Industrial and Corporate Change, Volume 11, Number 1, pp. 1–37

# Capital market development and mass privatization are logical contradictions: lessons from Russia and the Czech Republic

**Bruce Kogut and Andrew Spicer**

The introduction of mass privatization policies in Russia and the Czech Republic depended on the creation of impersonal capital markets to finance the needs of privatized companies and to provide a secondary market for the trading of securities. Yet, mass privatization created the contradictory conditions of generating millions of poorly informed shareholders, with no efficient markets for the sale of the shares. The absence of financial markets created systematic pressures to move assets by illegal or non-transparent means to users who value them more. Privatization created the incentives to destroy the financial markets critical to its success. A comparative case analysis of post-privatization market formation in both these countries demonstrates that the functional necessity for these markets does not engender their own creation. In the absence of institutional mechanisms of state regulation and trust, markets become arenas for political contests and economic manipulation. The irony of these policies is that a principal lesson has been that market reforms cannot create viable markets, only institutional formation can.

## 1. Introduction

The decisions to privatize Russian and Czech industry in the period from 1992 to 1994 constitute a unique experiment for the understanding of the relationship of markets, organizations and institutions. These policies of mass privatization were predicated on the presumption that private enterprises would be subject to superior governance properties due to interested external shareholders with access to capital markets. These capital markets provide not only information through price movements, standardized reports and investment research, but they also allow investors to exit as owners from companies they regard as unattractive.

Capital markets arose spontaneously following mass privatization in both countries. In Russia, 56 stock markets received government licenses by the end of 1995, one year after the end of the privatization program (Goskomstat, 1996). Moreover, international aid and advisers sought to foster capital market development through the provision of

**Table 1** Percentage changes in official GDP, 1991–1997

| Country | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| China | 7.7 | 12.8 | 13.4 | 12.6 | 10.5 | 9.7 | 8.8 |
| Czech Republic | – | –4.1 | 1.0 | 5.6 | 5.0 | 4.4 | 1.0 |
| Hungary | –6.8 | –0.6 | 1.3 | 6.1 | 1.5 | 0.6 | 4.4 |
| Poland | –7.6 | 5.3 | 6.1 | 8.3 | 6.5 | 6.0 | 6.9 |
| Russia | –5.0 | –14.5 | –8.7 | –12.6 | –4.1 | –4.9 | 0.8 |

Sources: Data for former Soviet Bloc countries, 1991–1996 are from Goldman (1997); 1997 data are from the World Bank (1998); Chinese data are from IMF (1998).

the technologies for institution creation, e.g. the principles of registration and deposit of securities. Although the Czech Republic took a more independent route, the financial markets of Western countries acted as powerful cognitive templates for the design of similar markets.

By 1998, the economies of Russia and the Czech Republic had seriously underperformed those of comparable countries. Table 1 presents economic data for five countries. Due to their historical and economic similarities, the two countries of particular relevance are Poland and Hungary. China represents a more distant benchmark of a poor, rural nation that has followed policies of 'gradualism' in its move towards a market economy. Only Russia and the Czech Republic followed policies of speedy, mass privatization. These data do not provide causality by an application of inductive logic; there are too many sources of causation to make confidently such an inference. However, there is little doubt that mass privatization has not created sustained levels of high economic growth and that the development of capital markets has also disappointed expectations.

We present below an analysis of mass privatization that takes into account micro-level contradictions in the policies to create markets. In this regard, we propose that the presumption of the governance advantages of private ownership was, above all, faulty in its own logic. The dynamics of financial market creation ride upon the success to reconstitute institutions that support impersonal trust among market participants. Yet, the fragility of the formation of markets is susceptible to erosion of trust in their operations if entrepreneurs should abuse the public good of institutions.

It is paramount to realize that mass privatization itself engendered massive incentives for the theft of property. On the one hand, it was the desired outcome of privatization that assets should be purchased by entrepreneurs who valued their ownership and control. There was no mechanism, however, by which shares could be purchased in efficient markets. By distributing shares to millions of poorly informed shareholders who could not transact in the existing financial markets, a class of entrepreneurs who placed a higher value on these assets than existing operators in

control strove to acquire these assets by extra-legal means. It is not simply that laws did not exist, it is that mass privatization in emerging and transition economies is logically flawed.

This paradox of the desirability of entrepreneurial ambition to propel economic reforms and the danger of abusive erosion of nascent institutions is a conundrum common to many transition and emerging countries. The conditions of radical economic change generate unusual opportunities for highly motivated individuals to profit from these circumstances. However, in the absence of established institutions, the economic incentive for many of these actors is not to develop the long-term market institutions that foster economic development. Instead, self-interested behavior leads to short-term manipulations of emerging markets that results in growing distrust of market exchange. In effect, the outcomes of mass privatization in both these countries confirm Polanyi's (1957) injunction that markets do not create institutions so much as institutions create markets.

John Coffee (1999) notes that there is a paradigm shift in the way financial economics views corporate governance, with law rising to primacy. To Johnson and his collaborators, the problem lies in the defects of civil law versus common law (Johnson *et al.*, 2000). Whereas civil and common law surely reflect societal and economic differences, it is hard to accept this argument given the existence proof that many civil law countries are wealthy. Evidence of convergence toward common law still does not dispel this contradiction. In fact, law itself did not seem to be influential in the Czech or Russian case. Coffee (1999) notes that

> Russian corporate law has largely borrowed (in a simplified fashion) the principal features and protections of US and UK corporate law. Apparently, expropriation can occur even when the law 'on the books' is nearly optimal. Perhaps, this should not surprise us for most of the 20th century that the 'law on the books' is often different from, and less important than, the 'law in practice.'[1]

Another way to recast this paradigm shift, then, is to view it as an admission that the state and society matter. In part, the role of the state is masked in the discussion in the new thinking of privatization under the rubric of regulation. In fact, those that advocated the 'depoliticization' of the economy are now calling attention to the success of the Polish privatization program that, because it was less radical, allowed for the *simultaneous* creation of regulatory mechanisms to safeguard the operations of financial markets.[2] Yet, these studies that call attention to law barely ask the question whether a weak state can staff and finance the court system, monitor and enforce

[1]See Pistor (1999) for a similar emphasis on security market regulation, not law, as critical.

[2]See Boycko *et al.* (1995) on depoliticization. Johnson and Shleifer (1999) count the number of regulations in Poland to argue that regulation was the driver of economic performance in Poland relative to the Czech Republic. Their earlier thesis of civil and common law is dropped by and large, as these two countries do not differ greatly in their corporate law. Leaving aside the malleability of their

securities regulation, and effect tax payments and enforcement. Or whether the production of law and regulations is itself a reflection of a state that is sufficiently strong to regulate and enforce? Or is it the belief that a judiciary, with a weak state, is adequate for financial markets? If so, then what stops the abuse of judicial power or enforces judicial decisions? In other words, the thinking about financial regulation has *implicitly* moved from the question of whether there should be a strong state, but rather what kind of state in what kind of society.

There exists already a literature, even when the focus is only on privatization and the transformation of post-socialist countries, that argues that economic policies are implemented in the context of existing institutional and social relations. As argued by the works of Nee (1989), Stark (1996), McDermott (1998), Murrell (1995), Spicer (1998), and Kogut and Zander (2000), the collapse of socialism did not present a *tabula rasa* to policy-makers. Rather, the privatized firms consisted of distinctive internal and inert resources (e.g. workers, technologies). As importantly, these firms participated in industrial networks inherited from the previous regime. In Stark's (1996) powerful phrasing, transformation does not begin from but *with the existing ruins of socialism*. It is fair to say that the recent rethinking of the impotence of the 'law on the books' versus the salience of the 'law in practice' is a recognition that behaviors largely grow in continuity with existing social and political institutions.

We adopt this institutional perspective of economic sociology to argue that privatization failed in three regards. First, privatization cannot itself engender financial markets that are critical to selling ownership to those who value control. Markets, in our view, play secondarily a role for exercising corporate governance, but by their first-order effects, provide legitimate mechanisms to sell and buy assets. If there are no markets, then the disparity between the value of the assets to current owners and those who seek ownership leads to illegitimate means to acquire control. Second, the efforts by actors, such as the World Bank, to provide 'technical assistance' are inadequate to bootstrap market creation in the absence of generalized beliefs and state enforcement supporting financial market development. Third, the weakness of markets and the state lead to solutions by private-ordering. In the case of weak law and state powers, such an ordering proceeds by the formation of concentrated industrial interests to wrest control. Whereas this solution might well dominate the alternative of the status quo of weak owners and no financial markets, it represents not only the denigration of financial market development, but also poses the question of the legitimacy of 'who' owns. This question of 'who' owns is not an economic issue, but ultimately a social and political one. Thus, the decision to privatize has ironically less to do with economic development than the political question of who owns.

The analysis presented in this paper follows the above summary in first establishing the effects of the policies, then the description of the efforts to build markets, and finally a discussion of the formation of industrial and financial groups. To provide clarity, we

arguments, the structure is the same: law and regulations are exogenous causes for development, the state plays no role.

present the background of economic reforms before turning to an institutional analysis of the attempt to establish capital markets in Russia and the Czech Republic through privatization policies. In this analysis, we pay special attention to the micro-institutional factors (i.e. institutional technologies) that support a chain of trust that links buyers and sellers through impersonal exchange in financial markets. In the last section, we migrate from the level of markets to that of politics and the state to widen the perspective on why markets cannot be created in the absence of institutions and political guarantees. The conclusions of the paper argue for a set of normative conclusions in sharp contradiction to the economic policies of mass privatization adopted in these two countries.

## 2. Mass privatization policy

The development of capital markets has long been seen as a fundamental element for the growth of capitalist economies. The traditional view in the literature on economic development is that these markets act as intermediaries between the decision of a person to save and the decision of an entrepreneur to invest and as vehicles for the efficient allocation and diversification of risk. Modern financial economics has augmented this view by emphasizing the critical role played by capital markets for the provision of appropriate incentives for managers. Because investors desire the maximum return on their investment, they will actively monitor managers to ensure that they are acting in the interests of shareholders. The provision of capital, the transformation of risk and the monitoring of managers are the triple roles played by capital markets.

It is not surprising, then, that the immediate policy debate following the collapse of socialism focused on the privatization of state-owned enterprises and the creation of capital market incentives for managers. Two primary camps of thought, both emphasizing the creation of capital markets, marked this early debate. The first stressed that privatization posed primarily a problem of corporate governance. This approach engaged the critical issues of whether privatization should consist of the simple distribution of shares to the population, or should also entail the creation of mutual funds that could more effectively act as monitors. By and large the eventual consensus, perhaps best represented in Frydman and Rapaczynski (1994), was that private ownership without capital market corporate governance would be disastrous.

