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UKRAINIAN PEOPLE BECOME RICHER ?

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No. 7

July 1994

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*“PRIVATIZING UKRAINE —  
WILL THE UKRAINIAN PEOPLE BECOME RICHER ?”*

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**Comments**

Financial support from INTAS Grant No. 2436 is gratefully acknowledged.

# **Privatizing Ukraine – Will the Ukrainian People Become Richer?**

## **Introduction**

Everyone in Ukraine is aware of the fact that over the last year privatization process is gaining speed. However, there are still obstacles on this path and privatization is viewed by the majority of the population with suspicion if not with outright hostility. It looks like the discussions on principles and methods of privatization in Ukraine will last until its accomplishment. At the same time, at least half of the people will lose their right to get guaranteed 1/52 millionth share of the pie<sup>1</sup> called state property.

Privatization, defined as the transfer of productive assets from the public to the private sector involving some type of a sale agreement has been enthusiastically undertaken as a remedy for main economic illnesses in Ukraine - a country with almost overall dominance of state-owned enterprises. It has been regarded as an effort to restructure the economic system, to accelerate economic growth by eliminating massive state intervention and promoting competitive incentives to increase efficiency, both allocative and productive. Equally important, the government hoped to reduce budgetary pressures resulting from subsidies and transfer payments towards loss-making enterprises. Revenue-raising through the sale of enterprises plays a secondary role due to the low assets' values in the post-communist economies and to the existence of voucher schemes of mass privatization, which implies the transfer of productive assets to the citizens free of charge.

It is possible to characterize the privatization process in Ukraine as the path of trials and errors. It started and was conducted without any distinct and well-prepared program, with a lack of coordination, not to say common purpose among the interested parties. A virtual absence of robust capital and financial markets and almost general non-acceptability of privatization in ex-communist social and economic environment exacerbated the problem. Only a slight stratum of the society actually realize the essence of the privatization process and gains thousands times more than 1/52 millionth part of the common pie. Therefore, it is crucial to analyze even the first steps of privatization to reveal its benefits and shortcomings.

## **Privatization in Ukraine: Where We Are?**

Whereas Central and Eastern Europe witnessed an explosion of privatization activity in 1992, Ukraine has been virtually making her first steps towards the complete ownership transformation since the fall of 1993.

Despite the fact that a number of privatization statutes has been passed early in 1992, namely the Law of Ukraine on the Privatization of the Property of State Enterprises of March 4, 1992 and the Law on Privatization of Small State Enterprises of March 6, 1992, and a

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<sup>1</sup>The population of Ukraine being 51912.3 thousand (1.01.1994).

privatization program has been approved by the Parliament, there was hardly a distinct plan how to implement it. That is why relatively few enterprises has succeeded in transformation from public to private ownership during 1992. The process developed mainly "spontaneously" owing to some initiatives of regional and municipal authorities<sup>2</sup>, and sometimes ambiguous leasing arrangements were used. At the end of 1992 the Government has issued a decree on "ending inappropriate commercialization of state enterprises" as well as a decree listing the types of enterprises that were not subject to privatization.

The first medium-scale privatization was held in Odessa early in 1993 with the sale of a meat-processing business, and the first auction of small privatization took place in L'viv on February 20, 1993, where the city government sold 17 small outlets. It is important to mention that the city received a record number of applicants - approximately 200 and L'viv authorities received almost one billion karbovanets' (nearly \$ 400,000) revenue from the one-day proceedings.

During the late spring of 1993 some crucial laws and decrees regarding privatization were issued, namely the decrees of the Cabinet of Ukraine On the Peculiarities of the Privatization in Agroindustrial Complex of May 17, 1993 and On the Conditions of Foreign Investment of May 20, 1993. The Decree of the President of Ukraine On Corporatization of Enterprises opens a new wave of transition towards a market economy. At the same time some legislative documents are only catching up, providing *post-facto* regulation of various market institutions initiated out of economic necessity. Thus there are numerous examples of investment funds already established without any legislative basis and it is difficult to overestimate their role in privatization process. They are targeted on the work with small investors, mostly with those categories of the population (pensioners, disabled, the military, students) that are least of all socially protected in the situation of radical ownership transformations.

