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Privatization Success and Failure: Finance Theory and Regulation in the Transitional Economies of Albania and the Czech Republic

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This paper examines the transition of economies of Albania and the Czech Republic, noting that their relative failure and success could have been predicted by academic literature. Financial intermediation theory predicted the rise of independently created mutual funds in the Czech Republic, while similar intermediation literature related to monitoring (or the lack thereof) predicted the development of the Ponzi schemes of Albania. These privatization success and failure stories highlight the primary importance of regulation, monitoring and enforcement in economies-in-transition. Lessons learned from privatization in developed countries may therefore not be directly applicable to newly emerging economies, as economies-in-transition do not have the regulatory and legal network in place to prohibit malfeasance. © 1997 John Wiley & Sons, Ltd.

INTRODUCTION

Perhaps no other change in economic philosophy has occurred as rapidly as that in the formerly communist countries of Eastern Europe. Unlike countries with developed or semi-developed capital markets, these economies-in-transition in Eastern Europe had neither securities law, regulatory bodies, capital market infrastructure, nor market-oriented accounting or reporting systems. Due to the nature of the changes involved, these Eastern European countries chose to transition from communist to capitalist economies, privatizing almost all of the assets under state control. While these economies-in-transition were not the first countries ever to undertake a privatization program (Latin America, the UK, France and the USA have all undertaken privatization programs at one time or another during their political and economic development), results from privatization programs in highly developed countries may not hold if implemented in developing or emerging economies.[1] The very size and nature of such a change and the vast number of people and economic resources affected seem to demand new approaches and ideas.[2]

Different Eastern European countries have pursued different paths and different strategies with varying success. In part, these strategies were the result of the initial conditions in which these newly emerging economies found themselves after the fall of the Iron Curtain. Some, such as the Czech Republic, 'inherited' economies which had continued to strive for independence under the Soviet yolk (as in 1968) and which had a history of independence and capitalism prior to 1945. Countries such as the Czech Republic, Hungary, and Poland were leaders of change, acting as a catalyst in the downfall of Soviet influence in Eastern Europe. Their economies, while weak from years under Soviet rule, had a strong base

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from which to start and rapidly embraced change. These countries also had political leaders willing to lead, creating new securities laws and regulations. Others, such as Albania—historically one of the poorest countries of Eastern Europe—found economic transformation forced upon them. Unwilling members of a global capitalist economy, Albania struggled as Russia slowly shed its grip on the economy.[3] Perhaps more due to the poor initial endowment it 'inherited' than to ideology, Albania held onto its old ways for too long and has been unsuccessful in making the change to prosperity.[4] Instead of prosperity, death and chaos have visited this former Soviet satellite.

Of particular interest to academics is that the most salient features of privatization of these two countries—the emergence of mutual funds in the Czech Republic and the Ponzi schemes of Albania—were predicted by finance theory as it relates to legal and regulatory issues. To understand the applicability of finance theory to the privatization programs of these countries, it is necessary to understand the unique nature and goals of privatization in transitional economies and to recognize the difficult position in which these countries found themselves just prior to the transition.

This paper, therefore, examines legal and economic issues related to privatization in Eastern European countries. The section (Why Privatize? Definitions and Goals) begins by examining and defining the goals of privatization. The following section (Privatization in Developed and Transitional Economies) discusses the differences between privatization in developed and transitioning economies. The section (Initial Conditions: The General Situation in Eastern Europe Before the Transition) then discusses the situation faced by post-communist countries in Eastern Europe upon the beginning of the transition of their economies. The section titled Laws and Privatization examines the experience of two such countries, Albania and the Czech Republic in their attempts to privatize their economies, while the last section concludes the paper.

WHY PRIVATIZE? DEFINITIONS AND GOALS

What is the underlying economic rational for privatization? The basis for the arguments in favor of privatization comes from the First Welfare Theorem and the Second Welfare Theorem of Economics, which relate a competitive allocation with pareto optimality. The First Welfare Theorem states that an allocation that is the result of a competitive equilibrium will be Pareto optimal.[5] However, the underlying tenet of modern-day privatization is the Second Welfare Theorem, which states that any Pareto optimal allocation can be achieved through the competitive process by the appropriate assignment of property ownership rights or redistribution schemes. It indicates that by changing the endowment structure, any pareto optimal allocation may be achieved through competitive markets. Economies-in-transition, therefore, are redistributing endowments in order to achieve through competitive processes a desired pareto optimal solution.

What then does privatization mean? Unfortunately, privatization means different things to different people. To some, it is the re-establishing the links from companies and factors of production to the capital markets. To others, it is a change in the corporate governance structure from the state to private hands. However, as Kay and Thompson (1986) and Vickers and Yarrow (1991) argue, economic efficiency is more likely affected by competition in the product markets than by ownership changes. Privatization is therefore a complex interlocking set of measures to change the way raw materials are converted into consumption goods by changing control, production, and pricing from the public to the private sector.[6]

To do so, many steps need to be taken in an orderly and systematic fashion. For example, to encourage trading, merely distributing shares is insufficient: laws need to be written; security and exchange commissions need to be established; accounting procedures need to be developed; clearing methods, brokerage houses and investment banks need to be created; and exchanges, physical or electronic, need to be arranged all before trading can take place.

Given the enormity of the task, why privatize at all? Privatization is of primary interest due to the implicit assumption that private control increases efficiency. Those promoting privatization believe that private ownership results in more effective control and thus more efficient use, thereby increasing the overall net production of society. As noted in Goldstein and Gultekin (1997), "if ownership of the factors of production can also be traded, then relative prices may be established which will allow for more efficient allocation of resources across assets, increasing the overall net production of society yet again. These increases in production enable a society to increase consumption.''

However, some debate the efficacy of the privatization process. Prager (1992), when examining the effect of privatization in LDCs, questions whether it is the public sector or the market that has failed. Using a theoretical model, De Fraja (1993) notes that if the government's utility function includes consumers' welfare functions, the public firm is at times more efficient than the private one. He notes that although it is Western opinion that ''...state-owned enterprises are less productively efficient than their private counterparts [...] in the long run, the allocative efficiency disadvantages of private firms are more than compensated by their superiority in productive efficiency [over public firms]'', his paper and others fail to find confirmation. On the other hand, Megginson *et al.* (1994) finds strong improvements in performance across many efficiency variables (including an increase in the workforce) in an empirical examination of the financial and operating performance of 61 companies from 18 developed or developing countries.

