THE WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Behavior of a Slovenian Firm in Transition

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Working Paper Number 26
February 1997

This paper was completed by the author during his stay at the Davidson Institute and the University of Michigan Business School as the first William Davidson Visiting Professor in February 1997. Disseminated in 1997 by the William Davidson Institute with permission from the author.

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1 INTRODUCTION

Modelling the behavior of business enterprises is one of the central questions in economic literature. It has aroused attention again in the past few years when different fields of economic and business science such as microeconomics, industrial organization, organizational behavior and comparative economic systems, have created new knowledge which has changed the traditional view of the economic organization.

This knowledge is of special importance for the countries in transition. If they want to join the developed economies, they have to achieve a significant economic growth which is based on higher efficiency of economic organizations. If the main point up to the present has been to achieve economic stabilization and ownership transformation, from now on even the most developed countries in transition like Slovenia will have to concentrate on forming the conditions for faster and more stable economic growth. Modelling the behavior of business enterprises in transition might contribute to the shaping of the measures to increase their efficiency.

A model is merely a description of reality in a simplified and highly abstract form. The factors which can affect a firm's behavior are so numerous that it would be impossible to include them all. Therefore, only the most essential factors can be included. Talking about economic growth in Slovenia, we are interested in the behavioral characteristics of enterprises in certain conditions, and how to achieve more efficient investment activities of enterprises.

In the next chapter I will first summarize the discussion on the behavior of business enterprises in developed market economies. The discussion is interesting, since it stresses all the complexity and interactions of the economic organization. The presence of private ownership in developed market economies has given rise to different forms of economic organization, a collection of contrasts, which has developed in time (evolution) and can not be mechanically transferred to other environments. This happens to be a fact also for the countries in transition where private property did not play its role for a long time. That is why the typical reactions of enterprises in the privatization process are different. The third part of the article deals with the characteristics of economic organizations in Slovenian environment and presents some suggestions which might raise the efficiency of their investment activities.

2 THE FIRM IN THE ECONOMIC THEORY

2.1 Models of a firm in developed market economies

2.1.1 The neoclassical theory of the firm

Although there exists more than one version of what may be called the "neoclassical theory of the firm", each can be characterized by two common features:

1. The firm is seen as a technological black box which combines marketed factors of production to produce marketable outputs. Its technological possibilities are usually represented by the production function, which specifies the amount of output corresponding to each feasible combination of factor inputs.

2. The rates of remuneration for the factors of production explicitly recognized in the model, such as capital and labor, are assumed to be determined on a market that is external to the firm (Aoki, 1986).

Assuming rational behavior, firms maximize the profit or value of the firm for the owners. According to this, rational behavior is explicitly ascribed to shareholders (entrepreneurs). Managers are only implicitly present as their agents. To employees, only the function of providing work supply is given to which managers react with suitable allocation of work.

The ideal of the neoclassical economy is atomistic competition. According to this, the neoclassical economy does not deal specially with the problem why some firms grow to a greater extent and others stay small. In its view, the differences in the size of firms are a result of the technology used, the different market structures in which firms operate, the nature of prices, the information to which they react and the characteristics of production factors markets. The neoclassical economic theory is normative and does not take into consideration the fact that economy is a self-regulative mechanism which changes the structure also as a result of its own operations (adaptive efficiency, Marris, Mueller, 1980).

2.1.2 The single-period models of a firm

The assumption of rational behavior of stockholders (entrepreneurs), on which the profit maximizing model of firms in the neoclassical world is based, has given rise to a variety of criticism. The most common one is that profit maximising did not describe the goal to which managers aspired. Four main reasons were put forward: 1) Firms may not be constrained by external forces to maximize profits. Studies have shown that in a large corporation there may be a divorce of ownership from control[1]. In addition, an absence of competitive policies by existing firms can permit departures from profit-maximizing behavior by others; 2) Managers do not maximize the profit because they cannot determine the expected values of marginal revenue and marginal costs; 3) Managers have goals other than single-period profits which they try to attain; 4) Some of the comparative

[1] Berle and Means were the first who argued that dispersed ownership in big firms may cause the divorce of ownership from control. Big corporations are to be controlled by managers (Berle, Means, 1932).

static predictions which may be deduced from assumptions of the profit-maximization model have been observed less frequently than those derived from alternative hypothesis (Reekie, Crook, 1995).

Dissatisfaction with the single-period profit-maximizing model prompted other writers to develop non-neoclassical models of the firm. The best known among the static models are: 1) Baumol's single-period sales-maximizing model and 2) Williamson's model of managerial discretion.