At the very beginning of 1992 some sort of voucher (a kind of artificial capital) has been created by setting up parallel accounts for every citizen of Ukraine at the State Savings Bank. It was assumed initially that these new accounts were to be used for the purchase of state assets only. However, in January 1993 accounts have been fully "monetized" with the permission to withdraw funds for other purposes. But there are still discussions on the economically and socially justified patterns of their utilization and, moreover, the State Program of Privatization for 1994 stipulates the further compiling of a more comprehensive list of citizens entitled to privatization vouchers<sup>3</sup>.

According to the privatization program all state-owned enterprises are classified into 6 categories (A,B,C,D,E,F) corresponding to their residual value (initial value minus

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<sup>2</sup>By October 1, 1992, some 9,700 retail shops and 5,900 catering establishments (accounting for 21 percent of retail sales) as well as 1,431 medium-sized manufacturing enterprises (about 21 percent turnover in that category) were operating under leasing arrangements.

<sup>3</sup>According to the official data of the State Savings Bank, by the 1.02.1994 only 706 thousand people (out of the registered population of Ukraine of 51912.3 thousand) used their "privatization property certificates" (vouchers).

depreciation) and some other qualitative characteristics. Enterprises of the category A are treated as small enterprises; of the categories B,C,D,F - as medium and large enterprises; and, finally, the category E consists of non-finished construction or property of liquidated enterprises (this category is usually combined with the category A). The program stipulates some sector priorities in privatization with paramount transformation of enterprises which mostly influence the development of the consumer market as well as of those which under the state control restrain financial stabilization and economic growth. These categories are mainly represented by the enterprises in retail trade, public catering and services, infrastructure and construction, light and food industries, forestry and agroindustrial complex. There are also priorities in privatization given to unprofitable enterprises<sup>4</sup>, enterprises with obsolete capital (depreciated by more than 70 percent), "frozen" enterprises and non-finished construction that previously has been financed from the central and municipal budgets.

The State Privatization Program settles a forecast of dynamics of shifts in the ownership structure during the period 1994-1996 (see Table 1).

Despite the negligible proportion of property already withdrawn from the state control in 1993 it is important to analyse some main trends and outcomes of the first wave of privatization in Ukraine, both from the point of view of regional and sectoral distribution of privatized assets. In order to reveal some regional trends it is reasonable to divide the country into 5 parts: East, West, South, Centre<sup>5</sup> and the city of Kiev instead of official administrative division into districts (oblasts).

**Table 1. Distribution of Property by Ownership Rights, percent.**

Property	1993 actual	1994 forecast	1995 forecast	1996 forecast
State property (without property of state farms and housing)	98	74	74	44
Non-state property	2	26	43	56
All types of property	100	100	100	100

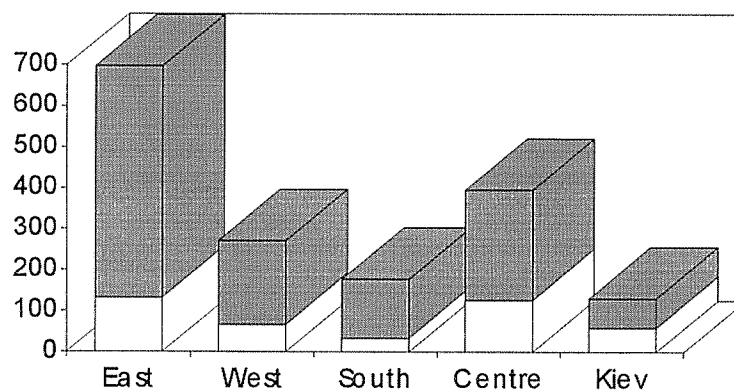
Privatization had increased drastically during the last 4 month of 1993 both in terms of the number of transactions and in revenues raised. The number of transactions had risen from 417 at the beginning of September to 1673 at the end of December 1993. Over the same time period revenues had increased from 38 bln karbovanets (krb) or \$ 4,750,000 to 1355.6 bln krb or \$ 45,000,000.