Another reason for privatization is to develop capital markets so that factors of production may be priced.[7] Trading of shares is desired as it will impart information to the market, which will increase efficiency by improving the allocation of resources from one area to another. The goal of privatization is not the creation of a stock market but the increase in efficiency and output. Thus, the creation of a stock market is a means to a desired outcome, and not an end in itself.

In developed markets, shares of a firm are the instrument through which a variety of investment, ownership and control issues are determined. Shares give the shareholder specific rights and claims in the financial world that are unique and are tied together as a bundle in the typical common share. A typical common share gives the holder the following:

(a) the ownership right to the underlying physical and intangible assets of the firm;
(b) a residual claim on the future earnings that result from the use of these assets; and
(c) the right to control the underlying physical and intangible assets.

Although obvious, these items are important in the study of privatization methods, as they each indicate different areas of concern. Most, if not all, privatization methods incorporate the use of shares in their proposals. However, many of the concerns that privatization proposals wish to address deal with only a subset of the three areas that a typical share encapsulates. For example, the primary goal of privatization is the increase in societal output. Therefore, it is the control feature of the share with which most privatization plans are concerned, as it is hoped that changing the control of the assets will result in a change in the use of the assets in such a way that an increase in the quantity and quality of goods will be realized.[8] The other features of a share are there to provide the proper incentives for the use of such control, although in actuality these incentives may not result in the desired outcome. Note, however, that the price of a share and the volume of trading will be a function of the aspects of the share listed above. There will be a market for control, as well as a market for the residual claim on the earnings, as well as a market for the underlying value of the assets.[9] Unfortunately, there will only be one instrument, the common share, for each of these markets. Therefore, certain desired outcomes, such as an effective change in the control of the firm, may not result if the market for trading shares is blocked.[10]

PRIVATIZATION IN DEVELOPED AND TRANSITIONAL ECONOMIES

The method and extent of privatization itself depends on both the state of the economy and the legal and regulatory system existent prior to the undertaking of such a program. As noted in Sappington and Stiglitz (1987), privatization affects the cost of government interaction in the firm's decisions. Thus, for countries such as the USA or the UK which have a developed market economy and established legal and regulatory systems, the emphasis of privatization programs is to reduce the influence of politics on business decisions by the transfer of state assets into the private economy.

Although there are substantial differences in the privatization experiences of developed and developing countries, the private sector has typically been at least a modest component of the economy. This is not true, however, for the economies in transition from communism to capitalism. For such countries, privatization attempts to transform the *entire* economy from one that is centrally planned into one that is market driven. Such changes not only require changes in ownership status (as in developed countries) but also a completely new legal and regulatory system. Legal issues such as defining ownership rights, control rights, transfer rights and mechanisms, disclosure requirements, bankruptcy law, insider trading laws and penalties, and fiduciary rights and responsibilities must be decided, codified, monitored and enforced. Thus, unlike developed countries, new legal, regulatory, and financial institutions need to be created, and new management and legal skills need to be developed as part of privatization programs in economies-in-transition. In addition, as noted in Lipton and Sacks (1990), such economies-in-transition need to commercialize many companies, from large to small, before and after processing them from state-owned to privately held.

Privatization in developed countries is therefore not comparable to the enormity of the task in post-communist countries, where it involves a total restructuring of the economy into an entirely different form with new institutions and management skills.[11] Privatization, therefore, is not merely an economic process; instead, it is a political and legal one. Indeed, privatization is a legal change of the economy. As with all legal changes, it is brought on by political will. While Boycko *et al.* (1994) note that—if properly structured—privatization may achieve desirable economic results in spite of the determination of privatization methods by political forces, Wyplosz (1993) argues that the politics of privatization require that governments not take actions which cause “strong minority objections”. Indeed, Aghion (1993) argues that “a complete reliance on privatisation and the operation of market forces may be an untenable restructuring strategy,” due to the large unemployment that may result from rapid privatization as the pace of new job creation will significantly lag layoffs.[12] Others, such as Murphy *et al.* (1992), argue against gradualism, noting the many pitfalls inherent with partial reforms.[13]

INITIAL CONDITIONS: THE GENERAL SITUATION IN EASTERN EUROPE BEFORE THE TRANSITION

A number of post-communist countries, such as the Czech Republic, are now well on their way along the privatization path, while others, such as Albania, have just recently begun their privatization process. In either case, it is useful to recall that the initial situation in many post-communist countries was quite bleak, and for some—such as Albania and Bulgaria—the situation has not changed dramatically.[14] Initially, post-Communist countries had little to no capital markets or regulatory supervision. Worse, the banking system was inexperienced in exercising market discipline on itself or its borrowers.[15] These financial institutions therefore could not initially provide the governance, monitoring or capital allocation functions of their Western counterparts. Furthermore, most individuals had very limited accumulated wealth, facing severely limited capital constraints.[16] The limited wealth and lack of credit markets also caused severe problems for transitional economies. Some, such as Aghion (1993), noted that initial wealth constraints might override efficiency issues related to privatization. Others, such as Calvo and Frenkel (1991), noted that underdeveloped credit markets might cause difficulty in privatizing Eastern Europe.[17]

Poor financial and managerial accounting also created significant difficulties.[18] The lack of reliable accounting data may have increased the *ex ante* risk of ownership, as noted in Bouin and Michalet (1991), or affected the use of mass scale public offers, as noted in Blanchard *et al.* (1991). The official initial owner of assets—the government—did not know the underlying value of the assets. While the managers may have had more information for the assets under their control, their information was not of very high quality as they were not operating under market conditions. Even relative prices were uninformative, as they were not market-driven.

This lack of accurate information was the result of two factors. First, accounting standards and reporting systems over the past 45 years were not designed for a market system, leading to a lack of accurate market-oriented historical information on which to base investment decisions. Even if this information were available, the prevalence of government subsidies, control and intervention limit the relevance of such data for imparting market information. Finally, the system, as it changes from a communist to market controlled economy, will be undergoing a change in fundamental values and prices as it adjusts to reach a new equilibrium. It is uncertain what future cash flows and interest rates will be, especially in the near term. These factors combined yield a situation in which there is little information provided to the decision-makers in the marketplace, and the value and reliability of existing information is low.

