take place and who from the beginning participates in drawing up an investment program and terms of the tender tailored to him.

The majority of the investment tenders that were held had nothing to do with investment, actually it was consolidation of stock in order to achieve control. In the best cases when foreign companies won tenders the long-standing relationship becomes legally formalized. In 1995 foreign companies were recognized as winners of 26 investment tenders. As a rule they were oriented towards the lowest risk investments, on the average between 5 and 10 million US dollars with the wide diversification of their interests by branch and by region. The overall volume of foreign investment resulting from these tenders amounted to 280 mln. US dollars.

The following data is brief description of investment tender of Svviainvest enterprise made by Alexander Radygin for OECD Advisory Group On Privatization Ninth Plenary Meeting "Management and Sale of Residual State Shareholding"(Berlin, May 6-7, 1996) Session II. Strategies for the sale of residual shares.

One of the best-known examples of attracting a really strategic investor (although it did not take place) was the commercial tender with investment conditions for 49% of Svviainvest shares. This company is really a financial holding and 85 regional telecommunication enterprises of Russia (except Tatarstan) contributed each 51% of its shares to the Svviainvest charter capital. At the first stage of the tender 25% of the shares (+1 share) were offered 770 mln. dollars with investment program for two years.

At the second stage (in 1996) the remaining 24% of the shares for sale were offered at the special cash auctions for portfolio investors. Out of this shareholding 7% have been reserved as an additional guarantee to the strategic investor until the international audit of the holding is completed in 1996. At the same time the controlling interest (51% + 1 share) was remain in the federal ownership. The conformity of the tender with the international standards was confirmed by the International Financial Corporation (IFC) and European Bank for Reconstruction and Development (EBRD) which were planning to purchase the company's stocks on the same terms as the winner of the tender.

On November 30, 1995 the Italian state telecommunications company "STET" was announced as a winner according to investment program, it was transfer to the budget more than 2.9 trillion rubles for the acquired shareholding. Formally the transaction failed because of a conflict over the mechanism of payment for shares ("STET" did not o transfer money to an escrow account until the licenses of the Svviainvest subsidiaries were re-registered and until the Russian party fulfills a number of other conditions).

Numerous experts offer a widest possible variety of potential reasons why this transaction, largest in the history of privatization in Russia, fell through: the winner's refusal was explained by the results of the parliamentary elections on December 17, 1995; the transaction was badly prepared (there was no international audit, no issue prospect, etc.) which, apparently was also explained by the hasty way of the holding company establishment, i.e. specially for this sale. STET's lack of funds; problems with the subsidiaries caused by the redistribution of profits since many of them had been included into the holding against their wish, St.Petersburg telephone network went to court to dispute the decree concerning its inclusion into the holding, it also proved to be impossible to include into the holding the shares of the relevant company of Tatarstan. The RF Ministry of Communications (Svviainvest is virtually a part) refused to provide institutional and technical support to the transaction with "STET" at the last stage. Accidental character of the STET's winning

(after its only competitor - consortium US West, Deutsche Telecom, France Telecom - which was "closer" to the RF Ministry of Communications refused to transfer the next guarantee deposit for some vague reasons) etc. [Radygin, A (1996), pp.13-14].

3.4.1 Cash privatization result.

The shares remaining in state ownership after mass privatization were to be sold for cash at investment and commercial tenders, cash auctions and specialized cash auctions in 1994-1995. The main objectives were to raise revenues for the budget and investments for privatized companies as well as keep the employment at the same level and maintain social assets of these enterprises.

While employment and social benefits were maintained, revenues from sales were ridiculously low by international standards since foreigners and other outsiders were effectively precluded from active participation due to political factors and the embryonic state of institutional, legal and regulatory enabling environment, such as well-defined property rights, capital markets infrastructure and strict enforcement mechanism [Lieberman et al. (1994)]. Insiders (mainly management and local officials) were the main beneficiaries of the process and managed to take full advantage of the circumstances and greatly consolidate their control over privatized enterprises. Often, they made every effort possible to lower down the price of sales, since they were basically selling shares to themselves through a concerted mechanism of full cooperation between management, regional property funds, state property committees and local administration. Lack of transparency, openness and competition was such that very few outsiders were effectively allowed to take an active part and "cash privatization" only firmed up the existing status quo without much cash to the State and little investment for enterprises. What has actually happened was a continued massive management buy-out of Russian companies, a fierce struggle for absolute control which was won by enterprise directors and several banks and proxy companies representing the interests of former and present officials [Alexeev et al. 1996] and unfairly enriched "Oligarch's" and organized criminal groups.

The Russian Privatization Committee believed that the process of privatization of the Russian economy would favor the changes necessary to make enterprises profitable [Institute for Economy in Transition, (1997)]. This process had effectively consolidated, since in 1996 the participation of the public sector was only 23% of the GNP [Panorama Privatizatsiya, (1997)]. According to the latest research on the behavior of Russian industrial enterprises under the new economic conditions, an increase in efficiency in the functioning of privatized enterprises has been observed so far when compared with partially privatized and public enterprises. This was a clear difference with respect to the initial stage of privatization through checks when the private sector did not show clear signs of change towards a better functioning than that of the public sector. However, it remains to be seen the true impact on the system of inefficient transfers of private savings to the State, as implied by the special auctions. Probably, if those savings were directed to the private sector instead, a higher net value in economic efficiency increase would be reached. Can be made conclusion that as a consequence of the latter, the process of convergence from informal rules toward those formal market rules to be adopted over time was much slower than in the opposite circumstances. [Julián I. Pla & Sobrecases F. García (2001), p.14]

During this period a decrease in transaction costs has been seen that was reflected in the adoption by these firms of market rules aimed at increasing efficiency. Generally speaking and in accordance with the tendency starting in 1993, there has been a change in inter-entrepreneurial relations, so that there were more and more enterprises establishing new productive links. Since 1995, 82% of the enterprises incorporated new clients, although the sales figures to new partners only reached 19% of the total. Likewise, 59% of the enterprises have looked for new suppliers, reaching a 24% average of total purchases. Parallel to this progressive increase in commercial independence, changes have

been introduced both in the production volume (which is no longer planned) and in the productive structure. Thus, since 1995, 68% of the enterprises have changed their production composition in such a way that new products represent 22% of total sales. [*Blasi, Kroumova & Kruse, (1997)*].

The paternalistic employment policies were, to a certain degree, applied in the privatized firms as a consequence of the informal agreements maintained by both workers and managers throughout the process based on checks. Therefore, the new managers did not implement a policy of downsizing, which makes the Russian economy still weak in terms of production because enterprises have lowered salaries and reduced the number of working hours instead of reducing the number of employees. This is despite the fact that the privatization of public enterprises does not allow them to keep the full-employment policies, which were in force during the planning period, and also in spite of the significant productive crisis faced by enterprises as a result of the Russian economic crisis. In fact, at the moment the problem of unemployment does not seem to be of much concern: the unemployment rate in relation to the active population in the Russian Federation is still very low, since it has increased from 1.1% in 1992 to 3.4% in 1996. However, the estimated unemployment rate was higher: according to the OECD and the ILO, the estimated unemployment rate was 5.5% in 1992 and 7.8% in 1996. Moreover, certain indicators only give relative importance (therefore aggravating) the unemployment rates registered. For instance, the number of people involuntarily working part-time in an enterprise or not being paid has increased: in 1995 the rate was 5.2% of the total active population [*Commader & McHale, (1996)*].

In the medium term, it is thought that as enterprises restructure and adapt to the new economic situation according to the formal market rules that need to be applied to reach higher levels of efficiency, they will lay off those with formal contracts without economically compensating them. It is possible to argue that the latter is one of the consequences of the process of privatization based on auctions, since the concentration of decision-making power was located in different economic agents than workers and managers. The main reason lies in the redistribution occurred in the property during the process given that workers have now a lower participation in the total share of the firm. Probably the paternalistic employment relations maintained in the enterprises during the process based on checks is start to be relaxed and the adoption of formal rules is follow suit in the new framework. [*Julián I. Pla & Sobrecases F. García (2001), p.15*]

It can also be highlighted the idea of individual utility maximization, as a formal market rule, was still being formed. For enterprises the new framework resulting from the money-based process of privatization as a consequence of a higher level of private property can change the former idea based on distributive principles that is, to get rich means to transfer wealth from others. Probably this adjustment of the former informal rule toward the formal rule mentioned, is also related to a learning curve by doing since economic agents are aiming at new objectives. [*Julián I. Pla & Sobrecases F. García (2001), p.16*]

3.5 1996 LOANS-FOR-SHARES

1995 was a turning point in the Russian privatization program. With the accomplishment of the mass privatization program and on the way of cash stage, the government announced a shift of priorities. The Russian Government emphasis was placed on maximizing privatization revenues. The Government wanted to raise revenue but found it politically difficult to sell its stakes in these enterprises, which had been excluded from voucher privatization. The first of this change was the cash and loans-for-shares privatization, which was at best controversial, if not actually rigged. The idea of the scheme was advanced by a consortium of the largest Russian banks Uneximbank and Menatepbank dominated on these auctions. The scheme envisaged that the banks would lend funds

to the government, taking blocks of shares in large and strategic enterprises as collateral. Blocks of shares would be auctioned separately to the banks, and the bank that offered the largest loan would be the winner.

The banks proposed to loan funds to the government for several years, with repayment secured by the government's controlling stakes in these enterprises. Every-one understood that the Government would not repay the loans, and would instead forfeit its shares to the banks that made the loans. [Black, B; Kraakman, R & A, Tarassova (2000)].

Beginning from 1994, the government often required bidders in privatization auctions to promise specified future investments in the enterprise. [LEXIS, Int. law Library, RF law File]. Once the winning bidder acquired the shares, the promised investments were often quietly shelved, or the shares were transferred to supposedly good faith purchasers, who weren't bound by the investment promise. An honest purchaser couldn't use these dodges, so dishonest purchasers tended to win the auctions.

Practice shows that government emphasis and reality were totally different. In all these tenders, the final price minimally exceeded the starting price, and thus, the state's earnings were insignificant. Loans-for-shares auctions were an audacious scheme to leverage wealth acquired in these dubious ways, by using it to acquire Russia's biggest companies for a small fraction of their value. [Lieberman, I. W. & Veimetra, R (1996), p.737] The main reasons for this were the lack of real competition, the collusive character of a number of the auctions, and the unsatisfactorily formulated demands and conditions of the privatization transactions.

The result is the twelve auctions of major Russian enterprises, which took place and have raised a total of 5.1 trillion rubles for the budget, including 1.5 trillion rubles of enterprise debts paid to the state. Requirement of this scheme was to hold the shares until 1 of September 1996 and within two years after that date banks could sell the shares and take one-third of the capital gains. While holding the shares, the banks had the right to vote at shareholder meetings, except over certain issues such as reorganization, liquidation and the issue of new equity.

Two reasons are typically put forward to explain the use of the loans-for-shares scheme. On the one hand, the chronic budget crisis and failure to meet budget targets for privatization in 1995 were among the most important reasons for the implementation of loan-for-share scheme. On the other hand, the banks wanted to gain control over some of the largest Russian companies as cheaply as possible. [Lieberman, I. W. and Veimetra, R (1996); Paul Hanke]

The implementation of the loans-for-shares privatization was questionable. The auctions were administered by the banks, which also could participate in them as both bidders and depositors for bids. The participation of foreigners was restricted and competing bids were often disqualified on technical grounds. For example, Uneximbank administered the auction for Norilsk Nickel and won it for USD 170.1 million, only USD 0.1 million above the starting price, by disqualifying a bid for USD 350 million on a technicality. By the beginning of 1998, this method had already been used for acquisition of shares in the oil holding company, Yukos, (45% initially and 33.3% after dilution; qualified control went to Menatep), Sidanko (51%; control went to Uneximbank), Sibneft (51%; formally control went to 'Neftyanaya finansovaya kompaniya'), Surgutneftegaz (40.12%; de facto the company bought up its own shares), Lukoil (5%; de facto the company bought up its own shares. [IET, (1997); Paul Hanke; Black, B et. al]

Despite the legal veneer of the auctions, they were to a considerable extent either the veiled purchase of shares by the enterprises themselves, or the direct non-competitive sale of shares to interested banks or Financial-Industrial Groups (FIGs). The numerous court hearings and examinations of the legitimacy of these deals in 1996-1997 do not provide any evidence of legal violations committed during the loans-for-shares auctions and subsequent sale of the shares. However, this is more proof of imperfections in the regulatory and legal base at the time, than of transparency in the loans-for-shares auctions that took place.

According to the Russian privatization law auctions are considered to have taken place if there was more than one participant and each of the participants guaranteed that the credits would be extended in the amount not less than starting price using the shares as collateral. A special auction commission, decides who would become potential participants, what would be the starting price of a shareholding-amount of loan and sets of additional conditions. The right to participate to the tender depends on amount of the loan. The official body offers the largest amount was recognized as the winner.

The credit agreement, pledge agreement in exchange the loan and commissioner agreement were signed with the winner. The commissioner agreement gives to commissioner, which usually was the creditor right to sell the shareholding by any method except for investment tender after September 1, 1996. 30% of the positive difference between the sales price of shares and the amount of all the relevant liabilities of the RF go the commissioner and 70% to the RF budget. The interest on the loan was calculated for the equivalent amount in ECU at LIBOR+0.5% annually for three-month deposits as of the date of signing the agreement. In fact, the state was getting the loans with the interest 2-3 times lower than market rate. The starting price of enterprises was established by the commission on the basis of 60-90% of the shareholdings market value depending upon its size. There was an argument in favor of such an approach referring to the world and domestic experience in the field of loans with the pledge of highly-liquid assets. During this the starting prices of the auctions offered to the commission by the members of the bank consortium turned to be 2-5 times lower than the approved ones. [*Radygin, A (1996), p.15*].

By initial plan approved by GKI for loan-for-share scheme 29 enterprises were putted in list that was actually compiled according to the banks request included the majority of the most attractive large Russian enterprises. In a number of cases strong managers opposition on the part of enterprises led to appearance of many additional requirements towards the auctions. There were both and positive and negative reasons: in positive ones is possible to confirm the financial interest of enterprises itself that were ignored when the revenues are transferred to the budget, in negative getting the status of auction organizer, reduction of shareholding and prohibition to sell it until the process of formalizing the federal ownership over.

Another privatization rule gave to firm's managers the right to acquire 30% of its shares cheaply if they first secured an agreement with the employees that would prevent the enterprise from going bankrupt for one year. Since proof that the enterprise would go bankrupt without the agreement, or wouldn't go bankrupt for a year with it, was in the eye of the beholder, this was an all-but-open gift of a controlling stake to the managers, in return for a phony agreement with the employees. [*LEXIS, Int. law Library, RF law File*].

As a result only 17 enterprises were offered at the auctions and 5 of them (JSC Bor, Techsnabexport, West Siberian Metallurgical plant, Kirovlesprom, Tuapse sea harbor) did not meet bids. Only 12 enterprises finally took part, half of which belonged to the oil sector. All the transactions were implemented within a two-month period, from 3 November to 28 December

1995. Two blocks were sold by the banks in 1996-1998, mostly to the banks' affiliates. The non-transparency of the auctions immediately caused a public uproar over privatization. In subsequent years, there were a number of attempts to revise the results of the loans-for-shares privatization, mostly on the part of the communist-influenced parliament. This contributed to the insecurity of property rights and delayed the restructuring of some of the companies concerned.

Actually it is wrong to understand auctions in Russian as some sort of competition, usually practice used on this auctions was direct sale to much earlier than auction take place known buyers. The foreigners participation was prohibited and weak resources of Russian commercial banks couldn't create normal competition environment.

There was no need to provide solutions to the legal problems in connection with the anti-monopoly regulation because such problems would have arisen only in case of sale. In principle this method as such is quite acceptable in case of such important sales under the specific Russian conditions, the question is how to guarantee the efficiency of each particular transaction for the state and for the enterprise at least in medium-term perspective.

It may happen that the pledged shareholdings would not become the property of the banks because of the different reasons. Then at the stage when the pledge is valid, the banks would be really interested not in the strategic management, but in obtaining the accounts of enterprises, in getting out of them as much profits as possible.

This factor (accounts) is crucially important in explaining the banks motives: transfer of the *Yukos* accounts from *Incombank* to *Menatep* was the most important, if not the sole reason why *Incombank* tried to participate in the loans-for-shares auction. There was possibility of other schemes as well, for example, - a bank extends a loan to the enterprise at the excessively high interest rate then the funds are channeled for its repayment; actual profits may not be shown on the reports and tax forms which would bring about lower prices of shares and it would be possible for the companies affiliated with the bank to purchase them cheaply [*Zharkov, V (1995)*].

3.5.1 Loan for share result.

When to speak about voucher privatization or MEBO I can admit that it was a very weak, but kind of privatization. When examine the Russian loans-for-share privatization I see only group of six of eight top Russian financiers, further oligarchs, with the heading by Anatoli Chubais. They are agreed among themselves who would own which company and at what price. This dividing takes place in 1995 when 12 export oriented companies, mostly oil and gas producers and metals exporters decided to privatize controlling stake. By voucher privatization were privatized only 29 percent, then the question was privatizing the 51 percent stake in those companies that was still owned by state. In practice this loans-for-share auctions were announced, but no one could bid, no foreigners, no even Russians who was out of the Chubais group. Anybody who tries to participate was disqualified for one reason or another. The final result shows that each of these companies fell in to hands of the oligarchs according to their decision made long before auctions. The price they paid were from 10 to 30 times less than the price at which these companies were sold in the market in the mid-1990. In other words the companies were sold from 3 to 10 percent of their market value. The following table gives us some concept about what took place at those auctions.

The six most expensive Loan-for-Share auctions (in million U.S. dollars)

Company	Auction price % auctioned	Market capitalization (Nov.-Dec. 1995)	Implied by market price	Market capitalization on the stock market (Aug. 1.1997)
Lukoil	5	35	700	15,839
Yukos	45	159	353	6,214
Surgut	40	88	220	5,689
Sidanco	51	130	255	5,113
Sibneft	51	100	196	4,968
Norilsk	(voting)	170	333	1,890

Source: Paul Klebnikov (2002), p.6 Market capitalization is the value of the market attributes to a company, measured by the number of outstanding shares times the market value of each share.

If I will follow Adam Smith' liberal theory and believe in the self-regulating powers of the market were indeed correct, then the subsequent failures could only be explained by faulty implementation. As a result consortium of corrupt officials and greedy oligarchs, who as it was said, had hijacked the process preventing privatization from producing the inevitable expected improvements.

The first step that we need to take here is to bring government into the picture. In a generally competitive world, with perfect information and zero transaction costs, there is no need for government. The real world, however, rarely complies with the strict assumptions of general equilibrium theory.

The great Cicero, for example, argued that since the state had been created to protect the private property of its citizens, it had no rights to infringe in any way on that property.

These statements agree well with the liberal message of Smith and his followers. The state should be kept from direct interference in the marketplace. As in any case of constrained maximization, there will have to be a balance struck. Simply pushing the government out of the picture altogether will indeed achieve the primary objective, but the collateral damage may well outweigh the easy gains. The real outcome of Russian privatization provides a tragic illustration of this point. Few have summarized it better than George Soros, stating at a 1998 conference that *"the assets of the state were stolen, and then when the state itself became valuable as a source of legitimacy, it too was stolen."*

By taking over the state, in effect, the Russian oligarchs not only made a mockery of the Smithian belief in the invisible hand, they actually succeeded in acquiring the Hobbesian right to extract at will. Mancur Olson, reflecting on the failure of the Russian economic reform program, has deflated the naive belief in deregulation as a panacea: "Some enthusiasts for markets suppose that the only problem is that governments get in the way of the market and that private property is a natural and spontaneous creation. Some individuals may though in libertarian-anarchists way that they may have possession without government, but there is no private property without government. Property

is a socially protected claim on an asset a bundle of rights enforceable in courts backed by the coercive power of government.”

In other words no one took care of the citizens, or the Russian national interests and I am not talking about the national treasure. The only one reason behind all of these manipulations and auctions was the reelecting of Boris Yeltsin. The Yeltsin with Chubais made a deal with the oligarchs that they offer almost for free these huge companies and oligarchs have financed the Yeltsin presidential campaign in 1996. In the final analysis the Russian economy suffered its worst decline in GDP. The population was impoverished, the Russian state was essentially bankrupted. In August of 1998, the ruble collapsed and the government defaulted on its debts. The government had declared bankruptcy. That was the final result of Russian privatization.

3.6. 1997 CASE-BY-CASE PRIVATIZATION.

It is possible to select three main part of property reallocation in industrial sector of Russian economy from beginning of privatization:

- Spontaneous stage in 1988-1991 when with coming into force of Soviet Union law about state firm temporary rent-cooperative boom assets of state enterprises in this or that form intensively passed in private sector;
- Stage of mass privatization in 1992-1994 when with help of check scheme large array of property has passed to inside and outside shareholders. Also there was a primary fastening of private property rights under totals of thousand joint-stock companies privatization;
- Also stage of scrambling control under created during privatization joint-stock companies including reallocation and concentration primary bought property rights which one began in 1993-1994.

Among typical forms of such reallocation it is necessary to select coming in light in 1993-1997 the following: 1) aggressive or matched shares buying up in secondary market (for managers, investment institutes, brokers, banks); 2) lobbying of particular bargains with shares blocks remaining in federal and regional authorities hands; 3) voluntary or administrative - forced retraction in holdings or financial-industrial groups.

By available estimations in 1997 scrambling for control was completed no more than on 30 % of Russian privatized firms. Rising intrusion outsiders and property concentration as major tendencies for standard privatized firm keeps value after 2003 as well.

In 1997 the privatization process entered a new stage where the government's policy in this field can be purpose oriented, there have appeared trends of the governments stricter control of the management of state property. This third stage was called case-by-case privatization. This new phase of post - privatization properties reallocation for which are characteristic following basic features:

- Usage or nontrivial technical schemes development (mortgage auctions legalized fussing of state shares, conversion of duties in valuable papers, sale of a debt receivable, confidence schemes, buying bills, handling preferred dividends etc.);

- Its main objects are largest or most interesting Russian companies where already took place some control restructurization (including determinacy with shares state);
- Active state assistance which - realizing concerns of largest financial-industrial alliances pursues also diverse own purposes (political, budget etc.).

Basic conflict of given stage was collision of old concerns (though and in new corporate shell) natural monopolies largest industrial and mining structures and new financial-industrial groups. Expansion concerns were crossed at new properties reallocation. Unconditionally important for the given conflict is understanding of registration of the political factor and imperious concerns in different branches of Russian authority, first of all in the government.

In other words, behind facade of largest (including non-realized while) bargains of 1995-1997 happened completing non-economical stage of property reallocation in a number of Russian key companies. In some of them arrangement between main center and improbable reparation of property - with other equal conditions was already reached. Final stage of control installation tightened by virtue of confrontation continuing and intensive lobbying, this process is multi-dimensional: its main parties are federal and regional authorities, natural monopolies, biggest banks and largest industrial enterprises.

All visible new phase of property reallocation (as between state and other interested institutes, between largest financial-industrial alliances) was connected to debt relations and their transformation in proprietary interests. In particular it serves as one more confirmation of that fact that key participants of reallocation process largest creditors - state, financial grouping and act natural monopolies have as common and contradictory concerns.

In total in 1997 RFPP has planned to sale by means of funds about 2 500 shares blocks (proceeds 0,5 bill. rubles), including 700 – under RFPP control. From January to October 1997 on sale were exhibited 1477 packages including 639 auctions, 247 special competitions, 49 investment competitions and 43 commercial competitions.

As well as in 1995-1996 government considered privatization in 1997 as a means of budget problems solution. Experience of former years has demonstrated lowest efficiency (for budget) mass sales in course of "money" privatization, therefore it was accepted solution to supply receipts in the budget by score of several large bargains.

In this contest some researches are connecting the concept of "individual project" with beginning of third - after "check" and "money" stages - stage of case-by-case privatization. Although this term was not legalized in law about privatization. Government interest in "individual projects " was reflected in decree No 363 from April 1, 1997 "about order of implementation individual federal property privatization projects (with changes of Russian Federation Government Decree N 564 from 12.05.97).

According to this document personal project of federal property privatization is the complex measures directed for privatization, apart from country locale or branch federal property and envisioning realization before sale preparation of this property with engaging independent financial adviser. The main purposes of personal project implementation were maintenance of maximum receipts in federal budget, engaging of investments and increasing productivity of privatized property. If the first purpose had indicated quite adequate current installations, the second and third had propaganda character.

In the end of November 1997 at expense of several large bargains a cumulative budget privatization task over executed almost in 2 times. So in the beginning of November total income from privatization has constituted about 120 bill. Rubles.

The largest bargain of 1997 became sale of blocking package (25 % a plus 1 share) financial-investment holding "Sviazinvest" on auction of July 25 1997. The holding was created in August 1995 51 % of shares are fixed as federal property and 49 % are intended to sale (25 % - for foreign and Russian investors, 24 % - only for Russian). Organizer of auction was bank "MFK" (group "ONEKSIM" Bank). Formal winner became certain Cypriot company "MUSTCOM" Ltd. (among founders - group "UNEKSIM" Bank.), offering 1,875 bill. Dollars.

No one of world largest telecommunication companies (or their consortium) did not participate in auction. After sale blocking package State does not have way (apart from full holding privatization) for engaging strategic investor. Some researches mark also increased hazard of holding disintegration, in this situation it was necessary for regional companies independently to search for strategic partners.

Important innovation became the Russian Federation President Decree from November 4, 1997 which has canceled a 15 percent quota of participation non-residents in charter capital of oil companies. At the same time in conditions of November crisis Russian financial market nesting of new means of case investors non-residents in Russian corporate papers remains debatable for critical period.

According to the data of the Russian Federation State property found for 1997 in private sector "had passed" about 3 000 firms (in 1995 - 6 000, in 1996 – 5 000). In total on January 1, 1998 about 127 000 firms entered in the sector of privatized firms (opposite about 124 000 to beginning of 1997).

Nevertheless according to the totals of 1997 at the cost of several large bargains a cumulative budget task for privatization exceed almost in 3 times. To the end of 1997 joint income from privatization has constituted 237 bill. rub out of which 18,654 bill. rubles went to the federal budget (under schedule – 6,525 bill., including 4,179 bill. from sales).

It was supposed that other sources, apart from large projects had brought appreciable income. From lease of federal property income in 1997 has constituted 305 bill. rubles (against 1,939 bill. under the schedule), obtained on state shares dividends - 407 bill. rubles (against 270 bill. under schedule).

Thus from point of view of formal budget criteria (fulfillment of budget task at any rate without schemes such as mortgage auctions) 1997 became the first year in a history of realization of "money privatization" which got success.

But not all bargains scheduled for 1997 were carried out. Practically no one of scheduled on last quarter large bargains were not held. Meanwhile, noticeable progress in maintenance of substantial transparency in preparation and implementation of bargains connected with sale of share blocks largest and most attractive firms was absent.

As we know by 1996 in Russia more than of 90 officially created holdings with a state participation existed. One of representative example became the creation in 1995 Open Joint-Stock Company

"Russian metallurgy". The authorized capital of this holding was formed from 10 percent shares blocks of 9 Russian metallurgical joint-stock companies and some other property.

To the beginning of 1998 in the state register were registered 72 financial-industrial groups (about 1500 firms and organizations, about 100 credit and financial establishments). Substantially now in Russia there are about 150 associations and economic units (industrial holdings), which are not financial-industrial groups officially, but formal tags could claim for such name.

In 1998 process of association of already formed large financial and industrial grouping began. Among the main incentives of such association - as objective needs long-term strategic alliances and world-wide tendency to concentration of assets and peaking of competitiveness between main national groups inability of imperious structures to form really "equal" and "stable" rules, protection particular financial concerns.

Well known example is the signing of memorandum about intention of oil company creation "UKSI" ("UKOS" and "Eastern oil company" by group "ROSPROM-UKOS" – "MENATEP" and "SIBOIL" and "East – Siberian OILGAS" company " by group "SIBOIL" – "LOGOVAZ" – "Integrated bank"). Although the applications for intention of new company also took place (at the given stage apparently only alliance of former companies). The participation in privatization "ROSOIL", "ONAKO", "SLAVOIL" purposes on creation of oil jumbo unconditionally have long-term strategic character.

Announced by the Russian Federation Property Found realization of "open competition" has changed repeatedly schedule of "ROSOIL" privatization in 1997: in miscellaneous versions 5-7 % of shares were supposed to be arranged among managers and workers, 50-65 % of shares to exhibit on money specialized auction remaining to sell by one package on commercial competition with investment conditions. Were offered "single" schemes (75 % plus share on proposal of fuel and energy ministry, "two side" (competition on 50 % a plus share and auction), "three stage" (two auctions till 25-35 of % shares and competition). A separate fundamental issue became a problem a tolerance of non-residents.

It is obvious the basic controversy around of the considered scheme has deployed on two directions:

"Strategic" and "case" approaches have pluses and disadvantages in the problem of maintenance of maximum income in budget. So multi-stage scheme of sales can expand a circle of primary participants and increase a competitiveness, and initial income, however allows in case of low transparency fastly to dissect away competitors and underestimate price on following stages (nevertheless at effective organization is possible also peaking of a competitiveness up to before completion of all bargains). The initial sale of a simple working control allows expanding a circle primary participants, but can "dissect away" of any other claimants at the subsequent stages by virtue of control installation fact.

The lumps sale of a package ensuring qualified majority allows to achieve high transparency of bargain and to attract large strategic investor, however has reduced competition of sales (by virtue of participants circle limitations) and possible income and "remainder" of shares cannot be located with allowance for unstable condition of financial markets in world and in Russia.

In the beginning of 1998 the Russian Federation State Property Ministry was stopped on following scheme: 50 % of shares (plus one share) were offered for commercial competition with investment conditions, 46 % - auctions, remained for managers and workers. The subsequent protests of some

potential tenders could, nevertheless, make government to agree with scheme “75 % + 1 share” including of non-residents.

Customary and traditionally such formulations as “engaging pass investments”, “realization of firms re-structuring”, “creation of socially unsheltered layers populations support gears”; “maintenance of receipts in federal budget”, “conditioning for real estate market development”, “rendering support to small business” were passing from program to program.

Other innovations of the program of 1998 could make surprise or at least cause bewilderment: “maintenance of an optimal ratio for domestic and foreign investments”, “implementation of protectionism in relation to domestic commodity producers”.

Also a document was adopted that was an actual forecast list of state unitary firms which were subject to transformation in to joint-stock company and also a forecast list of joint-stock company shares which were supposed to be sold. By substantiation of selection of indicated firms and joint-stock companies found ways and terms of their privatization alleged limitations on their privatization, size of share blocks being a subject for joint-stock company sale and forecast initial price of such share blocks. At same time firms with strategic character could not be in such “forecast list “ and could not be sold at actuation.

Practice of such compilation of firm lists in 1995-1997 has shown that around of firms candidates started bustle including governments, ministries, and locales deploys. Management of firms, potential buyers, their competitors, also well knows experience of former privatization programs passing in State Duma. It is easy to understand however lingering with preparation of such list with all escaping consequences for privatization sales of 1998.

Practically all planned sales had not taken place because of two reasons which coincided, as a rule, with the government’s initiative-due to ruble devaluation (starting prices were fixed in ruble equivalent which meant a 3-time drop in budgetary incomes in USD equivalent), due to the lack of interest from the part of foreign investors in cases when decreased starting price background seemed excessive to the stock market crisis or property structure was relatively fixed, there was no interest of both portfolio investors or large-scale shareholders who already established their control in the joint-stock company.

The only sale of RJSC “GASPROM’s” shares generated significant incomes for budget. In the period of time between autumn 1997-spring 1998 RJSC suggested government to sell 1- 3 % of its shares in a form of convertible obligations directly to strategic partners. Presidential Decree No 887 from 25 July 1998 about sales of the Russian joint-stock company “GASPROM” shares decreased government’s share in the RJSC from 40.87 to 35%, while government was proposed to determine the way of privatization and volume of package to be sold-maximum 5.87%. The government’s budgetary interest was clear while “GASPROM” faced another problem: to avoid a simultaneous ejection to market of a package exceeding overall number of its shares freely quoted in open market (up to 3% of RAO’s overall stake) to consider interests of holders of ADR, managers of “GASPROM” who according to some estimation control 7% of its share and RJSC itself - with 15% of its shares. Like in prior years standard privatization deals did not generate significant incomes to budget.

3.6.1 Case-by-Case result

The terms of the struggle for ownership redistribution have changed. In the condition of chronic crisis in Russian financial markets, since October of 1997 the mobilization of available financial resources (both internal and borrowed) to seize control over new entities has become more problematic task even for largest domestic financial groups. What concerns to potential foreign investors, the best evidence of their appraisal of the situation was a massive outflow from the corporate securities market in 1998. As per estimations, foreign investors had considered the Russia's markets as a higher systemic risk zone.

An apparently unfavorable situation for budgetary revenues might, however, facilitate privatization sales in cases when a sharp price downfall on markets allows completing processes of corporate control consolidation. Thus, if at the fast market growth stage many shareholders have to limit their activities to exclusively portfolio investment, a blocking, or, at best, a controlling interest, in the crisis situation a further concentration of stock capital becomes a logical course of action.

In that situation the continuing mass sales of shares could even accelerate. On the whole, as per the RF Ministry of State Property data (MSP, Russ. abbr. MGI) there was a possibility of sales of about 2 thousand “unbound” blocks of shares in 1998. The MSP made also a forecast of inevitable sales of share blocks for less than 25 per cent. As the events of recent years have demonstrated (the more so in the situation of a gravest crisis on financial markets) the speech had going not about sales, but about handing these packages over other private or institutional shareholders.

As a result, the privatization process reverts to the stage of spontaneous extra-economic development: on the one hand, because the government was disinterested in organization of standard transactions in the framework of residual privatization, on the other hand, because assets were cheap, and therefore market transaction criteria disappear. At the same time it may result in growing legal nihilism towards privatization process operators, thus bringing about further destabilization of ownership rights. Some legal decisions in the sphere of shareholders' rights destabilize the investment climate at large and hinder its improvement.

The most striking example of this was the adoption of Federal Law No. 74-FZ of 07.05.98 "On Specifics in Disposing of Shares in the Russian Joint Stock Company of Power Engineering and Electrification “United Power Grids,” and of State-Owned Shares in other “Joint Stock Companies of Power Engineering.” Article 3 of this law stipulates that foreign States, international organizations, foreign legal entities, and their affiliated Russian legal entities, as well as foreign individuals may own not more than 25 per cent of the total shares in the UPG, although at the time the law was approved foreigners already owned about 30 per cent of the UPG shares.

As per some estimations, the adoption of this quota, hypothetically meant a demand to nationalize a certain blocks of shares, was a key factor in the downfall of the Russian stock market in May of 1998. This factor was essentially a psychological one, since it is practically impossible to bring the share of foreigners down to the level prescribed by the law in a legal way. There is only one legal way to achieve this goal - by additional emission, which would have become possible only by the decision of a shareholders' general meeting followed by the registration of this emission in the FCS, who will have good reasons to refuse the registration referring to the RF Civil Code.

3.7 CONCLUSION ON RUSSIAN PRIVATIZATION

The basic idea

When about two decades ago transition from centrally planned economies to a free market economy with an economic system based on the origins of private ownership started, there was strong disagreement between economists and further advisers for privatization in transient countries. As Janos Kornai arguing in his “Making the Transition to Private Ownership” (2000) there were two strategies to carry out transition reforms. First is the organic reforms strategy, that was applied in Hungary and had great success, and the second strategy of accelerated privatization was applied in Poland, Czech, Russia, Armenia and some other transient countries. In Poland this strategy called to make successful changes in short time (six seven years), in Czech Republic it had more success but there also were serious mistakes in macroeconomic policy. The worst example of the failure of accelerated strategy or as it also call “Shock therapy” is the Russian privatization that, included the voucher scheme coupled with mass, MEBO or insiders privatization and the worst part the loans-for-share privatization. Russia also was using case-by-case privatization method but the result is so invisible that there is no a single example to point out. I think before making conclusion about Russian privatization results it is good to have a picture of both strategies, which will make easier to understand the final result.

Shock therapy did not work out in Russia. *Laissez faire* has not worked out anywhere. Emphasizing the abolition of state interference by Adam Smith and other early liberalists was historically connected with fighting against mercantilist state policy. The background of Russian shock therapy and the need to abolish the state governed economy is actually quite similar to the situation that Adam Smith criticized. However, in European established market economies, transformation was gradual and the role of the State never became one of a Smithian night watcher. Poznanski (1992:91) describes post-communist liberalism as the “perverse” interpretation of liberal philosophy. It is largely deprived of its traditional concern for universal well-being and, instead, praises the “jungle” struggle for survival or “private warfare”. It is not wondering that claims for restoring order have grown in Russia. These claims led to the increase in centralization and state bureaucracy, which were the evils which were supposed to be crushed by privatization and liberalization. The power of the former ministries was broken but bureaucracy has now concentrated in the Presidential Administration [*Nysten-Haarala, (2000)*].

The basic idea of organic reform strategy or gradual privatization consists in slow step-by-step sell of state owned enterprises and their assets preferably to outsiders able to invest in the new created companies. The insiders or anybody else will not get state property for free, every body has to pay fair price as insiders as outsiders. The new private sector creates by sale or liquidation of state companies. The first step in this strategy is the creation of new institutional mechanisms that would be a guarantee for security of private ownership, enforcing private contracts, and applying for affirmative action, through tax and credit policies. The strategy stressed the importance of hard budget constraints and consistent enforcement of bankruptcy and accounting laws. The important part of this strategy is the selection of companies to sell. Profitable companies are buying by investors while chronic loss makers are forced into bankruptcy and liquidation. The advocates of this strategy emphasized sociological considerations: the development of a solid, property owned by middle class is essential to the consolidation of capitalism. [*Kornai, J (2000), pp.1-4*].

The strategy of accelerate privatization emphasis on the rapid elimination of state ownership. It is usually privatization through “give away” scheme like voucher scheme. The main goals are the equal distribution to all citizens of state assets. In compare with slow sale strategy the main part of

State assets gets the insiders, but as the practice showed only for short period then this property concentrates in hands of criminals and oligarchs. With the rapid and wide property distribution and ownership reform, without creation of institution ground leads to inflation and poor economic performance.

The advocates of this strategy repeatedly cited the argument that, if the “window of opportunity” is open for privatization, the opportunity should be used and privatization must be carried out rapidly, while the state bureaucracy is still too confused and weak to resist. Changes of ownership have to be irreversible, or opportunities may be lost forever. It is also clear that rapid ownership change make impossible to new communist takeover. There are no questions that voucher privatization program is crucial to the victory of the government party in elections. [Kornai, J (2000), pp.1-4].

Probably now we have that start point of Russian rapid privatization. The cases are quite clear. 1. It makes impossible to turn back to communism. 2. Makes vigorous support for the new government with the president Yeltsin.

Kelsen (1991) was right when he claimed that any political system must be based on positive law. The problem, however, is that creating positive law is not enough in a state where the legal and especially the political culture are not developed to respect it. Legality is especially important in connection with privatization because a lot of temptations exist for personal benefit. It is vitally important to control and limit opportunism, which is typical for human beings everywhere [Williamson, (1985)]. In the Russian privatization of enterprises, opportunism took over due to the lack of control and the strength of informal social networks among the *nomenclature* and criminal organizations. There was a mutual understanding of opportunism in those circles because the window for personal opportunities was open to them.

Russian privatization shows that the role of the government is important in the transition process. A weak government that cannot or does not bother itself to control the process and only provides chances for opportunistic behaviour. Markets do not guide the process towards Pareto optimality because a functioning market does not exist yet. When the legal framework is vague, informal rules become more important. Legal rules were largely ignored and social networks counted more losses. Russian privatization had not led to efficient result. Insider groups were able to secure their positions and financial conglomerates, led by a few *oligarchs*, took over the earlier State monopoly in the economy. Privatization strengthened the role of informal institutions at the cost of formal legal rules. Privatization made it clear that informal social networks among the new elite are powerful, while the formal rules are weak and not respected. It was also a process that rather weakened than strengthened the development towards the rule of law. It proved that the political and economic elite does not show respect to the developing legal system as long as good relations among the elite can supersede the law. [Nysten-Haarala, Soili (2001)].

Even if privatization became petty stealing in common language, no one had to take the political responsibility. President Yeltsin’s resignation and apologies a few months before ending his presidency, was only a show covering the plan to give power to a reliable crown prince. And indeed, the people elected the crown prince, who is a good friend of many *oligarchs*. State power was lost in favour of *oligarchs* and instead of free markets economy, oligarchy economy was created. Public choice did not play a significant role in Russia because people felt that there were no choices. The propaganda campaign of the new elite, masking their takeover by securing jobs and preventing foreign takeovers, was effective. [Nysten-Haarala, Soili (2001)].

Privatizing examples

The best example of enterprise privatizing by its director or president and managers is the Gazprom privatization, which is the natural gas monopoly of Russia owns one-third of the global reserves of natural gas. If it is valued in international criteria this enterprise would be valued anywhere between \$300 billion and \$900 billion. According to Russian stock market estimation in 1997 it was valued \$40 billion. The typical stake that would be privatized through voucher approximately varies from 29 percent to 35 percent (presidential decree). The government took most of the big companies in Russia, including all the natural resources producers, and privatized 29 percent through vouchers. When the government decides to privatize 29 percent of Gazprom in the 1994 on voucher auctions the first thing what the government should not to do was giving the right to design the whole voucher auction to the Gazprom management. How it is possible to speak about any transparency or competition on this kind of auction if the auction holders and organizers were the enterprise managers themselves.

The Paul Klebnikov valued this auction as the greatest robberies of the century. The general director of Gazprom at that time, Viktor Chernomirdin, (the former Prime Minister of Russia) and the top management of Gazprom got together and did following. First of all, people who wanted to buy shares could only buy them in the tiny Siberian and Arctic villages where Gazprom had its deposits. Second Gazprom management reserved the right to buy shares from outsiders at a price they dictated. The result was that only Gazprom people ended up buying the shares and of course it was the managers who had the money to buy the vast majority of those shares and who ended up benefiting from the auction. As a result, the price at which Gazprom was privatized in 1994 by means of the vouchers were \$250 millions, which is 160 times less than the price of the stock market would be determined three years later. So it was less than 1 percent of the stock market value of the company. [*Paul Klebnikov (2002), p.2*].

Also there is good example of Russian loan-for-share privatization deal. The OneximBank by loans-for-share auction obtained 38 percent of the shares of Norilsk Nickel and made loan to the government U.S. \$170 million, in case that company makes annual profits of U.S. \$ 2 billion. This is the most typical Russian privatization method.

Here is the data about voucher value of Russian companies compared with market value (in million U.S. dollars)

Company Prices	At voucher auction Prices (1993-1994)		At Russian Stock Market	
Gazprom	250		40,483	
Unified Energy Services (electricity)	957		17,977	
Lukoil	704		15,839	
Rostelecom	464		4,172	
Yuganskneftegaz	80		1,656	
Surgutneftegaz	79		6,607	

Source: Paul Klebnikov (2002), p.4

From the presented above data we can make a conclusion that voucher privatization in Russia not only had failed but there was cynic plunder of state wealth, the citizens did not get any wealth and this large privatization was designed and implemented only for class of powerful managers and directors.

Here in my research I tried to show some of semi-official methods that were implemented in Russia some of the methods of wealth privatization without privatization and also to highlight the ways of appearance so many millionaires and billionaires in Russian society. For example, there is a well running state company, the person who decide to get all the company profit, get the managers of the company in his pocket in this or that way or replace them by own subordinates in the controlling position of the management. Then they sign the entire deals surround the company with a whole series of his middlemen banks, consulting companies, marketing companies, equipment suppliers, etc. In other words this person companies control all the outside connections. They are usually in offshore zones, some were in Cyprus, Switzerland, Caribbean. Then the managers sign contracts that resulted in elementary transfer pricing whereby all the profits and most of the cash revenues accumulated in those intermediaries. The state owned company step-by-step becomes bankrupt because of cash flowing to these intermediaries. But owner of that middleman companies become tremendously wealthy.

This is a simple example of burgling wealth from state owned industrial enterprises. But there is also other method also very simple to get profit from state owned natural resource companies. Most of oil and other companies set up trading companies to handle their export, the owners of those trading companies are usually the managers of the exported state companies, these trading companies usually are placed in offshore zones. The managers of state company sells the natural resources to the trading companies for a fraction of the world price, then trading companies sale the oil and other natural resources for the world price and keep all the profits in personal bank accounts in offshore.

The foreign advisers

Between 1992-1998 Russian authorities with the aid of the World Bank, the European Bank for Reconstruction and Development, the U.S. Agency for International Development, IMF and Western universities such as Harvard organized and implemented the largest and fastest privatization program ever seen. It means that they bear significant responsibility and have to explain their complicity in creation of this catastrophic privatization. *David Ellerman* the former chief economist of the World Bank argues that foreign advisers were terribly wrong while advising this large and accelerate privatization.

Nobel Laureate Joseph Stiglitz argued that privatization in the absence of a sufficient market supporting institutional infrastructure was a serious mistake that led more to asset stripping than to wealth creation. He argued that this should have been foreseen, if not by the first generation of transition reformers, then at least by their Western economic advisors, and presumably by the World Bank staff involved. The implication was that the headlong rush to privatization was a basic mistake, that most of the decline and pain associated with transition in general were avoidable. Much more attention should have been paid to the building the institutional, legal and administrative foundation on which properly functioning capitalism is based.

Foreign investors

There are several reasons why the foreigners had not invested in Russian economic, why they had not buy companies in Russia. First Western investors and financial institutions have some ethical standards, which prevented them from participating in the blatantly crooked scheme, which Russian, privatization was in 1990s. Second those potential foreign investors were blocked from participating in bits. Those few external investors who had obtained shares in the Russian privatization often complained that their stakes were illegally diluted or eliminated. Very often opposition in Russian had promoted the idea that the Russia was sold to the foreigners. According the official estimation foreign companies have purchased 10% of privatized state property, giving Russia U.S. \$ 1 Billion. But the whole value of the state property of Russia is not 10 billion, so the all arguments about the foreigners' intervention in Russian market are obviously untrue.

Nevertheless, informal rules on foreign investment are still applied in spite of a clear even official-formal rule based on liberalization that was approved by legislation. In this content, Russian economic agents establish informal entry barriers to acquire the privatized wealth, arguing reasons of national interest. Besides, if we analyze the nature of the process of privatization based on special auctions, it is not surprising that this was, in fact, an ad-hoc program since the aim established by the Government is initially to earn budget revenues. Thus, the financial institutions are lending money that is guaranteed by parcels of shares of these firms being privatized. At the end, since loans are not returned to the lenders, the lenders are the ones who obtain property rights on these firms, which complicates even more if not making it completely impossible the opportunity for foreign investment to accede equally to auctions as legislation guarantees. [*Julián I. Pla & Sobrecases F. García (2001)*]

For foreign investors, the Russian virtual economy is an obstacle to overcome and to gain access to the market. Foreign firms have to pay taxes since they receive cash from abroad. They are also inspected more and corrupted state officials would gladly receive bribes from them. Bribery, however, makes a foreign firm vulnerable. It can be thrown out from the market at any time, using illegal operations as a reason. Due to high barriers, foreign companies are not going to invest in restructuring Russian industry either, as they cannot be sure that they will have profit in the long run. Unstable political and economic institutions favor only short-term quick profits. Without trust in business partners and political decision-makers, the desperately needed investments in restructuring are not going to emerge. [*Nysten-Haarala, Soili (2001)*].

Success of Russian privatization.

The one successful case of privatization in Russia was in the beginning of privatization movement in the Gorbachev-era it was the lease-buy-outs scheme that involved small shops and enterprises usually textile workshops. And also the beginning of small privatization when all assets were sold by cash usually by their real price. The secret of the success was in reason that this shops and enterprises were bought by their collectives and managers who wanted to work and have a profit from the product not just from assets selling. These privatization methods were more realistic and healthy than the massive redistribution or property rights by mass privatization for some nominal value. What was a counterfactual or alternative to the mass privatization program in Russia? If the logic sounds then the Soviet leas-boy-out scheme and related experiments seem to be the closest thing to a counterfactual to grow out of the reform experience in the former Soviet Union.

