

Institutional Technology and the Chains of Trust: Capital Markets and Privatization in Russia and the Czech Republic

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Abstract

Institutional theories emphasize the important roles played by the state, political actors, and beliefs for the formation of viable markets. 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. However, 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.

Keywords: mass privatization, institutions, economic reform, Russia, Czech Republic

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 following the end of the privatization program (Goskomstat, 1996). Moreover, international aid and advisers sought to foster capital market development through the provision of the technologies for institution creation, e.g. the principles of registration and deposit of securities. Though 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 have seriously underperformed those of comparable countries. Figure 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 re-constitute 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 entrepreneurship should abuse the public good of institutions.

This paradox of the desirability of entrepreneurial ambition to propel economic reforms in light of 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.

There is a complementary set of macro-level factors for the failure of institution creation that concerns the entanglement of the politics of state power and powerful interests. As made powerfully clear by the work of Nee (1989), Stark (1996), McDermott (1998), and Murrell (1995), the collapse of socialism did not present a tabula rasa to policy makers. Rather, these 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 Starks' (1996) powerful phrasing, transformation does not begin from but *with the existing ruins of socialism*.

The institutional analysis of the failure to build deep capital markets in the Czech Republic and Russia seizes both horns of a recent debate regarding the primacy of cognitive premises and political actors. (See the useful discussion in DiMaggio and Powell, 1991, and Scott, 1995, as well as Hirsch, 1998.) Neither approach alone, in our analysis, is sufficient to explain the failure of the mass privatization programs. The new institutionalists have set Hegel back on his feet by emphasizing ideas and cognition as the bulwark of institutions. The primacy of taken-for-granted beliefs by indi-

viduals has caused a rejoinder from institutionalists that politics and agency are active influences on the formation and maintenance of institutions (DiMaggio, 1988; Hirsch and Lounsbury, 1997). Institutions are the historical covenants between politicized interests that are bound in coalitional collective action. It is this coalitional foundation that is not only the heart of Selznick's (1966) story of the Tennessee Valley Authority, it is also at the center of Carruther's (1996) account of the development of capital markets in England.

The history of market and institutional formation in transition economies is inexplicable without reference to the roles of both beliefs and political agency. Capital market formation rests critically upon the creation of trust in market transactions. This trust is supported by the adoption of what we call "institutional technologies" that are the basic and mundane foundations of formal capital markets. Yet, these technologies are not sufficient to generate "chains of trust" which ground the willingness of individuals to lend and borrow through market brokers and financial markets. Fundamental to the generation of this chain is the political coalition among powerful entrepreneurs to view transparent market transactions in their interests. These coalitions did not form in Russia and the Czech Republic, because it was not in their economic or political interests to support capital markets. Ownership of assets could be gained by other means.

We demonstrate the necessity to grab both horns of this institutional debate by examining the development of capital markets through a comparative case-method approach. We choose to examine Russia and the Czech Republic because of the similarity in their voucher mass privatization plans in relying upon the power of the market itself to drive economic development. Our research design is oriented toward the examination of the process by which impersonal capital markets become institutionalized as an accepted system of allocation following voucher mass privatization.

To provide clarity, we present first 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.

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 insure 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 camp 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, Shleifer, and Vishny (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 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.¹ 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 figure 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, 1, 849 joint stock companies, and 550 investment funds were privatized in less than four years. The scale and scope of

¹ An analogy can be made to the system used in some business schools for the allocation of space in elective courses and interviews. Students are given a certain number of “points” which they can bid in differing degrees for certain desired spots. Final allocation is based on market-clearing outcomes based on the total number of “points” bid.

these privatization programs make them one of the greatest examples of the non-violent transfer of property relations in the modern world.

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.² Large-scale privatization consisted of two waves held during 1992 to 1994. 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, they 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 figure 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 that was 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

² 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).

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.

Natural and Institutionalized 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 3 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, Shleifer and Vishny, 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.” (NYT, Jan. 27, 1991, p.103, quoted in Stark and Bruszt 1998, p.153 footnote).

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. At first, the political economy approach to self-interest focused on the inimical consequences of self-interest on socially-beneficial goals, as conflicting desires led to a Hobbsian 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 latter, natural market perspective, the singular 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 Pohl, Jedrzejczak and Anderson, 1995; Morgenstern, 1995; 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 be arena that drives the emergence of institutions to resolve hazards of exchange.

The new institutional perspective, in the sense defined by Powell and DiMaggio (1991) and Scott (1995), starts with beliefs and actions situated in an existing political and social context. Instead of assuming “markets” as an ideal-type model existing outside of existing social relations, this approach examines markets as institutions that are fully embedded in a broader social environment.

