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**Panu Kalmi**

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Bank of Finland  
Institute for Economies in Transition, BOFIT

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Bank of Finland  
Institute for Economies in Transition (BOFIT)

PO Box 160  
FIN-00101 Helsinki  
Phone: +358 9 183 2268  
Fax: +358 9 183 2294  
[bofit@bof.fi](mailto:bofit@bof.fi)  
[www.bof.fi/bofit](http://www.bof.fi/bofit)

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Panu Kalmi

## Ownership Change in Employee-Owned Enterprises in Poland and Russia

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### Abstract

This thesis discusses employee-owned enterprises (EOEs) in Poland and Russia, asking:

- 1) What are the benefits of and shortcomings of employee ownership in transition economies?
- 2) Will employee ownership be a permanent arrangement?

Employee ownership literature and special aspects of EOE in transition economies are reviewed. According to the literature survey, when shares are freely tradable, most problems associated with Yugoslavian-type enterprises should vanish. The remaining problems are employee risk-aversion as owners, decision-making problems arising from diverse preferences, and greater costs in obtaining external financing. In transition processes the advantages of insider privatization are clarification of property rights, speed and lowered costs, and employee participation in the privatization process. A major obstacle is insufficient funds for financing investment and restructuring.

Insider privatization was used in Poland and Russia as a privatization method due to political necessity. Insiders inherited a strong position – without their cooperation privatization could not have been carried out. In practice, firm success seems to depend more on the environment the firm is facing than particular ownership structures. The low level of investment may follow from the conditions of high uncertainty and lack of capital, rather than from particular ownership effects. On the other hand, there is evidence that EOE respond to market signals in a normal way, eg by increasing investment in conditions of improved profitability and reducing work force in recession. A common feature for Polish and Russian insider-owned enterprises is that control over the enterprise is concentrated to the hands of managers. This may have devastating effects on EOE when managers are inclined to asset stripping and rent seeking instead of increasing market value.

In examining the contention that insider privatization could be used as a temporary path to other property structures, the paper discusses the implications of share trade. Applying a take-over model adapted from Grossman and Hart (1980) and Shleifer and Vishny (1986), the writer suggests that the private benefits insiders enjoy may hinder ownership change. This is especially the case when the private benefits of control are large for managers large compared to the potential security benefits. On the other hand, concentration of shares to managers and large investors may increase the probability of ownership change. Indeed, this appears to be consistent with what is actually happening. Hard budget constraints and further development in bankruptcy institutions are recommended as ways to promote selection towards more efficient ownership structures.

Keywords: privatization, employee-ownership, Poland, Russia

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## 1 Introduction<sup>1</sup>

This paper discusses employee-owned enterprises (EOEs) in transition economies, particularly Poland and Russia. Employee buy-outs have played a very important role in privatization processes in these countries. Employee ownership in both countries is based on individual shareholding, and should be distinguished from the "worker self-management" notion popular in these countries in the 1980s. Under worker self-management, workers retain a voice in decisions affecting production, investment, profit sharing, wages, employment conditions, and the appointment and tenure of the managing director. The experience with worker self-management presently colours privatization approaches in these countries.

My main interest has mainly been determining the effects employee buy-outs (or give-aways) have on privatization processes. Of course, in the broader sense it is possible to discuss to pros and cons of employee ownership per se, as there is wide variation in formats and degrees of employee ownership. In the narrower sense, though, and particularly in the case of transition economies, employee ownership is usually argued for as a way to reduce social costs or resistance in transition, or conversely, criticized as a clumsy way to generate unnecessary costs and inflict economic inefficiency. I seek to deal with the latter discussion; first, by examining the actual impact of employee ownership in the transition processes, and second, by attempting to assess the permanence of the employee ownership phenomenon. Will employee ownership characterize

these economies for many years to come?

This study has three major purposes. First, I state conclusions that can be drawn from the literature of employee ownership and apply them to transition economies. Second, I discuss original expectations when frameworks for ownership are designed, and note such design may affect actual development. Third, I present a model of ownership change to better discuss possible effects of initial allocation of property rights on final outcomes. The principle of value maximization is used as a benchmark throughout the text, and focus is placed on the extent to which the firm works in the interest of its shareholders, and under which conditions it is advantageous for the shareholders to sell their shares. Individual rationality is assumed.

Employee ownership is examined in Chapter 2. As there is a vast amount of literature on this subject,<sup>2</sup> I have tried to select topics I believe are most relevant to this study. Moreover, I have tried to avoid repeating myself, so certain clearly important issues such as restructuring and corporate governance are not dealt with until Chapter 3. The literature review is deliberately limited to the Illyrian discussion, property rights issues, and industrial democracy, for they cover many relevant aspects to this paper from different angles. Results derived in this literature often follow specific assumptions made from firm ownership structure. I specifically discuss firms with collective ownership and firms with share ownership. Profit sharing is excluded from this study, because profit sharing firms do not in many cases cover our definition of EOEs; typically, shareholding is exercised by a fund on behalf of the employee and workers do not exercise control rights in the enterprise.<sup>3</sup> In the new market economies of Eastern Europe these schemes are much less used than employees' direct shareholding.

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<sup>1</sup> This paper is a slightly amended version of master thesis in economics approved at the University of Helsinki in October 1996. The author is grateful to Professor Pekka Sutela, who was the supervisor of the thesis. For comments and discussions, the author would like to thank Marek Bednarski, Alberto Chilos, Jerzy Pietrewicz, Tatiana Popova, Tomasz Stankiewicz, and Tuomas Takalo. Special thanks go to Rick Woodward, who has been most helpful and supportive since the very beginning of this project. He has also read and commented several parts of this paper. Naturally, all errors and omissions are those of the author. Opinions presented in this paper do not represent the view of the Bank of Finland.

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<sup>2</sup> For a thorough survey, see Bonin, Jones and Puterman (1993).

<sup>3</sup> An example of profit sharing schemes in practice is Employee Stock Ownership Plans in the USA (See Hansmann, 1990). For a description of different variants in theory and in practice, see Nuti (1992).

The Illyrian literature,<sup>4</sup> as its name suggests, was inspired by the Yugoslavian experience.<sup>5</sup> This literature compares two theoretical models of firm at the level of the whole economy. One economy consists of employee-owned firms (EOE economy) and the other of capitalist enterprises. Different equilibria of EOE economy are compared to those of the capitalist economy. My purpose is to describe EOE as an alternative organizational model of the firm, and not as an economic system. Therefore, I do not discuss Illyrian literature broadly.<sup>6</sup> However, much of the later literature is based on Illyrian literature, and therefore some introduction is useful.

A primary assumption of Illyrian literature is that claims to residual return of the firm belong to employees and thus are non-transferrable. The firm hires capital rather than owns it and employees maximize their earnings rather than the firm's value. While full efficiency is restored in the long run, this approach leads to supply perversities in the short run. Adherents of the property rights school<sup>7</sup> have, in turn, claimed that employee ownership leads to serious problems concerning the time horizon of owners, risk allocation and agency costs. They have also suggested that the firms adapt those forms of organizations and structures of property rights which delivers the product demanded by the customers with lowest possible costs, agency costs included.<sup>8</sup> In competitive markets, firms which do

not minimize costs do not survive, and this they claim is the reason employee buy-outs or employee-controlled firms are relatively rare in market economies - employee ownership would be an inefficient organizational form in comparison with investor ownership.<sup>9</sup> The industrial democracy school answers this claim by saying that employee ownership is not widespread due to hierarchical power structures in society and discrimination EOE inevitably face in capital markets. They also claim that an EOE is a more democratic and a more productive organization than a capitalist firm.<sup>10</sup>

Most of the literature of employee ownership discusses the role of EOE in developed market economies. Transition economies differ from these markedly in terms of legal enforcement and financial institutions. Therefore, we have to consider the question of organizational efficiency in a broader, *institutional* framework, i.e.

What were the patterns of ownership prior to privatization?

- Which are the attainable alternatives?
- How much path dependency is in the process?
- How does employee ownership affect institutional development?

In Chapter 3 we discuss the impacts of insider ownership in transition processes. I selected three of these processes into discussion: privatization, restructuring and corporate governance. Despite the opposition of mainstream economists and reform politicians, employee ownership became important part of Polish and Russian privatization largely because of existing control structures in enterprises before privatization. The impossibility of privatization through sales in large scale led to a search for alternatives. The mass privatization and insider privatization approaches are compared in this section.

On one hand, the monumental task of restructuring former socialist state enterprises appears an impossible task for insiders to execute; the firm-specific human capital of insiders hinders necessary downsizing, and the limited supply of

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<sup>4</sup> Illyria is located in the northwestern part of the Balkan Peninsula and has been inhabited from the 10th century BC onwards by Illyrians. It consists of present-day Croatia, Dalmatia, Bosnia and Montenegro (Encyclopaedia Britannica 1991).

<sup>5</sup> This body literature started with articles by Ward (1958) and Domar (1966) and the book by Vanek (1970). A good summary is presented in Meade (1972).

