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Privatisation and Corporate Governance in Eastern Europe: The Emergence of Stakeholder Capitalism

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The Emergence of Stakeholder Capitalism

Abstract
An unintended outcome of transition is the emergence of new forms of governance. Stakeholders other than shareholders influence corporate management to a higher degree than in mature market economies. Employees gained influence through ownership stakes or work councils, while elsewhere investment funds or governmental authorities retain influence via equity stakes or otherwise. This paper reviews privatisation and the newly created forms of private ownership to document the evolution of stakeholder capitalism and to discuss the opportunities and dangers that it may create for businesses in the region.

1. Introduction

In the transformation from central plan to market economy, privatisation had a central place in policy agenda, as private property is a central element of the market economy. All countries in the region have transferred ownership to private individuals and entities, yet the transfer of ownership alone does not suffice to create appropriate incentives for managers. Managers left unchecked may use their insider position in to serve their own personal interests rather than those of the corporation. Hence, a system of corporate governance is required.

Corporate governance is concerned with the means by which dominant decision makers (typically managers) are controlled by other interested parties (Monks & Minow 1995, p.1). The OECD defines corporate governance as 'the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance" (OECD 1999).

Effective corporate governance is particularly important during times of crisis when major corporate restructuring is to be initiated and implemented, as in the early years of transition. The management has to decide upon a strategy for the enterprise in the market environment, including major changes in product mix and organisational structures. This

restructuring has, due to path-dependency, long-term implications for the structure of the industry and its competitiveness.

However, systems of corporate governance have become a major obstacle to enterprise restructuring in CEE before and after privatisation. Privatisation other than by sales to outside investors often failed to create powerful incentives to guide managers in transforming firms. Therefore corporate governance has become the most debated issue in the transition economics literature (e.g. Frydman *et al.* 1999, La Porta, Lopez-de-Silanes and Shleifer 1999, Estrin 2002), and more recently in the management literature (Filatochev et al. 2000). The theory of property rights, primarily the principal agent model, has been the ideological foundation of the privatisation policy. However, many firms did not, as presumed by the model, end up in outside control but under the governance of a variety of stakeholders, including managers, employees and the state.

This chapter first outlines the objectives underlying the privatisation drive in CEE in the early 1990's, and then reviews the alternative methods of privatisation with their respective strength and weaknesses. I then discuss corporate governance under the different forms of ownership, noting the diversity of stakeholders with influence on management. While these patterns suggest a new form of stakeholder capitalism, firms generally do not appear to have created organizational structures that make stakeholder firms viable.

2. Theoretical Issues

2.1. Objectives of Privatisation

Given the wealth of arguments for privatisation, if may be useful to recall why state-ownership exists in the first place, not just in the former socialist economies (Ramamurti 1992). In mature market economies like Western Europe many large firms have been, and some still are, in state-ownership. They were originally set up to combine social with economic objectives, for instance in the health and education sectors or to overcome the market failure associated with natural monopolies for utilities and (traditional) telecommunication services. Elsewhere, the state pushed industrialization by funding capital-intensive investment projects, such as the steel industry.

Comparing public and private ownership of firms, both forms have their merits. In economic terms, the basic **trade-off** can be stated as follows:

- Under public ownership, the firm is run by a government bureaucrat who maximises a social utility function, which may for instance include redistribution to the poor, moderated by personal objectives of those holding effective power in the administration.
- Under private ownership, the firm is run such as to maximise profits. Profits are a component of social welfare, but not identical with it, for instance in the case of a monopoly.

Thus, neither system is perfect. The relative performance depends on the efficiency of the market (controlling private enterprises) and the efficiency of the political system (controlling state-owned enterprises). The first welfare theorem, a basic element of neoclassical economics, states that competitive equilibria obtained by free markets generate (Pareto-) efficient outcomes, independent of the form of ownership (Vickers & Yarrow 1991, Estrin 1994). The only assumption necessary to arrive at this theorem is that economic actors are utility maximizing. Even so, most economists argue that private ownership improves enterprise efficiency. This is attributed to different effects:

- Capital markets provide information on privately held firms, which facilitates monitoring of managers' performance, and creation of incentive contracts using for instance share options.
- Private ownership is the basis for creating opportunities for entrepreneurs to create innovations and reap the benefits, as emphasizes especially by the Austrian School of economists like Schumpeter and Hayek.
- Private ownership clearly separates the accounts of the firm from the government budget. In consequence, subsidies paid to the firm become observable, and can be scrutinized by political decision makers. This moreover leads to a tightening of the budget constraint because private firms would not expect extra funds in case of poor performance.
- Private shareholders pursue their individual utility function, which for most firms is reasonably well approximated by 'profit' maximization. The government as owner on behalf of society has to focus on 'social welfare'. This however is a vague concept that is interpreted differently by different interest groups, leaving considerable ambiguity for managers' performance criteria.

- Private ownership ensures that enterprise-level decisions are removed from the potential influence of interest group politics.

A different line of argument in the political discourse is that privatisation generates *revenues for the public sector*, and should therefore be promoted. This is however a faulty logic. In principle, privatisation only changes a future income stream to a one-off payment to the amount of the net present value of this future income. It does not change the net-worth of state assets. Even so, this may be off interest to the government if

- a country is highly indebted and lacks access to capital markets to finance its budget deficit. This situation may apply highly indebted emerging economies such Hungary in the early 1990's.
- a government is committed to reduce the “public sector borrowing requirement”, irrespective of the use of the funds. In some countries, like the UK during Margaret Thatcher’s reign, official statistics and the political discourse do not distinguish between public sector expenditures for consumption and for investment. Yet using privatisation revenues to pay for current expenditures may leave the country with depleted public wealth and a structural budget deficit.

Only if the government revenues argument is *combined* with an efficiency argument, i.e. privatisation raises efficiency and therefore the net present value under private ownership is larger than that under public ownership, then the arguments becomes valid. Then, the sales price (which is based on expected future revenues under private ownership) will exceed the present value of the state-owned firm.

In this view, the evidence that countries with high budget deficits and high foreign debt are more prone to privatise (Ramamurti 1992) allows two interpretations. It may be that countries did under financial constraints what they ought to do anyway, but could not implement, say for political reasons. Yet it may also indicate that some countries have tried to use privatisation revenues to fill gaps in their public sector budgets, thus postponing other necessary structural changes in public sector expenditures or revenue collection.

The extent of government revenues however depends on the methods of privatisation. There are important trade-offs between cash receipts and guarantees for investment and/or employment (extensively used by the East German Treuhand). Moreover, certain methods of

privatisation, such as voucher privatisation or free transfer to employees and management do not generate revenues.

In the East European context, further political arguments supported the drive for privatisation. It was expected to accelerate enterprise restructuring, and thus have a particular strong effect on productivity and efficiency of allocation. The authorities in transition economies may have neither the interest nor the power to impose effective governance on managers, or to create incentives to promote radical change (Estrin 1994). This may be due to the politically unpopular short-term effects of radical restructuring, the lack of entrepreneurial vision and managerial know-how of bureaucrats, or insiders-power in state-owned firms. Moreover, immediately after 1989, policy advisors were concerned about creating a momentum for reform, and ensuring the irreversibility of the reform process (Estrin 1994). In 1990, the return to a socialist regime was after all not yet impossible. Although this concern quickly faded, it had major implications for the path of reform chosen.

