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**Conference Paper — Manuscript Version (Preprint)**

## Privatization in Transition Economies: Case Study of Poland

*Suggested Citation:* Rapacki, Ryszard; Linz, Susan Johnston (1992) : Privatization in Transition Economies: Case Study of Poland, Southern Conference on Slavic Studies, Jacksonville, March 26-28, 1992, ZBW - Leibniz Information Centre for Economics, Kiel, Hamburg

This Version is available at:

<https://hdl.handle.net/10419/130183>

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Econometrics and Economic Theory Paper No. 9011  
Privatization in Transition Economies:  
Case Study of Poland

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Paper prepared for the Southern Conference on Slavic Studies  
Jacksonville, March 26-28, 1992

## **Privatization in Transition Economies: Case Study of Poland**

### *Abstract*

Contrary to expectations and announcements of policy makers in transition economies, privatization has taken longer than originally planned. This paper analyzes the institutional and behavioral factors that compound systemic barriers to privatization and thus transition from a centrally planned to a market economy. Part I describes the command economy legacy transition economies must overcome while initiating the structural transformation required to introduce a market economy. Part II presents preliminary results from Poland's privatization experience. Part III identifies the anticipated and unanticipated institutional and behavioral barriers to privatization in Poland. Part IV offers several lessons for other transition economies regarding the process and pace of privatization.

JEL Classification: O50, 120  
KEY WORDS: transition, privatization

## **Privatization in Transition Economies: Case Study of Poland**

Economies engaged in systemic transformation have captured the full attention and imagination of economists worldwide, both theoretical and applied. Historically unprecedented, the process of transition from socialist central planning to market allocation of goods and resources initiated in Poland and other formerly socialist economies of Eastern Europe has raised many important social, economic, and political challenges. With neither a relevant reference point in actual experience nor a well-formulated underlying theoretical framework, the economies currently undergoing the transition from socialism to capitalism must necessarily proceed in a trial and error manner.

Despite the rapidly expanding literature on the theory and practice of economic transition [Edwards 1990, Lee and Nellis 1990, Campbell 1991, Genberg 1991, Bornstein 1992, Linz 1992, Peck and Richardson 1992], the unique nature of this process is still far from being fully understood. This is particularly true of the core component of the transition process: privatization. Privatization often has been conceived by policy makers and scholars alike as a simple, "one-shot" transfer of ownership rather than a long-run process of social, political, economic, psychological and cultural change.<sup>1</sup> Even where a more complete definition of privatization is used, the tendency is to analyze privatization as a purely technical (legal) or economic process, with little importance attached

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<sup>1</sup> In the privatization program elaborated in the early 1990, Poland's leaders called for the transfer of property ownership and rights of 50 percent of the state-owned enterprises (SOEs) to the private sector within 3 years [Programme, 1990]. Similarly, in the Soviet Union one of the goals of Shatalin's "500 days" program for the initiation of a transition to a market economy was the transfer or sale of some 20 percent of the industrial enterprises within four months of adopting the program, with another 40 to 50 percent to be sold by the end of the first year of implementation, and a total of 80 percent of the SOEs to be "denationalized" in less than two years' time [Shatalin et. al. 1990].

to its corresponding behavioral and institutional dimensions.

Studies conducted by the World Bank and OECD [Corbo, Coricelli and Bossak 1991, Gelb and Gray 1991, Blommenstein and Marrese 1991], for example, have identified a number of systemic factors impeding economic transition in general and privatization in particular: the lack of well-defined ownership and property rights, a distorted incentive system, a shortage of managerial skills and adequately trained administrators, and the absence of such market institutions as a legal framework to establish and enforce contracts,<sup>2</sup> a commercial banking system, a domestic capital market, and a well-functioning communications system. While acknowledging the importance of these variables, limiting the analysis to systemic barriers excludes the influence of behavioral and institutional factors. Equally critical in an analysis of the transition process, they include, for example, social perceptions, labor-management relations, egalitarian attitudes, distorted work ethics, pervasive risk-averse behavior, vested interests, rent-seeking and "second economy" activities, and the prevalence of monopoly power in the economic bureaucracies of the former socialist economies.

This paper uses privatization in Poland to analyze the process and pace of economic transition. As a pioneer in transition and privatization, Poland encountered a variety of problems that inevitably will be experienced by other formerly socialist economies. If the learning curve associated with transition and privatization is steep, these economies will quickly acquire the relevant information and experience necessary to facilitate the desired structural transformation and thus avoid many problems Poland had to confront. If the

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<sup>2</sup> Poland was an exception in this regard having in place its pre-war Commercial Code of 1934.

learning curve is flat because special circumstances within each formerly socialist economy preclude the assimilation of Poland's experience, economic leaders will make the same mistakes, and no doubt create even new ones.

Using privatization as a mechanism for evaluating the transition process requires first an analysis of the factors that enhance or impede the transfer of property rights. The command economy legacy, perhaps the most significant determinant influencing the nature and scope of the privatization process, is described in section I. Section II provides a brief description and presents preliminary results of the privatization program launched in Poland in the autumn of 1989. Section III analyzes the anticipated and unanticipated barriers to privatization encountered to date. Finally, section IV offers lessons to be drawn from Poland's experience with privatization that may influence shape of the learning curve for other transition economies.