<sup>4</sup>Excluding enterprises that lose profits due to the state price regulations.

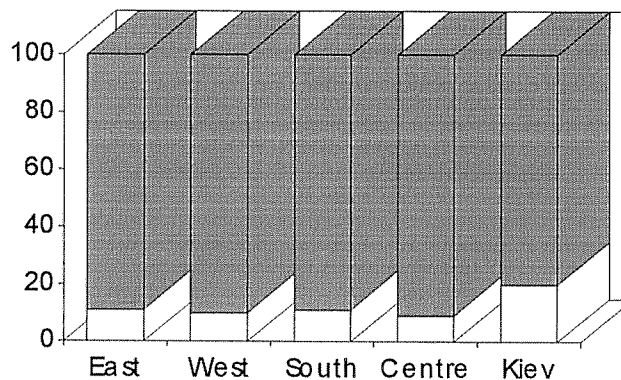
<sup>5</sup>East includes Dnipropetrovsk, Donetsk, Luhansk, Zaporizhzhia, Kirovohrad and Kharkiv districts (oblasts); West includes Zakarpattia, L'viv, Ivano-Frankivsk, Volyn', Rivne, Ternopil' and Chernivtsi oblasts; South includes Mykolaiv, Odesa, Kherson oblasts, Republic of Crym and the city of Sevastopol'; Centre includes Vinnytsia, Kiev, Zhytomyr, Khmel'nytskyi, Poltava, Sumy, Cherkasy and Chernihiv oblasts.

Recently the greatest speed of privatization of state-owned enterprises in terms of the number of transactions was observed in the East and the South (see figure 1). At the same time, this comparison is subject to the danger that the number of transactions is not the best indicator of the success or failure of the whole privatization process, since it does not take into account the value of the transformed assets as well as their share in the total volume of property to be privatized according to the Program in question. The data with respect to these shares is represented in figure 2, which shows that the privatization process is distributed across the regions almost evenly (the percentage of already privatized units varying from 9 to 11). The most active "privatizers" are Rivne (21.4 percent) and Chernihiv (19.7) oblasts, cities of Kiev (19.9) and Sevastopol' (30.6)<sup>6</sup>.

**Figure 1. Privatization of State Property by Geographic Region, 1.09.1993 - 1.01.1994, number of transactions.**



**Figure 2. Privatization by Geographic Region, percentage of already privatized units**

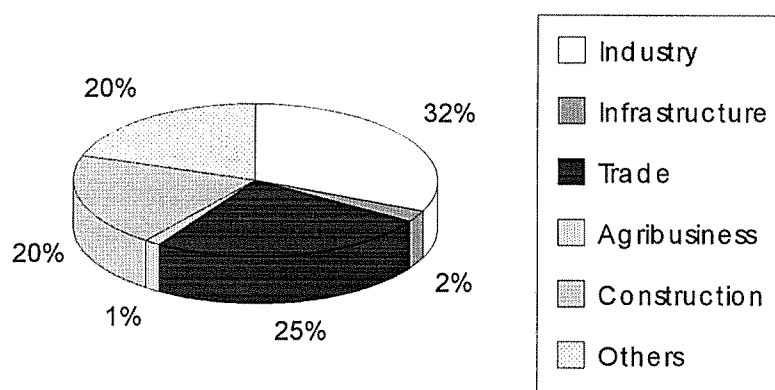


<sup>6</sup>As mentioned in the Report of the State Property Fund on the implementation of the State Privatization Program in 1993.

In terms of economic sectors (figure 3), privatization within the group "industry" that include such branches as forestry, light and food industries and production of construction materials, as well as trade and services is clearly dominating, whereas transactions in infrastructure (transport and public utilities) and agribusinesses are conducted on relatively minor scale. Such outcome supports the hypothesis that Ukraine has already involved in privatization not only unprofitable enterprises (as has been initially assumed), but also profitable ones<sup>7</sup>.

Ukraine, as well as the whole Eastern Europe, differs quite significantly from the other regions in the sectoral composition of its privatization projects. Infrastructure projects are marginal in comparison with other developing countries, where the transformations of ownership rights in infrastructure were clearly prevailing in privatization programs played out in 1988-1992.