<sup>6</sup> In Russia, insider ownership can even create a new economic system (Sutela 1994). Nevertheless, this system cannot be considered Illyrian.

<sup>7</sup> Classic works of this school on employee ownership are Furubotn and Pejovich (1970) and Jensen and Meckling (1979).

<sup>8</sup> Jensen and Meckling (1979, p. 470–471).

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<sup>9</sup> Ibid. (1979, p. 473).

<sup>10</sup> See Bowles and Gintis (1993) and Putterman (1993).

capital halts modernization efforts. On the other hand, restructuring can hardly take place without the cooperation of insiders. In the case of post-socialist governance structures, employees were well-positioned to prevent privatization if they considered that restructuring threatened their position.

One of the most challenging questions considering employee ownership in transition is corporate governance. In EOE, potential costs of policing management should be potentially lower because employees have lower-cost access to information on managerial actions than outside investors. This, however, hardly gives a true picture of what is happening in transition economies. I believe control structures must be seen as continuous extensions from the socialist era. If, indeed, employee ownership is a transient phenomenon, as many observers believe, we should ask then what the future system of corporate governance will look like so we can set institutional priorities. The main alternatives presented in the literature are the actual presence of large shareholder (German–Japanese model) or the potential emergence of dominant shareholder via stock market (Anglo–American system).

In Chapter 4 we discuss the empirical evidence on EOE in Poland and Russia to be able to judge whether theoretical considerations correspond with reality. There are important differences between the two countries worth noting. In Russia insiders have dominated all privatization, whereas in Poland large enterprises were mainly excluded from employee privatization. In Russia, EOE were formed as open joint-stock companies with minority outsider ownership, whereas in Poland they are usually closed companies, often with insider shareholders only. In Russia, insiders paid book value for enterprises (i.e. not adjusted for inflation and thus heavily discounted), whereas in Poland employees had to pay full (estimated) market value.

Acknowledging these differences, insider privatization in these countries can still be compared. I think it is justified in an attempt to trace the effects of employee ownership in transition economies. The following questions are considered:

How did the existing control structures affect on realized privatization programmes?

- How were they affected by the thinking of the reform politicians?
- What are the organizational forms of employee ownership?
- How do they affect the performance of these enterprises?
- What are the benefits and drawbacks of employee ownership?
- How does ownership change in employee owned companies?

Already at this stage of transition, the data allow some preliminary conclusions about ownership change in short run, although it is still difficult to tell at this time if these firms will eventually be investor-owned or owned by a small group of insiders (managers plus possibly some elite of employees), or if they will remain on a broad insider ownership basis. After all, the statistical evidence in this regard is neither specific or reliable, especially concerning registered share ownership in Russia.

Chapter 5 focuses on the ownership change processes. I introduce there a simple model of ownership change in the presence of one large institutional shareholder.<sup>11</sup> To avoid technical difficulties, a static perfect-information model is applied. This sacrifices realism in the model, which I have tried to correct by discussing alternative assumptions. I ask:

Does the original allocation of property rights lead to market failure or does the share market eventually lead to optimal allocation (i.e. is the Coase Theorem at work in transition economies)?<sup>12</sup>

Some basic concepts need to be introduced. “Employees” refers herein to a firm’s work force excluding management; and the terms “employee” and “worker” are used interchangeably. The term “insiders” refer to both workers and management, following the convention of economic literature. The term “capitalist firm” usually applies to enterprises, where means of production are privately owned. In the literature of EOE there is also a second meaning for the term, namely that

<sup>11</sup> This model is an adaption of the take-over models developed by Grossman and Hart (1980) and Shleifer and Vishny (1986).

<sup>12</sup> On this, see Sutela (1995).

the owners of the enterprise hire and fire the employees according to their own interests, and that the workers do not own the means of production or participate in the decision-making. As the EOE in Poland and Russia today are based on individual shareholding and these shares have a secondary market, we could call them capitalist firms according to the first definition. My purpose in this thesis is to discuss the differences between EOE and investor-owned firms. Therefore, the term "capitalist firm" is used in this text to describe only firms owned by outside investors. With the term "capitalist firm" I use interchangeably the term "traditional firm", referring to the ideal model of the firm in neoclassical economics. In a strict sense, "employee ownership" refers only to firms in which the employees have rights to residual earnings the firm generates *and* control rights in the enterprise.<sup>13</sup> In practice, we find many firms where there is substantial employee share ownership and yet they either do not have rights to control or they do not exercise it. The term "employee owned" is used here as a working hypothesis in assessing these enterprises.

A crucial concept in the following discussion is the distinction between private and security benefits derived from shareholding.<sup>14</sup> Security benefits, which are dividends, accrue to all shareholders, whereas private benefits accrue to that party which controls voting. An example of private benefits is that under employee control with minority investor ownership employees have incentive to allocate funds rather to wages than dividends.

A concept often used in the literature of transition economies is hard budget constraints. The notion of hardness or softness of budget constraints was first applied by the Hungarian economist Janos Kornai, who defined a soft budget constraint as a subsidy which is not explicitly specified, but is subject to bargaining. In addition to government subsidies, examples of soft budget constraints also include arrears in bank loans, inter-enterprise loans, taxes and wages, and soft administrative pricing. Softness of budget

constraints depends on what the environment will tolerate; thus making it a condition not dependent on markets, but on bureaucratic coordination and financial bargaining with the authorities.<sup>15</sup> Kornai defined the soft budget constraints for socialist environment. In the transition process, soft budget constraints continue, although their forms are changing. They apply not only to state enterprises but also to privatized enterprises. For privatized enterprises, the meaning of government subsidies and administrative pricing has significantly diminished. They are now more pronounced in the form of unserved bank loans, inter-enterprise debt arrears, tax arrears, wage arrears and arrears in leasing payments (in Polish EOE). The problem of soft budget constraints in the private sector is a serious problem which hinders macroeconomic and institutional development in transition economies. It is outside the scope of this study to tackle such a big issue; all I can do here is recognize its existence.

We should clearly separate managerial and employee ownership as two different categories. Managers as owners suffer less from collective choice problems than employees, and have better opportunities for rent-seeking and asset stripping. The traditional literature on employee ownership does not pay much attention to this issue, but in transition economies these differences are crucial. The literature on managerial ownership in economics is not very useful because it assumes developed mechanisms of shareholder monitoring which are largely absent in transition economies.<sup>16</sup>

Small privatization (restaurants, shops etc.) is not discussed here. It is fundamentally different to privatize enterprises with few employees than enterprises with few hundred employees in terms of complexity of operation and agency problems. I believe there are good reasons to turn very small enterprises into insiders because of the informational and motivational reasons as well as the human capital already invested in the enterprise.

Finally, a note on the concept of *transition*, which has come into wide use in recent years to mean a bunch of reforms which are supposed to bring post-communist economies closer to some

<sup>13</sup> Hansmann (1990, p. 1756).

<sup>14</sup> These concepts are borrowed from Grossman and Hart (1988).

<sup>15</sup> Kornai (1992, p. 140–144).

<sup>16</sup> For an overview, see Shleifer and Vasiliev (1994).

neoclassical idea of market economy. The assumed components of transition can include stabilization of the monetary system, price reform, privatization and enterprise restructuring.<sup>17</sup> I prefer to limit my focus to privatization, or even better, ownership change. My emphasis is not on separating enterprises from state control (although it is discussed too), but merely on how ownership changes when employees already are in control in enterprises. Concerning ownership change, I agree with the division proposed by Aoki, who has suggested that ownership regimes may be divided into three phases: the *communist regime*, the *intermediate transition process*, and the *post-transition regime*. The communist regime is here considered as the starting point before the beginning of legitimate privatization processes. During the transition process, the state gives up its direct influence on enterprises. In the post-transition regime, corporate governance structures are well defined, share ownership has become stabilized in a statistical sense, and mechanisms to replace poorly performing management are in place.<sup>18</sup> In my opinion, it can be quite safely asserted that both Poland and Russia are, according to this criteria, still in the transition process. Although there might be some confusion caused by the fact that in both countries important parts of industry are still in state control, or alternatively, it can be claimed that already during socialism enterprises had entered the transition process through worker self-management, my point is that, overall, neither of these countries can be said to have entered a post-transition regime.

Viable corporate governance requires sound legal institutions, enforcement of the law and a healthy financial system. These institutions, common to all market economies, take longest to build (e.g. systems of property rights, bankruptcy laws, contract freedom, company laws, financial regulation and capital markets). It is thus one thing to have markets in place, and quite another to have them operating as they should. This lag accounts for the paradox of transition: the state is essentially asked to enforce the institutions of a market economy while simultaneously giving up socialist type administrative control over the

economy. Institutional development in all countries is still in a transitional stage.<sup>19</sup>

## 2 Alternative approaches to employee-owned enterprises

### 2.1 The Illyrian literature

We will first present the structure of the Illyrian model. Many beliefs connected with employee ownership are based on this literature and its critique. At the same time it must be stressed that this theoretical structure has little in common with today's ownership forms in Poland and Russia. We first briefly discuss the assumptions concerning ownership structure and the behaviour these structures are supposed lead to in the firm. The purpose of this discussion is to characterize collective employee ownership so that it could later be compared to employee ownership based on individual shareholding.