### **I. The Command Economy Legacy**

Socialist centrally planned economies shared a number of common features: highly centralized decision-making, directive annual planning, state-owned property, and material incentives not linked to performance. The lack of clear-cut rules defining the responsibilities and rights of decision makers at different levels of the economic bureaucracy, described as an *undefined centralization* by Balcerowicz [1981], permitted communist party officials and government administrators to engage arbitrarily in both macro- and microeconomic management to the detriment of economic efficiency and performance. Simultaneously, the substitution of bureaucratic rationing for market allocation of goods and resources gave also rise to a *non-market destructive competition* among agents taking part in central plan formulation and implementation [Rapacki

1986].

These features of the command economy resulted in the atrophy of independent thinking and managerial initiative, and motivated pervasive risk-averse behavior. Their impact was compounded by the widespread use of the system of *nomenklatura* which contributed to the negative selection of individuals to key positions in state-owned enterprises (SOEs) and government administration [Rapacki 1986]. That is, neither initiative nor innovativeness appear to have dominated the characteristics of individuals that party officials typically appointed or promoted [Granick 1972, Berliner 1976, Conyngham 1982]. More important was the ability to function effectively in the bureaucratic environment.<sup>3</sup> The risk-averse behavior in turn strengthened the position of political officials who rewarded obedience and passivity with promotions. In short, the command economy produced in abundant supply those personal characteristics and professional skills that are largely inappropriate for successfully managing firms in a competitive environment.

A more general legacy of the command economy is seen in the elimination of the institutions, regulatory framework and system of incentives inherent to a market system [Lipton and Sachs 1991, van Brabant 1991, Nuti 1991]. In place of strong work ethics, entrepreneurship, and a business culture conducive to efficient production and distribution activities, rent-seeking activities tended to dominate the behavior of economic agents in the state sector [Winiecki 1991]. As explained by Baumol [1990], while the stock of entrepreneurial talent is fixed at any given point in time, the allocation of entrepreneurial talent is

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<sup>3</sup> Moreover, while plant managers may have been capable of resolving production problems and achieving production quotas, they lacked both the appropriate background and the financial and marketing skills necessary to effectively run a firm under the market environment [Lawrence and Vlachoutsicos 1990, Linz 1988a, 1988b].



guided in large part by the incentive structure: when the rewards associated with unproductive entrepreneurial activities are greater than those linked to productive innovations, entrepreneurs will engage in rent-seeking (legal but dysfunctional) or organized crime (illegal) activities. Indeed, Winiński [1991] documents the widespread rent-seeking activities of political, governmental and managerial officials in the former socialist economies.

Ill-defined property rights and policies of maintaining wages at a low level (*they pretend to pay us and we pretend to work*), represent third legacy of the command economy. Combined, they eroded professional ethos and distorted attitudes toward work. Moreover, as suggested by Bukovski [1984], these policies may have simultaneously contributed to the participation in second economy activities by nearly all members of society, albeit in varying degrees. Widespread participation in second economy activities provided a perverse legitimization for the communist regime. By the same token it also generated a strong incentive to maintain the status quo.

Widespread, deeply-embedded egalitarian attitudes are another legacy of the command economy that tend to impede the transition process. Surveys conducted in Poland,<sup>4</sup> Czechoslovakia, Hungary and the Soviet Union suggest a strong resistance to wide salary differentials and to performance-based pay [Obrman 1990, Okolicsanyi 1990, *Voprosy ekonomiki* 1990]. Egalitarian attitudes implicitly undermine the possibility of popular support for the very institution

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<sup>4</sup> While some recent public opinion polls in Poland suggest changing attitudes [OBOP 1992], the data do not demonstrate that reported values have been internalized by those polled. Moreover, even if less egalitarian attitudes are emerging, the reported attitudes may change as respondents become personally involved with transition and privatization, that is, as they or their family face the threat of unemployment. Anecdotal evidence documenting this phenomenon in Russia and other republics of the Commonwealth of Independent States is reported regularly in the **Wall Street Journal** and **New York Times**.

of private property. Thus, they adversely affect the transition to a market economy, both on economic and political grounds. Moreover, to the extent that egalitarian attitudes are associated with a negative social perception of education, that is, the recognition that education is not an important determinant of a successful professional career, these attitudes impede the transition process. Similarly, to the extent that egalitarian attitudes and the prevailing incentive structure fail to adequately reward mental as opposed to manual labor, these attitudes are incompatible with the system of values underlying market economy.

A well-documented legacy of the command economy, the combination of centralized decision making and state ownership contributed to a highly monopolistic structure of production. In the Soviet economy, for example, of the 46,000 state-owned industrial enterprises (SOEs), the top 600 utilized one-quarter of the capital stock, produced one-third of total industrial output, and employed one out of every five industrial workers in 1989 [World Bank et. al. 1990, Linz 1992]. Moreover, in almost two-thirds of Soviet product groups, a single enterprise accounted for more than half of total output [Capelik and Yakovlev 1992, Yakovlev 1990]. Similarly, in Poland the top 500 SOEs (6 percent) provided 47 percent of total sales of manufactured goods and generated some 60 percent of net income in industry in 1988. Conversely, half of the industrial enterprises altogether accounted for only 8 percent of manufacturing sales.<sup>5</sup>

Monopoly power impedes privatization by imposing costs in addition to those that would normally arise as a consequence of the transfer of ownership and rights.<sup>6</sup> Monopoly pricing during transition is inevitable. The time and

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<sup>5</sup> *Lista 500*, [1990] and *Informacja Statystyczna*, [1990].