Mathematically, the problem may be modeled as follows: The investor is interested in determining the value of a firm V. However, he/she can only observe X_i, where

$$X_i = V + \varepsilon, \quad \varepsilon \sim (0, \sigma^2)$$

The investor gets to observe N realizations of X, so

$$\begin{aligned} E[X] &= E[V] + E[\varepsilon] \\ &= V + 0 \\ &= V \end{aligned}$$

$$Var[\bar{X}] = \sigma^2/N$$

The situation facing an investor in Eastern Europe was one in which there are few observations (i.e. N is small) and in which the relaibility of these observations is small (σ^2 is large). Therefore, the reliability of the estimate of V was very low since σ^2, the variance of that estimate, was very large.

Thus, due to the practically non-existent level of information on individual firms, the high levels of uncertainty as to the eventual equilibrium make long-term analyses near impossible.[19] Managers, who might have more information overall, may not have useful information regarding the actual market value or potential for their firms as their external environment is changing rapidly and it is uncertain how they will adapt. In any case, due to concerns about fraud, insider trading, and political unrest, managers should be barred legally from acting upon their information. Even if they could do so, wealth and borrowing constraints may prevent them from being able to use their information in the marketplace.

Information plays an important role in the privatization process. Information may not only affect the relative pricing of a single firm, but also affect the overall success of the privatization effort in developing stock markets. As noted in Titman and Subrahmanyam (1997), the nature of the way in which information is generated will affect the development of capital markets. Publicly traded firms work well if information is both useful for resource allocation and relatively costless. In their model, "…the allocative as well as the informational efficiency of the stock market depends on the number of publicly traded firms, which implies there is an externality associated with going public."Another danger is volatility and market thinness. Because of this externality, an inferior equilibrium can exist where too few firms go public."[20]

Until privatization occurs, information will not be produced because there is no ability to realize private returns on investment in information. As noted in Grossman and Stiglitz (1980), with so little information available, information asymmetry will be low and almost all investors will be similarly uninformed.[21] A 1995 report from the American Embassy in Tirana notes that the absence of information provided to Albanian investors on the firms being privatized had a 'chilling effect' on the privatization process. The report further noted that officials from both the World Bank and the Albanian National Privatization Agency 'speak openly of 'lethargy and fear' (based on previous bad experiences and uncertainty) among ordinary… Albanians' participating in the privatization process.[22]

LAWS AND PRIVATIZATION: A TALE OF TWO COUNTRIES

The development of appropriate legal systems is essential to the well functioning nature of the privatization process. We will examine two countries with different legal systems and supervision that attempted privatization with varying success. One, the Czech Republic, has been a resounding success story. The other, Albania, is mired in war and despair.

Voucher Privatizations

Both Albania and the Czech Republic privatized using voucher schemes. Thus, before examining the experience of each country, it is useful to examine voucher privatizations. Under voucher schemes, vouchers are used in auctions to determine the initial distribution of shares of state-owned enterprises. Boycko *et al*. (1994) note that this method has been used by a number of countries, such as the former Czechoslovakia, Mongolia, Lithuania and Russia. By using the vouchers in auctions, the actual composition of citizens' ultimate initial endowment of shares will differ based on their bids during these auctions. Boycko *et al*. (1994) argue that initial distributions, or at least the method of initial distributions matter. They believe that choice provides more interest and *ex ante* political support than "a simple assignment to people of pieces of paper that are allegedly claims to assets."

Auctions, of course, do not require vouchers for their operation.[23] Shares of state-owned enterprises could be sold in auctions where cash is used for payment. However, voucher auctions are frequently proposed in lieu of cash auctions due to the perceived fairness of voucher auctions.[24] In voucher auctions, every citizen receives the same initial endowment of vouchers. However, the few individuals which currently have sufficient capital to participate in cash auctions may be viewed suspiciously by the remainder of the public if it is perceived that this capital was accumulated illegally and unfairly under the previous regime. In addition, there is also concern that foreign investors will purchase the nation's assets at bargain prices if cash auctions are used. As voucher schemes may be structured to exclude these groups, many feel that the *ex post* results from voucher auctions are likely to be more politically acceptable than those of cash auctions.

As noted in Goldstein and Gultekin (1997), one problem with voucher auctions is that the cost of setting up the voucher auction mechanism is a dead-weight loss to society after the process is completed. Voucher schemes require the creation of an entirely new additional market, the voucher auction bidding market, which is a sunk cost and is worthless as soon as the auction process ends. The high fixed costs included in the voucher system—including the cost of designing such a system, educating the populace, creating the proper infrastructure for the bidding process, etc.—could make it likely that the total societal costs will be greater under a voucher scheme.

In addition, society members unused to capital markets will have to learn one system only to discard it and learn another. Such a problem occurred in Albania. According to a report from the American Embassy in Tirana, "... several procedural flaws have hampered the [privatization] process... The leading problems concern lack of public information, understaffed and ill-equipped auction centers, and failure to distribute vouchers... to about half of the total population eligible..." The report continues, noting that some key issues were being decided after the process had already started, "...creating additional doubts and uncertainties." It goes on to note "...a lack of public information concerning both the enterprises and the auction process."[25]

In the Czech Republic, fixed-price auctions were held in which there were multiple rounds, with winning bidders receiving shares (the price being reduced in the next round for the remaining shares) in under-subscribed issues, *pro-rata* distributions in slightly over-subscribed issues, and no shares distributed and the fixed price increased in the next round for grossly oversubscribed issues. In an iterative process, the vouchers are returned and the process begins anew.[26]

The dead-weight costs of such voucher systems would be palatable if voucher auctions provided significant benefits, such as price discovery. In general, however, voucher auctions will not lead to efficient price discovery. Hillion and Young (1995), in an empirical study of the Czechoslovak auction, find that updating rules used in that auction injected noise and inhibited efficient price discovery. Goldstein and Gultekin (1997) also predicted that voucher auctions would not lead to efficient price discovery.[27] In fact, this is what happened in Russia. As Boycko *et al*. (1994) noted in Russia "...large investors just brought in suitcases of vouchers, and tendered them to get whatever shares they could get in an auction. Evidently, even large investors had no idea what the companies were worth, and felt that shares were cheap enough not to bother with complicated bids."[28]

Finance Theory and Successful/Unsuccessful Transitions

An interesting feature of the voucher systems is the possibility of endogenously created mutual funds. The appropriate legal and regulatory framework needs to be in place to enable the creation of such funds. While the Czech Republic provided for such a creation, Albania took longer to set up such a framework. As late as the summer of 1995, Albania had many securities and privatization laws still to be created or interpreted.[29] The relative success of privatization in the Czech Republic and the collapse in Albania may both be related to securities design, regulation, monitoring and enforcement.