A major assumption in Illyrian literature is connected with the ownership structure of the firm.<sup>20</sup>

In Illyria, *firms* are forbidden to hold claims on productive resources. They hire the assets which can be privately or socially owned (state owned).

The residual rights to profits the firm generates and decision-making rights belong to the employees. The right to profits is connected with their status as employees. When they retire, resign or are dismissed, they lose their rights to profits. They cannot sell their stake in the firm.

The employees collectively make production and employment decisions. Their aim is to maximize the average earnings per employee.

The employees' earnings consist of firm's revenue divided equally among the employees, instead of the competitive wage.

The maximization of employees' earnings in the Illyrian EOE (henceforth only EOE)

<sup>17</sup> Blanchard *et al.* (1991).

<sup>18</sup> Aoki (1995, p. 6).

<sup>19</sup> The World Bank (1996).

<sup>20</sup> The description of the ownership structure of Illyrian firm follows the article by Jensen and Meckling (1979, pp. 476–477).

corresponds to the profit maximization imperative of the capitalist enterprise. From this assumption, the scholars of the Illyrian firm drew the following propositions<sup>21</sup>:

- 1) Assuming that the firm's market entry and exit is without barriers, there is perfect competition, perfect mobility of the production factors and constant returns to scale, EOE's decisions on the output and employment are Pareto-optimal, just as they would be for a traditional firm in a competitive environment.
- 2) In the short run, when profits may be larger than zero or there may be losses, the EOE's decisions on output and employment are different from those of the traditional firm. In particular, the EOE reacts to the rise of output price by reducing labour input, and thus reducing production, and to the rise of fixed input price by increasing labour input and production.
- 3) In a monopoly situation, the EOE tends to restrict output more than a traditional firm.

The short run results follow from the assumption that every worker has an equal right to the profit of the firm. Consider a situation where the price of an EOE's output rises. From this, it would follow that the value of the marginal product of labour rises. A traditional firm would hire more workers, which would raise output. But the EOE reduces its workforce, causing a decline in output. Thus, the short-run allocation of resources in an EOE is clearly inefficient.

The underlying assumptions of these three propositions have been strongly criticized – especially the assumption of free entry<sup>22</sup> and the perfect mobility factors (e.g. the employee's right to resign and the working collective's right to dismiss the worker).<sup>23</sup> Indeed, the property rights school have had a field day with the claim that

worker ownership ultimately leads to Pareto efficiency in the long run. Besides that, even the idea of maximization of average earnings per worker is suspect – after all, EOE's should also have other objectives such as the welfare of employees and egalitarian principles. In such an arrangement it would be unlikely that the firm would dismiss some employees to raise the earnings of other employees when everyone could be better off.

The cooperative model of EOE is not a stable form of ownership, as two vicious circles almost inevitably undermine its long-term stability. First, consider what happens when worker earnings in the EOE are less than the competitive wage. Clearly, the most productive workers have incentive to move on other firms where they will be better paid. This, in turn, will erode the overall productivity of the firm further, and earnings will fall. The next tier of productive workers now has incentive to resign, which leads to a new productivity fall, a new wave of departures, and so forth. The second possibility is that workers' earnings are greater than the competitive wage. In this case, the existing workers will refuse to take on more workers as it would cause their earnings to diminish. On the other hand, it would pay the existing workers to hire new workers at the competitive wage. But if it is allowed to hire new workers with a wage contract, it would always pay the existing members to do so, as long as the earnings of the original members are higher than the competitive wage. Over time, the EOE would transform into a normal, capitalist firm. It should be noted that if the EOE could hire workers and pay them a competitive wage, it could react to changes in demand in a "normal" way. In fact the possibility to hire workers with a fixed, competitive wage would eliminate the "Illyrian" character of the firm and the firm would thereafter behave like a traditional, profit-maximizing firm. The Illyrian firm would survive only in conditions of zero profit, which leads to Pareto-optimal allocation of resources (see Appendix 1).<sup>24</sup>

<sup>21</sup> The ideas behind these propositions are presented in the Appendix 1.

<sup>22</sup> Jensen and Meckling (1979, pp. 489–490).

<sup>23</sup> Meade (1972, pp. 408, 420–422).

<sup>24</sup> This line of reasoning was first presented by Tugan-Baranovsky (1921), as cited in Weitzman (1991). As Weitzman points out, Tugan's reasoning resembles the Coase Theorem that inefficient labour allocations will be corrected by market forces, leading into a Pareto improvement.

## 2.2 The property rights school and the EOE

### 2.2.1 The time horizon problem

The model of the Illyrian firm as developed by Ward is really a one-period model. Unfortunately, Ward in his article never mentions how an EOE finances its activities. Since the firm cannot sell claims to its real capital (because the firm *does not own* the capital it uses) we must assume there are three possibilities, i.e.:

The workers divide the profit among a wage fund and an investment fund according to their decision.

The firm finances its activities through debt.<sup>25</sup>

#### 1) The state gives resources to the enterprise.

In their article, Eirik Furubotn and Svetozar Pejovich assumed that the firm's financing is arranged using the first alternative mentioned above. They showed that when there is more than one period, it pays the workers to invest part of their profits in investments.<sup>26</sup> They assume that the profit of the firm is equally divided among the workers. Thus, workers can invest their earnings in a deposit account with a fixed interest rate  $i$ , or put it into the firm's investment fund. An individual worker would rationally invest to EOE when the present value of his investment is greater than the present value of depositing money in the bank. This resembles the decision-making criteria the individual faces when investing in a capitalist firm. However, an important difference should be noted. In a capitalist firm, the shareholder's claims are for an infinite period, i.e. the shareholder and his successors have a legitimate claim on the firm's profits as long as the firm stays in business. The employee of the EOE has a claim on the firm's profits only as long as he is employed in the firm. Denoting the employee's required rate from

investment with  $r^*$ , we have

$$(1) \quad r^* > [i(1+i)^N] / [(1+i)^N - 1]$$

where  $N$  indicates the employees' forthcoming years employed in the firm.<sup>27</sup> Equation (1) is the reciprocal of the present value of an annuity factor at rate  $i$ . It is obvious that profit sharing between the wage fund and investment fund will provoke conflict, unless all employees do not have approximately the same number of years left in the firm. The capitalist firm does not have this problem, because the maturity of its shares is infinite and there exists a secondary market for its shares. The investment criteria for a capitalist firm is  $r > i$ .

### 2.2.2 Other problems with the Illyrian model

Furubotn and Pejovich also drew attention to the fact that investment may increase the firm's demand for labour.<sup>28</sup> Assuming that new workers get the same rights to profits as old workers, new workers, when hired, may reduce the incomes of older workers. The return from labour-increasing investments must thus cover also the losses following from the fact that there is now more people sharing the pie. Otherwise, older workers will seek to prevent the hiring of new people. That may lead the EOE to abandon projects which have a positive net present value. On the other hand, the firm may take on projects with a negative net present value, if they reduce the work force. Both practices are clearly disadvantageous in the sense of general welfare of the firm.

As mentioned, capital goods in Illyria may be privately or socially owned, and the firms may hire such goods. It is also assumed that it is no more costly to hire capital goods than buy them. In other words, the hiring contract does not create agency costs.<sup>29</sup> Jensen and Meckling claim that the agency costs of hiring are greater than owning the

<sup>25</sup> In Illyria the firm does not have ownership rights to capital, so it cannot use capital as collateral, which weakens its position in loan markets. Such unclear ownership arrangements are a real problem in today's Poland (see 4.1 below).

<sup>26</sup> Furubotn and Pejovich (1970, p. 443 ff).

<sup>27</sup> Jensen and Meckling (1979, p. 483).

<sup>28</sup> Furubotn and Pejovich (1970, p. 450).

<sup>29</sup> For a critique of this assumption, see Jensen and Meckling (1979, p. 480). The concept of agency costs they use is introduced in their 1976 article.

asset, because in the hire contract the user of asset does not have to pay as much attention to depreciation of the asset than if he would own it. They also claim that EOE cannot rent intangible assets such as training of the work force, marketing and design; or at least, it is impossible to renegotiate a new rent contract for every period.<sup>30</sup>

### 2.2.3 Risk allocation

The problems above are associated with particular assumptions of the Illyrian model, so they do not apply in cases where ownership is based on tradable shares and the firm owns the assets it uses. Nevertheless, the problem of risk allocation should arise in Illyria. But since there are no secondary markets for ownership claims in Illyria, we cannot meaningfully discuss risk diversification in that environment.

For example, assume workers have bought shares of the enterprise with their own savings. Further assume that these savings represent a significant part of their total wealth. We may conclude the employee is inadequately insured against risk for two reasons. First, the sources of employee's wealth are his human capital and financial capital. Because the employee is unable to diversify his human capital (he can be employed only in one place at time), it would be preferable for him to invest his financial capital in another place. Second, according to the portfolio theory, he would be better off diversifying his financial capital among several objects.