Leas-buy-out schemes were a form of mass privatization in the sense that each deal simply had to satisfy certain requirements in order to go through. Indeed, one of the problems with the lease-buy-out is that they were too fast and too popular the small firm level, the 10,000 Soviet firm were

privatized by lease-buy-out scheme before 1992 when the mass privatization enthusiasts realized that soon it would not be enough good companies to go into voucher privatization.

Martin Weitzman also at the time gave a pragmatic argument for the collective ownership 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.”
[Weitzman, M (1993), p. 267]

Chapter Four

PRIVATIZATION IN REPUBLIC OF ARMENIA

4.1 HISTORY OF ARMENIAN PRIVATIZATION.

On gaining its independence from the Soviet Union in 1991, and after establishing of the first democracy institutions Armenian Government initiated a privatization process of agricultural lands, then state-owned (public) housing and as a major condition for transition to a market economy, state-owned enterprises and incomplete construction sites (ICS). The privatization process in Armenia can be divided into three stages: *initial* (1991-1994), *large scale or mass* (1995-1998) and then cash or *decelerated* (1998-2001) and then *case-by-case* the process is on going also nowadays.

The *initial stage* was implemented under the dominance of an emphatically political goal that is the immediate elimination of the communism foundations. Privatization was seen as the only lifeboat for economic reforms. It was completed at an obviously accelerated pace.

Before the adoption of law on privatization and as preparation for privatization of state property, for 1991-1992 the Armenian Government had sold experimentally 335 (4 % of the total) small enterprises (retail shops, public food, services and other) to the employees of these enterprises through direct sales at nominal prices. The end-result was that most small business employees took the opportunity to purchase their businesses from the State using ongoing business profits as payment. This system proved to be extremely beneficial to the State, which was able to privatize quickly much of its small business inventory, and developing entrepreneurial class, which was able to continue the development of small businesses without an undue burden and made possible for government to collect 173.1 million rubles (about 1.6 million USD). Armenia has had successfully implemented a comprehensive stabilization and structural reform program. It was a swift made progress to start the processes from land reform and small-scale privatization. [UNDP report.]

In August 27, 1992, the President of Armenia has signed the Law of Armenia on "*Privatization of the State Enterprises and Incomplete Construction Sites*". The aim of the Law was to establish the juridical basis for setting a private relationship towards the basic production funds and, in this way, to create an efficient market economy. The subject, types, rules and order of privatization process was set under this Law. The Additions and Amendments to the Law on November 1, 1993, made by the Supreme Council of Armenia, set in place the order on restructuring, and on partial and free privatization of the enterprises. There was no special provision in the Constitution of Armenia on state monopolies but there were separate laws and government regulations regarding to the licensing of state monopolies [Amendment to the Law of Entrepreneurial Activity, 20th of June, 1991, No:415]

The list of enterprises that should not be privatized was also set out in "The Supreme Council Daily", 1994, No: 17, 18, 29). A Special State Commission was established to begin the preparation of enterprises for privatization. But unfortunately no serious attention was paid to such an important condition as setting the objectives. The same approach was applied in the second law *On privatization of state property* adopted in December 1997. The lack of negligence of the importance of clear-cut goals/objectives has had its negative impact on the normal process of privatization.

After adoption of the privatization law, the amount collected after selling “*small*” enterprises was 26,893,8 million drams (approximately 59.5 million USD) where the payment by certificates constitutes 88.7%.

In 1993 the first stock exchange was established and the new currency, the Dram, was introduced. Most prices were liberalized, and a stock market started to operate. Armenia has a good record in transition and has made a strong effort to create a favorable macroeconomic climate, which brought to consistent growth since 1994. Its commitment has won Armenia the continued support of international financial institutions (IFIs), bilateral donors, and its large worldwide Diaspora. Armenia has succeeded in establishing a relatively stable constitutional system and despite frequent government changes – in securing continuity in its program of economic and sectoral reforms.

Enterprise privatization that was partially free of charge preceded the second, large scale or mass privatization stage in Armenia in 1994, and was mostly voucher-based. The enterprises were sold through both closed and open auctions and open subscriptions. By the mass privatization program all citizens received tradable privatization vouchers that could be used in a variety of privatization mechanisms for the purchase of medium and large enterprises as well as small businesses. Based on foreign experience and taking into consideration the insufficient financial resources of the population, the Armenian authorities opted for free of charge privatization. According to the law, 30% of the value of enterprises included in the privatization programs was given to RA citizens in equal portions, i.e. through privatization certificates with a nominal value of AMD 20,000. Using these certificates to ensure a wide outreach of the privatization process proved an illusion of social justice as there was no logical continuation for making investments by certificates through appropriate tools and regulations. Specifically, there were neither investment funds nor other market infrastructure. Instead, having no alternatives, the citizens converted their certificates into cash, receiving more or less 30-40% of the nominal value. Thus the certificates did not achieve the main objective for which they were issued. Initially had putted into circulation as a means of payment to serve privatization objectives, they became instead a factor in the artificial reduction of privatization revenues.

Open subscription sales were the most widely used sales mechanism for medium and large enterprise privatization: more than 1,000 enterprises have been sold through this method. Direct sales of small companies and partial share sales to workers in medium and large enterprises were also successful components of the program according to which 20% of a state-owned property's value was given free of charge to those employees who had been working in such enterprises for at least one year. In fact, within a couple of months (08/1994 - 04/1995) 1,010 enterprises in the Republic (53% of the total) were privatized in this manner and was considered as a serious step in preventing the looting of large enterprises at that time and establishing a large group of proprietors. Due to that action, 126 571 citizens of the Republic became shareholders - an unprecedented results compared with FSU countries, which however, did not have a major impetus on enterprises' activities.

The focus of the Government's reform program has been on stimulation of the private sector. The most important sector for privatization and from the viewpoint of economic reforms was the privatization of medium and large state owned stock companies. Since 1995 1,562 enterprises have already been privatized or 63.4% of the enterprises listed for privatization including 900 enterprises within the 2001-2003 program. By the end of 1997, about 60 percent (around 6,000) of all small enterprises had been privatized.

Armenian voucher privatization program came to the end in December 1998, the pace of privatization was slowed, that reflected both the end of mass privatization and transition to the monetary privatization, and as it is often mentioned also a greater extent in the incorrect policy for evaluating the property that had to be privatized. Parliamentary elections in May 1999 further complicated matters, resulting in shifts within both the Parliament and the Government. Nevertheless, the new Government has shown a willingness to continue case-by-case privatization of large entrepreneurial and infrastructure companies, and to complete sales of other non-strategic enterprises, albeit with renewed caution. The new Government had the authority and ability to meet these challenges, and promises to continue along the economic reform path.

Key privatization or liquidation transactions include the sale of the remaining state-owned flourmills and bakeries, the privatization of the telecommunications company, the sale of two hotels to foreign investors, and the signing of a lease with an option to buy for the Yerevan Brandy Factory. Privatization accelerated toward the end of the second quarter of 1999: the sale of the brandy factory was finalized, the Government sold its remaining shares in large commercial banks, and major chemical plants, a precious stone companies and a hotels were sold to foreign investors.

This very circumstance has been decisive in the third, slowed down, phase of privatization. It is essential to define the correct price of the to-be privatized property or to elaborate a substantiated and applicable method, which would reflect the condition for privatizing state property with desirable characteristics and efficiency. For some years already the State has failed to recognize that there has been no significant progress in privatization. It appears that drastic measures should be taken to put the process on a normal track and to prevent the further destruction of the remaining state property.

Privatization results for 1999 have included the sale of 48 medium and large enterprises and objects, generating approximately 8 million USD in sales revenues and over 15 million USD in investment commitments. In addition to local investors, foreign investors, particularly from the worldwide Armenian Diaspora numbering in excess of five million people, have stepped forward to participate in privatization, providing an important link between Armenia and the international community. A strong early commitment to privatization and an overall balanced economic development policy have resulted in consistent economic growth since Armenia's low point in the early 1990s. In 1998 real GDP growth was 7.2 %, while 1999 estimates call for a 5.0 % increase.

The Government of Armenia has worked closely with international advisors on its case-by-case privatization program. Merrill Lynch was contracted to complete the sales of 14 key enterprises; four of which were successfully completed. The sale in 1998 of a 90 % stake in Armentel, the Armenian telecommunications monopoly, to OTE, the Greek State telephone giant, tops the list of key transactions, with a share purchase price of 142.5 million USD and investment commitments of 260 million USD. French spirits company Pernod Richard recently completed the purchase of the Yerevan Brandy Factory for 30 million USD plus development commitments. Finally, the sales of Hotel Armenia and Hotel Ani to Diaspora investment groups for 8 and 4 million USD respectively provide initial indications of the long-term attractiveness of the tourism/hospitality sector. The Hotel Armenia is now managed by Marriott Hotels and is a full part of the international hotel chain.

While positive results have clearly been received from case-by-case sales, sufficient attention was not given to key issues such as transparency and public relations. The result was lower public acceptance for privatization than perhaps was deserved - mistakes which are still being overcome today. In total, approximately 60 companies have been privatized to foreign investors, including such sectors as power generation (small hydropower plants), diamond processing, food processing

(breweries) and light industry, ensuring continued economic development and raising significant cash proceeds.

The Yerevan Municipality, along with the Government, is currently reviewing technical proposals for a medium-term concession of the Yerevan water distribution and treatment system. Bids have been received from numerous international players, including experienced companies from France, Germany, Korea, and other countries. Private sector involvement is seen as essential to improve the quality and reliability of the water systems throughout Armenia.

4.2 1988-1992 SPONTANEOUS PRIVATIZATION.

The process of “allocation” of state property got under way in Armenia (that time part of the USSR) long before the adoption of official decisions on privatization. It started the adoption in 1988 of the State Enterprise Association Act whose task was to give economic independence to state enterprises and destroy the managerial pyramid of “Gosplan (State Planning Committee) - ministries – enterprises”. In 1988-1992, new entities appeared in Armenian economy. When Mikhail S. Gorbachev began advocating economic reform in the late 1980s, Armenians introduced elements of the free market and privatization into their economic system. Cooperatives were set up in the service sector, work collectives began to take out leases on state enterprises (with or without buyout), although substantial resistance came from the CPA and other groups that had enjoyed privileged positions in the old economy. In the late 1980s, much of the Armenian economy already was operating either semi-officially or illegally, with widespread corruption and bribery. The so-called mafia, made up of interconnected groups of powerful officials and their relatives and friends, sabotaged the efforts of reformers to create a lawful market system. When the December 1988 earthquake brought millions of dollars of foreign aid to the devastated regions of Armenia, much of the money went to corrupt and criminal elements.

Beginning from 1991, the democratically elected government pushed vigorously for privatization and market relations, although its efforts were frustrated by the old ways of doing business in Armenia. In 1992 the Law on the Program of Privatization and Destatization of Incompletely Constructed Facilities established a state privatization committee, with members from all political parties. In mid-1993 the committee announced a two-year privatization program, whose first stage would be privatization of 30 percent of state enterprises, mostly services and light industries. The remaining 70 percent, including many bankrupt, nonfunctional enterprises, were to be privatized in a later stage with a minimum of government restriction, to encourage private initiative. For all enterprises, the workers would receive 20 percent of their firm's property free of charge; 30 percent would be distributed to all citizens by means of vouchers; the remaining 50 percent was to be distributed by the government, with preference given to members of the labor organization. A major problem of this system, however, is the lack of supporting legislation covering foreign investment protection, bankruptcy, monopoly policy, and consumer protection.

In the first post communist years, efforts to interest foreign investors in joint enterprises were only moderately unsuccessful because of the blockade and the energy shortage. Only in late 1993 was a department of foreign investments established in the Ministry of Economics, to spread information about Armenian investment opportunities and improve the legal infrastructure for investment activity. A specific goal of this agency was creating a market for scientific and technical intellectual property.

A few Armenians living abroad made large-scale investments. Besides toy factory and construction projects, Diaspora Armenians have built a cold storage plant (which in its first years had little

produce to store) and established the American University of Armenia in Yerevan to teach the techniques necessary to run a market economy.

Armenia was admitted to the International Monetary Fund in May 1992 and to the World Bank in September. A year later, the government complained that those organizations were holding back financial assistance and announced its intention to move toward fuller price liberalization and the removal of all tariffs, quotas, and restrictions on foreign trade. Although privatization had slowed because of the catastrophic collapse of the economy, Prime Minister Hrant Bagratian informed United States officials in the fall of 1993 that plans had been made to embark on a renewed privatization program by the end of the year. [*Source: U.S. Library of Congress*].

More detailed information about spontaneous privatization see in chapter III “Spontaneous privatization in Russia and Armenia”, at the moment of beginning “Spontaneous” privatization both countries were part of the Soviet Union and the process was similar for both countries.

4.3 SHOSK THERAPY.

Introduction

During the early 1990s the Armenian economy recorded a significant drop in output and all macroeconomic indicators significantly worsened. GDP declined by 60 per cent from 1989 to 1993, consumer prices rose 110 times just in 1993. During the first year of introduction of the dram as the national currency in 1993 it devalued from 14.5 to about 400 drams for one US\$.

Among the contributing factors to the economic crisis were the devastating earthquake, the collapse of the common market of the USSR and the inability of the CIS to effectively replace the Soviet economic structures, and the political and military instability in the region. At the same time independence allowed Armenia to take control over all economic levers, thus to lay the foundations for economic stability and reforms. The Government of Armenia launched a major structural reform program shortly after independence in 1991. It called for the liberalization of prices of most goods and services, liberalizing trade and the foreign exchange regime and support for private sector development.

Armenian policy makers adhered closely to the orthodox adjustment strategy offered by international financial organizations (mainly the IMF and the WB). Armenia’s small size, its economic weaknesses and regional isolation gave the IMF and WB an unusual influence over national economic policies especially the rapid stabilization of the economy. The adoption of the offered policies was motivated also by the acute need to attract foreign investments, in order to put Armenia on a growth path. Only external support made it possible to overcome a crisis. However, the Armenian economy continued to experience difficulties, which endanger its development prospects. First of all, despite the high rates of growth personal income levels remained far below those of the pre-transition period and lagged behind those of most other transition countries. Second, the stabilization policy didn’t attract foreign direct investment inflows, contrary to initial expectations. Third, Armenia accumulated a significant external debt, as the balance of payment remained largely negative, due to weak export capability. Finally, the development of the Armenian economy during the transition period was accompanied by the expansion of such negative social phenomena as poverty, emigration, and unemployment. All these put serious doubt over the sustainability of Armenia’s long-term growth. In order to better understand the specific factor that determine Armenian economic growth and its prospects we have to take into account its special initial conditions and analyze its weaknesses in the transition to a market economy.

Most of the relevant literature concludes that the main factors responsible for the variance of growth path across transition countries are initial conditions along with macroeconomic stabilization and structural reforms. The list of initial conditions contains a large range of variables, such as income levels, urbanization rate, industrialization, natural resources, geographical location, prior economic growth rates, economic distortions (repressed inflation, trade as share in GDP, black market exchange rate premium, and so on, institutional characteristics (market memory) and so on [*De Melo et al., (1997b), p.84; Kushnirsky, (2001)*].

According to the data set used by Campos and Coricelli (2000), Armenia was characterized at the point of entrance to the transition as a low income, highly urbanized, over-industrialized country with poor natural resources, with repressed inflation and medium (among FSU countries) black market level.

When I tried to assess the impact of the various initial conditions on the chances of successful privatization in Armenia, first of all I considered the unstable political and military situation in the region and the devastating earthquakes in Spitak both with devastating effects on the Armenian economy. The Spitak earthquake of December 1988 substantially crippled the economy, so much so that an economic hardship and chaos started in the country far earlier than in the other CIS countries. The earthquake affected about 40 per cent of the country's surface area. Infrastructure entities in some 20 per cent of the country's territory ceased to function; 230 industrial enterprises were destroyed. In general, 40 per cent of Armenian industrial potential was destroyed making transition even more difficult.

The conflict between Armenia and Azerbaijan resulted in transportation and economic blockade of Armenia, first by Azerbaijan and then also by Turkey. The main transport highways of Armenia, including the gas pipeline that provide more than 80 per cent of all imported gas from Russia passing through Azerbaijan, was blocked. In addition, the Abkhaz and Ossetian conflicts, which simultaneously started at the same time in Georgia, blocked trunk roads that connected Armenia with Russia in the north. As a result Armenia found itself in a full economic isolation. According to The World Bank, the Turkish and Azerbaijani blockades of Armenia costs between 30 to 38 per cent of its GDP (that is US\$ 570 million to US\$ 722 million annually). [*World Bank Report, No. 22854-AM, v. 2 (November), (2001), p. 89*].

Recent estimations show, that reopening of Armenia's borders with these countries would reduce just transport costs by 30–50 per cent with total benefits of more than 300 million euro.

The cost of the blockade was especially high because of the high dependence of Armenia on external trade. Under the Soviet Union and central planning, Armenia traded almost exclusively inside the Soviet Union, mostly with Russia and with a very narrow range of commodities. True the share of trade in GDP was quite substantial (in 1988 imports comprised 66.9 percent of GDP, and exports covered 47.3 percent). Open trade in all direction is essential for Armenia as a small country with limited domestic market, lacking natural resources and endowed with surplus of qualified labour force. [*A. Granberg (1993)*].

During the transition period export volumes have severely decreased as a consequence of old and new factors. There were the earlier production and trade distortions, low competitiveness of products, lack of communication with the outside world, absence of global marketing skills, landlocked geographical position, and high transportation costs. Then came the dissolution of the USSR that disrupted unified payment and settlements systems.

Coming back to other components of initial conditions, the levels of income and material wealth, Armenia was far below the USSR average. For example, per capita capital stock in 1988 was only about 70 per cent of that of the USSR average. [*Valentey S.D. and others (1993), p.53*]

The only comparative advantage of the Armenian economy at the entrance to the market was higher than average educational level of the population that is the level of its human capital.

Institutional Shock Therapy

According to David Ellerman the institutional debate about privatization is not "fast versus slow" or "rapid versus gradual" methods. It never was; that was another phony argument. The argument was institutional shock therapy (or blitzkrieg) versus incrementalism. One of the best treatments of this debate about institutional change is in Albert Hirschman's 1963 *Journeys Toward Progress* which far antedated the transition debate. Reformmongers in their strategies and even more so in their rhetoric could be divided into those who take an ideological, fundamental, and root-and-branch approach versus those who take an incremental, piecemeal, home-grown, and adaptive approach.

But the task was not resetting inflationary expectations with a dose of "shock therapy." The task was deep-lying transformation of many complex interconnected institutions. These institutions had evolved through decades of communism so the deeply rooted interconnections were not apparent, particularly not to the market Bolsheviks parachuting in from the West. The origin of what became known as the "shock therapy" approach to the transition was not only a bad analogy with inflation-stopping therapies. I fear the origin also laid the moral fervor of cold-warriors who sought to "wipe the slate clean" of the institutions of communism and to socially engineer in their place the new, clean, and pure "textbook institutions" of a private property market economy.

An incremental approach evolving reforms out of existing institutions (e.g., pushing decentralization all the way to the market with lease buyouts) would be an admission that "History matters." But history does not exist in neoclassical economic models and the people in the transitional countries wanted to escape their history anyway, all in one leap. Hence the embedded incremental route was rejected by the utopian social engineers from the East and West; it would lead to or through some halfway-house "third way" Western experts argued that only a slate-cleaning blitzkrieg approach during the "window of opportunity" provided by the "fog of transition" would get all the necessary changes made. That was the market-Bolshevik road to the "democracy" and "market economy" we see in Russia today. This mentality was not new. It was a reincarnation of the spirit and mindset of Bolshevism and Jacobinism.

There has been some recent criticism of the Washington consensus for "ignoring institutions." But the shock-therapists (or Bolsheviks and Jacobins for that matter) did not ignore institutions. Institutions were just "built" Jacobin-style with bright young people (some from elite western universities and financed by aid dollars) drafting "new institutions" which were then "implemented" by the "democratic powers" of presidential decrees. [*David Ellerman*].

Armenian Shock Therapy practice

As a base case lets assume that Armenia enjoys from open trade relations at world market prices, which are also applied to the domestic market. Here I agree with estimates of Nikolai Shmelev (1989) on the value of explicit and implicit (through favorable terms of trade) transfers of Russia to the Armenian Soviet Republic on the eve of independence, of US\$ 3.5 billion (out of a total to all republics of US\$ 50 billion). In the following I am discussing four shocks trade, demand, financial, as well as administrative shocks.

The losses due to the shock of declined demand were connected with the fall in output due to low competitiveness of Armenian industrial output, income deterioration across the post-soviet area and the collapse of the defense industry of FSU, to which the industrial production of Armenia was strongly tied. Calculations in ruble and dollar prices of the Armenian GDP by economic branch reveal the weaknesses of the structure of the Armenian economy as well as the sources of trade benefits. Higher real “exchange rate” (by 80 percent) for most export-oriented (80 percent) industrial production along with its large share in GDP contributed mostly to these benefits.

The calculations show that the losses to Armenia by selling its industrial exports to the FSU at world market prices rather than the actual ones are estimated at 13–14 per cent of GDP. The combined effect of the decline, almost complete disappearance of these exports, as well as the shrinking of demand (also due to the earthquake and war), is very extreme, as can be seen in the different calculations.

The financial shock was caused by the losses of transfers and capital investments from the federal Soviet government to the Armenia’s social services budget (health, education, housing, etc). These transfers are estimated at about US\$ 1.7 billion or 14 percent of 1987 GDP.

The institutional and administrative shock contributed to the general “disorganization” thus added to an even deeper transformational recession in Armenia. The negative impact of the disorganization and weak and incapable government was underestimated. In addition to the very important impact of the cut of all FSU networks, one has also to remember that a relatively large share of the Armenian economy was controlled directly from Moscow. The loss of control over these centrally subordinated sectors and the difficulties in establishing domestic control with little time to prepare and no ready institutions, added to the chaos that accompanied independence. Little early warning and the absence of real national government for many years brought about a largely spontaneous character of most transformation processes. All these together weakened the institutional power of the state and the general economic situation in Armenia to a greater extent than in other FSU economies. The process of reconstruction of the administrative system and other institutions was very slow and this increased the level of uncertainty and adversely affected economic activity. It also contributed to the expansion of the hidden economy with its long-term negative consequences.

After gaining independence, the primary focus of the economic policy of the government has been on “first-generation reforms” of stabilization and structural reforms but not on institutional reforms. Today, the gains of the first-generation reforms are in danger of being dissipated unless sustained “second generation reforms”, focusing on institutional development are implemented. The basic problem could be summarized as follows: existing distortion micro regulations and administrative discretionary practices prevent Armenia to take advantage of the potential gains associated with strong macroeconomic performance. So far the institutional development lagged far behind its economic counterpart, being partly responsible for huge distortions and inadequacies of the Armenian transition.

Continuation and completion of institutional reforms, proper public policy directed to alleviate excesses of shock therapy and externally funded and directed growth could create the necessary impetus for the quest for sustainable development and economic growth of Armenian state and society.

4.4 SMAL - SCALE PRIVATIZATION.

In separate countries transition to market relations by transformation of former socialist productive and economic basis began and prolonged to develop in different social and economic, political, historical and other conditions. Last largely determine this or that form selected by country, model of reforms and path of their implementation, policy of transition and specific factors, determining it. During transition the central place is allocated prices and markets liberalization, appearance of new firms and implementation of such economical programs, which one will supply or will keep, already reached stable price level.

The reforms of transient economics are interdependent and integrated system to which end result essentially influences liberalization and stabilization of economics. In the final accounting basic reform ensuring potential profit is creation of the free market. However in conditions of a macroeconomic unbalance and sharp money devaluation the free prices can't become reliable market tag. Problem number one at transition to free market is economics liberalization, which in combination to stabilization can ensure increase of transactions and economical growth efficiency in a transition period and after it.

The second problem is connected with the changes and development of the property right, frame of work motives and also private sector creation, which will dominate in economics. Launching conditions of the given country also important. In a number of countries with transient economics privatization can be more actual than in other. However meaning of effective privatization program using public support, can demand the solution of discordant problems and overcoming of numerous interrupting.

The third problem has a large value not only from economic, but also from the social and political points of view, it is connected with the decreased level of an impoverishment and other negative effects of transient on definite layers of population. In the total of reforms, in final accounting all have benefited (somebody more, other is less). However depending on launching conditions of country introduction in transient economics and from carried out reforms this process can be from the very beginning accompanied by dip of a life standard (that took place in Armenia). In this cause, for this problem solution, especially with the purpose of population poor layers protection it is necessary to conduct effective social policy and to execute such measures, which would ensure stable economical growth.

The main purpose of an economic policy carried out in Republic was the creation of market economy with social orientation. I am speaking about formation of such economics systems, which is characteristic for civilized countries, were the maximum satisfaction of material and spiritual needs of the citizens became an indispensable condition of development. On the way of solution mentioned above problem in countries with market economy is established and develops such system of economical relations, which one provides socially and economically effective activity of all economics as a whole. And last circumstance is based on the purpose of production manufacturer (or granting services) to receive profit. Thereby is provided satisfaction of a social demand on the given product (service), that is indispensable and sufficient condition for profit obtaining by goods and services manufacturer.

In countries with developed goods-money relations, market is the tool for productive and economics communications creation, sale and purchase of goods (services), exchange of the capital, manpower, information and etc. The market economy acts ground on objective economic laws and first of all ground on the demand-proposal law.

Nowadays Armenia is on paths to market relations and it is naturally that developed market infrastructures are fast increasing. Valuable market in direct sense of this word was not completely formed yet and still is necessary to create it. It is important to remember that formation of market relations and on this basis creation of market economy not the last goal itself but is the paths of country social and economic development.

Series of programs were adopted in Armenia for economics stabilization and transition to market attitudes. Some of them are in process of implementation. In these programs are indicated complex measures on stimulation business activity in Republic, perfecting tax-budget, financial and money policy, organization-structural reforms of economics, social hardening of population. The relevant place in these measures is allocated to problems of democratization and liberalization of economics. Formation of economical freedom for the managing subjects and creation medium conforming for it, (first of all legislative, then organizational structures) became one of the main streams spent now economic policies. [*Economic bulletin N 7, p.23, June (1992)*]

For market economy development large value had also liberalization of external economic relations, directional on stabilization of home country market and stimulation of the local and foreign investments, essential assistance to export. In issue of economics liberalization measures implementation Armenia has reached considerable successes, which will be fitted in the near future.

Despite of necessity and relevance of listed measures in economics transformation in to market, fundamentals of economical relations on the market formation is change of the property right of production assets, transition from a state ownership to alternate patterns of ownership. In the majority of former socialist countries this problem in practice is decided by means of privatization. Thus privatization of production assets is an indispensable condition and means for transition to market relations and also increase of market mechanisms and economics efficiency.

One of major problems, which one needs to be decided in any company within the framework of relations "firm-state", is the raise interest of firm and its workers in increasing of the volume and quality of production and granted services. [*Privatization Yearbook 1996, Edited by Henry Gibbon, Privatization International London(1999). pp 27-39*].

Introduction

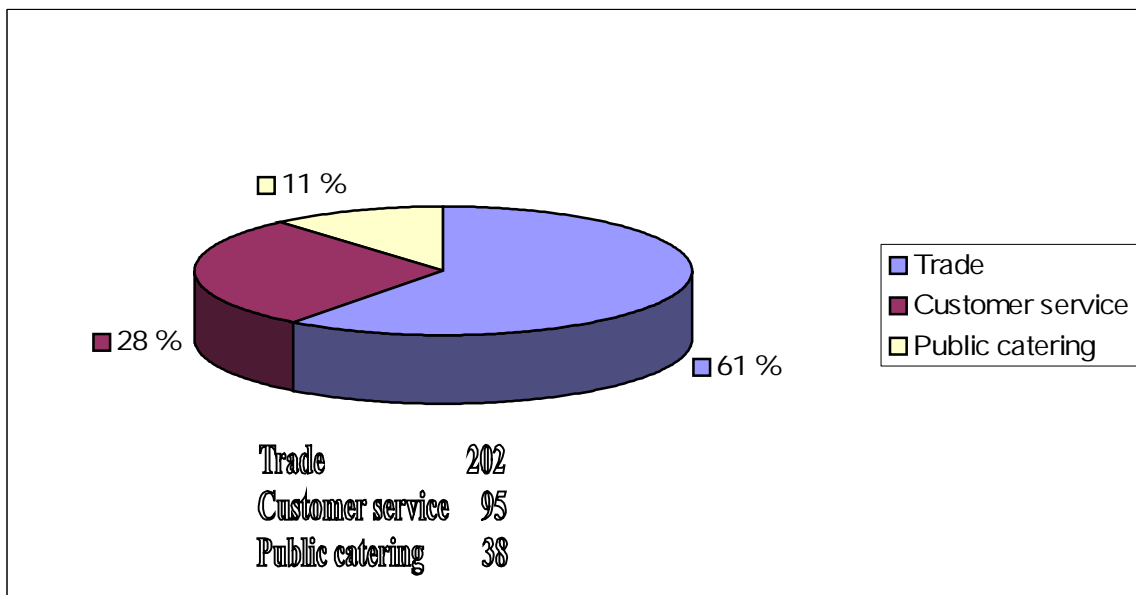
The liberalization of prices in 1992 has resulted in necessity of consumer market and firms of a mild, local, woodworking, mechanical engineering, chemical industry, building organizations privatization. The process of privatization was necessary to execute first of all in these area because monopoly characters of firms in conditions of a noncompetitive state ownership result in steady rise of prices and in conditions of a small salary rise to fall-off standard of life. Thus to stop the unmanageable growth of liberalized prices was necessary to turn-on the market engine "competition". It was possible to make only in conditions of ownership relations.

Readiness of companies to exchange a considerable proportion state ownership with other patterns of ownership increasing the buying power of population and realization of people ability to privatization. In building the non-socialist future a large role has played also experience of privatization in the majority of other former Soviet republics and socialist countries. The logic of this problem was simple, if all (or nearly all) subjects of a former system submit transition to new relations by means of privatization we can not remain indifferent to this.

Huge quantity more than 5 thousand objects of uncompleted building being in 1992 in different branches of economics were inheritance of former socialist economics and continuation of these objects building coast was higher than state financing capabilities and it was necessary to search other sources for financing and organization of construction work. [Report of the ministry of construction for (1991-1992). pp. 34, 42]. A sharp devaluation of money and impoverishment of population force to apply one of privatization models voucher privatization.

To the beginning of 1992 were already privatized 55 % of agricultural lands, 70 % quantity of cattle, 35 % of engineering, 83 % of collective farms and state farms. [Report of Ministry of Statistics of R.A (1992) p. 5-7]

Besides it is necessary to mention that in 1991 the Government of R.A has accepted number of decisions, which have regulated processes of small trade objects, public catering, consumer services and objects of uncompleted constructions privatization. In 1991-1992 were privatized 335 small objects, 202 trades, 95 - consumer services and 38 - public catering. [Report of Ministry of Statistics of R.A (1992) p. 84, Social-economic situation in Republic of Armenia for January - December, (1992), Yerevan].



From privatization in 1991-1992 were obtained 191,2 million rubles.

Privatization as long-lived and definitely capacious social-economic and political measure has logical and sequence stages of development that is why is necessary consequently definite communication and co-ordination of operations first in subject of forms and ways of privatization selection and second in problems of privatization policy in different branches of economics. So the first step of privatization process are preparatory measures precursor to privatization which should be largely applied to improvement of activity unprofitable (or having low profitability) firms. Concerning small objects, as a rule, it is necessary to execute accelerated privatization, allowing quickly to sale huge quantity of objects of retail trade, public catering and consumer services.

At the beginning stage of mass privatization in 1994-1995 considerable proportion of small objects, firms of a mild, local, wood-working industry and building complex, firms producing consumer goods, mechanical engineering and chemical industry and objects of uncompleted constructions were privatized. This process was prolonged and in 1996-1997. [Privatization program for years (1996-1998)].

By 1999 196 objects were privatized, from which 108 objects – by collectives of firms, 68 - renters and 20 firms on the competitive basis. During the same term 149 "small" firms were estimated, from which 31,1 % trade, 11,2 % - food shops, 9,2 % - consumer services and 11,8 % objects of public health services. The remaining "small" objects are acts in service branch and other areas. A considerable proportion of privatized "small" objects up to 34,7 %, makes leased objects. [*Report of Privatization Ministry years of 1999-2000*]

The order of "small" objects privatization

The labor collectives of "small" objects have the priority right of these objects privatization. The "Small" objects, foreseen to privatization by the Program and conforming by governmental order of Republic of Armenia. Within 20 days after obtaining the written proposal the labor collective should present to governmental body (Ministry on privatization) the written approval to buying of object under indicated price with decision of general meeting with purpose of company or limited company, and also to pay an initial fee at a rate of 5 percents of an indicated cost. In case of non-presentation of the written approval and non-payment of an initial fee in the indicated term the collective was disqualified to become owners.

Distribution of a portion between the members of labor collective is made under decision of labor collective (owners) members. The "small" object can be privatized by labor collective, if not less than 51 percents of its present workers have decided to become the owner. Thus on objects which have in structure more than two workers, the size of each portion should not exceed 40 percents of a ratable value and at structure from two persons - not less than 20 percents. The size of minimum part should not be lower:

for objects of retail trade -2 percents of a ratable value of object;
for other "small" objects - 1 of percent of a ratable value of object.

After acceptance by Government of Republic of Armenia decision about privatization of the given object by its labor collective last one was obliged within 30 days to enumerate on the special privatization account a total cost of object or at desire, - conforming part of this cost on a scale of payments by installments, by established Program for "small" objects, with allowance for initial fee. In case the payment was not made in the indicated term, the collective was disqualified to become the proprietor and initial fee does not return.

The prices of “Small” objects are estimated proceeding from cost of their property after reevaluation of taken territory-according to the established by Government of Republics of Armenia order and with size authorized by Government of Republic of Armenia authorized body correction factors of territory calculation cost.

Government of Republic of Armenia establishes the form and conditions of payment, proceeding from the Program, on presentation of authorized by Government of Republic of Armenia body. [*Privatization Law Article N 25*]

The schedule of payment terms for privatized state ownership applied to “Small” privatization and in case of state ownership direct sale.

Terms of payments volume under privatization bargains. Table N 1

The sum intended for payment (dramas)	Volume of initial payment (dramas)	Term of payment (years)	Amount of payments
Up to 2000000	100 %	-----	-----
2000001 - 5000000	Not less than 2000000 + 40 % of that part which exceeds 2000000	1	2
5000001 - 10000000	Not less than 32000000 + 30 % of that part which exceeds 5000000	2	3
10000001 - 15000000	Not less than 47000000 + 20 % of that part which exceeds 10000000	3	4
15000001 - 20000000	Not less than 57000000 + 10 % of that part which exceeds 15000000	4	5
20000001 - 25000000	Not less than 62000000 + 5 % of that part which exceeds 20000000	5	6
25000001 and more	Not less than 6450000	6	7

Sours: State Ownership Privatization Program for 1998-2000.

The buyer can at any time pay all remaining sum. At the next payment in established by Government of Republic of Armenia order is allowed a change indicator of the prices on privatized property. If the “small” object has rest from a consumption and accumulation fund, at privatization by labor collective this remainder can be utilized as a payment part of privatized property in a part due to the workers, becoming members of the given company.

In a case when “small” object not privatized by labor collective on the above-stated cases, labor collective deprives rights on priority and Government of Republic of Armenia makes a new order about privatization of this object on auction within one month. In a case if the object is not sold at auction Government of Republic of Armenia makes new order about privatization of this object by competition within one month. In a case of not sales object on competition Government of Republic of Armenia within one month makes a new order about liquidation and sale property of this object by order established in article 31 of Privatization Law. *[R.A. Privatization law Article 31]*

In similar conditions the public practice generated the internal requirement of privatization of firms on agricultural production processing, service of agriculture and also firms of branches adjacent by all of them. The privatization of one of the largest branches of economics agriculture and formation in it of a private property, essentially entered a planting inconsistency with a state ownership on firms of a process industry and on maintaining organizations (firms) that considerably reduced economic efficiency of agriculture. In the final calculation adding to manufacturing proportions in an economic chain “an agriculture - maintaining organizations (firm) - process industry “ not only did not promote a saturation of the consumer market by agricultural production and production of refining firms, but also essentially reduced a role of privatization of land in issue of a rise of living standards of the population.

It was already apparent that the majority of trade objects and consumer services basically were actually privatized and it was necessary legally to improve the actual situation. The company already for a long time has reconciled to the fact of the not legitimated privatization of consumer services and trade objects.

Small and Medium Sized Enterprises (SME’s) are considered main guarantee factors for social and economic stability in each country. Actually SME’s represent industrial and processing enterprises, crafts, whole sale and retail trade, farms, services and other sectors of economy. In European

Economic Zone SME's provide the 2/3 of all jobs, comprising from 40 up to 60 percent of GDP. Development of SME sector enables to smooth social - economic difficulties inherent in transition economies, thus creating stable conditions for further economic development.

During the last years industrial decline and unemployment rate increase in European countries with transition economy were substantially smoothed down due to aimed policy executed in SME sector. With regard to the peculiarities of SME sector its development to large extent is conditioned by the existence of purposeful state policy and strategy.

Strategic importance of SME's is conditioned by the following:

- § With considerably small investments and in a short period of time SME's can provide a big job opportunities, thus improving the situation in job market and solving a number of serious social problems;
- § newly created SME's often impact positively the restructuring and modernization processes of non-operating and non-profit large enterprises as well;
- § new technologies and innovations with more rapidity and less expenses are implemented by the SME's;
- § SME's rapidly get adapted to new market demands and offer new products and contemporary forms of services due to their flexibility;
- § SME development favors the creation of the middle class as the basis of contemporary society.

Finally, according to their strategic importance and further development potential, SME's contribute to revitalization and rehabilitation of all sectors and spheres of economy, thus fostering and the successful operation and development of large enterprises as well.

SME Sector in Armenia

The process of privatization and de-nationalization started in Armenia since 1991 and was conditioned by the realization of a new policy of transition from planned economy to free market relations. Privatization dialed with agricultural lands firstly, thus forming private agricultural sector in Armenia, then it passed to trade and service sectors, eventually finishing with the industrial units. Today private sector in Armenian economy can be considered as an actual fact.

Estimation of the role of the SME's and their influence on Armenia's national economy is a rather hard task, taking into consideration the absence of relevant legislation on and juridical definition of SME's. Consequently the Ministry of Statistics, State Register and Analysis does not conduct statistical registration of the sector. Nevertheless, according to expert estimation, SME's in Armenia comprise more than 95% of all registered enterprises.

As compared with Yerevan (capital), small business is less developed in Marzes (districts), which is conditioned by a number of factors, as for: lack of State Regional Entrepreneurship Development Policy, remoteness of Marzes from the capital and the main communication routes, etc. According to statistics, the bulk of businesses in capital have the status of enterprises, while the number of sole proprietors is prevailing in the regional business communities. This could be explained by the fact that regional businessmen are mainly engaged in agricultural production and realization and the status of sole proprietor is quite suitable for such kind of business.

General entrepreneurship data, to more or less extent mirroring the state of SME's in Armenia, are brought here to compensate the lack of SME statistics in the country. In 1994 the system of compulsory centralized registration of enterprises and sole proprietors was introduced into Armenia [Law of RA "On State Register", 1993]. This resulted in the registration of 93007 economic units, 49666 of which are sole proprietors, 43327 have the status of enterprises and 14 are unions of

juridical persons (2000-01-01 data). As compared with the corresponding period of the previous year, the number of sole proprietors has increased by 2443 and that of the enterprises by 2086, i.e. the number of registered sole owners is exceeding the number of enterprises by 17.1%.

Surveys and expert estimations show that about 40-50% of the registered enterprises are idle, with more than half of them being engaged in retail and wholesale trade. During the year 1999, 3775 sole proprietors and 496 enterprises halted their operations (doing necessary procedures in State Register) due to different reasons. According to 1999 data, the registration pace of the enterprises has been adequate to that of sole proprietors. A rather dynamic process of formation of a relevant legislative framework aiming to secure the entrepreneurial activities started in 1994, when new enterprises, mainly in trade and service sectors, emerged parallel to the process of privatization.

Objectives of SME Development Strategy and Policy

Peculiarities of SME sector, opportunities given by it and international experience in this field urged me to speak of the necessity for elaboration and execution of SME Development state policy. It is based on the main principles of economic development of RA as follows: free market economy, reinforcement and development of legal and practical basis of the competition field, establishment of private property as main substance of economic relations.

With regard to the role of SME privatization and their creation in economic revitalization of Armenia, SME Development state policy is aiming to achieve the following objectives:

1) Economic Objectives

The main objectives of small and medium entrepreneurship, as of key component of contemporary economy, first of all concern the economic field.

SME development state target policy implementation will result in an increase in SME's number, especially those engaged in productive activity. It will compensate the recent industrial sector decline. Consequently SME's increase will lead to escalation of market competition, which in its turn will significantly boost the quality of the local products. Increase in the market agents' number will enlarge the capacity of the local market. Local production of high quality goods will cut drastically the volume of the import of low quality and faked products and foster importation, eventually be conducive to a decrease in Armenia's negative trade balance.

State's legislative, financial and other assistance will encourage the entrepreneurs to return to legal framework thus reducing the shadow economy. Taking into consideration that small businesses usually are based on local resources, SME's development will significantly contribute to maximum utilization of local raw materials and machinery and optimization and reduction of the volumes of imported resources and semi-products.

Armenian SME's can use the idle industrial assets, revitalize non-basic production units of the enterprises (mainly large ones) operating at very low level of their capacities. Promotion of Small and Medium Industries will lead to some shift of finance from trade sector to industry.

Due to their relatively simple administrative structure, technological flexibility and less demand in investments for diversification, SME's are better able to operatively response to frequent market changes than the large enterprises.

Thus economic objectives of SME development policy are:

- § Significant increase in production volumes;
- § Shrinkage of shadow economy;
- § Escalation of market competition;
- § Upgrading of quality of local products;

- § Increase in export versus decrease in import;
- § Maximal utilization of local raw materials and technical resources;
- § Production diversification.

II) Social Objectives

SME's directly impacts social climate of the country and state social policy. Small businesses enlargement will foster job creation thus contributing to sharp decrease of unemployment caused by last decade's economic decline in Armenia. The development of small entrepreneurship will impact positively the incomes of bulk of the population subsequently increasing the purchasing capacity of the local consumers. The development of entrepreneurship will create advantageous conditions for self-realization of individuals, which is one of the prerequisites for the establishment of social justice.

SME Development will cease the dramatic outflow of population from Armenia as well as will foster immigration positively impacting the demographic situation.

Eventually SME Development promoting economic progress will prove beneficial for moral-psychological atmosphere in the society.

Thus social objectives of SME development policy are:

- § Creation of new jobs;
- § Increase in population's incomes and purchasing capacity;
- § Establishment and reinforcement of social justice in the society;
- § Decrease of emigration and promotion of immigration;
- § Improvement of moral-psychological atmosphere in the society;
- § Regulation of internal migration.

III) Political Objectives

State policy in any sector of the society's life eventually is as well pursuing political objectives with their relevant consequences.

SME Development will favour the creation and reinforcement of the middle class – a stratum, which constitutes the backbone of any sustainable contemporary society.

The development of entrepreneurship contributing to economic growth and security of the country will improve the image of the State and raise its international rating.

The realization of a targeted regional economic policy will result in economic safekeeping of Armenia's border regions.

Thus the political objectives of SME development policy are:

- § Formation and reinforcement of the middle class;
- § Provision of inter-political stability;
- § Enhancement of democracy;
- § Improvement of state's international reputation;
- § Reinforcement of border regions.

Main Directions for Implementation of SME Development Strategy and Policy in Armenia

Precondition for development of a viable SME sector in Armenia is considered the existence of favorable macroeconomic and competitive environment, regulated inflation, etc., which to some extent are the results of State systemised economic policy. For dynamic development of private and especially the SME sector in Armenia, it is important to conduct clear state policy in following main directions: *Legal and Regulatory Framework for SME*.

According to expert observations, to set a favorable environment for the development of businesses, especially in countries with transition economy, is impossible without creating relevant legal and

regulatory framework. It is mainly conditioned by lack of business development traditions and as a rule by frequent violations of law. The paramount obligation of the Government is to provide favorable legal and regulatory framework for the normal development of businesses. Legal and regulatory framework of the SME's should be based on the main concept of SME development policy and strategy.

During the last years a lot has been undertaken to create an entrepreneur friendly environment. Business related legal and regulatory framework was on the whole designed, particularly the laws and other legal acts defining and regulating banking activities and legal forms of entities, as well as licensing forms for some types of businesses, etc. The centralised state register system for economic units is already founded. The last two years might be considered those of development of legislation when new laws on tax, customs and other obligatory payments were adopted.

After the adoption of the new Civil Code of Armenia, January 1,1999, many old laws and legal acts became out of effect. Further laws and legal acts on civil right standards should correspond to the new Civil Code and only then brought into effect.

Unfortunately, Armenia still lacks legislation directly related to the SME's. From this point of view the adoption of the Laws "On State Support to SME's" and "On Chambers of Commerce and Industry", elaborated by the Ministry of Industry and Trade, will be of paramount importance.

The Law "On State Support to SME's" will serve as legal stronghold for State support to the latter, will specify SME criteria in Armenia and the main directions of State support to them. Besides, it presupposes the creation of an appropriate mechanism of provision of State guarantees for loan and investment attraction, as well as elaboration and implementation of SME development programs.

The adoption of the Law "On Chambers of Commerce and Industry" will enhance the creation of a general operating network of chambers of commerce and industry in Armenia. Tax environment improvements demand certain changes in Armenia's current tax legislation, which cannot be considered entrepreneur friendly due to several circumstances.

Firstly, Armenian businessmen make use of rather high interest rate and difficult accessible financial sources. Secondly, additional direct (expensive energy sources) and indirect (expensive cargo transportation costs) expenditures are very high in Armenia due to several global and external factors. Thirdly, restricted domestic market forces the Armenian enterprises to become export oriented, but competitiveness in foreign markets demands implementation of contemporary high technologies in production.

Evidently, the country's tax system, which is considered liberal and favorable by foreign experts, cannot successfully operate in Armenia. To create a favorable tax environment for the development of businesses, especially the SME's, it is of major importance to overcome the constraints created by the tax system, viz.:

§ big tax rates;

§ heavy tax administration.

It is important to revise profit and value added tax (VAT) rates and VAT calculation and collection mechanisms. A differential approach should be applied to VAT rates and non-taxable thresh-hold of Income tax should be increased. To simplify tax administration it is important to legally fix and strictly forbid VAT transferring delays, undue check-ups of the enterprises and the like.

Simultaneously, to foster the development of prior businesses and especially the SME sector, it is important to practice tax incentives:

- § for foreign small investments;
- § for domestic investments;
- § for implementation of new technologies;
- § for financing/loaning the SME's via the commercial banks.

Tax holiday envisaged for up to 500 million AMD foreign investments does not promote the attraction of small ones. So other incentives for small investments should be worked out as well. To avoid the start-up tax holiday abuses, which has its precedent, tax incentives should be applied to the investments and not to enterprises. For example, provision of tax discount equal to, let's say, 20% of the invested sum. Favorable tax regime should be applied to targeted economy sectors and regions. With regard to the importance of installation and development of contemporary technologies, it is necessary to reduce VAT rate for enterprises attracting such investments.

Financial Provision of SME's

Armenian entrepreneurs, both start-ups and veterans, have to encounter a vast number of obstacles, financial problems being perhaps the most critical ones among them. According to expert estimations, financial resources available in Armenia's financial market are limited especially those allocated to SME's, which is the result of poor state support to small business.

SME access to available financial resources is difficult due to several reasons, the main ones being:

- § high interest rates;
- § lack of mid-and long-term loans;
- § scarce appropriate guarantees for loan acquirement;
- § inadequate quality of business plans;
- § complicated loan acquirement procedure in banks.

State's main task in rendering financial support to the SME's should be the improvement of the condition of the SME subjects in the financial market as well as financing of the priority projects of highest efficiency and strategic importance.

The creation of a State loan guarantee system could become a notable step towards the solution of small businesses financial problems and the establishment of a SME loan guarantee State institution.