The Czech Republic At the onset of the privatization of the former Czechoslovakia, the creation of financial intermediaries such as mutual funds was not envisioned.[30] Over time, however, such mutual funds arose and were encouraged.[31] A reasonable economic question is why did such financial intermediaries appear endogenously and why were they popular?

To answer this question, consider the endowment of vouchers as an initial endowment of one unit of capital. Voucher packets can be easily tendered as they are small and fungible.[32] Thus, it was possible for entrepreneurs to offer financial intermediaries with which citizens could deposit their vouchers in return for a fixed payment after the privatization process is complete. The payment would be backed by the stock of whichever firms the financial intermediary managed to acquire with the vouchers. Such a system would have great appeal for Czech investor-citizens, as they would not have to master the complicated voucher auction process, nor would each citizen have to evaluate each company independently. Instead, the costs of discovery would be concentrated in the fund manager and then spread over the members of the fund.[33]

In addition, Czech investor/citizens may view tendering their vouchers to a fund as a more efficient method of effecting a change of control in the formerly state-owned enterprises. Without having the ownership concentrated in a fund, changing managements require the collective action of individual investors, who must be united and organized. As noted by Jensen and Meckling (1976), diffuse ownership inhibits shareholder control over management. If organizational costs are so large that they exceed the expected return the investor will receive as a result of the organization, then no one will undertake such an organization as the costs outweigh the benefits. With a diverse shareholder base, it is likely that the costs of organization will be very large.[34] On the other hand, concentration into mutual funds will allow managerial control.[35]

Since, absent concentration in a fund, each Czech investor was given such a small endowment of each firm initially, the relative benefit of organization for any particular individual will be small. Given shareholders that are widely dispersed and the difficulty of collective action, it is unlikely that the relative benefit of organization for any particular individual would exceed the cost. The wide dispersion of shareholders results in no organizational activity or control. In fact, the problem with public ownership as noted in Alchain and Demsetz (1972)—that each citizen is an owner of a public firm and thus does not feel much individual responsibility—would continue. Thus, it is reasonable that Czech investor/citizens may have viewed their vouchers as a unit of capital and preferred to have it managed by an intermediary.[36]

Research on financial intermediation, such as Leland and Pyle (1977) and Boyd and Prescott (1986) predict the creation of mutual funds under this scenario. Campbell and Kracaw (1980) extend this work to argue that these funds would also need to provide other services as well for their existence to occur. Perhaps the most applicable work is by Diamond (1984), which points out that a financial intermediary will minimize the cost of monitoring information (or, in this case, gathering information or exercising control). Diversification within the intermediary helps lower these costs. He also notes the optimality of debt contracts within his model and that the intermediary will hold *illiquid* assets. He notes "The centralization of monitoring each loan by a single intermediary will mean that there are not active markets for these assets" (p. 410). Boycko *et al.* (1994) note that such intermediaries will be forced to monitor effectively as, due to illiquid markets, they cannot trade effectively.

The benefit to vouchers, therefore, is the ease with which financial intermediaries may be created to mitigate the cost of transacting and monitoring. While mutual funds may also be endogenously created if shares are freely distributed to citizens directly, the transaction costs of handling so many shares may inhibit their growth. Thus, while the creation of a voucher auction market creates additional fixed costs, it may reduce the cost of financial intermediation sufficiently to make voucher schemes less costly than other methods.[37] To the extent that it also allows a greater number of firms to be publicly traded, there may be positive informational and allocative externalities as well, as noted by Titman and Subrahmanyam (1997).

However, the ease with which financial institutions can be created may also be a potential source of trouble for voucher schemes.[38] The key to Leland and Pyle (1977), Campbell and Kracaw (1980), and Boyd and Prescott (1986) is that the monitor must invest his own capital, and will suffer losses for non-compliance. Likewise, the key to Diamond (1984), is the non-pecuniary penalties incurred by the monitor, such as jail or having his legs broken, if he fails to honor his obligations to his investors. Managers of financial intermediaries will over-promise if they suffer no losses for non-performance.[39]

Diamond (1984) demonstrates that when there are no penalties for non-performance, funds will compete for size, inducing fund managers to make promises that may only be fulfilled by achieving size alone. There is no disincentive to make such promises as there are no penalties for non-performance. Only a few funds, however, will achieve sufficient mass to fulfill their promises; the rest will default.[40] Therefore, it is essential for this program to work that there are established legal regulatory enforcement mechanisms in place to assure non-pecuniary penalties (i.e. jail) for malfeasance on the part of the fund manager.

The experience with the voucher system in the former Czechoslovakia proves enlightening. As predicted, many mutual funds were created.[41] Most appear like the Diamond model, offering guarantees of fixed returns as high as 1000% for the deposit of vouchers, and the funds attracted a large portion of the outstanding vouchers.[42] However, the government had a great deal of leverage over such funds, partially by offering enough firms for the voucher auctions quickly enough so that the funds would have no problem meeting their promised returns, and partly by having state-owned banks offer similar funds with similar deals. Indeed, with the funds controlling so many of the vouchers and the government committed to releasing them for auction *at any price*, the funds could control the price at the auctions and therefore almost guarantee that they would be able to meet their commitments. The government, by committing itself to a rapid privatization process, therefore helped support these funds.

Speed, however, has its costs. The Czech economy is still reeling from its rapid privatization. Management problems still plague the funds and the companies in which they invested. Several of the banks themselves created investment funds which then accepted vouchers and thus now hold shares of the same companies to which they make loans. Due to the speed of the privatization, sufficient laws and regulatory bodies were not created before the distribution of shares to the intermediaries to prevent agency problems or to create open, clear and well-functioning securities markets.[43] Current attempts to rectify the problem *ex post* have proved insufficient. Consequently, capital is still deployed inefficiently. Privatization in the Czech Republic, while technically successful in moving share ownership from government to the private sector, has thus far fallen short of its main goal.[44]

Thus, while vouchers may lead to the endogenous creation of financial intermediaries, enforcement mechanisms are also required for financial intermediaries to function appropriately. No losses for non-performance encourage an inherent tendency to compete for size by over-promising, possible defaults by small funds and concentration of ownership by a few large funds. While comparatively successful, more oversight by the government and greater and more effective competition from state-run banks (which may have had an implicit government guarantee) would have resulted in a highly successful privatization program for the Czech Republic.

