CBS COPENHAGEN BUSINESS SCHOOL
HANDELSHØJSKOLEN

The Role of Different Ownership Structures for Restructuring
Evidence from Baltic and other Transitional Economies

Mygind, Niels

Document Version
Final published version

Publication date:
2002

License
CC BY-NC-ND

Citation for published version (APA):
Mygind, N. (2002). *The Role of Different Ownership Structures for Restructuring: Evidence from Baltic and other Transitional Economies*. CEES, Copenhagen Business School. Working Paper / Center for East European Studies. Copenhagen Business School No. 45

Link to publication in CBS Research Portal

General rights
Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

Take down policy
If you believe that this document breaches copyright please contact us (research.lib@cbs.dk) providing details, and we will remove access to the work immediately and investigate your claim.

Download date: 14. Nov. 2024

CEES

Working Paper No. 45 **September 2002**

The role of different ownership structures for restructuring - evidence from Baltic and other transitional economies

Niels Mygind

Center for East European Studies
Department of International Economics and Management
Copenhagen Business School
Howitzvej 60, Dk-2000 Frederiksberg, Denmark
Tel + 45 3815 2515 Fax + 45 3815 2500
© the author, 2002 e-mail: nm.cees@cbs.dk
Working papers from **CEES** *can be downloaded from:*
http://www.cbs.dk/centres/cees/publications/publications.shtml

The role of different ownership structures for restructuring - evidence from Baltic and other transitional economies

First draft September 2002[1]

Abstract

In the core of the transition in Eastern Europe is the change of enterprise governance with a change in the distribution of ownership rights on the different stakeholders involved in the enterprises. What has been the role of different types of ownership structures for the success of this restructuring process? Ownership of five different stakeholders is analyzed: state, employees, managers, domestic outsiders and foreign investors. The ownership changes are analyzed over four different stages of the transition process.

It is shown how employee ownership played an important role in the first stages of transition in some countries. Management ownership has been decisive for the dynamics of SMEs. Domestic outside and foreign ownership have grown with the progress of transition and play an increasing role for restructuring. The role of each ownership type is analyzed both from a theoretical point and with presentation of some of the empirical evidence on performance and restructuring. There is mostly referred to the experience in the Baltic countries, but evidence fro m Russia, Slovenia and other transitional countries are also included. Both theory and evidence put state ownership on the low and foreign on the high level of performance and restructuring. For the question of insider versus outsider the picture is less clear. The weight of different ownership structures are changing over the different stages, the change follows the governance cycle from state to employee, to manager, to outside/foreign ownership. The speed of change and the weight of different types is to a high degree a political question. The paper ends up with a list of policy recommendations.

---

[1]Paper presented at the International Seminar: Industrial Upgrading Strategies in the Age of Globalization: A Comparative Assessment of International Experiences, Havana, Cuba – September 25-27, 2002

Introduction – four stages of reform

The transition process in Eastern Europe means a fundamental change of institutions both at the macro- and micro level. In the core of transition is the change of enterprise governance with a change in the distribution of ownership rights on different stakeholders involved in the enterprises. These changes influence enterprise performance and restructuring of production, which is also a key element in the transition process.

What has been the role of different types of ownership structures for the success of this restructuring process? I will try to answer this question mainly based on the evidence we have collected in the three Baltic countries. If relevant I will also refer to some of the evidence from other transition countries in Eastern Europe and the former Soviet Union.

The transition and the development in governance structure and restructuring have run through *four different stages*:

<u>Gradual reforms in the pre-transition stage</u>. Gorbatjov's reforms in the second half of the 1980es gave more autonomy to managers in state owned enterprises and opened up for the first market oriented semi-private entities: new cooperatives, small individual firms, a few joint ventures with foreign capital, and possibility for employee to lease their enterprise. The Baltic countries were leading in this process of early reforms. Other East European countries such as Poland and Hungary had implemented more radical market reforms with the start of small private production entities and more openness to the Western world. The most comprehensive reforms were implemented in the former Yugoslavia already in the 1960'es with a high degree of enterprise autonomy and liberalization of prices and foreign trade. The self-management model meant that the ownership rights of control and income were transferred to the employees. This happened especially in the northern part of Yugoslavia, first of all Slovenia, while the strong party involvement prevailed in the south. These early reforms had a strong influence on the transition process after 1989. Because of the early reforms Hungary could implement a quite slow gradual reform process and still be the frontline reform country compared to Czechoslovakia with a much more conservative planning system

as starting point. Slovenia avoided most of the civil war, and was already in the early stages able to benefit from the market reforms of earlier years. When excluding East Germany taken over by the BRD, Slovenia is the richest country in Eastern Europe measured per capita.

The fundamental changes in Eastern Europe in 1989 and the dissolution of the Soviet Union in 1991 were soon followed by liberalization and start of privatization of the economy. With the liberalization of prices and foreign trade and the dissolution of the planning bureaucracy the enterprises got autonomy to start a process of market adjustment. Although the state still formally had the dominating ownership position, the liberalization and increased autonomy of the state enterprises resulted in a de facto transfer of some of the ownership rights to managers including a strong increase in the managers' control position.

The core stage of privatization was done with varying speed and methods in different transitional economies. In fast privatization countries such as Lithuania, Czech republic and Russia the peak of privatization was around 1993-94, while in more slow and gradual privatizations in Hungary, Poland, and Estonia the peak was in 1994-96. The privatization process followed different paths in different transitional economies because of differences in political development and other initial conditions connected to specific culture, history, technology, location etc. The formal rights of ownership was transferred from the state to different groups of owners with insiders as the core groups in countries like Lithuania, Russia and Slovenia, while outsiders, especially foreign investors, had a dominating role in countries such as Hungary and Estonia.