Around \$50 mln worth financial credit resources now available in Armenia provided to the enterprises by several relevant international and foreign organizations via commercial banks are important precondition for financing of SME's. It is worth mentioning that the interest rates of above resources are gradually decreasing. However, due to poor collateral furnishing of enterprises the level of realization of loans is too low. The acquired loans are mainly invested into trade and services.

Industrial Development

SME development policy, as part of the country's general economic policy, should reflect and concord with its principles and main directions. Production sector and particularly, industry, as one of the pivotal directions of the country's economic development, should be reflected in SME policy and be carried out via separate programs and undertakings.

Enlargement and development of the production sector, as one of the main directions of SME policy realization, will favour the realization of the main goals of SME policy, viz. increase in the production volumes, reduction of the deficit of the trade balance, efficient utilization of the local

raw materials, increase in the export volumes, re-operation of the idle productive capacities, diversification of production, etc.

In the Concept of Industrial Development, elaborated by the Ministry of Industry and Trade, SME's are considered as key components for revitalization of large enterprises in terms of the development of different sectors of economy and Regional Development. The range of proposals including different aspects of Industrial Development allows revealing the further co-operation options between large and small/medium enterprises – the mechanisms for establishment of mutual links and main directions of economic collaboration.

Innovations for SMEs

Enterprises using high and information technologies and innovative investments are as well considered prior for Armenian economy. But for separate SMEs, high-tech & innovations seem almost unavailable mainly because of being expensive. To overcome this and provide the enterprises with considerably equal opportunities business incubators, techno-parks and industrial zones are beneficial to create.

Business incubator is a group of newly created enterprises utilising the same premises and centralized services, accountancy, goods/raw materials purchasing opportunities and marketing.

Techno-parks are more preferable for industrial or high-tech enterprises because enhancement of production and industrial processes demands installation of new technologies. This is mutually beneficial for the scientists and the entrepreneurs that are scientific programs can be worked out and tested in business environment quite at hand and the entrepreneurs in their turn can use the scientific achievements. This model might efficiently work in Armenia, taking into account its scientific capacity and the existence of appropriate scientific centers.

SME Problems in Armenia

The privatization process in countries with transition economy has been taking place with difficulties and Armenia could not avoid these problems. The small privatization, including the selling of the trade sites, public food processing and service sphere, is the object of sharpest critics.

More than 6,700 small sites were privatized only in 1996 and 1997. The peak of small privatization has actually passed in Armenia. About 100 rather non-attractive for investor's sites are waiting to be privatized. Noteworthy that the total cost of sold small enterprises made about 25 bln drams or \$50 mln, while about \$500,000 entered the state budget, the rest part of the sum was paid by privatization certificates. [Markosyan. A.H., *Management of state enterprises privatization*, pp.123-127].

One of the basic problems bound with privatization of "small" objects is non-disbursement for privatized property. Privatization process was accompanied by the violations of the country legislation, which was caused by the lack of proper mechanism of selling. Thus, the Privatization Ministry informed that from 1997, the Ministry presented to the court 563 suits related delays of payments based on the agreements signed by the new owners of privatized sites and the Ministry. So for example in 1998-1999 the Ministry of Privatization of R.A has submitted 415 applications to court, under the data of the claims should be collected 3625,6 billions dramas. From them 111 claims get positive solutions and from 70 of privatized firms was collected 614,8 billions dramas. Because of non-disbursements of the next annual fees for the privatized property by one part of "small" objects owners price in the real estate market of R.A slumping.

The head of the Judicial department of the Ministry of Privatization Vahan Simonian explained that the new owners are actually unable to pay the sum. Last years some changes have been made in the privatization program, according to which the terms of payments were prolonged. Thus, the Privatization Ministry recalled almost all the suits. Nevertheless, 100 criminal cases have been instituted and the properties of 39 sites were confiscated. It means that the property of these sites have been offered for the auction. Simonian also informed that all these cases were transferred to the Department for obligatory execution of deeds, created by the Justice Ministry for execution of court's resolutions. But this process failed to work as well. According to the 53 article of the Privatization law, if the tender is not taking place, the department of the Justice Ministry estimates the cost of the property. Moreover, article 82 of the same law says that after each next auction the cost may be reduced by 20%, meanwhile there are not any limits. These sites will be finally sold for symbolic sum or even free. The Privatization Ministry is still trying to punish non-payers and presented other 20 new suits for the total sum at about 100 mln drams. There are no any guarantees that these suits will be considered. However, Simonian informed that some suits were considered that the decision is made. However, he refused to tell what sum the Ministry of Privatization lost and what was the role of the Department for obligatory execution of deeds.

Noteworthy that the specialists of the Ministry are unable to check up the whole property of the site before the privatization. Moreover, any estimation of the property by the specialists of the Ministry may be questioned and appealed by independent auditing companies, since the methods of estimation are imperfect.

The terms of small privatization are less specified in the law of privatization, meanwhile the small enterprises are more preferred in the capital of Armenia, and are more preferable than the industrial enterprises. Now, it is obvious that the small sites were privatized almost for free, that the sums did not reach the state budget and were owned by those bureaucrats who were rewarded for being not so stiff while implementing their duties or for adopting soft and appropriate laws.

No SME targeted policy was executed during the whole period of economic reforms and transition to market economy in Armenia. Surveys and expert research work done by SME division as well as by a number of NGOs, international and foreign organizations, allow having the complete picture of problems encountered by Armenian SME's. According to them, the following factors affecting on the development of entrepreneurship, especially small businesses can be outlined.

SME's in Armenia generally lacks the resources or contracts to attain the political patronage that drives access to resources and reduced risks. These are businesses that benefit most from rational government policy development and enforcement, while larger ones are more able to draw upon various advantages that can balance poor policy development and enforcement. SME development should be given careful nurturing attention, as it is widely recognized that an additional dollar invested in SME development generates significantly greater employment than a similar investment in large enterprises. The main barriers to the establishment and growth of SME's in Armenia include the following: (1) poorly paid civil servants who frequently avail themselves of opportunities to supplement their salaries from businesses with patronage and a biased judiciary; (2) limited purchasing power of the domestic population; and (3) difficulties faced by entrepreneurs in gaining access to credit.

1) Taxation as a major problem for Armenian SME's.

There are no incentives for the start-ups. Actual tax rates are not encouraging the development of enterprises as well as they are not conducive for both internal and external investments. Proprietors often complain of the tax system administration, which is said to be uncertain and unfriendly. Tax

regulations are complicated and are subjected to frequent changes, and information is hardly available for the taxpayers. In this state tax system boosts tax administrators to abuse power on one hand, on the other hand the businesses are given the chance to operate outside of law.

Access to finance is the next major factor hindering business development, viz.:

- § high interest rates;
- § shortage of mid- and long term loans;
- § difficulty in providing of collateral and loan guarantees;
- § inconsistency of the bank staff in assessment of the business plans.

Enterprise financing problems in Armenia are connected with almost lack of start up and development capital conditioned by transition period peculiarities. Low demand of the local market is considered to be a serious obstacle to progress. Although the internal market is far from the saturation point, Armenia's economy has to be oriented to great extent toward external markets in order to develop dynamically, which requires state support, time, finance and training.

II) Bureaucracy and corruption are seen as major irritants.

They exist in state (Tax Inspectorate, customs, licensing, registration, etc.) as well as banking systems. Having appropriate informal links with authorities and executives of the above institutions is still considered to be important and useful for successful businesses. There is not a national business-information and consulting system, offering value for money, quality services, with open access to it, to assist SMEs to compete successfully in local markets as well as abroad. Lack of vocational education and training system is another hindering factor which has a key role in market economy as an institution creating new forms of job organization, promoting entrepreneurship and propagating mentality of new age.

Availability of reliable statistics is a critical issue. Development and implementation of a comprehensive and timely strategy and policy in all sectors of economy, particularly for the SMEs, require as precise as possible, complete and up-to-date statistical data on economic units. It could prove useful for businessmen as well as for organizations and specialists dealing with issues on entrepreneurship.

SME Development Strategy would address the above issues and promote the creation of favorable conditions for the development of entrepreneurship in Armenia. Solution of SME problems could become a significant shift toward socioeconomic progress of Armenia.

The Principles of Implementation of SME Development Strategy and Policies

Small business in transition economies due to structural reforms, privatization and overall liberal policy become the key component of private sector. SME's in Armenia operate in a considerably unfriendly environment and encounter additional obstacles conditioned by transition period. Taking into consideration SME peculiarities, special approaches need to be implemented to overcome these obstacles.

In Armenia as well as almost in all transition countries due to some objective reasons the main productive capacities dramatically have lost. It creates huge unemployment with sharp decrease of incomes, which has to be addressed. Small enterprises could help to fill that increasing gap. In fact both large companies and SME's should develop simultaneously and jointly since their development concepts are not mutually excluding but vice versa are inter-complimentary. Fast and timely responding to changing demand of market, and offering small lots of goods SME's at the same time compliment the large enterprises' activities. They can take over that technological cycle'

sectors of large enterprises that is more feasible to accomplish in small-scale enterprise. Thus SME's collaborating with industrial giants conduces to optimize the whole technological cycle.

The SME's flexibility and their conformity to ever-changing demand of market perhaps are the most valuable characteristics in the post-industrial hi-tech world. In this respect the existing industrial infrastructure and capacities and, which is more important, available human resources in Armenia ensure that the economic development of the country can be achieved by the investments in high technologies and innovations.

SME Development Strategy and Policies must be carried out according to a number of cardinal principles, which are among the main concepts of socioeconomic development of Armenia. Foremost the projects and undertakings deriving from SME Development State Strategy have to be directed to revitalization and empowerment of industrial sector of Armenia. Particularly in this field the main efforts have to be performed in high-tech industries, innovations as well as informational technologies. The next important issue is Regional Development. The overcoming of existing economic disparities between regions of Armenia and fostering the social-economic uprising of underdeveloped regions or those in emergencies have to be amongst the key targets of the projects and measures aimed at SME's development.

Substantive achievements of Armenian economy can be assured in case of essential increase of export volumes and improvement of negative trade balance. One of the main principles SME Development State Strategy is fostering of import substitution and export oriented industries.

4.5 1994 MASS PRIVATIZATION IN ARMENIA.

As the world experience shows there is no ideal form (model) of privatization in one country. Each experience reveals both positive and negative consequences of this process. But always they are conditioned by a social-economic, political and cultural climate of the given country, degree of stability of society, efficiency of economics and developed of a legal regulation system, scales of public sector, availability of financial and bank systems and market infrastructures, specific weight of middle class in social frame of the population, national traditions (in particular concerning property) etc. Thus even in favorable launching conditions (for example in Eastern German) the frameworks of privatization are objective limited. [*Privatization Policy and performance. International Perspectives. Edited by P.Cook and C.Kirkpatrick. Prentice Hall, New York, (1995), pp.22-35*].

The Agency Problem

One of debatable problems, bounding with privatization is the problem of what is this, is it political or economical measure. It is possible to consider its objectives if to take into account that for achievement of this or that purpose (especially in scales of country) there are most miscellaneous paths and means. Let's consider one of the "standard" purposes of the State that is the increase of economics efficiency. For achievement of this purpose the State has set of means. One of them is the increase of incomes receipts in a State budget by increase of Tax weight. For it maintenance there are two basic paths: increase of a tax field (or "tax base"), second - increase of the bets of taxes. Other path of the budget income increase is a sale of production assets being a state ownership, and usage of the incomes, obtained from it, for state needs.

Thus despite of the political concerns tangent privatization it is the more economical measure and not because this process descends directly on economics, but because privatization from the point of view of an economic policy means:

- a) change of state and non-state proportions in economics strengthening of a private sector, increase of market infrastructures and in some countries - their creation,
- b) attenuation (in many cases - full termination), state influencing on all managing state and non-state subjects, limitation of planned economics management levers encouraging competition and in the more generalized form - granting economical freedom to firms,
- c) development of a private sectors accompanied by stimulation economical and social assistance to this quadrant,
- d) privatization of state firms by their disposal or subordination by other ways to the non-state managing subjects.

Some authors have opposite opinion about how to measure privatization programs in transition economies. They think that the program is largely dictated by political rather than economic conditions. At the start of transition, because the state held most assets, private wealth for buying them was inadequate. This led to the prospect of giveaways of state assets to a tiny segment of the population or foreign buyers a politically infeasible course of action in many countries. By contrast, because mass privatization allowed a much greater participation by the general population, it was more politically acceptable.

The method of privatization does seem to be matter in a great deal in explaining efficiency improvements, confirming the concerns of those that emphasized early on the agency problem: the well-known concern that non-owner managers do not have the same profit motive as owners and are unlikely to operate in the most efficient way assumed in theory. Long documented in industrial countries, the agency problem is seen anew in various ways in the many countries in transition. Although the evidence is far from being clear, the empirical literature does reveal an approximate ordering of superiority. Start-up firms are clearly the best performers, showing the greatest efficiency gains; firms dominated by outsiders, especially with foreign investors involved, generally show good improvement; insider-dominated firms are the least efficient among the newly privatized, with an unclear distinction between the management-dominated and the worker-dominated cases; the least efficient of all are the remaining state-owned enterprises.

In addition, the method of privatization appears to be matter in a way not foreseen earlier: some forms of insider-dominated privatization may generate vested interests that will work against the establishment of an open, competitive environment, and against providing a level playing field for start-up entrepreneurial activity. With government privileges added (most commonly so far in the form of tax exemptions), the result is a continuation of a soft budget and a distorted allocation of resources toward the less efficient and the politically favoured. *[Oleh Havrylyshyn, Donal McGettigan (1999), pp.5-10]*

Countries executing privatization pass this path variously. The privatization as a direction of an economic policy is reshaped outgoing from a condition of national economy and development strategies of country. However in all countries privatization is implemented under influence of different factors. If to group together the factors influencing the privatization, the main will be: value of the made and utilized national income per capita, frame of distribution of this income, levels of industry and agriculture development, condition of manufacturing and social infrastructures, condition of private sector development, its scales, efficiency, and value of the external and internal debt of country. Also value and outlooks of the foreign investments, ratio of the incomes and consumption of a state budget, capacitance of the local market, stability of a monetary policy, geopolitical position of country, political situation, condition of national security etc.

The mentioned factors have essential value in selection of the forms of privatization, queue and at the practical solution of other problems. Probably in decision making about firms privatization above named factors will have a miscellaneous directivity. In similar cases it is necessary to start with value of common vector of the factors. To accept this or that solution on privatization it is necessary to take into account that final result of this process is effectively operational firms, and under efficiency is necessary to perceive both economical and social efficiency.

The essence of economic reforms implemented in Armenia during the last twelve years was the formation of relations, institutions and management systems intrinsic to a market economy designed to achieve the following objectives:

- § price and foreign trade liberalism, acquisition of monetary policy tools and mechanisms;
- § privatization, multiform ownership, and creation of equal conditions for competition;
- § establishment and development of financial market institutions;
- § revision of the fiscal system and its relations;
- § restructuring of the state administration system and application of new management methods and forms, regulation of natural and technological monopolies;
- § formation of social security and a system of guaranties;
- § integration with international markets.

Certain steps were taken in line with all above-mentioned initiatives in terms of drafting legislation and applying its implementation mechanisms. When evaluating the efficiency of these reforms, it should be mentioned that in all areas there were sufficient positive and efficient solutions. However, generally approaches to such solutions were neither holistic nor coordinated and often they were incomplete, deficient and in some cases late and of an unrelated nature. In certain cases the basis of the reforms lacked fundamental and efficient solutions from the beginning. As a result, even the most timely laws and decisions were limited in terms of their positive impact since various sectors of the economy, although pieces of the same chain operated under different and sometimes contradictory regulations. Of course, the transition period implies and frequently demands a rapid response to emerging problems. However, afterwards it is necessary to define adequate, fundamental solutions.

It is not necessary to plot an illusion that is possible in short times and without shocks to privatize a large part of property. The main limits in this business are absence for population indispensable means for acquisition property and foregone at privatization (as well as any other wide area measures) negative social consequences (first of all high rates of unemployment growth).

Since gaining its independence and through 1994 economic reforms in Armenia were implemented against a background of a drastic economic decline. The causes of this decline included the disruption of the main transportation and communication routes as a result of the regional military and political conflicts, de facto blockade of Armenia, the energy system crisis, changes imposed due to external guidance of economic policy, and a sudden break in previously established economic ties. In the same time primary steps for foreign trade for economic reforms were taken, such as price liberalization, establishment of openness in foreign trade and economic boundaries that are objectively inherent to the shock therapy effect. All these were further complicated by a lack of experience in entering and establishing foreign markets and legally regulating product competition.

The impact of this factor on the process left deep gashes in the socioeconomic situation of the country and affected the future trends for economic reforms. Beginning from 1994, possibilities

arose for stopping the country's economic decline and for ensuring a measure of economic stability. At the same time it should be noted that the level of stability attained did not become a basis for equitable and dynamic growth. This was caused by a disproportion of reforms, shortcomings and mistakes in different spheres, as well as situational, rather than comprehensive solutions.

As a result, their efficiency was subject to the extent of their implementation at an administrative level and was limited objectively by time constraints. The country's economy is characterized by explicit disproportions particularly in regard to the maximal and minimal amounts of quarterly GDPs, which differ from each other approximately by a factor of four. This can be explained by the significant size of agriculture in the GDP structure. In the Soviet era, it constituted 12-12.5% whereas during the transition years it amounted to 43% maximum and 22.5% minimum (registered in 2000 as the result of a serious drought). The structure of GDP is highly differentiated by regions. Economic activity is concentrated in the capital city.

From the point of view of market reforms estimation started in Armenia in 1991 their totals and also selected model efficiency relevant value is “measurement” or “weighing” of reforms implementation outcomes. For advance estimation in reforms three main specifications will be used:

1. Liberalization of economics,
2. Development of a private property and property customs,
3. Availability of the conforming institutes and the directions of social policy. [*Reforms in Armenian Economics (1991–1993), pp 46*].

Each parameter is in its turn characterized by several parameters. So the liberalization of economics estimates three amounting: condition of a home market and price level in it, condition of foreign trade and currency convertibility, capability of companies creation. From this point of view in 1993 in Armenia there were available main conditions for development of market economy, free trade, convertibility for implementation of current operations, liberal policy concerning private business and creation of new firms.

Conducted by World Bank calculations of a liberalization degree for the term of years 1989-1995 as for 28 countries with transient economics have shown, that it was highest in Poland (7,3), then in Slovenia and Hungary (on 7,2), and lowest - in Turkmenistan (1,5). Armenia in a number of these countries takes 20-th places (2,8). It lags in CIS Turkmenistan, Tajikistan, Azerbaijan, Belarus, Ukraine, Uzbekistan, Kazakhstan and Georgia. [*From Plan to the Market, world development report (1996). Washington, W.B, p17*].

The second parameter also has undergone severe changes. As of 1995 in 9 countries Central and East Europe and CIS (Poland, Hungary, Czech, Slovenia, Estonia, Lithuania, Latvia, Albania, Russia) more than half of production volume was driven on a lobe of a private sector. This parameter for Armenia is 45 %, and in a number of 28 countries Armenia took 15-th place. [*From Plan to the Market. The report on world development (1996). Washington, W.B, (1996), p. 19*].

The fast development of a private sector in transient countries was conditioned by privatization of state firms and creation of new private enterprises. Depending on features of separate countries and privatized objects, in privatization levels and in efficiency of private possession of the property it is possible to note considerable differences. These divergences mirror influencing historical factors intrinsic to concrete countries and also composite political problems arising during reallocating of a national wealth.

Characteristically in some former socialist countries there are both and growth of investments and maintenance of a rather high standard of life. From this point of view the level of privatization may become one of the best parameters (if not main in issue of reforms estimation).

However is apparent that the successful transition to market economy supposes development of different patterns of ownership. The formal cession of rights observed during privatization it's only begun of property reforming.

To have full picture about liberalization of a national economy it is very important to apply for total estimations, which would reflect the main features of spent policy. In this sense the publications of fund "Heritage" and magazine "Wall Street Journal" in "index of economical freedom" represented annual data of 150 countries. For an estimation were taken into account 10 fundamentals economical parameters: policy in trade, tax, monetary, bank orbs, degree of government influencing on economics, foreign investments, ratio of the salary - price, degree of proprietary rights developments, order of business and scales of "black" market, which one estimate by a 5-degry system (how low estimation so high freedom of the given orb). The index of economics freedom is determined by an average estimation. Though for an estimation of each parameter specialists use about 50 economical parameters, nevertheless reduced classification has empirical nature.

In particular notwithstanding circumstance, that the basic 10 parameters render essential influence on economics however at the same time influencing value each of them in liberalization is various and from this point of view estimation would be more precise if for formation of a final estimation they had "weight" (factors). It is necessary to mention that the definition of weight influencing of each parameter on economics and degree of its liberalization enough hard activity and from the point of view of quantitative measurement also is subjective (as in the fundamentals of weights definition lie down the expert estimations). Armenia, which in this list takes 100-th horizontal, has received a high estimation of policy implemented in the field of trade, (2 grades). [*Torosjan T. Whose economy is freer. " The Finance and Banks " N 29, July 23 (1997)*].

And it is true, the market of Republic is free enough for import, though inside of country the trade relations still require ordering. The poorest estimation has received the monetary policy and investment situation in Republic. Above mentioned once again results in concluding that it is necessary to sink reforms for republic could take a worthy place in a number of civilized countries.

Property Rights

Establishing property rights and privatization refer to the next main set of reforms. The main objective is to remove the state from the ownership and decision making within enterprises. On one hand privatization is regarded as an important complement to liberalization and stabilization, on the other hand it is aimed at improving post-privatization performance of enterprises, that would arise from the commercial focus instilled by private owners and from effective post-privatization corporate governance.

Institutional change.

In the environment of economic transition the extent to which the state is able to ensure certain basic rules of market behavior is crucial to the success of initial reforms. Once the basic reforms of liberalization and privatization have been implemented and the state has consolidated its new role, the focus of institutional reforms shifts towards strengthening of the supporting institutions. It is worth mentioning that the establishment of institutions is a two side process of demand for institutions from the side of the developing private sector, and their corresponding supply from the side of the reforming state as well as the society in general.

Institutions

Institutions resonate with similar legal institutions of property, contract and legal infrastructure. Market is unfriendly systems of property law, contracts and legal institutions can lead to an increase in transaction costs and therefore reduce the incentives to effective investment, production and trade. The state therefore plays a crucial role in structuring a friendly market. This assumption is too simplistic. The nature of “institutions” is much broader and in many respects defined differently from legal ones. More significantly, while new institutional economics borrows legal ideas, it translates them into economic discourse.

Institutions executing privatization in Armenia

Two separate bodies, the Privatization Commission and the Privatization Board, originally supervised privatization in Armenia, although the Ministry of Economy eventually assumed supervisory responsibility. The commission, created to deal with privatization strategy, comprised ten members appointed by Parliament and then appointed by the president guaranteed way to politicize privatization. The board, created to deal with Divisions between the government, the commission, and the board led to delays and frequent stalemates. In March 1996 the commission lost its independence, was reorganized, and eventually was folded into the government. It currently functions as an advisory body staffed with deputy ministers representing economy, finance, and line ministries. In November 1996 the Ministry of Privatization was established, and the Privatization Board moved there. This movement helped centralize and facilitate decision-making.

Government Failure

In contrast to the question of when a government chooses to privatize, the question about the form and method of privatization is under theorized. In one of the few empirical studies exploring the determinants of a government’s decision to use (private) asset sales, [Megginson et al] argue that countries with less developed financial institutions, higher deficits and higher levels of income inequality are more likely to privatize state owned assets by using public share offerings.

The problems with privatization is possible to attribute to wider political factors, that is, the reform was either politically undesirable or unfeasible or the government's efforts were unfeasible [*World Bank, (1995), World Bank, (1992), Shirley, (1999), Cook, (1997)*]. While commentators from World Bank welcome the acceptance that prescribing privatization is not enough in itself, there is no shift in the underlying assumptions of the privatization prescription [*Cook, (1997), Ramamurti, (1999)*].

Leys (1996) and Tshuma (1999) have suggested that distrust of bureaucrats and prescription of privatization are based on “public choice” theory. According to the theory, state institutions as well as politicians and bureaucrats involved will work to maximize their institutional and individual self-interest and power rather than a wider “public interest” [*World Bank, (1981), Bates, (1981)*].

Yarrow (1999) similarly suggests: The rationale for seeking to reduce political influence on economic decision-making is, most usually, to improve incentives for economic efficiency on the level of the enterprise. Underlying the case for privatization is the view that there is “government failure”, in the sense that public policy is likely to operate in ways that, for one reason or another, impede the efficient functioning of markets.

“Property rights” theorists suggest that state sector inefficiency results from situations in which no individual or group has a clear stake in the assets of the enterprise [*Shirley (1999), Alchian and Demestz (1972), Barzek, (1989)*]. Consequently politicians and bureaucrats in business will produce

inherently inefficient results. The market mechanism ensures efficiency by overcoming the problems raised by “public choice” and “property rights”.

It is an interesting co-incident that argument in the governance report is that failures of its programmes were frequently connected to the quality of government or as Yarrow (1999) aptly terms “government failure”. The underlying argument of *Bureaucrats in Business* was also that privatization and state sector reforms were dependent on suitable regulation. Shirley states the “sobering” conclusion thus: The experience analyzed above suggests that a country which is not able to create a credible, efficiency enhancing regulatory regime is unlikely to regulate its state-owned infrastructure well [*Shirley (1999), p.131*].

Let see how should act economic policymaking. Pioneering work on this subject was made by the Dutch economist Jan Tinbergen, who delineated the crucial steps of economic policymaking. First, the goals of economic policy are specified, usually in a social welfare function that the policymaker attempts to maximize. Based on it, the policymaker identifies the economic targets. Second, policy instruments available to reach the targets must be identified. Third, the policymaker must have a model of the economy linking the instruments to the targets, so as to choose the optimal value of the policy instruments. That is why very important step to beginning privatization to have a good privatization program with clear goals.

A widely accepted set of macroeconomic targets is full employment and zero inflation. Available instruments are, broadly speaking monetary policy and fiscal policy. Tinbergen analyzed the theory of economic policy in a simple linear framework. When there are two targets and two instruments available, policymakers can achieve the desired level of both targets as long as the effects of the instruments on the targets are linearly independent. More generally, the policymakers have many targets and many available instruments. If there are N targets, these targets may be satisfied as long as there are at least N linearly independent instruments.

The various policy instruments may in fact be under the control of different policymakers. Monetary policy, for example, may be controlled by the central bank and fiscal policy by the executive and legislative branches. If policymakers do not co-ordinate their policies as Tinbergen supposed, there may still be a way to arrive at the optimal policy mix in a decentralized manner. The solution is to assign each target to the instrument (and hence to the policymaker) that has the strongest relative effect on that particular target. This is known as the effective market classification approach, introduced by Robert Mundell.

When there are fewer instruments than targets, it will not be possible to attain all targets simultaneously. Society will face the familiar problem of a trade-off between the different goals. In this case, it is useful to define a social loss function that represents the costs to society of deviations of the targets from the optimum values. Policymakers should then choose the targets so as to minimize the social loss. An example of this problem is the goal of eliminating inflation when it can only be done at a cost in terms of lost output.

In reality, the problem of policymakers is much more complicated than an insufficient number of instruments relative to targets. Economic authorities, for example, have to work under conditions of uncertainty. Here, the crucial point is the type of uncertainty that policymakers face. If it comes from exogenous shocks outside the control of policymakers such as bad weather (additive uncertainty), then uncertainty may not greatly affect the optimal choice of policies. Under conditions of a linear model and a quadratic loss function, in fact, additive uncertainty may simply be ignored, by setting the uncertain variables at the expected levels. This result is known as

certainty equivalence. If, on the other hand, uncertainty refers to the effects of instruments on targets (multiplicative uncertainty), then policymakers should in general be cautious-less activist-in the use of instruments.

In some cases, policymakers have a choice of instruments in that they can choose instrument A or B but not both. The monetary authority might have the choice of controlling interest rates or the stock of money, for example. As William Poole demonstrated, the choice of instrument depends on the source of shocks in the economy. When the money demand function is highly unstable, for example, then the interest rate should be preferred instrument when the investment demand is highly unstable, however, then a money supply rule may be more appropriate.

The most forceful attack against the standard approach to economic policy came from Robert Lucas in the mid-1970s, in the so-called Lucas critique. Tinbergen's framework was based on the idea that there is a stable quantitative relationship linking policy instruments to targets, and the idea was implemented using large-scale econometric models. Lucas argued that the large-scale models are unreliable. In that when government policies change sharply, the policy coefficients of the econometric models are likely to prove unreliable. In essence, he argued that the large-scale models fail to treat expectation appropriately, and thus are unlikely to be effective in predicting the effects of changes in policy rules. The practical importance of the Lucas critique is still a subject of active debate.

Most crucial issues regarding policymaking relate to a sequence of actions taken over a period often. Starting at some initial point, the policymaker must judge what are the best actions to take over a certain time period. Should the policymaker be bound by predetermined rules, or should he be free to act at each point in time? It is possible to found that rules tire useful in cases where the optimal policy is time inconsistent, in the sense that policymakers would be tempted to “cheat” on a pre-announced optimal policy at a later stage. Put differently, the time-consistent policy, in which the policy choice is made at each point in time, can be distinctly inferior to setting a policy course at the beginning of a long period and then sticking to it.

An example of the time-consistency issue is anti-inflation policy. The optimal policy may be to promise monetary restraint and then stick to it. But such a course is also likely to be time inconsistent, since once the central bank makes the promise of low inflation-and the unions act on the promise by agreeing to low wage increases-there may be a big incentive of the central bank to renege on the promise in order to expand output in the short run. It is precisely this incentive to cheat that takes away credibility from the announced low-inflation policy.

There is also a positive theory of economic policy, which studies how policymakers actually behave. Quite frequently, governments deviate sharply from the policies suggested by the normative theory. A starting point for understanding this discrepancy is to recognize that policymaking is not usually performed by a single government entity. Government actions are the result of several decisions taken at many different and often-competing levels (central, regional, and local governments; decentralized agencies; public enterprises; central bank).

The positive theory of economic policy has shed light on an apparent general tendency of governments to pursue overly expansionary fiscal policies. Several reasons for this tendency have been adduced, in addition to time-consistency problems. First, there may be a political business cycle, in which incumbent administrations pursue expansionary policies just before elections to influence the election results. Second, governments formed by coalitions of several parties may find it hard to agree on unpopular though necessary austerity measurers. Third, necessary stabilization

may be postponed because of a struggle between different groups of society on how to distribute the costs of the stabilization program.

This link between privatization and governance results from a reversal of an approach, which involved complete mistrust of the state to one which accepts that the state bears the responsibility for the creation of an appropriate institutional framework. Nevertheless, the institutions in the governance agenda are ones which provide an appropriate infrastructure for the operation of the liberal free market [*Faundez, (1997), Tshuma, (1999)*]. It would appear that public choice theory's prescription of the liberal market has been supplemented by a reliance on new institutional economics which prescribes an institutional framework of property rights, contracting and transaction costs for the effective maintenance of the liberal market [*Mercurio & Medema, (1997), 131*].

The economic case for privatization is made more in terms of what is wrong with SOE's than as a positive case for privatization and criticizes. In particular "government failure" is not inevitable and countries can be vary markedly in the quality of government and hence the quality of economic decision-making. Thus, reform strategies should be based on the nature and extent of government failures. In particular, the case for privatization in small poor countries should be particularly weak. The issue in many of these countries has not been political reluctance, but the absence of an adequate infrastructure to support privatization in situations where local buyers have lacked finance and expertise and governments have had to extend protection and subsidies. In the circumstances there has been heavy reliance on foreign or non-resident nationals. Yarrow (1999) suggests that whatever the relevance of the "public choice" or "law and economics" efficiency argument, the underlying reason for the push for privatization is the relative increase in the cost of government finance to support SOE's, privatization therefore became an imperative based on budgetary considerations.

The problems may have been of such an order that the very notions which underlie the definition of good governance in regulatory reform and of privatization itself are challenged [*Nellis (1999)*]. The underlying problem may be a definition of governance which is steeped in institutional economics and property rights theory. As McAuslan (1997, p34) points out: "An agenda which concentrates on the development of a market economy and uses that perspective to advance the cause of good governance is misguided. This model of development assumes that a market economy means less government so that the thrust of law reform is on less regulation, more rules facilitating transactions in the market, the acquisition of private property (where the market forces are assumed to take care of any inequalities in development) and judicial reform aimed at facilitating the settlement of commercial disputes.

The literature on economic reform and capital account liberalization suggests that the level development of capital markets and the health of financial institutions and the banking sector could influence the government's decision to privatize and the method by which it chooses to privatize.

Domestic political institutions may influence a government's decision to privatize and the method and form it uses. Democratization, legal institutions and property rights protection, electoral systems and party systems may all influence the government's decision to sell its state owned assets. Some argue that found that privatization programs are more likely to occur in pluralist, open political systems than in corporatist, closed systems. Molano (1997) argues that privatization outcomes are determined by the relationship between the organizational strength of interest groups, the strength of the national executive and institutional rules.

A country's relationship to the international economic order or its position in the international economic order may also affect specific domestic actors and subsequently, the propensity to privatize. As Keohane and Milner note, trade openness and capital mobility may adversely affect some sectors or assets holders more than others. These groups that are adversely affected by trade and capital mobility may be more effective in getting the government to implement protectionist policies.

Finally international actors may influence domestic politics and a government's decision to privatize. Multilateral organizations, such as the World Trade Organization, or financial organizations, such as the World Bank and International Monetary Fund may tie funding or incentives to policy programs and outcomes. For instance, both the World Bank and International Monetary Fund regularly condition financing on a government's commitment to economic and financial liberalization reforms. Multilateral lending agencies have forced governments to privatize SOE's, develop regulatory governance structures of the financial system, and implement stringent standards for extending credit.

4.6 Armenian Privatization program

In Republic of Armenia the structural reforms carried out after independence declaration are the main factors intrinsic to a national economy of macroeconomic stability and economical growth.

Concept of privatization

On August 27, 1992, the President of Armenia has signed the Law of Armenia on "*Privatization and Demonopolization of the State Enterprises and Unfinished Facilities*". The aim of the above Law is to establish the juridical basis for setting a private relationship. According to the law Privatization is alienation in established by the legislation of Republic of Armenia forms of state enterprises and objects of uncompleted construction to benefit of Armenian Republic citizens, their groups, the enterprises with state and a non-state participation, foreign persons. Privatization is granting in cases and order, statutory about privatization and other acts of Armenian Republic legislation the state enterprises and objects of uncompleted construction in confidential management, the lease, for creation of not state enterprises or enterprises with a state participation - without the right of alienation of a state ownership. [*Privatization Law Article N 4.1*]

.Object of privatization.

- § The state enterprise or their association;
- § Division of state enterprise;
- § Shares belong to the state of enterprises based on the collective or mixed property;
- § Uninhabited premises in the residential and uninhabited buildings belong to the state (local government bodies), not being general-purpose territories; [*Privatization Law Article N 4*]

Subjects of privatization.

Subjects of privatization (purchases of rights for participation in privatization) are:

- § Members of privatized enterprise labour collective;
- § Citizens and groups of citizens of Republic of Armenia
- § Not state enterprises;
- § Enterprises with a state participation in a case if the part of the given enterprise being a state ownership is subject to privatization;
- § Foreign persons.

Principals of privatization.

- § Process of privatization that passes in conditions of sharp structural changes should result in acceleration of these changes and to an increase of production effectiveness.
- § Privatization should allow at each phase step-by-step to remove from a circle of internal economics relations branches, branch groups, which one in its turn are base for the subsequent branches (groups) privatization.
- § Privatization and branch frame should start with requirements of the maximum fast investments, allowing the requirements of structural policy and bound with it financial straits.

Primary goals and Methods Envisaged by the Program

The main result of transition to free market economy is formation effectively operational economical system; thus, one of reference directions of transition to market economy is the creation of effective non-state quadrant including state firms of privatization. Privatization is not mechanical change of a pattern of ownership and first of all is process of transition from administrative-political responsibility of managing subjects to economical responsibility.

Main purpose of similar transition is granting to businessmen's capability to decide current economical problems within the framework of the market laws and to determine policy, course of action and tactics, independently to conduct policy of accumulation and consumption. Outgoing from changes of a state role and forms of control during transition to market relations, all activity on privatization should be conducted system, it should ground of the multifactor analysis, showing the differentiated approach to separate branches and orbs, updating stages of transition, harmonic combining changes of patterns of ownership, its usage with conforming infrastructures medium of managing and with creation of the bases for competition and also creating indispensable social-psychological environment.

The purposes, priorities and restrictions of a current period of privatization are established by annual programs of state enterprises and objects of uncompleted constructions privatization in Republic of Armenia. The project of the Program represents on session of National Assembly of Republic of Armenia and confirming by Government of Republic of Armenia previous to introduction of the Program in action.

The project of the Program contains: principles of selection privatized enterprise and objects of uncompleted construction, enterprises and objects of uncompleted construction, which privatization in the nearest year is not provided; the list of the state enterprises and objects of uncompleted construction by branches and spheres of economy which privatization is stipulated in the nearest year. Separately indicated the enterprises which privatization will be carried out on a way of free subscription to shares, and also the enterprises which privatization will be carried out on international competition. Volume of privatization certificates issue, a circle of persons, which have right to purchase certificates, issue order, distributions and certificates circulating, a nominal value of certificates and size of payment for their reception. Conditions of foreign investments using and foreigner's participation in privatization; the organizational, legal, technical and financial actions necessary for realization Privatization Program of state enterprises and objects of uncompleted construction.

Armenian privatization task and goals are following:

- § Rising of non-governmental companies percent in all quantity.
- § Increase of company's business productivity.
- § Improvement of state ownership privatization methods including wider application of auctions.
- § Increases incomes to a budget at the expense of receipts from a state ownership privatization.

Privatization methods

Sale of ownership interests (shares) of corporatised state-owned enterprises through voucher and money auctions and as a second method of privatization private offering for management and employees (MEBO);

§ Implementation of privatization by a method of a free subscription on shares for the management and employees.

§ State firm's privatization by a method of competitive sale.

§ State firms privatization by international competition.

§ Implementation of privatization by a method of a straight sale.

§ Implementation of privatization of a state ownership through auctions.

Privatization forms

a) sales on auction or on competition;

b) alienation of property for benefit of limited companies and the joint-stock companies established by labor collective or other persons;

c) sale of enterprise shares;

d) the repayment of leased property by leaser;

e) the repayment of a state shares by not state proprietors of enterprise;

f) sales of state enterprise, control shares of enterprise or other predefined share or a package of shares on international auction.

Privatization directions

Privatization in Armenia has passed on three directions. *The first* - privatization of the agricultural lands (economic reforms have actually begun from it). It is carried out in short terms (1991-1993), which became the reason of insufficient development of the legislation and made difficult granting lands to the new owners and their rational use. In result the agriculture land were shared on numerous individual farms (about 320 thousand), not motivated to cooperation and expansion of activity. Other lack was backing transition of new relationship between enterprises engaged in processing and storage of agricultural products, and also factories producing techniques for peasants.

The second direction was responsible for privatization of the state housing found (1993-1998). Due to its carrying out each citizen of R.A gratuitously became the owner of the apartment. This action had not only a wide social orientation, but also has substantially affected formation and foundation of the real estate market.

The third direction concerned the state enterprises and objects of uncompleted construction. The start for changes in this area has been given by governmental order about privatization of 335 small firms in sphere of trade, public catering and services (March, 1991). Privatization of the first large and middle enterprises was carried out only in May, 1995 when by a free subscription to shares were transferred to market 10 big by R.A measures factories of mechanical engineering, electrotechnical, light and the food-processing industry. To the beginning of 2003 first 736 large and middle enterprises were privatized. Actually 146 objects of various branches were transferred to the Ministry on management of the state property or later Ministry on Privatization.

According to program privatization process should stress from the following criteria:

§ Broad entertainment of the citizen's of R.A and foreign investors in process of privatization,

- § The liabilities for control of privatization process with exception groundless political approaches,
- § Targeting of privatization at repayment of the internal debt,
- § Directions of the sums obtained from privatization to a social protection of poor layers of the population.

The main approaches to privatization of large and middle firms have been stressed outgoing from following criteria:

- § Maintenance of national concerns (for example defensive capability),
- § Degree of readiness of firm to privatization,
- § Fitting of firms to branches and competitive orbs of activity,
- § Availability of one-type firms in non-state quadrant of economics and their competition,
- § Fitting of firms to stock-consuming, material intensive and labor-consuming branches,
- § The sizes of firms,
- § Firm's control organizational structures.

4.6.1 Mass Privatization

In mass, or equal-access, voucher privatization, the government generally gives away, or sells for a nominal fee, vouchers that can be used to purchase shares in enterprises. This technique was rarely used elsewhere in the world before the massive transition started in Central and Eastern Europe, but it has proved to be popular there, particularly in the Czech Republic in Armenia and in Russia.

Voucher privatization helps to overcome the shortage of domestic capital. At the outset of transition, voucher schemes were politically popular because they addressed the perceived unfairness of other approaches and avoided the charges of a sellout of national assets to foreigners. The difficulties associated with valuing enterprises before privatization are also avoided.

As the name implies, mass privatization is a quick, simple way of completing large, wide privatization programs just what the economies needed. Early proponents argued that the fast pace of voucher privatization would add to the credibility of reform programs and bolster their chance of success. At times, the speed could prevent employees or other interests from mobilizing opposition to privatization. Furthermore, the widespread participation of a country's citizens fosters a greater understanding of reform and creates a new owner class with a stake in the process.

Mass privatization has its downside, however. The main risk is that a dispersed ownership structure will lack the focus and power to direct effective corporate management. This, in turn, may scare off potential new sources of capital. In practice, these problems have been partly addressed by pooling ownership interests in investment or mutual funds. The funds, however, do not always have adequate management, control, and supervisory powers, and management can and do deprive them of essential information. In such cases, voucher privatization becomes merely ineffective absentee ownership. [*Oleh Havrylyshyn, Donal McGettigan (1999), p.7*]

Mass privatization in Armenia was complicated by a number of factors. The business prospects of most medium- and large-size enterprises at the turn of 1995 were hardly inspiring. Many enterprises made limited, if any, profit, and they would need deep restructuring to survive under market conditions. Their equipment was often obsolete; tax arrears and other debts were substantial; and information about their overall condition was sometimes difficult, if not impossible, to obtain. Expected privatization prices may also have been too high in some cases. [*Girair Achdjian (2000), p.117*].

The dilating of non-state ownership patterns is simultaneous with policy of privatization, which one is directed on change of the operational state firms status, including broad application of the different forms of state firms privatization, guesses development of a new firms network founded on the non-state forms and creation of a favorable legal and economical field.

The substantiation and selection of reference directions for privatization in 1994-1997 state firms and objects of the uncompleted building construction also recognizing that process implemented in conditions of payment means limitation that population used with the privatization purposes, as the government did not excrete padding credit resources. [*Privatization program for years (1994-1996)*, also report of Ministry of Finance for (1994), p 14, (1995), pp. 32,57].

The marked circumstance and also financial difficulties of large firms and necessity of wide area and long-lived precursor privatization of preparatory activity has limited scales of privatization of major concerns (especially of high-gravity and mining-metallurgical branches) in 1994-1997 years. For privatization of such firms they should be profitable and be in a stable financial position.

The form of transformation of the set above firms should become creation of companies with state and non-state participation. It is desirable to involve in preparatory process the foreign investor that is the relevant factor for increase of efficiency privatized firm's activity and their control. With this purpose on the international competitive basis would be privatized those firms which one have large capabilities of export and competitive products. Simultaneously with development of market infrastructures and in the total of broad privatization are created conditions for dilating scales of major concerns privatization.

4.6.2 MEBO

(MEBO) management-employee buyout. It implies a giveaway or a sale, often at steeply discounted prices, of all or part of the company to the people who work inside the company, be they managers or employees [*Gray (1996)*,p. 14]. This is why this approach is dubbed 'insider' model. The management-employee buyout component stemmed from the substantial privileges given by the state to managers and employees of the enterprises offered for privatization. The program granted these groups the opportunity to receive a significant fraction of shares either for free or with substantial discounts.

This model is always a popular one, enables fast and easy implementation. It is more equitable but rather inefficient. However, in all mentioned countries where it was applied as the dominant model, it failed in creating real owners. *Transition Report* published by the European bank for reconstruction and development in 1999 ranks these countries at the bottom of the list of most successful privatization policies. This suggests that insider model can be said to be, at best, a good substitution if the main model becomes too slow.

Mass privatization of mid to large enterprises began in Armenia in February 1995, with an emphasis on partial free privatization; 20% of book value of state-owned corporatized enterprises was given to employees free of charge. The law also gave employees the right to purchase 20 percent of the shares (20 percent of the remaining 80 percent) earmarked for the general public, or another 16 percent of total shares. Employees could also participate freely in the sale of the remaining 64 percent. [*Privatization Law*].

Overall, enterprises formerly owned by the state were sold through a number of schemes, such as free distribution of vouchers to their employees and to the Armenian population, closed and/or open

share subscription, auction, bidding, and direct sale to employees and/or a lessee. The great majority of these enterprises were thus transformed into open or closed joint stock companies.

On this stage, employees were given the option of buying enterprises through a closed share subscription. In the final stage, all those companies not yet bought by their employees were sold, in most cases through open share subscription. [*Armand Sarian (1999), 62-65*].

Pursuant to the decision of the RA Supreme Council of 1994, more than a thousand enterprises became Joint Stock Companies. The next step was mass privatization of state property, which had begun in early 1995. During a few years, hundreds of enterprises were privatized basically into open Joint Stock Companies (according to the data provided by the State Register, there are 4135 Joint Stock Companies in Armenia registered in early 2000, out of which 1690 are registered in Yerevan (capital)).

The said steps resulted in the large layer of shareholders emerged in Armenia (the Central Depository provides their number equaling 150,000). Given that the privatization was basically aimed at the increase in economy efficiency through introduction of corporate governance system and promotion of private persons' initiative, one can state that the goal set was not achieved in full because of the fact that no relevant explanation and instructions were carried out among the shareholders.

Notwithstanding the fact that along with economy transition a necessary legal basis has been formed meant to support the functioning of market mechanisms (the RA Law "On Joint Stock Companies" adopted in 1996, the RA Civil Code, adopted in 1998), it should be noted that:

Almost all-minor shareholders have no rudimentary idea about Joint Stock Companies and stocks, mechanisms of management over Joint Stock Companies and the most important issue – about their lawful rights. They neither fully realize the meaning of stocks nor distinguish the categories of shareholder and member of labor collective, equating them. Sometimes members of labor collectives empower themselves the authority of the General Meeting of the Shareholders, and elect the Board of Directors at their meeting.

Persons, involved in the executive bodies of the Association, realizing neither the range of their authorities nor their place and role in the system of governance bodies of the Association, quite often consider themselves owners of the organization.

Most of civil servants being authorized representatives of the State as a shareholder and major private shareholders, being members of top management of Joint Stock Companies (Board of Directors, executive bodies) and holding votes decisive in adopting decisions, have insufficient knowledge on principles and mechanisms of corporate governance. Hence, the said persons continue to apply command methods of governance, often exceed their rights and authorities. For instance, a Board of Directors adopts decisions, which are the competence of the General Meeting of Shareholders.

All the above results in the following:

- 1.the shareholders' legitimate rights were violated;
- 2.the principles of corporate governance were violated;
- 3.provision of information to the shareholders and transparency of the activity of Joint Stock Companies were not ensured;
- 4.management tasks were not duly performed;

5. resulted from non-observance of the RA laws and by-laws of Joint Stock Companies by their governing bodies, the activity of Joint Stock Companies was unlawful.

MEBO in Armenia were used as a second privatization method and this method didn't bring to any visible results.

4.6.3 Voucher Privatization

Voucher distribution and its use in Armenia

Proceeding from the Program and the appropriate Decree of the President of Republic of Armenia, the Government of Republic of Armenia issued privatization certificates. The right on reception of privatization certificates had only citizens of Republic of Armenia. The subjected to repression citizen of Republic of Armenia has the right to reception one additional certificate. In sphere of privatization the rights of children's whose age older than eighteen carry out parents or legal representatives of their rights and interests. The Program establishes the order and conditions of privatization certificates reception, volume of them issue. Volume of privatization certificates issue should make not less than 30 percents of cost stipulated to privatization by the Program state enterprise and objects of uncompleted construction.