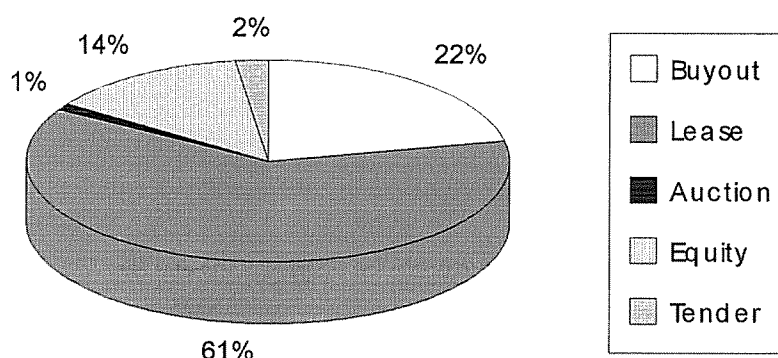
**Figure 3. Privatization by Economic Sectors, number of transactions**



With respect to the distribution of privatization transactions by the method of transfer (figure 4), the leasing arrangements dominate (61 percent) followed by the buyout (22 percent), whereas the role of tenders and auctions is negligible. Distribution of methods of privatization by geographical region is more or less even, buyout and leasing arrangements put together counting for 67.2 percent in the South and up to 93.2 percent in the East. However, this circumstance, carries the danger that state-owned enterprises are privatized mainly by the methods that involve least competition, which in turn may not lead to the optimal solution of the matching problem.

<sup>7</sup>Infrastructure and agribusiness for decades were among the main bottlenecks of the economy of the former Soviet Union. They absorbed enormous subsidies and transfer payments that resulted in their further deterioration. These sectors were treated as unprofitable and inefficient by definition and this prejudice is still widespread in the society.

**Figure 4. Privatization by Methods of Transfer, number of transactions.**

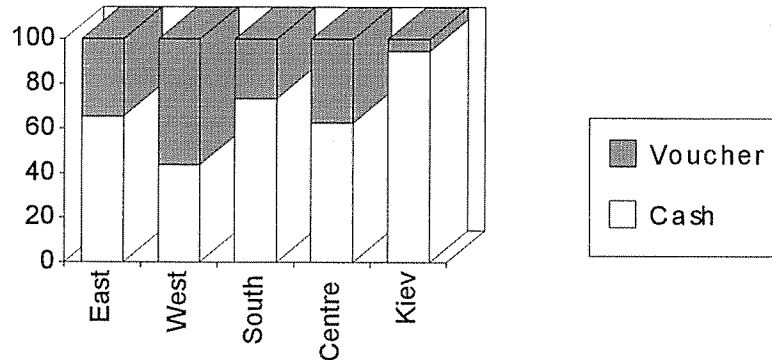


In general, the average asset value in Eastern Europe is significantly smaller relative to other middle-income countries. This common feature is noticeably reinforced by the hyperinflation in Ukraine, when the overwhelming majority of enterprises is sold at prices much lower than their market value<sup>8</sup>. As a matter of fact, privatization program seems to be less attractive from the budgetary perspective. Nevertheless, it is important to analyse its outcomes from the point of view of revenues raised in different regions. Almost a half (46.8 percent) of the total revenue was raised in the East. However, this counts for only 18 percent of the amount estimated by the State Program. At the same time, the contribution of the West to the budget counts for 25.5 percent, but it comprises 48 percent of the expected level<sup>9</sup>. These revenues are covered by cash and by vouchers, with cash prevailing, except for the West (see figure 5).

<sup>8</sup>A purchasing price is based on a book value of an enterprise adjusted for inflation. However, this book value, even being multiplied by some index indicating the level of inflation, cannot reflect the market value of the enterprise under hyperinflation. Thus, enterprises are quite often sold for a trifling sum. For instance, a furniture plant in Luhansk has been sold for the price of 135.5 mln krb (\$4,500,000), whereas the price of a small photographic laboratory "Orion", sold on an auction in the same Luhansk has reached 160 mln krb (\$5,333,280).