In the theory of the firm, it is usually assumed that the owners of the firm are risk-neutral. This follows from the assumption that all of them hold a well-diversified portfolio. They are not interested in the variance of an individual asset, but in the covariance of the particular asset with other assets in their portfolio. By diversifying their portfolio among several assets, they are able to eliminate the specific risk connected with swings of value in particular assets. It is therefore in the interest of investors that the firm take on those investment projects which increase the firm's market value. Because the owners of the EOE

cannot diversify their risk, they are also interested in variance from particular projects. In such situations, it may be rational from the owner's point of view for the firm to take on projects associated with a negative net present value, if they decrease the variance in the firm's value.<sup>31</sup>

The owners of the EOE face also the wealth constraint as swings in the firm's value may have substantial consequences to the wealth of the owners. In the extreme case of bankruptcy, employees lose not only their investment but also the difference between their wage and unemployment benefits. Therefore, the premium of a risky project is higher for the owners of the EOE, than it would be for the outside investors.<sup>32</sup> The EOE then does not use the net present value criteria when assessing a particular investment project. In this situation, the EOE invests less than it would be optimal.

Proponents of employee ownership have offered answers to these claims. First, this analysis assumes that the level of worker effort is the same regardless of ownership. If employee ownership motivates employees to take more effort, as argued by some proponents of economic democracy, this tends to limit the problem of effective risk-taking.<sup>33</sup> Second, the risk workers are exposed in their role as shareholders and the risk they are exposed to as employees are really two separate issues. Workers may substantially reduce their risk connected with their human capital by having controlling rights. Under employee ownership, the risk of dismissal is probably lower, because the employees are able to influence to this risk.<sup>34</sup> The risk arising from poor diversification obtains, with certain reservations, because in underdeveloped financial markets, owners have limited opportunities to diversify risk.

<sup>30</sup> Jensen and Meckling (1979, p. 481).

<sup>31</sup> Benelli, Loderer and Lys (1987, p. 560).

<sup>32</sup> Meade (1972, p. 426).

<sup>33</sup> Uvalic (1995, p. 7–8).

<sup>34</sup> Earle and Estrin (1995, p. 16).

### 2.3 Industrial democracy

As noted in the introduction, the superiority of investor ownership is evidenced, according to the property rights school, by the fact that such ownership is far more common than employee ownership. Industrial democracy supporters respond that employee ownership would be both more justified socially and more efficient in terms of labour productivity. Bowles and Gintis divide the effects of employee ownership into participatory effects and mutual monitoring effects.<sup>35</sup> Before inspecting these issues more carefully, it is instructive to note how the supporters of industrial democracy school explain the rarity of employee ownership.

Of reasons which could be called sociological (or perhaps ideological) Bowles and Gintis mention that the work force is not trained or experienced to work in democratic firms, and the environment in an economy composed mainly of capitalist firms is hostile to democratic firms.<sup>36</sup> There is also some purely economic reasons which give comparative advantage to the capitalist firm. Most important of these is limited supply of finance. An employee-owned enterprise in the strict sense would exclude itself from other sources of equity financing. Employees usually can only supply small amounts of finance, so the firms have to rely either on retained earnings or loan financing. Sticking to the assumptions that control rights are possessed exclusively by employees, suppliers of loan capital must get a higher interest as compensation for their capital, which puts the employee-owned firm at a disadvantage to capitalist firms.<sup>37</sup>

Under participatory effects, proponents of worker democracy note the greater psychological satisfaction a worker gets from working in his "own" enterprise. Sources making work more pleasant include non-alienating work, the breakdown of hierarchical relations in the firm, a sense of control and the value of democratic

processes themselves.<sup>38</sup> From an economic point of view, perhaps the more interesting question is related to the assumed mutual monitoring effects. Employee ownership can be understood as a ownership form to give monitoring tasks to that input which is hardest to monitor, namely labour. Labour is hard to monitor in team production because the marginal products of individuals are impossible to observe. In capitalist forms the monitoring of labour is given to the holders of residual returns, i.e. the owners of capital. According to the classic article by Alchian and Demsetz, the claims on residual returns guarantee that monitors do their job properly.<sup>39</sup> Bowles and Gintis suggest that by making employees residual claimants, the monitoring can be done with lower costs because the employees have the best information concerning work effort, and moreover have greater incentives to elicit effort.<sup>40</sup> Saved monitoring costs allow the firm to operate more efficiently. Alchian and Demsetz claim that this approach is inefficient in comparison with centralized monitoring because of the free-rider problem of the employees, i.e. each employee only will realize small potential benefits from increase in monitoring effort, so nobody has sufficiently strong incentives to invest more in monitoring.<sup>41</sup> In any case, it is probably hard to verify whether saved monitoring costs (because of better information) or increased agency costs (because of the free-rider problem) will eventually dominate.

The most serious problem of mutual monitoring, however, may not be free riders, but the nature of decision-making. By rejecting hierarchical relations in the firm, Bowles and Gintis ignore the problems originating from employees diverse preferences.<sup>42</sup> If the preferences of the employees are different (as they usually are), we need a political system to solve the

<sup>35</sup> Bowles and Gintis (1993, pp. 27–28).

<sup>36</sup> *Ibid.*, p. 31.

<sup>37</sup> *Ibid.*, p. 32; Putterman (1993, p. 131).

<sup>38</sup> See Hansmann (1990, 1769–1770) for a summary.

<sup>39</sup> Alchian and Demsetz (1972, p. 782).

<sup>40</sup> Bowles and Gintis (1993, p. 28).

<sup>41</sup> Alchian and Demsetz (1972, p. 786).

<sup>42</sup> The problem of diverse preferences is greater in EOE than in capitalist firms, where owners, at least in principle, aim for value maximization.

problems. A mechanism according to the principles of direct democracy would be decision-making at employee general meetings where each employee would have one vote. It is improbable that this kind of mechanism would lead into efficient decisions, and the costs of using such mechanisms could become very high if even the smallest matters have to be handled at such general meetings.<sup>43</sup> Decision-making based on direct democracy thus seems to be possible only in small enterprises with a relatively homogeneous work force.

Employees may, of course, hire a management team. It should be noted that a system where the employees are directly responsible to employee collective has many potential disadvantages. The employees as principals face the same problem of diverse preferences. In addition, if managers have lower pay in these enterprises (e.g. for egalitarian reasons) it is likely to lead to lower managerial effort and even corruption. A group of workers could try to bribe the management to realize their preferences.

From the governance point of view, it thus seems to be most efficient to delegate the management to elected groups of workers, perhaps working in cooperation with professional management, and this management team should be at least for a certain period be independent of employee control in decision-making.<sup>44</sup> This, of course, raises the agency problem of policing the management and gives to the firm a strongly managerial character. What is paradoxical here is that, apart from agency problems, this delegation of management sacrifices participatory effects; as Putterman puts it, "the effective *sense of control* is likely to be small when direct participation is limited"<sup>45</sup> (italics in original). He also states that some effects of participation, such as non-alienating jobs, may be achieved in firms with no employee ownership as long as these firms pay

attention to job innovation and shop-floor participation, irrespective of formal control rights.<sup>46</sup>

## 2.4 Summary

When the ownership of an EOE is based on tradable shares, there should be no reason for the firm to react inversely to demand changes or to allocate profits rather to wages than investments as long as there are profitable investment opportunities available. The problem which remains then is risk aversion of owners. Employee-owners may be able to insure themselves from the risk of job loss by having control rights in the enterprise, but as they are unable to diversify their risk connected with investments, they may be forced to pursue sub-optimal investment policies. On the other hand, residual claimancy status gives them incentives to give more work effort, which may outweigh the disadvantage of excessive risk bearing.

Decision-making issues are more problematic. When the employees have diverse preferences, the decision-making power of employees has to be limited for the sake of the firm's efficiency. This actually brings the firm close to profit-sharing models, where productivity effects are due more to increased incentives to elicit effort than from participation effects. The same problem of giving up some control rights applies equally to the financing of EOE's; when the firm needs more funds than are generated from retained earnings and employee savings, employees have to trade some control rights in order to get external financing. The reluctance of selling these rights may make the survival of EOE's difficult, and further may explain why there are so few firms in developed market economies which are majority-owned and fully controlled by employees.

<sup>43</sup> For the costs of collective decision-making, see Hansmann (1990, pp. 1780–1782).

<sup>44</sup> *Ibid.*, pp. 1790–1794. Hansmann makes here a special reference to the *Mondragon* producer cooperative in Spain.

<sup>45</sup> Putterman (1993, p. 140).

<sup>46</sup> *Ibid.* p. 142–143.