Validity of privatization certificates in period stipulated by programs of privatization is not limited. The fact of privatization certificates reception fixes by special mark in document certifying the person citizen of Republic of Armenia. Privatization certificates are distributed between citizens of Republic of Armenia, which have right on their reception, without payment of their nominal value. The size of payment for certificates reception is established by Program, proceeding from necessity of the reimbursement for their printing, distribution, the circulation and an exchange.

The privatization certificate has a nominal value, which appears in the monetary unit, which was officially taking place in circulation in Republic of Armenia. Privatization certificates, except for the cases stipulated in articles 31 and 34 of privatization laws were legal tender for payment of privatized property or share and were obligatory to a reception on all territory of Republic of Armenia extremely by a nominal value and within the limits of term of their action. Privatization certificates were subject to free sale and purchase in any of not forbidden by legislation of Republic of Armenia forms under the prices freely formed by their holders and intermediary organizations. The amount of privatization certificates which one person can dispose was not limited. Privatization certificates were not subject to repayment by state, state organizations and enterprises couldn't participate in sale and purchase of privatization certificates. At any payment for privatization, cost of part paid by privatization certificates, does not limit. The privatization certificates, which have served as a payment means for privatization, are removed by Government of Republic Armenia from the circulation and repaid. [*Privatization Law Article N 8*]

Privatization certificates issued by the previous privatization programs were valid until December 31st of 1998. [*Privatization Program years of (1998-2000)*]

One of the most important phases in any transition from a centralized economic system to a market economy involves privatization of large and medium-size enterprises, with the objectives of improving enterprise management, efficiency and competitiveness. Other major objectives include removing most of the nation's productive assets from government control and creating a market-oriented environment. In Armenia, as in Eastern Europe and the other former Soviet Union republics privatization of mid-to large enterprises has relied on the distribution of privatization vouchers. Each Armenian citizen was entitled to a voucher, and about 3.1 million vouchers were distributed in late 1994.

The face value of each voucher was set on 28 September 1994 at 10,000 Armenian drams (AMD), or approximately \$25, and was raised to 20,000 AMD in March 1995 to grow up for the effects of inflation. The total value of the vouchers was supposed to represent at least thirty percent of the book value of the enterprises to be privatized. They were thus to constitute a legal means of payment for shares and had to be bought, in theory at least, at their face value (Art. 8). The goals of this first stage were to inject more than sixty billion AMD into the economy; to redistribute part of the property of the nation to the people as a whole; and to encourage enterprise employees to have an interest in the efficient management of their factories.

Specify of Armenian voucher privatization

It is often argued that voucher privatization was necessary because of the lack of cash. In voucher privatization, vouchers would be given to all citizens for free (or for some very nominal cost) who could then exchange the vouchers directly for company shares or for shares in voucher investment funds (which would use the vouchers to buy company shares). The no-cash argument was that this free distribution was necessary since the citizens had no cash to buy shares.

Unlike programs in other transition economies, Armenian mass privatization program has been implemented without massive amounts of donor assistance. After independence in September 1991, Armenia achieved early success with small-scale privatization. By mid-1992 more than 300 small enterprises had been auctioned. This process stopped almost as quickly as it started, however, since the legal framework for privatization had not been fully developed. As part of the conflict over Nagorno-Karabakh, Azerbaijan imposed a trade and transport blockade on Armenia, and the Turkish border was closed. Compounded with civil strife in neighboring Georgia, Armenia became isolated, and structural reforms took a backseat to managing an economy under siege. Thus, in addition to the usual problems inherited from central planning and the exigencies of transition, Armenian enterprises faced difficulties created by the blockade. Given the small domestic market (slightly more than 3 million people) and lack of natural resources, many enterprises simply stood idle, waiting for a resolution of the Karabakh problem while exploring alternative trade routes and new markets.

Yet despite these difficulties, the government initiated mass privatization. Some Armenians argued that mass privatization should wait until it will be clear which enterprises will survive the blockade created unfair hardships and would, hopefully, be lifted. Until the Caucasus became more stable, foreign investment was unlikely. And many Armenians living outside of the country, obvious candidates to invest in the new economy were providing only humanitarian support. Nevertheless, the government adopted the voucher concept developed in other countries to begin rapidly privatizing enterprises.

The state owned more than 6,000 small enterprises and 2,000 medium-size and large enterprises, all of which, including infrastructure companies, had to be privatized. The most interesting feature of the Armenian case is not the quantity of privatization but the quality of the process. The Armenian program is similar to others in the region: it uses vouchers as the main privatization currency, employees have some privileges in the process, and public auctions are held regularly to sell enterprises. But the auction method-specifically, valuation and pricing issues-make the Armenian program notably different. As detailed below, the program uses a pro rata approach, in which the number of shares received depends on the number of vouchers bid. By June 1997 about 4,500 small enterprises had been privatized and nearly 1,200 medium-size and large enterprises had been offered for sale.

Pro Rata Approach

An informal market was created and anybody (including foreigners) could buy vouchers in many marketplaces. The Yerevan Stock Exchange has trades vouchers and quotes a daily price. In the early stages of developing privatization policy the government considered a first-come, first-served approach to the pricing and sale of shares. Enterprises were to be valued and share prices set according to these valuations. Shares would then be offered for sale and specific numbers of shares have to be sold at a designated price until there are no more shares to sell.

The government recognized the difficulty involved with this sort of administrative price setting. In addition to the Enterprise Sales and Voucher Distribution incompleteness of markets, the blockade made accurate valuation of Armenian enterprises problematic. Thus the program ran a risk of extreme under pricing or overpricing of shares that could not be corrected in subsequent rounds. All medium-size and large industrial enterprises were transformed into joint stock companies before privatization.

Initially there was a debate over the use of cash in privatization. Some analysts believed that some shares should be bought only for cash. The government believed that the Privatization Law made cash and vouchers interchangeable. Cash could be used to purchase shares. But who would use cash when vouchers could be bought at a discount? In most countries vouchers traded below their face value. If shares were to be sold for cash only, it would require amending the law. The government believed that allowing cash and vouchers to be interchangeable would help support the market for vouchers. Moreover, it thought that citizens had the right to use their voucher to invest in any enterprise to be privatized. If shares were reserved for cash-only purchase, this right would be denied. The government eventually won, and the mass privatization program accepted vouchers or cash for all shares offered for sale.

But Armenia is small country with limited resources-wanted a simpler solution and thus developed the pro rata approach. In this approach the valuation of the enterprise is only a starting point. For example, suppose the value of an enterprise is set at 100 million dram. Initially, 1 million shares would be offered at 100 dram each. Either the price of the shares or the number of shares could be altered, depending on the demand. The Armenians chose to change the number of shares. In the example, if there were demand for 2 million shares, then 2 million shares would be sold at 100 dram each (as stated, the price could have changed so that 1 million shares were sold at 200 dram each). Thus the value of the enterprise has changed because it is worth twice as much as the initial valuation. Alternately, if there were demand for only 100,000 shares, then 100,000 shares would be sold at 100 dram each. In this case 100 percent of the shares are still sold, but the enterprise's value has fallen to a tenth of its initial value. The Armenians realized, however, that under this method one person could come with one voucher and get all of an enterprise's shares. Collusion could not be entirely prevented. Thus the authorities required that 25 percent of the shares offered needed to be subscribed for an auction to be considered valid.

In the earlier example, at least 250,000 of the one million shares for sale had to be subscribed. If only 200,000 shares were subscribed when the auction closed, the enterprise was not privatized and all bids were canceled. The pro rata approach has several advantages: everyone is a winner, everything gets sold, and implementation is easy. First, the pro rata system is open and equitable. Any citizen that participates is free to choose where to invest and will always receive shares in the company they want. The pro rata system also avoids favoritism because all participants are treated equally in accordance with the number of vouchers they bid. This is a tremendous political advantage because the approach is popular with the public. Second, as long as the 25 percent minimum threshold is met, all shares of a given enterprise are sold. There are no residual

government shareholdings, as there are in other mass-privatizing countries. Finally, unlike schemes in other countries, the Armenian approach provides several useful lessons:

- § Quality is more important than quantity. The government's privatization program had ambitious targets-based objectives. These targets were not met, but they helped keep privatization moving forward.
- § Valuation of enterprises should be used only as a starting point. In Armenia's program, the pro rata approach seems to make everybody happy. It provides the semblance of a market valuation, although demand is not necessarily an indicator of price. However, demand may be the best alternative until a mature and liquid secondary market develops.
- § Capital market development is critical to the long-term success of mass privatization. Armenia's mass privatization is seen as the first step toward the creation of an equity market as well as a market for corporate control. In the first stage, shares have been sold (for vouchers) to the public. But secondary trading will help to establish better owners—those who want to cash out will and those who want control will buy in. Thus mass privatization must establish the legal framework and institutions needed for a capital market. The Armenians have realized this, and are developing this infrastructure.

A few “insider” participants, primarily managers of the enterprises that are being sold, attend most auctions. Some of privatized enterprises have now been operating for close to 5-7 years. Each enterprise has its assets revalued by the government just prior to auction. Asset revaluation was based on past profits, inflation since independence and book value. During the auction, an enterprise is sold provided the bid price (based on voucher face value) is at least 25 percent of the value attached to the revalued assets.

Aspects of economical relations change by a reference direction for Republic of Armenia have been transition to free market economy on the basis of ownership patterns diversity. The similar approach was dictated as necessity of effective economical system creation and logic of economical changes and the objective requirement to become constituent of world economics.

Mass privatization thus did not yield the expected results. Managers, sometimes in collusion with other insiders, manipulated production and profits prior to privatization to reduce the value of their enterprises. [*Markar Melkoni [Melkonian]*] Most Armenians sold their vouchers at 12.5 to 40 percent of their face value to make meager ends meet. [*Armand Sarian (1998)*]. By the end of 1997, about sixty percent of all small enterprises, and about sixty percent (1,250) of all medium and large enterprises, had been privatized. [*International Monetary Fund (1997)*].

By February 1998, when Levon Ter-Petrosian resigned, about 1,350 medium and large enterprises had been privatized: 1,036 through open share subscription, 123 through closed share subscription, 144 through sale to the lessee, forty-four through auction, and only three through international tender. [*Armand Sarian (1998), pp. 64-5*]. A report estimated that by the end of 1997, only seven percent of the population participated in the privatization process as shareholders. [*Human Development Report: Armenia 97, p. 36*]. The ministry of privatization gives a precise figure for the number of shareholders of medium and large enterprises as of 2 November 1998: 143,000 citizens that is, about 4.5 percent of the population that received vouchers. [*Ministry of Privatization of the Republic of Armenia (2000)*]. The concentration of wealth was greater, however, than these figures suggest. One economist has pointed out that 2.5 percent of shareholders control sixty percent of the shares of 713 companies privatized through open share subscription. [*A. Kh. Markosian, 85-6*].

Low liquidity and huge arrears of enterprises, caused by lack of markets and ignorance in marketing, is a large problem. The utilization of production capacity in the sample for large

enterprises was less than ten percent, while it was 20-30 percent in small and medium enterprises. Downsizing by more than forty percent and low salaries (the average salary was \$30). There was a low level of accounting and auditing services. In many cases, tax records were the only available accounting documentation. [UNDP report. Chapter 4 (2000)].

Revenues generated by privatization were somewhat lower than what the Armenian state apparently expected. Approximately fifty-five percent of Armenia's industrial infrastructure, almost all of the enterprises sold until the end of 1997, was privatized for \$800,000. [Tatoul Manaserian]. A 1998 Freedom House report, the data of which are likely to be approximate, puts state revenues from privatization around the end of 1997 at 342 million drams (about \$700,000), against projections of 3.5 billion dram (\$700,000,000) [Freedom House. Nations in Transition (1998)]. Thus, revenues amounted to one thousandth of the projections. Indeed, the minister of privatization, Pavel Ghaltakhchian, asserted that in 1997 privatization of state property had generated 50.4 million drams (about \$102,000), or 0.3 percent of the payments envisioned for 1997. [Pavel Ghaltakhchian (2000), p.5]

As it was mentioned, fully operating enterprises with established markets were sold for a few hundred dollars, which accounts for the disparity between projected and actual income. [Hranoush Kharatian (2000)]. By the end of 1997, Ghaltakhchian conceded that most privatized enterprises had not yet become successful businesses, while the minister of industry and trade, Garnik Nanagulian, stated that privatization has not helped industry yet. The government therefore reconsidered its approach, adopting auction privatization in cash for the remaining large enterprises. [Danielyan (1998)]. The new Law of the Republic of Armenia on Privatization of State Property, enacted by the National Assembly on 17 December 1997, reflected this transition from mass privatization to programmed privatization, as Ghaltakhchian put it. Whereas the proceeds from mass privatization in 1997 amounted to 50.4 million drams, those from programmed privatization in 1998 amounted to 43836.6 million drams, generating 90.2 percent of the expected payments. Programmed privatization worked better, it seems. [Pavel Ghaltakhchian(2000)]

Investment Funds

An Investment Fund Law was developed to regulate financial intermediaries. The authorities were concerned because pyramid schemes had already surfaced in Armenia, and the MMM scandal in Russia was happening at the same time. In developing the law, external advisers borrowed heavily from similar laws in the region. Licensing procedures were also developed. Nevertheless, investment funds have played no role in mass privatization so far, and by June 1997 only two investment funds had been licensed. Neither has been very active. Onerous licensing requirements, along with high minimum capital requirements, may have contributed to the lack of investment funds in the mass privatization program

4.7 Post-privatization firms performance in the Republic of Armenia

The shift to private ownership usually improves firm's performance. Post-privatization, profitability has generally increased, often substantially, as have output, dividends and investment. After reviewing many empirical studies at the firm level, touching a wide range of sectors and across countries in different regions and of different income levels, [Megginson and Netter (2001), p. 380] conclude flatly that "...privately-owned firms are more efficient and more profitable than otherwise-comparable state-owned firms"

But the question that privatization does not always work well. In low-income countries privatization has proven more difficult to launch, and less likely to generate quick, positive effects. There are

settings where many privatizations have not, or not yet, yielded visible, positive performance improvements the Armenia is an example. Even in countries where the process is an overall success, not every privatization improves firm performance. In three comparable studies, looking at 204 privatizations in 41 countries, from one-fifth to one-third of privatized firms registered very slight to no performance improvements, or, in some cases, worsening situations [*Meggison and Netter, (2001)*].

The research made on the ground of interviews made by CEPRA with managers and directors of selected companies, also used accounts and information about enterprises from official and non-official sources. This study presents the results of research of some 65 middle and large sized newly privatized enterprises in Armenia from 1994 to 1997. By the time of research these enterprises have been in private hands for 5-7 years.

The picture that emerges from research is not a pleasant one. The management, generally the same as controlled enterprises before, lacked a market orientation, which would enable them to adjust to new market economy. Their business strategy was extremely short term and opportunistic. Only three of the 65 enterprises had any new investment made in them. For many, prognosis was for continuing decline and ultimate bankruptcy.

By the time of mass privatization was planned that 75 percent of GDP and 90 percent of all firms in Armenia should be in the private sector. The normal procedure for privatization has been as follows. The employees of each firm receive shares representing 20% of those firms. The remaining 80 percent is auctioned to public auctions for vouchers. Every Armenian citizen has received one voucher, with a face value of 20,000 drams (\$35). [*Privatization Law Article N 8,10*] The auction is canceled if total bid price is less than 60% of the government's valuation of enterprise. [*Privatization Law Article N 30*]. The government valuation is based on past profits adjusted for inflation since independence and for the actual book value of assets. This research indicates that firm's management government valuation and makes it easier for them to purchase the firms in auctions.

The research revealed that controlling interest in the vast majority of enterprises was acquired by their former managers, who often continue to ignore minority shareholders. Cost accounting and external auditing were extremely rare and it is thus difficult for outsiders to monitor the affairs of firms. Some accounts, often-fraudulent ones, are kept for tax and statistical reporting purposes. About 100 firms for which privatization was attempted failed to meet the government established minimum auction price, though the average completed sale has been 120% of government's valuation. This fact is an indicator of under valuation of sold enterprises. On other hand open market value of vouchers has fallen to 2.5-5 of their original face value. Many members of civilians were forced to sell their vouchers in order to get money to live on which depressed open market prices as well as general public lack of confidence in privatized enterprises. The result of foregoing was that the purchasers of enterprises who used vouchers they had bought on the open market got them for 30-60 % of government's valuation of enterprises, which was itself manipulated to be as low as possible as reported below.

The researched firms accounts, with their limitations, show ever increasing inventories, increasing inter enterprise and tax arrears, flat sales, and near zero return in assets. It is unlikely that the arrears are misstated though sales and return on assets were more likely to be so. According to interviewers, in many case there were large unrecorded sales, both of products and firm asset. The managers typically have a very short time horizon and were plundering firms at the expense of minority stockholders and creditors. Since it was dealing with unrecorded transactions it is very

difficult to determine the incidence of this behavior. The only newly privatized enterprises that shown any promise of long-term viability are in agro processing, and a much lesser extent, the chemical and textile industries. Those with the poorest prospects appear to include those in the machine tool, furniture making and industries. Employment in the researched enterprises has declined and nominal wages to say nothing of real wages have declined in most of enterprises. Even so employment levels are probably overstated for well-known reasons connected with Former Soviet Economies-which it is often desirable to remain on employment rolls even if no salary is paid, because of social perquisites.

Were interviewed members of director's boards who controlled large portions of stock in the researched enterprises. About 20 percent of respondents are board chairmen, and almost half of them are employed as managers in the enterprise concerned. When asked, almost half said they would never consider selling their shares even if the enterprises were bankrupt, and less than 10 percent were willing to consider selling out to foreign investors. These attitudes reflect a lack of understanding of how markets should operate - or more precisely a feudal - bureaucratic rather than capitalist attitude toward ownership. They also reflect, in all probability lack of understanding of concept of bankruptcy or function of a secondary capital market.

When questioned about the major impediment facing their enterprises, the owners most common response was that there was no demand for their product, followed by complaints about excessive arrears in payment from others and heavy tax burdens. There was little concept that they needed to adjust the nature of their production to market demand, or that if there was no conceivable demand for what their productive assets could produce, sell those assets. Many of the respondents confused the need to market their products with the simple logistical handling of the products. About 70 percent reported that their enterprise had no marketing department, and only 10 percent saw any value in advertising.

Many of the enterprises have no future because they were founded on cheap energy and transport and guaranteed markets, which no longer exist. Many of them would do better to sell their assets and start with new enterprises, which match Armenian's current resource base, cost structure and access to markets.

Research Objective

This research has two main purposes:

1. To determine how perform the newly privatized enterprises, as shown by a number of performance indicators,
2. To provide policy recommendations for improving the performance of enterprises.

Part one of this research explains the methods used and the type of data collected. Part two presents an analysis of the post-privatization economic performance of 65 enterprises in seven economic sectors. Part three describes the economic and business environment of privatized enterprises. Part four presents the principal conclusions and recommendations.

Research Methods and Data Collection

There are two main approaches to evaluation of the impact of privatization on enterprise performance: the "synchronic" approach and the "historical" one [*Frydman et al., (1997)*]. The synchronic approach is based on a comparison of performance of state and private or privatized firms. [*Boardman & Vining (1989), La Porta & Lopez-de- Silanes (1997), Commander et al. (1996), Kokh et al., (1997), Anderson et al. (1997), Earle & Estrin (1997), Perevalov et al. (1998a, 1998b), Dewenter & Malatesta (1998) and many others use the approach in their studies*].

In the synchronic approach it is assumed that the firms compared work under the same conditions: at the same time, in the same markets, within the same environment. Nevertheless, it is practically impossible to find two identical enterprises, especially if one of the two should be a state-owned enterprise and the other a private one. There are always differences in capacity, equipment or supply; every enterprise operates in its own economic, political and social environment, and every enterprise is at its own stage of the life cycle.

From this point of view, it seems more reasonable to compare the ex ante and ex post privatization performance of the same enterprise, as the historical approach does. The approach was used, for example, by Megginson *et al.* (1994), Earle & Estrin (1997), Perevalov *et al.* (1998a, 1998b), Dewenter & Malatesta (1998) and by some other scholars [*Frydman et al., (1997)*].

At the same time, this approach is too straightforward. It permits only measurement of enterprise performance changes after privatization, but fails to isolate the privatization benefits from the impact of other factors that have also influenced the performance results.

In this survey used historical method to study impact of privatization on economic performance. The enterprise survey included 65 enterprises in Yerevan and five nearby regions (marzes) in seven sectors of economy. Three of 62 construction enterprises that had been privatized as of December 31, 1996 were picked for research, as were four of 25 privatized transport enterprises. The industrial enterprises were selected as follows: 16 of 84 privatized machine-tool enterprises, 6 of 11 privatized chemical enterprises, 13 of 141 privatized food processing enterprises, 17 of 66 privatized light industry enterprises and 6 of 18 privatized furniture making enterprises. Fifty-one of the industrial enterprises are in Yerevan and 14 are in the five adjacent regions.

Three criteria were used to select the enterprises for the sample. First, I chose, to the extent consistent with other two criteria, explained below, those that had been private the longest time. This meant that many of sampled enterprises were privatized in 1994-1995. The second criterion I tried to get some enterprises from most regions in Armenia. In order to appraise the economic performance of privatized enterprises, analysis has been split into two parts:

- 1) Internal analysis, which emphasizes enterprise management, marketing, and production activities,
- 2) External analysis, which emphasizes the enterprises' general market environment and assesses some of the special opportunities and pitfalls facing them.

The quantitative data used in this study are based on summaries of accounting data provided by enterprises. The data for prices and revenues are nominal figures, unadjusted for inflation, over the period quarter I, 1994 through quarter 4, 1997. I used nominal data in order to compare enterprises across industries. However, keep in mind that between first quarter of 1994 and the fourth quarter of 1997 prices increased by about 27 times. Inflation decelerated over the period. The accuracy of the quantitative data obtained in this research is considered to be low due to low quality of bookkeeping practices at most of enterprises. This situation is especially serious in enterprises outside of Yerevan.

The qualitative information is based on a poll of members of the boards of directors who in fact control most of enterprises stock. The opinions of these respondents can be considered as representing the strategies of new proprietors of enterprises. The research used CEPRA's interview of 180 board members, including 161 male respondents and 19 females. About 33% of the respondents were aged above 50 years and 41% were between 41 and 50 years. The remaining

respondents were 40 years or younger. Of the respondents, 55% have an engineering background and 25% have a background in economics. Of sampled board members, 20% are the chairmen of their respective boards of directors, and 13% are both the chairman of the board and the executive director.

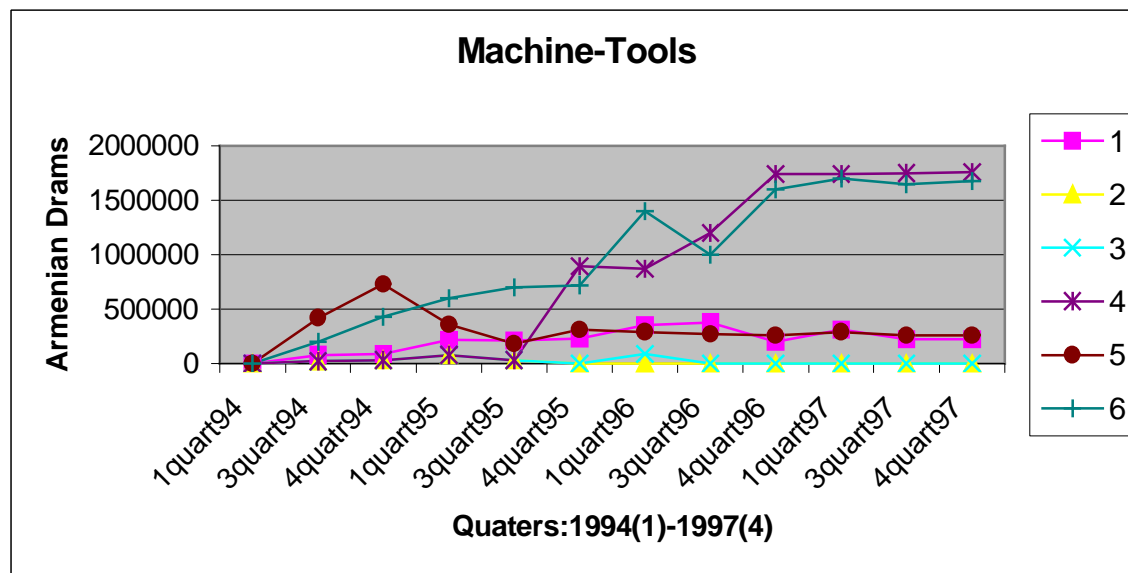
The analysis is based on the interviewers discussions with owners, managers, and staff at the sample enterprises. It also reflects informations that have been gathered from discussion with staff at the Ministry of Economy and Ministry of Privatization and Foreign Investment. All of the accounting data presented here was summed and totaled for all firms sampled in a particular sector. The profit rates are (total sampled sector profit) divided by (total sample sector asset value).

Within the former Soviet Union, Armenia was known as a country with a highly developed industrial sector. The growth rate of industry, although slowing, was positive until the earthquake of 1988. The earthquake destroyed about a third of industrial base and caused a decline in output that accelerated following the break-up of the USSR in 1991. This decline was characterized by sharp increase in prices of energy and raw materials, breakdown of economic cooperation between countries, blockade of surface communications, rising transportation costs, and loss of traditional markets. After independence and prior to privatization, the level of capacity utilization in industrial sector is estimated to have been about 15%-20%.

Machine tools.

Prior to transition period machine tool production was one of the leading industries in Armenia. The performance of several economic indicators during 1994 -1997 for 16 machine-tool production enterprises covered by the research is presented in the figure below.

Chart N 3



- 1. Sales;
- 2. Investment;
- 3. Profit;
- 4. Value of Inventories;
- 5. Value of Production
- 6. Value of Fixed Assets;

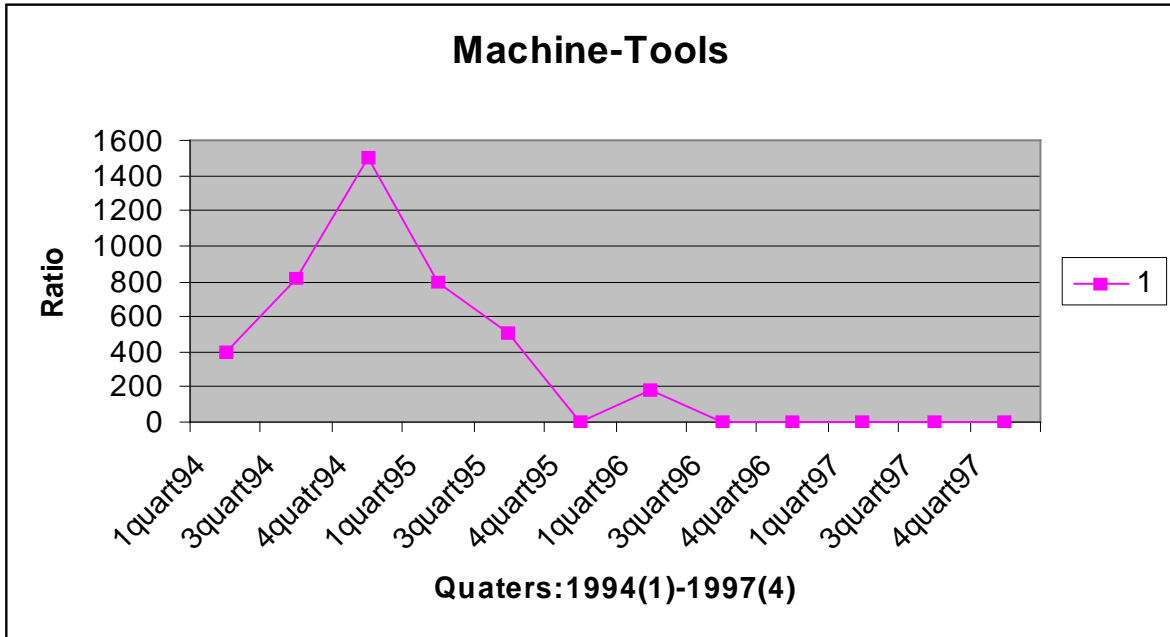
The value of production shows a surge in the forth quarter of 1994, which reflects the rapid inflation at that time. Privatization of these enterprises began in the second quarter of 1994 and continued through the first quarter of 1997. Just prior to privatization of each enterprise, assets were revalued by government according to a formula, which put a great deal of importance on profits of the current and previous quarters. Note that management, who were positioning themselves to buy enterprises, reported falling or zero profit in the critical quarters. While there is a large jump in the

value of fixed assets in the fourth quarter of 1995 as government revalued the assets, increase was not as large as it could have been. The managers were able to acquire up to 80% ownership enterprises control cheaply since the asset values were understated. The large jump in value of assets that followed largely reflects adjustment for past inflation. Once all the machine tool enterprises in this sample were privatized by the first quarter of 1996, asset book values remain relatively unchanged. Note that profit picks up in the first quarter after the bulk of the enterprises were privatized (third quarter 1995), as the new owners had less of an incentive to understate profits.

Inventories also show remarkable growth before and after privatization. This in part may reflect poor bookkeeping. In addition, inventories, which are revalued quarterly, include raw materials. The growth in prices of raw materials in many cases has outpaced inflation. All the enterprises since privatization supposedly have been subject to hard budget constraints (no direct government subsidies) so the growth in inventories with flat sales is only possible if there is unrecorded production leading to higher raw material inventory. This, however, does not explain all of the growth in inventories. Tax and inter enterprise arrears have been allowed to accumulate to point where they are serious impediments to business, and allow for large accumulation of unsold product inventories. Still, sales are underreported, profits are underreported and so tax bill is also understated. The only other possible explanation for the large inventories is that commercial banks are extending excessive credits to enterprises. It is known that many managers of industrial firms are also on commercial banks boards, directed credits of such magnitude would have shown up as investment or informally been revealed to our interviewers. Neither is true. Investment has been virtually zero before and after privatization, and our interviewers reported informally that there were underground sales, but not new loans.

Average profit ratio (defined as profit) of the researched machine tool enterprises has moved more erratically. Profit includes the traditional returns to sales of output, but also includes returns to sales of assets. The ratio peaked in the fourth quarter of 1994 (see chart N 4), when inflation was brought under control, and came close to zero in the fourth quarter of 1995. Prior to privatization, the book value of assets remained unaffected by inflation, so the ratio of profits to relatively unchanged fixed asset values skyrocketed. As privatization approached, the ratio fell sharply. This tendency is largely accounted for methods used to reevaluate fixed assets for privatization. Following privatization, profit ratio increased initially and then declined again to near zero. This reflects the behavior of managers who subsequently became the owners as explained above.

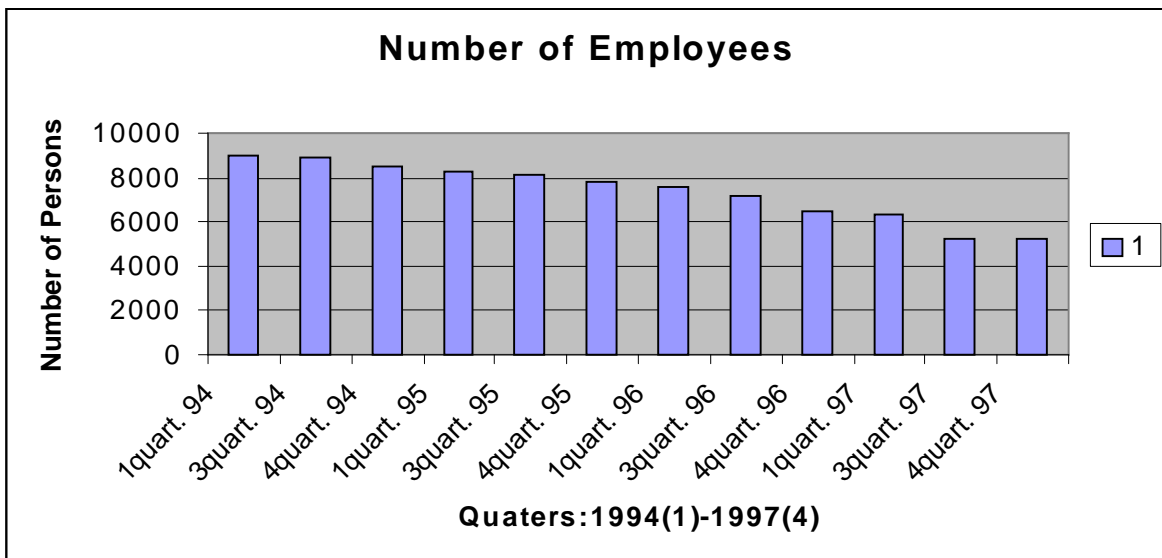
Chart N 4



1. Profit/Fixed Assets

The two figures presented in charter N 5,6 below shows numbers of employees and in average monthly salaries. In comparison to the first quarter of 1994 number of workers in the third quarter of 1997 was cut by 48%, whereas the average salary, over the same period, grew 20 times, but declined sharply in inflation-adjusted terms. The average current Dram salary shrank by 16% from amount 8300 Drams in quarter II, 1996, to 7300 Dram in quarter III, 1996.

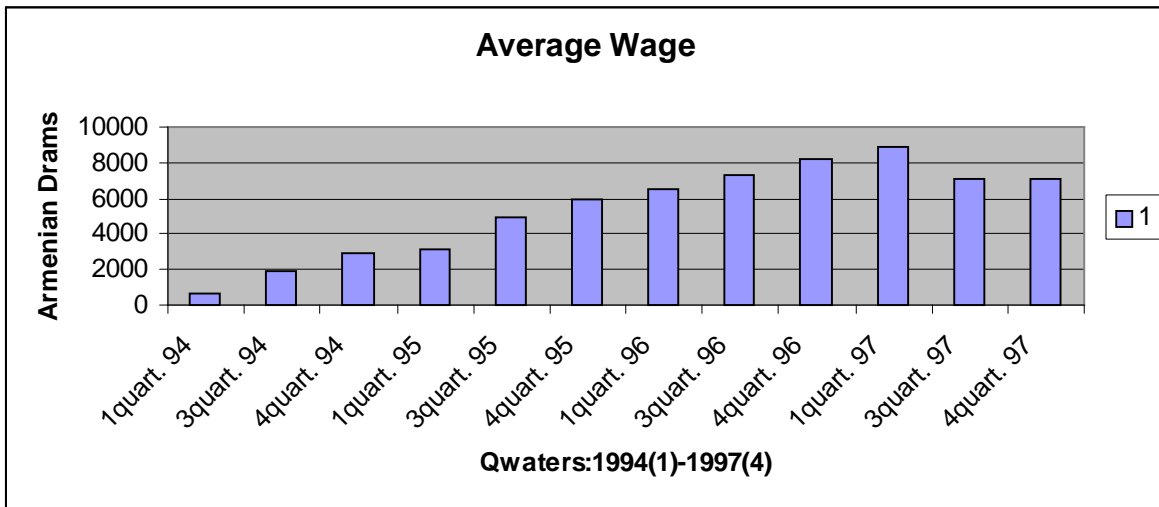
Chart N5



1.Machine-Tools

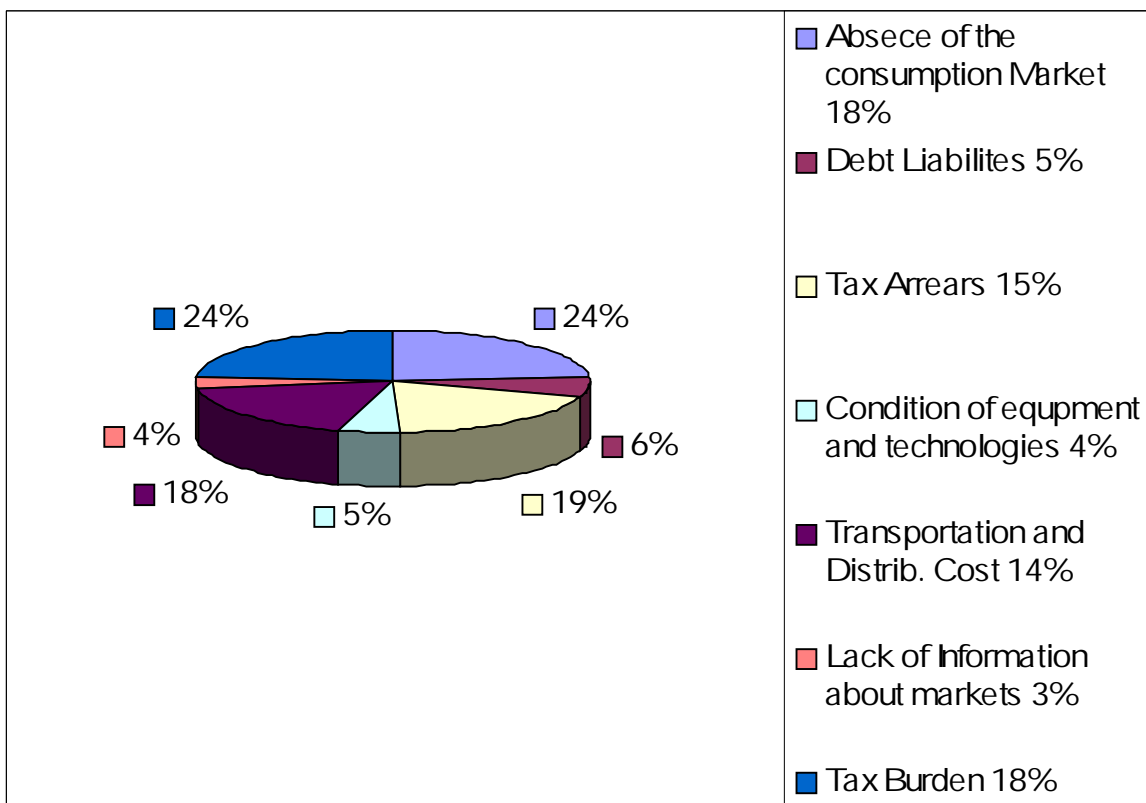
The figure below gives the answers of the survey respondents of machine tool enterprises regarding the principal impediments to their operations.

Chart N 6



1. Machine-Tools

Chart N 7



The four top impediments to business, in opinion of respondents, were: lack of a market, heavy tax burden, high transport and distribution costs, and tax arrears. While 76% of the owners say their most important problem is identifying new markets, only 30% would spend additional money on searching for such markets. Again, 95% say that they need a marketing department, but only 38% say they have a marketing department. These are problems common across all sectors of the economy, but the owners in the machine tool industry seem more acutely aware of the need for marketing, even if they don't know what to do about it.

About 13% of the respondents considered the high cost of production as the main impediment to growth. This response is especially interesting, because the firms lack proper cost accounting. Thus, the managers really do not have a clear picture of the costs of production. The following factors impacted negatively on the costs of production, by the owners opinions:

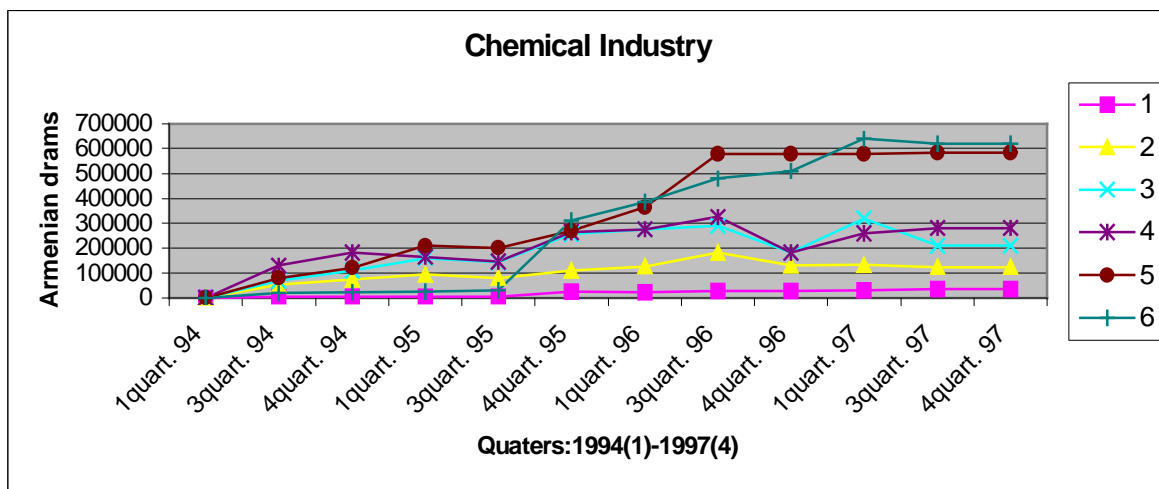
- a) depreciated equipment that was inherited from the Soviet Union and does not meet internationally accepted criteria,
- b) thousands of square meters of production space that requires maintenance but does not contribute to production,
- c) insufficient capacity utilization, resulting in high costs per unit of production,
- d) high proportion of raw materials costs in per unit cost of the product, and high transportation costs.

These responses, overall, reflect the supply-orientation of the owners. Their concern over the high cost of raw materials as opposed to marketing opportunities is evident. Despite the lack of demand, they feel need to maintain unused and depreciated excess capacity, as opposed to selling off assets that are not needed.

Chemical industry.

10 out of the existing 19 chemical plants in Armenia have already been privatized. The overview of economic indicators for the six of these enterprises in this research is presented below.

Chart N 8



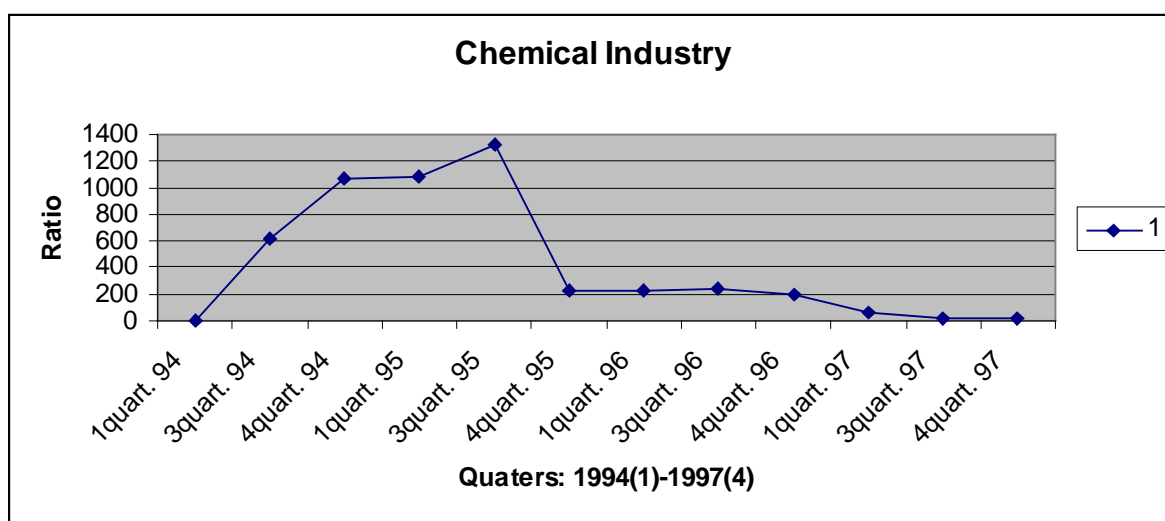
- 1. Investment;
- 2. Profit;
- 3. Sales
- 4. Value of Production
- 5. Value of Fixed Assets
- 6. Value of Inventories

Much of the same story that explains developments in the machine tool industry can be used to explain developments in the chemical industry. Privatization of enterprises in the sample began in the second quarter of 1995 and was complete by the fourth quarter of 1995. This can be seen in the value of assets, which rises throughout the fourth quarter of 1995 and remains steady in subsequent quarters. Manipulation of the profit figures to affect asset revaluation is still evident, but not as blatant as in the machine tool industry. There is some clear potential in the chemical industry, especially in the production and sales of cleansing agents for home and commercial use. Investment, though low, is increasing and the profit picture is more promising than in most other industrial sectors. Some output is even valuable enough to be flown out to CIS markets. The main problem in the long run is that the inputs are costly and dangerous to transport.

The chemical industry registered a sharp increase in inventories, with a dramatic surge beginning in the second quarter of 1995 stretching through the post-privatization period to the fourth quarter 1997. Reported sales also show gains, but the gains do not match the rise in inventories. Again “informal” sales that continue to be unreported are suspected to explain some of the discrepancy.

Below in chart N 9 is time series of average rate of return on assets of 6 sampled enterprises in chemical industry. Again, note the sharp drop in the fourth quarter of 1995, reflecting asset revaluation that start in second quarter. The same pattern is evident as in the machine tool industry, reflecting the same owner behavior in the current legal and regulatory environment. However, the chemical industry remains more profitable, than machine tools. Still, the current trend is for return on assets to decline, largely reflecting the increasing costs of inputs. On the average, through the first three quarters of 1996 profit ratio was 10%.

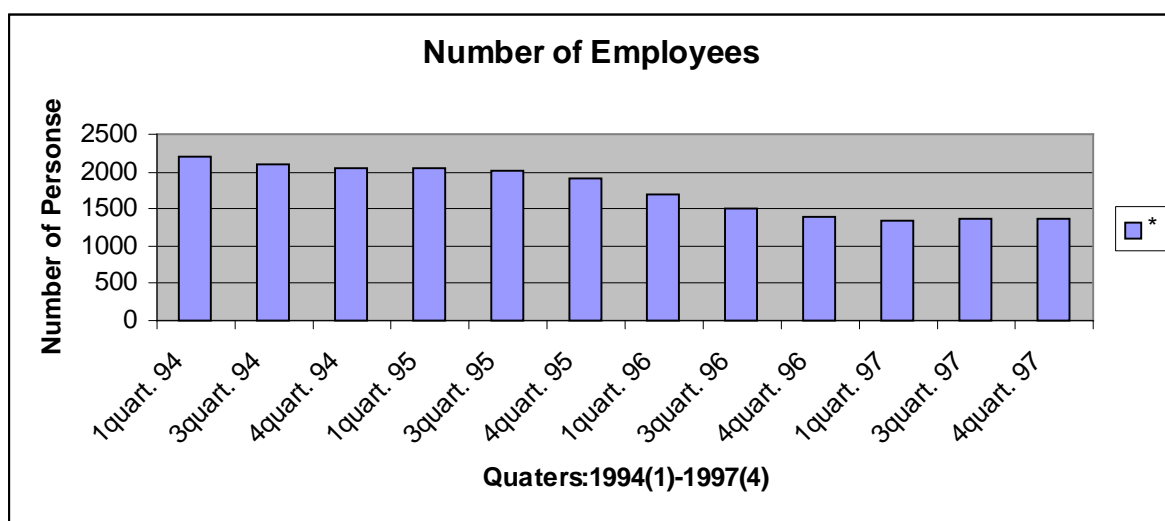
Chart N 9



1. Profit/Fixed Assets

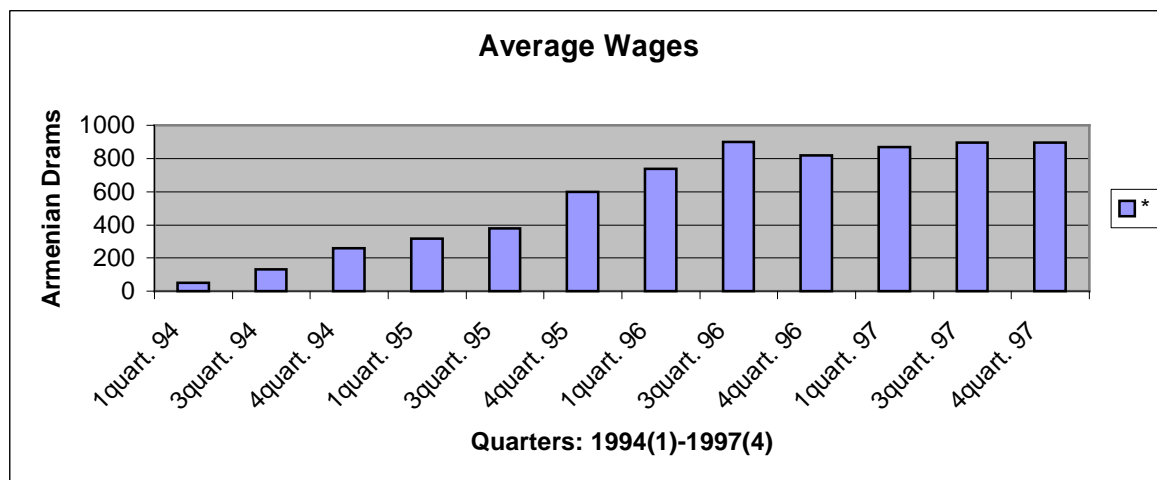
The chart N10, 11 present the dynamics of the work force and the average salary for the 6 sample firms in the chemical industry.