<sup>9</sup>One can observe the enormous range in figures representing the ratios of actually collected revenues from privatization to the Program's estimates. These ratios vary from 85.6% in Poltava oblast and 83.3% in Chernivtsi oblast to 3.9% in Sevastopol and 3.7% in Cherkasy oblast.

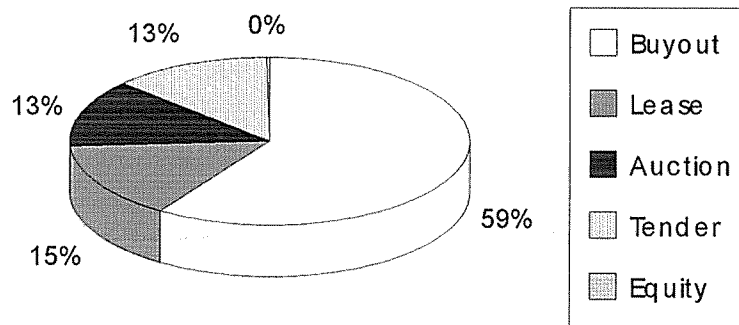
**Figure 5. Privatization by Amount of Revenues Raised.  
Cash and vouchers, percent.**



Finally, according to the Privatization Program, vouchers should account for 72-80 percent of the value of privatized assets, and the share of cash, consequently, is to be no more than remaining 20-28 percent. In some cases, the Program favours the voucher/cash ratio of even 89/11. However, actual figures for the first 10 percent of the privatized assets, shown in Figure 5, disclose almost the opposite proportion. This means that the concentration of capital tends to be much greater than the initial targets of the Program. The state, even imposing restrictions on some "illicit" or "semi-legal" transactions, is unable to stop such trends. In fact, the most profitable large enterprises are bought out with an amazing speed. The parties that possess insider information about these objects, including managers and employees, succeed in preserving their privileged position even under the new circumstances.

The transfer of ownership rights for municipal property has been accelerating since the beginning of 1993. The number of privatized units has increased sharply from 623 by the 1.09.93 to almost 2000 by the end of the year. The distribution of transactions by method of privatization indicates that the most popular procedure in this sphere is buyout, followed by lease arrangements with buyout, auctions and tenders (figure 6). The shares of the last three methods are almost equal.

**Figure 6 Privatization of Municipal Property by Methods of Transfer.**



In comparison with ways of the transfer of state-owned enterprises, described above, one can easily see a shift towards more competitive privatization methods with respect to municipal property.

This, we hope, may lead, *ceteris paribus*, to genuine restructuring of the whole sector of retail trade, public catering and services that compile main part of the municipal property. The more competitive methods of privatization might attract new teams of managers with entrepreneurial skills and talents as well as external sources of capital necessary for the revitalizing of the sector.

### **Auctions: an Alternative Approach.**

Auctions play an important role in economies in transition as they represent a simple way of allocation of various commodities and financial assets as well as of price determination under informational uncertainty. "Small privatization" implies the process of transferring property rights from the state to new private owners of businesses in retail trade, public catering and services. The main idea of using auctions in small privatization follows from their ability to determine the values of the assets close to their real market values in the absence of robust capital and financial markets.

What is the essence of the process of price formation in small privatization auctions? We may divide it into several steps. The first step consists of determination of starting price which is usually fixed according to the book value (residual value) of the establishment. On the next step, each potential bidder tries to estimate his private valuation of the item to be auctioned using all available information and his own experience, aptitudes and attitudes. A potential bidder may use different methods in desire to estimate the true value of the enterprise, particularly visit premises, check books, study a particular market or talk with

former managers and employees. By defining the value of enterprise he takes into account different aspects: some objective characteristics of enterprise, especially its location, field of specialization and possibilities to change it if necessary, technological innovations, the space for displaying merchandise and working experience of the staff, as well as some subjective features such as his aptitudes for entrepreneurship, attitudes towards risk, knowledge of the field and financial abilities. All this preparatory work will result in some private valuations of bidders which reflect the demand side of the market.