A different concern arose with the collapse of the old control mechanism, the central plan, and the de facto control of stakeholders within the firm over enterprises. The new units of government supposed to supervise and monitor the state-owned firms had neither the experience nor the instruments to fulfil this task effectively. Hence, there has been considerable concern - supported by anecdotal evidence - that the effective insider control during the transition period would allow managers to engage in *'asset stripping'* or *'tunnelling'*, i.e. removing assets of the firm for their own private benefit. This could be accomplished for instance by selling products or assets to other firms in which the top manager or his/her relations have an equity stake. To prevent such abuse of insider power, speed of privatisation was considered important.

The de facto control by insiders has also implications for the timing and the design of privatisation programs. Since insiders have more information about the firms than supervising government authorities, they need to be motivated to support the privatisation. In the case of Poland, they even had formal veto rights arising from the strong position of work councils (an outcome of the Solidarnocz-trade union led political change). In consequence, insiders in Poland and several former Soviet Union countries were often given preferential access to share ownership. Thus powerful stakeholders in the pre-privatisation period could retain their influence in the post-privatisation period (Mygind 2000).

In view of these multiple objectives, it is reasonable to ask if privatisation can actually live up to the expectations. The World Bank (1996) summarizes the extensive empirical research on privatisation and efficiency as follows:

> "Extensive empirical evidence from CEE and elsewhere indicates that most firms, whether state owned or private - or in between, as in the case of China's 'nonstate' enterprises - make efforts to restructure *if their avenues for rescue close and competition increases*. Shrinking subsidies combined with more open markets have universally resulted in labor shedding or falling real wages, or some combination of the two. ... Enterprises subjected to financial discipline show more aggressive collection of receivables, a closer link between profitability and investment, and a reorientation of goals from output targets to profits. Transition forces managers, for the first time, to focus on marketing and product quality." (World Bank 1996, p. 45, emphasis added).

This citation illustrates that privatisation is only one element of a reform package to improve enterprise efficiency, and the success depends on the entire package of institutional reforms. Research shows that *competition* is at least as important as privatisation for enterprises to improve their efficiency - a result consistent with empirical research on privatisation in the West (e.g. Vickers and Yarrow 1988). Therefore, the creation of competition through deregulation and liberalization occurred often simultaneously with privatisation. A competitive environment improves monitoring possibilities by performance comparisons, and it creates incentives for continuous improvement of the firm's resources and strategies. However, building the institutional framework for competition is distinct from ownership change as such. In many cases, this institution building has been partial. Hence, Bevan *et al.* (1999:14) observe that after privatisation, the key difference is "not how competition affects firm performance, but in the degree to which market forces in transition are either softened or distorted. Firms in transition face 'soft budget constraints' more frequently ... and also often obtain protected market positions of various sorts from their governments".

The process of designing and implementing competition policy has been far more complex although liberalization has been swift and comprehensive (Hare et al. 1999). Governments in the less reformed countries continue to protect markets of their local firms, in

Russia even at sub-national level,[1] and even if regulatory laws are introduced, they are not necessarily enforced.

Hence, privatisation is part of a broad program of institutional reforms, which also includes opening markets to competition, or regulatory frameworks creating quasi-competitive conditions, hard budget constraints, and effective systems of corporate governance. While privatisation advances many objectives, it is only one step in the process of restructuring the economy.

2.2. Corporate Governance

Throughout the capitalist world, governance systems are evolving towards the Anglo-American model, separating the shareholder function from that of other stakeholders, and monitoring firms through equity markets. Managers have to serve shareholders' interests, who monitor them through the stock market, while other stakeholders normally have comparatively little influence. Shareholders' lack of direct influence is compensated for by efficient stock markets. In particular, stock options provide powerful incentives for managers to act in shareholders' interest. Moreover, takeovers provide a mechanism by which widespread equity ownership may rapidly become concentrated (Shleifer and Vishny 1997). Managers act in anticipation of potential hostile takeover and thus aim at keeping the share price high, which is in the interest of shareholders.

In continental Europe, corporate governance systems assign stakeholders such as banks and non-managerial employees a formal role in governance. In Germany, banks play an important role in the monitoring of firms, as most individual shareholders delegate their voting rights to a bank, which then votes in shareholder meetings on behalf of its clients. Moreover, firms often entertain close relationships with their bank, which also may hold some equity. Banks thus have access to inside information, which permits detailed monitoring and gives them a central role in the monitoring process. Japan has a similar bank-based system of governance such that this model is known as the German-Japanese model of governance.

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[1] Empirical evidence is mixed, as some studies find evidence for effects of import competition. Russian domestic concentration had a slightly negative effect on productivity in Earle and Estrin (1997), while Jones et al. (1998) find market share to be associated with higher efficiency in Bulgaria. The small impact of domestic competition may be a result of static established patterns of interaction between incumbents and regional separation of markets. In Russia, a particular problem appears to be the lack of domestic entry, and thus contestable markets, in part due to protective

However, a global trend over the past two decades has led to more legal protection of shareholders, and reduced role of bank governance. For instance, German banks are divesting their equity stakes in non-bank businesses.

Yet, not only shareholders matter. Researchers taking a stakeholder perspective focus on the existence of multiple stakeholders other than owners of equity. A stakeholder is "any group or individual who can affect or is affected by the achievement of the firm's objectives" (Freeman 1984). The stakeholder literature questions the predominance of one stakeholder group - that is, shareholders - and assumes that the interests of all stakeholder groups have intrinsic value (Jones and Wicks 1999). Stakeholders can use both 'voice' and 'exit' strategies to influence the firm. The ability to exit strengthens effectiveness of the stakeholder's voice within the firm, as does a financial stake.

Three traditions of stakeholder research have evolved: instrumental, normative and descriptive approaches (Donaldson and Preston 1995). The instrumental view argues that if managers view the interest of stakeholders as having intrinsic value worth, and pursue the interests of multiple stakeholders, this would aid the performance of the firm as viewed from owners' perspective (e.g. Jones 1995). The normative shareholder perspective intersects with business ethics literature. It starts from the presumption that managers have a moral duty to consider stakeholders other than shareholders (e.g. Freeman and Evan 1990, Donaldson and Preston 1995, Kochran and Rubinstein 2000). This paper fits in the tradition of descriptive stakeholder research, which starts out from the fact that stakeholders exist, and that they factually have influence on management. This literature analyses theoretically and/or empirically which stakeholders matter, and why (e.g. Brenner and Cochran 1991, Mitchell et al. 1997), or how these stakeholders influence managerial action (e.g. Frooman 1999).

As a consequence of diverse forms of ownership, and diffuse control structures, theories considering stakeholders received considerable interest by analysts of corporate governance in transition economies (Buck *et al.* 1998, Berglöf and von Thadden 1999, Mygind 2001). Enterprises are complex social organizations that bring together individuals with very diverse and potentially conflicting interests. This holds especially true in enterprises undergoing the transformation from plan to market as not only internal but also external stakeholders aim to influence its restructuring strategy. The success or failure of enterprise transformation depends on the combined effort of *inter alia*,

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intervention by regional authorities (Broadman 1998). In other countries new entrepreneurial firms are a major source of competition (Estrin 2002).