<sup>6</sup> Production declines and rising unemployment are unavoidable as socialist economies move from plan to market allocation, given the overstaffing and

effort required to break up large state-owned firms is prolonged if SOEs resist the restructuring and reallocation of resources required by privatization. In many cases the monopolist is also a monopsonist, thus "demonopolization" and privatization necessarily involve large-scale layoffs in specific regions, a consequence difficult to face for newly emerging democratic regimes. Finally, in socialist centrally planned economies, large-scale SOEs typically provided a variety of services unrelated to production: housing, day care, health care, sports facilities, special shops for the distribution of *defitsit* goods. While inefficient in market economy, one legacy of the command economy is the absence of an immediate alternative to provide these services.

Finally, the command economy legacy is evident in the serious macroeconomic imbalances confronting each former socialist economy. Indeed, the decision to initiate the transition to a market-oriented economy stemmed from the need to reverse declining production trends, growing technological lags in most industries, and rising repressed inflation.<sup>7</sup> In the Soviet economy, for example, both Soviet and western estimates suggest output growth stopped in the mid-1970s [Aganbegyan 1987, 1988, Selyunin and Khanin 1987, Ellman 1984], yet wage increases were maintained and financed by printing money. Consequently, by 1989, the cash overhang was estimated at 170 billion rubles, an amount approximately equal to 9 months' earnings of the entire state-sector workforce [Linz 1991]. Similarly, in Poland in the fall of 1989, inflation was running at

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inefficient production of state-owned firms [Campbell 1991]. Production and employment declines are magnified as downstream enterprises produce less in response to fewer inputs. The recessionary economic environment adversely affects expectations and may be prolonged if domestic and foreign investors fail to participate in the privatization process.

<sup>7</sup> For discussion of macro imbalances in Czechoslovakia see [OECD 1990 and 1991, Gelb and Gray 1991]; for Hungary, see Havasi [1982], Marer [1986], Tardos [1981], Portes [1990], Kornai [1990].

over 3,200 percent annually, accompanied by widespread shortages of goods, and an accelerated velocity of money in circulation. The budget deficit averaged 29 percent of government expenditure during the first six months of 1989, and was being financed entirely through interest-free central bank loans. Foreign debt rose to \$42 billion (511 percent of exports), the money supply grew twice as fast as the price level (CPI) and the zloty was being "crowded out" by foreign monies (*dollarization*) [Gorski 1991, Kalicki 1991, Frydman, Wellisz and Kolodko 1991].

While the command economy imposed similar systemic and policy parameters upon each of the economies now undergoing transition, differences in their institutional, environmental, social, and cultural identities are well-established in the comparative economics literature [Gregory and Stuart 1992, Bornstein 1989, for example]. These differences have had both positive and negative consequences for the process and pace of privatization. Poland will be used as a case in point.

As a result of maintaining private property in its agricultural sector, Poland had a relatively larger share of economic activity taking place in a market-like environment than the other socialist economies. Approximately 75 percent of agricultural land in Poland has been in private hands since 1956. In 1988 private agriculture contributed 10 percent of GDP and employed some 21 percent of the laborforce. In short, the agricultural sector constituted a relatively large shelter for private initiative and entrepreneurship. Poland, like Hungary, also permitted relatively more private enterprise in retail trade, restaurants, repair services and handicrafts prior to the initiation of transition than the other socialist economies. By the end of the 1980s, the value added by private sector activities provided about 18 percent of GDP in

Poland, 15 percent in Hungary, and only 2-4 percent in other comparable economies [Milanovic 1989, Gelb and Gray 1991].

Although it might seem that Poland enjoyed a comparative advantage over other socialist economies given its relatively higher share of private sector activities, institutional and behavioral patterns inherited from the command economy and forty years without exposure to a competitive environment took its toll.

Ideological hostility towards the private sector in Poland was reflected in numerous economic, fiscal and administrative restraints imposed up on private enterprises. Private sector firms faced much higher taxation compared to public sector firms. They also frequently encountered additional discretionary fiscal levies and were obliged to operate in an unstable financial and legal environment, one where pricing rules were aimed at extracting maximum rents. The tight bureaucratic corset suffocated initiative in the private sector and dramatically increased the risk and uncertainty associated with day-to-day operations. These factors combined to distort incentives and produce a serious bias towards unreported, illegal or semi-criminal activities. Simultaneously, the symbiotic relationship between the official economy and second economy created an economic environment that encouraged entrepreneurs to start one business after another in rapid succession, trading off product quality, customers' confidence, and the firm's reputation for short-term returns.<sup>8</sup>

The institutional arrangements and behavioral consequences associated with

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<sup>8</sup> Similarly, private farmers, operating in a bureaucratic environment where state-owned monopoly suppliers (seeds, fertilizers, pesticides, tools and machinery, agricultural services), state-owned monopoly buyers (distributors and food processing industries), and a state-owned financial sector dominated, were exposed to the same distorted system of incentives and discouraged from long-term investments and allocating resources to most efficient uses.