Chart N 10



*Chemical Industry

Chart N 11



*Chemical Industry

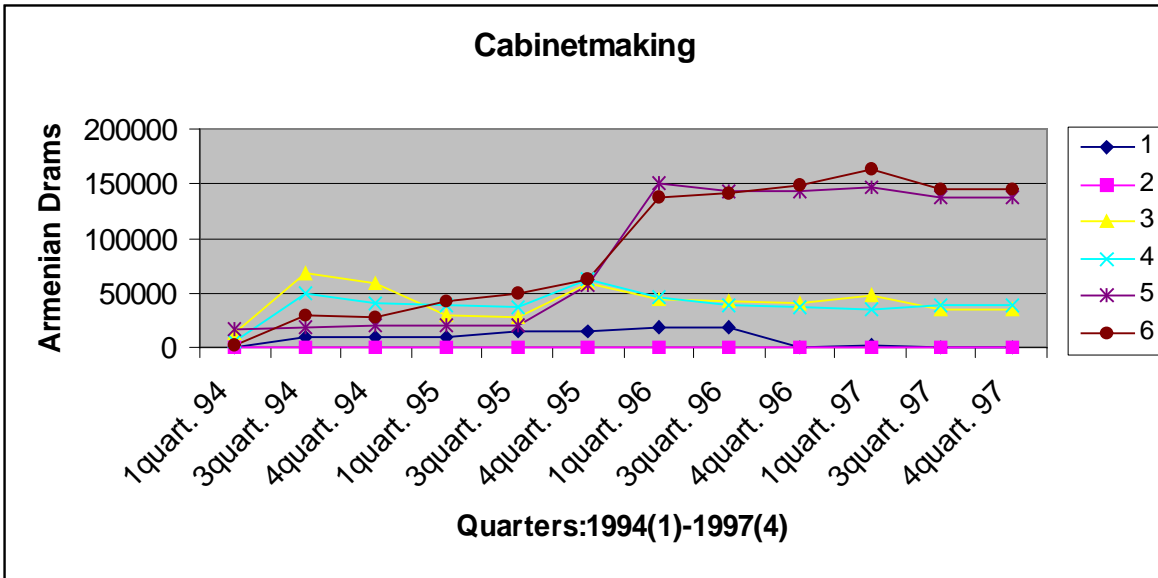
The rate of reduction in work force in chemical industry is low compared to other industries. Between first quarter of 1994 and third quarter of 1997 number of employees was cut by 24%. The average monthly salary through the same period grew 8.7 times, sharply below inflation experienced during this time. Because of decline in demand since independence and the inefficiency of the distribution systems, enterprises need to rely on consignment sales through intermediaries. There is fast growth in accounts payable and they are moving in tandem with the accounts receivable, not only in the chemical industry, but in the other industries covered by research as well.

Presently the chemical plants operate at less than 10% of their total capacity. Many of the respondents, approximately 68%, are not interested in selling their stock. These are predominantly people who have spent most of their lives at their plants and intend to remain as proprietors. If they had additional cash, 38% said they would buy new equipment, but only 17% said they would search for new markets. The supply-orientation still predominates in the thinking of new owners.

Furniture making.

17 of 18 factories producing furniture in Armenia have been privatized. Most of these are presently on the verge of bankruptcy. The chart for economic indicators of the 6 sampled furniture-making enterprises for 1994-97 is presented below in chart N 12.

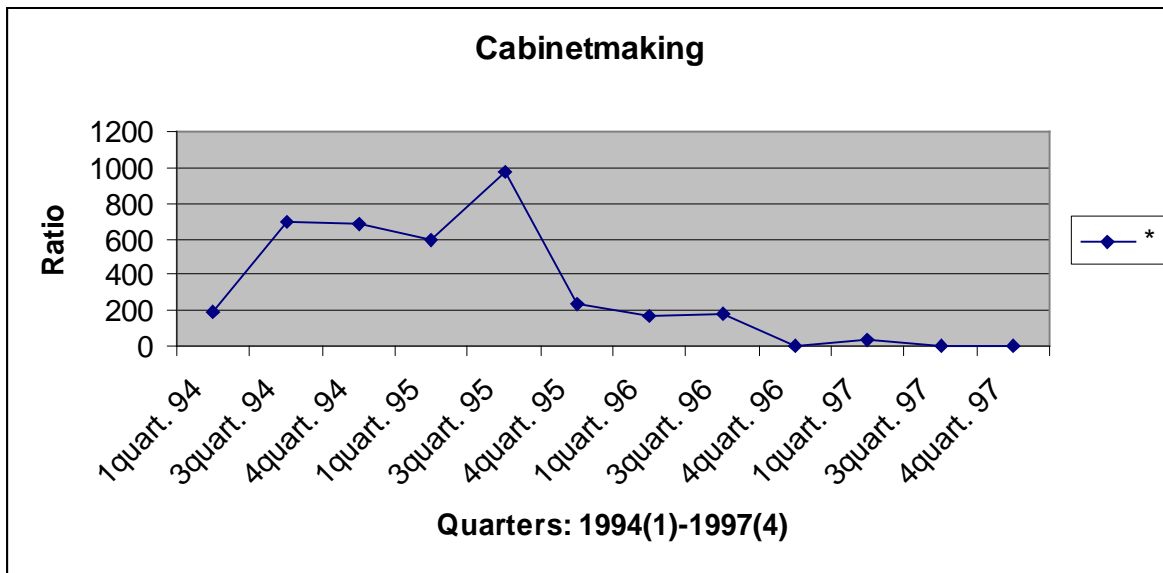
Chart N 12



- 1. Profit;
- 2. Investment;
- 3. Value of Production;
- 4. Sales;
- 5. Value of Fixed Assets;
- 6. Value of Inventories;

The same patterns are clear here as in the previous two industries, except outlook is the poorest of the three. That's because prior to independence, 90% of the wood used as inputs was imported from the Soviet Union at low cost. Now, the cost of importing wood is prohibitive. Below is chart N13

Chart N13



* Profit/ Fixed Assets

The charts N 14,15 below present the dynamics of work force and the average monthly wage for sampled enterprises since 1994. About 35% of workers in the sampled enterprises lost their jobs, and average wage has not nearly kept pace with inflation. Since third quarter of 1997, even average nominal salaries have declined.

Chart N 14

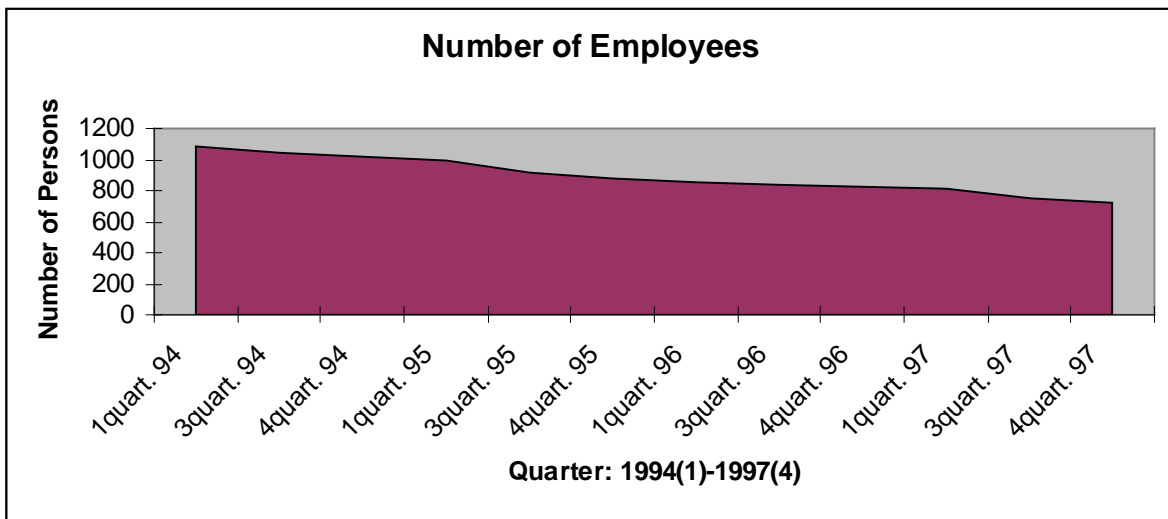
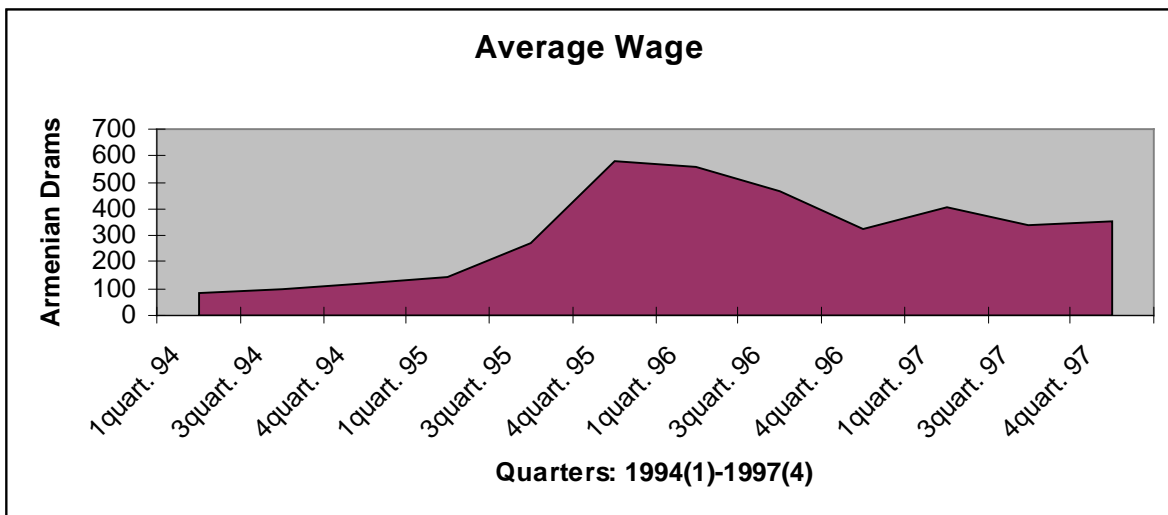


Chart N 15

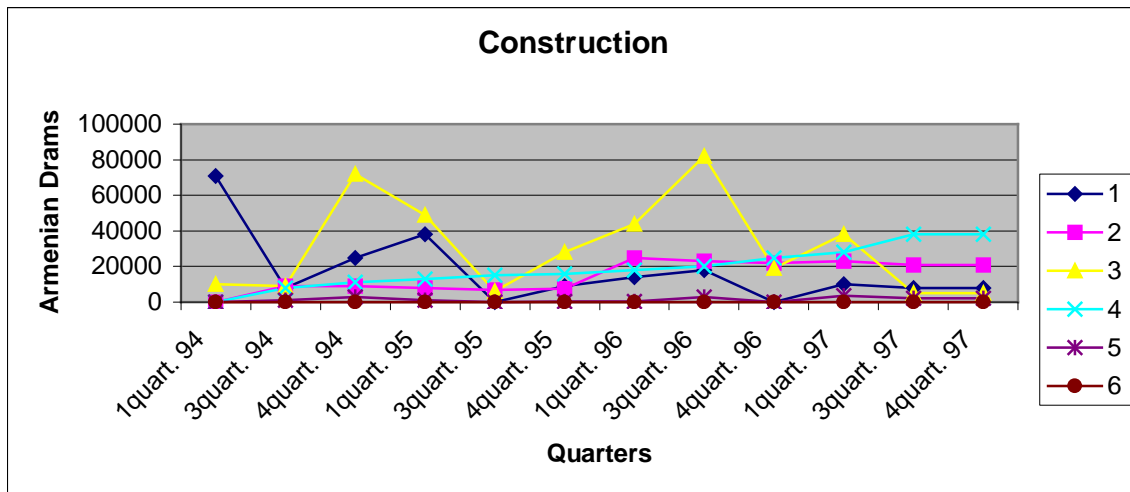


The furniture making enterprises currently use between 1-5% of their capacity. About 82% of the respondents described condition of their enterprises as bad, and a further 18% as very bad. None of these respondents reported the conditions as "satisfactory." Only 21.5% of the sampled owners consider the absence of a market as the main detriment to their enterprises. The enterprises cannot even compete in the domestic market with furniture imported from Iran and the United Arab Emirates.

Construction.

The construction industry is gradually adjusting to a much lower and "lumpy" demand since independence. A big project will boost business for a short time and then demand falls to very low levels until another large project is secured. Many of these enterprises are still padlocked or operate at 1 to 2% of their capacity. The dynamics of economic indicators for three privatized construction enterprises in our sample is given in chart N 16 below.

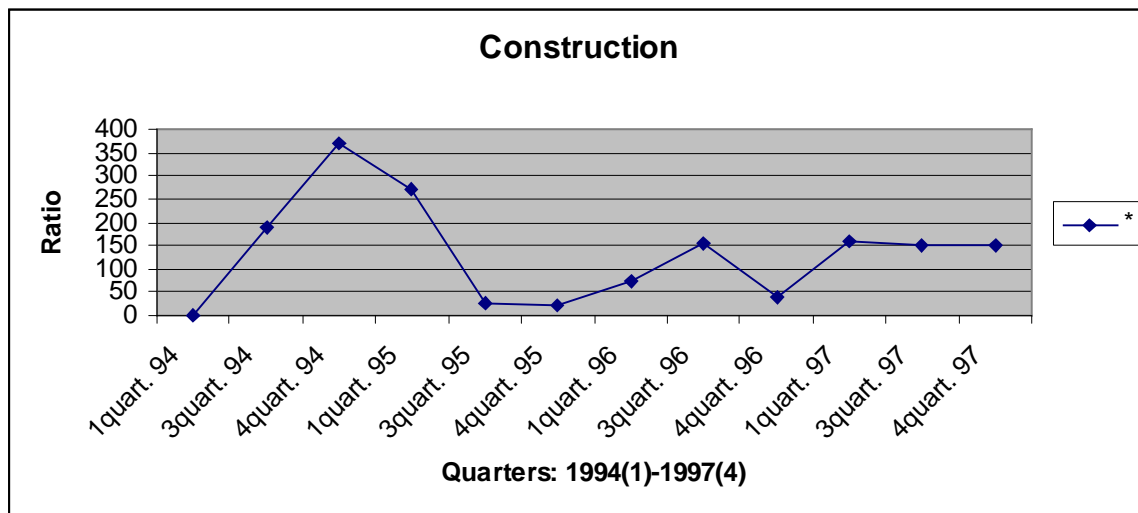
Chart N 16



- 1. Sales;
- 2. Value of Production,
- 3. Value of Fixed Assets;
- 4. Values of Inventories;
- 5. Profit;
- 6. Investment;

Production reflects the “lumpy” nature of demand. However, the rest of indicators behave in a manner consistent with general pattern observed and explained for other industries. Sales fell by a factor of ten, yet the value of inventories increased 32 times; profit numbers dip prior to asset revaluation and then begin to increase. As in most other industries, no investment has taken place either before or after privatization. The firms in the sample were privatized in the second quarter of 1995 as can be seen from behavior of asset value indicator over time. The profit ratio is presented in chart N17 below.

Chart N17



*Profit/Fixed Assets

Again, the rise in early 1994 reflects inflation; the dip to the second and third quarter of 1995 reflects managers attempts to understate the value of assets when they were revalued just prior to privatization. High return on assets here after privatization most likely reflects the sale of some construction equipment and materials.

Between first quarter of 1994 and third quarter of 1997 number of workers in construction enterprises was cut by 72%. This is the highest rate of work force reduction compared with other sectors. The highest level of average monthly salary was registered in third quarter of 1995-about \$40 per month, and this has subsequently declined. Qualified and cheap labors along with availability of local sources of building materials contribute to low cost of construction. This allows the privatized enterprises to successfully compete in market for occasional republican or regional contracts.

General Business Environment in Armenia

1. The process of privatization is stimulating creation and development of markets. Although the rate of privatization lags some other CIS market competition is being felt throughout the economy. This is true despite the insider manipulations and imperfect enabling environment.
2. Financial stabilization and some major improvements in banking system are creating a more favorable environment for development of private sector.
3. The interest of foreign businessmen in Armenia is gradually increasing. This reflects, in part, the macroeconomics stabilization that was established in 1995. Representatives of several well-known American, British and French companies are already established in Armenia. There are also joint ventures operating successfully, including Midland Armenia Bank jsc, Armentel Company, Shant, Jermuk Mineral Water Bottlers. The sizable communities of the Armenian Diaspora in the America, France and other developed countries provide the primary channel for influx of foreign capital into private enterprises.
4. In the last years, the National Assembly of the Republic of Armenia has passed a series of laws, including: the Law on Property, the Law on Enterprises, the Law on Privatization and Denationalization of State-Owned Enterprises and Unfinished Construction Sites, The Law on Foreign Investments and the Law on Bankruptcy. The National Assembly is considering the first part of a new market-oriented Civil Code. While many of the laws are flawed and contradictory, they reflect an honest effort by some National Assembly members to create a modern market-oriented legal system.
5. Armenia is striving to join the international community of nations supporting the move toward more liberal trade regimes. Armenia has recently become a full member of International Standards Organization (ISO) and WTO which will promote a number of Armenian exports to member countries of ISO and WTO. But unfortunately, there are few, if any, domestic firms that can comply with the ISO at this time. Armenia also has one of the most liberal foreign trade regimes in the CIS and the first of the former Soviet Union republics to accede to the World Trade Organization.
6. Armenia's energy situation is improving. Following the re-commissioning of the Metsamor nuclear power plant, the improved availability of electrical power has boosted growth of economy. Armenia is also preparing to meet demand for energy after the Metsamor plant is shut down in 2004.
7. Political stability is also an important factor in encouraging foreign investments. Today foreign investors view Armenia as a high-political-risk country, but the most recent issue of Euro money puts Armenia's investment risk factor lower than Georgia or Azerbaijan's risk factors.

Encumbrances

According to results of research the tax burden is one of the largest challenges that enterprises face. Armenian enterprises are liable to pay estimated taxes six times each quarter, in advance installments amounting to one sixth of preceding quarter's actual taxes. This system reduces the working capital of the enterprises. The tax burden consists of many taxes, including the 20% value added tax, the 30% enterprise tax, the 50 to 100% excise taxes, and the 37% payroll taxes. High tax rates induce many of enterprises to engage in illicit operations, some enterprises, although officially closed, continue to produce, without reporting to tax authorities. For a while, the operation of

enterprises was also negatively affected by excess wage tax, which limited deduction of wages from revenue to 15 times the minimum salary, for any salaries paid. This restriction was lifted in early 1997.

This research indicates that tax policies in Armenia are not supply oriented. They do not encourage savings and investment. Thus, they contribute to proliferation of shadow economy. This is further aggravated by uneven distribution of the tax burden due to informal payments to tax inspectors, deficiencies in the accounting standards, and the low level of tax administration.

The newly privatized enterprises have substantial tax arrears. As already mentioned, the bulk of such debt had accrued prior to privatization. The new proprietors, often unaware of full amount of debt, had to repay it immediately upon privatization. One might think that the state is attempting to preserve its control over the privatized enterprises through a system of debts and penalties. For example the enterprises, according to government regulations, must pay 75% of their profits towards the repayment of their indebtedness to the state. The decision taken by government in the end of October 1996 to waive fines for late tax payments in exchange for repayment of debts by December 1, 1996 was a step in the right direction for private enterprise development.

Among the most serious problems is the non-market attitude of personnel in some of government institutions, especially among tax and law enforcement officials. Many of these people seem incapable of changing their mentality to accept legitimate private enterprise and recognize that the enterprises are now independent of the government.

Intense competition due to the liberal foreign trade regime has impacted all of the researched sectors. Many domestic products are not competitive with the foreign products in domestic markets. The privatized enterprises are not protected from new competitors in the domestic markets from countries like Iran, where the prices for many goods are not liberalized and reflect substantial state subsidies. The privatized enterprises are not sufficiently strong or willing to conduct aggressive marketing activities. However, increasing protection against Iran's imports would be difficult to administer, and would increase the prices of imported consumer goods. This would not be politically popular, especially with lower income groups.

Armenia faces limited and inefficient routes of shipment. The traditional routes linking Armenia with its neighboring countries and the world have been blocked over the last fourteen years due to the controversies in the region. The only rail route currently in use transits through Georgia to the ports of Batumi and Poti. It is predominantly used for transporting humanitarian assistance to Armenia and only secondarily for commercial products. For the enterprises in the chemical and the machine-tool making industries, the only realistic transportation medium is the railway. Even if the rail system were modernized, there is no evidence that the markets in the CIS remain for Armenia's machine tools or most of its chemicals. Moreover, even if raw materials could come in via rail for the chemical industry, there is no evidence on size of the markets that this industry could serve.

Thousands of educated workers in many sectors of industry have left Armenia because of its economic conditions. The exodus of qualified labor has a negative impact on the entire economy of country, and may represent an irretrievable loss of manpower over the medium term.

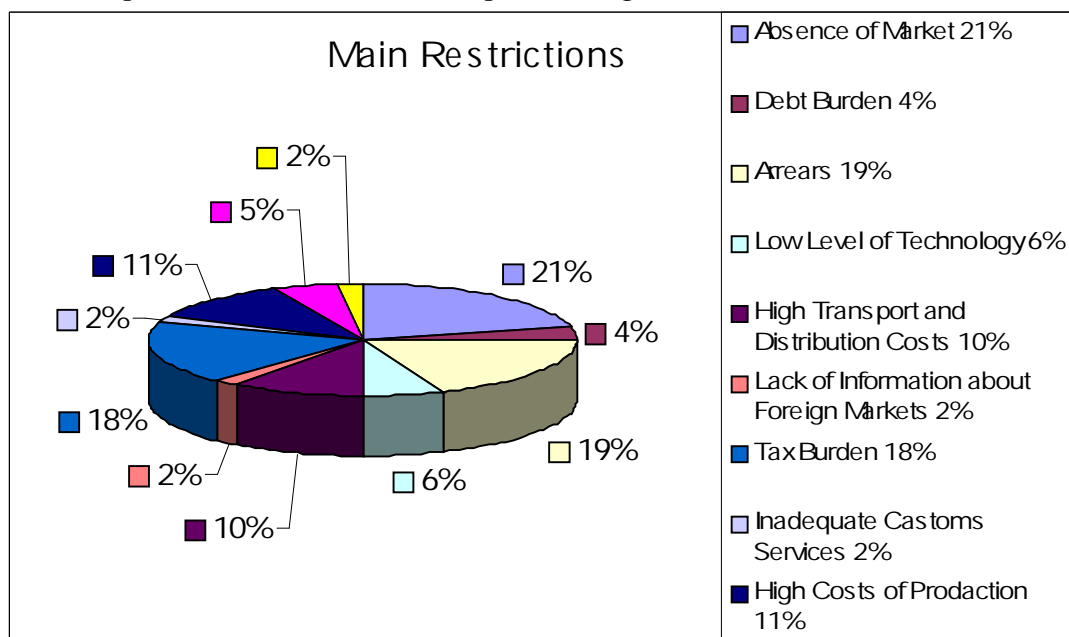
Armenia has relatively few raw materials. Despite transport problems, 70% of the enterprises in the sample still procure their raw materials from Russia. The machine tool making, light, chemical and furniture making industries depend entirely on Russian sources of raw materials. The costs of

alternative sources are also high. But several enterprises have made the transition to sourcing raw materials from non-CIS countries.

4.7.1 Conclusions and Recommendations

According to research of 180 members of boards of directors of the 65 privatized enterprises the following answers were received to the question, "What is the major impediment facing your enterprise?"

Main impediments identified reflect poor management. Chart N 18



The most common response was that there is no market for the enterprise's product. Arrears and the tax burden rank second and third as impediments. Nearly 10% consider high costs of production as the biggest problem for their enterprises and 10% are most concerned about shipping routes.

The new owners of enterprises are attempting to adjust, but are still clearly not trained to understand how to operate in a market environment, or what private ownership really means. In responding to the question, "What is your strategy as an owner-stockholder of enterprise?" 62.2% percent of owners answered that it is the need to penetrate new markets, but nearly 20% wanted to increase capacity utilization (who would buy the output?). Only a small percentage of the respondents, 3.9%, said their strategic objective was to increase dividends. Generally, the enterprises in the rural areas face more difficult operating conditions than the ones in Yerevan.

Planning and Strategic Vision

A lack of planning capacity and strategic vision is apparent in most of enterprises. In many cases the majorities of new proprietors are from among former top management of enterprises when they were state owned and have 20 to 30 years of managerial experience in the Soviet system. They are well versed in production flowcharts, and assign top priority to production rather than to increasing the stockholders' profit. The controlling shares of the enterprises, as a rule, belong to the former managers of the plants, who have become the executive chairmen and presidents of privatized enterprises. About 20% of the respondents are actually the board chairmen of enterprises, of which almost half are also executive directors.

The tendency among chairmen to hold the shares of their enterprises is also apparent. In answering the question "When would you consider selling your shares?" 51% said they do not intend to sell their shares, even if the enterprises were to go bankrupt. A mere 7% of the respondents are prepared to sell their shares to foreign investors and only 19.4% would sell if the enterprise were to fail. These attitudes are not consistent with private enterprise development. It also reflects the lack of a secondary stock market. Without seeing more enterprises go through bankruptcy and workout or liquidation, the managers probably don't understand the true meaning of "bankruptcy."

Another important issue is decentralization of management within enterprises. Many of the responding executive managers complained about the failures of their deputies and division heads to take independent decisions and responsibilities, which results in poor decision-making within the enterprise.

Enterprise valuation

The extent of the discretion involved in the process of privatization means that often no criteria are established for valuation of enterprises to be privatized with the results being necessarily subjective [Lissu, (1996)]. The current World Bank thinking is that there has been an overemphasis on valuation and that "governments have learnt that it is the market which determines values" [Sarbib, (1997)].

Enterprise Restructuring.

The sample enterprises, with a few exceptions, have not restructured themselves as legitimate private enterprises. The owners operate their enterprises to maximize their own short-term gains, given the current environment. Virtually all the enterprises were built under the assumption of almost free energy and nearly free transportation. With these two critical inputs now very expensive, many of enterprises should be forced to go through bankruptcy and liquidation. The behavior of majority of privatized enterprises does not, in essence, differ from that of the state enterprises.

Mass privatization is being carried out in condition of underdeveloped and in many cases, unclear legal and institutional infrastructures (laws on corporations, contracts, competition, collateral, bankruptcy, liquidation of assets, and accounting are either not in place, flawed, or in a constant state of change). Moreover, the court system is completely inadequate to enforce market-oriented laws.

The privatization experience in all countries with a history of centralized economic planning illustrates that mass privatization with underdeveloped institutional structures leads to inefficient oversight of the operations of the privatized enterprises and the assets of these enterprises tend to be sold off or misappropriated. This is particularly serious when the fixed assets are auctioned off based on their book value and are acquired by the former directors of the enterprises.

Investment in these enterprises is virtually zeroed. For those enterprises with no investment, restructuring, or legitimate activity, creditors need to be able to push the enterprises into bankruptcy proceedings, before all the physical assets are stolen. The lack of government solution or donors to the arise problems. The underdeveloped status of secondary market for corporate securities creates major problems in terms of forcing managers to change their behavior. In developed countries these markets are essential for controlling enterprises and providing financial inflows for investment and development.

The government should promote development of secondary capital market in order to stimulate efficiency of the market economy. While such markets are necessary, they are not sufficient to ensure that industrial sector of Armenia will be restructured in a fair and efficient manner. There must be an inflow of capital from somewhere to breathe life into private enterprises. And the enterprises that attract investment may not be the ones inherited from the former Soviet Union. The underdeveloped status of investment funds, which should have played a greater role during the mass voucher privatization. For example, in the Czech Republic 10 voucher investment funds control around 50% of the capital privatized through the vouchers. On the one hand, these funds serve as mutual investment institutions providing liquidity. While on the other hand, they play an important role in management of newly privatized enterprises as major stockholders, when the enterprises have value as going concerns.

Enterprises must deal with inadequate marketing channels. Many of enterprises have to conduct sales transactions with wholesale intermediaries based on consignment. In the current situation this results in lengthy periods before the receipt of revenues. The underdeveloped legal framework does not provide for fair resolution of disputes between producers and market intermediaries. Due to passive market strategies, very few enterprises venture to establish their own wholesale networks that would allow them to avoid unreliable market intermediaries.

The enterprises producing low quality products, with poor packaging. The enterprises of Armenia previously having been integrated into a centralized production system, delivered predominantly to domestic Soviet market. They now seem incapable of asserting themselves in foreign markets and are continuing to lose their positions in Russian market as well. Russia still accounts for the major share of Armenian industrial exports.

The data from above studies about post privatization firms performance shoes that about 70% of respondents acknowledged that there is no marketing department at their enterprises. Although the owners realize strategic significance of sales in new markets many have not grasped need for encouraging sales and advertising. Only 10% of the respondents realized importance of marketing. Almost 60% said that their enterprises do not spend any funds on advertising and 37% allocate less than 5% of total expenses to advertising. Many of the respondents confused marketing with merely shipping products and procuring supplies.

The enterprises need to develop marketing plans and to establish flexible and professional marketing departments if they are want to survive. The government should assist enterprises in developing relevant marketing skills, establish an aggressive advisory center for assisting privatized enterprises develop marketing and business plans, and set up practical training workshops. Even though there are some government-sponsored activities in these areas, more work needs to be done. Training managers in market-oriented business practices should get a high priority.

Inventory Control

In almost the entire reviewed sectors rate of increase in inventories exceed the growth rates of production and sales. This phenomenon is most salient in enterprises of machine-tool production industry, where inventories grew 40 times during study period, while sales grew only 10 times and production only 3 times. This phenomenon can be explained by:

Problems in products selling which results in increases in inventories of unfinished products and raw materials. This is supported by a system that allows ever increasing inter enterprise and tax arrears.

Changes in structure of costs that result in a much faster increase in prices of raw materials than in total costs of final products. For many enterprises pre-privatization proportion of raw materials in inventories was less than 50%, following privatization this proportion often exceeds 50%.

The accounting for sales is poor. In many cases the enterprises present false profit statements in order to avoid taxes, sell products illicitly for less than sales price but more than product costs, while the price disclosed in the accounting equals the costs.

Labor Force

The competitive strength of economy in Armenia comes from its educated and low cost labor. Results of my study indicate a strong tendency towards reduction in number of employees and reduced growth rates of salaries. And beginning in the third quarter of 1996 even current Dram average salaries started to decline. The only exceptions are enterprises in the food processing industry. The average salary in privatized enterprises does not exceed \$25 a month, with the exception of a few enterprises where it reaches \$50 a month. This situation may be explained by the following two reasons:

§ The deterioration of enterprises economic condition.

§ High income tax and payroll tax rates, which leads employers to pay some compensation "under the counter."

Accounting Standards

The accounting practices in enterprises are less than satisfactory. There are no external auditing procedures for these firms. Following the privatization many enterprises ceased to maintain proper internal accounting. The quarterly report submitted to the State Tax Inspections is the only official set of accounts. Many enterprises have ceased to calculate the product costs, which have resulted in eradication of mechanisms for formation of prices and tracking expenses. In addition many of the tax reports are not reliable. Unofficial sources lead us to believe that enterprises usually conduct two separate sets of accounts, one for internal needs and one for the "taxman". Often both are fraudulent. The belief of the vast majority of owners is that their enterprises have no future, so now is time to take out as much money as possible from the enterprises.

4.8 FOREIGN DIRECT INVESTMENT

By August 2000, 83 per cent of (1533) medium sized and large enterprises and 90 per cent of (6829) small enterprises had been privatized. The voucher program, covering the majority of SME's, ended in December 1998. The majority of vouchers were bought by enterprise insiders, leaving them effectively in control of privatized firms. Privatization now takes place only through cash sales. The 1998-2000 Privatization Program envisages completing the bulk of privatization by the end of 2000. However, the privatization process has decelerated since late 1998 partly due to the economic slow-down that followed the Russian crisis and the reduced reform momentum during the campaign for parliamentary elections in May 1999. In late 1998 the government started liquidation procedures for 22 unsold firms. By August 2000 the liquidation completed for 10 large enterprises, and 170 large enterprises are in the process of liquidation. These enterprises failed to be privatized at least twice.

Some 54 large and medium and 196 small enterprises were privatized in 1999. During the first eight months of 2000 19 large and medium and 24 small enterprises were privatized. By mid of 2000, 9 out of 17 firms offered through international tender had been privatized. Sales to foreign investors included holdings in tourism, a diamond factory, a chemical complex (sold to Russian investors) and the Yerevan Cognac Factory, which was sold for US\$ 28 million to Pernod Ricard (France).

To date, total revenue from privatization so far is estimated at more than US\$ 260 million. Of this amount, half was paid in cash and half in the form of privatization vouchers. Foreign investors have bought into about 60 companies. Five hundred companies are slated for privatization in 2000, including 75 strategic ones. These include the national airline, hydropower and thermal generating plants, power transmission enterprises (energy distribution networks), two major goods and passenger transportation concerns, hotels, the leading electronics firms, the main mining and metallurgy factories, the Yerevan Jewellery Factory, and companies in the construction materials, chemicals, textiles and wood processing sectors.

Industrial output grew by 5.2 per cent in 1999, but is still less than 50 per cent of the 1990 level. Industrial restructuring has been limited due to the accumulation of tax and energy arrears and limited capacity for bankruptcy enforcement, which have allowed insolvent enterprises to continue operations. Other factors hampering enterprise restructuring are the low levels of foreign investment, limited access to domestic finance and difficulties in accessing foreign markets, in part because of lack of border security. Moreover, the insider-dominated privatization process has left enterprises with little new capital to undertake modernization investments and no injection of new management skills.

Major foreign investment in Armenia Table N 2

Company	Sector	Investor	Purchase	Investment details
ArmenTel	Telecoms	OTE (Greece)	USD 142.5 million for 90% stake, including buy-out of private shareholder group	USD 260 million investment over 5 years
Yerevan Brandy	Beverages	Pernod Ricard (France)	USD 30 million for 100% stake	Commitment to development and to local suppliers
Hotel Armenia	Hotels	AK Development LLC (US)	USD 8 million for 80% stake	USD 22 million investment. Marriott Hotels hired as manager
Hotel Ani	Hotels	Ani Investment Group (US)	USD 4 million over four years for 100% stake	USD 5 million investment
Hotel Yerevan	Hotels	RENCO Spa (Italy)	USD 1 million for 100% stake	USD 6 million investment
Abovian Brewery and Bzhni Mineral Water	Beverages	Local investment group		Castel Group (France) brought in as majority shareholder
Sisian Textile, Goris Textiles & Maralik Spinning Factory	Textile	Garni Investment Corp (US-Armenia)		Two companies purchased, at open subscription and third through international tender
Jermuk Mineral Water	Beverages	Local investment group		US-Armenian JV
DCA	Diamond processing	Fanfino Ltd (UK)	US\$ 3 million for 100% stake	
Yerevan Municipality construction	Construction	Garni Group (US-Canada)	US\$ 500,000 to purchase the property	Completion due by 2003

Armenian investment legislation is liberal and open to foreign investors, who are being actively encouraged. Foreign direct investments have been increased rapidly in 1998. The largest investments are in telecom, food and drink processing, metallurgy and banking. Strong opportunities exist in electronics and electrical engineering.

In 1998 net foreign direct investment (FDI) inflows were over US\$ 228,5 million (equivalent to 12,3 percent of GDP), a remarkable increase on previous years, resulting from the acceleration of large-scale privatization. The cumulative inflow of FDI from 1991-97 was approximately US\$ 100 million. The government is committed to raising the low level of foreign investment, which in its view does not approach the full potential of available opportunities. In 1998 the government of Armenia organized at least seven large conferences (in the Middle East, Europe, CIS, USA and Armenia), attended by Armenian business representatives and existing investors, to boost interest among the international investment community, and in particular the Armenian Diaspora, which is showing an active interest.

The most common forms of FDI are joint ventures, green-field investments and participation in the privatization process. By the end of 1998 1,350 companies with foreign participation had been registered, a large number of which are involved in trading activities. A number of leading foreign companies have started operations, including OTE (Greece), Pernod-Ricard (France), Castel (France), Midland Bank (UK), Grand Tobacco (Canada), Coca-Cola (Greece), Glaxo Welcome (UK), Bristol-Myers Squibb (UK), First Dynasty Mines (Canada), Macmillan, IBM, Italtel, KPMG and Arthur Andersen. The main sectors for foreign investment have been telecommunications, beverages, banking, mining (mainly gold), tobacco, pharmaceuticals and financial services. The main sources of FDI have been Greece, France, Canada, the US and the UK.

Investment policy and incentives

Armenian investment policy is geared towards attracting foreign investors. Foreign companies may invest in any sector and enjoy the same treatment as domestic firms. The law guarantees the right to repatriate profits without limitation. Any currency may be freely converted and bank accounts may be held in foreign currencies. The main piece of relevant legislation is the Law on Foreign Investment of 31 July 1994. The Law aims to create an attractive environment for foreign investment, offering domestic treatment, a five-year grand-fathering clause in the event of changes in legislation, and protection (with full market value compensation). Foreigners may establish the same forms of business as local investors and follow the same forms company registration procedure. Foreigners may not own land, but may lease it for up to 99 years or use it under contract.

Investment opportunities

Strong opportunities exist in the electronics sector, optics, chemicals (including biotechnology and pharmaceuticals), mining, diamond cutting, tourism, software development, health-care/medical and financial services. In the Soviet Union, Armenia was one of the most industrialized republics, with a sophisticated high technology sector. The leading industries were mechanical engineering, electronics, chemicals and energy. Ninety-five percent of industrials production was exported to the rest of the Soviet Union and abroad. In spite of the economic collapse that followed the break-up of the Soviet Union, Armenia retained its high-quality engineering sector and numerous manufacturing facilities supported by scientific institutions. One of the most promising industries for development in Armenia is biotechnology. To harness the skills of its research scientists in this field, the government has set up a development program for the industry in cooperation with local scientific institutions.

The government is also planning the development and implementations of a pilot “Industrial Zone, Socio-economic Development Center ” project with a comprehensive vocational training center, over 100 SME turn-key projects and good quality industrial real estate designed to accommodate new businesses. The location will also have suitable road and railway connections and bonded warehouses.

One of the attractions of Armenia as an investment destination is its highly skilled labor force, which includes qualified specialists in electronics and electrical engineering, software design, optics, chemistry, construction, jewelry production and food processing. The standard of technology is planning the development of an Information Technology Zone, including a Software Development Park and promotion of private local and foreign software engineering center. The Zone will be sited in the center of Yerevan, near to the state university campus.

4.9 CASH OR POST VOUCHER PRIVATIZATION.

At the third stage (since 1998 when from reversal basically took out distributed earlier privatization certificates) paces of privatization became more moderated, circle of the subjects is more broad (as for the score of more broad engaging of population social layers and also foreign investors). Were privatized not privatized on the maiden stage middle and major concerns mechanical engineering, chemical, metallurgical and other branches (large part of all complex). The rate of privatization is accelerated and not only in manufacturing, but also in a social orb in particular in manufacturing and social infrastructures. Starts valuably to operate a system of market infrastructure, specially stock exchanges and investment funds, of organization process of usage all resource on the paid basis was almost completed.

At the third stage was reshaped the layers of businessmen are sunken fundamentals of non-state quadrant development: the legislative base, experience of enterprise activity etc. At this stage was envisioned also privatization of those firms of engineering and chemical industry to which one was possible to change profile in effecting on extension of composite home appliances and also agricultural and mechanization engineering of auxiliary operations and also production used already by privatized firms. Thereby were ensured multilateral development and transformation of market quadrant frame. And with the purpose of high maintenance of privatization performance it was possible to tender a working control of the shares to legal, including foreign faces. In case of object privatization on the competitive basis criterion of buyer selection should be not the price (as at the maiden stage) and the prospects for firm development, its retrofit, investment and proposal on profile change (investment competitive forms of privatization can be applied also at the maiden stage to restricted number of firms, purposing to accumulate definite experience for use it at the second stage of privatization).

At the third stage was carried out privatization of majority of large and medium firms, large development was received non-state manufacturing infrastructures (especially in the transport and communication), social orb (public health, services, formation). At this stage privatization of large metallurgical firms (including monopoly) and firms, having inter branch value on extension of building materials (for example effecting of concrete). The majority of firms, which have at the maiden stage non-state control, had to be privatized. At the end of this stage it was envisioned to finish a lobe of a state ownership in an industry till 20-25 of % (defense industry, a mineral-raw industry and part of metallurgy), in a manufacturing infrastructure - till 65-70 of %, had to be formed the non-state insurance frames, auditor services, intelligence systems.

The installment implementation of a privatization program has been enabling to deduce from state subordination a considerable proportion of firms. Under direct patronage of State were remained the main firm of strategic value and part of manufacturing and social frames. Basically in the property of State have remained the objects of public health services, sciences, tribal business and nurseries - seminaries, railway, motorways, airports, underground, military industry. Simultaneously in the marked areas have been detailed the process of privatization. In particular privatization of firms on exploitation of highways and also district branches of a veterinary service have been carried out.

The programs of state firms privatization and their implementation were estimated as permanent assets of stabilization and development of a social and economic situation of Republic, as the main tool for implementation of a government economic policy and as an integral part of state reforms. The purposes, priorities and limitations of a current stage of privatization were set under the annual program of state firms and objects of the uncompleted constructions of R.A privatization.

According to the main purposes of the State Property Privatization Program for 1998-2000 years (was adopted by national Assembly of R.A on December 26 1997) were:

- § Increase of economics privatization degree,
- § Increase of companies activity efficiency,
- § Completion basically state property privatization process,
- § Development of state property privatization methods, including maximum broad usage of competitions, as much as possible encouraging investment and sale of companies to strategic investors,
- § Increase of incomes in budget at the expense of obtained from state-owned property privatization means. [*Privatization Program for years (1998-200)*].

In Armenia for maintenance of legal and organizational base for state firms privatization conforming acts were adopted: the decrees of the President of R.A, laws and solutions of Assembly, solution of presidium of the supreme Body of R.A, solution of the prime minister, indicating of the Treasury and ministry of economics of R.A, methodical indicating, and orders.

For the given time was continued policy of privatization that enables engaging the greatest investments in privatized firms and sale last the strategic investors in condition by business programs. The fact testifies that from 45 firms including in privatization program 16 were sold on the competitive basis, (including international), in that case when within the previous years considerable weight of firms were privatized on the basis of a free share subscription. For example in 1998 by free subscription were privatized more than 140 firms and on competitive basis 23 [*Report of Ministry of Statistics of R.A (1998) p. 16, Social-economic situation in Republic of Armenia for January - December, (1998), Yerevan*]. With a condition that owners of privatized property are obliged to conduct investments and to provide increase of a social level of workers including maintenance of workstations creation new and well-timed payment of salary.

From the point of view advancing privatization methods, by government of R.A 13-th of October 1999 were conducted the following changes:

- § In a number of firms, privatization by a method of free subscription on share was exchanged to privatization without indicating of concrete methods that enables possibility to firms applies any type of privatization. For example if up to this, firms should doubly be offered to privatization by a method of a free subscription on share, now they can be bought by a straight sale.
- § In above mentioned period government of R.A has organized shares sale, on a securities market including of specialized institutes, of those firms which one were privatized with 34 percent of state individual share. [*Decision of the R.A government № 442 from 13-th of October 1999*]

In compare with past years the means going to budget from state ownership privatization have decreased, in 1998 the sum of receipts was equal 48,8 bill. drams from which one 48,6 bill. drams as a money and in 1999 19,4 bill. drams that has compound in 2,5 times less than in previous year [Report of Ministry of Statistics of R.A 1998-1999, Social-economic situation in Republic of Armenia for January - December, 1998-1999, Yerevan]. It is possible to explain the decrease of sums acting from privatization by the factor, that privatization certificates validity finished on that time but they act as means of payment for state ownership and also because of not in time annual payments for the privatized property. However the main cause of decrease financial incomes into budget from privatization of a state ownership was that in 1999 for privatization were offered those firms and companies, which were, demanding the least investment contributions. For example in 1998 on the basis of international competition were privatized such firms as "Armentel" the Armenian telephone communications (services lines), Yerevan plant on brandy effecting, "Armenia" hotel complex and hotel "Ani". These bargains were one of the largest in Armenian privatization and have introduced the appreciable income to budget of Armenia in 1998. Since 1999 as contrasted to previous years notably slowed pace of privatization, if during 1998 170 firms were privatized in 1999 only 54, it's in 3,1 times less than in previous year [Report of Ministry of Statistics of R.A 1999 p. 117, Social-economic situation in Republic of Armenia for January - December, 1999, Yerevan].

The main causes of boosting of privatization pace were following:

- § Unstable economic and policy situation,
- § Unpredictability of spent policy,
- § Large debts of privatized firms and availability set of proceedings concerning their property.
- § As against the former privatization programs in program of 1998-2000 issue of privatization certificates was not envisioned, that also slows down process of privatization.

For overcoming the marked above interruption, government of R.A has accepted number of orders: they regulate state ownership before privatization development;

- § The law of R.A Government № 747 from the 13 of December 1999 about "Measures on raising productivity activities of state ownership before privatization, "
- § Decree of Premier Minister of R.A № 760 from the 16 of December 1999 about "Activities on preparation number of strategic firms for privatization".

Were adopted orders for deactivation of firms and companies:

- § The law of R.A Government № 752 from the 14 of December, 1999 about "Ordering of measures for legal persons disbandment" in condition of R.A state ownership privatization program for 1998-2000 years.
- § Decree of Premier Minister of R.A № 756 from the 13 of December 1999 about "Schedule of number joint-stock companies disbandment".

Maiden of above-stated laws allows deciding such problems hinder to privatization, as:

- § Absence of state registration on private property rights.
- § Obtaining of comprehensive and generalized information about firms offered to privatization, about their material assets such as (order, license, right of use etc.)
- § Size discrimination of land lots held on the part of privatized objects.
- § Obtaining of information about obligations of firms offered to privatization.

The 14 of December, 1999 according to the order of R.A government N 752 was approved the order of unprofitable firms disbandment, included in a structure of privatization program 1998-2000 years. In particular approved order of organization and activity of commissions on firm's disbandment, their authority, assigning confidential control and interplay with the commissions, task by satisfaction of the creditors claims and also estimation of deactivated firms property and its sale on auction.

Program implementation in 1998-2000

Privatization, disbandment means and major concerns.

The Legal and Methodological basis of privatization and disbandment mean and major concerns. For maintenance of fulfillment of privatization program of 1998-2000 by R.A government were adopted the following solutions (disregarding of R.A government decisions about privatization, creation and disbandment some separately of taken firms.)

1. The decree N 499 of 5 of August 1999 on "Regulations of free subscription on share those firms in which one 50 % of charter capital shares belong to state".
2. Law of R.A Government N 752 of 14 of December, 1999 on "Ordering of measures on legal persons disbandment" in conformity to state ownership privatization program for 1998-2000 years.

By Premier Minister of R.A were adopted the following decrees:

About measures on fulfillment of R.A law № 519 of August 27 1999 in conformity to "Program of R.A state ownership privatization in 1998-2000 years", about activities on opening-up for privatization some of firms which has strategic value, № 760 December 16, 1999.