- Managers,
- Employees,
- Outside shareholders (after privatisation), who may be dispersed or concentrated
- Providers of non-equity capital,
- Providers of technology and managerial knowledge,
- Suppliers and customers, some related by a long-term cooperation,
- Former employees who may still have claims, for instance for a pension, and
- Government bureaucrats and politicians, whose support is necessary not only in firms in state-ownership, but also for private firms with a restructuring plan that depends on the regulatory environment, or direct or indirect financial support.

In transition economies owners are often comparatively weak relative to other stakeholders, and some of these stakeholders may have ownership rights too. Stakeholder theorists have described managers as the centre of a 'hub and spoke' stakeholder system (Jones 1995), which is a particular appropriate description of Russian reality (Buck *et al.* 1998).

Mygind (2001) provides some theoretical foundations for the strength of various stakeholders. He argues that stakeholders' desire to hold ownership rights is related to specific features of their relationship, including firm-specific resources, outside opportunities, their access to capital and their capability to monitor governance, as well as the homogeneity of the shareholder group. As the market efficiency assumptions of the agency model do not hold in the transition context of Eastern Europe, different types of ownership are necessary to protect the interests of for instance employees. With the progress of transition, market imperfections were remedied and the extent of insider ownership declined. The same is suggested by Buck et al. (1998, p. 100) who hypothesised that, in the long run, dysfunctional managerial behaviour would lead to failure of firms, and ownership patters would move towards outside shareholders with 'core shareholdings'.

Kochran and Rubinstein (2000) suggest that stakeholder firms can be successful if a) stakeholders add value to ongoing operations, b) organizational processes and governance systems are adapted to complement the contributions of the stakeholders, and if c) stakeholder interests are aggregated and conflicts managed effectively. Especially the third criterion creates considerable challenges for leadership in transition economies (Meyer 2001). To make stakeholder firms sustainable, Kochran and Rubinstein (2000) add two more conditions: a)

Stakeholders must have a voice in leadership succession and the incentives under which leaders are employed must motivate them to be responsive to the interests of all the stakeholders; and b) The firms needs to overcome resistance to the legitimacy of stakeholders other than shareholders, which may arise from political circles motivated by the Anglo-Saxon models, and informed by economists thinking in terms of agency-theory.

Figure 1. Alternative Methods of Privatisation

How, and to whom, to privatise?

	To the general population	To current managers and/or workers	To previous owners	To outside investors, such as foreign or domestic private firms	
By sale	Stock market flotation; from mid 1990's only	MBO, MEBO; e.g. Poland, Romania	---	Auction everywhere for small business	Negotiated sale, tender e.g. Hungary, Estonia
By free distribution	Voucher privatisation; most countries	---	Restitution; e.g. Bulgaria, East Germany	---	---

Source: inspired by Estrin (1994, p. 21)

3. Methods of Privatisation

When devising privatisation schemes for CEE, policy advisors could draw on the experience of Western countries, notably the UK and some developing countries. Yet, there were important differences. Firstly, while many major Western privatisations are in industries with natural monopolies that require complex regulation to create competition, most firms privatised in Eastern Europe enjoy monopoly powers courtesy of past or present government policy. Hence, the first wave of privatisation was related to liberalization of markets for capital, goods and services, but did not require the establishment of the complex regulation seen for instance in electricity or railway industry. Only in the second half of the 1990's, CEE countries started privatising their utilities. Secondly, some of the standard methods employed before were not usable in the transition context because capital markets were underdeveloped and private wealth was insufficient for private citizens to buy large firms. Therefore a range of innovative methods of privatisation have been developed and employed in the region.

Figure 1 provides an overview of the methods of privatisation, distinguishing recipients of the ownership titles, and weather or not they receive the ownership title for free.

Before reviewing in detail the methods of privatisation and their advantages and disadvantages, we need to establish the evaluation criteria that policy maker may consider. Based on the objectives of privatisation discussed above the following criteria have been considered (World Bank 1996):

- **Speed and economic feasibility:** some methods are fast if a single project is considered but slow if a large portfolio of firms is to be privatised. Political arguments, and the concern of insider abuse during the 'transition' period favour a speedy privatisation.[2]
- **Access to fresh resources**, both financial and human capital has been a major concern in view of the need to invest in marketing and new technologies, and to develop and implement new strategies.
- **Government revenues**, as discussed above.
- **Fairness**, as perceived by the local population, which in turn determines the political feasibility.
- **Corporate governance:** the means by which dominant decision makers (typically managers) are controlled by other interested parties.
- **Transparency** of the process. Nothing has been more damaging to the public credibility of the privatisation program, and in consequence the new market systems, than politicians or managers perceived to be enriching themselves.

Figure 2 summarizes the advantages and disadvantages of the different methods. The criterion of transparency depends more on the actual implementation than on the selected method, though arguable direct negotiations with potential buyers is less transparent than an auction or a voucher privatisation.

[2] However, Spicer et al. (2000:630) argue, "Entrepreneurship is better fostered through gradualist policies permitting negotiated solutions to restructuring". They are concerned that speedy privatisation may disrupt valuable business ties, and thus favour a more evolutionary approach.

Figure 2: Trade-offs among Objectives for Different Privatisation Methods

	Speed and feasibility	Access to outside capital and skills	Government revenues	Fairness	Effective corporate governance
Stock market flotation	- -	+	+ +	+	+
Equal access voucher privatisation	+	-	- -	+ +	-
Management buy-out	- -	depends on managers	+	-	+ +
MEBO with 'free' element	+	- -	- -	-	controversial
Sale to outside investors	-	+ +	+ +	depends on perspective	+ +
Restitution	+	depends on owner	- -	depends on perspective	+

Notation: + +: positive effects are highly likely, +: positive effects are likely, -: negative effects are likely, - -: negative effects are highly likely.
Source: inspired by World Bank (1996).

3.1. Stock market flotation

The most common method of privatising large firms worldwide is stock market flotation, i.e. the general population would be invited to buy shares in an 'initial public offering' (IPO). Theoretically, this method has many advantages: it generates revenues for government budgets, it is generally transparent and thus perceived as fair, and it tends to create a dynamic process of change, that also eases the access to new resources. In practice, however, IPO were not feasible in the transition context because they require developed stock markets, where the capital for the IPO can be raised. Yet stock markets were not in place Eastern Europe, savings that can be invested in corporate assets were small, stock market regulatory institutions had not been established, and detailed financial information on the firms that potential investors would require was not available.

A well-organized IPO can be similar to the theoretical model of an auction, and thus raise considerable amounts of money. Yet this requires complex institutions to prepare the firm for the IPO, to provide a prospectus to potential investors, as well as to supervise of the actual bidding process. Privatisation agencies, arguably with the exception of East German Treuhandanstalt, did not have the administrative resources to accomplish these tasks within

the time frame envisaged for privatisation. Hence, privatisation agencies used IPOs only from the mid 1990s onward for floating firms on the stock exchange, starting with Poland. These were mostly large firms such as telecommunication or electricity companies, and the initial IPO covered only a minority stake in the firms.

3.2. Voucher Schemes

To overcome the shortage of investable private funds, a innovative approach was developed, the 'voucher privatisation'. The basic idea of this approach is that all citizens receive a voucher, which they then can use to acquire shares in firms. Hence the basic idea of a public bidding process underlying an IPO was created artificially without requiring domestic savings. Voucher privatisation has been implemented in different ways across the region. Most transition countries with the notable exception of Hungary, have implemented a voucher scheme as a main pillar of their mass privatisation (World Bank 1996, Estrin 2002).