A second camp argued that privatization was above all a 'depoliticization' of the economy. This camp, whose view is best expressed in Boycko *et al.* (1995), concluded that the primacy of removing control from the state dictated a need to provide incentives for interested stakeholders (e.g. managers and workers) to support privatization by giving them considerable shares in the newly created private companies. The role of capital markets was less transparent, but still critical to the reasoning of the second camp. For through the creation of a secondary capital market for the trading of shares, managers and workers would be motivated to sell their holdings for reasons of consumption or for diversification. In addition, firms themselves would need to issue

**Table 2** Russian and Czech mass privatization programs

| | Russia (end of privatization) | Czech Republic (end of privatization) |
|---|---|---|
| Speed of mass privatization | October 1992–June 1994 | October 1991–March 1995 |
| New shareholders | 41 million (28% of population) | 8.5 million (80% of population) |
| Companies privatized | 16 642 (70–80% of industrial output) | 1849 (65–90% of industrial output) |
| Investment privatization funds | 596 | 550a |
| % of vouchers/points collected by funds | 23 | 68 |

Sources: Coffee (1996), Blasi *et al* (1997) and Frydman *et al.* (1996).

[a]Of the 550 investment privatization funds, 277 were organized as joint-stock companies and 273 were organized as unit funds. The data are from 30 May 1995, as reported in Podpiera (1996).

new equity to finance investment. Moreover, since outside investors (exclusive of the state) would hold a considerable minority positions, they would in any event be interested monitors through their board representation or shareholder meetings.

These two views strongly influenced the design of the privatization schemes in central and eastern Europe. Whereas Poland largely followed the prescriptions of the corporate governance model, the Czech Republic implicitly and Russia explicitly adopted a radical program to depoliticize ownership through a policy of mass privatization. Mass privatization consisted of the distribution of vouchers or points to the population who then could bid for the shares of state-owned enterprise. Given the need for speed and scope of the privatization efforts, and the lack of financial resources on part of the population, Western advisors argued that the free distribution of vouchers was a speedy, feasible and equitable method by which to undertake privatization (World Bank, 1996).

The Czech and Russian mass privatization programs are similar in their use of mass capital markets to assign property rights in former state-owned enterprises. As Table 2 illustrates, 41 million shareholders, 16 642 joint stock companies and 596 investment funds were privatized in Russia in a period of less than two years. In the Czech Republic, 8.5 million shareholders, 1849 joint stock companies and 550 investment funds were privatized in less than four years.

The Czech and Russian cases differed in a few critical aspects. Created prior to the Russian experiment, the Czech Republic program used a point system instead of vouchers.[3] Large-scale privatization consisted of two waves held during 1992 to 1994.

[3]The initial plan, and the so-called 'first wave' of privatization, took place prior to the break-up of Czechoslovakia into two countries. Our analysis is restricted to the Czech Republic. Excellent studies of the privatization process and the subsequent implications for corporate governance are Coffee (1996, 1998) and McDermott (1998).

Citizens could buy vouchers for prices representing about 25% of their monthly income. The bidding for shares was conducted through an electronic trading system, with terminals located throughout the country. Through several iterations, prices were adjusted with *ad hoc* intervention to clear the market.

The Czech authorities anticipated from the start the creation of investment funds and provided mild regulation, including restrictions on ownership of a company not to exceed 20% by any fund and also for the depository of shares operated by a bank. (A depository is required in order to receive dividends, pay transaction fees, etc.) Unlike Russia, the dominant Czech banks remained state-owned throughout the process. Their role as the primary source of capital gave them a more central role than banks in other central European countries; Czech firms had the highest debt/equity ratios in the region (McDermott, 1998). The state-owned banks own the largest funds, with a few prominent exceptions. In addition, the state is estimated to hold, on average, 28% of the equity in the privatized firms.

The growth of the investment funds, however, was not anticipated. Through their efforts and advertising, these funds increased dramatically the popular acceptance of the program. Though vouchers could not be traded on secondary markets, funds could purchase vouchers in exchange for shares in the funds; most funds were closed-end (meaning that they could be redeemed at their traded price, not their net asset value). The popularity of these funds can be seen in Table 2, where it is shown that they collected an estimated 68% of the points across the two waves of privatization. These data understate the high degree of concentration held by the largest funds; estimates show that the top nine investment firms held over 48% of the voucher funds, and six of these funds are held by state-owned financial institutions (Stark and Bruszt, 1998: 277). Since these funds also own shares in the sponsoring bank and other banks, the financial interests of the banks and enterprises are tightly intertwined (Coffee, 1996).

In Russia, enterprises voluntarily nominated themselves for privatization, first by becoming corporatized through the transfer of their ownership to the State Property Fund, headed by Anatoly Chubais. To make this voluntary decision attractive, the program offered three alternatives to the enterprises, all of which reserved a substantial allocation of shares for management and workers; on average, the state retained also 20% of the shares. As a consequence, only 29% of the shares of a company were on average auctioned (Blasi *et al.*, 1997).

The Russian program used vouchers that were purchased for a minimal price. These vouchers were bearer certificates, allowing for their sale to third parties or even their use as currency. These vouchers become the main medium through which privatization of state enterprises takes place. Ownership rights to newly privatized firms are assigned through voucher auctions, whereby investors use privatization vouchers to bid for different companies. Since there was no electronic trading system, actual purchases of shares had to be conducted at the physical site of the company. Russian firms were not required to issue certificates. The new owners' names are held in registries located in

thousands of locations throughout Russia, and the maintenance of these registries is the responsibility of the issuers, not stockholders.

Because many Russian citizens sold their vouchers for cash, only 28% of the eligible population are shareholders. During the first year of privatization, Russia passed legislation to permit the creation of investment funds. These funds, created as open joint stock companies, purchased vouchers from citizens in exchange for their shares. Voucher investment funds collected over 30 million privatization vouchers, or 23% of the 150 million vouchers distributed to Russians. At the end of privatization in July 1994, 596 voucher funds existed.

Thus, a major difference between the two country cases is the high ownership of shares by the Czech investment funds, many of which are controlled by the banks. In Russia, the high inside ownership and the active secondary market for vouchers allowed for the investment privatization funds to play a less important role in the post-privatization ownership structure than in the Czech Republic.

## 3. The institutional foundations of markets

Public accounts of the economic reasoning behind mass privatization policies in Russia and the Czech Republic focus on the role of private incentives and market exchange to drive the process of economic development. A leading policy adviser to the Russian government, Anders Aslund (1995) concluded that the fruits of markets reform and privatization were so immediate that Russia succeeded in creating a 'market economy' by 1995, only three years after the start of the privatization program. Other advisors posit that it was the 'belief in the preeminence of economic motives' as embodied in a theory of 'the Russian individual as homo economicus' that led Russian market reformers to implement their massive mass privatization program (Boycko *et al.*, 1995: 9, 49). The power of the market was similarly cited to justify the program in the Czech Republic. When asked about who will speculate on the stock exchange, Thomas Jezek, Czech Ministry of Privatization, said: 'It's sure that there is dirty money here, but the best method for cleaning the money is to let them invest it' (*New York Times*, 27 January 1991: 103, quoted in Stark and Bruszt, 1998: 221, n. 30).

These legitimating accounts of mass privatization are closely linked to a view of markets as natural phenomena that exist outside the social organization of the broader society. The intellectual roots of such an argument are described in Hirschman's (1977) analysis of the changing role of the concept of self-interest in explanations of social and economic institutions. Hirchsman notes that social theory at first focused on the inimical consequences of self-interest on socially beneficial goals, as conflicting desires led to a Hobbesian war of one against all. However, over time the concept of self-interest became tied to a broader conception of an invisible hand of a market that naturally mediated individual interests to reach collective goals. As seen from this natural market perspective, the challenge of mass privatization was to remove the state from control over economic affairs, allowing the forces of individual entrepreneurship to restructure

former state enterprises with little or no state interference. The invisible hand of the market would itself drive post-privatization economic development.

In practice, the naïve view of 'natural markets' put forth in some accounts of mass privatization policy was qualified by a subtle understanding that markets require themselves an institutional infrastructure (e.g. see Morgenstern, 1995; Pohl *et al.*, 1995). The Polish policy debate in particular cautioned against rapid privatization by vouchers due to the problems of uninformed investors (see Goldstein and Gultekin, 1998). An initial understanding of the institutional foundations of markets begins with the dominant approach in the new institutional economics that recognizes institutional qualifications to the natural market hypothesis. Institutions act as 'rules of the game' that define and order the broader action of the players who compete under these rules (North, 1990). These broader institutions help to overcome the inherent problems of exchange in markets characterized by imperfect information and individual opportunism.

However, many approaches in institutional economics maintain the idea of a 'natural' market as an idealized point of comparison. In less historically sensitive accounts, the theoretical question starts with the assumption that the 'market' is an initial state of nature troubled by transactional frictions. Institutions that define, monitor and enforce the property rights of organizations are the resolution to these frictions. Contextual factors influence the transaction costs to market exchanges, or in Williamson's (1991) phrasing, they act as 'shift parameters'. Yet, the market itself is theorized to drive the emergence of institutions to resolve hazards of exchange.

Economic sociology rejects this natural market approach, arguing broadly that economic behavior is conditioned by conceptions of social relations (Granovetter, 1985). Instead of assuming 'markets' as an ideal-type model existing outside of existing social relations, this approach examines markets as embedded in an existing political and social context (Biggart and Hamilton, 1992). It makes little sense to describe markets as 'first best' and varying institutional relations as 'second best'. Markets are always embedded in institutions. There is no atomistic market of textbook theory, because such markets cannot be observed in practice.

Even if more transactional than most markets, capital markets rely no less upon social networks and norms for their successful operation. Baker (1984) identifies the close personal ties that link groups of traders together into identifiable cliques through an analysis of the trading patterns of brokers on a national securities market. In a series of ethnographic studies in the stock, bond and futures markets on Wall Street, Abolafia (1996) demonstrates that actors who buy and sell in these markets are guided by numerous informal norms. Market exchanges developed routinized practices that allow for traders to engage in complex exchange based on verbal agreements and standardized contracts. Zelizer's (1978) study on the requirement for the cultural interpretation of death to change in order to support a market for life insurance similarly demonstrates the interconnections between market and beliefs. Markets do not spontaneously arise out a state of nature, but are closely linked to the social and political processes inherent in a particular time and place.

Problems of mass privatization are not abetted even when accompanied by formal laws of market ownership and exchange. The complementary political and social components of market exchange needed to transform 'laws on the books' to 'laws in practice' are missing. In the sections below, we expand on three aspects of the institutional foundations of markets that are lacking in the market environment in Russia and the Czech Republic following mass privatization: effective state powers to enforce basic laws and regulations, the operational technology to support trading between buyers and sellers, and a chain of trust to permit impersonal trading.

### *3.1 State powers*

The absence of state powers to regulate and control newly created market forces is considered desirable for the implementation of speedy mass privatization. The decentralization of an economy in a period of few years gives little time to develop new governmental mechanisms to regulate the new market system. Mass privatization therefore creates new private actors in the absence of the autonomous civil bureaucracy that Weber cited as critical in maintaining the legal framework that provides the background of predictability and control to Western market capitalism. As Evans (1995) succinctly summarizes, contemporary theories of the state in economic development have tempered Weber's emphasis on the state as autonomous from society by seeing state actors as embedded within a broader polity. There is still need for a strong state to provide a coherent and predictable political and administrative structure through which private market actors adjudicate and enforce both formal and informal contractual agreements. Thus, Stark and Bruszt (1998) conclude that market development requires a strong state and strong social actors.