labor-management relations in Poland appear to be having a negative impact on privatization. Poland's unique labor-management relations date back to 1956 when workers managed to enhance their role in enterprise operations. Under strong pressure from Solidarity, the government in 1981 reintroduced a co-determination role for workers' councils at each enterprise in the hiring and firing of plant managers, and in current production and investment policy decisions. As a result, Polish enterprise managers have been constrained by state officials (planners, ministers), by workers' councils, and by trade unions, a phenomenon labelled sometimes as a Polish "Bermuda Triangle". The 1981 Law on Workers' Self-Management established a new type of vested interests of employees in state enterprises, creating further distortions in property rights. The Law split the property rights bundle between workers, management, and the state: workers and managers gained the right to use and benefit from the use of enterprise assets, but the state as sole owner retained the right of exchange. In effect this law strengthened the bargaining position of workers' councils and trade unions for wage increases in excess of productivity or output increases.

As a consequence of these factors, Poland, like other former socialist economies, was ill-equipped to initiate a smooth transition from plan to market. Indeed, the transition process created a "systemic vacuum" where neither plan nor market governed production and distribution activities. Because the basic institutions inherent to a market mechanism were insufficient or strongly distorted, and because policy makers found it politically prudent initially to introduce only partial reforms,<sup>9</sup> the transition process in Poland and other

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<sup>9</sup> Magnitude of initial macroeconomic imbalances had direct consequence for scope and pace of transition process. The more difficult the initial economic conditions the political leadership faced, the greater the delay in implementing the institutional and structural changes required for the transition. Even in Poland, the first to introduce the transition with "shock therapy", macroeconomic stabilization took priority over privatization in the transition

former socialist economies can be compared to Myrdal's [1944, 1957] "vicious circle" phenomenon -- solving only one problem at a time when many problems need to be tackled simultaneously creates at least two additional problems. Raised expectations that the transition to a market economy would occur rapidly and result in an "economic miracle" in terms of the quantity and quality of output, and hence higher living standards, has made the transition even harder to fully initiate.

## **II. Privatization in Poland: Preliminary Results**

Officially, Poland's leaders declared privatization a priority in 1989, yet unofficially *spontaneous privatization* had been occurring since adoption of the 1986 Law on Joint Ventures and the 1988 Law on the Freedom of Economic Activity. The former created an incentive for SOEs to establish joint equity ventures with foreign firms; the latter permitted the formation of private limited liability and joint stock companies. Simultaneously managers of SOEs and part-owners of the joint equity venture or private company, SOE managers (or their relatives) set up private companies by appropriating the SOE's assets either through in-kind contributions, leasing, or transfer pricing.<sup>10</sup> All three mechanisms greatly undervalued the firm's assets and thus contributed to continued inefficient use. Moreover, to the extent that the former nomenklatura

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process [Outline 1989, Gelb and Gray 1991].

<sup>10</sup> Spontaneous privatization which entailed the establishment of new fields of rent-seeking activities (private business and the fringe of state-owned sector) and new sources of financial wealth for the communist rulers and their cronies, may be seen as an important explanatory variable for the surprisingly peaceful take over of power from the communists in Poland in 1989. Having established new bases for their rent-seeking activities they may have felt more secured of not losing everything while giving up their political monopoly and retreating to the newly emerging private sector generating vast business opportunities.

were mostly unskilled at working within a competitive market environment and yet well-positioned to impede the introduction of policies that would facilitate the emergence of such an environment, the transition process has been prolonged.

In the first draft of Poland's economic transition program submitted to the IMF in the fall of 1989, privatization was to bring about both short- and long-run benefits. First, the sale of state-owned assets was to facilitate the liquidation of the monetary overhang. Revenues arising from the sale of state-owned assets and increased tax revenues generated by the expanding private sector were expected to improve the budgetary situation. It was also believed that privatization would be conducive to a higher propensity to save and thus would lessen the inflationary pressures in the economy. Privatization not only was seen as the primary vehicle for improving economic efficiency but also was expected to induce institutional and structural changes as firms competed for scarce resources and goods. Finally, it was expected that privatization would result in an equitable distribution of property rights and the creation of a middle class, which in turn would facilitate the systemic transformation being implemented and act as a stabilizing factor in the budding democracy [Outline 1989, Jedrzejczak 1991].

Political constraints, legislative bottlenecks, and a strong commitment to achieving macroeconomic stabilization contributed to the 9-month delay in establishing the legal and institutional bases for privatization in Poland [Jedrzejczak 1991, Nuti 1991, Slay 1991]. Moreover, strong disagreements on the content and format of the privatization program resulted in an incoherent final version that was a compromise between diverging economic (efficiency) and social (equity) interests.

The July 1990 Privatization Law adopted a three-pronged approach to



privatization: *capital privatization, privatization through liquidation, and small-scale privatization.*<sup>11</sup> *Capital privatization* was to encompass mainly large-scale SOEs (500+ employees) in good financial standing. SOEs selected for capital privatization were first transformed into joint stock corporations (*commercialization*) with the State Treasury holding 100 percent of the shares. The shares subsequently were disposed of by public offering (20 percent offered at a 50 percent discount to employees, the remainder to individual investors) or direct sale (auctions or invitations to tender). *Privatization through liquidation*, designed to embrace mostly medium- and small-scale SOEs in good financial condition, did not require legal transformation before divestiture. Privatization through liquidation meant either the direct sale of the firm's assets to an outside investor, or the contribution of liquidated assets to a newly established company, or the lease of assets to the firm's employees or management. *Small-scale privatization* involved the leasing or transfer of assets of those firms that employed 10 or fewer workers.