The following departmental statutory acts were designed:

On establishment of minimum prices on the privatized state ownership, is registered in the Ministry of Justice of R.A 26.02.1999, N 114.0074.150698,

Information package of input data about privatized state ownership of R.A, is registered in the Ministry of Justice of R.A 02.06.1999, N 114.0082.100699,

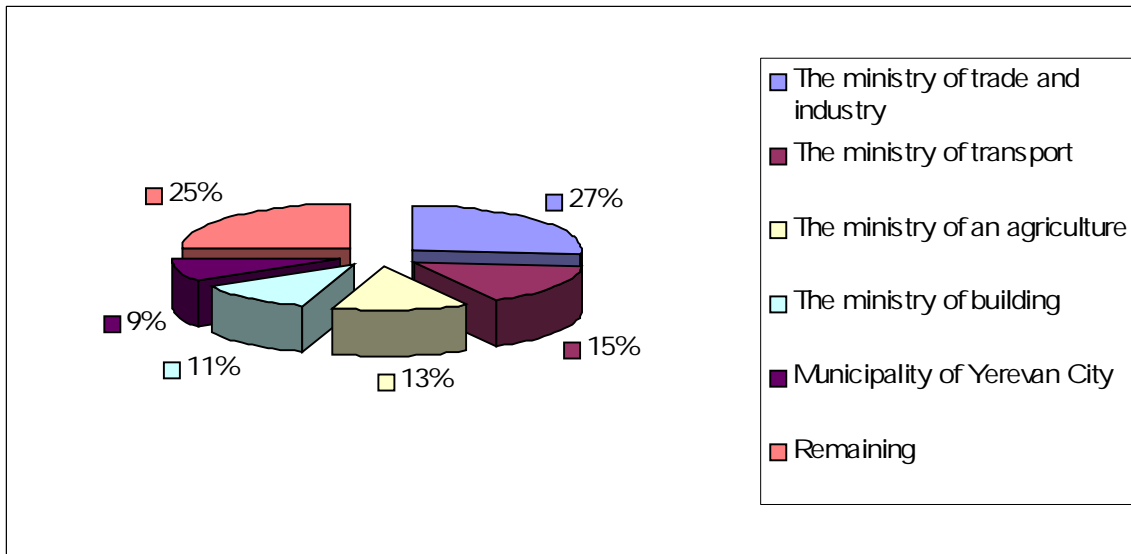
On regulation, usage and contents of firms property reformed by R.A government decision, is registered in the Ministry of Justice of R.A 27.06.1999, N 114.0106.160899,

Within 1999 were passed the decisions of R.A Government about privatization of 136 firms mentioned in the program or again selected in a consequent of privatization program adaptation. Were privatized 45 firms, 24 of them by free subscription on share, 18 on competitive basis, and 3 by a way of simple sale. By way of simple sale were sold property of 9 corporations, which were not keeping in the program of privatization. Privatization didn't take place on 82 firms. [Markosyan. A.H., *Management of state enterprises privatization*, p.27].

The main causes that these firms were not privatized were losing commodity and services market; large debts of firms; absence of an outlook, equipment wearing, necessity of large investments etc. The founder of 27 % of firms were Ministry of Trade and Industry of R.A, 15 % ministry of Transport and Communication of R.A., 13 % Ministry of Agriculture of R.A, 11 % ministry of Construction of R.A, the founder of 9 % of firms was municipality of Yerevan city, 25 % remaining

offices. [Report of Ministry of Statistics of R.A 2000 p. 32, Social-economic situation in Republic of Armenia for January - December, 1999, Yerevan].

Charter N 19



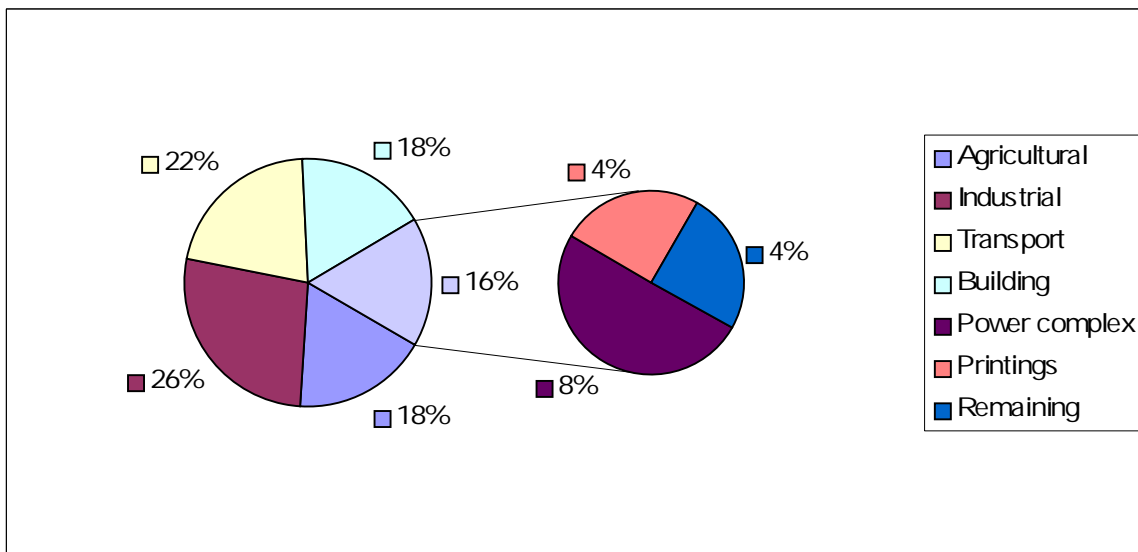
The information on privatization means and major concerns is mirrored in the tables NN 3,4,5,6,7,8.

Methods of sale

(1.) Implementation of privatization by a method of a free subscription on share.

Within 1999 were adopted numbers of R.A Government decisions about privatization by a method of free subscription on share 56 firms mentioned in the program or again selected. Within 1999, 86 firms were offered to privatization by method of free subscription on the share, from which one 24 were privatized and privatization of 62 firms was not held. By method of free subscription on share privatized 26 % of industrial firms, 21 % of transport, 17 % of agricultural, 17 % of building, 8 % firm of a power complex, 4 % firms of a printing business and 4 % remaining. [Report of Ministry of Statistics of R.A (2000) pp. 47-49, Social-economic situation in Republic of Armenia for January - December, (1999), Yerevan].

Chart N 20



For given term at no one of privatized by that way firms was not taken place reallocating of shares. All firms were privatized by participation of minimum shareholders number of which make 25 %, only at two firms "Spitak Tparan" and "Yerevan microbuses" number of shareholders has compounded 26 %. For firms privatized by method of free subscription on share, were not conditions about mandatory investments and social protection.

Table N 3 gives information about firms privatized by the method of free subscription on shares.

N	Firms codes according to the program	Title of firm according to program	The founder (ministry, municipality)	Launching price of share (thousand dramas)	Nominal value of one share (thousand dramas)	The final charter capital	The % of implementation of a subscription
1	30017	"Shinarar" closed joint-stock company	Municipality of Yerevan City	35694	1000	11156	25,004
2	74731	"Anpopail" state closed joint-stock company	Industries and trade	1398	1000	350	25,036
3	74732	"Gosplan" state closed joint-stock company	Industries and trade	70011	1000	180	25,316
4	60342	"Nairy" state closed joint-stock company	Transport	16267	1000	4077	25,063
5	20560.1	"Egegnadsori" "Gladzor" state closed joint-stock company	Urban building	63331	1000	15910	25,122
6	74701.1	"Govazd" state closed joint-stock company	Industries and trade	4920	1000	1543	25,102
7	21422	"Spitaki Tparan" state closed joint-stock company	Information sciences and printings	299	1000	98	26,421
8	60304	"Yerevan microbuses" state closed joint-stock company	Transport	524370	1000	137384	26,2

[Report of Ministry on Privatization years of (1998-2000)].

(2.) State firm's privatization by the method of competitive sale.

Privatization of state firms by competition;

On competition are sold:

- a) firms presented to privatization by competition.
- b) "small" objects, which were not bought by their labor collectives.
- c) property of abandoned state firms.
- d) objects of uncompleted building.

The right to participate in privatization on competitive basis has citizens, group of citizens of Republic of Armenia, non-state firms and foreign bodies without limitations. The labor collectives have the right to participate in competition on the common basis.

The winner of competition recognizes us the body whose proposal corresponds to all requirements. The proposal, in which one price tendered for object are lower than 50 percents of the launching

price are not esteemed by competitive commission. Competition is ceased without acknowledging the winner in case if the proposal due to this or that reason is not obtained, or if the proceeding proposals do not correspond to competition conditions. Availability only one proposals can't warrant for the competition termination without winner declaration.

The foreign faces participate in competitions with official currency of Armenian Republic. Government of Armenian Republic banking establishments of Republic of Armenia at a common commercial course should transfer the foreign convertible currency in official currency of Republic of Armenia in one of definite. [Privatization Law Article N 299].

Table N 4 gives information about firms privatized by a method of competitive sale in 1998.

Table N 4

Code	Ministry	Address	Decisions of R.A government.		Date of competition			Price (thousand drammas)	Investments	Winner
			Quantity	N #	Date			USA Dollars	Thousand drammas	
21575	Industry	Sisian	2	322	29.05.98	07.07.98	64.000	0	535.500	"GARNI" Co.
20330	Agriculture	Yerevan	3	350	08.06.98	05.08.98	30.000	0	4.800	R.Mangasaryan
500062	Agriculture	Hrazdan	3	409	26.06.98	14.08.98	12.200	0	3.000	"GNORD" Co.
20359	Agriculture	Yerevan	3	409	26.06.98	21.08.98	196.029	0	537.000	B.Carapetyan
21581	Industry	Hrazdan	3	350	08.06.98	26.08.98	2.000	0	5.000	Workers
21860	Industry	Yerevan	3	437	13.07.98	16.09.98	100.000	1.000.000	0	"AMF" LTD
20816	Urban building	Hrazdan	3	437	13.07.98	23.09.98	2.748	0	2.000	M.Frangyan
20796	Urban building	Cajaran	3	437	13.07.98	23.09.98	12.993	0	3.000	V.Abrahamyan
21851	Industry	Yerevan	3	350	08.06.98	30.09.98	5.300	0	15.000	Workers
20921	Industry	Shirack	3	500	12.08.98	30.09.98	11.354	0	0	S.Davtyan
20179	Agriculture	Yerevan	3	554	04.09.98	19.10.98	2.593	0	38.500	H.Hovsepyan
20168	Agriculture	Hrazdan	3	552	04.09.98	26.10.98	13.465	0	10.000	A.Nazaryan
21860	Industry	Charentsavan	3	550	04.09.98	03.11.98	35.500	550.000	0	"DVIN" Co.
	Transport	Nalbandjan	1	600	22.09.98	30.11.98	100	0	1.500	M.Sagatelyan
	Industry	Ijevan	1	600	22.09.98	01.12.98	1.900	0	10.000	A.Mehrabyan
	Water resources	Sevan	1	639	17.10.98	04.12.98	12.000	1.668.000	0	"ALKON" LTD
20561	Urban building	Tsaxckadz.	1	639	17.10.98	08.12.98	10.000	979.000	0	"ALKON" LTD
20321	Agriculture	Abovan	3	707	11.11.98	15.12.98	11.000	0	10.000	A.Mnatsakanyan
20761	Urban building	Armavir	3	676	02.11.98	18.12.98	6.374	0	12.000	R.Badalyan
21575	Industry	Ijevan	3	724	19.11.98	25.12.98	25.000	0	2.950.000	B.Hydaverdyan
		All					554.556	4.197.000	4.137.300	

[Report of Ministry on Privatization years of (1998-1999)].

(3.) State firms Privatization by international competitions.

By international competition have been sold only firms provided by Program for privatization in the form of international competitions.

To sale by international competition are subject:

§ Firms as a whole,

§ Monitoring part or block of shares,

§ Other earlier definite lobe or block of shares.

The rights of participation in privatization in form of international competitions have the bodies, established by point № 1 of article № 6 of privatization Law, without limitations.

According to Republic of Armenian Government order about privatization of state firm in the form of international competition are established: conditions, terms and site of negotiations of competition, launching price of part of firm being a subject privatization, forms and terms of payment, condition of participation in competition, order of competitive proposals discussion, definition of competition winner, termination of competition without declaration of winner, the property right transfer to winner of competition. [*Privatization program for years (1998-2000)*].

Government of Republic of Armenia on presentation of convener of Government of Republic Armenia have set a competitive commission, which one public, including - outside of Republic of Armenia declares about competition, its terms and conditions, prepares competition, carries it out and determines the winner of competition. The competitive commission is competent lead straight negotiations with participants on competitions with the purposes of refinement of competitive proposals, if diverse was not stipulated by the governmental order of Republic of Armenia about privatization of state firm on international competition.

International competition should be publicly announced-not less than for one month prior to the beginning of international competition, if diverse was not stipulated by the governmental order of Republic of Armenia about state firm privatization on international competition. The winner of international competition considered the body whose proposal corresponds to requirements. The competitive commissions can't limit the rights of separate persons on participation in competition, if about it is not indication in the Law or Program.

The privatization certificates couldn't be used as a legal tender in case of state firms' privatization on international competition except for a case established by point 3 in Privatization Law. [*According to the R.A. Privatization law Article 34*]

Table N 5 gives the information about firms privatized on international competition by method of competitive sale in period of 1998-1999.

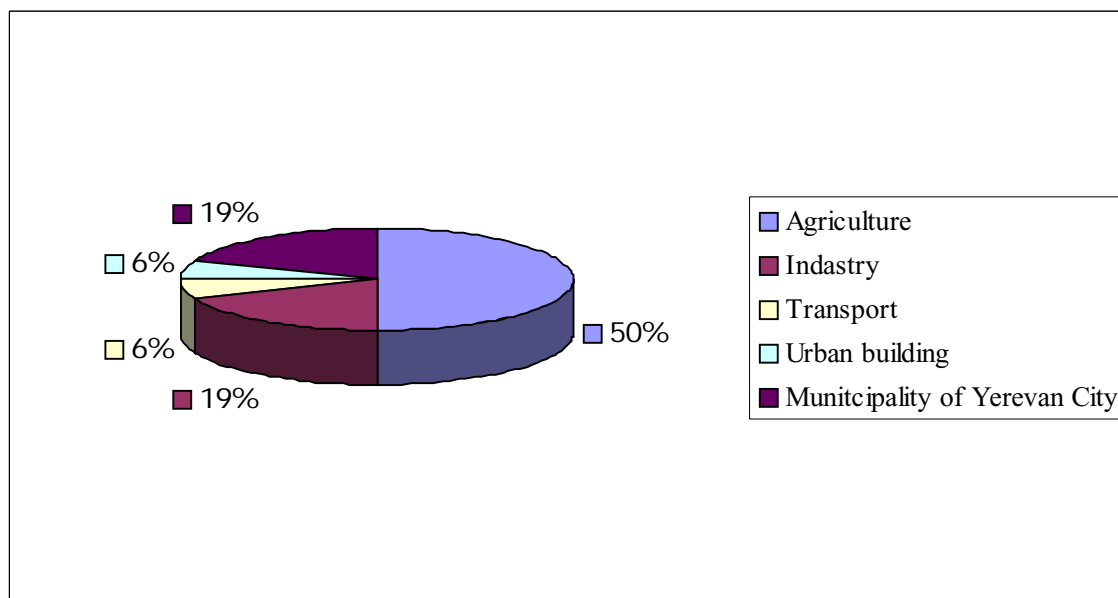
Table N 5

№	Code	Ministry	Address	Decisions of R.A. government			Date of competition	Price (thousand drammas)	Investments		Winner
				Quantity	#	Date			USA Dollars	Thousand drammas	
1	73785	Industry	Yerevan	2	570	09.12.98	04.02.98	601.000	2.450.000	0	Workers
2	21862	Industry	Charent.	2	589	17.12.98	04.02.98	13.000	0	10.500	S.Shalgah
3	21502	Industry	Yerevan	1	358	11.06.98	09.12.98	52.000	0	160.000	S.Sargsyan
4	21502	Industry	Sevan	2	359	11.06.98	02.12.98	20.000	0	30.000	A.Avetisyan
5	4935	Industry	Yerevan	2	358	15.01.99	03.03.99	550.000	0	4.000.000	"RENKO" LTD
			All					1.236.000	2.450.000	4.200.500	

[Report of Ministry of Privatization yers of (1998-1999)].

For the given period by competitive basis 50 firms mentioned in the program of privatization for years of 1988-2000 were offered to privatization. From them 38 firms were offered to privatization on the competitive basis for the reason that they twice were tendered to privatization by a method of free subscription on the share, but both times were not privatized. 7 of firms were offered to disbandment in conformity to the law of R.A about "Privatization of a state ownership". Only 10 firms from offered to privatization on the competitive basis were privatized and as on the competitive basis the property of 6-th of the disbanded firms were sold. Privatization of remaining 34 firms was not held. 50% of privatized firm-agricultural, 19 %-industrial, 6 % transport, 6 % urban building and as 19 % of firms were established by municipality of Yerevan City.

Chart N 21



Owners of firms privatized on competitive basis in 1999 were obliged to make 4781210 thousand drammas payment as after privatization investment. [Report of Ministry of Statistics of R.A (2000) pp. 20-21, Social-economic situation in Republic of Armenia for January - December, (1999), Yerevan].

(4.) Implementation of privatization by a method of a straight sale.

Within 1999 by the method of a straight sale were privatized 12 firms from which one 9-th renters of a state ownership not marked in privatization program and three were marked.

Table № 6 with information about these firms is shown below.

Table N 6.

N	Title of firm	The founder (ministry, municipality)	Estimated cost (thousand drams)	Number and date of government decision	Buyer
1	"LAVAR-90" Co.	Industries and trade	40179	N 157, 29.05.97	Workers
2	"AKORD" Co.	Industries and trade	2677	N 120, 26.02.98	Leaser
3	"KRUNK" LTD	Agriculture	28622	N 795, 14.12.98	Leaser
4	"VERADARTS" LTD	Transport	2721	N 844, 28.12.98	Leaser
5	"PLASTMASA" Co.	Municipality of Yerevan City	1807	N 82, 20.02.99	Workers
6	"SHINNOROGUM" LTD	Urban building	21751	N 82, 20.02.99	Leaser
7	"JRKONSTRUKTSIA" LTD	Agriculture	54271	N 310, 12.05.99	Leaser
8	"ALUMINE" LTD	Municipality of Yerevan City	70122	N 310, 12.05.99	Leaser
9	"ARABKIR" LTD	Public health services	83639	N 334, 21.03.99	Leaser
10	"DCA" S.Sh.Co.	Industries and trade	3 mils. Dollars at the rate in drams	N 196, 31.03.99	Beforehand known buyer
11	"PROMETHEY-CHEMYSTRY" C.Sh.Co.	Industries and trade	1,5 mils. Dollars at the rate in drams	N 283, 05.05.99	Beforehand known buyer
12	"DERINAPOLOGIA" S. Co.	Public health services	56817	N 676, 02.11.99	Workers

[Report of Privatization Ministry years of (1996-1998); (1998-2000)].

(5.) Implementation of privatization of a state ownership through auctions.

Sale of state firms from auction.

- a) firms presented to privatization on auction;
- b) "small" objects, which were not bought by their labor collectives;
- c) property of abandoned state firms;
- d) objects of the uncompleted building.

The right to participate in privatization in auction has citizens, groups of Armenian Republic citizens, non-State firms and foreign bodies without limitations. The labor collectives have the right to participate in auction on the common basis.

The solution for sale of indicated objects from auction and about form of auction takes Government of Republic of Armenia. The sale by auction implements in that case, when from buyer was not required fulfillment of certain conditions (except for indicated in the privatization Law conditions bound with observance of labor collective concerns and preservation of firm manufacturing structure (profile)). After marking decision about realization of auction, privatization of the State-owned property of Republic of Armenia was implemented by auction commission, which publicly declares about auction and executes it. The winner of auction recognizes a body offered a ceiling price. At auctions the price can't be lower than 50 percents from the launching price in opposite case auctions were recognized as not acted.

The foreign bodies participate in sale of state firms privatization in the order established by point 7 of the article 29 of the Law on privatization. [According to the R.A. law Article 30]

Within 1999 through auctions 2 firms marked in program of privatization were privatized.

Table N 7 with information about these firms is shown below.

N	Title of firm	Founder (ministry, municipality)	Estimated cost (thousand dramas)	Original cost (thousand dramas)	Date of auction realization
N	Title of firm	Founder (ministry, municipality)	Estimated cost (thousand dramas)	Original cost (thousand dramas)	Date of auction realization
1	"HAYCHEMYSTRYPLAN"	Industries and trade	195	195	30.01.1999
2	"Metropoliten"	Transport	3259	3259	16.04.1999

[Markosyan. A.H., Management of state enterprises privatization, p.187].

The sale property of abandoned state firms on competition or at auction.

In the case if property was not privatized in the established by present Privatization Law order and abandoned by governmental order of Republic of Armenia, these state firms were selling on competition or in auction. The property of abandoned state firm could be sold on competition or in auction:

- a) Whole, as a property complex;
- b) In parts, in quality previously of disjointed property sub complexes.

In the public declaration of sale of property of abandoned state firms should be indicated those kinds of activity, which was authorized act on it territory. The acquisition of abandoned firms property on competition or at auction does not attract for the buyer of any obligations, bound with the property obligations of abandoned firm concerning the third persons, and also with labor relations. In a case if the competition was ceased without winner declaration in established by the legislation of Republic of Armenia order, were declared auctions sales of territory and property.

In case when the auction was considered as not acted in established by the legislation of Republic of Armenia order the launching price was reduced and declared new auction sale of territory and property. The privatization certificates couldn't be used as a means of payment for abandoned state firm property acquisition. Obtained from abandoned state firms property sale money resources should be used for repayment of obligations of this firm in sequence and order established by the legislation of Republic of Armenia. The money resources, which have left after executing the obligations, were passed to the budget of Republic of Armenia. [According to the R.A. law Article 31].

Within 1999 were adopted solutions on disbandment 145 firms kept in the program and also subdivisions which have arisen from a structure of these firms as a result of reallocating.

The data of table № 8 show receipts of means from state ownership, obtained during privatization in 1999 and as of 01.01.2000 years. The sums are submitted in thousand dramas.

Table N 8

	Sum obtained from state ownership privatization (thousand dramas)	
	On 01.01.2000	During 1999
1. Large and mean firms	100830373,6	17613488,9
By privatization certificates	39766020	
By money	61064353,6	17613488,9
2. "Small" objects	26155258,6	1531520,8
By privatization certificates	23846500	
By money	2308758,6	1531520,8
3. Objects of unfinished building	497084	309309
By privatization certificates	176180	
By money	320904	309309
The sum 1+2+3	127482716,2	19454318,7
By privatization certificates	63788700	
By money	63694016,2	19454318,7

Source: [Report of Privatization Ministry years of [1999-2000].

Privatization program for 1998-2000 assume completing privatization of approximately all medium and large enterprises by the end of 2000. New sales were carried out in cash, as the voucher program was no longer in effect. By the end of 1998, over 57% of medium-sized, and 90% of small enterprises were privatized. In 1999, 45 large-and medium-sized assets and 170 small businesses were privatized. According to the Privatization Ministry, 500 companies were selected for privatization for an estimated \$30 million in 2000. These companies are: the national airline, three hotels, the leading electronics firms, the main mining and metallurgy factories, two major goods and transportation concerns, the companies in construction materials and textiles etc. The privatization of the electricity distribution network, which is up for sale to strategic investors in 2000, is not included in this estimate. According to the EBRD Armenia Country Investment Profile, the total income from privatization is approximately \$250 million to date. The private sector currently accounts for more than three-fourths of Armenia's gross domestic product.

Privatization in-1998–2000was governed by the Law on Privatization and the Law on the Privatization Program. These laws came into force in early 1998 and, together, provide the fundamental legislative framework of privatization. The Laws encompass everything concerning the process, from who may participate in privatization to the methods used and the companies that were subject to privatization.

When first approved, the program included more than 200 medium and large enterprises that were available for privatization for the first time. These included enterprises from all sectors of the economy, including infrastructure companies, power, water and sewage, etc.

One important component of the program was that all enterprises previously approved for privatization yet unsold remain approved and available for privatization. This is important as privatization was not limited to companies recently approved but includes companies from previous programs, all small businesses and unfinished constructions identified and yet unsold. Through December 1998, there were approximately 850 medium and large enterprises available for privatization.

The governmental body responsible for implementing privatization in the R.A is the Ministry of Privatization (MoP). Only in rare cases the MoP was declared as the body that manages the State

companies, and therefore it had been co-operate closely with the sector-specific line Ministries that manage the enterprises. Based on material that it receives from the line ministries, the MoP prepares assessments and suggests privatization methods.

The Government was responsible for approving of the specific privatization decision for each enterprise to be privatized. According this decision, the MoP implements the privatization transaction and signs contracts with buyers. Policy to date has been to sell stakes in their entirety, leaving few residual or minority stakes in State hands.

Through 1998, more than 70% enterprises of RoA were in private hands and over 50% of the working workforce was employed by private businesses. Though many of these developments changes were taking place in the private sector outside of the privatization process, privatization continues to play a key role in the development of the sector of economy.

The Government of the R.A continued to develop the privatization process in 1999. Tenders with increased preparatory work and more rigorous investment requirements became more important. This method of privatization gave the MoP better opportunity to understand the enterprises, to attract quality buyer, and to create conditions in which enterprise development was a priority. Cash paid for shares was no longer an absolute priority, with the ability of the buyer to improve enterprise development and social conditions taking on greater importance.

The Government focused on the power sector privatization. The sector was under restructuring as a precursor to the eventual privatization of several components, including both generation and distribution of electricity. Foreign advisers were working in this area and the R.A was looking for foreign and domestic partners for many of these complicated privatization projects.

Privatization through the capital markets became more integral method. Have been established procedures, which allowed companies to be privatized using local capital market participants. This enable the R.A to conduct primary and secondary market offerings for shares using the developing expertise of local capital markets participants while providing additional opportunities for capital market transactions.

Liquidation

Enterprise liquidation became an increased priority. The MoP has identified more than 200 companies that had not yet been privatized and were appropriate for liquidation. These companies had little value as going concerns due to the presence of excessive debt or unproductive assets, but they might possess certain assets that could be quite productive. The MoP developed this process and carried several test-cases in the first half of 1999. If successful, enterprise liquidation could play a significant role in the transition process.

Investors

The MoP and the Government were continuing to expand their search for prospective domestic and international investors. The R.A became much more productive in its search for partners to participate in the development of the local economy, including through the privatization process. Efforts were made to bring in strategic investors and Armenian Diaspora, who bring with them a unique interest in Armenia and significant management and technical expertise. The increased marketing campaign includes extensive use of new media and the internet as well as promotion through conferences, delegations, and international organizations.

4.9.1 Conclusion

With the completion of mass privatization, the privatizers were no longer looking to maximize the speed or volume of privatization. Instead, the Government and the MoP were concentrating on attracting quality investors into strategic sectors of the economy and establishing privatization and post-privatization frameworks that will ensure the economic viability of as many Armenian enterprises as possible. This is not an easy task, but nevertheless a critical one.

In December of 1999, the Armenian Government passed three new decrees related to privatization on preparing enterprises to go through the privatization process, on privatization of 20 strategic enterprises of high economic value, and on procedures for carrying out liquidation more effectively. The decrees are aimed at improving and accelerating the privatization process. Privatization of large, strategic enterprises, especially the state energy company, has the real potential to bring large revenue to the State budget.

4.10 CASE-BY-CASE PRIVATIZATION.

Case-by-case privatization is a traditional method of divestiture used in most countries as opposed to mass privatization, which was used mainly in transition economies where speed and scope of the program were of primary importance. The case-by-case method implies developing a privatization strategy for each industry and enterprise, fully taking into account all the individual specifics. While it is more effective in terms of achieving major objectives of privatization regarding efficiency, revenues, corporate governance, investment and technology transfer, it is less effective in terms of speed and scope and therefore was rejected by some reformers at the first stage of privatization. The case-by-case privatization can be counted as the best way to consolidate achievements of cash privatization.

Privatization of so-called “strategic” enterprises was deferred until 1998-2000. The international tenders for large-scale enterprises have spurred increased foreign participation in privatization. The government in March 1998 has encouraged the involvement of the Armenian Diaspora in the process, have been sold through international tender the telephone operator Armen Tel, the Yerevan Cognac Factory, and the Armenia, Ani and Yerevan hotels. Now is going ahead privatization's include Armenian Airlines, and services at Zvartnots, the international airport serving Yerevan, as well as the Hrazdan thermal power plant.

During 1998-99, several large enterprises were successfully sold, including:

- § ArmenTel – Greece’s OTE holds 90%; the Government of Armenia 10% of shares.
- § Yerevan Cognac Factory – Purchased by the French firm Pernod Ricard for \$30 million
- § Hotel Armenia – Purchased by U.S. investors for \$8 million, and to be managed by Marriott International Corporation
- § Hotel Ani – Purchased by U.S. investors for \$4 million
- § Hotel Yerevan – Purchased by Italy’s RENCO Spa for \$1 million
- § Yerevan Municipality Construction – Purchased by Garni Group (US-Canada) for \$500,000
- § DCA – Purchased by Fanfino Ltd. (UK) for \$3 million.

4.11 PROBLEMS COMPLITING PRIVATIZATION

Any country starting privatization (sometimes-wide area), as a rule should ensure indispensable for this condition. The experience demonstrates that for realization of effective policy in the field of

privatization it is necessary to execute legislative and organizational measures, to supply training of personnel, classified rearrangement of firms, to form a public opinion.

Creation of a legislative field.

Taking into account value of privatization in business of property and rights nature change on it as a fundamentals of economical relations and also that this process concerns all citizens of country. The main condition for its implementation in a lawful state is the acceptance of the conforming laws, programs and set of subordinate legislation. That's a reason why privatization to precede wide area of legislative activity. It is possible to mark also general tendency, which one is marked in all countries executing privatization adopted legislative acts in short terms (sometimes 1 year) subject to numerous changes and additions by virtue of that again adopted documents as under the contents and on volume basis essentially differ from previous. It once again testifies that each country having choose this or that form of privatization makes changes in it outgoing as from social and economic development problems of the given country at present and from requirements to overcome interrupting in path of privatization and more effectively to control it.

Organizational measures.

For privatization of State firms there are specialized state bodies. In Armenia bodies executing privatization are the ministries, office, agencies, committees, funds, board, commissions etc. Is apparent that the state bodies realizing privatization have the different forms. However as a rule, since marking decision about privatization and before implementation of this solution in process is not involved only one State control body. Privatization of the State-owned property as the relevant measure, guesses availability of "dividing walls" or "gaskets" in decision making between bodies of government administration at transition from one control body to other it is possible to control the adopted solution and secondly, maximum eliminate negative consequences of control process. One of the main requirements shown to bodies executing privatization is objectivity in decision making and exception of these bodies in the received solutions. In many countries are presented enough stringent requirements to persons of these bodies for reduce to minimum abusing. [Markosyan. A.H. *Management of state enterprises privatization*, p.148].

Personnel training.

The major condition indispensable for organization and privatization realization in Armenia was an availability of conforming specialist. Armenia executing privatization does not made dispositions of such kind specialists in the centralized order. From this point of view it is necessary to mention the relevance of Armenian government activity in a problem of fast personnel training. Taking in to account gravity of a problem, governments should make even the schedules of personnel training for privatization.

Basic directions of personnel fast training are:

- § Selection by government on the competitive basis specialists for transit of two-three months retraining courses in foreign countries,
- § The government with assistance of international financial organizations should selects those foreign centers, institutes, in which one per the nearest one - two year the specialists should pass retraining,
- § Organization for persons who graduate from universities (legal and economical) special courses on privatization,
- § Training centers creation for privatized firms specialists,
- § Exchange and implementation of foreign countries experience (specially those which has wide experience of privatization),
- § Formation of public opinion.

During privatization in Armenia (especially at its initial stage) were important differentiated consideration interests of society and its separate groups with the purpose of economical and social consent achievement on this problem.

The totals of privatization determine concerns of different group of people, instead of economical rationality and concern of each groups in own way influences this process. The speech goes about inverse concerns of following basic groups of the participants: the state - tax bearer (firms, citizens), suppliers - sires, sires - customers, hired workers - managers, trade union - businessmen, and private owners - hired workers. The state was interested in high-effective economics, which will supply stable and growing receipts to budget. The proprietor, as against the managers and hired workers, has continuous profit, orientation on obtaining of maximum profit for what they were ready to use current means of consumption. For the hired worker main was a growth of current incomes, economical independence, activity place constancy and satisfaction by activity. The customer has a goal to gain more cheaply qualitative goods and services.

It is necessary to add that, as a rule, participant of a social production acts acting and as sire, and as a hired worker, and as a proprietor. Such differences of concerns results the society to definite consent, which is very important to take into account during privatization. From that follows, that privatization in Armenia could become effective action if there would be mutual consent of all society groups, support of society, formation for different groups and layers of consciousness that it is expedient for all. For successful privatization implementation important value had interrogations activity in mass media, the sociological interview and other activity, formation of a positive public opinion concerning privatization, as if process of privatization will be not promoted by all society as a whole or its main body it has no success.

All meaning of indispensable for privatization activity that government legibly has explained to society, goals of privatization policy and has customized a public opinion for the benefit of its realization. As more lobe of state sector in the given country as more shortly terms for it privatization, so important to work in that direction. It is important positive political customize in the given society and in particular effective work of different subdivisions of government. The government executing privatization should have first of all legible policy of it management:

- § Privatization linkage with a national development strategy of country, with economical and administrative reforms, with policy of liberalization and regulation of economics;
- § Coordination of privatization with policy in following reforms-financial, social, national security and defense;
- § Final scales of non-state sector in economics;
- § Policy of privatization on separate branches;
- § Increase of economics private sector and efficiency of domestic private enterprises;
- § Attractiveness of privatization for foreign investors;
- § Resources and technical equipment supply of privatization process;
- § Transparency of government policy.

For the beginning of the privatization process and implement it without hesitation is necessary have appropriate approaches and purposes. The cooperation of opposition forces and governments is especially important for activity of the highest body of country legislation, when receiving acts concerning privatization (law, program and etc.). The approaches of political forces to privatization can be different, however it is desirable, that the philosophy concerning this policy is unified.

The consent gains the special importance in case, when in Governmental body working representatives of different political forces. The totals influencing of the country political factor on

privatization process will depend apparently from cooperation of all political forces and favorable political situation.

The classified reorganization of firms

One of the main causes of low efficiency of privatization process in Armenia is the imperfection of its implementation methods. In course of privatization process emerges of national capital underestimation and also still low efficiency of privatized firms activity. In similar circumstances it is necessary to revise privatized firms cost underestimation at a rate of non-disbursements and debts - this main cause of installation so low launching price. Important element supply of privatization process efficiency is privatization with a condition or warranties of financial environmental sanitation of privatized firms and re-structuring of debts.

Major amounting element of structural reforms is solution of a non-payments problem, which one significantly affects efficiency of spent policy. However until now problem has not received solution: still there is no precise statistics of the non-payments, are not designed comprehensive programs and gears on repayment of the former non-payments.

Organization-legal reorganization.

A country executing mass privatization, in a case if is not envisioned firms liquidation before privatization will reorganize state firms and firm with state participation in closed or open type joint-stock companies. In Armenia the problem was solved basically by means of partial gratuitous privatization, as a result of which 1010 mean and small state firms of different branches of economics have turn into closed joint-stock companies with authorized capitals ratio 20 to 80. [Report of Ministry of Statistics of R.A 1996 p. 23, Social-economic situation in Republic of Armenia for January-December, 1996, Yerevan].

Until 31 of December 1997 all state firms should been reorganized in state joint-stock companies. This process had a number of consequences, which were important for privatization and firm's reorganization. Maiden - organization-legal reorganization is the prior condition for further firm shares sale, which was necessary for implementation of traditional privatization by public sale. Second this is more important, that during application of privatization miscellaneous ways were available stable proposals of auctioned firms, to have constant capability of their shares acquisition.

The organization-legal reorganization allows to free firm from the superfluous orbs of business intrinsic to a centralized scheduled system. So, before privatization the industrial firm has responsibility not only for the basic production activity, but also for rendering a number of social services to the employees, sometimes and all population of city, village, as objects rendering these services (objects of public health services, manger, clubs, the schools, sport halls etc.) were on firms balance. Separation of large industrial complexes into more small-sized units, their transfer to the conforming local authorities or their separate privatization is the important element of organization-legal reorganization process. Besides the redemption of firms from unusual for them kinds of activity also is important because due to this from the former monsters of the socialist term are excreted working parts. The solution about firms privatization adopted by Armenian government basically has supplied their organization-legal reorganization but execution in fact was very weak. [Markosyan. A.H., Management of state enterprises privatization, p.161].

Financial reorganization.

The governments of post-communist countries including Armenia during implementation of privatization decided one common problem: excessively poor financial condition of a biggest part of state firms. Many of these firms had before privatization the large debts, carries large losses at a

transient stage the situation was aggravated with actuating of market prices and competition. The business banks from the beginning of reforms prolonged to grant poor credits to traditional clients and when owing to tighter policy of the money and bank control were overlapped firms financial sanctions. Part of firms prolonged goods deliver to the constant partners, increasing interfactory indebtedness instead of its repayment, hoping that the banks again will salvage them, by granting the soft loans." [*Report of a central Bank of R.A Yerevan, 1996, N2, page 12*]

Almost in all post communist countries transition from the centralized scheduled system to market relations was accompanied by bank crisis. This crisis differed from crisis in economics of developed countries because of that actually all hopeless credits were issued to state firms that significantly has hampered privatization process.

System reorganization.

In spite of the fact that the opening-up of firm for privatization is the widespread form in many less developed countries, in post-communist economics the large volume of state sector interrupted with firms reorganization before privatization (exception makes only of Germany after affiliation and without developed economics Western Germany it would be impossible). Other countries had centralized planning could not finance large consumptions of all country, indispensable for reorganization. Nevertheless they have executed reorganization of some major concerns before privatization, and after it. For example, in the Czech Republic this process implemented by Fund of National Property. In Hungary except for 100 companies, which were included in "Program of a centralization of debts", 160 very large companies (overall costs more than 10 bill. dollars) were transferred to the State holding - company, which takes responsibility for their reorganization after privatization and financial environmental sanitation. Poland after privatization has accepted a number of the projects on reorganization with different consequences.

The experience of Moldova is useful also. The creation of a legislative field was based in this orb on government decisions "About urgent actions on improvement and reorganization of a financial and economic situation of industrial firms" (May, 1995) and "About agency on reforming firms and rendering them technical assistance in post-privatization term" (June, 1995). The legislative field of Moldova in 1996 was supplemented by a decision of government "About padding measures on reorganization of firms", as well as by a number of the laws, in particular "About leasing". The law "about firms reorganization" was submitted to parliament, which also is invoked to boost a legislative field. Create of state creditors agency, which are signed with firms having the liabilities before state at a rate of 3 million ley (650 thousands. dollars) and more, the memorandums - agreement and are controlled process of their fulfillment. These firms incurrent the obligations on fulfillment of reorganization schedule matched with creditors. [*From Plan to the Market. The report on world development (1996). Washington, W.B, (1996), p. 72*].

In Armenia companies for their reorganization get number of privileges, in particular, extension of payments terms of the fines and fine of the taxes, calculated owing to non-payment, capability their full or write-down hereinafter, extension of taxes payments time in a budget, tax vacation within the limits of a calendar year is granted to the firms which have concluded the memorandums-agreements, extension of payments terms in to a pension fund, re-legalizing of business banks credits and their percents in the share of these firms, decrease of the profit tax bet for 2-3 years with a condition of obtained means direction to updating of a circulating capital. [*Privatization Law Article N 25*], [*State Ownership Privatization Program for (1998-2000)*].

The irrevocable debts and interfactory indebtedness.

In all post-communist countries there was a problem of irrevocable debts, and a sanction was necessary for liquidity of a banking system, and consequently for maintenance of stability of economics. According to the available data, the value of debts has compounded for 76 firms of 6 Ministries of R.A (having arrears more than 20 million dollars.) about 5,7 bill. drams, almost half which one is a share of a ministries of an industry and trade system firms and 60 % of arrears-on a lobe of the value-added tax. [Report of Ministry of Finance of R.A. for years 1996 p.88]. In a structure of R.A firm's debts the large lobe is made by the indebtedness of social insurance and calculated fines. Number of employers, which owe to Pensions Fund and seizure of R.A more than 1 million drams, for which one the stale debt makes 6,8 bill. drams, fine 10,3 bill. drams.

Having the purpose of stale debts repayment to Pensions Fund and seizure of R.A and with the purpose of calculated fines penalty by a decision of the government of R.A N 320 from August 5, 1997 it is authorized to Fund to receive property and material assets tendered the obligors to realize by auction method and to reset the mentioned debts. [Decision of the R.A government № 320 from August 5, (1997)].

By other decision of the R.A government (№ 321 from August 5, 1997). Comity of Pensions Fund and seizure of R.A is entitled to free the diligent payers of social deductions from the calculated fines concerning stale debts, to prolong terms of their payments or to lower the size of the fines sum. [Decision of the R.A government № 321 from August 5, (1997)].

Last reforms, which were carried out in a banking system of Republic of Armenia, had resulted in that number of incapable banks essentially has decreased. The size of business banks capital that is meeting the demand a Central Bank of R.A should till 1.01.98 compound the sum, equivalent as a minimum to 350 thousand USA dollars and after January 1, 1998 - 600 thousand dollars. The similar requirement to the sizes of the bank capital and failing of separate banks to work in market conditions have resulted that as of December 1, 1997 quantity of the registered banks and branches has compounded accordingly 30 (instead of almost 100 per past years) and 141. Total amount of the pronounced charter capital of business banks as of December 1, 1997 has compounded 14259 million drams and from a beginning of 1997 was increased on 36,7 percent. [Report of Ministry of Statistics of R.A (1997) p. 75, Social-economic situation in Republic of Armenia for January - December, (1998), Yerevan].

From the law of R.A "About privatization program of state-owned property of R.A on 1998-2000" withdrawn limitation on participation of business banks in privatization and the forms of this participation and its consequences are now discussed. [Privatization Program for years 1998-2000].

Procedure of bankruptcy.

The property of state firms often privatized by means of an admission of insolvent firms by the bankrupts. Certainly, in market economies an admission of firms insolvent, their bankruptcy and reorganization are esteemed as a financial sanction concern to the given firm. From Central and East Europe countries Hungary was the only country, where a similar way has received broad application. In the beginning of 1992 there began to act the law about bankruptcy. Due to application of the law about bankruptcy mutual debts of firms were reduced considerably. The method also was applied as one of main methods of privatization. Approximately 500 major concerns recognized become bankrupt, and there right on the property (by the way of property or as the operational concerns) was transferred to a private sector.

In Republic of Armenia the financial reorganization of firms is failed, moreover, since November of 1996 with the purpose of returning of debts to a budget is applied gear of expropriating. With the purpose of protection firms from bankruptcy taking in lists of privatization in new law about bankruptcy are mirrored some gears. *[Article N 75 of R.A law "About financial improvement and confession of insolvency (bankruptcy) of legal persons, the enterprises which are not having status of the legal person and businessmen's"]*.

Reorganization of activity and joint-stock control.

Second and by effect most important component of firm's renovation is reorganization of firms activity, due to that firms becomes profitable in conditions of free market economy. Concept of "reorganization of activity" includes changes in an orb of a production firm activity in frame of control, in market policy issue and increase of productive capacity. These changes can be carried out on those firms, which are subject to a market stimulants system. The most important stimulants concerns to company's control. The following five kinds of institutes during reorganization of firms act as the controlling agents the state, private owners, institutes of the market capital, not bank financial institutions and banks. Besides that they are a means of joint-stock supervision installation, secondary markets (in case of closing down of enterprise, together with capital markets) become main way escaping from firm for the majority of shareholders. Certainly capital markets can play important role in business of firms financing. The capital markets have begun to develop with a high speed in countries of Central and East Europe and former Soviet Union.

The origination of market relations in Republic of Armenia became the cause of securities market formation and development of auctioning process. In 1990 were built maiden ACCT "Menua", "Zakneftegazstroy", "Are", in 1990-1993 were formed almost 17 goods-raw exchanges, more than halves had in the organizational frame share divisions. The formation of the secondary market was promoted by stock exchanges (Yerevan stock exchange, goods-raw exchange "Adamand", Gumry stock exchange). For regulation of an orb a number of acts - approved by government of R.A order "About investment funds", "About debts design of budget of R.A by the way of exchequer bills", "About order of management list of the joint-stock companies shares", "About the order of valuable papers accommodation by means of auction sale" was designed and orders approved by the minister of the finance and economics of R.A About licensing of valuable papers market participants", "About a subscription to valuable papers", "About proficiency of investment funds control directors and faces executing market deal of valuable papers", "About preliminary and main licensing of investment funds of R.A", "About registration of valuable papers circulars of investment fund of R.A and them issue", "About licensing of valuable papers of R.A investment funds depositaries", "About licensing of investment funds control", "About licensing of forms manufacturing, importation and implementation of the forms of valuable papers of R.A".

With assistance of Italian organization CNA Veneto, located in R.A under the program of Tacis FIN-AR and also American organization USAID (within the framework of program which carried out retraining of conforming specialists) was conducted order of management-centralized list of proprietors, charter of investment companies and securities transactions. *[Gerar Delor: The report on business trip in Armenia, Yerevan, (1997) p. 23-25]*.

The role of banks in business of joint-stock supervision installation became the cause of long-lived discussions. Sometimes debate fell into to what approach should be accepted: the approach of specialized Anglo-Saxon banks or European universal banks. Actually on this problem responded from practical point of view: countries of Central and Eastern Europe have universal banks. It, unconditionally, does not mean, that freedom is given to banks to gain lobes in any size. In Hungary the business banks can gain bank valuable papers only at the rate of 15 % from the guaranteed

capital, and investment houses - at the rate of 40 %. In not financial companies banks can have no more than 51 % of capital. In Republic of Czech and in Slovakia the possession of valuable papers is established at the rate of 25 % of capital and in the separate companies - there are less than 10 %. For acquisition of greater lobe previously it is necessary to receive the consent of a central Bank. In Poland this threshold makes 25 %, in Republic of Armenia 15 %. (According to the law PA “About banks and banking” Article 35. About investment and joint-stock activity): Without the preliminary consent of a central Bank the banks are forbidden to execute such bargains or operations, as a result of which one bank participation:

- a) Considerable participation in the authorized capital any of other face,
 - b) In the authorized capital any of other face are exceeded by 15 % from the general capital of the given bank,
 - c) In the authorized capitals of all faces exceeds 35 percents of general capital of given bank
- [Report of a central Bank of R.A Yerevan, (1996), N2, page 65]*

It is necessary to distinguish two problems. Maiden falls into roles of banks during joint-stock managing: it corresponds to their role ensuring financing of firms debt. The second problem falls into to tendency of banks to become the large shareholders in the commercial companies. From the point of view of maiden problem probability of appreciable supervision achievement is great. If the company in a large degree depends on the debt, and bank finances it, there is a large capability that it will gain places in company board, so will participate in it control. If the frame of firms capital orient to valuable papers, guessing, that the capital markets will prolong to develop with today's speed, the banks will play a very small role during joint-stock firms control. By everything is illogical grant to banks of a privilege during joint-stock supervision, if, certainly, legal field, adjusting the bargains strictly acts. The similar orientation can cause also to create interrupting in a securities market.

Joint Stock Companies and Investment

According to the post Keynesian privatization model incorporates oligopolistic mark-up pricing, investment behaviour integrated with pricing, and money wage determination based on conflict *[Norman, (1996), p. 518]*. It is investment, not relative prices, which is the central point in an economy. Investment is dynamic, constantly in motion, and never resting in an “equilibrium” position. Money and monetary institutions are extremely important in influencing economic activity and are thus not “neutral” *[Keynes, (1936)]*. In contrast to the neoclassical view, money can influence real and nominal economic variables in the short and long run *[Davidson, 1994, p. 17]*. In a monetary economy output is determined by effective demand and there is no reason why effective demand should be at the level of full employment.

Investment in Armenia faces a serious obstacle since the joint stock companies actually do not follow the requirements of corporate management. Even the open joint stock companies are closed in reality because of the absence of stable stock pricing. According to the 2001 program of the Securities Commission of Armenia, 84% of the existing companies in Armenia do not follow transparency principles, i.e. they are not publishing their financial records, and 81% were not audited. 68% of enterprises have violated the principles of corporate management, i.e. the rights and legal interests of the shareholders were seriously violated, 52% have violated the rules of bookkeeping, and 29% have not convened annual general meetings of shareholders. The majority of joint stock companies in Armenia do not use the international standards of accountability and accounting that were adopted in 1999-2000. These are conditions for transparency required first of all for foreign investors.