A major advantage of this method is its high appeal to the voting public. In the political discussions, it was often considered the *fairest* method of privatisation, because of its egalitarian nature, giving each citizen equal access. In fact, it might be closest to the abstract socialist ideal of making the people at large owners of capital. The expected political support for the government did however not materialize except in the case of the Czech Republic. A related advantage was the high *speed* of implementation as no individual negotiations and evaluations were required. And with broad shareholding, the foundations for capital markets were being established, as shareholder would want to trade their shares. However, the people were buying 'the cat in the sack' in that they often had limited information about the economic viability of the firms they were bidding for. In this way, the bidding process could in some cases, like Romania, more likened to a lottery than to an auction.

The main problems of the voucher schemes were the ownership structures that emerged after the privatisation. In most cases, especially in the Czech Republic, ownership was widely disbursed, while elsewhere insiders acquired substantive shares, for example in Russia. The problems for *corporate governance* arising from these constellations are discussed below. Voucher schemes did however not generate any *revenues to the government* budget, nor did it provide *new resources* to the firm. However, it was expected that after the clarification of ownership, the firms would find it easier to access capital markets and recruit skilled people.

3.3. Management Buy-Out and Management Employee Buy-Out

Insiders can buy equity shares through management-buy-out (MBO) or management-employee-buy-out (MEBO) schemes. The latter often draws upon special financial incentives provided by governments, for instance access to loans under favourable conditions. In Russia, MEBO has been mixed with voucher privatisation as employees could use their vouchers to acquire shares in the firm they work for.

MEBO and MBO are often strongly supported by those working in the firm. They may be able to convert their stakeholder position into shareholdings, and thus formalize their informal influence over the firm. Insider support overcomes resistance to privatisation, and substantially facilitates the negotiation process. However, the valuation of the assets of the firm is as tricky as when selling to an outside investor, and the information asymmetries between insiders (managers) and outsiders (privatisation agency) are even starker.

A major challenge with buy-outs is the privatised firm's ability to access fresh capital and other complementary *resources*. The privatisation itself brings no new resources. The acquisition of resources thus depends on the new owner-managers' ability to attract them. Often MBO/MEBO firms start out with considerable debt, i.e. the loans taken out by the new owners to acquire their equity shares. Moreover, banks tend to be reluctant to lend to insider owned firms, as they may favour employees over debtors' interests. Hence raising additional capital can be a major challenge.

The *revenues* that a government can obtain from an MBO/MEBO privatisation depend on its modalities. A traditional MBO generates revenues equivalent to the firms value for the old owners. However in many MEBO cases, preferential loans have been given to new owners to finance the MEBO, such that there are no immediate revenues. In fact the incentive scheme may contain a considerable subsidy. Outsiders may question the *fairness* of MBO/MEBO's because it favours those working in 'good' enterprises, while those employed in poorly performing firms or in the public sector obtain no benefits. Moreover, the transparency of MBO negotiations is often low, leaving room for rumours about insiders getting unfair advantages. The *corporate governance* implications of these forms of privatisation depend on the actual new ownership structure.

3.4. Sale to Outside Investors

A sale to outside investors can occur through an auction, which is a suitable method if information on the firm is readily available and the several bidders are interested in the firm.

This method has been use successfully for small firms. Larger firms can be sold through a tender process, in which a round of bidding is followed with direct negotiation with the winning bidder. A pure auction is not feasible where bids may vary not only by the price but for example employment guarantees and investment commitments. Due to the complexity of tender processes, some businesses have also been sold following direct negotiations with interested buyers.

The sale to outside investors was *feasible* in the context of the so-called 'small privatisation', as small business units such as shops, restaurants, hotels or repair shops were so to domestic investors, often those who managed them in the past. For medium and large size firms, the only possible outside investors were foreign investors, as local persons lacked the necessary wealth (and credit worthiness) to buy firms.

A sale to foreign investors is attractive for several reasons. It generates substantial *revenues* for government budgets, unless - like in Eastern Germany - enterprises are given away at low prices in return for investment and employment guarantees. The new owners can generally also provide financial *resources* and new management skills to the firm, which enables deep restructuring. Moreover, the new owners are firmly in control and have strong incentives to restructure the firm towards a profit oriented organizations. The potential disadvantages of this form of privatisation are the *feasible speed* of this approach, the political acceptability of foreigner taking over local businesses, and extreme case the possible foreign dominance, and thus potentially dependence, in a particular sector.

However, considerable resources and time are required to assess each individual firm, and to negotiate with potential buyers. Auctions can speed up this process, but these too have to be prepared, and may require individual negotiations with the winning bidder to stipulate the details of the deal.

By the *fairness* criterion, a sale to foreign investors are no better or worse than other methods, if markets are efficient. Citizens do not get direct ownership in firms, but - theoretically - the government revenues from the sale of state assets translate into lower taxes. In practice, there may be obstacles for governments to realize the true value of a firm, especially if privatisation is implemented very fast. Firstly, information asymmetries favour firm insiders and their business partners over outsiders. Secondly, the organization of auctions that meet the requirements set out by economic theory, notably full information, is difficult and costly. Thirdly, the under-valuation of currency during transition weakens the sellers bargaining position. These concerns of local agents contrast with foreign investors who claim

to have overpaid, or discovered the true costs of restructuring and other liabilities only after having taken over a firm.

In the *political process* surrounding privatisation it is also seen as a disadvantage that the population at large receives nothing tangible. A related but equally important political concern is the low transparency of negotiations with potential individual investors. Especially in the context of mass privatisation and thus radical change of the ownership structure of an on national level, such concerns are politically important. Solid economic analysis of costs and benefits would alleviate some but not all of such concerns.

3.5. Restitution to former owners

In many countries where property had been expropriated after world war II, previous owners and their descendants received the ownership titles or were otherwise compensated. One might expect such re-assertion of old ownership titles to be the fastest way to establish clear ownership. However, in practice the clarification of ownership titles after 40 or 50 years has in many cases been lengthy and cumbersome. Legal documents may have been destroyed; inheritance claims need to be settled, and firms may have to be separated from larger units in which they have been integrated. In particular East Germany saw many assets left *in libido* while ownership conflicts were being settled. This period of inaction contributed to the output fall and gave newcomers opportunities to establish themselves on local markets.

From a legal perspective, restitution of the original property appears to be the most natural approach. However, the original property rarely exits still in the same form, a building has been renovated, a firm has been restructured, and agricultural land may have become a suburb. The anecdotal West German asking an East German homeowner to leave his house because it is standing on his grandfather's land illustrates the conflicts arising with restitution. Several East Europeans saw it as a massive transfer from those who worked to build factories and houses over 40 years to those who left the country to grow rich, and thus question the ethics of such restitution. Many countries thus opted compensating former owners in cash, tax benefits or vouchers rather than returning the original property.

The governance implications of restitution to former owners vary. There are cases where a Western returné took over the company, and contributed entrepreneurial energy and complementary resources to build a flourishing enterprise. Equally, there are cases where the new owner in the next generation has no interest or competence to run the firm, and in the best case would sell the firm to an interested third party. Most difficult where those cases

where a business unit had to be separated from a larger business for restitution, thus disrupting the production process.