Despite being the fifteenth draft, the Privatization Law adopted in 1990 failed to establish the necessary preconditions for successful privatization. As a consequence, disappointed with the slow pace of privatization, Bielecki's government in 1991 came up with several innovative proposals: *cluster privatization, mass privatization, express privatization, and privatization after restructuring* [Mass Privatization 1991, Bandyk 1991, Kwasniewski 1991, Nuti 1991]. Cluster privatization involved selecting specific industries for

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<sup>11</sup> Leveraged buy-outs by employees, management contracts, asset stripping and fragmentation (splitting) of existing SOEs were also included in the initial program as a means to achieve privatization. When the legislature passed the Privatization Law in July 1990, they simultaneously created the Ministry of Ownership Changes to implement the program. Since November 1989 till then there had been a specialized privatization unit within the Ministry of Finance.

privatization. The mass privatization scheme was to be based on the free distribution of ownership vouchers to the general public. Express privatization consisted of the leveraged sale of small-scale enterprises in good financial standing -- requiring only a 20 percent down payment plus approved financing. Privatization after restructuring involved hiring an outside management team for 3 years to restructure the SOE in order to improve its financial condition before privatization. By increasing the number of firms eligible and simplifying the business valuation procedures, these four newly adopted measures were to speed up the pace of privatization.<sup>12</sup>

Between August 1990 and January 1992, a total of 1,258 SOEs were subject to privatization procedures [*Statystyka Polski* 1992]. This group constituted 15.1 percent of all state-owned firms in Poland, employing 10.2 percent of the total labor force in the state sector, 13.8 per cent of its assets and contributing 21.2 percent of total pre-tax income in this sector.<sup>13</sup>

Not all privatization programs have been equally successful. Capital privatization initially targeted 308 SOEs, yet only 26 to date actually have been fully privatized; the rest remain in the care of the Ministry of Ownership Changes as corporate entities.<sup>14</sup> In numerical terms, privatization through liquidation has had a much larger impact. At the end of 1991, of the 950 SOEs

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<sup>12</sup> An important development for long-term success of privatization yet having only a marginal impact on capital allocation in the short-term, the Warsaw Stock Exchange was established in April 1991. Coupled with the simultaneous creation of the Securities Commission, Poland effectively established the foundation for the future development of a domestic capital market.

<sup>13</sup> This and subsequent data on privatization results are based on *Statystyka Polski* (1992) and own calculations; the share indices refer to end-1990, while the remaining data are from end-1991.

<sup>14</sup> Only 11 firms have been subject to public offering and their stocks are being currently quoted on the Warsaw Stock Exchange. The remaining 15 firms have been sold directly (private placements) to domestic or foreign investors.

initially targeted for this procedure, only 200 SOEs have been privatized.<sup>15</sup> During this same period, cluster privatization was to encompass 34 sectors, yet only 8 studies have been completed, including breweries and footwear.<sup>16</sup> In general terms, "privatization from above", the divestiture of large- and medium-scale SOEs, has advanced much slower than expected and its actual results have been well below the original government targets. This trend seems to confirm serious doubts regarding the speed, cost and effectiveness of privatization based on bureaucratic control and execution [Frydman and Rapaczynski 1991].

In terms of producing the most visible results in transforming the ownership structure of the Polish economy and generating corresponding efficiency gains, privatization from above was more than matched by "grass-root privatization" -- the fast expansion of existing private firms and the entry of new small-scale private businesses. During the course of 1990-1991, the number of private firms quadrupled, from 350 thousand to 1.4 million, employing 4.5 million people (38.2 percent of total non-agricultural employment in Poland).<sup>17</sup> These figures include the growth of joint equity ventures with foreign partners: from 1,645 at the end of 1990 to 4,796 by the end of 1991.

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<sup>15</sup> 534 within the framework of the Act on State-Owned Enterprises, and 416 on the basis of the Privatization Law. The liquidation (or bankruptcy) procedures were also envisaged in case of insolvent SOEs, as provided by the 1981 Law on State-Owned Enterprises, whereas the Privatization Law set up juridical bases for liquidation and subsequent privatization of SOEs in sound financial position. The provisions of the Law on State-Owned Enterprises, apart of bankruptcy procedures, have been concurrently used for privatization of some SOEs.

<sup>16</sup> **Business International** 10 February 1992. In fact, 2 public companies quoted on the Warsaw Stock Exchange were breweries and had been privatized via this track.

<sup>17</sup> Including agriculture these figures were by end-1991 7.6 mn and 47.8 percent, respectively. Own calculations, based on data from *Statystyka Polski* (1992).