Deep restructuring and integration into the global economy is the stage, which the most advanced transitional countries went into in the second half of the 1990'es. The early stages of reform were followed by a steep fall in production when enterprises performed *reactive restructuring* – that is, adjustment to the shift in cost and demand structure with cuts in production and employment. Later stages of transition included new products, new production methods, new organizational structures, new markets etc. This *deep or strategic restructuring* was both a process of starting new enterprises and of restructuring existing enterprises. To build up this new production structure it was

necessary with new capital, technology, management skills, and networks. It was also necessary that the governance structure gave the managers and the owners new incentives and instruments to perform this strategic restructuring. Different ownership and governance structures (including the institutional environment of the company) had different impact on the process of restructuring.

In this paper I will analyze ownership by the following five stakeholder groups: state, employees, managers, domestic outsiders and foreign investors. A specific form of ownership is defined as the complete dominance of a specific stakeholder group. Whether it is 100% ownership, majority with more than 50% or just dominating with a higher ownershare than other groups will be specified when relevant. Each section will first give a short overview over the diffusion of the specific ownership type by location and over time, then follows a short theoretical discussion in relation to restructuring and finally some empirical evidence is presented. In the end I will conclude and give some recommendations and perspectives for different types of ownership/governance in the transition process.

State ownership and restructuring

Since it was not possible to privatize all State owned enterprises overnight there has been a period with widespread state ownership in all transitional countries. Privatization of small enterprises was rather fast leaving the larger enterprises for state ownership for a longer period. In some countries also large privatization was rather fast leaving only relatively few state enterprises in strategic sectors such as infrastructure, energy and other utilizes. Also the privatization programs were not successful in selling all enterprises. Sometimes the most problematic enterprises were left in state hands. Sometimes the state postponed privatization of strategic enterprises with a strong market position and relatively high profitability. Therefore, the performance of state owned enterprises depends on, which state owned enterprises were left after the first rounds of privatization. Different paths of privatization can thus mean quite different results for empirical studies of different ownership structures. This is related to the

socalled selection bias: whether the causality goes from ownership to performance or from performance to ownership structure.

When the economy is liberalized the scope for management decisions increases concerning prices, products, markets etc. Although the profit formally belongs to the state, many state owned enterprises retain and reinvest their surplus. In this way part of the right to profit effectively belongs to the enterprise under the control of management. In case of losses state owned enterprise may have a hard budget constraint so deficits are not covered by the state or state banks. The final result can be non-payment of wages or ultimately a liquidation of the company. However, there is often a soft budget constraint for state owned enterprises with state subsidies covering losses, acceptance of tax-arrears, or soft loans from state banks. This may result in lack of financial discipline in state owned enterprises, Boycko et al (1996).

There is a strong governance problem in state owned enterprises because the managers often have de facto control, while the financial returns belongs to the state. The manager has limited incentive to secure the return for the owners. Instead the manager can maximize personal utility by following own goals. Ultimately, this means that managers have an interest in tunneling values out of the company to a company de facto owned by themselves or their relatives. Therefore, restructuring is expected to be quite weak in state owned enterprises. However, liberalization of the economy and the following commercialization of state owned enterprises may put more competitive pressure on state owned enterprises and improve efficiency (Yarrow 1986).

The empirical results are not completely as negative as the theory suggests. Early results from Poland showed that a group of state owned enterprises also performed quite strong restructuring in the early years of transition, Pinto et. al (1993). One reason was that Polish state owned enterprises were under quite tough budget constraints. Some results for Russia, like Brown and Earle (1999), also show that state owned enterprises are doing relatively well in a general declining economy. However, the bulk of the research for Eastern Europe shows that state owned enterprises are doing worse than privatized enterprises. Claessens and Djankov (2002) analyzes 6000 enterprises in 7 East European countries and find that privatized companies have higher growth in sales

and labor productivity with increasing effect over time after privatization. The superior performance of privatized firms in transitional economies is confirmed in a recent survey on empirical studies by Megginson and Netter (2001). Analyzing early privatization in Slovenia (Smith et al 1997) shows that both enterprises fully privatized to insiders and to foreign owners show higher productivity than enterprises continuing under social ownership. Frydman et al (1999) shows for a set of enterprises from Hungary, Poland, Czech and Slovakia that the longer periods of time since privatization means better performance measured as average growth in sales and other variables. We have used the same model for the Estonian data (Jones and Mygind 1999b). The model has quite low explanatory power and most of the results are insignificant. However, the results confirm that state owned enterprises have lower sales growth than privatized enterprises. In another study of the Estonian panel of around 660 enterprises for the period 1993-97 Jones and Mygind (2002) show that state owned firms have 15-22% lower productivity levels than private enterprises. In a cross section analysis for all the three Baltic countries covering the mid 1990es (Jones and Mygind, 2000) the results are quite mixed. However, those results that are significant go in the direction of state owned enterprises being less efficient than private.

Employee owned enterprises

Employee owned enterprises are not widespread in the Western developed economies. The exceptions are a high number of producer cooperatives in Italy, France and Spain (Bonin et al 1993, Uvalic 1991), and notably the Mondragon cooperatives, which are industry leaders in the Basque Country (Thomas and Logan 1982). Also the ESOPs in US comprising around 15 mill employees show the increasing importance of this type of ownership (Blasi **).

Employee ownership became surprisingly widespread in the early stages of transition (Uvalic and Vaughan Whitehead 1997). It was the dominant ownership structure in Russia (Estrin and Wright, 1999), Lithuania (Mygind 1997) and Slovenia (Uvalic 1997), but also widespread especially in smaller and medium sized enterprises in countries like Estonia, Latvia (Mygind 1997), and Poland (Jarosz 1994). This was

both the result of privatizations and the limited opportunities for different forms of outside ownership in the early stages of transition (Mygind 2001a). Note, however, that this was just the initial type of ownership. In all countries except for Slovenia there was in the following years a strong tendency away from employee ownership toward management ownership and in some cases a further development to outside concentrated ownership (Jones 1998, Estrin and Wright 1999, Mygind 2000, Mygind 2002). Managers bought shares from employees at quite low prices. Employee ownership was also diluted because the steep fall in employment meant that many retired employee owners became outside owners, while new-coming employees very seldom became new owners (Kalmi 2002). The data shows in this way a typical "governance cycle" from employee ownership – to manager ownership –in some cases ending up with core outside ownership (Mygind 2002).