The joint dependence of the state and society provides a different view on the institutional basis for capital market development. Not surprisingly, institutional economics has emphasized the rule of law over the intervention of the state, while the new institutionalism of sociology emphasizes the ancillary role played by social networks.[4] An example pertinent to financial markets is North and Weingast's (1989) argument that capital markets for public debt developed only when governments could credibly commit to honor their obligations, i.e. submit themselves to the rule of law. The institutional riposte to this study is Carruthers's (1996) analysis that cites evidence pointing to the role of social networks and political affiliation rather than credible commitment to law. The credible commitment of North and Weingast essentially poses a political analysis: when is a government credibly committed to respecting its own law? Carruther's argument is that this credibility exists only in terms of the political consensus. In a sense, ultimately, political society is what credibly commits a government to its announced policies.

The thesis of the strong state is problematic for the natural market view, especially for proponents who viewed privatization as an act of 'depoliticization'. A statist

[4]There is, though, a dissenting and influential minority in both camps. See Stiglitz (1994) and Amsden *et al.* (1994).

perspective highlights the role of political intermediation for the development of new markets and governmental structures. The states of the formally socialist countries entered the period of transition extremely weakened; the policies of mass privatization further weaken the state at the very moment of the creation of nascent capital markets. Exactly because of the absence of a strong state, the rule of law cannot be assumed to be effective in the post-privatization period, and, in fact, is itself prey to the political interests of competing groups. In any period of transformation, the profit resulting from private information can be considerable, not only for purposes of trading, but also for the acquisition and ownership of assets. Because of these political gains, entrepreneurial individuals are under massive incentives to organize political action that supports a favorable regulatory regime. Clearly, one cannot assume that these powerful interests prefer transparent capital markets. The dilemma is that the state is too weak to act as an independent, countervailing force against the emerging interests developed through market reform policy.

### *3.2 The institutional technology of micro-markets*

If government is not strong enough to create and enforce law, an important question in these societies is whether market participants themselves can construct self-regulating mechanisms to support market-enhancing rules and regulations.[5] Indeed, this is the Coasian perspective that the gains to mutual trade should lead to private solutions. Markets consist of numerous extra-statal technologies that enable self-regulating markets. The core of the qualified natural market thesis is the 'endogenous' resolution to the threats posed by informational hazards in capital market formations through the implementation of institutions to provide transparency, monitoring and enforcement.

For instance, financial markets consist of mechanisms, which we label 'institutional technologies', that strengthen property rights, provide verifiable information on prices, and monitor and enforce in order to produce institutional trust. This technology includes the registries that record ownership claims to shares, the depositories that permit the clearance and settlement of shares, the broker/dealer licensing that restricts entry to individuals who meet certain financial and fiduciary standards, and the stock market regulation that establishes criteria for the creation of such markets as well as for the requirements to list a company's shares. The 'technical assistance' by international organizations, such as the World Bank, AID, British Knowhow Fund or EBRD, is often the transfer of these institutional technologies to emerging and transition economies.

Part of the argument for distributing privatization vouchers/points through investment fund organizations was that these private actors themselves could solve problems of information, monitoring and exchange that small-shareholders could not (Phelps *et al.*, 1993; Lieberman *et al.*, 1995). Moreover, international organizations provided strong technical assistance in the post-privatization environment to try to create new institutional technologies in the emerging capital markets. However, these

[5]See Ostrom (1990) for a criticism of the Hobbesian state as a resolution to collective action dilemmas, and for the analysis of 'constitutional' influences on the incentives for self-regulation.

efforts only highlight the fact that none of this micro-market infrastructure existed prior to mass privatization in either Russia or the Czech Republic. Brokers, dealers, investment funds, stock markets, registries and depositories all needed to be formed in an extremely rapid manner to meet the forced demand of the mass privatization experiment. However, whether the organizations designed to operate with privatization vouchers could transform into viable financial entities and markets in the post-privatization environment was an untested component of mass privatization policy.

### *3.3 The chains of trust*

One of the puzzles in economic theory is understanding why people do not always follow their self-interest. For example, the transfer of institutional technology to bootstrap markets often seeks to resolve the free-rider dilemma so heavily emphasized by Olson (1965) and Ostrom (1990). Why should participants pay dues or contribute effort to the public good of self-regulation? Yet, it is easy to observe from everyday transactions that people conform to social norms, even when the probability of being sanctioned for defection is low.

In Western capital markets, people live by 'taken for granted' beliefs that if they invest, they will receive a future fair return. This is an extraordinary belief when we consider the number of intermediaries to many transactions. Intermediation, as one of the key functions played by financial markets, operates on the principle that savers postpone their consumption by *trusting* their money for investment by others. Institutional trust—to use Zucker's (1986) useful phrase—is based on a confidence in the workings of a complex institutional environment designed to minimize the opportunities for fraud and theft in complex economic exchange. In a passage of particular relevance to contemporary Russia, Shapiro (1987: 630) makes a similar observation in her analysis of impersonal trust, noting that in the breakdown of institutions, individuals may prefer to 'keep their money in mattresses, literally and figuratively—fearful of future transactions and cautious about transforming their tangible property into a symbolic share of collectivized wealth'.

The state and institutional technology play an important role in developing the regulatory framework to protect fair rules of the game. The state cannot, however, dictate trust, nor can the transfer of institutional technology itself assuage a wary public. States may define standards of normative and legal behavior, and institutional technologies may provide a basic blueprint of regulatory oversight. Yet, nevertheless, the foundation of voluntary market exchange rests ultimately on the individual beliefs of investors that the broader institutional system works in practice to protect their investments.

It is important, as a consequence, to distinguish between the 'background' knowledge that actors need to perform competently from the 'constitutive' knowledge of how the game should be played (Zucker, 1986). The common error in looking at the adoption of capitalism is to focus on whether people were competent in responding to price changes or in pursuing profits. But for functioning capitalistic markets to exist,

there has to be a constitutive knowledge of what constitutes the rules of the game. This point derives from Durkheim's (1922/1984) seminal insight that contractual obligations require non-contractual understandings. It is not law that enforces the quotidian operations of a market, or even regulation; it is the constitutive knowledge by actors of the institutionalized rules of the game.

In this regard, it is fundamental that an important dilemma in mass privatization policies was the absence in both Russia and the Czech Republic of a previous history in impersonal exchange through financial markets. The potential to build upon the existing ruins of socialism did not exist for the new markets. As a result, the creation of financial markets was a radically different problem to privatization and restructuring. Although the socialist economies developed extensive bank and enterprise ties, they had no markets, or institutional experiences, for the issuing and trading of certificates of ownership, namely stocks. Yet, it was the development of such markets that was critical to the success of the policies of mass privatization.

From this perspective, the introduction of financial markets in Russia and the Czech Republic was hampered not only by the absence of regulatory and intermediary organizations, but also by the fragility of expectations held by market participants due to the disruption in socially grounded knowledge. The millions of new shareholders had little idea of how to evaluate and monitor the activities of the companies or funds that controlled the property rights that they had received in the privatization process. The emergence of a new set of beliefs and expectations about market operations and functions therefore was endogenous to the process of capital market formation. The initial experiences of market exchange as defined through the mass privatization process provide a powerful template upon which initial beliefs are formed.

To understand the systemic linkage between the factors described above, consider first the representative beliefs in a socialist economy before the transformation. Almost all studies of the socialist economies point to the myth of a centrally planned economy. Rather, these economies were characterized by bargaining, whether in the setting of targets, in the provision of supplies to downstream firms, or in the agreement struck between workers and managers. In Kornai's (1980) influential analysis, these were supply-constrained economies characterized by chronic shortages. As a consequence, black markets were a critical element to the socialist period, and daily experience in the bartering over luxury and necessity goods was a taken-for-granted behavior (Stark, 1989; Ledeneva, 1998). It simply is not true that socialism lacked experience in the most basic of market transactions, namely barter. The early prediction by Burawoy and Krotov (1992) that the transformation would move toward merchant capitalism was based on the recognition of these initial conditions.

In the context of firm relations, these bargaining relationships were encapsulated in partly formalized, partly informalized entities. Most of the advanced socialist countries during the 1970s attempted to resolve the bargaining impasses by giving authority to central enterprises responsible for associated supplier firms. The findings of Stark (1996) and McDermott (1998) indicate that enterprise ties in Hungary and the Czech

Republic are a re-creation of the institutionalized patterns of behavior during the socialist era.

However, a key difference between the socialist and capitalist economies—apart from the powerful role played by competition—is the relative importance of impersonal exchange in financial markets. As Granovetter (1985) has remarked in general, and Baker (1984) has observed even for most transaction-oriented settings of capital markets, economic behavior is couched in a nexus of social relations. Yet, the prevalent perception of participants outside the inner trading market is of a transaction marked by an impersonal exchange, for the identity of the buyer or seller is unknown to each other. Impersonal transaction is viable because the institutionalized anticipation is that behavior is relatively predictable and that means-ends relationships are understood. These taken-for-granted anticipations of the wider market participants are the foundation of the willingness to use credit cards, to allow liens to establish credit in mortgage markets, and to purchase items by phone or via the internet.

In this wider perspective, financial market formation consists of the creation of a trading community regulated by both formal and informal mechanisms. Participants engage in a series of transactions enacted through a chain of trust. This chain of trust consists of the links that extend from the buyer of a security, to the intermediation by agents and other intermediaries that enact the transaction, to the seller; and vice versa. External to this community are market participants who accredit impersonal trust to a financial market that rides, ironically, upon the quality of personal trust among traders, brokers and financial entities. Financial markets are more than 'intermediaries', as classically described by economic treatments, between savers and ultimately investors in physical capital. They are arenas in which trust is so routinized that verbal agreements are held to be binding.

For this reason, the historical absence of financial markets in socialist economies is a fundamental starting point for the analysis of the formation of new social, as well as economic, organization. Given this absence of existing market institutions, the attempts to create impersonal financial markets were always subject to competing institutional solutions offered by powerful actors, e.g. banks or investment funds, that were influenced by the new opportunities created by the collapse of the socialist regime. In this sense, the political efforts to establish financial markets and the strategies by powerful social interests represent, in Fligstein's (1990, 1996) phrasing, competing conceptions of market control.

In the analysis below, we focus on the relationship among immediate market participants to generate the institutions required for institutionalized trust among investors. The provision of institutional technology is critical to the micro-foundations of trust and institutions, but the efficacy of these instruments is strongly impaired by the loss of credibility that should be infused in the market through government rule-setting and dominant market participants. This tension between competing conceptions of control expressed the stalemate among interests competing for ownership of privatized assets. Without embedded action or legitimate government

regulation, capital markets were a curious sideshow to the wider efforts to repossess the assets of the former socialist state by powerful private interests.

## 4. Research design

Our research design is a qualitative data methodology based upon Mill's notion of a method of agreement (Ragin 1987). By method of agreement—a standard methodology in comparative research—we wish to demonstrate that two countries sharing similar initial conditions, Russia and the Czech Republic, underwent a similar 'treatment' called mass privatization and experienced a similar result, namely fatal impediments to capital market formation. Method of agreement cannot establish causality, but it can reject causal claims.