Baumol (Baumol, 1959) builds his model on observations of the behavior of large enterprises which - in circumstances of imperfect competition - have a lot of reasons to increase their market share and to maximize their sales revenue instead of profit. Large firms even pay managers according to their sales revenues. These enterprises produce more than those which maximize profit, and their reactions to changes of market parameters are different. In this sense they do not always follow the interests of their shareholders to achieve a maximum level of profit. On the other hand, there is some minimal level of profits, a profit constraint, which must be earned. This level is determined by the firm's desire to keep its dividends and share price sufficiently high to keep existing shareholders quiescent and to be able to raise new capital at a future date. Only after this profits constraint has been earned, profits become subordinate to sales in the firm's hierarchy goals.

Williamson's model of managerial discretion (Williamson, 1967) represents an even greater step away from the static profit maximizing model. In his opinion firms operate in a weakly competitive environment. Ownership is separated from control, and that gives a great deal of the discretion power in decision making to managers. As long as the firm is generating a minimal amount of profit, managers can make use of this power in order to increase their utility. Williamson argues that the most important motives of businessmen are desires for salary, security, dominance and professional excellence. These can be gained by additional expenditures on staff (power), managerial emoluments (perks) and discretionary investment. It is argued that these provide additional utility and it is their utility which managers aim to maximize.

2.1.3 The multi-period models of behavior of a firm

The multi-period models of a firm (dynamic models) are growth-centered. If we introduce time into the profit-maximizing model, the firm will be assumed to act in a manner which will maximize the present value of expected future profits (Baumol, 1962). If, however, we take into consideration that managers aim to maximize their utility, then we talk about the managerial multi-period models. Thus, Marris (Marris, 1972) presents a model in which managers maximize their utility, which depends only on the firm's growth rate, subject to a security constraint. According to this model, managers decide for growth because of the diversification rather than an increasing revenue from existing products. At relatively low rates of growth there would always be some new products earning (temporary high) monopoly profits. However, eventually greater rates of diversification result in successively lower profitability because of the following reasons. Firstly, the methods of increasing the diversification rate reduce profitability by reducing total revenue or increasing total costs relative to the firm's size. Such methods are: increasing advertising expenditure and greater R&D. Secondly, faster growth would require a faster growth rate of skilled management. This means that less time would be spent by experienced staff in performing their original tasks, and inefficiencies would arise. Thus, the demand for growth starts to decline. On the other hand, the supply of growth depends on the size of profits. The enterprise can reach it with investment activities which are financed by retained earnings. As the retention ratio rises, profit might decline after a certain point, which is caused by lack of profitable projects. This causes a drop of share prices. Managers face the danger of hostile take-over. That is why they prefer to adopt the firm's growth rate to the minimal value of shares which still guarantees a safe employment.

2.1.4 Satisficing and organizational coalition

Simon (Simon,1959) introduces a concept of satisfactory level of profit instead of the concept of profit maximizing. Since managers do not have all the information, the course of events in the decision making process runs according to the satisfactory level of profit. Businessmen act with "bounded" rationality. What the satisfactory aspiration levels of profit will be depends on past experience and will take account of future uncertainties. If they do not reach the goal of satisfactory level of profit, they search for causes (search behavior) and adapt their plans (aspiration levels).

Cyert and March (Cyert, March, 1963) made a next step away from the simple profit maximizing model by presenting a firm as a coalition of decision makers: managers, workers, shareholders and customers, who all have their own goals. For the firm as an organisation to survive, the coalition members must be satisfied with less than their maximum objectives, since the resources are not available to satisfy them all. The consequence is an "organizational slack". The slack exists because firstly, it is difficult to ensure the minimum acceptable reward to the coalition members. Secondly, the resources tend to be underexploited, since it is difficult to know the maximum productivity of a man or a machine. Since there exist a conflict of objectives, the final set of goals of the firm will, at least partly, be the outcome of political decisions.

2.1.5 Business enterprise as internal organization

These two models are the predecessors of the transaction cost economics and are important for their three basic messages. Firstly, they have highlighted the problem of organizational slack. Secondly, by their lack of general applicability they have shown how it is possible to reconcile profit maximization models with the rule of thumb techniques, which must obtain support from within the organization. Thirdly, the firm is not a black box but a nexus of contracts. Internal organization is important.

The transaction cost economics is based on Coase's assertion (Coase, 1937, 1960) that the establishment of a firm is connected with the authority, or with the capabilities of internal organization to economize with transaction costs. When transaction costs are absent, the value maximising behavior is achieved by efficient contracting. Efficient contracting may take place within the juridical firm or outside it in the market place. Coase argued that firms (hierarchies) would exist and replace market transactions when the costs of transacting exceeded the costs of internal organization.

On this basis, Williamson (Williamson, 1976, 1985) has developed the theory of which organisational mode - the juridical firm or the outside market purchase and sale - economizes best on these costs. Transaction costs fall into two main categories: co-ordination costs and motivation costs. Co-ordination costs are the costs of using the market price system (co-ordination costs outside the firm) and the co-ordination costs within the firm (transmission of directions downwards to dispersed sections, and gathering and transmission of information upwards). Motivation costs arise from two sources: information asymmetries and imperfect commitments. Transaction can be carried out either on the market or within the firm. Which way is chosen depends on the dimensions of transaction costs, which are of special importance when: 1. transactions require investments in specific assets; 2. transactions are carried out frequently over a long period of time; 3. the level of product standardization is low; 4. performance measurement of transactions is difficult; 5. transactions are design connected (Milgrom, Roberts, 1992).