Why became employee ownership so widespread in the first years of transition? Three main explanations are given below:

Following Marxist tradition it can be argued, that ownership by employees excludes the possibility of a capitalist owner exploiting the workers. Thus, it was possible to promote this type of ownership already when the socialist ideology dominated political life. This was the case with the self-management system in the Yugoslav economy and the "new cooperatives" and "leasing by the worker collective" in the former Soviet Union.

According to the official ideology the working class formally owned the enterprises in the command economy. When decentralizing the ownership rights after 1989/91 the ownership should thus be transferred directly to the employees in the enterprises. This was part of the political arguments in Russia, Lithuania and to an even higher degree in Slovenia, where privatization opened up for a continuation of self-management in the form of employee ownership. However, the self-management system was based on *collective* ownership, where the labor-collective had the rights to control and the rights surplus. The individual employee could not sell his/her share when leaving the enterprise. The new type of employee ownership was based on

individual ownership, where each employee owned shares, which could be sold and give the employee a capital gain.

Finally, the conditions with weak legislative institutions and weak capital markets in the early stages of transition meant that outside investors were in a weak position leaving most of the playing field for insiders (Mygind 2001a).

The traditional theory of the so-called "Illyrian firm" predicts inefficiencies such as: adjustment problems, underemployment and underinvestment (Ward 1958, Domar 1966, Vanek 1971, Meade 1972). However, these predictions were based on the Yugoslav model of collective ownership. The change to individual ownership means that maximization of income per employee is parallel to maximization of the value of the individual shares, that is profit-maximization with the same expected behavior as the normal textbook company (Mygind 1992). However, this result is based on quite strong assumptions of a perfect market for individual shares as well as a perfect capital market in general. Under more realistic assumptions there are limitations in the transferability of individual shares implying an element of collective ownership. Therefore, the specific goals of employees in relation to wage and job-security may imply a behavior of the company in the direction of the Illyrian firm: Reluctance of cutting employment may be a barrier for reactive restructuring. Risk concentration, lack of capital from the owners and problems of alignment of goals with other investors (especially banks) may contribute to lack of capital, underinvestment, and lack of deep restructuring in employee owned enterprises. Heterogeneous workforce may cause conflicts and hamper the decision-making process (Hansmann 1988).

These failures of employee owned enterprises are widely referred to in the mainstream analysis of employee ownership, and most economists like Aghion and Blanchard (1998) conclude that manager ownership is more efficient than employee ownership, and that outside ownership is the most efficient structure, especially if it is concentrated. The positive side of employee involvement is often neglected in this analysis, but it can be argued that employee ownership results in higher motivation and enhanced organizational performance (Ben-Ner and Jones 1995). Mutual monitoring may dominate the problems of free-riding, which was emphasized by Alchian and

Demsetz (1972). The agency problems between owners, managers and employee will be substituted with alignment of interests, and shorter governance chains will be an advantage in the typical transitional situation of inefficient institutional framework (Stiglitz 1999). Reduced turnover and increased incentives for employee-owned firms to invest in specific human capital can also improve productivity (Mygind 2001a). Note, that some of the beneficial effects of employee ownership concerning alignment of interest, motivation, lower turnover etc. may appear also with minority employee ownership.

These arguments make it difficult to predict whether employee ownership is a plus or a minus for performance and restructuring. Overall it can be expected that the weaknesses will prevail when considering high capital intensive sectors combined with a weak capital market, while the positive side may be dominating in sectors based on high inputs of human capital (Mygind 2001b). However, the complexity of the different factors points to empirical investigations to be the final benchmark.

Most theories about employee ownership assume that the employee owners de facto control the enterprise and their goals are reflected in the behavior of the company. However, in most countries in Eastern Europe a paternalistic type of management was prevailing in the command economy, and after the formal takeover by employees the managers continued to dominate decision-making (Earle and Estrin 1996, Jones 1998, Mygind 2002, Kalmi 2002). This is a serious governance problem of separation between management control and the financial ownership rights belonging to employees. Like in the state owned enterprise the manager have both the opportunity and the incentive to transfer values from the employee owned enterprise to his own pockets. The short governance chain and the information level of especially higher educated levels of employee may make it more difficult for managers to appropriate assets in employee owned firms compared to state owned enterprises. Both theory and empirical evidence from the West indicates that active participation of the employees improves efficiency (Conte and Svejnar 1990). This combination of ownership and employee participation is part of the background for the success of the Mondragon cooperatives (Thomas and Logan 1982). Such participation is seldom found in Eastern

Europe. The only exception was the self-management system in the northern more developed parts of Yugoslavia, including Slovenia, where the employees de facto participated in decision-making and selection of managers. This experience gave Slovenia a better background for successful employee ownership compared with other transitional economies.

The overall success of the Slovenian transition can be taken as an indicator that an economy with a strong base of employee ownership can be competitive. The relative bad performance of Russia also with a strong employee owned sector can be taken as a counter example. The low employee participation and management domination in Russia compared to the strong participation in Slovenia is probably the main explanatory difference.

The micro based empirical literature is in general quite negative in relation to employee ownership. Djankov and Murrell (2002) in their meta-analysis merging a serie of different empirical analyses find that worker ownership belong to the worst group of enterprises in relation to restructuring. In their survey on empirical literature Megginson and Netter (2001) also conclude that employee owned enterprises are underperforming compared to outside owned enterprises. On the other hand show studies for Slovenia that employee owned enterprises are performing relatively well. Smith et al 1997 find for Slovenia early transition (1989-92) that both increasing employee ownership and foreign ownership is connected to higher productivity. Later studies like Prasnikar et al (2000) find no major differences in the strategic restructuring between insider and outsider owned enterprises.