The total nominal value of 1,170 existing open joint stock companies in Armenia is 63.3 billion drams or 6% of GDP [LOGIKA]. Basically they are companies that were privatized by open trade/subscription of shares (100,000 shares out of 150,000 belong to company employees due to the fact that 20% of shares were given free of charge to the employees of state owned companies). [B. Tunyan (2000), p. 19-27].

However, the above mentioned indicators do not create a complete picture of these companies, since the controlling package of shares is mainly concentrated in the hands of a few people. Stated otherwise, these formalistic open joint stock companies are violating the rights and interests of small and medium shareholders.

Another important factor that will contribute to the free flow of capital is the creation of an environment that ensures equal competition based on legislation as well as practical mechanisms. This first of all requires banning double standards in current legislation and imposing strict limitations on monopolization. In reality the opposite scenario holds true, and as a result, some spheres of import, export as well as some forms of trade and production are monopolized. That these trend continue and develop means that opportunities for equal competition are brutally violated, and this substantially constrains the free flow of capital. Because there was no antimonopoly (antitrust) legislation, during the last ten years the State had to promote its situational and almost inefficient struggle against technological and organizational monopolies. The respective law was adopted in 2000 but its practical regulations have not yet to be enforced.

Given the widespread use of double standards of current legislation and the legal imperfection of the judicial system dealing with the regulation of the economic sphere, bankrupt and healthy enterprises exist side by side. As a result there are cases of non-payments between businesses, accumulation of debts due to bad loans that are expanding through a multiplying effect and becoming a factor for limiting economic growth. The accounts payables of the large and medium enterprises alone in 2000 add up to the equivalent of 1 billion USD. [IMF (2000)].

As a result of double standards, those enterprises, which operate within a legal framework, find themselves in an obviously disadvantaged position, whereas bankrupt enterprises are at an advantage, as they quite often benefit from the protection of the State. They receive indirect, disguised subsidies, thus preserving their property rights. The cost price of production/services of these enterprises is decreased, thereby resulting in a distorted structure of solvent demand. Consumers and producers receive incorrect pricing signals and certain areas of the economy and some enterprises drop out of this unfair field of competition.

There still exist the beliefs in society that even with the kind of protectionism described above, those enterprises that remained in the public sector, the former "flagships" of the economy, can be saved and revitalized. In fact, the solution to this problem lies in the regulation of state enterprise activities, their control, performance evaluation, as well as a coordinated approach to their liquidation, if they cannot be privatized or when there is no alternative. It is clear that granting them the formal status of a state joint stock company has not had any substantial impact on bringing their performance into line with market criteria.

I believe that prior to privatization, state enterprises must have adequate regulation and supervision, which is make possible to prepare for a more successful privatization and prevent wasting the limited budgetary resources spent on them.

Other future alternatives for state enterprises:

- based on state-defined strategic evaluation criteria, inclusion of an extremely limited number of enterprises in the special group of state treasury enterprises (the latter do not pay taxes and their total income goes to the state budget), with direct supervision and reallocation of their financial flows,
- introduction of trust management,
- constant monitoring of financial transactions of all other enterprises that are in the preparatory phase of privatization or that are already privatized.

In the past fourteen years process of establishing statehood, the introduction of a national currency, the Dram, represents an important stage. The change in currency was, in fact, imposed at that time, since the country was not ready for it. The Central Bank was not a well-established institution and there was a lack of foreign exchange reserves to ensure the stability of the national currency.

Due to these conditions, as well as a result of price liberalization and hyperinflation caused by other factors, the currency rapidly lost its value. However, within less than two years, the Central Bank managed to assume the legally reserved function of the nation's treasury. It introduced specific monetary policy tools and to some extent ensured the manageability of the inflation rate and, consequently, the exchange rate of the national currency.

Starting from the end of 1995, one of the most important achievements in Armenia was its macroeconomic stability. It is remarkable for its low inflation rate and has been achieved through certain coherence between monetary and fiscal policies and tough behavior. On the other hand, starting from the end of 1998 in pursuit of macroeconomic policy, characterized by the strong control of inflation, there have been marked deflationary trends. This is rather undesirable for an economy that has a significant gap in its balance of payments. The prevailing model for managing inflation by controlling the monetary base does not promote economic growth, either. During the last years, higher inflation rates were predicted than were actually registered: 8% in 1999 and 5% in 2000

Reforms for Development of the Financial Market

Legislation on taxation underwent substantial review between 1997-2000 when fundamental new laws on taxes were adopted, based predominantly on international standards. This was a genuine breakthrough, considering that taxation legislation and the previous system had been exclusively fiscal. However, some principal problems regarding enforcement still remain unsolved in taxation legislation and the administrative system. Under these circumstances the promotion of sustainable and accelerated economic growth does not translate into a taxation policy that will also solve current fiscal issues.

Taxation relations in RA are regulated by the laws on taxes, profit tax, income tax, property tax, land tax (direct taxes); value added tax, excise tax, and simplified tax as well as by the law on fixed duty (which substitutes profit and value added taxes).

The changes in taxation legislation at the end of 2000 created two major groups of taxpayers: (i) fixed and simplified taxpayers and (ii) those taxpayers who prefer paying profit tax: thus the final choice was left to the taxpayer, excluding any pressure from the State.

The above-mentioned process was directed to and resulted in a prevalence of indirect taxes. In 2000 the ratio of indirect taxes in the structure of tax revenues tripled in comparison with 1994; currently they account for 70%. This means that eventually the tax burden is transferred to end consumers, including citizens. Presently, the established prevalence of indirect taxes has no alternative in terms of reducing the shadow economy and thereby significantly decreasing the property tax since it

contributes to the capitalization of enterprises privatized by insignificant investments and promotes domestic investments.

In the course of the next several years, and taking into consideration certain proportions of the economy development, the taxation burden of businesses should be gradually modified to put more stress on direct income taxes, while preserving the boosting impact of taxation mechanisms.

4.12 CONCLUSION

The privatization policies implemented in the Commonwealth of Independent States (CIS), Central and Eastern Europe, either in the form of shock therapy or gradualism highlighted the urgent need of privatization of state enterprises. However, both transition processes, either shock therapy or gradualism, resulted in a substantial social cost: a large reduction in output, high unemployment and inflation and a breakdown of institutional norms resulting in corruption and illegal activities. Privatization was singled-out by all schools of economic thought as the most important transition policy, due to the direct link with output, employment and inflation.

The development of capitalism in Armenia has taken place under the extreme and abnormal conditions of the shock therapy process, which the historical experience of civilized capitalism could not warrant. Those who, due to their privileged position under the old regime, were able to exploit their status have been allowed to do so under the new economic conditions.

The initial distribution of private property was paramount since the initial distribution of property would determine those members of the society who could start from an advantageous position. It was anticipated that once the property rights were properly defined, the ownership of equity in privatized enterprises would be relocated to the most effective users. This conclusion was based on a simplifying assumption about the nature of capital markets in the transition economies and did not take into account the actual reality. In an environment in which market power was permanent, due to the nature of technology and industrialization, the “free” market process would not be able to alleviate any of the inequalities arising, rather, these inequalities would increase in magnitude.

For the shock therapy supporters, establishing a free-market environment would have ensured that only efficient owners would survive the market test. In a neoclassical transition economy, the only just distribution would be through a free market because it would not involve any form of coercion. However, given the high transaction costs and informational asymmetries of capital markets, the initial ownership structure has been sustained over time and, thus, the privatization methods used have governed the property ownership structure even after shock therapy.

Post Keynesians argued that the privatization process in the neoclassical model was formulated independently of any macroeconomic, political, bureaucratic and structural considerations. These elements of the transition process resulted in delaying privatization. The privatization process would be inhibited by economic uncertainty and by adjustment shocks inherited in the neoclassical transition model. Financing the purchase of enterprises with credit, in an unstable environment of sharp interest rate increases, could only deter privatization. Also, the recession created detrimental economic conditions for the new entrepreneurs [Rondinelli and Yurkiewitz, (1996)].

The privatization schemes of the neoclassical model ultimately failed because the model did not provide any form of assistance to enterprises to overcome the difficulties associated with the introduction of market relations. In such circumstances, an absolute hardening of firms budget constraints not only drives poorly performing firms into bankruptcy but also destroys enterprises

that would otherwise be quite capable of making a high performance adjustment [Stark, (1996), p. 1019].

In addition, large-scale privatization was not essential to overcoming shortages as the neoclassical transition model stipulated. It appears that the soft budget constraint explained inflation rather than shortages [Ellman, (1994), p. 11]. For these reasons the transition process called not for the dismissal of all state intervention and state property but for their streamlining and adjustment to the new conditions. Active state intervention was required using state property as a policy instrument since market outcomes are often the result of activities of various lobbies and informal organizations, including the organized crime [Kolodko, (1999), pp. 16, 17].

The main objectives of privatization in Armenia was to remove the state from ownership, the establishment of hard budget constraints, to avoid asset stripping and rent seeking and to eliminate the state from the decision making process within the enterprise [The World Bank, (2002), p.x; EBRD, (1999), p. 32]. However, the removal of state property and directives made life very difficult for enterprises. Instead of a market network, there was a network of personal connections, based on 'whom you know' and what position the person held.

The neoclassical transition model highlighted the need for privatization of state enterprises, in the form of auctions [Kornai, (1990), p. 83; Kornai, (1992)]. However, according to the post Keynesians selling state enterprises to the highest bidder violated equity principles. The amount of savings available in the transition economies was not enough to finance a large privatization drive. The only people who could purchase firms were those who had benefited under the previous regime through the black-market and illegal activities. The typical answers from mainstream economists "the firm is worth whatever someone is willing to pay for it" or "let the market decide" were problematic where there was not yet a market and where, in fact, the explicit motive for the sales was to create a market [Stark, (1990), p. 359].

Meanwhile, contrary to the neoclassical transition model where culture did not matter, it appears that the privatization strategies pursued had a high degree of national path-dependence. This resulted in "a complex mosaic of national and regional pathways" [Smith, (1996), p. 135].

The free distribution of vouchers was widely used by transition economies, Armenia choose it as the primary method of privatization. However, the myth behind the development of the widespread ownership of private property through the free distribution of vouchers "peoples" privatization [Braguinsky, (1998), p. 231] had not materialized, nor had the dream of "people's capitalism". For the transition towards capitalism to succeed, it was essential to gain the support of the managers. Support was gained by allowing management to keep its privileged position and, at the same time, to substantially increase their fortunes despite the "free distribution of shares" [Weisskopf, (1996), p. 281; Simon, (1999), pp. 1, 2]. Control still rested with management, who disregarded the owners of vouchers. They considered vouchers to be inconvenient, as they did not help raise capital but required a dividend payment.

Thus, the gains have been captured by the managerial class, who has successfully won rents from the state in the form of privatized enterprises, state subsidies, credits and tax evasion.

A number of conclusions can be drawn from Armenia's experience with privatization. First, national wealth was swiftly and in great disproportion redistributed to the benefit of the rich strata of the population. [UNDP, Human Development Report: Armenia (1997), p.36]. Second, new owners who had bought these enterprises for close to nothing had no obligation to invest in them.

They did not have any interest in investing in new equipment or upgrading or modernizing their facilities, by cooperating, for example, with foreign partners. [UNDP report, (2000)]. Instead, they sold whatever assets they could from their enterprises, including machinery, at the price of metal scrap in Iran or other countries.

Fledgling capitalists appear to be running extractive industries, strip-mining the old Soviet infrastructure, exhausting inputs, selling off inventories, and then closing shop to scrap the machinery. Visitors to Meghri may watch the Mercedes trucks with Iranian plates haul ton after ton of scrapped industrial infrastructure out of Armenia. [Markar Melkoni (Melkonian) (2000)]

Last 2-3 years accomplished by significant slowdown of privatization because of the huge debts enterprises have accumulated through no fault of their own, and which should be regulated. That is, the state as seller should approve the transaction before the initiation of the privatization process according to the law on privatization of state property (Article 24). This, unfortunately, is currently not the practice. During the period of preparatory activities such important issues as the financial audit of state owned stock companies and registration of the shares, at the expense of revenues collected through the privatization of enterprises are not addressed.

It could be noted that the expectations of the people regarding the privatization of state enterprises have not, to date, been met. Specifically:

- a large group of private proprietors has not been formed,
- an effective market has not been established,
- the number of operating enterprises decreased, resulting in an increase in the number of the unemployed,
- the investments made for the privatization of enterprises are largely insufficient.

Privatization of Armenian state property will proceed in a just and efficient manner only when the consequences of the process are taken into consideration and serious preparatory work is done in case of each to-be-privatized enterprise.

According to the 2001-2003 state property privatization program, approximately 900 enterprises had to be privatized but it did not take place, hence I recommend the following:

- elaboration of a comprehensive program identifying the goals of privatization process/clarification of the goals of privatization;
- implementation of a correct policy for evaluating of the to-be privatized property;
- prior to privatization, carrying out comprehensive preparatory activities for state owned stock companies, e.g. possible regulation of debts, conducting audits by state means (before privatization of enterprises) and registration of securities;

The economic reforms cannot be considered complete without an efficiently functioning financial sector and an established capital market. In this regard Armenia is at the initial stage of reforms. Whereas there are some savings in the country (time deposits of the population account for approximately 4% of GDP) [E. Sandoyan, (2000)] no mechanisms and conditions are in place for converting these savings into investments. Establishing of latter is one of the pre-conditions for marking the end of the transition period since it will also solve diverse problems, including social issues. At present it should be stated that the capital market is in its embryonic stage and that the absence of circulation of corporate securities limits the possibilities of individuals who are ready to make small or large investments.

The absence of investment and financial tools also limits the possibilities of corporate and private business entrepreneurial risk diversification. The embryonic stage of the financial market in Armenia is also conditioned by the underdevelopment or in some cases absence of necessary infrastructures, namely independent evaluators, realtors, stock exchange structures, brokerages, investment funds and companies, auditors.

The law *on regulation of the securities market* adopted in 2000 and the activities of the Securities Commission, established in accordance with that law, should become a serious impetus for establishing the capital market.

A process of asset recombination of property was occurring, often behind the scenes, whether a recombination from state to private firms or from some private firms to other private firms [Gray, (1996), p.11]. This gave rise to a new form of ownership, which [Stark (1996, p.1014)] named “recombinant property”. “Recombinant property is a particular kind of portfolio management. It is an attempt to have a resource that can be justified or assessed by more than one standard [Stark (1996), p.1014]. In this way managers and banks controlled and reaped the benefits of the most profitable parts of the enterprise, while the unprofitable, loss-making and inefficient parts became the responsibility of the state.

Recombinant property did not increase efficiency because it did not reduce monopoly power since the same management effectively still controlled the numerous break-ups. In addition, there was a loss of economies of scale. Instead of genuine restructuring, there was a transfer of the responsibility to the state. The privatization program in transition economies resulted in new forms of property in which the qualities of private and public ownership were dissolved, interwoven, and recombined.

Given the fact that the only condition for privatization in this manner is the value of securities sold, in most cases the State does not care about the sold property after-wards. Absence of any commitments (economic or social) of the parties involved has created a situation where currently many companies have appeared in the hands of inefficient owners who bear no responsibility for them.

The superiority of private property over state property, as a number of economists argued, should not be interpreted as implying that state property did not have a role. There was a role for state property in areas where private property did not function efficiently, that is, whenever there was market failure. The contentious issue is whether state property should be instituted beyond the areas of market failure. Post Keynesians would argue that there is a role for state property beyond market failure [Targetti, (1992), p. 6].

In addition post Keynesians claimed that market failure was extensive, encompassing market power and information. Their main contention, however, was that the majority of property should still remain in private hands.

Vicker and Yarrow (1991), pp. 113–118 argued that empirical evidence demonstrated that private property had efficiency advantages in competitive conditions, but was not superior when there was market power. Meanwhile, when state-owned firms were subjected to competition similar to private firms, their performance was more efficient [Comiso, (1992), p. 228]. It was not ownership that determined efficiency but environmental factors. Thus the development of competitive conditions and a regulatory framework should have been the goal, not ownership.

The case for privatization in the transition economies became even less clear when the underdeveloped markets for capital, corporate control and managerial labour were considered. The absence of a capital market in which take-over can be initiated, the lack of corporate control in the form of institutional norms and the substantial imperfections in the managerial labour market, could only promote managerial failure. Under these conditions, enterprise managers did not behave in an “optimal” way as prescribed by the neoclassical model. This actually facilitated ‘spontaneous privatization the transformation of state enterprises into joint-stock companies whereby the managers became the new owners [Stark, (1990), p. 366; Eyal et al., (1997), p. 88].

The post Keynesians concluded that no form of ownership was perfect. Private firms suffered market failures, a divergence between private and social benefits and costs. Public enterprises experienced government failures, a divergence between political and social benefits, and costs. Thus private ownership, while eliminating government failure, still gave rise to market failure. The most appropriate ownership structure depended on the magnitude of the imperfections. For this reason [Stark (1996), p. 1023] argued that ‘it is not in finding the right mix of public and private but in finding the right organization of diversity to yield both adaptability and accountability that post-socialist societies face their greatest challenge.

Consequently, there were no firm guidelines with respect to the appropriate ownership structure. The experience of mature market economies demonstrated the variety of ownership structures in market economies and the changing character of ownership structure over time. As such, the framework of political and social institutions, traditions and history and the state of economic growth of the particular country had to be included in the analysis of the development of property relations [Targetti, (1992), p. 6; Taylor, (1994), p. 80].

A market economy requires not only liberal regulation and private ownership but also adequate institutions [Kolodko, (1999), p. 2]. Empirical evidence reveals that the success of privatization in terms of revenues and stakes sold requires suitable legal institutions and developed capital markets [Bortolotti et al., (2001), p. 109]. Consequently, there was no single ideal strategy with respect to privatization.

There is a tacit acknowledgement by the World Bank group that in Armenia taken place poor governance of privatization, the first phase of Armenian privatization may have suffered from a lack of transparency and inefficiencies, and not all stakeholders were involved in the privatization process. Nevertheless, there was a contradictory approach to resolution of the problems because of the underlying mistrust of the state. Resulting in the creation of legally and politically powerful privatization quangos that are insulated from government interference [Sarbib, (1997)].

In practice, these quangos become more accountable to global agencies at whose initiative and with whose assistance they are created. Jacobs, the head of OECD Program on Regulatory Reform suggests (1999, p1) that relations between the institutions of the state, the market, and civil society to sustain market led growth and boost potential social welfare. In particular, he suggests “New or adapted regulatory institutions supported by civil society are required to maximize the potential benefits of vigorous market competition”.

In the case of Armenia we can see that Armenian government is not open up, they are not realizing the importance of public relations both nationally and internationally. At the same time, the technology revolution is contributing to the process of democratization by providing more information, and in turn, stimulating an increasing demand for information and accountability. Hence, in response to public distrust of privatization, governments is not taking steps to address the

lack of publicly disclosed information on divestiture procedures, concluded deals, the impact of privatization, and on the use of sales proceeds. As I have said, many citizens have yet to see or feel the “benefits of privatization”. They need convincing that privatization is good for the country and for them; and that means keeping them informed. With increasing demand for information and transparency, all the more important now that the major enterprises are on private hands.

Blanchard and Kremer (1997) have claimed that the absence of contract enforcement mechanisms was a primary factor causing the dramatic fall in output during transition in the Armenia. From the evidence gathered labour and diffuse individual ownership is more prevalent in the CIS than in Central and Eastern Europe. While foreign, investment fund, concentrated individual and bank ownership is less prevalent. The types of owners that require substantial institutional assistance have received less support from institutions in the CIS than in Central and Eastern Europe. Thus, a critical factor explaining the smaller effect of privatization in the CIS is the large share of labour ownership, arising in an environment where the institutions did not provide fertile ground for labour managed firms to be effective and viable [*Djankov and Murrell, (2000), pp. 41–42*].

Thus, since the CIS has an ownership portfolio that contains a greater share of labour managed firms in an inadequate institutional environment, the structure of ownership explains the under-performance of newly-privatized firms in the CIS [*Djankov and Murrell, (2000), p. 39*].

Did the private owners of the newly privatized enterprises restructure the firms? [*Carlin et al. (1995), p. 450*] concluded after a study of 450 newly-privatized enterprises in the Czech Republic and Slovakia, Hungary Poland and Russia between 1990 and 1993, there was little evidence that privatized enterprises were more likely to restructure than state-owned enterprises. By using studies and a survey of 65 manufacturing firms in Armenia over the 1994–97 period, I found that privatization did not affect restructuring and enterprise performance. Consequently there is no clear evidence that the privatized enterprises perform better than the state enterprises just in the aftermath of privatization. Based on my findings possible to suggest that restructuring, rather than privatization, should had been put at the center of the government analysis of enterprise sector reform.

In relation to whether restructuring should precede privatization, the answer was clear for the post Keynesians. They believed it was the responsibility of the government to use discretionary measures to ensure the viability of the enterprises before and after privatization. The government should assist and equip enterprises with the essential internal structure necessary to survive the competitive market process [*Davidson and Davidson, (1996), p. 215*]. “Governments do not kill state enterprises when they are inefficient. They subsidize them, “preserve jobs” in them, protect them from “unfair competition” in a word nurse them rather than kill them” [*Frydman et al., (1997), p. 85*]. Moreover the maintenance of state enterprises facilitated the development of a civilized society, since the transition would not necessarily involve a massive increase in unemployment.

Through privatization of medium and large state owned stock companies in Armenia, 103,521.1 million drams (approximately 215.8 million USD) were collected where purely monetary revenues constitute 61.6%. Although the amount of revenues collected through privatization is important, it cannot be considered as criteria for measuring privatization's efficiency. The problem should be viewed from another angle whether strategic, i.e. efficient managers/investors purchase the enterprises.

According to the neoclassical transition model, the transfer of state property to the private sector would have improved efficiency because of the profit motive. This presupposed effective competition, and also assumed that profitability was the appropriate measure of efficiency. Meanwhile, firms found it necessary to enter into some loss-making activities so they could retain a good reputation even amid fierce competition. In addition, the post Keynesians argued that privatization should not be used as a means of financing budget deficits. Empirical investigations confirmed that privatization policies, not only in transition economies but also in mature market economies, were motivated by an attempt to improve the budget [Bortolotti et al., (2001), p. 128].

Such a practice was myopic because it failed to consider the loss of future revenue streams. Profits of state enterprises were part of the government revenue, a company tax could not be considered a perfect substitute; thus privatization resulted in a substantial loss of government revenue. Additionally, the privatization of state enterprises would also lead to a reduction in spending for social services, as the state enterprise also played the role of a provider of social *welfare* [Kapstein and Milanovic, (2000), p. 16; Djankov and Murrell, (2000), p. 8]. Consequently, “privatization in itself is neither necessary nor sufficient for allocative efficiency” [Horne, (1995), p. 385]. Armenia implemented shock therapy and then mass voucher privatization model that is why before 1998 there was no real revenue to the budget. Almost all payments for the privatized property were made by means of vouchers.

Privatization in an environment of hyperinflation and instability could only breed corruption. Instead of the development of an efficient private ownership structure, managers responded to the high level of uncertainty by breaking their firms along divisional, factory, departmental and workshop lines, into numerous joint stock and limited liability companies.

The history of mankind shows that corruption has existed for thousands of years. Seven centuries ago Dante has assigned bribe-takers to the lowest layer in his Inferno. In privatization context is important to know how the functions reserved by the state are performed. The processes involving the development of a market economy, establishment of new political and social infrastructures, and transformation of new social values in Central and East Europe, the former USSR and, including Armenia, created an environment conducive to the development of corruption.

In terms of its prevalence, corruption can exist on personal, institutional and system-wide levels. This definition implies that corruption cannot exist in the private sector. However it does exist, especially in large corporations (particularly in procurement and human resources departments).

1. On the personal level, corruption is highly individual. Some officials or politicians abuse their public position, and this is more a question of an individual's character, rather than the nature of the existing system.
2. On an institutional level, corruption obviously can be found in certain areas of the economy (for example the most profitable economic sectors or areas most closely controlled by state).
3. System-wide corruption is spread virtually throughout all areas. It is implemented with involvement at personal and institutional levels. System-wide corruption is actually the most dangerous and the most difficult to overcome.

Unfortunately, corruption in Armenia currently has spread to all spheres of life and all forms, i.e., it bears the danger of acquiring systemic prevalence. At the same time, it is interesting to study the results of a research-survey conducted in the framework of the Caucasian bureau of the Institutional Reforms of the Informal Sector (IRIS) program, whereby investors determined that "...the

corruption level in Armenia is lower than that in other CIS countries and corruption is not systematized.

The old system of corruption has been eliminated and a new one has not been created yet". However, the investors consider this situation to be less favorable, since the corruption is unpredictable. Other sources, for instance Transparency International 2000 perceived corruption in Armenia as rather high, scoring it at 2,5 in a range from 10 (highly clean) and 0 (highly corrupt) [*NHDR (2000), p. 94*].

Above all, privatization in Armenia was undermined by favoritism and corruption. A report sponsored by the U.S.-Armenia Business and Investment Association (USABIA), an organization whose goal is to promote investment, trade, and business ties between the United States and Armenia, captures some of the problems:

Relationships between high-ranking government officials and the emerging private business sector is another phenomenon that encourages influence-peddling between officials and the private firms from which they benefit. Powerful officials at the federal, district, or local levels acquire direct, partial, or indirect control over emerging private firms. Such control may be exercised through a hidden partner position or through majority ownership of a prosperous private company. The involvement can also be indirect, e.g., through close relatives and friends. [*U.S.-Armenia Business & Investment Association. (2000)*]

The Former Armenian President Levon Ter-Petrosian's brothers, Telman and Petros, as well as the president's closest and most powerful ministers were tainted by large-scale corruption and profiteering did much to tarnish the president's image in the minds of most Armenians [Dudwick]. As many of the new rich were happy to display their acquired wealth, popular distrust and disgust toward the regime became pervasive.

Reflecting on in "What Went Wrong in Russia", a scholar who has written extensively on transitions in post-communist societies presumably to democracy and market economies has argued that Russia's privatization is probably responsible, more than any other single factor, for the evaporation of democracy's legitimacy there [*Charles H. & Fairbanks, Jr. (1999)*]

Much the same could be said of privatization in Armenia, although Armenia's fraudulent presidential elections of 1996 helped to de-legitimize Ter-Petrosian's regime as well. David Petrosyan, a columnist for the Noyan Tapan news agency and a thoughtful observer of Armenia's political life, has described the relationship between the new Armenian oligarchs and the parliamentary deputies elected on 5 July 1995 as follows: By the mid-90s, the leaders of the main oligarchic structures of Armenia were: Thaelmann Ter-Petrosyan (the brother of the first president of Armenia), who controlled manufacturers and industrialists, the construction business, part of the local market in oil products, part of the incomes generated from transport junctions, and who was a kind of umpire in inter-oligarchic disputes; Vano Siradeghyan (former interior minister), who controlled part of the local market in oil products, part of the incomes generated from transport junctions, the greater part of the food market, the smaller part of bread production, and the woodwork and timber industry; Vazgen Sargsyan (former defense minister), who controlled part of the local market in oil products, part of the incomes generated from transport junctions and the greater part of bread production.

Respectively, the mentioned oligarchs had strong lobbyist groups in the 190-seat parliament elected in 1995. Among them were: the Reforms parliamentary group (over 50 mandates) led by

Thaelmann Ter-Petrosyan personally; Timber Lobby (23 mandates) dominated by Vano Siradeghyan; Grain Lobby (25 mandates) controlled by Vazgen Sargsyan.

At this stage I can make a conclusion that there was need for the government to play an active role in the market process, due to extensive market failure. Thus, restructuring and establishment of the regulatory framework had to precede privatization. However, “some critical minimum of property rights” reform may have to be undertaken quickly, democracy without a solid market economy is unthinkable.

Chapter Five

COMPARISON OF PRIVATIZATION METHODS IN ARMENIA AND IN RUSSIA

5.1 INTRODUCTION

The current global economic landscape is colored with the experiences of countries confronting and adjusting to global economic integration and the inherent pressures that the new economy impose on countries to deregulate, liberalize and privatize. However, despite this omnipotent force of globalization, countries have responded differently and have embraced policy reform to varying degrees. Even when considering one of the most widely subscribed policy reform programs namely, privatization. I find a great deal of variation in the extent to which countries have privatized and in the form of privatization. Economists have long lauded the benefits of privatization derived from greater efficiency gains, which then translate into improved social welfare. Given this, necessary expect to see countries over the world privatizing their nationalized assets, but review of global privatization transactions suggests that countries are not uniformly embracing privatization programs.

Different methods of privatization may lead to different majority ownership structures, with differentiated impacts on firm performance. Assuming that full privatization is associated with relatively efficient matching of owners to firms, it may be expected to lead to the most effective corporate governance of our three types of privatization. In contrast, MEBOs and leased buyouts may lead to managerial and worker entrenchment, while mass privatization may lead to diffuse ownership structures and long agency chains. The case-by-case privatization mostly with participation of foreign capital leads to efficient ownership.

This analysis has significant implications for developing countries that have still to undertake privatization programs. It suggests that the method of privatization is an important policy choice, and that, despite the great criticism it has received in recent years, mass privatization may be the appropriate choice in situations where capital markets are highly imperfect and the distribution of wealth is not well correlated with the distribution of managerial ability.

Most countries of the former Soviet Union adopted legislation for privatization as early as 1991-92. Along with countries in East and Central Europe, the scale of privatization as part of the transition from a command to market-driven economy in the FSU countries was unprecedented. Despite widespread consensus to remove the State from running production enterprises, implementation was held back by lack of consensus on how to proceed with privatization and by the lack of effective institutional framework.

Below is given the table that shows the privatization methods in researching countries.

Table N 9

Country	Privatization methods	
	Main	Secondary
Armenia	MP1	MP2, MEBO
Russia	MP2	OS, MEBO

Abbreviations: MP1-mass (voucher) privatization with equal access of all citizens, MP2 - mass (voucher) privatization with significant concessions to insiders, MEBO - management and employee buy-outs, OS – sale to the formally outside owners.

Sources: Boehm, ed., 1997; EBRD, 1997,1998; IET, 1998.

Privatisation of large enterprises in both focal countries proceeded in two stages. First, state-owned enterprises were converted into joint-stock companies, a process often referred as “corporatization” or “commercialization.” Second, ownership shares were transferred via sale or some form of mass privatization.

A major issue was to remove government from controlling enterprises. The competing demands of these two objectives, enterprise performance and fairness were met in different ways in three basic methods of privatization.

My empirical analysis shows that the method of privatization plays an important role in economic growth. However, I also find that if it is mass privatization that has the positive effect in Central European Countries, it is relatively weak for transition economies of Armenia and Russia. This may happen because in any economy the ability to purchase a firm, or at least a substantial ownership share, is imperfectly correlated with the skills required to run the firm efficiently. In the economy with an extremely underdeveloped capital market, “wrong” owners will tend to persist for longer.

After Armenia and Russia case study research I have been found more similarities than differences in their privatization process. Both countries have started with the same political conditions and the same economical structures. Following is analyse of privatisation impact depends on the implemented privatisation methods in Armenia and Russia.

Table N 10

Country	Armenia	Russia
	Privatization Impact	
Privatization Method		
Shock Therapy (As precondition)	1A Negative	1B Negative
Small-Scale	2A Positive	2B Positive
MEBO	3A Neutral/ Negative	3B Negative
Mass Voucher	4A Negative	4B Negative
Cash	5A Positive	5B Positive/ Negative
Loan-for-Share	Have not been implemented	6B Negative
Case-by-Case	7A Positive	7B Positive/ Negative

1A. Institutional and administrative shock contributed to the general “disorganization” thus added to an even deeper transformational recession in Armenia. The negative impact of the disorganization and the weak and incapable government was underestimated. The absence of real national government for many years brought about a largely spontaneous character of most transformation processes. All these together weakened the institutional power of the state and the general economic situation in Armenia to a greater extent than in other FSU economies.

1B. Shock therapy with price liberalization produced a shock with long lasting and unexpected effects without being able to rapidly turn Russia into a market economy. Jump of prices that make ordinary citizens more poor and results from emerging large-scale structural unemployment.

2A. Due to relatively simple administrative structure of small enterprises, technological flexibility and less demand in investments for diversification, they were better able to operatively response to frequent market changes than the large enterprises. Small-scale privatization in Armenia results in significant increase in production volumes, escalation of market competition, maximal utilization of local raw materials and technical resources and production diversification.

2B. For small enterprises and assets, such as shops, restaurants, and apartments, the reformers chose to leave details of the privatization effort to local authorities. The most common approach was to auction small enterprises and assets for cash. Often the buyers were the workers themselves. The approach proved successful, and by 1995 over two-thirds of all small businesses in Russia had been privatized. These small businesses have become the foundation for a growing middle class.

3A. MEBO in Armenia were used, as a second privatization method and this method don’t bring to any strong results. Instead to result in visible progress the shareholders’ legitimate rights on many enterprises were violated, the principles of corporate governance were violated, management tasks

were not duly performed, resulted from non-observance of the R.A laws the activity of Joint Stock Companies was unlawful.

3B. The Russian MEBO works to concentrate ownership in the hands of the top management. It was just planned redistribution of wealth from whole population to hands of some limited number of person. Major of privatized enterprises without dependence in what way they have been privatized did not have at beginning stage effectively acting owner. That was not real privatisation, but denationalization process that did not only involve privatization of the ownership rights, which would become basically private, but also a management change on the macro and the micro economic levels.

4A. The privatization experience in all countries with a history of centralized economic planning illustrates that mass privatization with underdeveloped institutional structures leads to inefficient oversight of the operations of the privatized enterprises and the assets of these enterprises tend to be sold off or misappropriated. In Armenia fully operating enterprises with established markets were sold for a few hundred dollars. The citizens got nothing, control got former directors, managers and bureaucrats. Most privatized enterprises had not yet become successful businesses, while stated that privatization has not helped industry yet. (condition on 1998)

4B. Russian reformers were motivated by purely political considerations, they were need to move very quickly to “break the back” of the power of the “red directors” who controlled the state owned enterprises. As a result the vast majority of Russian citizens got nothing out of voucher privatization. The people who did benefit the insiders and financial operators who bought up all the vouchers and got up control of the main enterprises at unbelievable small price. The unhealthy privatization process likewise distorted the Russian securities market. The conclusion on voucher privatization impact in Russia follow: first the redistribution of the property or simple juridical re-registration of the owners right on the enterprise assets without involvement of large private financial resources. Second wide social disappointment with the results of privatization in the case of massive bankruptcies of joint-stock enterprises and investment funds. Third the state dreaming to get substantial revenues from privatization to cover budget deficit and finance the most acute social problems also have failed so far.

5A. In 1998 by cash privatization were made significant revenues for Armenian budget. At international competitions were sold some of strategic enterprises, big hotels, ets.

5B. Very few outsiders were effectively allowed to take an active part in Russian cash privatization. Cash privatization only firmed up the existing status quo without much cash to the State and little investment for enterprises. What has actually happened was a continued massive management buy-out of Russian companies, a fierce struggle for absolute control which was won by enterprise directors and several banks and proxy companies representing the interests of former and present officials. Revenues from sales were ridiculously low by international standards since foreigners and other outsiders were effectively precluded from active participation due to political factors and the embryonic state of institutional, legal and regulatory enabling environment.

6B. In practice loans-for-share auctions were announced, but no one could bit, no foreigners, no even Russians who was out of the Chubais group. In the final analysis the Russian economy suffered its worst decline in GDP. The population was impoverished, the Russian state was essentially bankrupted. In August of 1998, the ruble collapsed and the government defaulted on its debts. The government had declared bankruptcy.

7A. Case-by-case privatization in Armenia can be characterized as a positive by this method were privatized strategic enterprises in 1998-2000. Then this method was implemented for water and power distribution net privatization.

7B. From point of view of formal budget criteria (fulfillment of budget task at any rate without schemes such as mortgage auctions) 1997 became the first year in a history of realization of “money privatization “which one got success. But as a result, the privatization process reverts back to the stage of spontaneous extra-economic development: on the one hand, because the government is disinterested in organization of standard transactions in the framework of residual privatization, on the other hand, because assets are cheap and therefore market transaction criteria disappear.

5.2 BEGINNING OF PRIVATIZATION

The privatization process began with the small enterprises, primarily in the service sector, such as retail, catering, personal services and construction. In Russia and Armenia, lease-buyouts were the preponderant method for small privatization. This part of privatization was an almost unambiguous success story in both countries with a virtually overnight transformation of mentality and behavior of former state employees into that of private owners and managers. During small-scale privatization (SSP) about 75,000 small businesses were privatized in Russia and 6850 in Armenia... The world experience shows that it is small entities that are best prepared to changes in the external environment which can adjust almost immediately to market conditions and concentrate on raising efficiency and productivity rather than rent-seeking, mutual crediting and lobbying for subsidies as large and medium enterprises tend to do.

Mass privatization involved transferring state assets to the population essentially free of charge. The primary vehicle of mass privatization has usually been vouchers, which are distributed or sold to citizens, regardless of their work affiliation. This method was an effective and popular means of privatization in many countries, not least because it resulted in broad ownership rather quickly. Because citizens became shareholders at low or zero cost, this method was perhaps most politically acceptable. On the other hand, mass privatization had potentially negative repercussions with regard to enterprise restructuring. The method fails to address the resource needs of a newly privatized company such as fresh capital, management expertise, technology, and access to markets. Also, the resulting broad ownership structures may complicate corporate governance.

The first and main method of privatization in Russia was MEBO then on the second stage coming voucher privatization then cash privatization and final stage as well as in Armenia case-by-case stage. In Armenian privatization first of all was implemented mass voucher method and only as a minor method that not really affect to privatization process MEBO, then also like in Russia implemented cash method.

5.3 VOUCHER PRIVATIZATION

Between October 1992 and January 1993 150 million Russians could receive their vouchers at their local Savings Banks. In Armenia on 28 September 1994 were issued first vouchers and till end of mass privatization 3,8 millions vouchers. In Russia and Armenia vouchers were tradable, in Russia the fee was only 25 rubles (5 cents at the prevailing exchange rate) with the face value 10.000 rub. In Armenia the face value of each voucher was set at 10,000 Armenian drams (AMD), or approximately \$25, and was raised to 20,000 AMD in March 1995 to grow up for the effects of inflation. The total value of the vouchers was supposed to represent at least thirty percent of the book value of the enterprises to be privatized.

Shortly after its introduction, the voucher became the first liquid security in Russia. It is actively traded on dozens of organized exchanges throughout the country. An informal market was created and anybody (including foreigners) could buy vouchers in many marketplaces. In Armenia at the time of mass privatization works two organized exchanges were traded vouchers, the “Yerevan Stock Exchange” and “Gymry Stock Exchange” have trades vouchers and quotes a daily price. In the early stages of developing privatization policy the government considered a first-come, first-served approach to the pricing and sale of shares. Enterprises were to be valued and share prices set according to these valuations. In both countries vouchers also were traded on black market.

The totals of an implementation of a program of mass privatization lying behind frameworks of quantitative assessments were and remain a subject of controversies. From the point of view of the ideologists of the Russian and Armenian privatization, the pragmatically substantiation of introduction of this model became the way to get control with real situation on that moment and it became a beginning of technical privatization: absence of possibility solvency demand of the population; zero concern of the foreign investors; the availability more than huge of state and municipal firms and companies; necessity of maximum high rates of legal privatization process (at the first stage) for blocking of intensive spontaneous privatization and series other.

The idea of voucher privatization as in Armenia as in Russia was equal distribution of vast majority of state industrial assets to every citizen. By means of voucher that gave to each citizen a proportional stake in privatizing assets government would promote equality in share ownership of state owned assets. On one hand it is very good idea, attempting to create owners of small business that could make a new middle class level which will be supporting ground for the growing democracy. But reality was large acquiring of state property by their former managers and directors.

The result that privatization leaders put a huge quantity of products onto the market at ones the price become very low because of demand upset and moreover face value of the voucher was very low. The population was likewise deprived of effective participation there was no transparency or even reasonable time for participants to make serious decisions. That entire mean those average citizens, after received the vouchers and don't understand even how to use that vouchers, sold their vouchers on the street to meet daily expenses.

The people who did benefit in Russia and Armenia the insiders and financial operators who bought up all the vouchers and got up control of the main enterprises at unbelievable small price. It was as a mechanism of redistribution of property among directors and managers of enterprises.

5.4 MEBO PRIVATIZATION

The evaluations of actual participation of the employees and managers of enterprises in their privatization in various countries rather hardly differ from each other. Nevertheless findings of many researches show, that the employees ownership has taken the certain niche within the framework of transitional economy.

This method incorporates a variety of specific measures to transfer enterprises to their own managers and employees, known variously as insider privatization or management and employee buyouts. The management-employee buyout component stemmed from the substantial privileges given by the state to managers and employees of the enterprises offered for privatization.

In some cases, management and employees acquire a controlling interest (Russia). In others, minority shares were transferred to employees at preferential terms (Armenia). Direct, large-scale transfer to “insiders” was the most popular form of privatization in Russia. Through voucher-based programs, most privatized firms became owned primarily by managers and employees.

Russian mass privatization program 1992-1994 was designed in way that offered the generous entitlements to managers and employees. These insiders were able to choose from among three options, or privatization methods.

The combined lobby group of managers and employees compromised an option that allowed enterprise insiders to buy 51% of the shares at a closed auction prior to public sale. 29% of the shares had to be left for voucher privatization and 20% for the government to be sold through cash auction or investment tenders.

The Russian MPP worked on concentration ownership in the hands of the top management. Even if the first idea was the equal distribution of property, the end result speaks for itself. The MPP was designed and implemented to undo insider social capital and to legally disempower the insider coalition of stakeholders with the collective interest in preserving and improving the enterprise as a going concern.

The advisers favoring employee ownership in Russian privatization did not pay any attention that using a worker ownership, as a part of voucher program would require a mechanism for collective decision making. By the privatization law individuals were allowed to sell-out their shares that met dilemma situation with the eventual non-cooperative solution of most workers to sell out their shares to the managers because of delay in salary.

The practice shows that even shares are not sold to managers that took place on about 60% of Russian industrial enterprises that were privatized and transformed in joint-stock companies of an open type (by privatization law) in rough approximation are under joint control of managers and labor collectives. From them almost 40 % of enterprises the workers has the main pack of shares (it is necessary to remember that it was only on beginning stage) but the real control was in manager's hand. Thus not dependent do the workers have small or big package shareholders they are not organized, as a rule isolated and have no opportunities to realize the rights of owner even when control over enterprise formally belong to them.

Armenian Mass privatization of mid to large enterprises began in February 1995, with an emphasis on partial free privatization; 20% of book value of state-owned corporatized enterprises was given to employees free of charge. The law also gave employees the right to purchase 20 percent of the shares (20 percent of the remaining 80 percent) earmarked for the general public, or another 16 percent of total shares. Employees could also participate freely in the sale of the remaining 64 percent.

The fact that those actors are characterized as rent-seekers implies that an enormous amount of economic resources would be invested in arranging particular interests through collective choice mechanisms and, therefore, do not eliminate the supposedly existing transaction costs from which the new framework of property rights is built.

Major of privatized enterprises without dependence in what way they have been privatized did not have at practice effectively acting owner. And in Armenia and in Russia motivation of managers and directors of privatized enterprises can not be characterized by positive shifts. Using by the state

and privatized enterprises administration the capital of those enterprises for short term speculative operations in trade, on financial and stock markets has assumed a mass nature (of course at the first stage when they had wealth to sell) naturally that this operations are made not in interest of the strengthening of financial situation at given enterprises, but carried out for the purpose of personal enrichment. The orientation to short term financial results, engaging basically in operations of a speculative nature slows down the formation of incentives for economic stability.

The ordinary scheme of getting enterprise under control looks the same and on voucher step and on the step of MEBO. The general director of the company with the closest managers get together and by all the vouchers (or the major block of shares) from their workers. They easily do this because they had grown rich or moderately wealthy by embezzling funds from the enterprise in the preceding years, and because of the market price and vouchers and shares were so low the directors and their managers would end up buying control of the company for almost nothing.

5.5 CASH PRIVATIZATION

In 1994-1997 in Russia and from the beginning of 1998 in Armenia were registered a stable and continuous decrease of the new enterprises participation. In Russia by 2000, the state still owned 3100 blocks of shares (via "golden shares") and 7 to 8 thousand unsold ones. In Armenia about 900 unsold enterprises. The sale of these shares and enterprises became the key problem of privatization policy per se pursued in 1995 through 1999 in Russia and 1998 though 2000 in Armenia.

Dilemma existing in through 2000 was settled in favour of budget, so maximization of federal budget revenues became the priority by the start of cash privatization.

The new privatization program has many changes, from the system of free allocation of property to real sale, from accelerated privatization to a rather slow privatization designed to ensure restructuring and investment.

As to the valuation of property in the course of privatization retains its formal position: the final selling price should be determined on the basis of auctions and tenders (i.e. through open bidding and money auctions). So the initial reserve price has been raised and it is based on one of the reevaluations carried out after 1 January 1992.

A new scheme of distribution of the privatization revenue was introduced. While earlier almost all privatization revenue went into the budgets of different levels, since July 1994 51% of the sale value of the enterprise (shares) were transferred to a special account of the enterprise itself for investment purposes (Russia). In practice this means that a potential buyer pays only half of the required price since the other half should be returned to restructure and develop production (also in Armenia). Although such an approach does discriminate against the enterprises that have already gone through privatization at the first stage, nevertheless this was a powerful incentive for a potential investor to participate in privatization.

In Russia by cash scheme was planned an absolutely new model of the benefits for workers and managers of enterprises would be adopted, with two possible options: receipt of 25% of privileged non-voting shares or purchase at face value of 10% of voting shares with a 30% discount and payment deferred for a year. The grounds for such an approach were the ending of vouchers (as a privilege for the entire population) and a new policy emphasis on the initial formation of large 'external' holders of enterprises' shares.

But GKI did not manage to make such a drastic cut in benefits for the workers in a “pure” form, since, in line with the Fundamentals, the previous model remains in force.

In order to attract “strategic” investors who will improve control and management of an enterprise, and who are interested in its long-term progress, was planned that rather large blocks of shares, not less than 15-25% of the authorized capital of an enterprise, should be put up for auction and for investment tenders. It is especially important that this is done with regard to the blocks of 10-20% secured as federal property but with practically no one being in charge.

In Armenia there were not any new benefits for insiders and cash sales were made on the ground of special auctions and tenders with foreign participation. The cash sales with investment tenders options, with coupe of case-by-case privatization in 1998 brings significant revenues for state budget and made 90 percent of the sum obtained from privatization. It does not mean that cash privatization was so successful it is only speaks about inefficient mass privatization.

If the voucher was method of large participation of citizens, the physical persons did no have real opportunity to participate in the special auctions. At the same time it's practically the only way for a small investor to acquire shares since almost all the operators of the secondary market of corporate securities deal with large shareholdings.

In a number of cases the cash auctions (usually in the form of closed tenders) became the final stages of specialized auctions during which not all the offered shares had been sold.

The main problem with the situation when the investment tenders were not taking place was the lack of local investors, long term nature of pay back of investments, unclear legislation, and common tendency to invest in short term projects.

In Russia its majority of the investment tenders which were held had nothing to do with investment, actually it was consolidation of stock in order to achieve control. In the best cases when a foreign company wins tenders the long-standing relationship becomes legally formalized. In 1995 foreign companies were recognized as winners of 26 investment tenders. As a rule they were oriented towards the lowest risk investments, on the average between 5 and 10 million US dollars with the wide diversification of their interests by branch and by region. In Armenia the same story was only with OTE Company that takes monopoly control over telephone net. The other few cash sales were made with large investments.

This is a clear difference with respect to the initial stage of privatization through checks when the private sector did not show clear signs of change towards a better functioning than that of the public sector. However, it remains to show the true impact on the system of inefficient transfers of private savings to the State, as implied by the special auctions. Probably, if those savings were directed to the private sector instead, a higher net value in economic efficiency increase would be reached.

During this period a decrease in transaction costs has been seen that is reflected in the adoption by these firms of market rules aimed at increasing efficiency. Generally speaking and in accordance with the tendency starting in 1993, there has been a change in inter-entrepreneurial relations, so that there are more and more enterprises establishing new productive links.