The economics of transaction costs takes into account the bounded rationality of economic subjects. Within the limits of the information available to them, they tend to satisfy rather than maximize. The costs of searching out the information to maximize are unacceptably high. Due to the fact that information is also asymmetrically distributed, economic subjects behave in a strategic and opportunistic way[2]. Therefore it is necessary to be protected against their opportunism with a suitable contract. Internal organization (unified relational contract) is an example of protection against opportunism in the case of specific and recurrent transactions.

Information asymmetry results in pre-contractual opportunism. Adverse selection is an ex-ante information asymmetry problem and it arises because one set of parties to a trade conceals or misinterprets information about itself. To avoid adverse selection, enterprises create their reputation or wish to persuade the customer by standardized products. Job seekers signal the education they achieved, whereas manufacturers underline the quality of their products by providing long-term guarantees and warranties.

Information asymmetry, on the other hand, makes possible post-contractual opportunism. If a contract provides complete protection of one party and cannot be supervised by the other, the first one may undertake a hidden action to the detriment of the second one. This type of behavior is known as "ex post strategic behavior" or "moral hazard", which leads to a hold-up problem and threatens to break the contract. Even if moral hazard has been detected, incomplete contracts generally imply that enforceability is difficult, certainly costly and perhaps impossible. One way to economize on bounded rationality and opportunism is to adopt the governance structure of a unified relational contract, in other words: common or joint ownership of both assets, namely a vertical integration.

Moral hazard, adverse selection and information asymmetry also underlie the new theories of principal and agent. They refer to a special problem of bounded rationality of economic

[2] Using a stratagem to achieve a goal is the highest degree of opportunism.

subjects when their risk preferences differ. As it has already been pointed out, the agent (manager), for example, can pursue goals different from those of the owner (principal). The reason lies in the fact that the agent is conventionally assumed to be the risk-averse party, while the principal is the risk-neutral one.

2.1.6 Influence of macroeconomic environment on firm behavior

The transaction costs theory explains the formation of large firms and internal organization of firms by the size of transaction costs. The reason why American, German and Japanese firms drove British firms, which retained too long the form of family businesses, out of international markets at the end of the 19th century, might lie in the fact that they carried out three sorts of investment: investment in production, investment in marketing (geographical expansion) and investment in management (Chandler, 1993)[3]. Specific knowledge was mostly formed at top management level, because the firm, as a rule, had no patterns regarding its formation. In this way, it acquired the first mover advantage and oligopolistic power as well as the entry on new markets by geographical expansion (the advantage of economies of scope) and diversification of products, and consequently, it achieved the possibility of further growth[4].

Williamson sees the reason for the existence of multidivisional firms in managing the transaction costs, since the center allocates capital more easily than the capital market (when individual divisions act as independent firms, Williamson, 1975). He also points out the firm's specificity of human capital and cost-saving which can arise from the formation of the firm. Such cost-saving is possible: 1. because the workers are willing in a modern firm to share some risk with the shareholders who, in exchange, are willing to take relatively higher risk through the corporate institution; 2. because of the willingness of the employees to co-operate and the ability of the employer to adapt and monitor the production effectively under uncertainty; 3. because of the skills and knowledge formed on the job and embodied in the employees as well as the ability to generate and utilize them efficiently, and 4. because of the collective skills formed on the shop-floor and embodied in the team of employees, as well as the ability of the employer to generate and utilize them efficiently. These capabilities, specific to an individual firm, cannot be attributed to an individual person, but to the internal organization. If co-operation between the shareholders and the employees is such as to enable optimal risk sharing and efficient use of specific abilities, knowledge and resources, the firm might form an organizational rent (Aoki, 1986).

Taking into account that also managers might make independent decisions that are not in the shareholders' interests, a game going on within the firm between the managers, shareholders and employees could be identified, a game which can have a co-operative or

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3 This led to the professional management on all three levels: top management, middle management and lower management.