Albania Unfortunately, the transition from communist to capitalist has taken an ugly turn in Albania. The violence in the streets during the first quarter of 1997 was a result of the collapse of Ponzi schemes that had caused losses for many of Albanian citizens.[45] The origin of these Ponzi schemes was the result of the tight credit markets in Albania. Entrepreneurs, needing capital, were unable to get loans from the banks.[46] As noted by The Albanian Times (1996b), "Pyramid schemes began springing up about three years ago as young companies sought cash that the over-stretched banking system could not supply." Ponzi scheme hucksters stepped into the void, offering interest rates as high as 50% per month for short-term loans. Albanian citizens, anxious to escape the worst poverty in Europe, even sold their homes and cattle to give the Ponzi schemes as much cash as they had. Such a huge increase in cash flow toward financial assets caused a commercial crisis as retail sales plunged. Even worse, "[m]any Albanians working abroad send their wages home so their families can buy leks [the Albanian currency] to invest in the schemes", causing an otherwise inexplicable "dizzying rally by the lek against western currencies" in 1996 (Albanian Times, 1996b).

Such a failure of the market could be predicted by Diamond (1984). As noted above, Diamond (1984) predicts the creation of financial intermediaries in such an instance, where both the investment (by the Albanian citizens) and the loan (to the Albanian companies) are in the form of a debt interest. However, as Diamond notes, non-pecuniary penalties must be in place to prevent false claims and promises by the intermediary. In well-functioning markets, the government, through regulation, supervision and monitoring provides such oversight, requiring capital on the part of the financial intermediary as in Leland and Pyle (1977) and Boyd and Prescott (1986), and providing jail sentences as in Diamond (1984), to ensure compliance and prevent malfeasance.

Unfortunately, the Albanian government did neither, idly standing by. According to the Albanian Times, "[t]he government has said it is *looking* into ways of controlling the schemes, but so far has *taken little action*..." (emphasis added). Three years after the Ponzi schemes started, "Albania's parliament has set up an independent committee of economic experts to gather information on the pyramid schemes and report their findings to parliament" (Albanian Times, Dec. 17, 1996), a classic example of too little, too late.[47]

This unfortunate result indicates the need for security laws and financial regulation to be in place before the execution of complicated privatization schemes. Economic issues, be they microeconomic, such as privatizing the economy via voucher systems, or more macroeconomic, such as tightening credit markets, require a well-regulated, fair, and well-capitalized market to ensure ultimate success. To be sure, the Albanian economy did not start with many advantages. However, the Albanian people needed the legal protection and oversight of the government to enable them to take advantage of all that capitalism has to offer. Often overlooked, securities laws and regulation help prevent massive societal dislocations caused by malfeasance. While some economists may argue that when uninformed or over-trusting citizens lose their money the appropriate economic equilibrium results, it is not a stable political equilibrium. (While Keynes noted that "in the long run, we are all dead", this was not his prescription for the short run.)

As a result of these Ponzi schemes, Albania has not yet executed its voucher privatization. It is uncertain if the endogenously created mutual funds that arose in the Czech Republic will be replicated in a country that has already had such disappointment with endogenously created financial intermediaries. As noted earlier, the Albanian privatization program was not going smoothly before the current collapse; it is debatable when, if ever, it will be able to resume.

The situation in Albania has continued to deteriorate. The government's failure to act to make laws to insure a successful transition has resulted in its inability to act at all. As noted in the Economist (1997a), "Parliamentary elections in late June and early July were supposed to be a first step towards bringing order back to Albania. Since then the country has become, if anything, even more lawless. criminal gangs that had split much of the country into fiefs are free again to feud. Bandits flourish. Roads kept open by the foreign troops are again dangerous." Without its ability to impose law, the government is powerless to restore normality, let alone to promote economic recovery.[48] As noted by the Economist (1997a), "...without order, donors will withhold large-scale aid, businesses will not function and taxes will stay uncollected. The outlook, though it could be worse, is still treacherous."

Thus, while issues predicted by finance theory aided privatization in the Czech Republic, ignoring the same theories plagued privatization in Albania. The pursuit of tight official credit markets coupled with the lack of supervision of unofficial ones gave rise to predictable Ponzi schemes. Western economists should view the collapse of Albania as completely predictable and preventable. Part of the culpability of the current crisis may be left on western institutions to the extent that they urged such a tight monetary policy without simultaneously requiring the development of strict laws and enforcement mechanisms. Economists trained in legal and financial intermediation theory could have predicted and prevented such carnage.

CONCLUSION

Albania and the Czech Republic are lessons in what can go right and what can go wrong in economies transitioning from communist to capitalist. The primary difference between the experiences between the two are the legal and regulatory frameworks which surrounded their privatization, as well as the initial condition in which each found themselves after the dissolution of the Warsaw Pact. For the Czech Republic, it inherited relatively good underlying assets, a proximity to major Western powers, and a tradition of capitalism prior to 1945. It then provided a good legal framework around which it rapidly privatized, allowing the development of successful mutual funds. The Czech Republic is now attempting to deal with problems related to its rapid success. Albania, on the other hand, reluctantly led into the Western world, inherited none of these factors. The poorest nation in Europe, it resisted the transition and, due to a lack of appropriate financial system development, devolved into civil unrest.

The results for both of these nations could have been predicted by academic financial intermediation literature, particularly Leland and Pyle (1977), Diamond (1984) and Boyd and Prescott (1986). The appropriate application of these theories would have predicted relative success in the Czech Republic and failure in Albania based on the value of their initial endowments and the legal systems both had in place. Other privatization research that was examined in developed or developing countries provided fewer insights due to the difference in the development of the securities laws in developing countries (which already have some public firms and thus some laws) and economies-in-transition.