It can also be highlighted that the idea of individual utility maximization, as a formal market rule, is still being formed. For enterprises the new framework resulting from the money-based process of privatization as a consequence of a higher level of private property can change the former idea

based on distributive principles that is, to get rich means to transfer wealth from others. Probably this adjustment of the former informal rule toward the formal rule mentioned is also related to a learning curve by doing since economic agents are aiming at new objectives.

5.6 LOAN FOR SHARES PRIVATIZATION

The banks proposed to loan funds to the government for several years, with repayment secured by the government's controlling stakes in these enterprises. Every-one understood that the Government would not repay the loans, and would instead forfeit its shares to the banks that made the loans.

Practice shows that in all these tenders, the final price minimally exceeded the starting price, and thus, the state's earnings were insignificant. Loans-for-shares auctions were an audacious scheme to leverage wealth acquired in these dubious ways, by using it to acquire Russia's biggest companies for a small fraction of their value. [Lieberman, I. W. & Veimetra, R (1996), p.737] The main reasons for this were the lack of real competition, the collusive character of a number of the auctions, and the unsatisfactorily formulated demands and conditions of the privatization transactions.

Two reasons are typically put forward to explain the use of the loans-for-shares scheme. On the one hand, the chronic budget crisis and failure to meet budget targets for privatization in 1995 were among the most important reasons for the implementation of loan-for-share scheme. On the other hand, the banks wanted to gain control over some of the largest Russian companies as cheaply as possible.

The implementation of the loans-for-shares privatization was questionable. The auctions were administered by the banks, which also could participate in them as both bidders and depositors for bids. The participation of foreigners was restricted and competing bids were often disqualified on technical grounds.

Only 17 enterprises were offered at the auctions and 5 of them (JSC Bor, Techsnabexport, West Siberian Metallurgical plant, Kirovlesprom, Tuapse sea harbor) did not meet bids. Only 12 enterprises finally took part, half of which belonged to the oil sector.

It is wrong to understand actual auctions in Russian as some sort of competition, usually practice meet on this auctions was direct sale to much earlier than auction take place known buyers. The foreigners participation was prohibited and weak resources of Russian commercial banks couldn't create normal competition environment.

The voucher privatization or MEBO I would mention as very weak but any way kind of privatization. The examine of the Russian loans-for-share privatization shows only group of six of eight top Russian financiers, further oligarch, with the heading by Anatoli Chubais. They had agreed among themselves who would own which company and at what price. This dividing take place in 1995 when 12 export oriented companies, mostly oil and gas producers and metals exporters were decided to privatize controlling stake. In Armenia loan-for- share as a privatization method was not introduced. It was replaced by other not so visible but in the same effective method to acquire property. At the time of voucher privatization By the mid-90s, the leaders of the main oligarchic structures of Armenia were: Thaelmann Ter-Petrosyan (the brother of the first president of Armenia), who controlled manufacturers and industrialists, the construction business, part of the local market in oil products, part of the incomes generated from transport junctions, and who was a kind of umpire in inter-oligarchic disputes; Vano Siradeghyan (interior minister, at that time), who

controlled part of the local market in oil products, part of the incomes generated from transport junctions, the greater part of the food market, the smaller part of bread production, and the woodwork and timber industry; Vazgen Sargsyan (defense minister, at that time), who controlled part of the local market in oil products, part of the incomes generated from transport junctions and the greater part of bread production.

5.7 CASE-BY-CASE PRIVATIZATION

A third form of privatization is sales to outsiders. This consists of sales on a case-by-case basis, typically to one specific outsider investor through public or closed tenders, direct sales, or auctions. They were the main vehicle for foreign direct investment, and were more popular in some countries in East and Central Europe they were also used in Russia and Armenia.

Their advantage is that new owners bring investment capital and access to markets. Their disadvantage is that, on a piecemeal basis, this form of transfer is time-consuming and costly. It is also, naturally, limited to those state enterprises with the best prospects for yielding a return on investment, and has been especially popular in extractive industries. This method has been more effective earning of immediate cash for government budgets and less effective in restructuring large sectors of the economy

In the Central European countries, foreign investors are proving to be agents of effective and rapid restructuring. Foreign participation has been much lower in countries where voucher privatisation has been implemented, across the FSU. However, other factors such as distance to European markets, a lag of several years behind Central Europe in beginning the restructuring process, more recent and deeper recessions, as well as even more limited connections to Europe before the political transformations began, also account for this difference in foreign investment.

5.8 CONCLUSIONS

According to the data above I can make the following conclusions:

- § Small scale privatization in both countries had the best positive result and creates the middle class owners that produce vast majority of countries GDP.
- § Main difference between Russian and Armenian voucher privatization in its fashion is the Pro Rata Approach implemented in Armenia. This approach did not make any changes in the final accounts. MEBO in Russia was implemented as a dominant method, in Armenia it was counted as a minor privilege to insiders and did not play important role. The final result speaks in both countries spikes for itself. Mass privatization became a very important step, but only the first step towards efficient ownership and production. Despite this overnight change of ownership of thousands of enterprises, little has changed in terms of governance, management or efficiency, clearly not as much as was expected. Massive abuses, running down assets, tax evasion, nonpayments crisis, corruption and personal enrichment of management at the expense of their companies' well-being largely offset any efficiency gains that could have happened due to freeing of the private initiative, releasing market incentives and hardening budget constraints. The mentality of the management remained the same. Being accustomed to soft budget constraints, they continued their lax financial practices, preferring to credit each other through mutual arrears and save on tax arrears and salaries to employees instead of trying to raise efficiency and productivity.
- § Russian cash privatization revenues from sales were ridiculously low by international standards since foreigners and other outsiders were effectively precluded from active participation due to political factors and the embryonic state of institutional, legal and regulatory enabling

environment. In Armenia major revenues were made in the state budget by cash privatization method in 1998 by means of sale some attractive for foreign investors industrial enterprises and hotels.

§ In Russia case-by-case privatization has very controversial result. In Armenia were privatized only few industrial enterprises. In Armenia the most case-by-case tenders were held after 2000 in power and water distributing nets that is not subject of this thesis.

Chapter Six

General Conclusion

There have been numerous empirical studies of privatization programs, which have found efficiency gains to firms, industries, and financial markets in a multitude of developed and developing economies. Former Soviet Union is conspicuously not well researched yet. Some reasons for this include the lack of reliable and consistent firm data both before and after privatization, the absence of vital business mechanisms and institutions to distribute reliable business information, and misconceptions about what privatization actually is.

Most of these scholarly works concerning FSU either tell the story of one privatization type in individual countries, provide some sort of story of how privatization was done in one country, or provide “how to” or “what should happen”, goals of privatization in transition economies, or the debate of firm restructuring vs. firm privatization; what should come first? None of these studies cut to the quick of the question that puzzles us concerning privatization in Former Soviet Union: Did the economic experiment work? Are these programs a success? Did voucher privatization, and the privatization programs that carried out in FSU, deliver what they promised? Are the firms after privatization performed well?

The research problem was to determine “How does privatization works in case of state property redistribution and what final result it has?”

My analyses are conducted to determine the effects of different aspects of a privatization programs in focal countries. The characteristics of a privatization programs that are considered include privatization types. The types of privatization considered in the analysis involve mass privatization, manager/employee privatization, privatization through sales and some findings from case-by-case privatization.

In addition, is analysed shock therapy economic reform implemented in tandem with privatization to determine whether or not the post-privatization changes can be attributed to privatization, or other economic reforms. Different combinations of privatization type, presence of privatization law, and controls are used, two at a time because of the number of countries in the sample, to design an experiment that describes the mean changes in the process of privatization in these transition economies.

The main purpose of this paper is to consider two reform cases - Russia and Armenia - both of which experienced successes, difficulties and failures for various reasons. One of the questions arising in such studies is could the countries learn from one another, or could other countries learn from the lessons of these two countries? There are two major and extreme views on the usefulness of comparing the experiences of Armenia and Russia. The first view is that it is absolutely useless, and the second view is that these experiences are easily transferable. Should the second view be right, who should learn from whom? Armenia from Russia, or Russia from Armenia? Or perhaps third party countries should learn from both Russia and Armenia.

I do not share either of these extreme views. My opinion lies somewhere in between (where exactly is yet unclear and more research and further practical experience of these countries in the future will clarify things). What is important at this stage is to demonstrate that there is a great deal to learn from the countries experiences in both privatization policy and implementation approaches. Despite

specific local historical, economic and political conditions, reform leaders make choices on strategy and policy mechanisms and their mistakes could have dramatic consequences on the long-term results of the reforms.

Both Russia and Armenia have made profound progress in their privatization programs, with both positive and negative results. This chapter concentrates on analyzing some important consequences of privatization, including methods of privatization and post privatization enterprise performance, in both countries. The final conclusion on which country has done better in its transition efforts is left to the population of these countries, and they will use their own criteria for comparison. This study tries to provide some arguments and objective information on which to base these conclusions.

My analysis is based on five chapters of the thesis, assessment of two country case studies provided in Chapter 3 (Russia) and Chapter 4 (Armenia), as well as other broadly available published and unpublished sources as well as personal experience. The Russian case provides an excellent overview of the privatization policies, their implementation and the results. It also covers the worldwide opinions of different researchers on Russia privatization, though its general bias tends to be a bit negative and tends to ignore some evident positive reform achievements. In contrast, the Armenian case concentrates mainly on the enterprise level and provides what is perhaps too highlight a picture whilst ignoring some serious problems, particularly in the financial and corporate government fields.

6.1 PRIVATIZING STARTING CONDITIONS

By late 1990, the Soviet Union had disintegrated into a number of independent nations and the Commonwealth of Independent States (CIS) was formed. These Newly Independent States were in economic disarray and needed drastic reforms in order to prevent economic and social collapse. The communist economic structures of these countries had failed. These economies were all driven by a focus on production rather than on market forces and consumer demand. The all kind of supplies was down, production was at a virtual standstill, unemployment was growing, the currencies were depreciating and inflation was soaring. The primary challenge to reformers was to change the focus of these economies from a production to a market orientation.

Foreign advisers' recommended beginning reforms with shock therapy. The freeing of prices, convertibility of currencies, allowances for free trade and the divestiture of government assets, or privatization was all part of the shock therapy in Russia and in Armenia. The economy of both countries was already highly monetized in 1990 with a large "money overhang" representing resources that had already been supplied to the planned economy. This overhang caused high inflation when prices were freed, eroding confidence in financial savings. No transition economy can avoid its starting conditions, but reformers can and do make choices that critically affect the early success and longer-term stability of market reforms.

Shock therapy did not prove to work out neither in Russia nor in Armenia. *Laissez faire* has not worked out anywhere. Emphasizing the abolition of state interference by Adam Smith and other early liberalists was historically connected with fighting against mercantilist state policy. The background of shock therapy, the need to abolish the state governed economy, is actually quite similar to the situation that Adam Smith criticized. However, in European established market economies, transformation was gradual and the role of the state never became one of a Smithian night watcher.

Additionally, unlike in developed countries there was not even the most primitive institutional backbone in these countries to support any type of business or financial transactions. For privatization to commence, financial and legal systems have to be created simultaneously as firms were being released from government control.

In Russia and Armenia like in all FSU, privatization was occurred in a vacuum, there was no pre existing private sector before privatization or it was but not legal one with its own rules of the game. In Armenia and Russia was necessary to create the market itself. The proposed solution to this problem was presented in the guise of voucher mass privatization.

Privatization in focal countries has been ruthless and swift and there were many doubts the reforms have succeeded in social terms. Among disturbing features were fragmentation of property rights, a high level of criminalization and the merely formal nature of the privatization of ownership. The bulk of the property transferred into private ownership has gone to employees of the enterprises concerned. A closer look at the quality of the property being privatized also shows that much of it is too run down to attract other buyers. Where enterprises are making substantial profits, or own valuable property, workers have often failed to get their share against a combined onslaught by managers, criminals, share speculators and crooked officials.

The results of privatization are closely linked to the privatization approach that was adopted in Russia and in Armenia, that according to my study take as an example Russian privatization policy. The architects of the reform wanted to carry out privatization in the minimum time. They failed to give people a chance to first understand and digest the results of the first stage of the reform, including the liberalization of prices, which had caused production and consumption to plummet. Some authors believe that would privatization been effected gradually, the people's response to the changing economic situation might have foiled the reform altogether. Another reason for the haste was to make reforms irreversible and create a new class of owners. But as a result, big amounts of capital were amassed in the shadow economy or through speculation, bribes and embezzlement. Persons closely involved in these dealings, such as corrupt officials and well-informed enterprise managers, have therefore come to hold key positions in the economy.

According to estimates by the Ministry of the Interior in Russia 70-80 percent of privatized and private firms and commercial banks are obliged to make payments to criminal gangs and corrupt officials. The strong position of the former nomenclature in privatization is apparent from cases where managers misappropriate shareholdings. For example, one channel of privatization concerns the accumulation of individual savings deposits and vouchers by financial institutions in a situation and pattern of property relations that is highly confusing. Hundreds of voucher funds and investment agencies that resemble mutual funds have sprung up to utilize the vouchers of ordinary Russians who lack the confidence to invest in the stock market for themselves. In a number of cases, a fund has proved to be a bogus structure set up by criminal or near criminal elements to take advantage of the lack of state supervision.

6.2 MASS PRIVATIZATION

One of the problems with mass privatization is the difficulty in establishing the boundaries of the private sector. There are at least two reasons for this: first, "official" forms of privatization played a relatively minor role until recently. They served either to legalize property rights already gained "unofficially" or paved the way for further redistribution of property by mass privatization. Secondly, "specific" forms for developing the private sector have been widely practiced. These have included not only directly expropriating state property, but also unofficial forms such as

legally transferring part of the added value created by state-owned enterprises (SOEs) to the private sector. Financial holding companies, semi-state-owned banks and other financial structures intended to open parallel money and stock markets, and take advantage of debts and credit dependence among enterprises to “trap” debtor industries and force them to privatize their assets by legal or illegal means.

As a result, the entire public sector industry privatized up to now in Russia was sold for only US\$12 billion due to this ineffective privatization strategy. Since management and workers were allowed to retain a large percentage of ownership, there has effectively been no change in the management of these organizations, resulting in very poor response from private sectors or foreign investors. Overall, management and workers received 51 per cent of the stocks in privatized SOEs at 1.7 per cent of the book value. Performance of these privatized enterprises has gradually deteriorated since privatization was more political than economic. Three quarters of Russian corporations are in need of radical and far-reaching restructuring. At least a quarter of those firms should be bankrupt. Although a bankruptcy law exists since 1992, it has never been seriously put into effect (fewer than 1,000 companies have been declared bankrupt).

Russian one hundred biggest companies have extremely serious problems of corporate governance. Many companies have openly flouted shareholders rights by issuing free shares to insiders and blocking the appointment of outside directors. Around 17 per cent of companies illegally maintain their own shareholder register, while 44 per cent had bought back and resold their own shares to insiders rather than retiring them.

At the same time it would be a mistake to state that Russian and Armenian reformers were completely wrong and that they should have followed some other more successful country example. Many countries were just not in a position to choose between gradual and rapid strategies. In focal countries economic reforms paralleled the dismantling of a repressive political system. It had to overcome huge trade declines as well as severe macroeconomic imbalances and structural distortions created by central planning. As yet it has not been able to generate the savings necessary to sustain its greatly overbuilt state sector.

Armenia faced an extremely difficult choice: rapid systematic reform entailing deep and often painful structural adjustment, or incremental efforts to introduce change while trying to protect the status quo. It leads to spiraling inflation and economic and political disarray. Rapid reform has been easier when political change has been rapid and fundamental. Citizens who supported the new political system also supported market-oriented policies. In Russia, quite a large part of the population did support neither the political nor the economic changes.

In Russia, the main emphasis was first on state property privatization, delaying opening of the market to new entrants. Even today in Russia the most attention is paid to the privatization of SOEs and much less to the development of new firms.

In summary, reforms have been deepening and widening not because there has been a grand plan to pursue a complete transformation from a planned economy to a market economy, but rather because reforms have been pushed forward when the economic, political and social climates have permitted and were propitious, and when altered expectations and the urgency of readdressing newly emerging problems have required action.

The reason of mass privatization programs implementation in Russia and Armenia was that there were so many SOEs to be privatized that it would have taken many years to privatize all these firms

in a case-by-case fashion. (Economic point of view). Also there was a reason get rid of the power of old communist management structure (Political point of view). Meanwhile, as firms were slowly privatized, the ones that were not privatized would stagnate and totally deteriorate before they could be privatized.

Voucher privatization allows for many SOEs to be privatized at once instead of on a case-by-case basis, as it was done in most other privatization programs. This was considered to be particularly important in focal countries where thousands of firms had to be privatized at once. At the privatization auctions, vouchers were later used to bid for shares of an SOE.

The primary theoretical basis for mass privatization is based in “State vs. market” theory. Mass privatization is based on the premise that the State can not manage assets in an efficient way. Therefore, selling these assets to the private sector as quickly as possible will remove the inefficient State management and replace it with private sector owners who will have a personal stake in the success of the firm. The new owners will have the incentives to manage the firms effectively in order to increase their personal wealth. In order to increase personal wealth, the owners will look for possible growth opportunities within an economy. These owners will also serve in a governance capacity, and make sure the make operational and financial decisions to increase the value of the firm. Also, the owners will have better knowledge than the State about demand for their firms products and services, and will be better able to allocate firm assets efficiently to fulfil market demand.

The impetus behind mass privatization is political in scope. Wide distribution of shares and speedy privatization are political goals instead of economic ones. These goals of mass privatization actually conflict with many long-term economic goals of privatization. The main concern of privatization was to remove an SOE from State-influence as quickly as possible, and as is fairly as possible, no consideration was made for the vital institutions that must be in place before successful privatization can take place. Van Hayek asserts that even though centralized planning is not the answer to economic growth, true laissez-faire capitalism is not the answer either. Van Hayek stated that a carefully thought out legal framework is necessary for competition to work beneficially competition being the hallmark for efficient asset allocation. [*Skidelsky, (1996)*]. Many of the privatization programs in FSU were implemented with old socialist ideas of fairness in mind, and ignored that a beneficial market economy must have the institutions and infrastructure in place to keep it in check.

Another premise of mass privatization is that whether enough firms are privatized quickly, a critical mass of firms in the private sector will lead to the development of institutions necessary to form a market economy. [*Goldstein and Gultekin, (1997)*]. This critical mass theory has the premise that a market can develop simultaneously with market institutions. Once a large enough number of firms is in the private sector, then private sector market institutions will develop to fulfill financial and information distribution needs of the private sector.

However, this assumes that a market can be formed without the information required and without the rules of the game established to make it a market. Without rules established and mechanisms in place to relay reliable information, every firm in a particular market functions in a vacuum of sorts. If firms are in a vacuum, and are not accustomed to participating in a market then it will be very difficult to convince the firms to participate in the market and to defer to market institutions after the fact. That is why it was so important for Armenian and Russian governments to create preliminary market institutions and rules before privatization starts. These institutions establish the

rules of the game in terms of disclosure of firm information, incentives, and the parameters to measure firm growth and value.

Both and criticism and supporters of check model converge only in one: the formal quantitative success of the program of mass privatization is indisputable and is obvious. The totals of an implementation of a program of mass privatization lying behind frameworks of quantitative assessments were and remain a subject of controversies. From the point of view of the ideologists of the Russian and Armenian privatization, the pragmatically substantiation of introduction of this model became the registration real situation on the moment of a beginning of technical privatization: absence of possibility solvency demand of the population; zero concern of the foreign investors; the availability many thousands state and municipal firms and companies, necessity of maximum high rates of legal privatization process for blocking of intensive spontaneous privatization and series other.

6.3 MANAGEMENT/EMPLOYEE PRIVATIZATION

In Russia one of the most popular ways to privatize SOEs was the transfer ownership through shares to the managers and employees of the enterprise in question.

Kaplan (1989) and Smith (1990) found that improved operations in firms that have experience MEBOs are due to improved incentives rather than through layoffs of workers or the managerial exploitation of shareholders. In FSU it was found that even though workers may sometimes be dismissed, in other cases, privatization laws prohibit the firing of redundant workers. In many cases, there was no market for the privatized shares where the employees can sell these shares for a fair price. Instead, the employees are at the mercy of management to buy their shares for an arbitrary price that does not reflect their true intrinsic value.

The MPP works to concentrate ownership in the hands of the top management. Even if the first idea was the equal distribution of property, the end result speaks for itself. The MPP was designed and implemented to undo insider social capital and to legally disempower the insider coalition of stakeholders with the collective interest in preserving and improving the enterprise as a going concern it is a bit disingenuous to picture the assets stripping by the top of managers. Was this incompetence or just planned redistribution of wealth we don't know, but I think any economist may forecast that in absence of money on workers and citizens even for support normal level of life the wealth should be moved from whole population to hands of some limited number of person. In any way it can be counted as a failure of management-employee buy-out and accepted us a management and directors capture of wealth.

In some countries as well, the mandated under pricing of shares that were distributed to managers and employees encourage the MEBO. Since many of the SOEs sold by the State were unprofitable, and the State was aware of this, an article by Ben-Ner and Jun in 1996 seems somewhat to explain why this under pricing may happen. Although the State is making this as a purely political decision in order to be seen as distributing wealth to the population, Ben-Ner and Jun found that in a market economy, owners of relatively unprofitable firms will sell out for low prices. This was true in Russia and Armenia many of the SOEs were unprofitable and unwieldy after years of State management. These SOEs were sold for government-issued vouchers that cost the holders little or no money. Therefore, the governments who implemented these mass privatization programs were not sell the enterprises for low prices but give them away.

The government, however, has many different options on how to proceed with privatization, including privatization auctions, sale of the firm or firm assets, debt swaps, and so on. The government often would just prefer to hand it over to the managers and employees because it is quicker, and is perceived as fairer.

Once the enterprise is corporatized, how the newly created shares are distributed is just as important as the method chosen for privatization. How privatized shares are distributed determines how well the firm will be restructured, and hence, how well it will be able to compete in the new market economies. If the shares in a newly privatized enterprise are distributed in a way that creates a concentrated ownership structure with an oversight mechanism, then the improved operational and financial efficiencies desired from privatization will most likely be achieved.

In Armenia shares were also distributed to managers and employees during the privatization process. This was done to privatize SOEs quickly, as well as to portray the privatization programs as fair. From an efficiency standpoint, if managers become the owners of a firm, managers' incentives should become aligned with those of the owners/shareholders, and the firm should be managed more efficiently. If managers know their personal wealth depends on how well the firm performs, then managers should do everything in their power to improve firm operations. However, as discussed in chapters 3 and 4 this appears not to be the case in focal countries.

The problem, when considering privatization in FSU, is that privatization is an economic innovation, but it is used to achieve broader political and societal goals. This innovation has been implemented in markets with no financial institutions, or very primitive ones at best, with no enforceable accurate way to record financial information, and designed with the specific motivation to achieve political goals. Knowing this, to judge and measure privatization performance in terms of information that does not exist or is not reliable, coming from institutions that are primitive or do not exist, and from a financial innovation that is politically motivated, is ill advised.

The privatizers made two fundamental mistakes, first were the extraordinary speed of the reformation, and second the absence of solid legislative support and public understanding. Market reforms were simply equated with privatization, with no understanding of the necessary infrastructure required. Such fundamental reforms require time for society as a whole to understand the reforms psychologically and for government it was the time to create new law and new institutional infrastructures. There was no time for social adaptation and integration of privatization ideas and for most of population privatization meant nothing. But other picture for enterprise directors whom were given almost immediate possession and control of enterprises assets. Nothing changed in the methods and style of enterprises governance and nothing changed in the mentality of the directors and managers.

The biggest mistake was passing too much state owned industrial companies in to the market at ones, and it in condition that there was not ownership law and ownership security which make quite impossible for foreign investment and participation.

As a result the value of enterprise offered for privatization shrank to almost meaningless amounts. The vast majority of Russian citizens got nothing out of mass privatization. The people who did benefit the insiders and financial operators who bought up all the vouchers and got up control of the main enterprises at unbelievable small price. The unhealthy privatization process likewise distorted the Russian securities market.

A number of conclusions can be drawn from Armenia's experience with privatization. First, national wealth was swiftly and in great disproportion redistributed to the benefit of the rich strata of the population. [UNDP, *Human Development Report: Armenia (1997)*, p.36]. Second, new owners who had bought these enterprises for close to nothing had no obligation to invest in them. They did not have any interest in investing in new equipment or upgrading or modernizing their facilities, by cooperating, for example, with foreign partners. [UNDP report, *Chapter (2000)*] Instead, they sold whatever assets they could from their enterprises, including machinery, at the price of metal scrap in Iran or other countries.

So my conclusions about mass privatization result are: first: the redistribution of the property or simple juridical re-registration of the owners right on the enterprise assets without involvement of large private financial resources. Second: wide social disappointment with the results of privatization in the case of massive bankruptcies of joint-stock enterprises and investment funds, which accumulate up to 50 percent of issued vouchers. Third the dreaming to get substantial revenues from privatization to cover budget deficit and finance the most acute social problems also has failed so far.

It could be noted that the expectations of the people regarding the privatization of state enterprises have not, to date, been met. Specifically:

- a large group of private proprietors has not been formed,
- an effective market has not been established,
- the number of operating enterprises decreased, resulting in an increase in the number of the unemployed,
- the investments made for the privatization of enterprises are largely insufficient.

In the first place, I can argue that although bureaucratic planning has been reduced, a large percentage of the power is still concentrated in the hands of bureaucrats. In particular, in the case of industry, the bureaucrats have designed the process of privatization wielding considerable influence on the constitutional bills. This leads me to state that a significant number of rent-seeking effects have not been eliminated or reduced as required in a process that is aimed at increasing efficiency in the allocation of resources. That is what happens under a privatization program implemented initially in the industrial sector through checks. As a consequence of this behavior, no major changes are observed in the final outcome of the *new private* enterprises compared to the *former public* ones. Obviously, the longer this process takes, the worse the results are in terms of efficiency. Therefore, the new structure of property rights will not add any net value to the total welfare. The expected final effect is that bureaucracy will take control again.

6.4 LOAN FOR SHARES

Two reasons are typically put forward to explain the use of the loans-for-shares scheme. On the one hand, the chronic budget crisis and failure to meet budget targets for privatization in 1995 were among the most important reasons for the implementation of loan-for-share scheme. On the other hand, the banks wanted to gain control over some of the largest Russian companies as cheaply as possible. [Lieberman, I. W. and Veimetra, R (1996); Paul Hanke]

Despite the legal veneer of the auctions, they were to a considerable extent either the veiled purchase of shares by the enterprises themselves, or the direct non-competitive sale of shares to interested banks or Financial-Industrial Groups (FIGs). The numerous court hearings and examinations of the legitimacy of these deals in 1996-1997 do not provide any evidence of legal violations committed during the loans-for-shares auctions and subsequent sale of the shares.

However, this is more proof of imperfections in the regulatory and legal base at the time, than of transparency in the loans-for-shares auctions that took place.

In all these tenders, the final price minimally exceeded the starting price, and thus, the state's earnings were insignificant. Loans-for-shares auctions were an audacious scheme to leverage wealth acquired in these dubious ways, by using it to acquire Russia's biggest companies for a small fraction of their value. [*Lieberman, I. W. & Veimetra, R (1996), p.737*] The main reasons for this were the lack of real competition, the collusive character of a number of the auctions, and the unsatisfactorily formulated demands and conditions of the privatization transactions.

It is wrong to understand actual auctions in Russian as some sort of competition, usually practice meets on these auctions was direct sale to much earlier known buyers. The foreigners participation was prohibited and weak resources of Russian commercial banks couldn't create normal competition environment. These statements agree well with the liberal message of Smith and his followers. The state should be kept from direct interference in the marketplace. As in any case of constrained maximization, there will have to be a balance struck. Simply pushing the government out of the picture altogether will indeed achieve the primary objective, but the collateral damage may well outweigh the easy gains. The real outcome of Russian privatization provides a tragic illustration of this point. Few have summarized it better than George Soros, stating at a 1998 conference that first "the assets of the state were stolen, and then when the state itself became valuable as a source of legitimacy, it too was stolen."

6.5 FIRM PERFORMANCE

The success of privatization around the world can be measured in a number of different ways. The measurements of success using firm performance data tend to be the most popular way to measure privatization success. These studies measure success by using before and after privatization firm data.

The same types operating information could theoretically be collected from firms in Armenia and Russia representing firm performance both before and after privatization, but this technique would be ill advised and unsuccessful. According to the Nichole Castater the success of privatization in FSU cannot be measured in the same way for the following four reasons:

1. Before privatization firm data for newly privatized firms is not available, and if it is available, it is government-mandated data and therefore contrived and inaccurate.
2. After privatization firm data for newly privatized firms, if it is available, is not really comparable from firm to firm or from country to country
3. Privatization in FSU is not simply a financial innovation to raise government revenues, or reduce government expenditure and debt. Privatization is politically driven, and thus its goals are not purely to improve the financial and operating performance of the firm, but as part of a larger plan of societal transformation.
4. In many parts of FSU, privatization is actually corporatization or restructuring. So the information collected before and after privatization may not even involve a privatization.

In my approach was used economic performance data collected in several years after privatization. Using non-parametric statistical techniques for several years after privatization, I have studying whether there was any positive significant change in operating performance after privatization? I have found that in the short run perspective neither in Armenia nor in Russia enterprises after privatization did not perform better, and if there was some of enterprises with a good performance they have been good running and profitable also before privatization.

My study highlights that major of privatized enterprises without dependence in what way they have been privatized did not have at practice effectively acting owner. Motivation of managers and directors of privatized enterprises can not be characterized by positive shifts. The using by the state and privatized enterprises administration the capital of those enterprises for short term speculative operations in trade, on financial and stock markets has assumed a mass nature (of course at the first stage when they had wealth to sell) naturally that this operations are made not in interest of the strengthening of financial situation at given enterprises, but carried out for the purpose of personal enrichment.

6.6 PRIVATIZATION SUCSSES

The only successful case of privatization in focal countries was in the beginning of privatization movement in the Gorbachev-era it was the lease-buy-outs scheme that involved small shops and enterprises usually textile workshops. And also the beginning of small privatization when all assets were sold by cash usually by their real price. The secret of the success was in reason that this shops and enterprises were both by their collectives and mangers who wanted to work and have a profit from the product not just from assets selling. This privatization method was more realistic and healthy than the massive redistribution or property rights by mass privatization for some nominal value. What was a counterfactual or alternative to the mass privatization program. If the logic is sound then the Soviet leas-buy-out scheme and related experiments seem to be the closest thing to a counterfactual to grow out of the reform experience in the former Soviet Union. Cash privatization cooped with case-by-case privatization was also one of success stories in Armenian budget fulfillment but still don't play any role in property redistribution.

6.7 AVENUES FOR FURTHER RESEARCH

Meanwhile much has been learned about privatization as political and economic policy, there are several important areas that need further research. I believe that, in particular there are several aspects of privatization that need to be understood much better for the public administration and policy reason. First, privatization program in Armenia and Russia by their very goals and structure are broad economic reforms. In this regard the privatization should be viewed in more broad perspective. It is necessary to examine the reforms in following areas in economy: education, infrastructure, health, capacity building. In terms of privatization, the education and retraining managers, owners and local investors in former socialist countries are vital to privatization success. As mach they are educated as well enterprises will be restructured and managed. Infrastructure not only helps to everyday operation of newly privatized firms, but is also necessary for the growth of these firms and private sector development in general. It is the legal and financial institutions should be already in place in order for the privatization process to be a success. The privatization of health brings to the disappearing many of these services with less private or public institutional available to replace these services to the population. In this case privatization leads to deterioration of health and life expectancy has dropped since privatization. Capacity-byilding is very important because if the growth of institutions and knowledge are prohibited by political motives or program design privatization can not act as a catalyst for the transitional reforms.

Second, vital area of research is the labour economics of privatization program. In my research I have paid very small attention to the problem of unemployment or what actually privatization program costs to SOEs worker? How commercialisation of SOEs affects on them? Finally what role can privatization play for Armenia and Russia in long term growth perspectives?

6.8 CONCLUDING NOTE

The economic case for privatization in researched countries was done more in terms of what is wrong with SOE's than as a positive case for privatization and criticizes. In particular "government failure" is not inevitable and countries can be vary markedly in the quality of government and hence the quality of economic decision-making. Thus, reform strategies should be based on the nature and extent of government failures. In particular, the case for privatization in small and poor countries should be particularly weak. Such huge country like Russia could have a grate success in privatization but because of many obstacles and corrupted officials it has also inefficient and weak program. The problem in many of these countries was not political reluctance, but the absence of an adequate infrastructure to support privatization in situations where local buyers have lacked finance and expertise and governments have had to extend protection and subsidies.

The method of privatization seem to be a matter in explaining efficiency improvements, confirming the concerns of those that emphasized earlier on the agency problem: the well-known concern that non-owner managers do not have the same profit motive as owners and are unlikely to operate in the most efficient way assumed in theory. Long documented in industrial countries, the agency problem is seen a new in various ways in the many countries in transition from central planning to competitive markets. Although the evidence is far from clear, the empirical literature does reveal an approximate ordering of superiority. Start-up firms are clearly the best performers, showing the greatest efficiency gains; firms dominated by outsiders, especially with foreign investors involved, generally show good improvement; insider-dominated firms are the least efficient among the newly privatized, with an unclear distinction between the management-dominated and the worker-dominated cases; the least efficient of all are the remaining state-owned enterprises.

To accept this or that solution on privatization it is necessary to take into account that the final result of this process is effectively operational firms, and under efficiency it is necessary to perceive both economical and social efficiency.

The strategy of accelerate privatization emphasis on the rapid elimination of state ownership. It is usually privatization through give away scheme like voucher scheme. The main goals are the equal distribution to all citizens of state assets. In compare with slow sale strategy the main part of state assets gets the insiders, but as the practice shows only for short period then this property concentrates in hands of criminals and oligarchs. With the rapid and wide property distribution and ownership reform, without creation of institutions ground leads to inflation and poor economic performance.

Nobel Laureate Joseph Stiglitz argued that privatization in the absence of a sufficient, market supporting institutional infrastructure was a serious mistake that led more to asset stripping than to wealth creation. He argued that this should have been foreseen, if not by the first generation of transition reformers, than at least by their Western economic advisors, and presumably by the World Bank staff involved. The implication was that the headlong rush to privatization was a basic mistake, that mach of the decline and pain associated with transition in general was avoidable. Much more attention should have been paid to building the institutional, legal and administrative foundation on which properly functioning capitalism is based.

It is obvious that there is mismatch between the institutions of investor protection and the ownership structure that were emerged after privatization in many transition economies [*Pivovarsky, (2001), p. 6*]. Such arguments, illustrate clearly that in order to foster the emergence of an effective private sector, not only is the implementation of a well-designed privatization strategy

important, but the institutions are also vital. It is tempting to conclude that the general market and competition environment is much more important than privatization as such, and the method of privatization. [*Havrylyshyn and McGettigan (1999), p. 36*], in agreement with these statements. In conclusion, the task of privatization is not merely one of changing ownership per se. rather it involves changing an entire socio-economic system by creating many institutions required in a market economy to enable owners to exercise full ownership rights and corporate government responsibilities [*Gray, (1996), p. 8*].

Consequently, “the pace of privatization should not outrun the development of adequate supervision authority” [*The World Bank, (2002), p. xxxi*]. The empirical literature suggests that when effective institutions are lacking, costly substitutes emerge in their place and asset stripping theft, and other violations of property and shareholder rights become widespread [*The World Bank, (2002), p. xvii; Djankov and Murrell, (2000), p. 6*]. Conversely, institutional innovations can help to moderate the damaging effects of less-than optimal policies including privatization [*Djankov and Murrell, (2000), p. 67*].

The society that permits the maximum generation of trials is the one that has the best likelihood of solving problems through time, as Hayek has persuasively argued. Adaptive efficiency encourages the development of decentralized decision-making processes that will allow societies to explore many alternative ways to solve problems. It is equally essential to learn from failures so that change consists of the generation of organizational trials and the elimination of organizational failures. There is nothing simple about this process since organizational failure may be not only probabilistic but also systematic, due to preferences with respect to ideologies, which may give people, on the basis of imperfect knowledge, preferences for the kind of solutions that are not oriented to such efficiency. Institutions define the incentive structure of a society. Different institutional rules will determine the kinds of economic activity that will be profitable and viable and also shape the adaptive efficiency of firms and other organizations via rules that regulate entry, governance structures, and the flexibility of organizations.

Competition, decentralized decision making, and well-specified property rights as well as bankruptcy law are critical. It is essential to have rules that eliminate not only failed economic organization but also failed political organizations. The structure of rules, therefore, must be not only one that rewards successes but also one that vetoes the survival of maladapted parts of the organizational structure, which means rules for dissolving unsuccessful efforts as well as for promoting successful ones are necessary.

Institutions are the constraints that human beings impose upon themselves to structure human interaction. They consist of formal rules and informal standards of behavior and of their enforcement characteristics. Formal rules include political (and judicial) rules, economic rules, and contracts. Political rules broadly define the hierarchy of the polity, its basic decision structure, and the explicit characteristics of agenda control. Economic rules define property rights. Contracts contain the provisions specific to a particular agreement in exchange. Given the bargaining strength and interests of the decision making parties the function of the rules is to facilitate exchange, political or economic.

Informal constraints include conventions that evolve as solutions to coordination problems and that all parties are interested in having maintained norms of behavior that are recognized standards of conduct; and self imposed codes of conduct such as personal standards of honesty and integrity.

It is the institutions that deliberately or accidentally create the externalities that alter choices. The lower is the cost that we incur for our convictions (ideas, dogmas, prejudices) the more they contribute to outcomes [Nelson and Silberberg, (1987)]. As noted above, agreements may be enforced by a third party (societal sanctions or the coercive force of the state), by the second party to the agreement (retaliation), or by self imposed standards of conduct. How effectively agreements are enforced is the single most important determinant of performance. The ability of societies to enforce agreements across time and space is a crucial underpinning of efficient markets. On the surface it would appear to be an easy requirement to fulfill. All one needs is an effective, impartial system of laws and courts for the enforcement of formal rules; the “correct” societal sanctions to enforce norms of behavior; and strong normative standards of behavior of honesty and integrity to undergird self imposed codes of conduct.

Understanding of institutional change entails understanding of the stability characteristics of institutions and of the sources, the agents, and the direction of change. A basic function of institutions is to provide stability and continuity by dampening the effects of relative price changes. Institutional stability makes possible complex exchange across space and time. Channels of exchange, both political and economic, that make possible credible agreements are necessary conditions for the efficient markets, which underlie high-income societies. This condition is accomplished by the complex set of constraints that constitute institutions. Among these are formal rules nested in a hierarchy, each level more costly to change than the previous one.

More than half a century ago [Coase (1937)] argued that transaction costs are the basis for the existence of the firm. That is, if information and enforcement were costless, it is hard to envision a significant role for organization. What is it about transaction costs that lead to organization. The answers have ranged from the firm being a form of exploitation [Marglin, (1974)], to a response to asset specificity [Williamson, (1975),(1985)] to a response to measurement costs [Barzel, (1982)].

Organizations are a response to the institutional structure of societies, and, as they evolve, may alter that institutional structure. The institutional constraints together with the traditional constraints of economic theory define the potential wealth maximizing opportunities of entrepreneurs (political or economic). If the constraints result in the highest payoffs in the economy being criminal activity, or the payoff to the firm is highest from sabotaging or burning down a competitor, or to a union from engaging in slowdowns and make work, then we can expect that the organization will be shaped to maximize at those margins. On the other hand if the payoffs come from productivity enhancing activities economic growth will result. In either case the entrepreneur and his or her organization will invest in acquiring knowledge and "learning by doing skills" in order to enhance the profitable potential. As the organization evolves to capture the potential returns it will gradually alter the institutional constraints themselves. It will do so either indirectly, via the interaction between maximizing behavior and its effect on gradually eroding or modifying informal constraints; or directly, via investing in altering the formal rules.

But it is not just the efforts of organizations to alter the rules that shape long run economic performance. It is also the kinds of skills and knowledge that organizations will induce the society to invest in. Investment in formal education, new technologies and pure science has been a derived demand from the perceived payoff to such investment. Institutional change then is an incremental process in which the short run profitable opportunities cumulatively create the long run path of change. The long run consequences are often unintended for two reasons. First the entrepreneurs are seldom interested in the larger (external to them) consequences but the direction of their investment influences the extent to which there is investment in adding or disseminating the stock of knowledge, encouraging or discouraging factor mobility, etc. Second, there is frequently a

significant difference between intended outcomes and actual outcomes. Outcomes frequently diverge from intentions because of the limited capabilities of the individuals and the complexity of the problems to be solved.

How does one create institutions? It is not just "getting the prices right" at a moment of time (allocative efficiency) that is our objective, but getting them right over time (adaptive efficiency). To accomplish that objective requires much more than transferring assets from public to private hands (important as that task is). It also entails the development of a legal system that will embody the correct incentives (of adaptive efficiency); the creation of effective and impartial enforcement by that legal system; the development of organizations made up of entrepreneurs who will invest in the kind of skills and knowledge essential to sustained productivity increase. It also entails the establishment of a polity that will broadly support and enforce the new property rights; will undertake those investments essential to sustained productivity increase that are privately unprofitable because of public goods or free riding attributes; will mitigate the insecurities and uncertainties associated with a competitive, interdependent world.

If economies were not characterized by institutions and if instrumental rationality characterized human decision making then the problem of modern economic growth would be reduced to a matter of preferences. Political entrepreneurs not only would know the political and economic policies that would direct them on to an adaptively efficient path, but also could overnight transform the institutional framework to create the proper incentive structure. Because institutions do result in "lock-in" and the actors proceed on the basis of limited information and subjective models as guides to choices, the paths of economies diverge widely and persistent poor performance can continue. Both of these characteristics of institutions are crucial to policy formation in the restructuring of economies. Procedural rationality because it means that the subjective models of the actors that are responsible for the way they process information shape the way individuals perceive problems and hence shape the choices they make. In this context the ideas, ideologies, dogmas and myths that people believe in matter and the successful restructuring of an economy is going to entail restructuring of people's perceptions.

Path dependence implies that the organizations that were evolved as a response to the institutional framework that is being replaced will have tenacious survival ability and will attempt to "sabotage" the institutional transformation-taking place. This is particularly true of the government bureaucracies that have carried over from the earlier institutional structure. New organizations (political and economic) must be created and fostered that have a stake in productive efficiency since the long run viability of the new institutional framework will depend on the support of organizations with a stake in adaptive efficiency. The foregoing analysis implies that successful privatization must take into account the characteristics of institutions and organizations and be complemented by policies that lead to adaptively efficient economies.

The institutional framework of the economy is incorporated in the analysis, influencing the cyclical processes and the growth of the economy. Post Keynesian policy recommendations would have been applicable to the transition economies where uncertainty was such a characteristic of the process. In addition to the uncertainty associated with the normal functioning of the market, the transition process gave rise to "transition uncertainty". The transition uncertainty was due to institutional and systematic transformation, behavioural inheritance of the past and political and social changes [*Lah and Susjan, (1999), p. 591*].

Thus, the implementation of the neoclassical model of privatization did not necessarily encourage restructuring rather resulted in a cruel deception, in which many individuals colluded, a few profited, and the public at large was the great loser [Oberschall, (1996), p. 1039].

The superiority of private property assumed that the enterprise owners were preoccupied with the management of the enterprise, or that they were able to put pressure on management to follow their decisions. The post Keynesians claimed, however, it was very difficult for owners to be able to exert any pressure on the management. Even in mature market economies, with a shareholding culture and well-informed shareholders, shareholders could only put moderate pressure on management. In the former centrally administered economies, where there was a lack of ownership skills, inappropriate information and the legacy of gigantic enterprises, management effectively had total control of the decision-making process. In mature market economies as enterprises grow, the more ownership is separated from management and the more likely management is to pursue independent goals. Thus “the link between ownership, effort and reward in manufacturing is indirect and fuzzy” [Bunknall, (1997), p. 12].

The neoclassical transition model’s assumption that private property results in efficiency could only be true if ownership and managerial skills appropriate to the “free” market process were inherent and not learned. On the contrast, if ownership and managerial skills were taught and time-consuming to acquire, the result would be a different combination of skills and hence ownership and co-ordination structures different from those defended by neoclassical supporters. The achievement of a civilized society, which is the goal of post Keynesians [Davidson and Davidson, (1996); Marangos, (2000)], would ensure that management would be representative of society and motivated by civic values, giving rise to civilized leadership interested in more than optimizing resource allocation.

Post Keynesians viewed labour-managed firms favourably as a means of restructuring state enterprises. This was because labour managed firms are democratic which enhances workers’ loyalty and commitment resulting in positive effects on labour productivity [Targetti, (1992), p. 13]. Post Keynesians believed worker motivation would have been increased to make enterprises efficient and profitable, at the same time mobilizing support for the transition process. Labour-managed firms would have required government financial assistance and an appropriate institutional structure so that they would not be disadvantaged. In such circumstances, labour-managed firms could have become a transitional mechanism allowing people gradually to adjust their behavior with maximum participation. “This [labour managed firms] seems to be the only feasible way to make the inevitable process of social transformation more stable and fair” [Bin, (1992), p. 190]. It was up to the reformers to exploit and further develop the existing co-operative property structure. This can be achieved by free distribution of shares to the workers. This is in contrast to the neoclassical privatization policy of free distribution of shares to the whole population.

Actual privatization, hardened budget constraints and product market competition appear to be important determinants of enterprise restructuring in Central and Eastern European countries, while they are less effective in the CIS. As well, privatization to labour in the CIS has been worse than state ownership [The World Bank, (2002), p. 71]. The difference in impact of privatization between CIS and Central and Eastern Europe is due to the varying degree of institutional development [Djankov and Murrell, (2000), p. 69].

Privatization in focal countries shows that the role of the government is important in the transition process. A weak government that cannot or does not bother to control the process only provides the

chances of opportunistic behavior. Markets do not guide the process towards Pareto optimality because a functioning market does not exist yet. When the legal framework is vague, informal rules become more important. Legal rules were largely ignored and social networks counted more. Russian and Armenian privatization did not lead to an efficient result. Insider groups were able to secure their positions and financial conglomerates, led by a few oligarchs, took over the earlier state monopoly in the economy. Privatization strengthened the role of informal institutions at the cost of formal legal rules. Privatization made it clear that informal social networks among the new elite are powerful, while the formal rules are weak and not respected. It was also a process that rather weakened than strengthened the development towards the rule of law. It proved that the political and economic elite does not show respect to the developing legal system as long as good relations among the elite can supersede the law.

ABBREVIATION

(ADRs) - American depository receipts
AMD - Armenian Dramm
(BOT) - Build-Operate-Transfer
CEPRA - [Center for Economic Policy Research and Analysis]
(CIS) - Commonwealth of Independent States
CPA - Communist Party of Armenia
EBRD - European Bank for Reconstruction and Development
(FDI) - Foreign Direct Investment
FIGs - Financial Industrial Groups
FSU - Former Soviet Union
GAZ - (Russian abbreviation) Gorky Auto Factory
(GDRs) - Global Depository Receipts
(GDP) - Gross Domestic Product
(GKI) - (Russian abbreviation) Federal Property Fund
ICS - Incomplete Construction Sites
IFC - International Financial Corporation
IFIs - International Financial Institutions
IMF - International Monetary Found
IPO–Plus international Public Offering Plus
(ISO) - International Standards Organization
(MEBO) - Management-employee buyout
MMM - (Russian Abbreviation) Investment Found
MoP - Ministry of Privatization
(MPP) - Mass Privatization Program
(NIFs) - National Investment Funds
(NIS) - New Independent States
R.A - Republic of Armenia
RF - Russian Federation
RFPF - Russian Federal Property Found
RJSC - Russian Joint Stock Company
RSFSR - Russian Soviet Federative Socialist Republic
SME - Small and Medium Enterprises
(SOE) - State owned enterprise
SSP - Small-Scale Privatization
UPJ - United Power Grid
USSR - Union of Soviet Socialist Republics
VAT - Valued-Added Tax
(SWOT) - Strengths, Weaknesses, Opportunities, Threats
WB - World Bank
(WTO) - World Trade Organization

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