4 Specific knowledge of the firm was already discussed by Marshall (Marshall, 1925, Book IV). Chandler refers to it as "organizational capabilities", which include the firm's resources, established procedures, firm's contacts and team work. Some time is needed to develop them (Chandler, 1993). Referring to it, Porter speaks about competitive advantage of a firm. What marketing strategy the firm will choose, depends among other on its internal advantages and disadvantages (Porter, 1990).

a non-co-operative outcome. Co-operation in the sense of the game theory does not mean that either party sacrifices its own interests for the sake of the other, but only that each communicates and co-ordinates its actions for the purpose of furthering its own interests. Aoki relates the existence of a co-operative game in a modern firm to the macroeconomic environment, which adopts or not the so called managerial view according to which a corporate firm operates as a sort of coalition of stakeholders such as shareholders, employees, suppliers, costumers, and even the general public. The manager of the corporation is visualized more as harmonizing the objectives of those groups. In this sense, American firms differ from those in Western Europe and Japan in that they emphasize more the so-called traditional or classical approach, which requires from the managers to work exclusively in the interest of the owners, i.e. shareholders. The shareholders sovereignty model is therefore more a characteristic of the American economy, where management functions as a surrogate for shareholders and adopts decisions for their benefit. Western Europe and Japan incline more towards the corporate managerialism model, where management adopts decisions for the benefit of both - shareholders and employees. A variant of this model is the managerial discretion model, where independent managers adopt decisions with regard to their utility function, taking into account the limitations imposed by shareholders and employees. In Germany, on the other hand, large firms are characterized by a two-tier governance structure with minority representation of employees. Aoki believes that among the above-mentioned models the best results are achieved by the corporate managerialism model. The shareholders' sovereignty model neglects other internal groups in a firm and thus the sources of internal efficiency. In the case of unbalanced bargaining power in favor of employees, the participative management model causes a decline in the firm's growth and may also endanger the firm's existence, due to the emphasis put on the interests of one party (employeeism). In the corporative managerialism model, managers are the integrative and intermediating factor. Thus, the internal efficiency of a firm is increased and organizational rents are formed (Aoki, 1986).

2.2 Basic outlines of the discussion on firm's behavior in developed market economies

Our debate has shown that internal organization of a firm is important and must be studied separately from, although in conjunction with, other micro- and macroeconomic co-ordination mechanisms. The extent to which a firm can transact more cheaply than the market or the plan, depends on the organizational structure of the firm itself as well as on various attributes of the market or plan mechanisms (Ben-Ner, Brada, Neuberger, 1993). Simple models of firm's behavior, such as, the profit maximizing model or the model of maximizing shareholders' value, can only be used as an approximation of the firm's behavior in a market economy. For better understanding of actual happenings, a deeper insight into the operational structure of firms is needed. The debate has hitherto mainly shown two important aspects:

1. Regardless of who the principals are, they inquire how to discipline the agents so that they will work in their interest. Therefore the modern microeconomic theory emphasizes the study of contractual relationship between shareholders (principals) and managers (agents), dealing with different aspects of disciplining managers. Thus it

studies the owners' control and costs of the control, contracts between shareholders and managers which should prevent managers' moral hazard (the principal and agent theory), market of managers and product markets as the arbiter of managers' work, and the threat of take-over as a way of disciplining managers. It mainly deals with contractual inefficiency due to incomplete and asymmetrical information as well as opportunistic behavior. It shows that each method of managers control has its advantages and disadvantages, and that different circumstances require different methods (Ricketts, 1994). But in general, contracts are imperfect. For that reason, there is a variety of statutory provisions that regulate the relationship between shareholders and managers in real life;

2. In order to enable a manager to carry out his integrative and intermediating role among the corporate constituent bodies, it is necessary to create an adequate macroeconomic environment which emphasizes the possibility of creating firm's internal efficiency as well as organizational rents. Therefore it would be useful to view the firm's management in a wider perspective which includes not only the relationship between shareholders and managers but also economic environment (Franks, Mayer, 1992, 1996). This particularly applies to the countries in transition, which have thus far been adopting the classical model of corporate governance, neglecting the very influence of different economic environments on the firm's performance. Neither have they taken into consideration other forms of corporate governance formed, for example, in Germany or Japan, nor the findings of the modern microeconomic theory (Garrod, 1996). Thus I proceed to the discussion of the behavior of Slovenian firms.

3 THE BEHAVIOR OF A SLOVENIAN FIRM

3.1 The development of a Slovenian firm

The term Slovenian firm refers neither to state-owned firms nor to small or medium-sized firms with private ownership, but to a firm that is undergoing social ownership transformation and was known in the past as a Yugoslav firm[5]. In this relation, the Yugoslav self-management economy was described as less efficient than the developed economies, and - because of the greater importance of the market and a more emphasized export orientation - more efficient than those in the centrally planned economies. It was considered to be a bargaining process, where three institutions functioned as the principal bargaining parties in the self-managed firms: self-management, operative leadership and socio-political organizations. The bargaining process thus also included managers who

[5] The calculations made by the Ministry for Economic Affairs on 12/31/ 1993 have shown that these firms employed almost 50% of the labor force in the business sector (231,750), had a 37.5% share in the total book value of social capital, and created 39.2% of revenues in the business sector. An important part of economic activity in Slovenia is thus carried out in the state or state-linked firms (the Development Fund), as well as in small and medium-sized, privately owned firms. However, the firms in ownership transformation are important for our debate, as they possess some organizational knowledge and are, consequently, important for possible investment activities.

represented their own goals, such as maximizing their income and the possibilities of promotion (J. Prašnikar, Svejnar, 1988). However, the testing of a model using the data from Yugoslav firms in the 1970s and the 1980s has shown that the perverse behavior predicted by the Ward-Domar-Vanek model of a self-management firm did not prevail in Yugoslav practice, as firms emphasized both wages and employment. Employment response to output price changes was insignificant (J. Prašnikar, Svejnar, Mihajlek, V. Prašnikar, 1994).