The problem with this method of privatization is, again, connected with the fact that information about the true value of the enterprise being sold by auction is asymmetrically distributed among participants of the bidding process (I suggest to describe this phenomena as "asymmetric access"). Insiders, especially managers, obtain information about the value of enterprise from their own internal activity at the enterprise. Outsiders derive their information mainly from public sources or observable results of functioning of the enterprise. Consequently, quite often insiders are likely to be better informed about the objective true value of the item sold and have comparative advantage in bidding against outsiders. On the other hand, it could happen that outsiders' as well as insiders' private valuation is based mainly on their potential ability to reconstruct an enterprise and make higher profits. There is a pitfall for less informed bidders to bid too high in desire to win the auction, in other words, to overestimate the true value of the enterprise and follow so-called "winner's curse". From this point of view the English auction (an open ascending process of price formation) has a comparative advantage over other types of auctions as it decreases the effect of "winner's curse". It is due to the fact that in open auction bidders' private information about the true value of the item becomes partially public and according to this less informed bidders correct their bids. However it does not overcome this phenomenon completely.

One of the important questions that often deals with the level of competition provided by the auction. This question leads to the problem of number of bidders and its influence on the price formation. It is quite obvious that the more bidders there are in auction the more often on average each bidder reestimates his own valuation in the bidding process. As a result, an English auction with a sufficiently large number of bidders provides access to other bidders' private information and, hence, mitigates the "winner's curse" effects. However, it does not mean that final price consequently increases as number of bidders rise. There is double-sided effect of increasing competition through increasing number of bidders. Direct effect tends to increase the price. Simultaneously, a rational bidder "bases his bid not only on his own estimate of the items worth, but also on the presumption that he has the highest estimate". If the "winner's curse" really hold, it may lead to potential bankruptcy of new owners due to the overvaluation of the true value of the enterprise. Thus, in fact, a small business bought on the auction could become a liability instead of an asset. It means that bidders trying to avoid "winner's curse" bid very cautiously.

While an open auction procedure could lead to a better initial allocation of capital assets, it does not take into account the abilities other than money of the new potential owners, to bring real restructuring into the sectors in question. Besides, it is a time-consuming procedure which needs some special assistance in its preparation and conducting.

Having all the above considerations in mind, it is important to analyse some results of public auctions organized by the International Finance Corporation (IFC) in Ukraine during the period from February 1993 to March 1994. Information on more than 20 auctions held in Ukraine with the aid of this international organization allows to make some conclusions. In most cases the privatized units do not include real estate. They either embrace the purchase of inventories and equipment and the right to lease the premises, or the right to lease premises, inventories and equipment altogether with the right to buyout in 5-10 years. To distinguish between these two cases, we can use the term "property rights" in the first one and "lease rights" - in the latter.

The information available on the 20 auctions among those organized by the IFC shows that there were 86 cases of selling "lease rights" and 35 - "property rights", out of 121 privatized units. The initial price of these units has increased on average for more than 900 percent and the revenue raised by these auctions counts for 82456 mln krb or \$6549 thousand. Approximately 39 percent of the winners were represented by the working collectives of the enterprises sold on the auctions. The average price of an object reached 680 mln krb or nearly \$54 thousand, with the range from 3 mln krb to 10 bln krb.

Our study focuses on the analysis of some regularities of the process of the price formation revealed by the auctions. To catch the influence of the possible factors of the price determination, the following regression function has been chosen. Four independent variables were included in the regression: log of starting price (LSP) and area (measured in square metres) of an enterprise (SQ), a "lease-property" dummy variable (LP)<sup>10</sup> and a dummy variable for the "insider-outsider" situation (INS), equal 1 for insider. The regression was run for 85 available observations and included log of final price (LFP) as a dependent variable. The following regression equation has been obtained:

$$\text{LFP} = 4.85 + 0.45\text{LSP} + 0.54\text{INS} + 0.00014\text{SQ} - 0.51\text{LP},$$

(0.26)            (0.066)            (0.27)            (0.00032)            (0.26)

where the last two coefficients are not statistically significant.