Capital markets, often thought of as highly transactional in character, rely 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) clearly 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.

The breakdown of socialism was not simply a change of economic regime, but a radical shock to the reservoir of trust that people employed in their everyday lives. In this environment, institutional trust -- to use Zucker's (1986) useful distinction-- quickly erodes, leaving an increased use of personal (or process-based) trust built on the basis of established relationships. 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."

In this regard, it is fundamental to our analysis to recognize 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 than privatization and restructuring. Though 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.

The collapse of socialism was marked not only by the lack of knowledge regarding capital markets, but also by the structural disruption and opportunities posed by rapid social change. These structural opportunities, as Hirsch and Lounsbury (1997) emphasize in drawing attention to power and agency for understanding institutions, quickly lead to new aggregations of interest and power in these countries. Thus, the moment of ripening beliefs about the behavior of capital markets coincided with the emergence of powerful interests.

The “transition” from socialism to capitalism represents, then, an unusual experiment that lays bare the relationship of beliefs to the emergent social and political context. The policy of mass privatization presents the problem of the logical necessity of formal assignment and transaction of property rights in an institutional environment with little history of financial market exchange. In comparison with established economies, two factors were lacking in the market environment in Russia and the Czech Republic: effective state powers to enforce basic laws and regulations, and a market infrastructure to intermediate between buyers and sellers.

State powers:

The absence of state powers to regulate and control newly created market forces is inherent in speedy, mass privatization policy. 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. The thesis of the strong state is problematic for the natural market view, especially for proponents who viewed privatization as an act of “depoliticization.”

Not surprisingly, then, 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.³ An example pertinent to financial markets is the North and Weingast (1989) argument that capital markets for public debt developed only when governments could credibly

³ There is, though, a dissenting and influential minority in both camps. See Stiglitz (1994) and Amsden et al. (1994).

commit to honor their obligations, that is, submit themselves to the rule of law. The institutional response to this study is Carruthers' (1996) analysis that cites evidence pointing to the role of social networks and political affiliation rather than credible commitment to law. It is this role of social networks that Stark and Bruszt (1998) argue is essential to the analysis of socialist transformation.

The states of the former socialist countries entered transition vastly weakened; the policies of privatization reduced their power 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 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 can not assume that powerful interests prefer transparent capital markets. However, there is little capability of the state to act as an independent, countervailing force over the emerging interests developed through market reform policy.

Institutional Technology:

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.⁴ 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 to formation of capital markets through the implementation of institutions to provide transparency, monitoring, and enforcement.

For instance, financial markets consist of mechanisms, that we labeled above “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

⁴ See Ostrom (1990) for a criticism of the Hobbsian state as a resolution to collective action dilemmas, and for the analysis of “constitutional” influences on the incentives for self-regulation.

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 so-called "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.

In Russia and the Czech Republic, none of this market infrastructure existed prior to mass privatization. However, mass privatization policy demands that these infrastructural elements be formed in an extremely rapid manner, as a functional capital market is a pre-requisite for free-market mass privatization policy. Brokers, dealers, investment funds, stock markets, registries and depositories were all necessary components of Russia and the Czech Republic's privatization programs. However, whether the organizations designed to operate with vouchers can transform into viable financial entities in the post-privatization environment was an untested component of mass privatization policy.

The chains of trust:

The essence of economic exchange in western capital markets is the trust that individual investors have that they will receive a future fair return. 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. This institutional trust 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. The state and the 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 ex-

change rests ultimately on the individual beliefs of investors that the broader institutional system works in practice to protect their investments.

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 (Ledeneva 1998; Stark 1989). 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 enter-

prise ties in Hungary and the Czech Republic are a recreation 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 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.

To White (1981), markets are "role systems" characterized by competition among players following consistent strategies within a defined social community. It is because markets are role systems that it is theoretically impossible to separate out economic actions and expectations from the social groupings in society. 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 based upon the historically existing relations in these societies and upon the new opportunities opened up 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 (i.e. natural versus regulated market models) 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.

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. Our use of interviews accords with Burawoy (1991: 272-3) who has called the “interpretative case method” where “macro and micro, general and particular, are collapsed... The micro is viewed as an expression of the macro, the particular an expression of the general.” 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 of 1994 to 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. (See the appendix that 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.

Capital Market Formation in Russia, 1992-1997

The 1993 Investment Company Law in Russia defined the basic legal foundation for the formation of capital markets in Russia. By law, *voucher investment funds* were allowed 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, Sept.3, 1996).