3.6. Privatisation processes

Across the transition economies in Europe and Central Asia, a mix of different privatisation methods has been used, and the specific programs vary in many details. A broad overview is given in Table 3, which outlines which methods have been most important in each of the countries covered by the EBRD. The table also reports the EBRD's assessment of progress in privatisation and corporate governance. The advanced countries relied to a larger extend on direct sales, while MEBO has been very important in some of the slow privatising countries.

However, the choice of privatisation method, and the selection of potential investors, is not a straightforward process that is implemented on a master plan. Political institutions, mostly the parliament, take basic decisions; and privatisation agencies or other governmental authorities take administrative decisions. Many stakeholders in the firm, or individuals and organizations that wish to take a stake in the firm, aim to influence these decisions in their favour. This makes the decision processes is complex, and subject to political interference.

Stakeholders may gain influence based on legal rights, including equity stakes, or by using their control over resources needed by the organization as bargaining lever (Mygind 2001). They may participate in formal negotiations and decision making processes, or seek influence ocess by informal means, including politicking. This may involve appeals to public opinion and the media to support ones cause, or thorugh internal tactics such as manipulation of interests, manipulation of information, or manipulation of time (Antal-Mokos 1998).

In the short run, intense politics divert managers' attention from running the business. Instead of developing products, pleasing customers, trying to gain market share etc., managers will be preoccupied with "doing the deal" (Antal-Mokos 1998). This eventually hurts corporate health: market positions may erode, and the financial situation may weaken. In the long run, some otherwise viable firms may go under, and some stakeholder are able to formalize and retain their influence, for instance by 'converting' their stake to equity.

Foreign investors have to take these complex negotiation processes into account when considering a bid, which may lower their interest to become involved. The more the local firm is drifting before a foreign investor can take over control, and the more agents are involved in the process, the more difficult it becomes to turn the firm around to become a profitable affiliate of the investor (Meyer 2001b, Meyer 2002).

Table 3. Method and Progress of Privatisation

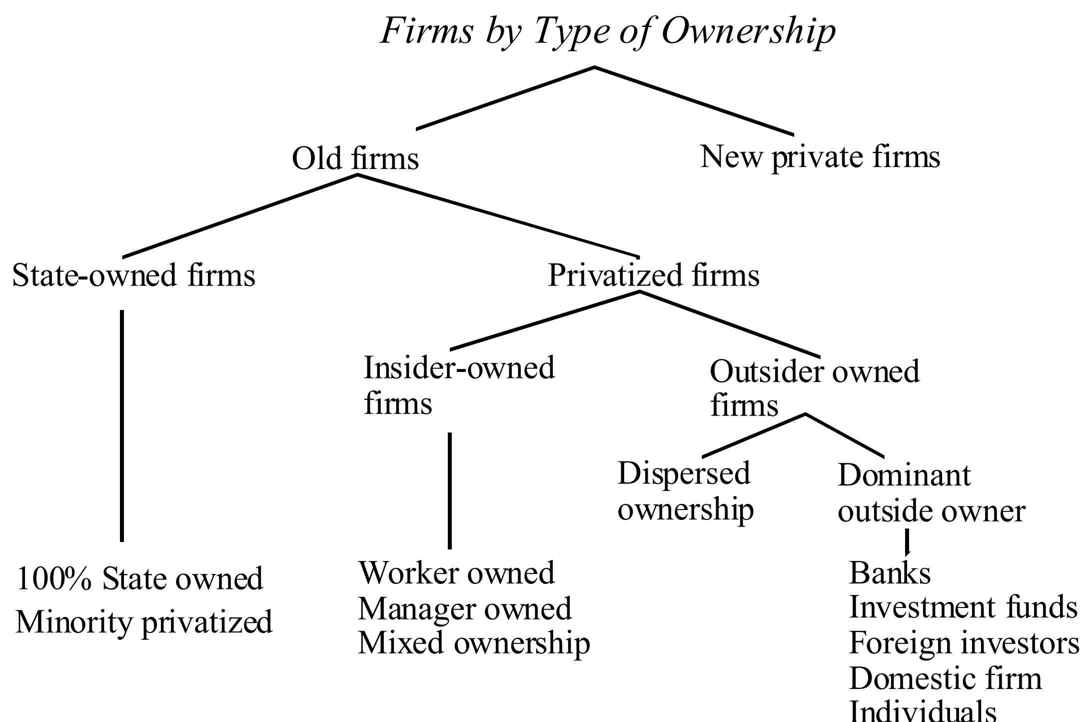
	Method of Privatisation		Private sector share, mid 2001	EBRD Index		
Country	Primary	Secondary		Large Privatisation	Small Privatisation	Corporate Governance
Czech Republic	Voucher	Direct Sale	80%	4	4+	3+
Hungary	Direct Sale	MEBO	80%	4	4+	3+
Estonia	Direct Sale	Voucher	80%	4	4+	3+
Slovakia	Direct Sale	Voucher	80%	4	4+	3
Lithuania	Voucher	Direct Sale	75%	4-	4+	3
Poland	Direct Sale	MEBO	75%	3+	4+	3+
Albania	MEBO	Voucher	75%	2+	4	2
Bulgaria	Direct Sale	Voucher	70%	4-	4-	2+
Latvia	MEBO	Voucher	70%	3+	4+	3-
Russia	Voucher	Direct Sale	70%	3+	4	2+
Armenia	Voucher	MEBO	70%	3+	4-	2+
Georgia	Voucher	Direct Sale	65%	3+	4	2
Romania	MEBO	Voucher	65%	3+	4-	2
Slovenia	MEBO	Voucher	65%	3	4+	3
Kazakhstan	Voucher	MEBO	65%	3	4	2
Ukraine	MEBO	Direct Sale	65%	3	4-	2
Croatia	MEBO	Voucher	60%	3	4+	3-
Macedonia, FYR	MEBO	Direct Sale	60%	3	4	2+
Kyrgyz Republic	Voucher	MEBO	60%	3	4	2
Azerbaijan	MEBO	Voucher	60%	2	4-	2
Moldova	Voucher	Direct Sale	50%	3	3+	2
Tajikistan	Direct Sale	Voucher	50%	2+	4-	2-
Uzbekistan	MEBO	Direct Sale	45%	3-	3	2-
Bosnia & H.	Voucher	Direct Sale	45%	2+	3	2-
Serbia & M.	n.a.	n.a.	40%	2	3	2
Turkmenistan	MEBO	Direct Sale	25%	1	2	1
Belarus	MEBO	Voucher	20%	1	2	1

Note: EBRD indices are assessments a the scale: 4 + standards and performance typical for advanced industrial countries, 1 = little reform progress;
Source: EBRD (1999, 2002).

What is the **empirical evidence** on privatisation, does it generate the expected improvements in enterprise efficiency? A major research effort has been devoted over the past decade to the empirical analysis of post-privatisation performance (reviewed by Havrylyshyn and McGettignan 2000, Djankov and Murrel 2002, Estrin 2002). Early studies did, contrary to expectations, not find significant improvements in performance clearly attributable to privatisation. However, the overwhelming evidence across CEE is today, that privatisation has increased productivity. For example, Claessens and Djankov (1998) estimate that privatised firms increase their total factor productivity by on average 5% per year across seven CEE countries. The effect of privatisation on performance is however much smaller in Russia and Ukraine, where the relevant coefficients were small (Barberis et al. 1996, Earle and Estrin 1997) or insignificant (Estrin and Rosevear 1998). More differences are observed between SOEs and privatised firms if measures of strategic restructuring are applied (Earle and Estrin 1997, Estrin and Rosevear 1999). However, the effects are not as large as many policy makers expected, such that the many observers find the overall performance of the corporate sector rather disappointing (e.g. Nellis 1999, Spicer et al. 2000).