Western advisory and lending institutions should therefore take note of both economic and legal settings, particularly as they relate to securities and financial intermediary regulation and supervision, prior to making recommendations to newly emerging economies. Some macroeconomic issues may need to wait for implementation until after certain legal and regulatory microeconomic issues have been resolved. As we have seen in Albania, failure to do so may have dire consequences for those involved.

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NOTES

1. See Vickers and Yarrow (1991).
2. Goldstein and Gultekin (1997) analyze the many variety of privatization proposals suggested for Eastern Europe. These proposals fall into various categories. The general fund scheme calls for the creation of a single, large mutual fund containing all of the shares of the privatized companies with the public holding the mutual fund shares. Other proposals call for the distribution of vouchers to be used to bid for the shares or even direct distribution of shares to the public. Some limited forms of financing have also been suggested, such as debt financing of shares similar to the leveraged buy-out (LBO) concept or employee stock ownership plan (ESOP) financing. Some others recommend privatizing the pension fund system in conjunction with other measures, such as increasing the role of the banking system. Goldstein and Gultekin (1997) examine three major categories of proposals and predict results based on finance theory. A description of many of these schemes suggested for Poland may be found in Gultekin and Wilson (1990). See Mendelson (1991, 1992) for other issues relating to Eastern European privatization.
3. According to Euromoney (1993), 'Albania is seeking to recover from nearly 50 years of isolation, xenophobia and dictatorship which gave it the lowest standard of living in Europe. Poverty and under-development were compounded by misguided attempts at industrialization; most of the old factory buildings now stand empty and vandalized. Moreover, when the former regime finally crumbled, it left chaos and disorder in its wake, including an empty treasury and acute shortages of food and other necessities.'
4. According to Gene Ruli, Albania's Minister of Finance, "... while other former members of the Communist bloc had initiated partial reforms or measures for one or two decades, we maintained the most rigid economy in the world up until the last day of the socialist regime... our infrastructure is the most backward and inefficient in eastern Europe." See Euromoney (1993).
5. As noted in Varian (1984), a competitive allocation is an allocation a and a price system p such that
   (1) firms maximize profits, i.e. y_f is the optimal solution to:

$C_f(p) = \max\ p * y_f$ s.t. $y_f \in Y_f$ for firms $f = 1..N$, and

(2) households maximize utility, i.e. given initial shareholdings s_{hf} and $C_f(p)$ and endowments e_h, consumption x_h is the optimal solution to:

$$\max u_h(x_h) \text{ s.t. } p * x_h = p * e_h + \sum_{f=1, h=1}^{N, M} s_{hf} * C_f(p)$$

(3) and markets clear, i.e. for goods $i = 1..\ L$,

$$\sum_h x_h^i \leq \sum_h e_h^i + \sum_f y_f^i.$$

6. Thus, privatization has the ultimate goal of increasing societal consumption by increasing the output of vastly under-utilized assets and by a more appropriate allocation of resources across these assets. These two changes occur in different markets. The first change, changing the control of the factors of production, occurs primarily in the labor markets. The second change, the reallocation of resources across assets, occurs in the capital markets. While some may argue that the change in control also occurs in the capital markets, this is only true to a limited extent. The capital markets do control the ownership of the assets. However, for most assets, the 'control' that matters is not as much the ownership but the management of the assets. These changes occur more often in the labor market, where laborers and managers are hired and fired. Most of the time, changes in control of the factors of production occur due to the firing of the CEO or other managers and the hiring of others. It is rare that a direct change in ownership is required, and even when ownership does change, the result is usually the changing of one manager for another. A takeover is not required to change control of the assets, just a change in the number and type managers and/or laborers. (This presumes, however, that the current owners are also interested in efficiently managing the assets—a tenuous assumption under communism.)
7. Titman and Subrahmanyam (1997) indicate that privatization may help the development of such markets by providing a critical mass of traded assets. Yeaple and Moskowitz (1995), however, cast doubt on the effectiveness of privatization in achieving this objective, noting that the academic literature has not yet definitively determined that privatization in countries with existing capital markets has further developed these markets.
8. Not all aspects of the potential for changes in control are good, however. Franks and Mayer (1990) note that with the possibility of takeovers, employees may reduce their firm-specific human capital investment and managers may shy away from long-term investment.
9. Fama (1980) notes that separation of ownership and control may be efficient in large corporations.
10. For example, Grossman and Hart (1988) note the free rider problem inherent with an atomized shareholder base. If shares are widely held such that the holdings of any individual agent are small, individual shareholders will not have the proper incentives to exercise their control and remove inefficient incumbent management. Grossman and Hart (1980) argue that the possibility of takeover bids will encourage existing management to realize higher values of the firm. If a takeover is impossible, however, due to the lack of trading, such an increase in the realization of the firm's value may not take place. Bagwell and Judd (1989) consider control issues relating to payout and investment decisions. They note that transaction costs of rebalancing portfolios are an important factor in the optimal decision rule. If transaction costs are small, than majority rule is optimal. If, however, trading is blocked due to high transaction costs, than a different rule is optimal. Their model indicates both that blocked trading affects the market for control and that control is important for issues beyond takeover situations. Conversely, if the market for control reaches equilibrium, it is possible that trading will cease and therefore although optimal control may have resulted, information as to the allocation of resources may not result as there may not be revealing prices. This is the case when there is a complete merger, takeover, or buyout. At this point, the shares of the initial firm are no longer available on the market, and therefore the resource allocation information contained in the price of these shares will not be made available to the general market.
11. Such extensive changes are not easily accomplished overnight. As noted in Goldstein and Gultekin (1997), the lack of a private sector—including market-oriented managers and accounting and reporting practices—as well as inadequate financial and corporate governance structures, combined with the general inefficient deployment of assets, monopolistic market structures and the overall size and scope of the privatization program, has inhibited its rapid implementation. Aghion (1993) notes that lack of managerial resources, costs, and administrative problems have also slowed the pace of privatization. Yet, due to political considerations, such delays may not be sub-optimal. Some, such as Dewatripont and Roland (1992a,b) and Roland (1993) argue for gradualism in the transition to market economies due to political considerations and to prevent the reversal by the current (or subsequent) government of reforms due to political pressures.
12. As noted in Roland (1993), to ameliorate such political concerns privatization programs may involve the free distribution of assets. Boycko *et al.* (1994) also note that the privatization proposals of many economies-in-transition initially called for the free distribution of assets (in combination with sales) of assets.
13. The Albanian Minister of Finance noted "It is necessary to diminish state ownership as soon as possible because during this transition period the

state-owned sector has deteriorated rather than improved in production and management. I believe that it is necessary for the sector to fall under private ownership in order to operate profitably.'' See Euromoney (1993).