Official statistics report that by the end of 1991 the private sector contributed approximately 45 percent of Poland's GDP, an increase from 19 percent in 1989.<sup>18</sup> Comparable figures suggest that private enterprise provided approximately 30 percent of GDP in Hungary, 10 percent in Czechoslovakia and 7 percent in Bulgaria.<sup>19</sup> The share of Polish private sector activities ranged from nearly 90 percent in retail trade, to 80 percent in trucking fleet, 60 percent in wholesale trade, 55 percent in construction, 46 percent in imports and to 24 percent in manufacturing.<sup>20</sup>

Three points need to be made while assessing the quantitative results of privatization in Poland during 1989-91 period. First, parallel to privatization of the "real" sphere, the Polish government pursued policies aimed to demonopolize, restructure and privatize the banking sector, insurance companies and pension plans. Simultaneously, it initiated measures to create institutional investors, including mutual funds. Second, changes in the relative weights of the public and private sectors took place under the conditions of a deep recession in the Polish economy. While the state sector's response to the restrictive macroeconomic policy and stabilization program was mostly negative, the private sector expanded rapidly from 8 to more than 25 percent of GDP between 1990 and 1991. This expansion occurred despite an overall decline in output and sales for the economy as a whole (12 percent of GDP in 1990, 8-10

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<sup>18</sup> Excluding agriculture - about 33 percent (increase from 9 percent in 1989). Since these shares have been calculated in current prices, they may be subject to certain distortions, in particular in the case of agriculture, in view of the unfavorable trends in its terms of trade vis-a-vis the rest of the economy during 1989-91. Part of the increase is due to inclusion of cooperative sector (contributing 10% GDP in 1990) in private sector calculations.

<sup>19</sup> *Rzeczpospolita*, 5 February 1992; **New York Times**, 20 January 1992.

<sup>20</sup> *Statystyka Polski* (1992) and own calculations.

percent in 1991).<sup>21</sup> Third, we doubt that the initial efficiency gains associated with the rapid expansion of the small-scale private sector can be maintained in the longer run. The eruption of private entrepreneurship during 1989-91 was confined principally to activities involving low capital intensity and those that demanded relatively unspecialized professional skills. Further privatization will require massive investment and restructuring -- the privatization of heavy industry, mining, transportation, some segments of construction, for example. Further privatization will also require specialized inputs or expertise currently unavailable (or insufficiently available) in Poland -- the privatization of high-tech industries, financial services, investment banking and capital markets, for example.

While attempting to assess a privatization program implemented in Poland in 1989-91, several major policy flaws should be stressed.

First, legislative bottlenecks and political struggles over the content of the privatization program during the fall of 1989 and summer of 1990 imposed a 9 month delay in its implementation. This delay cannot be fully justified by the initial macroeconomic imbalances and the need to focus on the stabilization part of economic transformations.

Second, some of the privatization objectives as originally spelled out were incompatible. It is not possible, for example, to simultaneously achieve efficiency and equity. Although a two-year period is perhaps too short to evaluate success in achieving specified goals, there have been no clear efficiency gains either in the operation and performance of most privatized SOEs or in terms of their spillover effect on the overall economic environment. In part this stems from the equity bias in the privatization policies implemented

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<sup>21</sup> *Statystyka Polski* (1992), *Rocznik Statystyczny* (1991).

in 1990-1991. It should be noted, however, that despite the self-imposed bias, the equity objective of privatization has not been attained either.

Budget revenues did not increase as anticipated as a consequence of privatization. Owing to substantial delays in the implementation of the privatization program, as well as to the very nature of hyperinflation and the shock therapy to reduce it, privatization failed to absorb the monetary overhang in the short-run as originally expected. In 1991, for instance, the proceeds from sales of state-owned assets amounted to 3 billion zlotys, only 20 percent of the targeted figure [*Stan Państwa* 1992]. Revenues from corporate taxes in the short-run also have been below the expected level. To date, privatization has had no clear anti-inflationary impact in Poland. At best, it may contribute to some reduction in inflationary pressure in the medium-run by absorbing private savings.

If privatization means creating a full-fledged competitive environment, then "privatization from above" constitutes only one of several components of the package serving this aim. The other components include: anti-monopoly policy, entry of new firms, attracting foreign capital, and restructuring the existing SOEs to increase efficiency. Privatization in Poland thus far has suffered from an overemphasis on "privatization from above", in general, and capital privatization through public offering, in particular. The emphasis on capital privatization was based on the British privatization experience of early 1980s which stressed a customized approach to each privatization case. Despite its obvious merits, privatization through public offering turned out to be an ineffective strategy in Poland. Capital privatization proved to be a very costly and lengthy procedure, imposing insurmountable burdens on government

administration, and thus producing numerous bottlenecks and inefficiencies.<sup>22</sup> In short, capital privatization was incompatible with the existing systemic and institutional framework in Poland -- an underdeveloped commercial banking system, a nascent capital market, and the lack of standardized business valuation methods. Moreover, the program based on public offerings resulted in a wide dispersion of ownership thus inhibiting effective governance control.

The privatization program in Poland also turned out to be an autonomous component of the economic reform package. In particular, privatization was not integrated with the industrial and structural policies. This gave rise to many inconsistencies in the privatization program, including the absence of clear-cut rules of privatization, the absence of well-defined selection criteria, and the lack of strategic priorities that identified which sectors and industries should be promoted and subject to privatization first.