For the Baltic countries we have the deepest analysis for Estonia, but also some more preliminary evidence from Latvia and Lithuania. The problem of reverse causality of performance determining the choice of ownership structure we have analyzed for a large Estonian panel (Jones and Mygind 1999a). We find that large and capital intensive firms are much more likely to be owned by outsiders. Insider owned enterprises have from the start a bias in the direction of low capital intensity and low size. Notably, there are no significant results concerning performance causing the type of ownership. Insider owned enterprises can neither be assumed to be cream-skimming the best opportunities

nor to be more likely to appear as defensive takeovers where the economic prospects are bad from the start.

Baltic employee owned enterprises perform better than state owned enterprises and domestic outside owned enterprises: In the Estonian panel analysis employee owned enterprises had levels of factor productivity only slightly lower than management owned enterprises, on the same level as foreign owned enterprises, and clearly higher than domestic outside owned enterprises and state owned enterprises (Jones and Mygind 2002). In a summary of different analyses (both multivariate and simple descriptive statistics) for the three Baltic countries (Mygind 2000) find that the results vary much depending on which variables are used as measure for performance. When using labor productivity as a measure employee owned enterprises are following the sample average while for factor productivity they belong to the highest group of efficiency. This can be explained by the fact that employee owned enterprises have relatively low capital intensity and investment measured per employee. This is also confirmed by recent case evidence (Mygind 2002). Lower capital input may mean lower labor productivity, while total factor productivity remains high.

The earlier mentioned typical "governance cycle" from employee ownership – to manager ownership – ending up in some cases with core outside ownership show that employee ownership in the Baltics and in Russia is not stable and lack attractiveness for the owners compared to management ownership. At the same time it shows that this type of ownership is not a barrier for ownership changes. Insider ownership in the initial stages does not establish a strong path dependency, which blocks further reforms. This result contrasts the predictions by Blanchard and Aghion (1996). Insider owned enterprises lack capital and have low investment levels, but case study evidence from the Baltics (Mygind 2002) show that insiders are eager to attract outside owners with capital for restructuring.

Management owned enterprises

Enterprises majority owned by managers make up the most frequent form of ownership in the West. It is the classical start up form of the entrepreneurial firm. It is

most frequent in small enterprises and later in the governance cycle, when the company has grown larger, outside investors play a greater role. In the traditional command economy management ownership was not legal. However, at some point micro enterprises or individual enterprises – one-person-firms were legalized in certain sectors. Still, the next step of employing wage-earners was against traditional Marxist ideology. However, the new cooperatives with employee ownership made it possible for managers to develop firms with more workers. In many cases this ownership form was just a cover for de facto control by the manager.

Soon after the political changes in 1989 in Eastern Europe and 1991 in the former Soviet Union it was made legal to start up new enterprises without narrow restrictions on who could be the owner. In most cases new enterprises were started by owners directly involved in management. Wild privatizations and legal privatizations of small enterprises contributed further to the development of manager ownership. In some countries there were advantages for broader employee takeovers in the small privatization. This was the case in Estonia and Latvia in 1992-93. Later on these advantages were taken away. It was more difficult for a small group of managers to take over a large enterprise, but there are examples of such takeovers in the Baltics. However, insider privatizations of larger enterprises most often involved a larger group of employees. Then followed a period of a gradual concentration of ownership in the hands of a group of managers and high level employees (specialists). In a later stage in the governance cycle, either connected to a crisis or to a need of extra capital for high growth, external investors may take over part of the ownership. Such changes can be observed in the Baltics although still on a limited scale (Mygind 2000 and 2002).

Management ownership is an elegant solution of the governance problem since there is no separation of control and financial owner-rights. The managers have a strong motivation to use the assets in an efficient way. On the negative side there is a concentration of risk in the hands of the manager, possible lack of resources such as capital and in some cases also management skills. Management takeovers rarely bring access to international networks. Such takeovers may conserve the existing structure, not open up for the necessary shifts of unqualified managers. The managers miss the

counter-play from a strong external owner. Therefore, the quality of the managers play a core role for the quality of management and thus for performance and restructuring. The process of establishing management ownership often functions as a selection mechanism: The processes which demand a proactive initiative will only be made the most entrepreneurial managers: such as establishing a "new cooperative" in the Soviet time, starting a new firm or organizing a spin off from a state owned enterprise in the early years of transition. Also a management-buy-out of employees demand some proactive action from the manager (Carlin and Landesmann 1997). Privatizations strongly favoring insider ownership like in Russia involve just a reactive action to be expected also from managers without much entrepreneurship and skills for restructuring enterprises.

In Russia the frequency of new enterprises is quite low (OECD 2002) and therefore most manager ownership are found in old privatized enterprises. Seen in this perspective it can be expected that manager ownership may not be so successful in Russia. This is in fact confirmed by studies such as Brown and Earle (1999) and the merged studies by Djankov and Murrell (2002). However, other studies by the World Bank (2002) strongly emphasize that new small enterprises are important elements in strategic restructuring since they are more productive than existing enterprises. The most successful restructuring countries like Poland and Hungary has a high frequency of small new enterprises. It can be assumed that most of these enterprises are owned by their managers.

Our studies for the Baltic countries show that management ownership is doing quite well. In the panel study or Estonia by Jones and Mygind (2002) management ownership has in fact the highest factor productivity of all ownership types.

Outside domestic owned enterprises

Domestic outside investors have in most transitional countries played a less important role than in the West. Well-functioning diversified share ownership is closely connected to a well-functioning capital market not yet existing in transitional countries. The voucher privatizations gave some elements of this type of ownership, but most

shares were pooled in investment funds resulting in some concentration of ownership. Such investment funds play an important role in countries like Czech Republic and Poland. Other domestic blockholders were quite rare in the first years of transition. A period of accumulation of capital was needed. This happened through different channels: successful management owned enterprises, access to cheap state owned natural resources bought for low state regulated prices and sold at much higher world market prices, tunneling of assets from state owned enterprises, exploiting state loans with negative real interest rate, use of networks in the privatization process to acquire state resources at very low prices. This happened mostly through channels where the capture of the state of a small elite was a key element. The oligarchs in Russia are well known for this type of capital accumulation, but there were elements of such behavior in most countries. The Russian oligarchs established Financial Industrial Groups with a bank in the core of the group and with concentrated shareholdings in a number of large industrial enterprises.