14. Euromoney (1993), when discussing Albania, reports that ''Europe's poorest country still faces immense challenges, including high unemployment, primitive infrastructure, chronic current-accounts deficits and large arrears on its foreign debt.''
15. Genc Ruli, the Minister of Finance of Albania, commented ''The banking sector was also in a state of disorder as banks had provided local enterprises with automatic lending without respecting economic criteria.'' See Euromoney (1993).
16. These capital constraints were not ameliorated by outside (foreign) money as many countries imposed limitations on foreign ownership as part of their privatization plan. These limitations follow naturally from the above theory in that foreigners are likely to have more wealth than the indigenous population. Barring any legal constraints, it is likely that there would be a massive intertemporal transfer of wealth and consumption from the local population to the foreign population, resulting in foreign ownership of the majority of assets in the country. While there are many potential benefits of such a structure (due to more effective management techniques, industry expertise, information acquisition abilities, and optimal intertemporal transfer opportunities), the political cost of such a transfer was deemed to outweigh such benefits by most countries.
17. Some tight credit markets, such as those in Albania, were by design. Euromoney (1993) noted Albania's ''relatively tight monetary and credit policies.''
18. One Czech fund manager, when discussing issues related to privatization, noted ''the figures for one thing were ridiculously out of date'' (Eade 1994).
19. Eade (1994), when discussing the Czech Republic, noted that due to the poor quality of the data ''there was little point in the [Czech privatization mutual] funds being over-scientific.'' One fund manager noted that ''the quality of financial results is so misleading that we can't very well use them to make investment decisions.''
20. Another danger is volatility and market thinness. Pagano (1989) also warns of market breakdown due to the mixture of high volatility and high transaction costs. He notes ''thinness and the related price volatility may become joint self-perpetuating features of an equity market, irrespective of the volatility of asset fundamentals.''
21. In Grossman and Stiglitz (1980), the number of informed traders is endogenously determined based on the cost of acquiring such information. The cost of information could be very high and its quality low. Therefore, with the possible exception of management, it is likely that there will be few, if any, informed traders in the market. More accurately, the relative asymmetry in information between market participants will be low since the quality of information is so poor and the cost of accumulating information is so high. Thus, there will be little information accumulation, price system will not be informative and the markets will be very thin due to high information costs. Of course, some members of society may be able to accumulate information on a limited number of companies via a variety of means (outside of official channels). Most, however, will not be able to do so. Under classic asymmetric information theory, a knowledgeable few would be sufficient to achieve a number of socially beneficial results (such as accurate pricing); however, this requires that the individuals have easy access to large amounts of capital, which is or was not the case in the initial stages of privatization in post-communist countries.
22. See US Department of State (1995b).
23. Likewise, voucher schemes do not require auctions. For example, as noted in Goldstein and Gultekin (1997), ''... distributing vouchers which can only be tendered one-for-one for specific shares is identical to simply distributing the shares themselves with one additional step in the process. If vouchers with a nominal value are distributed which may be tendered for a variety of shares that will be offered without an auction process, the government is actually attempting a typical initial public offering (IPO) process. Such IPO processes may accept either both cash and vouchers or just vouchers alone. In either case, the government will need to price the shares before the IPO and over- and under-subscriptions may result from under- or over-pricing. For this reason, distribution methods using auctions have been suggested in order to avoid the necessity of developing a mechanism to determine share allocation.'' Boycko *et al.* (1994) discuss voucher design, including whether vouchers should be denominated in points vs currency, whether vouchers should be tradable or not, and the benefits of voucher auctions. in political and economic terms.
24. Bolton and Roland (1992), Van Wijnbergen (1992) and Aghion (1993), have called for non-cash auctions.
25. See US Department of State (1995b).
26. See Nellis (1990) for a description of the Czechoslovakian scheme before its implementation.
27. Goldstein and Gultekin (1997) note ''While voucher auctions may be intuitively appealing because the process seems competitive, the emerging results are not necessarily relative prices. Establishing relative prices still requires an investment in information and creating ingenious auction schemes that mimic the role of money. Short of this, voucher auctions become an arbitrary allocation scheme. The problems associated with a low level of information continue to apply to voucher auctions as they do to any other distribution mechanisms. Unless there is substantial investment in information, auctions do not solve the problem of valuation.''
28. Recall again that Eade (1994) noted that the fund manager of the top-performing Czech fund felt that ''as far as initial stock-picking is concerned, there is little point in the funds being over-scientific'' due to the poor quality of the data available.

29. See US Department of State (1995a), which reports on "Future Investment Prospects in Albania", an international investment conference. G-24 co-chairman and director of DGLA of the European Commision P. Benavides Salas commented "... a number of foreign investors indicated that they were experiencing practical difficulties relating to the interpretation and implementation of the legal, fiscal, and administrative frameworks. This is an area which requires serious attention and prompt action by the government..."
30. In an article just before the first auction for 1,200 firms occurred, Economist (1992) noted that one of the major changes to the privatization scheme in Czechoslovakia is "... private investment funds will dominate the auctions—a development that has taken the government by surprise."
31. Boycko *et al.* (1994) note that the creation of financial intermediaries was encouraged by the Czech and Russian privatization programs. They note that one benefit of such financial intermediaries is that they will accumulate sufficient shares to become a core investor, and thus help alleviate corporate governance concerns that accompany diverse ownership. Boycko *et al.* (1994) also note that governments can encourage outsiders to get large blocks to alleviate the governance problem, as was done in Czechoslovakia and Russia.
32. In general, voucher systems encourage specialization, since, as shown above, those who concentrate their bidding will be more likely to receive the shares, or, in fact, any shares at all. This will increase investors' idiosyncratic risk. On the other hand, voucher schemes may be appropriate for privatization which include all state-owned assets, and not just the largest of the state-owned enterprises, as some individuals may use their vouchers to purchase a small store or enterprise in its entirety. This action may be privately optimal for the individual involved if he/she receives some additional benefit, as in Grossman and Hart (1980), as it is, in effect, a takeover of the small enterprise. Winton (1993) indicates that for certain firms large investor claims will provide optimal monitoring and control, resulting in optimal managerial effort. In fact, Winton (1993) shows that under certain conditions, unlimited liability ownership forms, such as a sole proprietorship or a partnership, are more optimal than limited liability forms, such as a corporate form with limited liability.