Despite the clear distinctions in law, the formal boundaries separating different types of financial organizational forms were not followed in actual practice. The government estimates that up to 2,000 "unlicensed" financial companies operated on the financial markets during mass privatization. An "unlicensed" company is (a) a financial company that undertakes activities outside its legal scope, or (b) 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. Specu-

lation 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. In addition, 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 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 also not well perceived and often used to the advantage of the financial party. For instance, one company interviewed was officially registered as an investment company, which 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 percent 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 experience 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 nation-wide 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 two thousand 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 100 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 its

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 6,000 percent 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 2,000 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 cents. 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 parts of the Russian legal code. MMM had not registered as an investment company, and the legal rules which 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.⁵

⁵ For information about MMM, see *Izvestiya*, Dec. 11, 94, December 18, 1994, Jan, 19, 1995; *Nezavisimaya Gazeta*, July 28, 1994 p. 1-2; *Chicago Tribune*, August 16, 1994. For information about Tibet, see *Komersant-Daily*, No.49, March 18 1995 or *Komersant*, No. 11, March 29, 1994, p.48.

Institutional Response

The development of the post-privatization capital market infrastructure is closely related to the initial experience of frauds in the initial development of capital market development. A clear example is the fate of the voucher investment funds. In March 1995, the Federal Commission on the Securities Market, a supervisory body equivalent to the Securities and Exchange Committee in the US, achieves the status of a cabinet ministry in the Yeltsin government. In July 1995, a presidential decree called for the Federal Commission to develop a new investment vehicle, the unit investment fund. Unlike the joint-stock company status of the voucher investment, unit funds were not to have shareholders. Instead, the relationship with their investors is governed by contractual trust indentures. Moreover, the unit investment funds were to be much more tightly supervised than the voucher investment funds. Regulations for net asset evaluation, information disclosure, depository services, audit reports, tax payments and portfolio standards were to be introduced before the licensing of management companies to run the new unit funds.

The Russian government hoped that some of the unlicensed financial companies could be transformed into unit investment funds in an attempt to recover the assets from the largest unlicensed financial companies. For instance, initial plans were for the assets of one of the largest of these unlicensed companies, *Russkii Dom Selenga*, to be transformed into a unit investment fund so that its shareholders could recover some of their investment.

A second rationale for the development of unit investment funds was to try to attract investments into the capital markets among the Russian population. The Federal Commission argued that the Russian population's initial experience in financial markets had led to extremely negative attitudes towards the new capital markets. Based on the government statistics on household savings, the Federal Commission estimated that the Russian population held from \$20-30 billion hidden in their mattresses, instead of invested in formal financial assets. 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)

The creation of the unit investment funds effectively meant the end of the voucher investment funds as a viable vehicle of investment. As a vice-chairman of the newly created Federal Commission in Russia put it:

Voucher funds served their function. Their goal was to create the infrastructure to pass out the vouchers. But privatization is now over. The voucher funds no longer play an important role. New functions need to be developed in this stage of development. That new role is going to be played by unit investment funds.

In choosing the unit investment fund as the main investment vehicle in the future, the Federal Commission acknowledges that the voucher investment funds have not succeeded in the goal of developing a broader capital market in Russia. They argue that a strongly regulated fund is needed to develop the broader confidence among the population to invest their savings in these new markets.

The Federal Commission's intervention into the financial markets has not been 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 more clearly identify the broader legal infrastructure of the market. New licensing criteria for brokers, dealers, stock markets, registrars, and depositories were all introduced. In each case, the new rules sharply curtailed the number of participants on the market.

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, Dmitri Vasilyev, the chairman of the Federal Commission and formerly one of the central policymakers for the privatization program, stated that his budget included enough funds to hire only 117 employees. He estimates that 4,000-5,000 bureaucrats are needed to enforce the regulatory acts that already exist, let alone to produce new regulations. He thus argues that regulation can only be achieved through self-monitoring, which can occur within a professional industry organization (Kremlin International News Broadcast, 1995).

The dilemma to 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.

Another broad intervention into the security markets in Russia has been the careful development of a new electronic trading system, the RTS system. The RTS is managed mainly by the National Association of Stock Market Participants (“NAUFOR”), a self-regulatory body that has developed rules for trading on the RTS. More liquid stocks (shares of approximately 75 companies) are traded on RTS-1, and less liquid stocks (approximately 96 companies) on RTS-2. The RTS accounts for approximately 65% of all Russian stock market turnover in 1997. The average daily turnover in the RTS in the first quarter of 1997 was U.S. \$38 million. Although there are more than 60 licensed stock exchanges in Russia, exchange based trading is limited. Outside the approximately 100 stocks that these exchanges trade, the stocks of the remaining 1000s of privatized firms are not traded on these exchanges.