During the first stage of privatization (fall 1989--spring 1991), the main focus of the program rested on the privatization of firms rather than on ownership transformations of the whole economy. Thus, for instance, the choice of the first groups of firms for public offering under the capital track was made based on the individual characteristics of SOEs and not on macroeconomic considerations. As a result, privatization initially neglected the possibility of spill-over effects. In particular, there were no sectoral studies conducted until the spring 1991 to identify where privatization would be most effective in terms of efficiency gains. Nor was there any consideration of customizing the privatization process to take into account the competitive environment already existing in some sectors. In short, Poland's privatization program initially

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<sup>22</sup> In part this stems from the small number of people employed by Poland's Ministry of Ownership Changes--200 persons, compared with more than 3,000 people employed by the Treuhandanstalt in Germany.

ignored backward and forward linkages, vertical and horizontal integration, and the differential impact associated with privatizing end-use producers as opposed to the manufacturers of intermediate goods.

Finally, in view of the pronounced trends that developed in Poland during 1991 -- the dramatic deterioration of the financial standing of many SOEs, liquidity squeeze, collusion between SOEs and state-owned commercial banks extending easy loans to insolvent state firms, the growing share of bad debts in these banks' portfolios and the real threat of a "domino effect" entailing collapse of both SOEs and commercial banks if not supported by the government -- it also seems a plausible hypothesis that the sequencing of privatization has been inappropriate. Because of the vital importance of the financial sector to the transition process, Poland's experience suggests that privatizing the financial sector should occur concurrently with privatization of the real sphere in the sequencing of systemic reform [Brainard 1991, Bornstein 1992].

### **III. Barriers to Privatization**

In course of implementing the privatization program, some of the obstacles encountered in 1990-1991 were anticipated. It was recognized, for example, that certain features of the command economy legacy would impede privatization, although the magnitude and persistence of the adverse impact was greatly underestimated. Moreover, numerous obstacles encountered during the first two years of privatization in Poland were completely unanticipated.

Several anticipated factors impeded the direction, pace, sequence and effectiveness of the privatization process in Poland. First, while the absence of adequate managerial skills and attitudes was acknowledged, this has turned out to be one of the most critical barriers to privatization. In most cases,



former SOE managers appointed under the nomenklatura system retained their positions in newly-privatized firms. With some exceptions, they were ill-equipped to handle the new environment and the challenges it created. In a few instances new Supervisory Boards have acted as catalysts for initiating necessary changes in management performance. Yet there is little doubt that the creation of a managerial class, both in terms of appropriate skills and educational background, as well as personal characteristics, attitudes toward risk, dynamism, innovativeness, and so forth -- compatible with the market economy -- will take at least one generation. This time frame, while optimistic, is still much longer than originally expected and will require committing substantial resources to the education, training and the relocation of managerial personnel.

Facing rising unemployment, declining living standards, and the loss of job security, Poland's blue-collar workers quickly became disenchanted with the privatization program. It is a paradox that the blue-collar workers, whose support for Solidarity in 1980-81 and again in 1988-89 played a decisive role in the collapse of communism in Poland, will be the main losers in the transition to a market economy. The deeply internalized belief in their historical role as the vanguard and champion of change in Polish society, a belief strengthened by the introduction of the new labor-management system in 1981, coupled with deeply-embedded egalitarian attitudes have produced widespread opposition to privatization. Distorted work attitudes persist, and the increased propensity to use the strike weapon has discouraged foreign investment.

Successful privatization of Poland's SOEs entails dismantling the workers' councils and hence the loss of co-management prerogatives by employees. Yet, the 1990 Privatization Law requires the consent of workers' councils to initiate

privatization procedures in targeted SOEs. If not accompanied by satisfactory compensation for the loss of their property rights, privatization acts against workers' vested interests and thus is subject to their strong resistance. Such resistance slows down the pace of privatization and increases its social and budgetary costs by prolonging negotiations and reducing potential government revenues.

A fourth anticipated barrier to privatization was the delay caused by the absence of conventional financial and accounting techniques employed prior to the initiation of transition. It was well-understood that capital privatization would require the valuation of state-owned assets prior to establishing a sale price. Yet the extent to which the magnitude of the systemic constraints -- the distorted financial environment, the unreliable accounting system, the lack of capital markets and any relevant price references -- would impede an accurate valuation was unanticipated [Rapacki, Jagiello and Kucharski, 1990].

When the Polish government embarked on its privatization program in 1989, the low level of domestic savings was thought to be one of the most important constraints to rapid privatization.<sup>23</sup> Experience has shown this factor to be of relatively small significance. In fact, the stock of savings has grown in real terms, but domestic investors have proven unwilling to take over state-owned firms. This may stem in part from the general deterioration in the financial standing of SOEs, and in part from the failure of the government to devise and

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<sup>23</sup> According to various estimates, the total personal savings in Poland by the end of 1990, including both domestic and hard currency bank deposits and hard currency savings held outside the banking system, were equivalent to some 15-21 percent of the net book value of public sector productive assets [Lipton and Sachs 1991, Breitkopf, Gorski and Jaszczynski 1991]. Assuming the propensity to invest in stocks to be similar to the patterns prevailing in Western countries (15 percent of bank deposits) this figure would amount to only 3.5 percent of the assets expected to be privatized.

implement a policy aimed at restructuring selected SOEs prior to their divestiture.

Several obstacles to privatization were unanticipated.

A major barrier to the rapid transfer of ownership and rights was the depth and persistence of the recession in the state sector and the corresponding poor performance of privatized companies. The experience of the SOEs transferred to private hands during 1990-91 seems to indicate that most firms adjusted only very slowly to market challenges. For example, out of 11 companies quoted on the Warsaw Stock Exchange, only 5 have improved or were able to maintain their financial position in 1991; the remainder suffered losses or displayed symbolic net profits. These proportions in the whole group of privatized firms may be even worse, since 2 companies who went public operated in the beer industry, one of the few sectors not affected by the recession, and one was a joint venture with foreign capital.