The characteristics of Slovenian economy thus led to the development of an evolutionary path during the transition to the market economy. This path was characterized by a stabilization policy under soft-budget constraints with a restrictive monetary policy, exogenously determined money supply, and a policy of floating exchange rate. It was also characterized by a relatively slow process of ownership transformation, and gradual legal changes of the market environment (Mencinger, 1991, Bole, 1992)[6]. The opponents of the gradual process claimed that stabilization of the economy could not be achieved by measures of monetary and fiscal policy, if the capital market was not immediately implemented, and if it was not followed by efficient functioning of the labor market and final products markets (Sachs, Lipton, 1991). According to them the capital market must therefore be preceded by a quick privatization through free distribution of shares to the public and to different funds. On the other hand, the defenders of the gradual approach were convinced that privatization was only one element of market economy, and therefore had to be taken together with other measures of marketization of the economy (Bajt, 1992).

The rivalry between the two approaches determined the way of transformation of socially owned firms in Slovenia. The first concept prevailed in the selection of instruments of macroeconomic stabilization policy, while the second one prevailed in the selection of privatization models, i.e. the model of voucher privatization. If, on the one hand, due to the loss of Yugoslav markets, firms responded surprisingly well to the changed market environment, on the other hand, the excessive emphasis on the transfer of the classical model of corporate governance to the Slovenian environment in reality undoubtedly caused a great vacuum. The preconditions for this shareholders' sovereignty model[7] in Slovenia were not fulfilled, therefore the external governance of Slovenian firms was not put into effect. Because in the privatization law, the wider concept of corporate governance structure did not prevail, the advantages of Slovenian economy are slowly disappearing (Mramor, 1996)[8]. The enterprises remain closed to external investitures. If they want to open, they will have to get active owners. The lower the value of shares, the sooner this could be achieved (breakdown of the capital market). If they remain closed,

[6] Some economists worried that the gradual process of transformation, which was opposite to the revolutionary process of transformation in some other former socialist countries, would repeat the failures of the self-managed economy (Hinds, 1990).

[7] More about the distinctions between the shareholders' souvereignty model, the corporative managerialism model and the participative management model, see Aoki (1986).

[8] It is the Ribnikar-J. Prašnikar-Kovač privatization proposal which rely on the transformation of the social ownership to the preferential shares of the pension funds and provides new investitures with decision making power on the basis of common stocks, which accounts for the wider concept of corporate governance (J. Prašnikar, Svejnar, 1993)

they will not be interesting for external investors through the primary capital market. And they will not get any interest from the banks either, because banks do not have any access to internal information (Ribnikar 1996).

3.2 Modeling the behavior of a Slovenian firm and some suggestions how to increase its efficiency

First, we have to draw our attention to the features of Yugoslav self-management which, to some extent allowed the forming of internal organizations, i.e. cooperations between managers and employees, and the forming of organizational rents[9]. Related to this, the internal buy-out as a prevailing method of privatisation[10] proved only to defend enterprises against artificially created owners (Ribnikar, 1996). This reaction of the enterprises is understandable, but on the other hand, it brings along the closed enterprises, discussed above. The 'employeeism' described by Nuti (Nuti, 1995), is thus more and more characteristic of Slovenian firms. If employees in the value adding process gain a larger share at the expense of surplus wages and excess employment than it is appropriate, and/or if employees play a more important role as stakeholders than the shareholders, they will appropriate rents and gradually drain out the company by undermining its fundamentals. Appropriation of rents causes segmentation of the labor market and the spillover effect, which raises the aggregate level of wages and the share of labor cost in the total cost in the economy (Bole, 1997). High expectancy regarding the level of maximal wages and salaries is influenced by the incompetence of the taxation policy to collect taxes of the small business sector, and by operations of some managers, who in different ways appropriate the largest possible share of the company liquidity flow. On the other hand, the major cause for the growth of labour costs in the economy lies in the concept of efficiency wages which are set by companies in a favorable position. The main contributors to this are partners in the collective bargaining process, employer and employee representatives, who take inappropriate positions in the bargaining process. While the employer representatives strive for higher wages in successful enterprises, which affects the segmentation of the labor market, employee representatives strive for excessive minimal wages, which causes the spillover effect and diminishes the competitive strength of Slovenian firms.