### 3 Employee ownership in transition processes

#### 3.1 Privatization

Conventional wisdom on transition processes considers privatization as a key element in transition, together with such measures as stabilization, price liberalization and liberalization of foreign trade. The need to privatize is rooted in the belief that the state as owner is incapable to change firm's behaviour more market-oriented.<sup>47</sup> Other reasons include, e.g. managerial motivation, entrepreneurship, innovation and budget revenues for the state.<sup>48</sup> New owners are expected to bring fresh capital and technical know-how to enterprises, to make firms more market-oriented and restructure them.<sup>49</sup> It has been argued that for purely economic reasons, privatization through sales would be the best alternative. It would give the enterprises those owners who would be in best position to bring new capital and carry restructuring measures. It would also bring more revenue to the state budget than through selling claims at discounted prices or giving them away.<sup>50</sup> The main problem seemed to be, where to find entrepreneurs and investors capable to undertake these tasks. Domestic savings were in short supply and the interest of foreign investors was also limited. The latter was due especially to deficient legal enforcement and xenophobic reactions of local population in Eastern Europe. Because it is often impossible to sell enterprises to an outside investor at prices that reflect the true value of assets, there have been widely used schemes where assets are sold at discounted prices or even give-away prices to citizens or enterprise insiders.<sup>51</sup>

In economic literature, citizen privatization (or mass privatization) has usually been more

supported than insider privatization for social and economic reasons. First, mass privatization has been supported because of its greater perceived fairness, i.e. all citizens benefit from privatization, not just those who happen to be employed in privatized companies.<sup>52</sup> Mass privatization is also thought to create a broad class of owners, and thus form a basis for broader democratic and free market reforms.<sup>53</sup> Communist state property in the traditional jargon, of course, was said to belong to the people; so a very common observation is that mass privatization simply entitles citizens to *de facto* ownership of assets on which they already have a claim.<sup>54</sup> The citizens claim to state property has thus been considered senior to the claims employees have on state enterprises.

Mass privatization brings with it corporate governance problems. Dispersed minority holdings are likely to lead to free-rider problems when owners lack sufficient incentives to control the management. Thus, most mass privatization pro-programmes include built-in financial intermediaries to help solve the corporate governance problems. While there has been considerable debate as to what should be the nature of these intermediaries, it is beyond the scope of this review of literature.<sup>55</sup> The main problem of such schemes has been that they tend to create artificial transaction costs which can eradicate distributional effects and impede the privatization process.<sup>56</sup>

Employee ownership has often been criticized because for problems associated with corporate governance. Insiders are feared to exploit their position through excessive wages, redundant employment, under-investment and decapitalization. Some of this criticism lacks relevance, because it refers to the Illyrian literature or Yugoslavian experiment, whereas institutional

<sup>47</sup> See, e.g. Shleifer (1995, p. 98–100).

<sup>48</sup> Estrin (1994, p. 13).

<sup>49</sup> Nuti (1995b, p. 106).

<sup>50</sup> The World Bank (1996, p. 52).

<sup>51</sup> For an overview, see Nuti (1995b).

<sup>52</sup> Lipton and Sachs (1990, p. 309).

<sup>53</sup> Lewandowski and Szomburg (1989, p. 264).

<sup>54</sup> Blanchard *et al.* (1991, p. 38).

<sup>55</sup> See, e.g., Lipton and Sachs (1990); Tirole (1991); Frydman and Rapaczynski (1994).

<sup>56</sup> Weitzman (1991, p. 266); Nuti (1995b, p. 108).

framework in Eastern Europe is clearly different.<sup>57</sup> The criticism of employee ownership is not limited to economists – many reformist politicians and foreign experts have expressed criticism of insider ownership as well. The opposition of foreign advisors has also possibly limited the use of insider ownership in transition economies.<sup>58</sup>

Citizen ownership or employee ownership is sometimes regarded as a transient phenomenon.<sup>59</sup> Eventually, these enterprises will evolve into joint-stock companies having individual citizens or employees as minority shareholders as it is common in Western Europe. Some economists have seen a positive role for employee ownership in easing this transition.<sup>60</sup> Major advantages for insider privatization in comparison with citizen privatization is that it is quick and cheap to organize. Rapid transformation is needed in situations where there is fear that the government may renege on its policies and return to an anti-market stance, or managers and members of the *nomenklatura* start illegally expropriating company assets.<sup>61</sup>

Another argument for employee ownership is political expedience. Enterprise insiders, especially managers, had control rights in enterprises before transformation. A privatization programme which ignores insiders may not be politically feasible. Indeed, insiders have been a considerable role in choosing privatization strategies and organizing it in both Poland and Russia (see section 4). On the other hand, privatization through giving majority of shares to employees can be seen as protecting employees rights in the company against expropriation by managers. Moreover, giving rights to residual revenue is likely to give a correct set of incentives

to that party who already had control rights.<sup>62</sup>

### 3.2 Restructuring

Dittus and Prowse identify two basic situations that call for enterprise restructuring. The first is overcapacity, which is typical in older firms involved in basic industries. This kind of restructuring usually implies downsizing, i.e. capacity cutting and lay-offs. The second restructuring task, which is more typical for young firms in expanding industries, is financing research and development which is capital intense. In transition economies, both types of restructuring are relevant: enterprises can be both too large and need modernization in order to survive. What is important for us is that insiders are seen as a potential hindrance to restructuring in both cases. First type of restructuring is best to be conducted by outsiders with no previous relations with enterprise insiders, so that the owners would be able to carry painful restructuring measures. The second type of restructuring requires venture capitalists who are willing to supply equity capital to the firm and acquire a majority stake in the company.<sup>63</sup> Clearly, firm-specific human capital and limited investment funds are a burden to restructuring for insiders.

Due to uncertainty, employees may block restructuring efforts, even if Pareto improving restructuring would be feasible. If one could be certain who will benefit from privatization and who will lose, employees will choose privatization and restructuring only when the majority benefit from restructuring. Moreover, losers may expect to be compensated from the benefits of restructuring. However, in condition where uncertainty prevails, risk-averse employees will prefer the *status quo*, from which the expected utility to them is greater than restructuring.<sup>64</sup> Another problem is that in the situations where

<sup>57</sup> On the discussion over employee ownership in transition see Uvalic (1995, pp. 15–16).

<sup>58</sup> *Ibid.*, p. 23 n 35.

<sup>59</sup> Chilosi (1996, pp. 78–80).

<sup>60</sup> See Bogetic (1993, p. 464); Chilosi (1996, p. 86–88).

<sup>61</sup> Shleifer (1995, p. 111).

<sup>62</sup> Bogetic (1993, pp. 467–468).

<sup>63</sup> Dittus and Prowse (1996, pp. 37–39).

<sup>64</sup> Aghion, Blanchard and Burgess (1994, pp. 1335–1340); Carlin, van Reenen and Wolfe (1994, p. 29).

Pareto improvements would be possible, compensations could not be agreed upon because of the problems of collective decision-making.<sup>65</sup> This applies to EOE's based on share ownership, and even more so to state enterprises where worker councils are still in effect and decision-making is based on the one man-one vote principle. Fear of suffering in the restructuring process is probably the most important reason for worker opposition to privatization.

The time horizon problem (i.e. that the employees prefer current consumption and wages instead of investments and profit maximization) also applies here. In the transition the market uncertainty is high, and in the presence of uncertainty (especially concerning employment) invariably forces employees to act in their short-term interests. For example, under the threat of bankruptcy, asset stripping may be preferred strategy to restructuring. The negative effects of time horizon problem are diminished by giving the employees the rights to residual returns. An essential point here is property rights. As long property rights are uncertain, employees have little incentive to maximize their future returns. It should be noted that all kind of owners suffer from time horizon problems under market uncertainty and unclear property rights and prefer rapid, speculative capital gains over a far-sighted strategy.<sup>66</sup>

Perhaps the worst problem of EOE's in transition is the lack of capital. When enterprises are sold to insiders, even at discounted prices, the sale will generate a modest pool of savings which may not otherwise be available. Because employees many times do not have lot of capital to invest, employee-buyouts would be advantageous in branches which are less capital intensive. But in more capital intensive industries EOE's face a disadvantage; if they are reluctant to give up their control rights, they must accept a higher price for capital (see section 2.3). If insiders are unwilling to trade their control rights for capital, the firms may be forced to rely on internal financing. Concerning the capital demand side, the owners of the EOE would presumably prefer loan financing, because they could then reap all the upside

gains.<sup>67</sup> But, in transition economies the impossibility to offer collateral constitutes a real problem. In Poland, the EOE's can offer their property as collateral only when they have paid all their leasing payments. Other obstacles are the deficiencies of the banking system in transition economies. The impossibility of getting bank loan forces the firms to rely on internal financing.

Despite all the above drawbacks, there are valid justifications for employee ownership in restructuring. Downsizing generates major social costs as entire plants are closed down. In areas with a single large employer, the plant closing can be socially devastating to many people. Weitzman views employee ownership as an important device to overcome this problem. After employee buy-out and employees become shareholders, they will be amenable to a temporary pay-cut. When the economic situation improves, some employees can then move to better paid job opportunities.<sup>68</sup> This view comes close to the theory of profit-sharing in the view that during a depression, income will adjust rather than employment;<sup>69</sup> but whereas in profit-sharing schemes this outcome is due to organizational arrangements so under in employee share ownership there is no automatic mechanism which would lead to the preference of high level of employment. The Polish experience challenges this view as employment policy in EOE's has been very flexible (see Chapter 4).