In the Baltic countries diversified outside owners have developed in relation to the voucher programs, which only involved minority shareholdings in Estonia and Latvia, and in Lithuania outside owners were to a high degree crowded out by insider domination. Another source of diversified owners were employee owners leaving their firms without selling their shares (Kalmi 2002). But diversified outside ownership resulted only in rare cases in majority outside ownership. Strong external domestic blockholders were also quite rare, but there are some examples especially in Latvian.

The theoretical predictions for outside ownership depend on the degree of concentration of ownership and the type of external owner. In Eastern Europe with undeveloped capital markets and relatively weak position of diversified shareholders there is a strong governance problem of separation of control going to managers and the financial ownership rights going to weak diversified shareholders. There is a free-rider problem since each of the small owners does not have enough incentive to collect information and perform monitoring of the managers. This is why we usually find outside ownership connected with a quite high concentration of ownership in the hands of a strategic investor.

The type of stake in relation to the company also plays an important role. Especially financial stakeholders such as banks and investment funds are interesting. Banks can benefit from combining the interest of lower risk on loans through better access to information. However, if a bank has dominant control it can be expected to follow a more risk-averse investment strategy than ordinary shareholders (Schleifer and Vishny 1999). For investment funds the second order governance problem of who monitors the monitors is the core question. If such funds have a dominant position and the diversified shareholders of the funds do not control the administrators of the fund, these administrators can appropriate rights by tunneling values from the portfolio of firms to firms under their direct ownership. This happened in the Czech system of investment funds and an important reason why restructuring in the Czech republic was lacking behind. Dispersed ownership and governance problems in investment funds and state funds caused also problems for many large Slovenian firms in the years following privatization (Gregoric et al 2000), but in spite of this Slovenia has been doing quite well in the restructuring process.

The evidence for outside domestic ownership points in the direction of quite high performance/restructuring compared to other types of ownership (Frydman et al 1999 and Megginson and Netter 2001). Djankov and Murrell (2002) find that outside blockholders including investment funds and banks belong to the highest category of performance. Notably, this is especially the case for CIS countries probably related to quite strong performance of the Financial Industrial Groups. For the Baltic countries outside domestic ownership is in general doing worse than insider ownership. This is the case in the panel study on Estonian enterprises (Jones and Mygind 2002), and also the growth of sales for a large group of Lithuanian enterprises show worse performance for outside domestic ownership (Mygind 2000).

Foreign ownership

There were a few examples of market oriented FDIs starting as Joint Ventures in some specific sectors already before the changes in 1989 and 1991 in countries such as Hungary and Romania, and a few in the USSR. In the early stages of transition some

investors took the chance to use the first mover advantages on the new market, but the main wave came in relation to large privatizations in the countries that opened up for direct sale to foreign investors. This happened first in countries like Hungary and Estonia, but later most other countries including Latvia and Lithuania also opened up for direct sale to foreign investors. However, it was not enough to offer state owned enterprises for sale. There is a close connection between FDI and advances in the general reform process with consequent stabilization and liberalization with clear rules of the game. The hesitant and low foreign investments in Russia and other CIS countries are both the result of slow progress in the transition process and privatization methods favoring insiders and domestic investors. Slovenia was also reluctant in opening up for foreign investments, but reforms progressed quite fast.

Foreign core owners are normally analyzed separately from other types of outside blockholders because foreign investors have specific advantages in relation to restructuring of the enterprises (Meyer 1998): Foreign strategic investors have a much better supply of capital both from internal sources and from their relations to international financial networks. Foreign investors are normally in a strong governance position in relation to management. A foreign takeover often means a shift of management. Foreign investors are also strong in supply of new technology and integration into international production chains both in relation to supplier networks and in relation to market access. On the negative side specific local conditions may play a role: such as cultural barriers in relation to local employees and barriers for integration into the necessary local networks primarily in relation to the state bureaucracy.

If the institutional setting is fragile with a weak state captured by local investors the lack of a leveled playing field means a disadvantage for foreign investors and results in relatively low of foreign investments. There is a close relation with the level of foreign investment and the conditions for foreign investors related to the development of transition. The transition frontrunners such as Hungary, Estonia, Poland and the Czech Republic have also the highest FDI/capita. Russia and most other CIS states have not offered foreign investors similar opportunities and FDI has been rather low. In

Russia domestic Financial Industrial Groups dominate the financial sector as well as heavy industry, energy, and raw materials.

The privatization methods play a key role for foreign investments. Direct sale favors investors with good access to capital including first of all foreign investors. Therefore, they played a key role in privatizations in countries like Estonia and Hungary, but in later stages they also had an important role in countries like Latvia, Lithuania, Poland and the Czech Republic. The success of the transition and restructuring in Estonia and Hungary is in fact to a high degree related to the high foreign investments. Foreign enterprises have been leading in installing new technology, developing new organizational structures and new markets.

Most studies on the enterprise level confirm that foreign owned enterprises are leading in performance and restructuring. In a few studies there is no significant results, but no studies show significantly lower performance by foreign companies. (see Djankov and Murrell 2002, Megginson and Netter 2001). For the Baltic countries we found in the Estonian Panel that foreign owned firms were in the top group for total factor productivity together with insider owned enterprises, while outside owned enterprises and state owned were lagging behind. The results from other studies (Mygind 2000) for all three Baltic studies show that foreign owned enterprises had the highest labor productivity and wages and the highest investment levels. They had from the start the highest capital-intensity. This explains that labor-productivity is higher, but total factor productivity only on the level of insider owned enterprises.