Appropriate regression coefficients for the log of starting price and for the dummy for "insider-outsider" are statistically different from 0. The main factor of the price formation is the starting price, although for the auctions held in Ukraine the corresponding coefficient is less, than, for instance, for the Czech Republic (0.8)<sup>11</sup>. Square footage does not play an important role in the price formation as well as the type of selling agreement, whenever it is "lease" or "property" (on the basis of our sample we could not reject a null hypothesis that the coefficients in question are equal to 0).

The dummy variable which represents winners-insiders vs winners-outsiders has a

<sup>10</sup>LP=1, if the "property rights" are sold and 0 in the case of the "lease rights" acquisition.

<sup>11</sup>This conclusion was made on the basis of the survey of 300 privatized small outlets in the Czech Republic, Hungary and Poland, provided by the author of this paper while working for the Privatization Project (CEU, Prague).

positive effect on the log of final price and the regression equation coefficient (0.54) is statistically significant with the probability of 0.95. It means that on average winners-insiders pay the higher price than winners-outsiders. This fact can be explained in two ways. First of all, if an insider prefers to remain in the bidding process to the end and wins the auction, it implies that he has the highest valuation of the unit being sold. Taking into account that he has an asymmetric access to the "insider" information about the true value of an outlet, one can make a conclusion that the insider's participation and victory in the bidding process is an indicator of the high market value of an enterprise. The latter conclusion is enhanced by the fact that on average insiders tend to participate in less competitive methods of privatization, which is confirmed by the outcomes of the transition process in Eastern Europe. Secondly, the law on small privatization in Ukraine stipulates some formal privileges for insiders, namely a 30 percent discount on the final price which could be paid in several instalments during 1 (or even 3) year. It means that insiders, *ceteris paribus*, are able to bid a higher price than outsiders.

However, all the above mentioned factors included in regression equation explain only 41% of the variation of final price. In other words, there are factors, such as the location of outlets, their field of specialization and others, which could explain, at least partly, the remaining share. In any case, it is reasonable to analyse even this simplified version of regression model.

Ukrainian cities and towns have witnessed the powerful wave of successful auctions with positive outcomes, although there are still fierce discussions concerning efficiency and justice of this fashion of privatization. There is an evidence of their positive impact on the life of people. Firstly, the prices of outlets sold through the auctions tend to decrease and sometimes are quite affordable<sup>12</sup>. Secondly, the new owners of private establishments implement sufficiently vigorous restructuring and, sometimes, innovative efforts which substantially change the situation in the internal consumer market. Thirdly, local authorities use to direct revenues raised through the auctions to create and improve municipal infrastructure and to meet everyday needs of the citizens (repairing roads, purchasing waste-collecting vehicles etc.).

Regarding the arguments of those supporting other methods of property rights transfer, it is necessary to mention some of the disadvantages of auctions. For instance, auctions are more time-consuming and require the participation of at least two or even three bidders who are willing to buy an outlet. They are expensive and labour-intensive to conduct. Moreover, a comparative advantage of competitive tenders, for instance, is connected with their commitment to the characteristics of a potential buyer other than the availability of money.

Finally, it is necessary to stress that the main problems of small privatization transgress the bounds of the mere advantages and disadvantages of the ways of transfer of ownership

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<sup>12</sup>Cafe "Ice-cream" was sold through the auction in Rivne for merely 27 mln krb (\$900).

rights themselves. They depend in a great deal on the existing legal infrastructure and the system of taxation, as well as on the division of responsibilities and resources between various tiers of government (from central to local) and other factors. The analysis of the latter deserves a separate study.

## Conclusions

The main conclusion that follows from this analysis deals with serious gaps in the legislative base of the Ukrainian Privatization Program. As long as these gaps remain there will be a place for the old and the new "illicit" transactions and distortions. The new ownership structure requires development of capital and financial markets as well as newly-orchestrated state institutions to conduct and control the process of privatization.