As the long-term benefits of private ownership are rarely disputed, empirical researchers have focussed their main attention to differences of performance between firms in different forms of ownership. The results do not show consistent results concerning the relative efficiency of different ownership types in privatis*ed* firms, except to note that newly established firms outperform old ones. Djankov and Murrel (2002) based on a review of 23 empirical studies infer that the most efficient forms of ownership are foreign ownership, concentrated outsider ownership, and managerial ownership. In the middle category are bank ownership, commercialised state-ownership and insider-ownership. The weakest firms are in state-ownership or with dispersed outside ownership. Overall, few performance differences can be explained by the differences in ownership and governance structure, especially in the former Soviet Union (Estrin and Wright 1999). Possibly more important are the institutional framework and the means available to shareholders to actually monitor and influence managers, in other words the mechanisms of corporate governance.

Why did privatisation not induce the expected deep restructuring? Two lines of argument have been advanced in the literature. Economists have primarily focussed on ownership and corporate governance structures that may or may not create suitable incentives for managers to fulfil the owner's objectives. However, the unsatisfactory enterprise



performance led to a sense of dissatisfaction with agency-based perspective as main avenue for analysing enterprise transformation, and the search for alternative theoretical approaches (e.g. Spicer, et al. 2000, Uhlenbruck et al. 2003). Management scholars have additionally analysed the process of change in the firms, which is more complex than what can be depicted in formal economic models (e.g. Newmann 2000).

4. Governance under different forms of ownership

The problems of governance in the transition economies vary with the ownership. The privatisation processes led to a variety of ownership patterns within each country of the region, as illustrated in Figure 1 adapted from Earle and Estrin (1997). This includes dispersed shareholders, investment funds as dominant owners, management and employee owned firms, firms with residual state ownership as well as firms with partial or full foreign ownership. These alternative forms of private ownership create very different mechanisms of control over management.

4.1. Dispersed ownership

The voucher-based mass privatisation has led to severe but often unforeseen corporate governance problems. Policy makers and their advisors who designed these schemes

generally had in mind to create Anglo-American types of governance systems. However, the practice has shown that this model depends on sophisticated institutions that were not in place at the time, and moreover are difficult to create where frameworks are unclear and the law enforcement is weak.

With dispersed ownership and indirect control structures, many shareholders have the right to monitor the firm. Yet few if any may have the necessary power, incentives and capabilities. Individual shareholders with a few shares have only little leverage to influence management, as they would only get a small return on their monitoring efforts, and many may lack the basic expertise to understand corporate accounts and corporate strategy.

The Anglo-American model requires credible threats of takeovers, and thus efficient and liquid markets for equity - which are rare in emerging markets. The nascent stock markets lack efficiency and transparency, and the legal requirements to involve outside shareholders and to publish relevant information are established only gradually, and even slower implemented. Even basic accounting and auditing practices have not been implemented everywhere. Hence outside shareholders face considerable information gaps.

In many transition economies, investment funds have sprung up, like in the Czech Republic, or been created by the privatisation authorities, like in Poland. They became major stakeholders in voucher-privatised firms. Yet this raises the issue of who controls the controller? In other words, do the managers of these funds have appropriate incentives to act in the interest of the shareowners whose shares they administer?

The **Czech** scheme - the first and most publicised - privatised a major share of the country's assets in several waves of multiple-auction bidding processes. Investment funds attained considerable power through the accumulation of vouchers and bidding on behalf of individuals. They control major Czech businesses, but in turn are often owned by banks, that largely are still state-owned even ten years after the onset of transition. This creates interdependent institutions without clear monitoring and control structures, but with multiple agents that have hold-up power (Hayri and McDermott 1998). The concern for corporate governance under such conditions stimulated considerable research in the Czech Republic. Claessens et al. (1997b) find that firms with ownership concentrated among a small number of shareholders or investment funds tend to perform better in terms of both operating profits and market valuations. Based on the same data, Weiss and Nikitin (2002) find that the results depend on the type of owner, as firms with ownership concentrated in bank-managed funds show inferior performance. They attribute this to the fact that these are typically 'closed-end

funds' where shareholders have less leverage to control fund managers. The lack of effective corporate governance structures has frequently been blamed for the slow progress of enterprise restructuring in the Czech Republic (e.g. Nellis 1999).

In **Poland**, mass privatisation was delayed due to political conflicts over its conditions, while policy makers tried to avoid the pitfalls of the Czech scheme. In 1996, shares of some 500 enterprises were allocated to government-sponsored investment funds, which in turn were privatised through vouchers that are now traded on the Warsaw stock exchange. Each enterprise was initially owned by a fund holding 33% of equity, plus minority shareholdings by the other funds, workers, and the government (¶awniczak 1997). Each fund had a supervisory board appointed by owners, i.e. initially the privatisation agency, who in turn recruited international financial service firms or consortia as management firm. The boards of the industrial firms participating in the program consisted of 4 representatives of the lead shareholder fund, 2 representatives of the minority shareholders, one representative of the state treasury and 2 employee representatives. The funds would manage the stakes like a closed-end investment fund, and trade shares in individual firms as they found appropriate, including sale to foreign investors (¶awniczak 1997). While overcoming defaults of corporate governance in the Czech voucher privatisation, the Polish scheme still suffers from conflicts between different control institutions, including the funds' supervisory boards, the management firms, and the state representatives on either board.

In **Russia** the voucher privatisation of 1993 has mixed elements of ownership transfer to insiders and to the public at large. Although the policy advisors intended to create dispersed ownership and liquid stock market along the Anglo-American model, most firms ended up under the control of insiders (e.g. Estrin and Wright 1998, Buck et al. 1998). Outside shareholders have experienced in particular obstacles to gaining a fair share of the economic return of the firm in the absence of legal institutions to enforce their claims. This includes investors holding substantial blocs of share. In contrast to Czech evidence, ownership concentration was *not* found to improve performance by Earle and Estrin (1997).

Thus, the voucher schemes of CEE have been a large social experiment, with long-term implications that are yet to be revealed. Many expectations have not been met, but they may have been overly optimistic. Throughout CEE, voucher-privatised firms have been struggling with creating effective mechanisms of governance, and defining the role of diverse stakeholders. In many cases, investment funds are the dominant stakeholder, acting on behalf of shareholders, whereas elsewhere managers are effectively in control.

4.2. Managerial ownership

If managers own a firm, the principal-agent conflict between managers and owners is eliminated. Partial managerial ownership may help to align the interests of managers and owners, but under some constellations may raise concern over the protection of minority shareholders. However, several arguments suggest that also managerial ownership in transition economies can pose potential problems for governance. This concerns firstly the entrenchment of incumbent managers, and the selection mechanisms of recruiting the best-qualified individuals into leadership positions.