Our argument is, clearly, not only inferential. We posit, deductively, that the reform policies were inherently flawed because privatization created intense pressure for assets to be transacted, and yet there were no institutional mechanisms by which to effect these transactions. The detailed history that we provide seeks to establish that the transfer of institutional technologies took place and still markets did not form due to the failure of state regulation and of political interests to support these developments. In the sense that these conclusions suggest normative statements, we are also joining organizational and institution theory to the debate on mass privatization policies that have been dominated by economic analysis.

The data for this study are mainly derived from interviews in Russia and the Czech Republic held intermittently during the period 1994–1997 (see the Appendix). The interviews were conducted with government officials, investment and commercial bankers, investment fund managers, multinational corporate managers, members of self-regulatory capital market groups, World Bank officials, and academic policy advisers. In Russia, over 150 interviews were conducted as part of a larger research project into post-privatization outcomes in this country, of which 21 were conducted in September 1997 with primarily regulatory agents in government and self-organizing associations. (Earlier interviews are reported in Kogut, 1996; Pistor and Spicer, 1997; Spicer 1998.) Seventeen interviews were conducted with investment bankers, regulatory and government officials, and privatization experts in the Czech Republic during field research in the summer of 1997. Interviews were conducted in Russian, English, Czech and German, with translators present when needed. An additional nine interviews were held with World Bank officials in November 1997. (The Appendix summarizes the affiliation of the primary interviewees.) Primary and secondary material was used to confirm and supplement the interview data whenever possible. The narrative of the events in the paper describes the outcomes of capital market formation in these countries up to the end of 1997.

## 5. Capital market formation in Russia, 1992–1997

The capital market orientation of the Russian mass privatization led to a number of

new regulations that created new legal categories of economic activity in Russia. The newly created *voucher investment funds* were designed to attract vouchers and cash from the population to create a closed-end mutual fund portfolio. In contrast, *investment companies* were not allowed to attract investment from the population. However, they were allowed to buy and sell vouchers and securities on their own accounts and on the account of clients. *Financial brokers* were allowed to buy and sell vouchers and securities on the stock exchange and *investment consultants* were allowed to underwrite the issuance of new stocks and to provide financial advice to companies. By the end of 1993, just over one year into the mass privatization, over 600 investment funds, 300 investment companies, and 900 brokers and investment consultants had received formal licenses to compete on the newly created financial markets (*The Securities Market in Russia*, no. 18, 3 September 1996).

Despite the clear distinctions in formal regulation, the formal boundaries separating different types of financial organizational forms were not followed in actual practice. The 'law on the books' did not match the 'law in practice'.[6] The government estimates that up to 2000 'unlicensed' financial companies operated on the financial markets during mass privatization. An 'unlicensed' company is (i) a financial company that undertakes activities outside its legal scope, or (ii) a company that operates on the market without any type of government license. A financial company engages in activity outside its legal scope if it undertakes activities that are not included in the rules that define the organizational form of which it is a member. For instance, an investment company might offer bank deposits even though it has no license to act as a bank. The government estimates that by the end of 1994, over 80 million Russians had invested from 50–70 trillion rubles ($5–7 billion) in these financial concerns (Federal Commission for the Securities Market, 1996a).

Three reasons explain the massive influx of unlicensed financial intermediaries into the market during this period. First, a number of opportunities for speculation, arbitrage and trade existed. Mass privatization took place during a period of monetary reform and high inflation. Entrepreneurial financial companies benefited from the uncertainty of the environment in a number of ways. Speculation on the secondary voucher and foreign exchange markets allowed the opportunity for risky, high-return investments. Similarly, differences in exchange rates and prices across the many regions of Russia could be exploited for great gain. Opportunities in trade, imports and real estate also existed for companies that had access to capital. In Russia, many banks grew dramatically during this time of gross differentials in money markets.

Second, the lack of regulatory oversight allowed financial agents to participate in the

[6]By 'law' we mean the formal regulatory orders issued by the Russian government, which the government claimed should be considered as legally binding despite the fact that these presidential and ministerial decrees rarely received formal approval by the Russian Duma. Our concern is with the way that formal regulation in the Russian capital markets compared to actual practice. Others (Pistor, 1997; Fox and Heller, 1999; Black *et al.*, 2000) have demonstrated in great detail the mismatch between regulation and practice in corporate governance activities in post-privatization Russia.

market virtually at will. It was commonly observed in the interviews that during this period of capital market formation, the population tended to view stock in similar terms to that of debt. One public World Bank document noted that the 'general public does not yet seem attracted to trading gains. Most activity reflects a "bond" mentality driven by the issuers' promises of exceptionally high current payout (often plus a lottery-type premium) rather than an "equity" mentality that looks to price appreciation' (Morgenstern, 1995: 93). The distinction between capital markets, e.g. equity and bonds, or the pricing of risk was not well understood.

In Russia, the notion of risk was not widely understood, and this lack of knowledge was often used to the advantage of the financial agent. For instance, one company interviewed was officially registered as an investment company that was legally forbidden to accept investments from the population. Yet the company found a simple solution to avoid regulatory prosecution for engaging in such behavior: it simply made two contracts. It made an oral promise to the customer to return the balance plus a percentage after a specified time period, just as if the customer was making a bank deposit. The customer also signed a piece of paper, however, saying he had hired the company to buy stocks for him; as an investment company, the company was legally entitled to buy stocks for individuals, but not to accept direct investments. The company then kept the formal contract, and a large number of excess stocks, in case regulators inspected its activities. This device was but one of many ways this company, and countless others, found to circumvent legal regulations (see St Giles and Buxton, 1995: 50 for a similar example.)

Third, unlicensed financial companies succeeded in attracting money because Russian investors were inexperienced. They had no prior history with financial investments or inflation during the Soviet period and were willing to invest significant savings in those companies that offered the highest returns—even if little information was available about what the company intended to do with their investments. There was intense competition among financial intermediaries to induce the population to invest. Massive advertisement campaigns offered guaranteed returns of several thousand percent per year in rubles (and hundreds percent returns in dollars). For instance, the Tibet Company offered an interest rate of 30% a month in nationwide commercials in March 1993; this rate would yield a return of over 2000% a year. It is estimated that over 600 000 investors from cities throughout Russia invested up to 3 billion rubles ($3 million) in Tibet. The President of the Tibet Company disappeared in the middle of 1995; investors did not recover any of their investment in Tibet. Most of the individuals who had invested in the other 2000 Russian financial companies also lost their investments.

A large number of financial companies also issued 'stock certificates', which stated that a certificate owner was entitled to buy a legal share of the company. No mechanism, however, was created to allow for the exchange of the certificate. Despite the fact that these 'stocks' offered no ownership rights, they were widely traded on the street, in the metro, as well as in the official stock markets. One financial journalist estimated that

95% of the daily trading in securities at the Russian stock exchanges in 1994 took place in these certificates (Baranov, 1995). This estimate is especially striking, given that it was believed that 90% of all trading during this time took place outside of the scores of stock exchanges that populated Russia (Morgenstern, 1995).

An example of this phenomenon can be found in sales of the 'stock' MMM, which dominated the financial markets in Russia during this time period. MMM was not a voucher investment fund, but a pyramid scheme. MMM advertised its share prices several days in advance, ensuring that the price increased twice every week. It also engaged in a massive advertising effort to convince individuals to invest; the story of an elderly Russian couple slowly getting richer and richer through their investments in MMM dominated television commercials during this time. Although shares of MMM were actively traded in a secondary market, the company also created its own network of dealers, which redeemed and sold shares at advertised prices. In the six months of its existence, MMM's price increased 6000% on Moscow's stock markets. It is estimated that 5–10 million Russians invested in MMM certificates.

By the end of privatization in July 1994, the financial markets in Russia were booming. The voucher funds and the banks, as well as the 2000 unlicensed companies had attracted billions of dollars to the market during the period of privatization. However, the markets fell as quickly as they were created, starting with MMM. In July 1994, the price of MMM fell within two days from a high of $62 on Russian stock exchanges to a low of 50¢. Individuals who had invested in MMM now found their stock certificates were virtually worthless.

The aftermath of the MMM scandal exemplifies the difficulty that the Russian government had in controlling fraudulent funds. The MMM directors were not charged with any breach of the securities law because the company argued successfully that it had not broken any part of the Russian legal code. MMM had not registered as an investment company, and the legal rules that applied to such concerns thus did not apply to it. In short, MMM was not illegal, but non-legal: it existed outside the current legal code, and could not, or at least would not, be prosecuted under existing laws. In fact, MMM continued to sell its certificates even after its spectacular crash. Although Mavrodi, the president of MMM, faced potential charges on tax fraud, he found a unique way to avoid prosecution: he won a seat in the Russian Duma, where parliamentary deputies were exempt from criminal charges.[7]

## 6. Institutional consequences and response

In November 1994, four months after the crash of MMM, President Yeltsin strengthened the powers of the Russian equivalent of the US Securities and Exchange Commission (SEC), the Federal Commission on the Stock Market (FCSM). He gave the

[7]For information about MMM, see *Izvestiya*, 11 December 1994, 18 December 1994, 19 January 1995; *Nezavisimaya Gazeta*, 28 July 1994: 1–2; *Chicago Tribune*, 16 August 1994. For information about Tibet, see *Komersant-Daily*, no. 49, 18 March 1995 or *Komersant*, no. 11, 29 March 1994: 48.

new commission the authority to issue statutes that had the force of law within the government, and named Anatoly Chubais, the first deputy prime minister in charge of the economy, as the top official of the new commission. Chubais appointed Dmitrii Vasilev, another young market reformer, to oversee the operations of the Federal Commission as its executive director.

The actions of the FCSM are clearly identifiable as an institutional response to what the new regulators perceived as the negative effect that the activities of unlicensed financial companies had on the development on post-privatization capital markets. After the fall of the pyramid schemes that had initially dominated the formation of stock market exchange in Russia, trading in Russian securities began in late 1995 on a limited number of 'blue-chip' companies in the oil and gas, electric utilities, metals and telecommunications industries. Yet, as Blasi *et al.* (1997: 80) point out in their analysis of the 100 companies with the highest market capitalization in 1996, these 'blue-chips' were precisely the companies that had been withheld from the mass privatization process. The vast majority of the over 16 000 medium and large size companies that had undergone mass privatization did not develop enough trading volume to allow for a liquid secondary market to develop. The trading that did take place consisted mainly of companies that had mainly been privatized mainly through a 'loans-for-shares' scheme between the government and the main Russian banks. In return for a series of 'loans' to increase government revenues in April 1995, these private banks received control rights to the remaining government shares in these large 'blue-chip' companies.

Yet, the first regulatory actions of the new Federal Commission were not directed toward the lack of a secondary-market for the joint stock companies privatized through voucher auctions. Nor did the FCSM present new regulations to deal with the slow death of the voucher investment funds, which, among other problems, had little ability in the illiquid market environment of the time to develop sufficient cash-flow from their voucher investments to remain solvent (Pistor and Spicer, 1997). Instead, the FCSM initially focused on what they perceived as an even larger consequence of the initial period of capital market formation in Russia: the complete withdrawal of domestic investment from formal financial markets. The Federal Commission argued that initial beliefs had developed in Russian financial markets, but that these beliefs equated financial investment with lotteries and pyramid schemes. The Commission estimated that Russians held from $20–30 billion of savings hidden at home instead of invested into companies through financial intermediaries (Spicer, 1998). Moreover, the new regulators believed that their job was not only to develop new laws to regulate the market, but to assure the public at large that they were able to enforce these new rules in practice.