    While one benefit of this method of privatization is that it will allow optimal ownership of small businesses, and will allow governments to structure such ownership in an optimal manner, other methods of privatization do this as well. In particular, privatization schemes that use vouchers with a fixed nominal value would also work, as well as schemes that incorporate ESOPs or LBOs. As noted by Vuylsteke (1990) and Hinds (1990), a mixed strategy calls for separate privatization forms for large and small companies are optimal as they would also achieve this result. The auction process itself is not a necessary component of deriving the benefit noted in Winton (1993).
33. As the top performing Czech fund manager explained, "investing through funds is so much easier mechanically. It's hard enough for us to get reliable information on companies, but near impossible if you're an individual investor. You also have the advantage of diversification which spreads the risk" (Eade, 1994).
34. In addition, no one shareholder has any incentive to incur such costs, since, as Grossman and Hart (1980) note: "The proper management of a common property is a public good to all owners of the property... If one small shareholder devotes resources to improving management, then all shareholders benefit." (p. 59).
35. Eade (1994) notes "as the stakes in certain companies held by these funds grow, so does their influence over restructuring heavily over-manned Czech industries." One fund manager noted that the issue of corporate governance poses a dilemma, as he felt portfolio management must be the primary role of the funds. However, he went on to note "none the less I think we do have to get involved—we can't afford to act purely as portfolio managers. Before privatization thee companies had been without management for over two years." Another fund manager concurred, noting "we're taking very much a long-term view, backing certain sectors and working with management of those companies to help them move forward."
36. Such developments are not unprecedented in Western markets either. One Czech fund manager noted that the same thing occurred in the UK in the early 1900s. "These are classic Edinburgh-style closed-ended investment trusts" (see Eade, 1994).
37. A problem with arguments for the development of financial intermediaries is that non-tendering shareholders will also benefit from any steps that the financial intermediary might take to improve the earning potential of the firm, as noted in Grossman and Hart (1980). As the investors already own shares in the firm at no cost to themselves, they can "mimic" the holdings of the financial intermediary in the sense of Campbell and Kracaw (1980) merely by following a buy-and-hold strategy. Therefore, as noted by Campbell and Kracaw (1980) or Grossman and Hart (1980), it is necessary that financial intermediary owners receive some private benefit from owning the financial intermediary, either due to management contracts of the financial intermediary with the firm or due to other services the financial intermediary can provide. Otherwise, no one will tender their shares to a financial intermediary and will instead simply hold their portfolio, partially because brokerage costs prohibit them from selling their shares. However, the use of vouchers should allow the low cost development of financial intermediaries if one can assign them before the auction takes place.

38. Other dangers include a reversion to the inefficient ways of the past. Boycko *et al*. (1994) note that there is a danger that such funds, instead of overseeing and monitoring managers, could instead become "lobbyists for state credits and subsidies" for the firms.
39. It is debatable, however, that the managers were overpromising returns. The returns were conditional on the success of the voucher privatization and seemed relatively secure based on the initial valuation. Economist (1992) notes that "An advertising blitz... by the astutely named Harvard Capital and Consulting... saved the entire voucher scheme from oblivion. The Harvard fund pledged to pay people at least ten times their 1035 koruna investment for their voucher points a year after shares began trading. Since each voucher booklet represented a claim on assests worth 25 000–80 000 koruna, this was not a nonsensical offer—provided, of course, that the scheme worked, that the shares became tradable, and that the asset valuations meant something."
40. Eade (1994) reports "Some investors are still awaiting the promised payout. [The head of Harvard Capital] is now said to be ill and recuperating in Switzerland, amid rumours that the secret police attempted to blackmail him... Scandals aplenty surroun[d] the fund business, along with allegations of non-disclosure..." One fund manager said "many people were disappointed with their experiences in the first wave... many [said] they did not even know the results of the first wave yet."
41. Economist (1992) states "[a] horde of other funds followed in Harvard's footsteps, including those run by state-owned commercial banks, nearly all offering similar, or even more generous guarantees... 437 funds have collected two-thirds of all voucher points."
42. Eade (1994) reports "During the first wave a plethora of funds persuaded 72% of the 8.5 million financially-naive Czech and Slovak voucher holders to invest through these vehicles."
43. The opaque stock market attracts little foreign investment. Economist (1997b) notes "…little progress has been made with another vital reform: making more open a stockmarket [sic] so murky that few foreigners dare invest in it."
44. Economist (1997b) states "The heart of the problem was a sloppy mass privatisation, which in theory handed ownership of thousands of firms to citizens but actually left them to be mismanaged by bank-controlled investment funds, which gained control of most of the shares. [A]ttempts to undo the damage by belatedly creating the institutions and rules of a mature market economy are not working. [The] first target ought to be the links between banks and investment funds, which together siphon off profits from good companies and prop up bad ones with loans. Until they are snapped, Czech industry will not be restructured."
45. Dealing with the internal strife caused by the Ponzi schemes continues to plague Albania. According to the Economist (1997a), Neritan Ceka, the Interior Minister is still struggling with "... pacifying Albania's southern towns, where the anarchy unleashed by the collapse of pyramid investment schemes turned into rule by criminals."
46. The banks were not sufficiently capitalized to help without government assistance. As noted in the Albanian Times on December 17, 1996, "Bank privatization in Albania has been seriously hampered by the inability of a sizable share of clients to pay back their loans." The November 1996 issue of the Albanian Times noted "... despite urgent cash demands by Albanian and foreign investors operating in Albania" the banks would not be privatized soon (Albanian Times, 1996a). The Director of the Savings Banks of Albania noted "Management is the key for running a bank and presently there are no banking managers."
47. On the other hand, the Albanian Times itself did not take the lead in advising citizens of the dangers. In the November issue of the Albanian Times, it dryly noted that "[o]pinions are divided on where the companies find the cash to repay their creditors."
48. As the Economist (1997a) notes, "The government must quickly set about controlling inflation, cutting the budget deficit and cleaning up a hideous financial mess. But, above all, [if] must re-impose a rule of law."

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