Employee ownership may also through greater enterprise stability affect positively to restructuring. Because the human capital of insiders is tied to their continued employment in the firm, and since they have probably invested in some firm-specific knowledge, they would have incentives to maintain the capital stock.<sup>70</sup> This is supposed to contrast with the incentives of outsider investors, which would, after buying the company at discounted prices, profit through arbitrage by liquidating assets. Such fears have generated considerable worker opposition. Most likely, the maintenance of human capital is still a

<sup>65</sup> Earle and Estrin (1995, p. 35).

<sup>66</sup> Uvalic (1995, p. 20).

<sup>67</sup> Baer and Gray (1996, p. 71 ).

<sup>68</sup> Weitzman (1991, p. 62).

<sup>69</sup> Nuti (1992, p. 682).

<sup>70</sup> Bim, Jones and Weisskopf (1994, p. 254).

greater problem with employees than managers due to poor education and bad employment markets.

There are other compelling reasons to make employees partial beneficiaries of the restructuring process, however. One is the avoidance of internal conflicts. Given the high degree of insider power in enterprises and existing institutions of co-determination, employees may seek to halt restructuring efforts initiated by outsiders.<sup>71</sup> Avoidance of such open opposition is probably one of the main reasons insiders were given such an important role in initiating privatization. Also there is the previously mentioned informational advantages insiders enjoy. In the conditions of poor information, insider cooperation is necessary for outsider investors. Employees could be motivated into promoting restructuring by *giving* them minority stake in the company. This has been realized in Poland's mass privatization programme.

### 3.3 Corporate governance and insider shareholding

#### 3.3.1 Profit expropriation and managerial discretion in EOE

The problems of corporate control may be divided into two groups. First, there has to be established shareholder control over managerial discretion. Second, there must be mechanisms to ensure that those who have controlling rights in a company do not use them to harm other shareholders (this problem exists because rights to control and residual returns are not perfectly linear).<sup>72</sup> The first problem can be interpreted as a classic principal-agent problem, while the second is a problem of protecting minority rights. These problems have special implications in transition economies. While it may very well be that the principal-agent problem is in practice more pressing, transitional literature tends to dwell on profit expropriation.

The first necessary condition for profit expropriation is naturally that *insiders exercise the*

*control rights in the enterprise*. The second necessary condition is that their stake in excessive wages and other private benefits from control is higher than their stake in dividends.<sup>73</sup> If the enterprise is 100 % owned by the insiders, ownership claims are equally divided among them and their ownership claims are based on tradable shares, insiders should be indifferent as to the allocation of profits as wages or dividends. Any ownership concentration among insiders would lead them to favour allocation as dividends for one would not be expected that those employees who are shareholders would prefer to allocate profits to wages to the benefit of employees who are not shareholders. The problem of profit expropriation arises when there is substantial, but not majority, outsider ownership in shares, while the claims of insiders, who do hold majority ownership (i.e. the dominant controlling position), are dispersed. Then it may happen that the insiders use their controlling position and allocate profits to wages. Respectively, any concentration of shares among insiders would, in this scheme, ease the problem of profit expropriation. However, we shall see that profit expropriation is a real problem in transition economies, albeit for reasons different than those presented above.

In transition economies, there is a fundamental difference between insider employees and insider managers. Because of deficient monitoring of managerial actions, potential private benefits for managers may substantially overcome their potential security benefits. In the literature of corporate governance, it is assumed that managers tend to empire building (i.e. they prefer to grow firm size rather than shareholder value) and expect personal perks (luxurious offices, company planes, etc.). In the case of transitional economies, we should also add asset stripping.<sup>74</sup> Other private benefits include the utility of power and the social prestige of being a manager.<sup>75</sup> Protection of these benefits leads into the entrenchment of managers if properly working checks and balances of corporate governance are not in place.

<sup>73</sup> *Ibid.*, p.12.

<sup>74</sup> Shleifer and Vasiliev (1994).

<sup>75</sup> Rydqvist (1992, p. 50).

<sup>71</sup> Earle and Estrin (1995, p. 32).

<sup>72</sup> Nuti (1995a, p. 2).

As mentioned, proponents of employee ownership have stressed that in employee-owned companies the agency costs of policing management are potentially lower than in investor-owned firms because the employees have the best opportunities to monitor management and they have the best information about the firm.<sup>76</sup> An interesting case is that under mixed ownership structures the presence of minority employee shareholding also increases information to other shareholders. Employees are naturally willing to hold their shares only in the case that they believe the firm will be successful. If they sell their shares, it can be seen as a signal to other investors that the firm is in trouble. In situations where information is very noisy, this effect is pronounced, and increases economic rationale for co-ownership.<sup>77</sup>

Despite these theoretical advantages, there is doubt that in the early phases of transition employees actually are able to introduce control over managers.<sup>78</sup> Indeed, empirical observations seem to confirm this fear.<sup>79</sup> Workers are generally passive when it comes to monitoring. Thus, it is arguable that the relation between employee-shareholders and management can be considered as a normal principal-agent relationship. We should also remember, though, that the employees are the managers' agents and managers have the power to dismiss workers. Because the voting procedures in shareholders meetings are often open, employees may find it hard to vote against management for fear of being laid off. In Russia, employees often cannot exercise their voting rights, rather a collective uses the employee voting block according to the management's wishes.<sup>80</sup>

While employees do have incentives to monitor the management depends largely on institutional arrangements, the importance of self-management traditions should not be exaggerated.

1980s Poland has often, somewhat erroneously, been considered to be a pioneer in worker self-management because of the existence of worker councils, which, in principle, was a co-determinative body. In practice, though, the main role of these councils was to satisfy the labour collective's social needs such as job security and housing. Worker councils had only minor influence in enterprise's operations and wages (though according to the statute, worker councils should decide on remuneration). Moreover, workers councils were usually not staffed by rank-and-file employees, who generally showed little interest to the institution, but by members of party and party sponsored trade unions.<sup>81</sup> The evidence from Russia and Poland indicates that management style remained paternalistic despite the existence of such worker institutions. (In Russia, codeterminative bodies were almost completely under management control, although they imposed some control over directors and prevented the worst abuses.) Greatest emphasis, perhaps, was placed on keeping good inter-enterprise relations between management and workers.<sup>82</sup> Given this background, it is hardly surprising that workers never gained specific training in corporate governance. On the contrary, inertia in social relations may today keep up the old structures.

If the monitoring over managers is deficient, their behaviour will then be determined according to their own incentives. If managers have a vested interest as shareholders, this will correct their incentives, especially if they have control rights anyway. Yet, majority shareowning by managers is not common even in transitional economies, so we may hypothesize that managerial power is quite independent of the level of their shareholding, at least at the early stage of transition. Estimates of decision-making power in enterprises show that managers tend to dominate irrespective of ownership structure.<sup>83</sup> Thus, giving managers more shares would likely increase their interest in

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<sup>76</sup> Hansmann (1990, p. 1768).

<sup>77</sup> Bogetic (1993, p. 468).

<sup>78</sup> Frydman and Rapaczynski (1994, pp. 145–147).

<sup>79</sup> Blasi (1994, pp. 138–139); Gardawski (1995, p. 68).

<sup>80</sup> Blasi and Shleifer (1995, p. 28).

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<sup>81</sup> Federowicz (1994, pp. 65–74).

<sup>82</sup> Clarke and Kabalina (1994, p. 7); Bim (1996, p. 22–24).