Conclusion: Ownership cycle - perspective and policy recommendations

The connection between governance structure and restructuring is quite complex both in theory and in relation to the empirical evidence. The analysis also showed that different ownership structures play different roles in different stages of the transition process. The changing roles of the different ownership over the four stages is summarized in table 1:

State ownership can be challenged on many aspects from a theoretical point of view and the evidence from transitional economies support the prediction that state

owned enterprises underperform in relation to other ownership types. Privatization is justified in most cases. However, privatization cannot be performed as a big bang, but must be seen as a long- term process. This process can start already in the pre-transition period as reforms increasing the scope of action in the state owned enterprises and opening up for market adjustment of prices. This happened in fact in Hungary and Yugoslavia and was an early start of the transition process. The first privatizations concerned spin offs and small enterprises. It took several years before the bulk of enterprises went through large privatization. In between was a period of commercialization where state owned enterprises functioned in the more or less liberalized market economy. State owned enterprises were met by competition, and they could respond by adjusting production, prices and markets. An important condition for success in this period was the implementation of hard budget constraints for these enterprises and opening up for competition from domestic and foreign entrants. Successful liberalization combined with effective stabilization could secure the first stages of restructuring and turn the falling production to new growth like it happened quite early in Poland in spite of slow implementation of large privatization. The slow privatization process gave time for building up the institutional framework of: legislation, enforcement, capital market etc. to secure a well-functioning enterprise governance system necessary for the large privatization to be a success. The privatization or liquidation of some of the most problematic enterprises in mining, heavy industry and the privatization of some strategic enterprises in infrastructure and utilities were postponed to the consolidation stage. Some enterprises in sectors like health, education, and research continue to be state owned.

An important part of deep restructuring is done through the entry of new enterprises covering gaps, which were not filled by the command economy. In some countries like Poland, Hungary and later even in the Soviet Union this process started already in the pre-transition period. This was the early introduction of insider ownership, both as employee owned new cooperatives and with the start of manager owned micro enterprises.

Employee owned enterprises have in this way been in the early frontline in the transition to the market economy. Most important was this process in the northern part of the former Yugoslavia with a quite developed and open market economy with a high degree of employee participation in ownership rights. Here lies the background for the successful transition of Slovenia, today the richest economy in Eastern Europe.

In most countries employee owned enterprises continued to have a role in small enterprises and also in relation to small privatization. In some countries like Russia, Lithuania and Slovenia employee takeovers was the main method of privatization of medium and larger enterprises, still leaving the largest enterprises to outside investors. This type of insider takeovers have been criticized by mainstream economists, but the theory of the restructuring potential of employee owned enterprises is quite ambiguous. There are negative predictions in relation to employee goals, supply of capital and investments, but advantages in relation to alignment of interests and employee motivation. The evidence is also mixed with quite negative results from Russia and some central European countries, but more positive results from Slovenia and the Baltic countries. A general tendency for employee ownership is low capital intensity and quite low investment because of lack of capital. Total factor productivity is not lower than for outside owned private enterprise.

In most countries with widespread employee ownership the managers continued the paternalistic tradition from the command economy. The employee owned enterprises were de facto controlled by management, and the governance cycle for many of these enterprises has been management buy-outs and transformation to management ownership. Such a takeover eliminates the governance problem of separation of control and financial rights, but the distributional conflict between profits for the owners and employee wages returns. It does not solve the problem of lack of capital. However, the change to management ownership happens in a later stage in the transition process with a more developed banking system with increasing potential for supplying also insider owned firms with loans. Still, lack of capital may push the next step in the governance cycle to more outside ownership. The quite dynamic change of ownership does not confirm the fear of insider ownership blocking for outside owners.

Employee ownership can play an important role in early stages of the transition and then change to other forms.

Although such dynamic change certainly shall be an opportunity. There are also potential benefits for later stages in keeping and developing the more participatory form of employee ownership. Therefore, it cannot be concluded that advantages for employees in the shall be avoided. It is a political decision how to balance the conditions for different types of owners in the privatization process. The employees could be given the opportunity to invest some of their money/vouchers in their own firm, to make it a pro-active decision to establish employee ownership. It can be recommended to establish specific supporting institutions to exploit the advantages of employee participation. The experience from the successful Mondragon cooperatives in Spain shows the importance of clear rules for employee participation, access for new employee to be owners, emphasis on training, access to bank loans for employee owned firms. In the right institutional framework employee ownership can be an important element of the future consolidation process with further restructuring and developing of more advanced production based on a high content of human capital. This can both be in the form of full employee ownership and developed enterprise democracy and in the form of minority ownership for motivation of key employees.

Management ownership has played an important role for restructuring in most of the transitional countries. Starting with individual enterprises in the pre-transition period and developing fast in the early stages of reform with full liberalization of entry of new firms and with small privatizations. The most successful transitional economies like Hungary, Poland, Estonia and Slovenia has a very dynamic SME sector mainly based on management ownership. Full liberalization removing red tape, licensing, and prohibitive taxation as well as the creation of possibilities for training, consulting services, financial institutions strengthen the possibilities of entry of new firms. The strong differences in development of SMEs in different countries in transition are to a high degree related to the quality of the state. SMEs do not need an advanced development of the capital market and the overall corporate governance institutions.

Therefore, it is also possible with fast development in the early stages where the SMEs fill many of the gaps left from the command economy.

Is there is a trade off between developing a well functioning SME sector and the political goal of high equality? The dynamics of the SME sector of managerial (family) owned enterprises can be hampered by excessive taxation. The experience from Russia is that much regulation on start-ups gives special opportunities for already established firms, limits competition, promotes corruption and ends up in high inequality combined with low dynamics. The dynamic development of Estonia combined with quite simple regulation and low level of corruption is an advantage for the whole society including lower income groups.

The full ownership incentives can only be developed if the ownership rights are clearly defined and enforced. Russia has had a long period with uncertainty around property rights and here is one of the main reasons behind the widespread asset stripping and capital flight. Managers took out short term profits because it was unclear who would benefit from more long term oriented investments and restructuring.