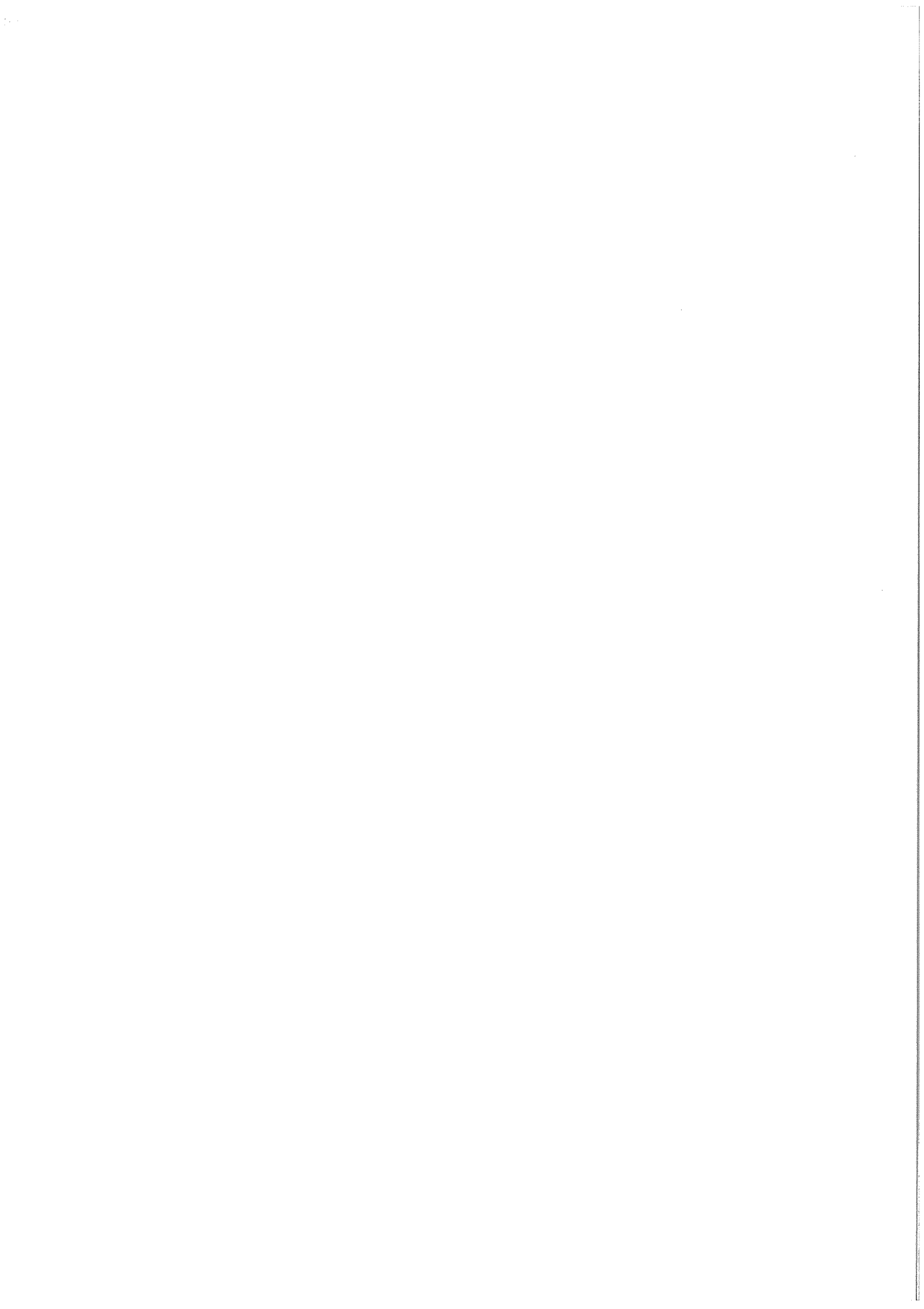
The process of capital concentration is quite obvious and only some decisive state restrictions on the "spontaneous" transactions in the privatization of large enterprises, along with a wide-spread information supply, could somehow prevent its further development.

One of the main arguments in favour of various forms of ownership is based upon the increased chances of those systems that use diversified approaches to decision-making to survive. The same argument is valid for the variety of methods and procedures involved in privatization. Only the combination of these approaches can lead to positive outcomes. The first steps of Ukrainian privatization raise more questions than provide answers.

So, will the Ukrainian people become richer as a result of privatization? – I think they might.

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