This is a general trend in Slovenian economy. However, the fact that there were different types of firms at the beginning of ownership transformation leads to the conclusion that it is possible to differentiate among various models of their behavior also in the present situation. Anecdotal evidence shows that circumstances in Slovenia have created the following models of corporate governance:

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[9] J. Prašnikar and Svejnar claim that a successful transition strategy in Slovenia should recognize that enterprises at the beginning of transformation fall into three main categories: (1) viable and mostly internally financed enterprises with powerful insiders (workers and managers), (2) highly indebted enterprises, which either are viable or could be made viable by a rescue operation (restructuring), and (3) highly indebted and non-viable enterprises. (J. Prašnikar, Svejnar, 1993).

[10] In 89% of the companies in ownership transformation employees will own more than 50% of the company. However, the total book value of capital in this insider controlled companies is 45% (Jaklin, 1995).

- The managerial discretion model relies on the increased role of managers in the decision-making process. If managers have a sufficiently high level of ownership in a firm, or expect that they will have it in the future, or if for a variety of reasons, they behave like outside owners and build their relations with employees in such a way that the formulation of side-transactions is possible, we can then speak of a managerial discretion model with residual control[11] **(1a)**.

- If, on the other hand, employees do not have residual control, then managers may make decisions, which allows to appropriate a portion of liquidity flow from the enterprise (i.e. by-pass firms) **(1b)**.

- If employees have so much power that they can influence management and thus force decisions which will be useful to them (excessive salaries and over-employment), we can talk about "employeeism" in the enterprise. In its most extreme form, which can utterly exhaust an enterprise's cash flow, it leads to an emphasised role of unions (unionism)[12] or even an emphasized role of politics in business (politicism) **(2)**.

- Finally, it is worth noting that firms with the majority of external owners because of the aforementioned characteristics of the transitional period, are rare in Slovenia **(3)**.

However, prevailing "employeeism" cannot be abolished by the law. Likewise, we cannot expect it to be dismissed by external owners, at least not in the near future. The speed of changing of the ownership structure depends on the amount of domestic savings. As they are small, the surplus supply of privatizational shares can be suppressed by a low share price. Moreover, direct foreign investments in Slovenia would be welcome. But, Slovenia is not very interesting because of its small market[13]. The possibility of breakdown of the capital market makes opportunities, especially to the foreign speculative capital, which is interested in ownership of the most profitable Slovenian enterprises (Mramor, 1996).

A wider concept of the enterprise governance is thus a suitable framework for a discussion on proper measures to increase investment efficiency of a Slovenian firm. First, it is necessary to stop the general growth of wages, which is not based on productivity but is a consequence of the existence of economic rents. Since one of the main reasons for this is still high protection of the economy (Damijan, 1996), further opening of Slovenian economy will definitely contribute to its decreasing. However, economic rents cannot be totally abolished in the conditions of soft budget constraints (employeeism). That is why,

[11] This model is based on the experience of Japanese firms as developed by Aoki (1986) and Miyazaki (1993).
[12] However, the establishment of fixed terms with employees which are dictated by employment contracts and the substance of which is generally decided in negotiations among labor unions, management and the government (macro-corporatism), is another characteristic of the institutional structure of Slovenian economy, which does not contribute positively toward the adjustment of enterprises to market conditions.
[13] For more, see Prašnikar, Bizjak, Kavs, 1996.

according to the experience of similar countries in transition[14], an adequate taxation of "high wages" is a necessary measure to restore macroeconomic balance.

The objection that taxation of "high wages" diminishes employees' incentives, which should be also true in the case of firms with the managerial discretion model with residual control, does not hold. By introducing management compensation models such as incentive stock plans and stock options plans, and by introducing deferred profit sharing plans for employees, it is possible to bring into force suitable incentives for further growth of these enterprises. However, a formulation of the managerialist view which regards the integrative and intermediating role of managers, would be welcome in Slovenia in this situation. In that sense, these enterprises are the potential take-overs of less efficient enterprises, which, for example, become such because of the inefficient management. In this way, a more efficient practice of management can be spread in Slovenian economy. This goes along with the fact that take-overs are the most effective strategies of those enterprises which want to divide risks and function in a form of multidivisional firm (J. Prašnikar, Reščič, 1989). Analysis show that in Slovenia, too many enterprises depend on ripe strategic business areas, and that the portfolio of main product groups of enterprises on the curve of life cycle is strategically dangerous (Pučko, Lahovnik, 1996). With a suitable tax policy, compensation policies for managers and for employees could be encouraged as well as take-overs of enterprises by more successful ones. At the same time, we should devote our attention to the law of bankruptcy and its implementation, and to establishing a secondary market for the assets of enterprises in bankruptcy and liquidation.