Incumbent managers often could hold on to their jobs throughout the privatisation process. For instance, voucher schemes do not have a build-in mechanism to replace managers that may hold their position since being appointed during socialist times - commonly known as 'Red Directors'. If the owner-managers control a large share of equity, and their outside career opportunities are lower than their current income, then they have strong incentives to retain their share to increase their job security.

If, on the other hand, managers acquired the firm through an MBO, this process is likely to act as a selection mechanism that brings only the most qualified individuals into the top management positions (Carlin and Landesmann 1997:89). Only managers believing in their ability to improve enterprise performance would be willing to invest their own capital, and only well qualified managers would be able to raise capital externally to finance the MBO. After the privatisation, managers have often increased their holdings of equity by acquiring shares from employees or other shareholders (possibly at undervalued prices), for example in Estonia (Jones and Mygind 1999, Kalmi 2002). Both entrenchment of incumbents and entry of capable entrepreneurial managers may drive this trend.

A different line of theoretical work attributes superior performance of private firms not only to incentives for agents but the ability of private firms to attract and select more qualified managers (Rosen 1992, Barberis et al. 1996). The efficiency of mechanisms of replacing managers may be crucial for restructuring performance because lack of managerial qualifications for the market economy is a major source of poor performance. MBOs, and even more Management Buy-Ins, contain a competitive element to select better qualified manager-owners. These arguments suggest two propositions on the performance implications of managerial ownership. Firstly, the individual personality of the manager, in particular the qualification and the entrepreneurial talent, is crucial for performance of manager-owned

firms. Secondly, firms acquired through MBO perform better than those acquired by managers in a voucher scheme.

Both propositions are supported by empirical evidence. Case studies (e.g. Newman and Nollen 1998, Johnson and Loveman 1995) show that exceptional managers distinguish the best performing firms. In Newman's cases, strong leadership in terms of strategic thinking, decisiveness and initiative, and attention to operational efficiency distinguished the most successful Czech firms. Djankov (1998) also stresses the importance of qualifications as he finds that Moldavian enterprises in which managers have engaged in retraining have substantial sales increases and conduct more restructuring.

The importance of bringing in new managers, rather than creating stronger incentives for incumbents is highlighted in two studies. Barberis, Boyko, Shleifer and Vishny (1996), who present one of the first major quantitative studies on the effects of privatisation in Russia, analyse 452 shops, and find that human capital *change* stimulates restructuring. Similarly, Claessens and Djankov (1998) find that performance in the Czech Republic is improved by *changing* managers, but *not* by providing managers with *incentives* in form of equity stakes. All their performance indicators are negatively correlated with the length of tenure of the general manager of the firm, but positively correlated to external recruitment of managers.

Neither Barberis et al. (1996) nor Claessens and Djankov (1998) find evidence for equity ownership by managers to be related to improved performance. However, neither of them included MBOs. Other studies, e.g. Earle and Estrin (1997a) and Jones (1998), find better performance by management owned firms. Djankov (1999a) finds management ownership to have positive effects on productivity and asset sales at low levels (below 10%) and at high levels (over 30%), but negative in the intermediate category. The evidence may also be indicative of insiders taking advantage of their knowledge and control, as dispersed outside owners lack effective means to monitor managers. It may however also be due to the different avenues that led to management ownership.

4.3. Employee ownership

Employee-ownership is common where the privatisation procedures gave insiders preferential access to ownership (Uvalic and McVaughan-Whitehead 1997, Jones and Mygind 1998, Buck

et al. 1998).[3] Especially in Russia, the rapid mass privatisation has been achieved by providing insiders opportunities to attain ownership reight and thus motivate their cooperation in the privatisation process (Boyko *et al.* 1995, Blasi *et al.* 1997, Wright *et al.* 1998). However, many commentators see the widespread employee-ownership as an obstacle to enterprise transformation because workers may pursue motives other than profit maximization, complicate internal decision processes, and inhibit radical change in the organization (e.g. Boyko et al. 1995, Havrylyshyn and Gettigan 1999). On the other hand, employee-ownership can have positive effects on productivity through motivation and a cooperative atmosphere that increases trust and information sharing (e.g. Ben-Ner and Jones 1995).

Based on principal agent models, Aghion and Blanchard (1998) explore the effects of insider ownership. They conclude that if deep restructuring requires both external finance and further labour shedding, then insider privatisation should be avoided. However, giving managers equity shares in the privatized firms would improve their incentives to behave in more profit maximizing manner. If insider ownership is preferred, then Aghion and Blanchard (1998) argue for tradable shares to avoid entrenchment of incumbent managers. However, as many employees see ownership shares primarily as a means to increase their job security, they are likely to collude to inhibit sales to outsiders (Kalmi 2000).

The empirical evidence on performance implications is hotly debated as many Western advisors see it as a key obstacle to restructuring (e.g. Havrylyshyn and Gettigan 1999).[4] The results of empirical studies of the effects of insider-ownership on firm performance are highly sensitive to the selected proxy of performance. Furthermore, insider ownership has to be distinguished between manager-owned firms and employee-owned firms.

Most studies find beneficial effects from employee-ownership compared to the status quo of state-ownership. However, generally foreign- and managerially-owned firms outperform employee-owned firms (Djankov and Murrel 2002). Yet some studies also find

[3] Contrary to widely held perceptions, partial employee-ownership is also a common phenomenon in Western countries, including the USA as reported by for instance Demsetz (1983) and Blasi and Kruse (1991).

[4] The most cited study showing the performance of employee-owned firms is indistinguishable from state-owned firms is Frydman *et al.* (1999). However, Kalmi (2002) notes that their sample is somewhat problematic. It consists of 185 firms in Poland, Hungary and the Czech Republic, of which only 10 were employee-owned, all in Hungary. Kalmi notes that a random sample should normally have included employee-owned firms in Poland.

positive effects of employee ownership compared to dispersed shareholding on production efficiency (Smith *et al.* 1997, Jones and Mygind 1999). However, after controlling for endogeneity of ownership, i.e. the fact that insiders are more likely to take over good firms, the positive effects disappears in Central Europe. For CIS countries, worker ownership even has a negative effect compared to status quo state-ownership, while manager-ownership and general insider-ownership has positive effects (Djankov and Murrel 2002, p. 762, 786).

Russia presents a special case of employee-ownership, as it is widespread but often does not give effective control to employees. Following the voucher privatisation with special preferences for employees, many firms are formally employee-owned, but effectively controlled by managers. Several authors point out that Russian managers have dominating influence over major decisions, whether owners or not, also in nominally employee-owned firms (Blasi *et al.* 1997, Jones 1998, Mygind 2001). Buck *et al.* (1998) found that although firms were nominally employee-owned, managers perceived market conditions and state control as key constraints to their freedom to act. Moreover, managers in the majority of their sample firms intended to buy shares from employees, or had already done so. In most of these cases they openly admitted that these acquisitions were designed to prevent the sale to outsiders (Buck et al. 1998, p. 96). Employee influence appeared to have actually declines with privatisation, evidenced with fewer employee representatives on corporate boards. The governance implication is that the separation of ownership and control allows managers to pursue their personal objectives at the expense of the interests of the employees. Kalmi (2002) finds employee-ownership is generally not motivated by the goals of improving labour relations and of improving productivity, as are employee-share ownership schemes in the West. Rather they are seen as means to attain higher job security. Thus, ownership does not lead to more participation and restructuring to increase motivation and productivity.