The FCSM's proposed solution to the lack of trust in financial investment was the creation in 1996 of a new investment vehicle, the unit investment fund. The Commission argued 'that as much as 10% of domestic savings—or some $2–3 billion—could be drawn into equity investment through well-regulated, reliable investment funds' (Federal Commission, 1996b). Unlike the *laissez faire* regulatory strategy

pursued in the formation of voucher investment funds, the Federal Commission tightly supervised the formation of unit investment funds. Unit funds are open-ended funds that grant investors the right to redeem their shares. Unlike the joint-stock company status of the voucher investment, unit funds do not have shareholders. Instead, the relationship with their investors is governed by contractual trust indentures. The Federal Commission developed complex regulations for net asset evaluation, information disclosure, depository services, audit reports, tax payments and portfolio standards before any company received a license to manage a unit fund. The FCSM tightly controlled the number of entrants into the market, favoring foreign companies over domestic competitors in awarding new licenses (Pistor and Spicer, 1997).[8]

Foreign managers actively lobbied the FCSM for strong regulation over the new unit fund market. As one US unit fund manager put it in one of our interviews in the summer of 1996:

> Our greatest fear is whether the [Federal] Commission is really going to recognize their responsibility here. Their responsibility is to supervise this market with an iron fist. The frustrating, ironic and paradoxical situation we find ourselves in is going to the Commission and saying, 'you have to regulate us incredibly strongly. If you are not going to do that, we are not going to launch a fund.' It's an absurd position to be in.

This manager argued that strong regulation over the marketplace was needed for his fund to succeed as he wished to tap the retail market for financial investment in Russia. He wanted to associate this new investment vehicle with similar funds in regulated, Western markets, not with the Russian's own experience with MMM and other unlicensed financial companies.

The Federal Commission's intervention into the financial markets was not limited to the development of a new type of investment fund. In 1996 new laws on joint-stock companies and on the securities market began to identify more clearly the broader legal infrastructure of the market. New licensing criteria for brokers, dealers, stock markets, registrars and depositories were all introduced. To help remedy enforcement problems of these new laws, the Commission enacted regulations to permit the formation of self-regulating organizations. In explaining in 1995 his support for self-regulating organizations in the securities market, Vasilyev stated that his budget included enough funds to hire only 117 employees. He estimated that 4000–5000 bureaucrats were needed to enforce the regulatory acts that already exist, let alone to produce new regulations. He thus argued that successful regulation of the market could only be

[8]The first license to manage an unit investment fund went to a Westerner, Elisabeth Herbert. Ms Herbert was at the time the girlfriend of Jonathon Hay, the main Western legal advisor to the Federal Commission. The perception of favoritism in granting unit fund licenses later became part of a US AID investigation into the distribution of Western aid to Russia. See Wedel (1998) for a description of the multiple reasons why US AID initiated its investigation into the role of Western advisors in Russia.

achieved through self-monitoring, which needed to take place within a professional industry organization (Kremlin International News Broadcast, 1995).

The dilemma of creating self-regulatory bodies is the classic collective action problem. Without formal statutory powers, these self-regulatory bodies rely upon voluntary membership and fees. Many registrars, depositories and brokers choose to free ride, and of course some prefer not to join because they do not want to comply with the regulations. The Commission responded to this problem by authorizing, subsequent to their formation, only one self-regulatory association. If approved by the state, these associations (e.g. for registrars/depositories, broker/dealers or investment funds) have the power to recommend to the Commission who should be licensed, and hence membership in these associations is for all intents and purposes mandatory.[9]

Overall, the post-privatization capital market in 1997 had very little resemblance to the initial market created during mass privatization in 1992. Most of the investment funds, broker/dealers and stock exchanges that initially entered the market were unable to the meet the standards of the FCSM's new licensing laws. For instance, the formation of the unit investment funds meant the end of the voucher investment fund as a viable organizational form. The manner in which the new rules for unit funds were developed made it nearly impossible for voucher funds to transform themselves into this more profitable type of investment vehicle (Pistor and Spicer, 1997).

However, the actions of the Federal Commission have not gone uncontested. A resolution of a conference of nearly 250 voucher investment funds in April 1996 states that the 'clear intention of the politics surrounding the regulation of the securities market is the liquidation of the voucher investment funds'. They blame the new regulations for unit investment on the intent of FCSM to push the voucher investment funds off the financial markets by allowing unit investment funds to enter the market with little competition.

Similarly, the banks have argued that the new strict power of the Federal Commission curtails the ability of banks to participate freely in the new security markets. After a public battle between the Federal Commission and the Central Bank, a resolution was signed in March 1996 between the Central Bank and the Federal Commission, brokered by Chubais. In this agreement, the two regulators agreed that the ultimate power in regulating the new financial markets resided in the Federal Commission. Yet, it was decided that banks would be able to participate on the securities market, and, against the wishes of the Federal Commission, the Central Bank would have the power to license banks to operate on the financial markets. Despite the efforts of the Federal Commission to control the emerging financial markets, this protocol demonstrated their lack of capability to actually implement their authority in practice. The granting of authority to the Central Bank to license their own members was a major defeat for the Federal Commission in their battle for control over Russia's capital markets.

[9]See Frye (2000) for an in-depth analysis of self-regulating organizations in the Russian financial marketplace and the important role that the Federal Commission, and Western aid organizations, played in the formation of these professional groups.

## 7. Capital market formation in the Czech Republic, 1992–1997

By and large, the privatization program in the Czech Republic proceeded with fewer public scandals than in the Russian case. In part, this difference is due to the greater degree of centralized control over the mass privatization process in the Czech Republic. Ownership rights of privatized companies in the Czech Republic were registered in a centralized security center, therefore avoiding the problems of firm-owned registrars and the emission of unregistered bearer shares as in Russia. The Czech Republic also forbade secondary trading in vouchers/investment points, therefore decreasing the incentives for financial companies who wished to become involved only in short-term speculative trading to enter the market. Moreover, Czech voucher auctions took place through an electronic trading system—the RM System—that in theory allowed for greater transparency in the privatization process. The Czech auction has been largely evaluated as generating processes that reflected underlying asset values (e.g. Hingorani *et al.*, 1997).

All privatized firms became listed on both the Prague stock exchange and the RM electronic trading system used in the privatization process immediately following privatization. The capitalization of the listed Czech stock market reached $14 billion in 1995, which far exceeded the market capitalization in any other post-Soviet economy (Pohl *et al.*, 1995). However, despite the potential for capital market development in the post-privatization Czech economy, transparent market exchange of ownership rights has not emerged. Instead of exchange on either the main stock exchange or the RM system, most trading has taken place outside formal markets. The only record of these trades is the report of ownership changes to the central registrar, the 'Security Center'.

The volume of security transactions in each of these three different markets—the Prague stock market, the RM electronic trading system and the Security Center—in December 1996 is shown in Table 3. At the Prague Stock Exchange (PSE), in the 'unlisted' market, sometimes called the 'free' market, little information disclosure of the issuer is required. The PSE assumes no obligations about the credibility or truthfulness of any of the information presented. The main and secondary markets are the 'listed' markets. For the main market, the following conditions must be met: public offer amounts to 200 million korunas (Kc), and a liquidity requirement of Kc 300 000 of an average per day trading value recorded in the central market for the last 12 months prior to submission of the application. Issuers are obliged to provide the PSE, on a quarterly basis, with all relevant economic information. By the end of 1996, the market capitalization of the listed market was Kc 443 billion and the free market Kc 115 billion.

The hope was that the RM electronic trading system would transform itself into a broader electronic system in the post-privatization economy. However, only 9% of overall trading took place on this system. The Securities Center handled 56% of security transactions, even though its primary function was to maintain a central registry of security owners and the issuers of securities. The Center simply recorded ownership changes when trades were conducted. No price information about the trade is required, and only the names of the nominal owners need to be provided to the registry. One of

**Table 3** Initial capital market outcomes in the Czech Republic, December 1996

| | |
|---|---|
| Prague Stock Exchange | 34% of total security transaction<br>listed market: 96 issues<br>unlisted market: 1574 issues |
| RM System | 9% of total transactions<br>electronic trading system |
| Security Center | 56% of total transaction<br>centralized registry<br>no price disclosure |

Source: Prague Stock Exchange (1997), Ministry of Industry and Trade of the Czech Republic (1997).

our interviewees referred to it as 'a black market'. And yet the bulk of trades occur outside of the main stock market at prices that are not transparent.

The lack of external market valuation combined with weak regulatory oversight has led to massive raiding of the profitable assets of companies—what the Czechs call 'tunneling'. The most common type of tunneling is illustrated in Figure 1, in which the investment fund insiders or managers of company A sell their assets to friendly investors at a high discount. For instance, CS Fondy, originally a voucher investment fund, was sold three times between 11 February and 3 March 1997. In the last deal, the fund went to a Russian group calling itself KosMos, which installed a new board of directors. The fund's assets were liquidated, creating a cash reserve of Kc 1.3 billion. The money was then transferred to two other companies, and finally wired to an account aside the country. According to Thomas Berka, who represents a CS Fondy Shareholder association, CS Fondy's 75 000 shareholders were left with 'shares in a chicken breeder whose shares have no real value'. Despite some internal dissent, the finance ministry approved the transfer, though public outrage eventually led to the resignation of the deputy finance minister, Vladimir Rudlovak (*Central European Economic Review*, May 1997: 18).

Foreign firms are not by any means immune to losing control over their assets. The affair of Creditanstalt, an Austrian bank, is representative. A Czech investment banker explained:

> If a shareholder of a fund has 10% of shares of the fund, you can call for an extraordinary shareholder meeting. In many cases there are hundreds of thousands of shareholders, so most of them will not come. You can then change the management, and make fraud. Creditanstalt had the sixth biggest fund. They thought they were completely safe, a 20 year contract and all these things. This group Motoinvest began to buy them, having 11% they called for an extraordinary shareholder meeting. Creditanstaldt's parent company in Vienna decided that they had no force to protect

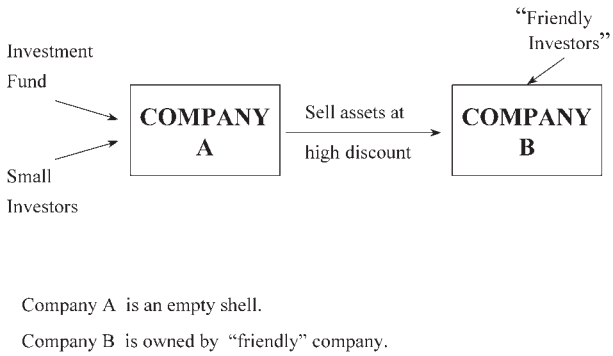


**Figure 1** Tunneling in the Czech Republic.

> themselves, and they sold the fund two months after it was introduced on the London Stock Exchange. Of course, the fund was destroyed. Motoinvest made money. Creditanstalt made money. The only people who lost money were the small investors. The Creditanstalt fund used to be sold for around 1000 crowns per crown, but afterwards it was sold for ten or twenty crowns.