Domestic outside investors play only a limited role in the first stages of transition. Diversified domestic ownership cannot function because the capital market is not developed, and strong domestic blockholders are rare because there have been too little time to accumulate capital. However voucher privatizations promoted elements of this type of ownership in some countries like the Czech republic. Most voucher-shares were pooled in investment funds resulting in some kind of concentrated outside ownership. However, the governance problem between the diversified holders of shares in the investment funds and the administrators of these funds became the most serious governance problem resulting in scandals and mismanagement in many countries with voucher mass privatization programs like Czech republic, Russia and Lithuania. Strong regulation of the funds was necessary to secure an efficient governance system. In the most advanced stages of transition it can be expected that investment funds and different institutional investors related to insurance, pension funds etc. will play a stronger role. Also diversified domestic shareholders wild get a more important role later in the consolidation stage with the parallel development of capital markets. Also

domestic blockholders will grow stronger during the transition. In some countries like Russia this happened quite fast with the oligarchs exploiting their personal network in relation to a weak state. On the negative side such capture of the state means high inequality, it may be a barrier for further reform, and crowd out other potential investors, both small entrepreneurs and foreign capital. On the positive side such concentrated ownership may result in strong governance and strengthening the restructuring process.

Foreign ownership has strong advantages in relation to deep restructuring because of high supply of capital, management skills, technological know how, and international network. The evidence confirms the strong performance and restructuring abilities of foreign ownership. In a limited scale FDI can start already before the fundamental political changes, but the bulk of foreign investments have been related to large privatization in countries such as Hungary and Estonia. A general condition for attracting high foreign investments is advanced liberalization and stabilization of the economy and most important clear rules of the game. The hesitant and low foreign investments in countries like Russia are both the result of slow progress in the transition process and privatization methods favoring insiders and domestic investors. Foreign investments played a key role for restructuring in Hungary and Estonia. The positive effects include high capital supply, industrial upgrading, increased competition, and linking local production into advanced international production networks. Some of the capital-intensive infrastructure sectors have also received high foreign investment in many transitional economies, resulting in a technological jump into the information society. In the consolidation stage more green-field investments and acquisitions of existing private companies can be expected. Such acquisitions will make up the final point in the governance cycle from state ownership, to employee, to manager, to outsider/foreign ownership.

Perspective and some policy recommendations

There is no simple answer: to what is the best ownership structure for the efficient use of resources and for promotion of the necessary restructuring. It depends

on political priorities, stage of development, as well as specific cultural and technological conditions. The experience in Eastern Europe shows a great variety in governance structures, concerning the speed of privatization, the prevalence of state ownership, the division between insider and outsider ownership, the importance of employee ownership, and the openness for foreign investments. There is no simple recommendation concerning the optimal balance between the different forms. One successful country, Hungary, had much emphasis on foreign ownership and limited weight on employee ownership, while another success story, Slovenia, had strong emphasis on employee ownership and limited weight on foreign ownership.

Some final policy recommendation for countries still in the early stages of transition:

- Market orientation can be started already before the fundamental political changes. It cannot substitute real market reforms, but ease the following transition process.
- Market orientation can include opening for employee and management owned enterprises already in the pre-transition stage.
- Employee owned enterprises may be supported in the privatization process without problems for long term restructuring. Deep restructuring can be implemented in the employee owned enterprise, or ownership will change.
- If long run survival of employee ownership is a priority, the institutional framework should be improved: rules for trading employee shares, training, consultancy, loans.
- Good opportunities for manager ownership is necessary for a dynamic SME-sector. Remove red tape, licensing, prohibitive taxation.
- Clear rules of the game, simple and clear regulation. Lack of clarity and transparency opens up for corruption and capital flight and no restructuring.
- Voucher privatization must be accompanied with regulation of investment funds.
- Flexibility is needed for dynamic adjustment of ownership structures. Different structures must compete on the market on how resources can be used in the best way.

Table 1 Governance cycle: potential for different ownership types in different stages

\stage **ownership**	**early reforms** no fundamental political change	**early transition** liberalization small privatization	**large privatiz.** institutional reform	**consolidation** institutional reform deep restructuring
state	state dominant, experience with some autonomy	stage of commercialization large enterprises	main part of production privatized	last privatizations some sectors still state owned
employee	introduction of market elements self-management start restructuring	advantages for insiders in small privatization	advantages for insiders in large privatization	change to management consolidation human capital industries, support institutions
manager	individual firms start restructuring	high potential for new management SMEs	high potential management SMEs	change to outside diversified/core
diversified domestic outside	no role	no role	voucher privatization governance?	increasing role with development of capital market
core domestic outside	no role	a few	developed from manager own. FIGs	including diversified (minority) owners
core foreign	restricted JVs start restructuring	first mover FDIs	direct sale	acquisitions/greenfield integration into global production chains

Literature:

Aghion P. and O. Blanchard (1998) On Privatization methods in Eastern Europe and their implications, *Economics of Transition*, vol 6, no 1, pp 87-99

Alchian A. and H. Demsetz (1972):"Production, Information Cost, and Economic Organization", *American Economic Review*,December,62(5), pp 777-95.

Blanchard O. and P. Aghion (1996): On Insider Privatization, *European Economic Review*, 40 pp 759-66.

Ben-Ner A. and D. Jones (1995): Employee Participation, Ownership and Productivity: A Theoretical Framework, *Industrial Relations*, no 34, pp 532-54

Bonin J., D. Jones and L. Putterman (1993):"Theoretical and Empirical Studies of Producer Cooperatives: Will the Ever the Twain Meet? *Journal of Economic Literature*, 31(Sept), pp 1290-1320.

Boycko, M., A. Schleifer and R. Vishny (1996):"A Theory of Privatization", *Economic Journal*, 106 (March), pp 309-19.