<sup>83</sup> Earle, Estrin and Leshchenko (1995, p. 35–37).

profit maximization.<sup>84</sup> Accepting this, however, means that we abandon the primary goal of enforcing effective mechanisms of corporate governance. Potential private benefits which managers achieve through asset stripping may be so great that they overcome any potential security benefits. This leads, naturally, to a destructive strategy, especially in the case where the future prospects of the firm are poor.<sup>85</sup>

There is a further reason to argue against managerial control. Managerial turnover in transitional economies is generally low. Because managers usually have good connections from earlier period, so they may be better in extracting subsidies from the state, especially if the government officials are same persons than in the socialist era. This perpetuation of soft budget constraints may have harmful long-term effects on macroeconomic and institutional development.<sup>86</sup>

### 3.3.2 Alternatives of corporate governance under insider-dominated transition economies

If employee ownership is really going to be a transient form of ownership, we should think which governance mechanisms would lead to ownership change with the least possible transaction costs, and what are the feasible alternatives of corporate governance. In the theoretical literature, the main alternatives in discussion were German-Japanese system and Anglo-American system. The German-Japanese system relies on the actual presence of one or several holders of sizable blocks of shares, who then seek to exert their voice in the running of the company. The Anglo-American model relies on the potential emergence of a dominant shareholder. Under a well-functioning secondary market for shares, the threat of take-over is generally sufficient to discipline the management team.<sup>87</sup>

In the Anglo-American governance system, the stock market controls the management. The value of poorly managed companies is lower, and the shareholders either sell their shares ("exit") or dismiss incompetent management ("voice"). Stock markets provide feedback on managerial actions and allow the possibility of takeovers. However, the applicability of this device of control is extremely limited. First, market information must meet very high quality requirements. When information is noisy, it is impossible to filter out distinctions such as whether the changes in firm's value are due to management actions or shocks in the market. Second, the possibility of takeovers requires liquid stock markets, where potential raiders are able to identify possible sellers with low cost. Obviously, control of management can be left to the stock market only in highly developed market economies.<sup>88</sup>

By contrast, the very presence of insider ownership hinders the development of the secondary markets for enterprise shares in transition economies. When insider owners are reluctant to sell their shares, the market for shares does not evolve. This is a serious obstacle to the emergence of an Anglo-American system. On the other hand, a common historical observation is that stock markets emerge at the last stage of financial development, so for transition economies the underdevelopment of these markets at present should not be worrisome.<sup>89</sup>

Illiquidity of shares makes the reliance on the Anglo-American system virtually impossible. In the transition phase, governance mechanisms such as competitive product and factor markets, board of directors and bankruptcy procedures will work imperfectly until appropriate market institutions develop.<sup>90</sup> Therefore, it seems that the only reachable alternative in the short run may be the German-Japanese system, whereby a few large blockholders closely monitor management. Whether appropriate blockholders are banks, other financial institutions, commercial enterprises or some other institution, is beyond the scope of this discussion.

<sup>84</sup> Nuti (1995a, p. 13)

<sup>85</sup> Bim (1996, pp. 13–14).

<sup>86</sup> Earle and Estrin (1995, p. 37).

<sup>87</sup> Nuti (1995a, p. 7).

<sup>88</sup> For a detailed discussion, see Milgrom and Roberts (1990) and Tirole (1991).

<sup>89</sup> Weitzman (1991, p. 257); Perotti (1994, p. 55).

<sup>90</sup> See Tirole (1991) and Phelps *et al.* (1993).

One interesting scheme deserves mention, however, because it is an attempt to solve the dilemma of external financing and insider control rights discussed in section 2.3. Aoki proposes a scheme whereby external financing to enterprises would be provided by banks. In every firm the lead bank would be holding a small equity stake for the sake of better information (say, 5 % of the stock). Control in the enterprise would remain with insiders as long as the enterprise is able to service its debt. When the enterprise can no longer meet its obligations, control rights revert to the bank. The bank would then either write off the debt, convert it to equity, and auction the equity; or, alternatively, start liquidation procedures.<sup>91</sup> In this system there is both a carrot and a stick. As long as EOE's are able to service their debt, control rights remain with them, and they also keep all upside gains. When the firm gets into trouble, control rights are removed. The problem in transition economies is that banks themselves may be unwilling to perform such a role, since they lack the skills to act as monitors.<sup>92</sup> If the banks do not voluntarily take such a role, it could be expected that forcing such a system may create artificial transaction costs.

### 3.4 Summary

The general opposition to reform expressed by politicians and economic advisors in the early stages of transition led to a general ignorance of the potential positive effects of employee ownership in transition. Such effects include rapid privatization with low costs and minimization of worker resistance. Given that insider privatization plays an important role in most transition economies, institutions of employee ownership need to be better designed to recognize the power of insiders from the start. Such institutions would facilitate free tradability of shares and give minority owners guarantees against discrimination. For instance, some employee stock could be non-voting.

The drawbacks to insider-owned firms

originate from identifiable sources, i.e.:

Insider human capital is partly firm-specific which makes insider owners more reluctant to downsize than other owners.

- Insider-owned firms have relative disadvantage in capital markets because of their unwillingness to trade away control rights.

Conversely, employee ownership also offers potential benefits in the restructuring process. By reducing excessive downsizing, it promotes enterprise stability and may lessen social costs of transformation. This justifies the idea of making insiders beneficiaries of enterprise transformation, e.g. by giving them free shares.

In corporate governance, the most pressing issue is to prevent managerial opportunism. The drawbacks of managerial control are asset stripping and rent seeking. Experience has shown employees to be generally passive in enterprise monitoring. Because management monitoring is best conducted by shareholders, this gives justification for outsider ownership. There are compelling arguments that corporate governance development will go into the direction of the German-Japanese system whereby one or several large blockholders take control of enterprises. These might be financial institutions such as banks or investment funds, or commercial enterprises. To minimize transaction costs, free tradability of shares is essential here also.

## 4 Employee ownership in Poland and Russia

### 4.1 Poland

#### 4.1.1 A brief history of Polish privatization

At the beginning of the 1990s, Polish enterprises began to move from the social to the private domain. Privatization was recognized from the start as an essential part of transition to a market economy. Initially, Polish policymakers put heavy emphasis into public offerings and trade sales. Public offerings, of course, require a functioning secondary market for corporate shares. The

<sup>91</sup> Aoki (1995, pp. 15–17).

<sup>92</sup> Dittus and Prowse (1996).

institutional framework for stock markets was created by reopening the Warsaw Stock Exchange in April 1991. The first five state enterprises privatized in Poland were sold through public offerings at the end of 1990. This approach proved to be expensive and time-consuming. The valuation of companies was difficult as none of the firms had a record of performance in the market economy, and public interest was lower than anticipated by the issuers. The government soon rejected this alternative as a major form of privatization.<sup>93</sup>

Privatization through trade sales met with better success. Under Polish law, trade sales may be prosecuted through tender, public auction or negotiated private placement. In practice, privatization through tender has been unused. Most often the buyer is a foreign private company (or companies), who acquires the majority stake in the company. Such investors want ready access to the controlling stake. However, it must be stressed that public offers and trade sales (these methods have been commonly referred as capital privatization) are only viable for large companies in good financial condition. For smaller companies, this method is simply too costly. This method has been consistently favoured by the government because it gives firms a strong owner and budget revenues for the state. As of the end of 1995 there were 159 enterprises privatized through capital privatization. Of these, 23 were privatized through public offerings, 3 through management-employee buy-outs and 133 sold to active investors. In 73 cases of last 133 cases, the largest investor in the enterprise was a foreign company.<sup>94</sup>

In terms of numbers, privatization through liquidation has been most successful. In Poland, there are two ways to privatize state enterprises through liquidation. These methods are commonly referred to as direct privatization. The first method is based on the 1981 Law on State Enterprises (with later alterations), and is intended for companies in bad financial standing. The assets of the enterprise are sold or contributed to a successor company. Another way to privatize

through liquidation is based on Article 37 of Poland's Privatization Law, which is meant mainly for companies in good financial condition. The assets of the enterprise are sold, contributed or leased to private company(s). From these, leasing has been the most popular method.<sup>95</sup> Of the 1,039 enterprises privatized through Article 37 liquidation, 748 was privatized using leasing or tenancy arrangements.<sup>96</sup> Recently, the Government has tried to restrict direct privatization. For example, the latest law proposal from summer 1995 states that enterprises employing more than 500 employees are not eligible for direct privatization.<sup>97</sup>

The conditions of leasing are that the lease must be made to a company in which more than half of the employees of the former state enterprise are shareholders, and the new company must be capitalized at least to the extent of 20 % of the estimated value of liquidated enterprise before the lease takes effect. Leasing contracts are for a period of 5–10 years, and after all payments have been made, ownership rights will be transferred to the new company.<sup>98</sup> Average employment in enterprises privatized through leasing was in December 1991 at 285, falling to 209 by mid-1994 due to large scale lay-offs.<sup>99</sup>

In autumn 1995, the Mass Privatization

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<sup>95</sup> On the basis of the leasing arrangement, the state still owns the assets the enterprise leases, and the ownership rights are (in most cases) transferred at the end of the contract. Control rights are, however, transferred to the lessee at the very beginning, and that is why leasing can be treated as a form of privatization. See Gomulka and Jasinski (1994, p. 225 n 21).

<sup>96</sup> GUS (1996, p. 32).

<sup>97</sup> Ustawa (1995, art. 39). In the same article is though stated that with the allowance of the Council of Ministers an enterprise which do not fulfil these conditions may still be privatized through direct privatization.

<sup>98</sup> There are also tenancy arrangements which do not automatically lead to the transfer of ownership rights. However, these arrangements are rarely used in comparison to leasing arrangements. See Frydman, Rapaczynski, Earle *et al.* (1993a, pp. 188–190).

<sup>99</sup> Bukowski (1995).

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<sup>93</sup> Frydman, Rapaczynski, Earle *et al.* (1993a, pp. 183–185); Gomulka and Jasinski (1994, pp. 221–225).

<sup>94</sup> GUS (1996, p. 34).