In accordance with the wider concept of corporate governance and introduction of managerialist view, it is necessary to discuss the role of banks in corporate governance. Because of the special procedure of restructuring the banks in Slovenia[15], the banks are now very often eliminated from the governance structure of Slovenian enterprises. Because of low depth of capital market, which is expected also in the future, it would be reasonable to incorporate banks into the financing of Slovenian enterprises to a greater extent. As a result, an organic link between banks and enterprises would be achieved according to the elementary goal of banks to be financial agents. At the same time, the need for the state to be so strongly involved in the economic activities of firms would decrease. At this moment, three basic obstacles can be identifies which prevent banks to be more effective in this field. Firstly, Slovenian banks are still appropriating considerably high rents because of the weak competition, and are not really interested in this matter. Secondly, because they have lost contact with enterprises, their information on the performance of enterprises is limited, and so is their knowledge in this field. Thirdly, for the participation of banks in corporate governance, enterprises will have to endorse a part of their control to the banks[16].

[14]Poland, for example.
[15] The main charachteristic is the replacement of the bad bank assets with long-term government bonds in two Slovenian major banks. Banks came under the state ownership and were required to increase their profitability. More about this, see J. Prašnikar, M. Čok, T. Oražem, 1996.
[16] For more information, see Anderson, Berglof, Mizsei, 1996.

3.3 Industrial policy in Slovenia and small enterprises

In Slovenia, there is a lot of discussion about the substance of industrial policy in transition. Let me first say that I am in favor of the market failure approach to industrial policy[17]. If all markets existed and operated efficiently, industrial policy would not be needed. Under industrial policy I understand economic instruments which lead to a productivity rise in economy and are used when the market does not perform its function efficiently. For the countries in transition, Estrin gives the following matrix of industrial policy and its measures (Estrin, 1996):

Table 1: Industrial policy of the countries in transition

Industrial problem	Potential policy	Likely to be beneficial
1. Low productivity		
-sectoral reallocation	supporting "winners" and penalising "losers"	No
-long run growth	long run supply policies	Yes
2. Increase the share of the private sector	privatization policies	Yes?
3. Encouraging a balanced firm size distribution	SME policy	Yes?
4. Preventing anti-competitive behaviour	competition policy trade policy	Yes
5. Managing state owned sector	regulation policy governance structure	Yes

Source: Estrin, Industrial policy in transition, 1996

According to Estrin, it is reasonable to use policies to increase productivity which stimulates long run growth (education). Fast privatization could have important gaps. To prevent anti-competitive behavior of enterprises, it is suitable to use the competitive policy and trade policy. Regulation policy and proper forms of corporate governance are important for efficient management of state ownership. Encouraging a balanced firm size distribution is the goal of the policy for accelerating the growth of small and medium sized enterprises. However, Estrin requires caution in this relation, because of its limited range. As this is also experienced in Slovenia, let me explain some findings on the behavior of small firms in Slovenia.

[17] As Eisenstat says, one of the advantages of writing about industrial policy is that everyone could define it as he prefers, because no one knows what it really is (Eisenstat, 1992).

Slovenia has a long lasting tradition of independent small firms organized as craft firms, joint ventures between private and social capital, ("contractual organizations of associated labor"), as well as a number of small-scale socially owned firms [18]. The new legislation introduced in 1989, abolished the previous restrictions on the entry and growth of small private firms. Since then, we have seen rapid development of the small business sector. In 1990, for example, there were 6,313 small private firms which employed 13,800 workers (2.1% of the employment in the business sector). Taking into account the small socially-owned firms with up to 50 employees, this number increased to 7.5%. In addition, there were about 33,300 craft firms. In 1994, the number of small private firms increased to 48,435 firms with 78,000 employees. Their share in total business revenues was about 25%. However, these are not final figures, as the intended process of transformation of craft firms into small private firms and sole proprietorships has not been concluded yet[19].

The findings of recent research (Bartlett and J. Prašnikar, 1995) show that the great majority of small firms in Slovenia are owner-managed family firms. The older traditional craft firms are found mostly in the manufacturing sector, while the new limited liability companies have sprung up in the trade and service sectors. However, the distinction between these two legal forms is likely to disappear under a new company law which will transform many craft firms into sole proprietorships. Only those firms which function as special vehicles for traditional skilled craft activity will retain the craft status, as in the neighbouring Austria and in Germany.

Small firms tend to serve mainly the local market where competition is less severe than on the wider national or export markets in which more established and larger manufacturing firms compete. However, Slovenian small firms face a number of problems. Many firms encounter an inelastic demand for their products and have difficulties justifying an increase in output because of the lack of demand. In addition, most small firms are forced to rely on internal sources of financing, both when starting up and when expanding, due to the severe restrictions on loans and the relatively high rates of interest dictated by the stabilization policy (although interest rates did begin to fall in 1994).