Second, the balance of power in the newly-privatized companies has also impeded the privatization process. Poland's experience indicates that privatization failed to substantially change the distorted internal power structure in the enterprise. Trade unions assumed the role of the discarded workers' councils. Indeed, both Solidarity and OPZZ have sought to redefine their identity in the new political environment by exerting strong pressure for wage increases. Their position has been facilitated by the lack of an effective governance control and inadequate management in these former SOEs.

A completely unanticipated phenomenon that emerged after the enforcement of the Privatization Law has been the perverse adjustment of managers in many SOEs, frequently in collusion with workers' councils, to the new privatization framework. For example, privatization through liquidation created several

possibilities by employees to acquire state assets, including leveraged buyouts, lease, or direct sale. Anecdotal evidence suggests that in many cases SOE managers have pursued a deliberate policy of depleting the value of SOE assets, thus depressing the sale price or lease fee, and enabling them to acquire the property rights much cheaper than would otherwise be the case.

It also came as an unexpected development that the private sector continued to engage in dysfunctional entrepreneurial behavior. Despite the newly emerging market institutions and competitive environment, rent-seeking activities and unproductive entrepreneurship patterns inherited from the command economy revealed strong inertia. In addition, widespread tax evasion, financial scandals, smuggling, and other activities became more prevalent.

Finally, the protracted recession failed to bring about the closure of inefficient SOEs and thus the expected reallocation of resources to more efficient uses. The hard budget constraint imposed by tight monetary and fiscal policies has been substantially softened as a result of collusion between state-owned commercial banks and SOEs. The former extended easy loans to the latter, including insolvent firms and those on the brink of losing financial liquidity. This trend has been strengthened by forced intra-firm credits (extended collection periods of receivables).

#### **IV. Lessons and Conclusions**

Two years of experience with privatization in Poland has illuminated many problems and challenges inherent to economic transition. In particular, policy makers are now better informed about the interdependence between privatization and transition and the systemic, behavioral and institutional barriers hindering the progress of privatization and transition. The lessons learned from Poland's

experience stem partly from an objective evaluation of the privatization process in a post-communist society. In part, they must also be attributed to subjective factors: errors and inconsistencies in the privatization program and other related government policies.

The following conclusions deserve, in our view, special attention:

1. The proper design, sequencing and implementation of the privatization program in particular and the transition strategy in general requires a careful examination of and appreciation for the historical determinants associated with the negative legacy of the command economy.

2. Among the most crucial historical determinants of privatization, largely neglected or underestimated in Poland at the outset of the transition process, institutional and behavioral factors stand out. As described above, they impeded the systemic transformation by adversely affecting the direction, pace and effectiveness of the privatization process, making the process of change more lengthy and socially costly. We could refer to them as a mentality barrier to privatization, deeply rooted in the outgoing system, sometimes referred to as an "inner communism" or "homo sovieticus" legacy.<sup>24</sup>

3. The privatization process is prolonged if only a single method of SOEs' divestiture is implemented. When privatization encompasses multiple methods, as was the case of Poland after 1991, greater flexibility and effectiveness results.

4. As a means to create a competitive environment, privatization needs to come not only "from above" but also "from below". In addition to the sale of SOEs, the government must simultaneously support and encourage other ways of

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<sup>24</sup> The latter term draws directly from the title of famous Zinoviev's book [Zinoviev 1978].

creating a competitive environment, including demonopolization and restructuring of existing SOEs. To be successful, privatization must include a "grass-roots" element which includes attracting foreign capital.

5. To be successful, privatization needs to be treated as one part of an overall transition policy, and be subordinated to its priorities, objectives and available resources. This refers in particular to industrial and structural policies. For privatization to be effective, it is also important that other components of systemic transformation, including appropriate institutional and legal framework, be in place - if possible - at the same time. For example, because of the vital importance of the financial sector for a successful transition and privatization program, emphasis must be placed early on to implement a fundamental reform that starts with the privatization of banks. The overhauling of the financial sector, therefore, should proceed at least concurrently with privatization of the "real" sphere in the sequencing of systemic reforms.

6. The privatization program ought not to rest on a customized divestiture of firms but focus instead on the comprehensive restructuring of ownership and property rights in the whole economy. Our analysis indicates that a privatization strategy based on a sectoral approach is the most viable vehicle for bringing about the most desirable outcomes in terms of speed, effectiveness and potential spillover benefits.

7. The Polish privatization program encountered strong resistance in enterprises, partly stemming from the labor-management system adopted in 1981. This system created new vested interests in the SOEs, further complicating the already unclear issue of property rights and the ability to convert them into State Treasury joint stock companies in one fell swoop as was done in the former

GDR by Treuhandanstalt. Such a move would necessarily have been accompanied by an adequate compensation to workers in terms of privileged access to the stock of their companies.

While Poland has many institutional and behavioral characteristics that make it unique among former socialist economies, Poland's experience with privatization offers late-comers to the transition process -- Russia and other republics in the Commonwealth of Independent States, for example -- valuable lessons for a successful structural transformation.

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