Buck T., I. Filatotchev, M.Wright and V. Zhukov (1999): Corporate Governance and Employee Ownership in an Economic Crisis: Enterprise Strategies in the Former USSR, *Journal of Comparative Economics, vol 27 no 3,pp 459-474*

Carlin and Landesmann (1997): From theory into practice? Restructuring and dynamism in transition economies, *Oxford Economic Policy*, vol 13, no 2, pp 77-105.

Conte M.A. and J. Svejnar (1990): The Performance Effects of Employee Ownership Plans pp 143-181 in *Paying for Productivity: A Look at the Evidence*, edited by A.S.Blinder, Washington, D.C.: Brookings Institution, 1990.

Djankov S. (1999) The Restructuring of Insider-Dominated Firms: A Comparative Analysis, *Economics of Transition*, vol 7, no 2, pp 467-79

Djankov S. and P. Murrell (2002): Enterprise Restructuring in Transition: A Quantitative Survey, The World Bank/University of Maryland, working paper.

Domar, E. D. (1966): The Soviet Collective Farm as a Producer Cooperative *American Economic Review*, 56(4): 734-758.

Estrin S. and M.Wright (1999): Corporate Governane in the Former Soviet Union: An Overview, *Journal of Comparative Economics, vol 27 no 3,pp 398-421*

Frydman R, C. Gray and A. Rapaczynski (eds) (1996): *Corporate Governance in Central Europe and Russia*, Budapest, CEU Press

Frydman R, C. Gray, M. Hessel and A. Rapaczynski (1999): Private Ownership and Corporate Performance: Some Lessons from Transition Economies, *Quarterly Journal of Economics*, 114 (1999): 1153-91.

Gregoric A., J. Prasnikar and I. Ribnikar (2000): Corporate Governance in Transitional Economies: The Case of Slovenia, *Economic and Business Review*, vol 2, no 3, pp 183-207.

Hansmann, H (1988):"Ownership of the Firm", *Journal of Law, Economics, and Organizaiton*, 4(2), pp 267-304.

Jarosz M. (1996): *Employee-Owned Companies in Poland*. Warzaw, ISP PAN.

Jones D. (1998): The Economic Effects of Privatization: Evidence from a Russian Panel *Comparative Economic Studies*, 40, 2, pp 75-102

Jones D. & N. Mygind (1999a):The Nature and Determinants of Ownership Changes after Privatization: Evidence from Estonia, *Journal of Comparative Economics, vol 27 no 3, pp 422-441*

Jones D. and N. Mygind (1999b): Ownership and Enterprise Performance: Evidence from Estonia, in *Equality, participation, transition*. V. Franicevic & M. Uvalic (eds.), McMillan

Jones D. and N. Mygind (2000): The Effects of Privatization on Productive Efficiency: Evidence from the Baltic Republics, *Annals of public and cooperative economics*, vol. 71, no.3

Jones D. and N. Mygind (2002): Ownership and Productive Efficiency: Evidence from Estonia, *Review of Development Economics*, 6(2), 284–301, 2002

Kalmi P. (2002): *On the (In)stability of Employee Ownership, Estonian Evidence and Lessons for Transition Economies*, Ph.D. serie 10.2002, Copenhagen Business School

Meade J.E. (1972):"The Theory of Labour Managed Firms and of Profit Sharing", *Economic Journal*, 82, pp 402-428.

Megginson W.L. and J.M.Netter (2001): From State to Market: A Survey of Empirical Studies of Privatization, *Journal of Economic Literature*, vol. 39, June, pp 321-389.

Meyer K. (1998): *Direct Investment in Economies in Transition*, E. Elgar: Aldershot.

Mygind N. (1992):"The Choice of Ownership Structure", *Economic and Industrial Democracy, 13 pp 359-399.*

Mygind N. (1997): Employee Ownership in the Baltic Countries, chapter 2 pp 49-79 in Uvalic and Vaughan-Whitehead (1997).

Mygind N. (2000): Privatisation, Governance and Restructuring of Enterprises in the Baltics, *Working Paper, CCNM/BALT(2000)6, OECD*, Paris.

Mygind N. (2001a): Enterprise Governance in Transition - a Stakeholder Perspective, in *Acta Oeconomica*, no 3. pp. 315-342

Mygind N. (2001b): Economic Performance of Employee-owned Enterprises – Theory and Some Evidence from the Baltic Countries, in *Inussuk, Arctic Research Journal*, no 1. pp. 63-109

Mygind N. (2002): Privatization and enterprise governance in Latvia - nine cases, *CEES working paper*

OECD (2002): Russian Federation, *OECD Economic Surveys*, 2002/5 – February, Paris

Pinto, B., M. Belka and S. Krajewski (1993): Transforming State Enterprises in Poland, *Brookings Papers on Economic Activity,* no 1 pp 213-70.

Prasnikar J., Svejnar J. and P Domadenik (2000): Enterprises in the post privatization period: Firm level evidence for Slovenia, IAFEP conference paper.

Sertel M. (1982):"*Workers and Incentives*", Amsterdam: North Holland.

Stiglitz J. (1999): Whither Reform? Ten Years of Transition, paper presented at the Annual Bank Conference on Development Economics, April 1999

Thomas, H and C. Logan (1982):*"Mondragon - An Economic Analysis"*: London: Allen and Unwin.

Uvalic M. (1991):"The PEPPER Report: Promotion of Employee Participation in Profits and Enterprise Results in the Member States of the European Community", *Social Europe*, Supplement no. 3.

Uvalic M and D.Vaughan-Whitehead (1997): *Privatization Surprises in Transition Economies - Employee-Ownership in Central and Easter Europe*, Ed. Elgar.

Vanek J. (1971):*"The General Theory of Labour-Managed Market Economies"*, Ithaca, NY: Cornell University Press.

Yarrow G. (1988): Privatization in Theory and Practice, *Economic Policy*, 2, pp 324-64.

Ward B. (1958):"The firm in Illyria: Market Syndicalism", *American Economic Review* 48: 566-589.

World Bank (2002): *Transition, The First Ten Years, Analysis and Lessons for Eastern Europe and the Former Soviet Union*, Washington, D.C.