A slightly more sophisticated example is transfer of cash to a holding company. Figure 2 illustrates this more complicated example. Two companies borrow from banks and then purchase shares of each other which are held by a common holding company, at a price that is not revealed. The holding company ends up with cash for relinquishing the shares; the two firms are now highly leveraged. One interviewee believed one of his investments was tunneled through this method. They believed that it would take years to resolve the matter in court, and it is not even clear whether this action is illegal. They eventually sold their small stake in the company that was being liquidated to the holding company.

A similar example can be found in the scandals that plagued Agrobanka, the largest collector of investment points in the second-wave of privatization. In late 1997, 11 officers and employees of Agrobanka were arrested as a result of the alleged embezzlement of shareholder funds from Agrobanka-affiliated IPFs. A December 1995 battle for control of Agrobanka between Motoinvest and Investicnia precipitated the crisis. Investicnia eventually retreated on the condition that Motoinvest buy a large share in a troubled bank controlled by Investicnia. After an audit of Agrobanka by Price Waterhouse in 1996, an administrator for the bank was appointed (Coffee, 1998: 73).

The lack of transparent market prices combined with a fear of the tunneling of assets has led to large discounts of the closed-end Czech investment funds. Most of the Czech funds have turned out to be scandalously poor investments. The aggregated discounts of the 15 largest investment funds ranged from 35 to 45% of net asset value on the Prague Stock Exchange over the course of 1995 and 1996 (Podpiera, 1996). While discounts of closed-end funds are not unusual, these discounts are far above Western standards. Moreover, discounts in investment funds beyond the top fifteen have fallen

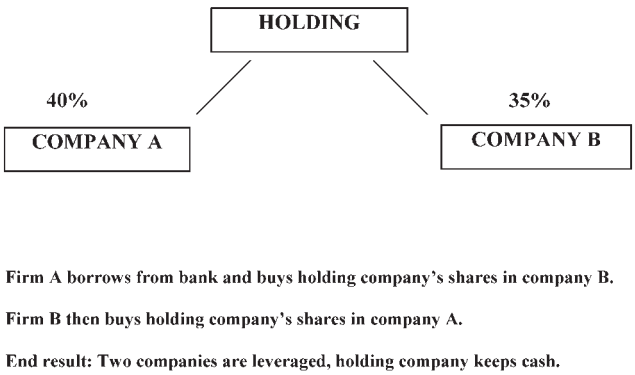


**Figure 2** Tunneling assets in the Czech Republic.

to 80% or more (Czech Securities Exchange Commission, reported in World Bank, 1999).

Investors who have been able to sell their shares have received far below the net asset valuation of the funds. In fact, it is often the funds themselves that buy back their own shares at a discounted rate from initial buyers, creating an incentive for funds to temporarily decrease the market value of their shares. For instance, in 1996 the Harvard Consulting Company, who controlled many of the largest funds from the privatization process, announced that they were merging their multiple funds into a single holding company, therefore adding another layer of non-transparency into the already closely held company. The price of some Harvard funds declined 22% in one week, allowing the owners of the Harvard Fund to buy back many of their shares at a greatly reduced price. The new holding company, Daventree Ltd, is based in Cyprus and is effectively outside the control of the Czech authorities (Coffee, 1998).

These cases indicate that a principal concern of the post-privatization era has not been corporate governance, but the legal transfer of assets from uninformed investors. Several studies show that privatized firms have performed better than state-owned ones. Even if these studies are proved to be true, they leave unaddressed the question of whether privatization alone created the better performance, or if the movement of ownership to motivated interests contributed, though at the cost of the minority investors. It is also clear that some, at least in the Czech case, believe this transfer is desirable, as discussed below.

### *7.1 Institutional consequences and response*

The policies of the Czech Republic were constructed around a strong free-market orientation characterized by an unwillingness to regulate *ex ante* anticipated problems. The preference is to see *ex post* what evolves (Coffee, 1996, 1998). The initial legislation was designed to obstruct the formation of large financial industrial groups, but did not create regulatory entities, such as an equivalent to the US SEC. The economic philosophy of the administration of Prime Minister Klaus has been to foster competitive

markets with minimal government interference except for the blockage of concentrated economic power by financial and industrial groups. In September 1997, one broker described the problem of trying to create self-regulatory bodies in the Czech Republic:

> We cannot have at this point in time a true self-regulatory body. The government issued over 500 brokerage licenses. They were issued precisely to make it difficult to establish self-regulatory discipline. That would be much easier to establish if you have 30 properly capitalized, properly equipped brokers.

Many cite the inadequate institutional oversight in capital markets as a primary reason for the economic stagnation of the Czech Republic. In opposition to the minimalist regulatory policy, opposition parties and many financial investment firms have lobbied for increased government regulation. Following the collapse of the Klaus government in the fall of 1997, several important changes have been made to the regulatory order.

One of the most important changes has been the creation of the Czech Securities Commission. However, the power of the Commission is still unclear: as yet it is not an independent body and has no rule-making authority (OECD, 1998).[10] In addition, the Czech government recently has required that all closed-end funds trading at a discount greater than 40% be converted into open-ended funds within one year of the enactment of the regulation. Open-ended funds trade at the value of the net asset values, and shares must be redeemed at this value. There is, therefore, a strong incentive for investment funds to improve their performance. At the same time, the government further reduced their restrictions on holdings by a fund of a given company from 20% to 10%. Unlike in Russia, the Czech government remains forcefully opposed to the formation of financial industrial groups through investment fund holdings. However, it remains very unclear how the conversion from closed-end to open-ended funds shall take place given the illiquidity of trading of most shares. In other words, the Czech regulatory philosophy now takes the stance that markets must be regulated in order for markets to exist.

Some of the funds have been converted from financial joint stock companies into industrial joint stock companies. This conversion permits the funds to act as an industrial holding and thus avoid legislative limits on their holdings, as well as the supervision of the Ministry of Finance and the depository (Mejstrik, 1996: 223). The expectation is that very few of the funds will remain as portfolio investors. In effect, the Czech stock market has diminished to a substantially smaller role in the economy than in the heady days following privatization.

[10]The new head of the Commission, Jan Mueller, noted he had an uphill battle: 'I know foreigners see us as a den of thieves and I want to do something about it. But I have negligible power to regulate the market' (*Financial Times*, 12 May 1998).

## 8. Lessons from economic history

As described below, many of the actors in policy formation regarding mass privatization were academic economists. A frequent explanation for the policy recommendations of that time was that there was little prior history from which to learn. In fact, it is odd that the problem of capital market formation was not explicitly anticipated, as it is a recapitulation of similar histories in the UK, the USA and elsewhere in the 1800s, where capital markets were destabilized by the absence of institutional technologies. The resolution of these hazards was the creation of the regulatory and statutory requirements that arose over time. It was widely agreed that British markets were severely impaired until the Gladstone committee recommendations resulted in a major change in company law in 1844 (Hawkins, 1986). Still, the failure to develop adequate shareholder protection is largely credited with the high number of bankruptcies and fraudulent behaviors. In his comparative study of capital markets, Foreman-Peck (1990: 35) concludes that because 'British legislation governing the formation and operation of limited liability companies imposed among the least requirement of information disclosure to shareholders or outsiders of any major economy in the world, with the exception of the United States of America', these laws encouraged company formations in the early years of the 1844 Act. However, due to the lax rules for incorporation there was a very high failure rate arising from the 'moral hazard' imposed on promoters of new companies. Fraudulent behavior was rife during the first years of the Act especially in the finance, insurance and banking sectors. Despite regulation at the end of the 1800s, the newspaper *Statist* remarked in 1895 that 'so rotten in the public estimation has the whole business of company promotion become that it is now almost useless to offer for subscription an issue of Ordinary shares in an industrial enterprise' (cited in Hawkins, 1986: 21).

In the USA, the creation of the SEC arose out of concern with insufficient and misleading information. To some, such as Bentson (1976), the SEC was an unnecessary institution since it is in the interest of firms to establish reputations for honesty. However, most historians of the SEC find ample examples of widespread abuse prior to the SEC. Seligman (1995: 565) notes that 'Bentson's suggestion that there was little security fraud before 1943 is ludicrous.' He then notes the many acts of enforcement at the state level, observing that in 1932 alone, New York state secured injunctions against 1522 persons and firms and instituted 146 criminal prosecutions.

The experiences of countries that have not yet achieved economic growth comparable to the USA and the UK suggest, further, that failures to redress imperfections in capital markets through regulation can be an important impediment to development. For example, Stephen Haber (1997: 170) concludes in his comparison of Mexican and Brazilian textile industries that:

> Government regulatory policies had a significant effect on growth of capital markets in Brazil and Mexico. The divergence in capital-market development between the two countries was clearly the result of different

> policies regarding the formation and operation of banks, the reporting of financial data, and the reporting of stockholder identities. In short, capital-market development was not completely endogenous to the process of economic growth; government regulation exerted powerful independent effects.

In the Mexican case, the loose financial requirements discouraged investments unless minority investors identified powerful interests linked to the government as co-investors.

## 9. Weak states and rampant politics

These early historical accounts support the argument that the entrepreneurial, and often unscrupulous, efforts to transfer ownership rights in the post-privatization environment in Russia and the Czech Republic arose from the particular method in which capital markets were developed in these countries. The unusual factor in post-communist economies was the massive speed and scale with which capital markets were created through mass privatization policy. The subsequent events were not epiphenomenal; the policies chosen influenced events.

Mass privatization did not depoliticize Russia. It only removed direct state ownership prior to the creation of adequate law, institutions and social consensus. The post-privatization history of Russia and the Czech Republic recapitulates the historical lesson that government participation is critical to the establishment of institutions that support market exchange. Markets do not spontaneously spawn but arise out of the creation of institutions that support the personal trust among direct market participants, and the impersonal trust of the ultimate buyers and sellers in this market. All modern capital markets in developed capitalist economies consist of mandatory rules of disclosure, accounting methods and oversight entities to contribute to the development of impersonal market exchange. Rules establish requirements to register ownership, to provide for clearing of shares through depositories, and to enforce minimal capital provisions and other standards on brokers and dealers. The purpose of these rules is to increase market efficiency and to ensure fairness by making public information regarding not only prices (an essential requirement to efficiency) but also the reputation of market participants.

Some of the proffered legal suggestions to the problems in the Czech and Russian capital markets are designed to strengthen the representation of minority shareholders on boards.[11] These perspectives on self-organization and minority shareholder protection are too late to prevent the consequences of tunneling of assets. They miss the observation that mass privatization itself creates the conditions of a repressed equilibrium that could not be resolved through corporate governance pressures on

[11]See Coffee (1996), as well as Black *et al.* (1996), on self-enforcing law.

individual firms. *In a classic law and economic calculation, theft was bound to increase because the gains were so enormous.* Yet, the powers of the state to counter the deleterious effects of these interests on capital market formation were lacking. As a consequence, political action by powerful interests is highly favored in these settings.