Overall, the post-privatization capital market has very little resemblance to the initial market created during the mass privatization period. Most of the investment funds, broker/dealers and stock exchanges that were initially created do not compete in the new market. New rules and regulatory structures were developed to tightly control the actions and behaviors of the new market participants. The main motivation for this new set of rules is to avoid the scandals of the first period in which unlicensed companies and pyramid schemes dominated the overall market. The new Federal Commission says that it is the need to control fraudulent behavior and to develop trust in the overall market trading which justifies their strong intervention into the capital markets.

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 in-

vestment funds.” They blame the new regulations on the intent of the new regulators 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 first deputy Prime Minister, Anatoly Chubais. In this agreement, the two regulators agreed that the ultimate power in regulating the new financial markets resided in the Federal Commission. It was decided that banks would be able to participate on the securities market, and the Central Bank would have the power to license banks to operate on the financial markets. However, the Central Bank needed to monitor and enforce the security market regulations developed by the Federal Commission’s standard. Therefore, the compromise is that the banks will be able to compete in the new securities market, but that the Federal Commission will develop the regulations with which the banks must comply.

Capital Market Formation in the Czech Republic, 1992-1997

By and large, the privatization program in the Czech Republic proceeded with less 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. (See, for example, 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, Jedrzejczak and Anderson, 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 Dec. 1996 is shown in figure 3. At the Prague Stock Exchange, in the “unlisted” market, now 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 CZK 200 million, and a liquidity requirement of CZK 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 Stock Exchange, on a quarterly basis, with all relevant economic information. By the end of 1996, the market capitalization of the listed market was 443 billion CZK and the free market 115 billion CZK.

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 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 4, 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 Feb. 11 and March 3. In the last deal, the fund went to a Russian group calling itself KosMos, which installed a new board of directors. The funds’ assets were liquidated, creating a cash reserve of 1.3 billion CZK. 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. (The Central European Economic Review, May 1997, p.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 bank 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. Creditanstalt’s parent company in Vienna decided that they had no force to protect 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 5 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, eleven 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, p. 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 between 35-45% 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 to 80% or more.

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.

Institutional 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 Securities and Exchange Commission. 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 fault 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 regu-

lation. 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.⁶ 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 in opposition 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.

Discussion: Institutional Technology and the Chain of Trust

We began with the claim that the analysis of the failure to develop capital markets in Russia and the Czech Republic following mass privatization should grab both horns of the institutional debate of initial beliefs and political interests. In both countries, mass privatization created intense pres-

⁶ 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, May 12, 1998).

tures over the control of the newly privatized enterprises. The combination of illiquid markets and highly dispersed owners creates an unusual situation for motivated and well-informed investors to acquire high valued assets. Yet, the financial markets to facilitate, or to render transparent, the efforts of these entrepreneurs to acquire these assets were created haphazardly in tandem with the privatization programs. The entrepreneurial puzzle is how ownership could be acquired from dispersed owners in the absence of developed capital markets. Ironically, the entrepreneurial resolution to this puzzle of separating nominal ownership claims from the disposition of the assets led to substantially damaging the development of financial markets. In effect, the public has shares, but the market has sharks.

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.

Attempts to build this institutional technology failed partly for the mundane reason so heavily emphasized by Olson (1965) and Ostrom (1990), namely, that participants refused to pay dues or contribute effort to the public good of self-regulation. 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.⁷ 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 individual firms. As a consequence, political action by powerful interests is highly favored in these settings. Yet, the powers of the state to counter the deleterious effects of these interests on capital market formation were lacking.

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 who 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. Currently, 80 FIGs are legally registered in Russia, representing over 5 million workers, with another 50 applications still pending (Petkoski, 1998). As in the development of many financial markets, 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 led 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 is 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. (See Lieberman and Veimetra 1996, for a discussion.)

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 en-

⁷ See Coffee, 1996, as well as Black et al., 1996, on self-enforcing law.

tity 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 (Haryri and McDermott, 1998; 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 the role of an autonomous bureaucracy to establish rules is not sufficient. 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' (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 condi-

tions that weakened the property rights of the new owners. The reliance on natural market formation created tragically 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.