Overall, the research findings have established a typical pattern of entrepreneurial activity in Slovenia. A typical Slovenian entrepreneur seeks to exploit good business opportunities by establishing a new firm. He either leaves his position as a qualified worker or manager in a medium-sized or large socially-owned firm. By using limited physical capital financed by his own savings or by those of his family, and by utilizing his own human capital and that of his family members, he establishes his firm and enters a local market. The initial key objective of such an entrepreneur is survival. To secure its survival, the firm services the chosen market niche with the primary goal of increasing the market share. However, the small amount of

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[18] On the development of small craft firms in Slovenia, see more in Bartlett and J. Prašnikar (1995).

[19] In principle, the Slovenian Government advocates two kinds of policy development in favor of small-scale enterprises. As mentioned, the general direction of the economic policy is towards stabilization and deregulation of the economy. In order to speed up these developments, the Slovenian Government has introduced certain policies for small business. These can be divided into various forms of tax subsidies for newly established small enterprises, subsidies for employment, financial services for small business development and building support networks for small firms.The question remains how effective these specific policies are (J. Prašnikar, 1994).

capital available to the entrepreneur and the level of potential profits attract other competitors. Thus, over the course of time, the level of potential profit in the local market decreases. As a result, small firms which are growth-oriented try to enter national or international markets where there are better business opportunities. Under the conditions of underdeveloped capital markets this can be achieved through better utilization of human capital. An econometrical study indicates that human resource efforts to a certain degree contribute to the competitive advantage of enterprises[20].

This pattern, the principal feature of which is the rapid rate of small firm creation during recession, seems to be a qualitatively new feature of small firm development in the economies in transition. It is linked to the opening up of new niche opportunities in a previously highly regulated economy. Such opportunities are explored by growth-oriented entrepreneurs rather than by unskilled workers as a defensive response to unemployment which has often occurred in the West. Hoggett, Futo & Kallay (1995) refer to this pattern of growth as the "Budapest" model. It appears to be applicable also in Slovenia.

A study of employment in small Slovenian firms[21] confirms that in the period of early transition (1991-93) the employment growth was linked to the characteristics of firms and entrepreneurs. In general, the older the firm, the lower the employment growth. Firms in the manufacturing sector tend to grow slowly, while smaller firms tend to grow faster. The more educated the entrepreneurs, and the younger they are, the more workers they employ. Objective (economic) variables may therefore be strong predictors of small firms' employment behavior. Nevertheless, the research also indicates the importance of more subjective determinants of employment, such as the entrepreneur's perception of opportunities for further employment growth and entrepreneurship.

The entrepreneurs who demonstrated the highest employment potential in the early transitional period (1991-93) were young, well educated entrepreneurs prepared to devote a large portion of their own time to the firm. These firms are, in large part, located in the non-manufacturing sector, they are young and relatively small in size (following the Budapest model). Apart from this group of entrepreneurs, the research identified another group of new, non-manufacturing firms owned by relatively young entrepreneurs which are not prepared for further employment growth. Those firms, in their initial phase, are already relatively large and show a low motivation for further growth. They want to stay in their present stage of development. This can partly be explained by the fact that this group of entrepreneurs is represented by experienced and well informed ex-employees (usually managers) of big socially-owned firms who are expected to have an accurate estimation of the market and the employment potential of their firms right from the start of their business activities.

The third group of entrepreneurs in the period under discussion consists of older entrepreneurs operating in the manufacturing sector, which were established before the onset of the market economy (principally craft firms). These are mature firms which in the past operated at an above-the-average level of employment. Low employment growth during the period under

[20] See Ferligoj, J. Prašnikar, Jordan, 1996.
[21] See Bartlett, J. Prašnikar, Valenčič, 1995.

examination cannot be explained by low entrepreneurial motivation or by the firm's size. Our main argument refers to the Jovanovic learning model which stipulates that, due to the loss of Yugoslav markets and the new market and institutional conditions, this group of firms did not accurately estimate their true efficiency.

Comparing employment growth of firms in two periods, 1991-93 and 1993-95, and looking at similar groups of firms, the analysis shows that the differences among the groups of firms observed in the period of early transition disappeared in the next period. There is no substantial difference in employment growth in the mid-transition period (1993-95) among the various groups of firms. Additional investigation shows that by including a new variable in the classification, the actual growth performance of firms in the period 1993-95, there is a new group of firms with the highest employment growth. The firms which form this group are relatively young, mostly located in the manufacturing sector, very small as measured by employment size, and at the beginning of the mid transitional period.

The research of the behavior of small sized enterprises thus shows, that in the initial period, there existed some characteristics of behavior of small firms which could be attributed to the features of transitional period. But gradually, Slovenian small-sized enterprises are becoming more and more like the small firms in the developed market economies. In this view, the major goal of the economic policy is to provide a stable macroeconomic and microeconomic environment and to enable a normal access of small firms to financial markets. The research also shows that it would be proper to add to this a policy which would additionally focus on human capital development in small-sized enterprises (education). Of course, this statement does not apply only to small-scale firms but to the rest of the economy as well.

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