However, the casualty of these entrepreneurial endeavors has been the formation of impersonal financial markets. The failure of the state to regulate has its counter-reflection in the attempts to achieve a private ordering through industrial groups. Much as in the case of the emergence of large and powerful groups that influenced the development of capital markets in London, Russia has witnessed a close alliance between the formation of financial industrial groups (also known as FIGs) and the government. As of 1997, 80 FIGs were legally registered in Russia, representing over 5 million workers, with another 50 applications then pending (Petkoski, 1998). As in the development of the financial markets described above, the most active financial market in Russia has been for the trading of government bonds in order to finance the chronic deficits. These deficits are partly the outcome of the insufficient powers, or will, of the government to collect taxes, sometimes from the large banks who are the major purchasers of the bonds. The fiscal crisis of 1996 lead to a loans-for-shares agreement, in which the government struck a 'Faustian bargain' to accept loans from the banks in return for shares of large enterprises placed in escrow in case of default. To a large extent, these efforts at a private ordering of ownership and financial control are an expression of societal interests at political odds with formal attempts to create impersonal markets. Not surprisingly, international agencies and some governmental authorities see the rise of business groups as counter to the efforts to create natural markets (discussed by Lieberman and Veimetra, 1996).

The Czech case is more nuanced. The Czech government has aggressively curbed the creation of financial groups by restricting the percentage of shares that can be owned by any financial entity other than an individual. The restriction on large group formation has strongly impeded the recombination of traditional ties into new entities. Yet, the reconstitution of industrial networks is an important feature of the economic landscape. The conversion of the funds into holding companies has largely come after the weakness of capital market regulation permitted the transfer of assets to the hands of relatively few individuals and enterprises. This experience deeply depressed market participation and the valuations of the investment funds. As in Russia, a weak capital market has been partly compensated through a private ordering. Many industrial enterprises were converted into holding companies after 1989, with their constituent members marked by strong contractual ties among themselves and to other suppliers (McDermott, 1998; Haryri and McDermott, 1998).

The evolution of business groups, even if politically contested, points to the endogenous features of transformation that are not simple policy instruments open to the state. Stark and Bruszt (1998) argue that it is not sufficient for an autonomous bureaucracy simply to establish rules. Rather, successful transformation also requires a social nexus by which policies are negotiated and implemented. The development of

capital markets is, by the converse of Stark and Bruszt's argument, troubled exactly because there was little prior experience of financial institutions in socialism. A potential resolution, reinforced by Carruthers's (1996) history of the birth of capital markets in London, is the self-organization of decentralized regulation created by powerful interests who profit from the market, and the willingness of government to establish the legal and regulatory framework to support and to curtail their ambitions.

The lessons of the two countries reinforce this conclusion by offering the counterfactual: an impaired government cannot channel the efforts of powerful interests to support financial market creation. Developing the chain of trust amidst disappearing assets was a hat trick that could not be accomplished in either country. Without impersonal financial markets, the policies of mass privatization had no institutional mechanism by which to perform the task of intermediating in the reallocation of ownership. The efforts by industrial groups to fill this gap posed a serious challenge to reform policies. With inadequate financial markets, privatization policies in both countries created conditions that weakened the property rights of the new owners. The reliance on natural market formation tragically created an erosion of the rule of law and norms. It is the direction of this causality that appears entirely to run counter to the standard economic analysis of transition and developing economies.

## 10. Conclusions

It is the dilemma of mass privatization policies that they establish the promise of mass ownership, but ultimately depend upon capital markets to achieve the concentration of shares in the hands of strategic investors who can effect control. Since the formation of capital markets themselves rides upon the efforts of concentrated interests, there is an inherent contradiction in mass privatization policies: the markets that are required to permit trading among the millions of dispersed owners cannot form until motivated participants can support the institutions of markets. It is, however, simply not in the interest of many of these participants to create transparent markets.

The weakness of capital markets in the Czech Republic and Russia is partly the outcome over the ambivalence of government intervention in the transition process. The role of government is contentious even in highly stable democratic states. In the context of transformation, the intervention of the state is strongly resisted by some parties as a reversal to socialism. In fact, the argument of Boycko *et al.* (1995) that privatization served to 'depoliticize' the economy deceptively fails to separate state authority from the political agency of interested and motivated parties to transition policies.

The easy equation of politics and the state is probably never fully justified and is certainly open to examination in the context of the highly fluid conditions following the collapse of socialism. No doubt, a more accurate phrasing of the depoliticization argument is the 'debureaucratization' of the former central planning apparatus, which privatization achieved in the form of transferring ownership from ministries to private

hands.[12] However, to view the elimination of state ownership as a decrement in politics is to ignore conceptually the extra-statal influence of political actors in the post-privatization period.

The pragmatic conclusions from this study are that mass privatization policies are inherently marred by internal contradictions. Markets are not created as a logical implication of the elimination of state control over economic activities. 'Transition' policies are implemented through the institutional construction of new behaviors rooted in a procedural knowledge of what constitutes a market. The initial experiences of capital market participation did not reinforce subsequent participation for the vast number of citizens in either country. As a result, formal financial markets did not emerge to provide a means by which to enable the informed sale of shares distributed through the privatization policies.

The analysis of these two cases suggests, however, a more far-reaching issue. Howard Becker (1992) argues that case analysis always poses the question 'What is this a case of?' as an iterative feature of the research. To a great extent, these comparative cases are about the creation of the new owners. In this regard, there is a troubling implication, namely that the creation of dispersed owners was never the primary intent of privatization policies in the first place. Retrospective analyses that stress the remarkable achievements of transferring assets rapidly to the private sector ignore that privatization policy itself created the conditions for an emergence of an élite ownership class.

In this respect, privatization has been above all a process that determined the new owners in Russia and the Czech Republic. Whether the concentration of wealth was unforeseen or even undesired by policy-makers is an important historical question. The corporate governance perspective on privatization emphasizes that moving ownership to the hands of motivated owners is critical to the restructuring process. By this logic, the concentration of ownership into the hands of a few is not unwanted, even if the means of accumulation were destructive to capital market formation. What is clear is that the implications of the privatization experiment for who becomes an owner and who becomes a worker was quickly understood by many resourceful entrepreneurs who seized control over privatized assets by often legal but dubious behaviors detrimental to market formation. The historical event called mass privatization created a unique moment for the identity of an ownership class of the emergent capitalist societies. These outcomes of 'who owns' are the most critical legacy left by the privatization experiences.

The deductions made from the analysis of the Czech and Russian efforts to develop capital markets are relevant not only for the understanding of theory, but also for the development of appropriate policies. Without an understanding of organizational and institutional theories, policies to aid socialist transformation are trapped in a developmental lens that ignores the inertia of organizational resources and the

[12]It is important to underscore Campbell and Lindberg's analysis (1990) of the important influence of government in the United States through regulation.

institutional context of social action. The implicit functionalism of the economic policies presumed that capital markets would arise in order to serve the financing needs of privatized companies and to provide a secondary market for the trading of securities. However, the experiences in both countries show that politics can be displaced, but not eliminated; that ambiguous ownership rights can engender unanticipated outcomes; and that market solutions without institutional understandings create insurmountable market failures. The irony of these policies is that a principal lesson has been that market reforms cannot create viable markets; only institutional formation can.

## Acknowledgements

We would like to thank Gerry McDermott, Jan Mladek and Jan Svenjar for many helpful discussions. We are indebted to Ira Lieberman for his time in providing an oral history of the privatization experience in Russia and of the role of the World Bank, and Bruce Carruthers, Michael Lounsboury, Gerry McDermott, William Pyle, Christine Oliver, Huggie Rao and anonymous reviewers for their comments. John van Maanen gave us critical advice on the use of case methodology. Financial support for this paper has been provided by the Reginald H. Jones Center and the International Research Fund of the Wharton School.

## Address for correspondence

B. Kogut: Wharton School, University of Pennsylvania, Philadelphia, PA 19104, USA; kogut@wharton.upenn.edu.
A. Spicer: A. Gary Anderson Graduate School of Management, University of California at Riverside, Riverside, CA 92521, USA; andrew.spicer@ucr.edu.

## References

Abolofia, M. (1996), *Making Markets: Opportunism and Restraint on Wall Street*. Harvard University Press: Cambridge, MA.

Amsden, A., J. Kochanowicz and L. Taylor, (1994), *The Market Meets its Match: Restructuring the Economies of Eastern Europe*. Harvard University Press: Cambridge, MA.

Aslund, A. (1995), *How Russia Became a Market Economy*. Brookings Institution: Washington DC.

Baranov, A. (1995), 'Otsutstvie zakonodatelnoi basoi sposobstvovalo spekulyatsiyam s tsennimi bumagami na predyavitelya,' *Izvestiya*, January 19.

Baker, W. (1984), 'The social structure of a national securities market,' *American Journal of Sociology*, **89**, 775–811.

Becker, H. (1992), 'Cases, causes, conjunctures, stories, and imagery,' in C. Ragin and H. Becker (eds), *What is a Case? Exploring the Foundations of Social Inquiry*. Cambridge University Press: New York.

Bentson, G. (1976), *Corporate Financial Disclosure in the UK and the USA*. Saxon House: Lexington, MA.

Biggart, N. and G. Hamilton (1992), 'On the limits of a firm-based theory to explain business networks: the Western bias of neoclassical economics,' in N. Nohria and R. Eccles (eds), *Network Organizations: Structure, Form and Action*. Harvard University Press: Cambridge, MA.

Black, B., R. Kraakman and J. Hay (1996), 'Corporate law from scratch,' in Frydman, Gray and Rapaczynski (eds), *Corporate Governance in Central Europe and Russia*, vol. 2. Central European University Press: New York.

Black, B., R. Kraakman and A. Tarassova (2000), 'Russian privatization and corporate governance: what went wrong?,' *Stanford Law Review* (in press).

Blasi, J., M. Kroumova and D. Kruse (1997), *Kremlin Capitalism: Privatising the Russian Economy*. Cornell University Press: Ithaca, NY.

Boycko, M., A. Shleifer and R. Vishny (1995), *Privatizing Russia*. MIT Press: Cambridge, MA.

Burawoy, M. and P. Krotov (1992), 'The Soviet transition from socialism to capitalism—worker control and economic bargaining in the wood industry,' *American Sociology Review*, **57**, 16–38.

Campbell, J. and L. Lindberg (1990), 'Property rights and the organization of economic activity by the state,' *American Sociological Review*, **55**, 634–647.

Carruthers, B. G. (1996), *City of Capital: Politics and Markets in the English Financial Revolution*. Princeton University Press: Princeton, NJ.

Coffee, J. C. (1996), 'Institutional investors in transitional economies: lessons from the Czech experience,' in R. Frydman, C. W. Gray and A. Rapaczynski (eds), *Corporate Governance in Central Europe and Russia*, vol. I, pp. 111–186. CEU Press: New York.

Coffee, J. C. (1998), 'Inventing a corporate monitor for transitional economies: the uncertain lessons from the Czech and Polish experiences,' in K. Hopt, H. Kanda, M. Roe, E. Wymeersch and S. Prigge (eds), *Comparative Corporate Governance: The State of the Art and Emerging Research*, pp. 68–138. Oxford University Press: Oxford.

Coffee, J. C. (1999), 'Privatization and corporate governance: the lessons from securities market failure,' working paper, Columbia University Law School.

Durkheim, E. (1984), *The Division of Labor in Society* [originally published 1922], trans. W. D. Halls. The Free Press: New York.