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, Shleifer, and Vishny (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.⁸ However, to view the elimination of state ownership as a dec-

⁸ It is important to underscore the analysis of Campbell and Linberg (1990) of the important influence of government in the United States through regulation.

rement 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 elite 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 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.

Figure 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 is from Goldman (1997). 1997 data is from the World Bank (1998). Chinese data is from IMF (1998).

Figure 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)	1,849 (65%-90% of industrial output)
Investment Privatization Funds	596	550*
% of Vouchers/Points Collected by Funds	23%	68%

Sources: Coffee (1996); Blasi et al (1997); Frydman, Pistor, and Rapaczynski (1996)

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

Figure 3

**Initial Capital Market Outcomes
Czech Republic**

Prague Stock Exchange

34% of Total Security
Transactions (Dec. 1996)

- Listed Market - 96 Issues
- Unlisted Market - 1.574 Issue

RM-System

9% of Total Transactions

- Electronic Trading System

Security Center

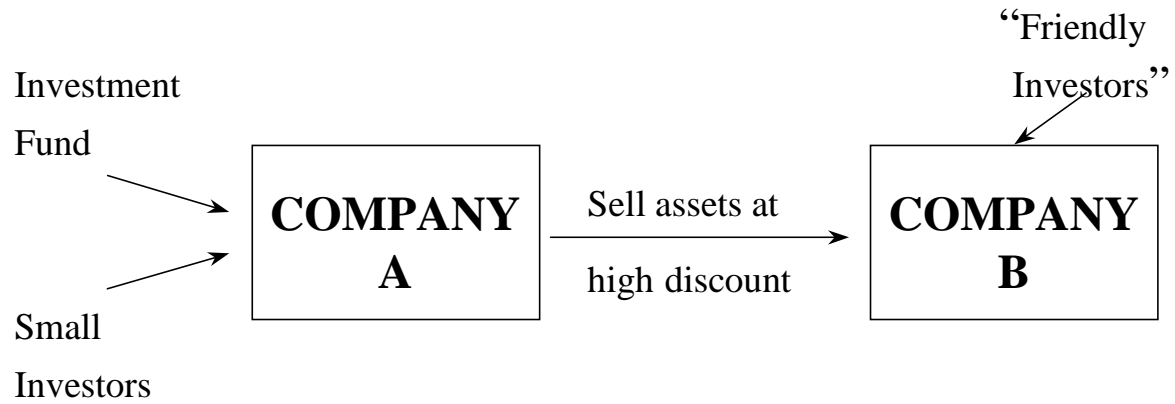
56% of Total Transactions

- Centralized Registry
- No Price Disclosure

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

Figure 4

Tunneling in the Czech Republic

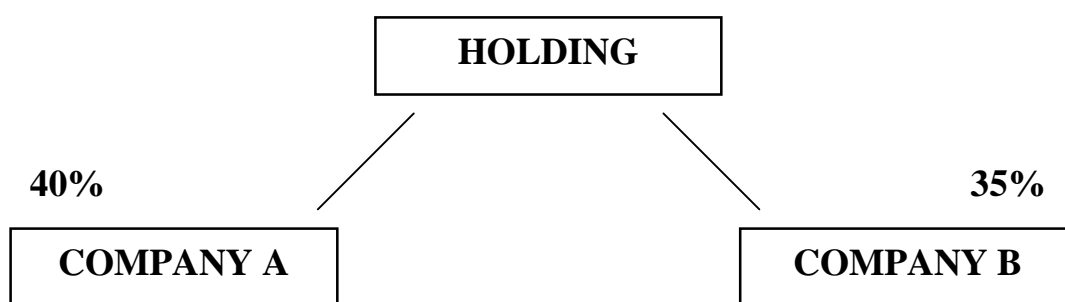


Company A is an empty shell.

Company B is owned by "friendly" company.

Figure 5

Tunneling Assets in the Czech Republic



Firm A borrows from bank and buys holding company's shares in company B.

Firm B then buys holding company's shares in company A.

End result: Two companies are leveraged, holding company keeps cash.

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Appendix

A) Interviews Conducted in Russia and Czech Republic, August-September 1997

<i>Type of Interviewee</i>	<i>Number of Interviews</i>	
	Russia	Czech Republic
Government Officials	2	1
Journalists	1	1
Market Exchange Systems*	6	2
Policy Advisors/Consultants	5	5
Private Financial Companies (Bankers/brokers/fund managers)	5	5
Professional/Industry Associations**	2	3

* 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.

** 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, D.C. October, 1997

Nine interviews with World Bank officials closely involved in the formation and implementation of mass privatization programs in East-Central Europe.