As employee-ownership arose out of specific conditions of privatisation, a key issue is weather it will be sustained in the long term, or weather it is a temporary phenomenon. The need to raise fresh capital would be expected to induce insider-controlled firms to accept new outsider equity stakes and provide acquisition opportunities. However, most early empirical studies suggest that outsiders face considerable obstacles to obtain ownership and effective control of privatised firms, among other reasons because stock market institutions such as protection of minority shareholders are not in place, especially in the former Soviet Union. Empirical studies thus report that patterns of ownership change only slowly and the share of

equity held by outside investors is slowly increasing (Buck et al. 1998, Jones and Mygind 1999).

Kalmi (2002) presents more recent evidence in his PhD dissertation. He shows that in a representative sample of Estonian firms, the percentage with dominant employee-owners declined from 19.8% at the time of privatisation to 15.1% in 1995, and further to 7.5% in 1999. However, including managers and former employees, the proportion of firms in insider ownership stays roughly stable. Kalmi (2002) moreover explores the dynamics of ownership changes. He finds that shares are rarely traded, and new employees are not offered the opportunity to acquire shares. Rather, ownership structures change by increased shareholdings by former employees, and via new share issues to raise fresh capital where employees do not buy new shares. If shares are traded, they tend to be acquired by managers. Since share-ownership is commonly seen as a means to increase job security, insider-owners collude to prevent sale of shares to outside investors. However, employee-ownership declines mainly due to attrition, as the institutional context does not provide mechanisms that would enable or encourage new employees to acquire shares.

However, the influence of employees is not limited to their ownership of shares. One unpredicted consequence of east European privatisation is the influence that managers and/or worker councils attained, *de facto* or *de jure*, notably in Poland and many CIS countries. Workers attained considerable influence over managerial decisions pre-privatisation in Poland, while their counterparts in Hungary and the Czech Republic actually had less influence than in, say, Germany (Estrin et al. 1995a). Consequently, many cases have been reported in Poland, where work councils have blocked restructuring proposal (Carlin et al. 1995) or a the take-over by a foreign investor (Bak and Kulawzuk 1997). In many cases, insiders managed to convert their *de facto* control into formal ownership by opting for privatisation modes that gave them preferential access to shares. This explains why many firms, particularly in Poland and the former Soviet Union, have managers and employees as minority or even majority shareholders (e.g. Åslund 1995, Blasi et al. 1995).

In conclusion, through a variety of channels, inside stakeholders have been able to attain formal ownership and/or control rights. In some cases, this translates to effective influence over strategic decisions made by management; in other cases, notably in Russia, managers are effectively in control. However, few if any firms appear to have adapted an organizational culture that would promote the democratic and motivational aspects of employee ownership; and over time, the share of employee-owners is declining (Kalmi 2002).

This is a gradual process, and in the medium term, companies have to live with employee owners, for better or worse.

5. A Future for Stakeholder Capitalism?

The transition economies have developed corporate governance systems that differ from those in mature market economies, even taking into account the variation between for instance the USA and Continental Europe. Some of the largest firms in the region are subject to weak governance while enjoying close contacts to government and, in some ex-Soviet Union states, considerable barriers to entry. Yet other firms have gone far in shedding these legacies of the 20th century. The emerging diversity of governance mechanisms and competition patterns is likely to be a continuing feature of the region for years to come.

The evidence and analysis indicates that clear governance structures as suggested by agency theorists are more the exception than the rule. The advice to create clearer governance structures and an institutional framework to support them is likely to benefit in the long term, but does not help addressing problems facing businesses in the short run. Managers in many firms have to deal with the fact that many stakeholders that take an active interest, and may have possibilities of blocking restructuring decisions (e.g. Hayri and McDermott 1998).

New forms of corporate governance are emerging in CEE, which we may call stakeholder capitalism. This creates unique opportunities and challenges for managers and for stakeholders. On the one hand, some managers are in effective control of the firm as shareholders and other stakeholders are too disbursed to monitor them. This creates corporate governance problems, as managers appear free to pursue their own objectives at the expense of others. On the other hand, some managers face multiple stakeholder interests with some degree of influence over their decisions, which creates unique challenges for leadership to coordinate diverse groups of people to pursue a common path of change (Meyer 2001a). Especially, when faced with a need for radical corporate change, this task can be daunting. Thus managerial power may be too large in some cases, and too small in others.

The unusual circumstances of economic transition led to unusual patterns of ownership, and thus unusual governance structures. These governance systems may not be conducive to radical change due to complex coordination challenges, as too many stakeholders may inhibit change. The most frequent heard advice is to change ownership and governance structures such as to meet the assumptions of theory, in particular to create clear principal-agent-relationships, and to oblige managers to provide more information about the

firm. There has been less discussion on new approaches to management that would help overcoming the inherent coordination problems of stakeholder ownership. Yet this should be worth thinking about, as changes in corporate governance systems will take time. In the meantime, *firms that manage the coordination task best are likely to outperform the rest*.

The decision making by building consensus among stakeholders has several potential pitfalls, it may be time consuming, and not conducive to change that is radical or that involves major trade-offs between (relative) winners and losers. In contrast, decision making by principal over agents is quick and decisive, although possibly divisive, and the managers have a strong authority to implement decisions, if the person legally in charge makes decisions. Arguably, decision-making by consensus is more appreciated in the cultures of continental Europe, including Eastern Europe, and Asia, while decision making by principals over agents is more associated with Anglo-Saxon cultures.It is unclear how persistent the stakeholder influence will be. The stakeholder capitalisms will be sustainable only if firms develop appropriate organizational structures and cultures to take advantage of the motivation that employee-owners may contribute. A crucial aspect will be to develop mechanisms of coordination and conflict resolution. Thus, stakeholder interests must be aggregated, and conflict be managed effectively. This required adaptation of organizational processes and governance systems to complement the contributions of the stakeholders. If on the other hand, stakeholder firms do not demonstrate that they can perform well, they are likely to convert to conventional governance structures. This applies in particular where no mechanisms exist to give new stakeholders, such as new employees, access to equity stakes, while retiring employees leave the firm and become outside shareholders. In consequence, there are strong tendencies of convergence to West European models of governance, as banks and investment funds gain influence, while employees lose influence.

6. Conclusion

The privatisation process in CEE has created various forms of stakeholder ownership, especially insider ownership. Gradually, ownership patterns are moving to outsider ownership, and more concentrated ownership. Employee-owned firms ’deteriorate’ while there is no mechanism to create new ones, while financial institutions gain in competence and influence. At the same time, gradually, financial market institutions are improving. However, the convergence to West European or Anglo-Saxon systems of governance is slow. The

identity of multiple stakeholders may change, but stakeholder influence will be around for quite some time.

This creates challenges for managers, and in consequence for academic researchers. Future research may pay more attention to the practical consequences of stakeholder ownership. For example, how can firm take advantage of the potential benefits of stake-holder ownership, i.e. the motivational effects? What are the leadership challenges in stakeholder-owned firms, how can leaders overcome conflict, and build consensus? How does firm's performance change as it is changing from one form of ownership to another, say from employee ownership to managerial or outsider ownership? These questions should be addressed not only by cross-sectional studies, as most of the research so far is, but by using longitudinal research designs, or panel data.

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