Evans, P. (1995), *Embedded Autonomy: States and Industrial Transformation*. Princeton University Press: Princeton, NJ.

Federal Commission for the Securities Market (1996a), 'Training manual for perspective unit fund managers,' manuscript (in Russian).

Federal Commission for the Securities Market (1996b), 'Unit investment funds,' http://wwwfe.msk.ru/infomarket/fedcom/enews/law.html .

Fligstein, N. (1990), *The Transformation of Corporate Control*. Harvard University Press: Cambridge, MA.

Fligstein, N. (1996), 'Markets as politics—a political-cultural approach to market institutions,' *American Sociological Review*, **61**, 656–673.

Foreman-Peck, J. (1990), 'The 1856 Companies Act and the birth and death of firms,' in P. Jobert

and M. Moss (eds), *The Birth and Death of Companies. An Historical Perspective*. Parthenon: New Jersey.

Fox, M. B. and M. A. Heller (1999), 'Lessons from fiascos in Russian corporate governance,' manuscript.

Frydman, R. and A. Rapaczynski (1994), *Privatization in Eastern Europe: Is the State Withering Away?* CEU Press: Budapest.

Frydman, R., K. Pistor and A. Rapaczynski (1996), 'Investing in insider-dominated firms: a study of Russian voucher privatization funds,' in R. Frydman, C. W. Gray and A. Rapaczynski (eds), *Corporate Governance in Central Europe and Russia*. CEU Press: Budapest.

Frye, T. (2000), *Brokers and Bureaucrats: Building Market Institutions in Russia*. University of Michigan Press: Ann Arbor.

Goldman, M. (1997), 'Comments and discussions: the unofficial economy in transition,' *Brookings Paper on Economic Activity*, **2**, 222–230.

Goldstein, M. and N. Bulent Gultekin (1998), Privatization in post-communist economies,' in J. Doukas, V. Murinde and C. Wihlborg (eds), *Financial Sector Reform and Privatization in Transition Economies*. Elsevier: Amsterdam.

Goskomstat (1996), *Official Statistics for 1996*. Russian Government: Moscow.

Granovetter, M. (1985), 'Economic action and social structure: problem of embeddedness,' *American Journal of Sociology*, **91**, 481–510.

Haber, S. (1997), 'Financial markets and industrial development: a comparative study of goverment regulation, financial innovation, and industrial structure in Brazil and Mexico,' in S. Haber (ed.), *How Latin America Fell Behind. Essays on the Economic Histories of Brazil and Mexico, 1800–1914*. Stanford University Press: Stanford, CA.

Haryi, A. and G. McDermott (1998), 'The network properties of corporate governance and industrial restructuring: a post-socialist lesson,' *Industrial and Corporate Change*, **7**, 153–193.

Hawkins, D. (1986), *Corporate Financial Disclosure, 1900–1933: A Study of Management Inertia Within a Rapidly Changing Environment*. Garland: New York.

Hingorani, A., K. Lehn and A. Makhija (1997), 'Investor behavior in mass privatization: the case of the Czech voucher scheme,' *Journal of Financial Economics*, **44**, 349–396.

Hirschman, A. (1977), *The Passions and the Interests: Political Arguments for Capitalism before its Triumph*. Princeton University Press: Princeton, NJ.

International Monetary Fund (1998), *IMF World Economic Outlook, May 1998—Statistical Appendix*. IMF: Washington, DC.

Johnson, S. and A. Shleifer (1999), 'Coase versus the Coasians,' working paper, Sloan School, MIT.

Johnson, S., R. LaPorta, F. Lopez-de-Silanes and A. Shleifer (2000), 'Tunneling,' American Economic Association Proceedings.

Kogut, B. (1996), 'Direct investment, experimentation, and corporate governance in transition economies,' in R. Frydman, C. Gray and A. Rapaczynski (eds), *Corporate Governance in Central Europe and Russia*, vol. 1. Central European University Press: New York.

Kogut, B. and U. Zander (2000), 'Did socialism fail to innovate? A natural experiment of the two Zeiss companies,' *American Sociological Review*, **65**, 169–190.

Kornai, J. (1980), *Economies of Shortage*. North Holland: Amsterdam.

Kremlin International News Broadcast (1995), Press conference with the vice-chairman of the Federal Commission for Securities and the Stock Market, Dmitry Vasilyev, 28 March.

Ledeneva, A. (1998), *Russia's Economy of Favours: Blat, Networking and Informal Exchange*. Cambridge University Press: Cambridge.

Lieberman, I. and R. Veimetra (1996), 'The rush for state shares in the 'Klondyke' of Wild East capitalism: loans-for-shares transactions in Russia,' *George Washington Journal of International Law*, **29**, 737–768.

Lieberman, I. W., A. Ewing, M. Mejstrik, J. Mukherjee and P. Fidle (eds) (1995), *Mass Privatization in Central and Eastern Europe and the Former Soviet Union: A Comparative Analysis*. World Bank: Washington, DC.

McDermott, G. (1998), 'Industrial networks and the politics of institution building in the post-socialist Czech Republic,' Ph.D. dissertation, Department of Political Science, MIT.

Mejstrik, M. (1996), 'Privatization in the Czech Republic and Russia: the voucher model,' contribution to the Egon-Sohnen-Symposium.

Ministry of Industry and Trade of the Czech Republic (1997), *Analysis of the Czech Economy and MIT Sectors in 1996*. Prague.

Morgenstern, C. (1995), 'Capital market development and financing Russia's transformation,' in I. Lieberman and J. Nellis (eds), *Russia: Creating Private Enterprises and Efficient Markets*. World Bank: Washington, DC.

Murrell, P. (1995), 'The transition according to Cambridge, Mass.,' *Journal of Economic Literature*, **33**, 164–178.

Nee, V. (1989), 'A theory of market transition: from redistribution to markets in state socialism,' *American Sociological Review*, **54**, 663–681.

North, D. (1990), *Institutions, Institutional Change and Economic Performance*. Cambridge University Press: Cambridge.

North, D. and B. Weingast (1989), 'Constitutions and commitment. The evolution of institutions governing public choice in seventeenth century England,' *Journal of Economic History*, **49**, 803–832.

Olson, M. (1965), *The Logic of Collective Action*. Harvard University Press: Cambridge, MA.

Ostrom, E. (1990), *Governing the Commons: The Evolution of Institutions for Collective Action*. Cambridge University Press: Cambridge.

Petkoski, D. (1998), 'Financial industrial groups in Russia: key drivers behind their formation,' unpublished mimeo, World Bank.

Phelps, E., R. Frydman, A. Rapaczynski and A. Shleifer (1993), 'Needed mechanisms for corporate governance and finance in eastern Europe,' *Economics of Transition*, **1**(2).

Pistor, K. (1997), 'Company law and corporate governance in Russia,' in J. Sachs and K. Pistor (eds), *The Rule of Law and Economic Reform in Russia*. Westview Press: Boulder, CO.

Pistor, K. (1999), 'Law as a determinant for equity market development: the experience of transition economies,' manuscript.

Pistor, K. and A. Spicer (1997), 'Investment funds in mass privatization and beyond,' in I.

Lieberman, S. Nelson and R. Desai (eds), *Between State and Market*. World Bank: Washington, DC.

Podpiera, R. (1996), 'The Czech investment fund industry: development and behavior,' working paper 22, Williamson Davidson Institute..

Pohl, G., G. Jedrzejczak and R. Anderson, (1995), *Creating Capital Markets in Central and Eastern Europe*. World Bank, Private Sector and Finance: Washington, DC.

Polanyi, K. (1957), *The Great Transformation*. Beacon Press: Boston, MA.

Prague Stock Exchange (1997, 1996), *Fact Book*. Czech Republic.

Ragin, C. (1987), *The Comparative Method: Moving Beyond Qualitative and Quantitative Strategies*. University of California Press: Berkeley.

Seligman, J. (1995), *The Transformation of Wall Street. A History of the Securities and Exchange Commission and Modern Corporate Finance*. Northwestern University Press: Evanston, IL.

Shapiro, S. (1987), 'The social control of impersonal trust,' *American Journal of Sociology*, **93**, 623–658.

Spicer, A. (1998), 'Institutions and the social construction of organizational form: the development of Russian mutual funds, 1992–1997,' Ph.D. Dissertation, Wharton School, University of Pennsylvania.

Stark, D. (1989), 'Bending the bars of the iron cage: bureaucratization and informalization in capitalism and socialism,' *Sociological Forum*, **4**, 637–664.

Stark, D. (1996), 'Recombinant property in east European capitalism,' *American Journal of Sociology*, **1001**, 993–1027.

Stark, D. and L. Bruszt (1998), *Postsocialist Pathways: Transforming Politics and Property in East Central Europe*. Cambridge University: Press New York.

St Giles, M. and S. Buxton (1995), 'Investment funds and privatization,' in I. Lieberman and J. Nellis (eds), *Russia: Creating Private Enterprises and Efficient Markets*, pp. 45–54. World Bank: Washington, DC.

Stiglitz, J. (1994), *Whither Socialism?* MIT Press: Cambridge, MA.

Wedel, J. (1998), *Collision and Collusion: The Strange Case of Western Aid to Eastern Europe*. St Martin's Press: New York.

White, H. (1981), 'Where do markets come from?,' *American Journal of Sociology*, **87**, 517–547.

Williamson, O. (1991), 'Comparative economic organization: the analysis of discrete structural alternatives,' *Administrative Science Quarterly*, **36**, 269–296.

World Bank (1996), *World Development Report: From Plan to Market*. Oxford University Press: New York.

World Bank (1998), 'Country at a Glance' development data. World Bank: Washington, DC.

World Bank (1999) *Czech Republic: Capital Market Review*. World Bank: Washington, DC.

Zelizer, V. (1978), 'Human values and the market: the case of life insurance and death in 19th century America,' *American Journal of Sociology*, , 591–610.

Zucker, L. (1986), 'Production of trust: institutional sources of economic structure, 1840–1920,' *Research in Organizational Behavior*, **8**, 53–111.

## Appendix

*(A) Interviews conducted in Russia and Czech Republic, August–September 1997*

| Type of interviewee | Number of interviews | |
|---|---|---|
| | Russia | Czech Republic |
| Government officials | 2 | 1 |
| Journalists | 1 | 1 |
| Market exchange systems[a] | 6 | 2 |
| Policy advisors/consultants | 5 | 5 |
| Private financial companies (bankers/brokers/fund managers) | 5 | 5 |
| Professional/industry associations[b] | 2 | 3 |

[a]In Russia, this includes representatives of the Russian Stock Exchange, Central Russian Stock Exchange (TsRYB) and the Russian Electronic Trading System (RTS). In Prague, this includes representatives of the Prague Stock Exchange and the RM Electronic Trading System.

[b]In Russia, this includes representatives from NAUFOR (National Association of Security Market Participants) and PATRAD (Professional Association of Registrars, Transfer-Agents and Depositories). In the Czech Republic, this includes representatives from the Czech Pulp and Paper Industry Association, German–Czech Industry Association and the Metal Trade Union.

*(B) Interviews conducted at the World Bank, Washington, DC, October 1997*

Nine interviews with World Bank officials closely involved in the formation and implementation of mass privatization programs in east and central Europe.