Programme was introduced (henceforth referred as MPP).<sup>100</sup> This programme is based on 15 investment funds, which hold the shares of slightly more than 500 Polish enterprises. The ownership of these enterprises is dispersed among these funds in such a way that every fund holds 33 % of the shares in 34 firms and the rest of the shares are dispersed among other funds, the state and the employees in these enterprises. Later the companies will be sold to investors and they will be listed on the Warsaw Stock Exchange. The citizens, in turn, hold the share certificates of the investment funds. These certificates are immediately tradable, and they will be later convertible into corporate shares.<sup>101</sup>

Before a firm is included into the MPP or sold to investors, it is first to be corporatized. Corporatization, in this sense, means that the firm is transformed into a joint-stock company owned by the State Treasury. Corporatization has been understood as an intermediate step to privatization. Since 1994 the policy of the Government has been to introduce corporatization for all remaining state enterprises. In summer 1995 the Parliament accepted a law proposal for changing the corporatization procedures. However, the law was later deemed by the Constitutional Court as unconstitutional.<sup>102</sup>

The slow pace of Polish privatization has been widely recognized. Of the 8,441 state enterprises included in the privatization process in 1990, 5,208 were transformed or were in the transformation process at the end of 1995. Of these, only 159 were privatized through capital privatization, which represents the "real privatization". 1,039 companies were privatized according to Article 37, and 49 companies were in this process. Of 1,379 companies undergoing liquidation proceedings, only 383 had finished the process. 916 companies more were transformed in state-owned joint-stock companies, of which 508

were included into the MPP. Finally, 1,654 agricultural companies were transferred into the ownership of a state treasury agency.<sup>103</sup> These numbers clearly indicate that the Polish privatization has still a long way to go.

#### 4.1.2 The Role of employees in Polish privatization

Employee participation in Poland has its roots in the socialist era, especially in the 1980s. One of the aims of the Solidarity trade union was to improve working conditions in state enterprises. From its initiative was introduced employee self-governance in the 1981 law on state enterprises. The law introduced a co-determinative body – an employee council to be elected by the employees. The employee council supervised the directors and had the authority to hire and fire them, to approve production plans, and had many other important functions. In reality, their influence was rather limited. The directors continued to dominate the decision-making with the support of middle-level management.<sup>104</sup>

Since the change into the market system, the position of worker councils changed rapidly. They now had decision-making power in issues which earlier had little influence. One of the most important reason for managers to initiate corporatization or direct privatization was to be released from the hierarchical subordination of the employees.<sup>105</sup> In the privatized companies, employee councils were liquidated. To smooth tensions associated with the ownership change, considerable concessions were made in the favour of the employees. The employee's position in the process was strengthened by the requirement that privatization takes place only if a majority of employees agrees. They also were granted certain other advantages. In capital privatization, they have the opportunity to buy company shares up to 20 % of the total at a 50 % discount after the enterprise is privatized. In capital privatization, the employees often maintained their

<sup>100</sup> A programme for mass privatization was approved by the Polish Government in 1991 and the law concerning mass privatization in 1993, but its implementation was constantly delayed.

<sup>101</sup> Ministry of Privatization (1995).

<sup>102</sup> Corporatization is discussed more in detail in Kalmi (1995, pp. 49–50, 61).

<sup>103</sup> All figures from GUS (1996, p. 30).

<sup>104</sup> Federowicz (1994).

<sup>105</sup> Szostkiewicz (1994, p. 74).

representation in new corporate boards, although there was no more legal obligations for this.<sup>106</sup> On the other hand, there is evidence that the employees are selling their shares fast to other owners of the firm, to outside investors and to management.<sup>107</sup> In companies included in the MPP, the employees got 15 % of the companies' shares for free.

In a significant scale, employee ownership took place in leasing privatization and in small privatization (restaurants, retail stores etc.), but in some extent also in privatization in the agriculture and in some enterprises undergoing liquidation proceedings.<sup>108</sup> However, this section will focus on leasing privatization only. In the following, we consider the liquidation process and leasing payments.

The initiation of the transformation process requires the approval of managers, employees, and the state representatives (Ministry of Privatization and founding body).<sup>109</sup> Usually the initiators were managers and employees.<sup>110</sup> After the initiation and the approval of the employees, valuation and other preparatory methods are taken, and the approval of Ministry of Privatization is required. After that, the state enterprise will be liquidated, and its assets will be leased to the successor company, formed by the employees.<sup>111</sup>

By restricting the right to use the real estate, the Ministry of Privatization wanted initially to guarantee that the firms do not liquidate their assets. The impossibility to use real estate as collateral, is together with leasing payments the greatest difficulty these firms face today. According to the leasing contract, the lessee pays according to the value of leased assets divided by

the length of the agreement plus interest on the unpaid portion of leased capital. The interest rate is determined to be three quarters of the refinancing rate of the National Bank of Poland (or 30 %, whichever is lower). In 1993, the requirements of leasing payments were eased. The decree from May 1993 offered the possibilities to partial release or delay of leasing payments, with the condition that at least 50 % of the net profit is used for financing the real estate.<sup>112</sup> Since 1993 there has been attempts to introduce other liberalizing measures. In the Pact of State Enterprises from 1993 (which did not pass in the parliament) it was proposed that the firms would get complete ownership rights to the real estate after paying 30 % of the leasing payments and the interest rate would be lowered to 50 % of the refinancing rate.<sup>113</sup> This would have allowed the firms to use the real estate for collateral. The issue was repeated in the 1995 law bill, which was deemed unconstitutional by the constitutional court.

The employees in nearly all cases financed the initial capital mainly from their own savings. Sometimes enterprises obtained additional funds from their profits or from the enterprise's housing fund, created in the communist period. Bank credits were rarely used, due to high interest rates.<sup>114</sup> The valuation of enterprise assets is quite complicated process, which last from few months to even more than a year. In some cases, the assets were clearly undervalued, whereas in some other cases the assets were valued too high. Some companies would be able to pay their leasing payments in a less time than a year; on the other hand, approximately 40 % of the companies have difficulties to pay their leasing payments in time.<sup>115</sup> The reason the government has tolerated the fact that these firms are not serving their leasing payments is that they would otherwise degenerate into state ownership, and their liquidation would generate additional costs for the government.

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<sup>106</sup> Szomburg, Dabrowski and Kaminski (1994, p. 27).

<sup>107</sup> Landowska (1995).

<sup>108</sup> Woodward (1996, p. 27).

<sup>109</sup> Founding body here means the state organ overseeing the enterprise, usually a ministry or *voivodship* (i.e. administrative district).

<sup>110</sup> Szostkiewicz (1994, p. 73).

<sup>111</sup> Frydman, Rapaczynski, Earle *et al.* (1993a, pp. 188–190).

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<sup>112</sup> Teluk and Wojnowicz (1995, p. 2).

<sup>113</sup> Baczowski (1995, p. 134).

<sup>114</sup> Gardawski (1994, p. 95).

<sup>115</sup> Szomburg (1996, p.12).

#### 4.1.3 Economic performance of EOE's

Before assessing the performance of Polish EOE's, a brief characterization of their environment is needed. At the beginning of the 1990s, Poland went into a sharp and short recession. By the beginning of 1992, its GDP had dropped 14 % and industrial production 27 % compared to the situation two years earlier.<sup>116</sup> Since 1992 both GDP and industrial production have been constantly growing, and in the end of 1995 the GDP is about the same level as in 1989 and industrial net production has reached the level of 1990.<sup>117</sup> At the same time, there have been structural changes in the composition of GDP and industrial production. Rapid changes in market structure cause noise in transition, i.e. today's winners may be tomorrow's losers. A good example are employee-owned construction firms, which in the 1993 were among the best enterprises of EOE's, but in 1995 have fallen into the worst-former category.<sup>118</sup>

In general, the profitability indices of Polish EOE's are close to those enterprises privatized through capital privatization or those included in the MPP, and much better than those of state enterprises.<sup>119</sup> This probably should not be interpreted as a factor following from the ownership arrangements. Into the leasing privatization was included only firms with good financial standing. However, there are significant differences among enterprises according to their size and branch. The best results achieved enterprises in industry, services and enterprises employing more than 300 employees. The worst results were in small enterprises employing less than 100 employees and in trade and in construction firms. This is somehow paradoxical, because this method of privatization was originally intended especially for trade companies and small enterprises. The reason for bad

performance for these companies is that these companies face a more competitive market than firms in industry.<sup>120</sup>

EOEs seem to have adopted various devices to cut down costs. Interestingly, the employment policies of EOE's have been very flexible. Between 1990 and 1993, these enterprises reduced their workforce approximately by a quarter.<sup>121</sup> This seems to undermine the fears expressed by some economists that employee ownership would lead to excessive labour hoarding. This may also suggest that when the firms are forced to reduce costs in a competitive market, then in a short term lay-offs are easier to execute than modernization or introduction of new technology. It should also be remembered that labour reductions are part of reorganization of enterprises into a market environment. Even state-owned enterprises reduced their work force significantly in the beginning of the market reforms.<sup>122</sup>

According to Pietrewicz, there is a clear positive relation between the pace of the employment decrease and the growth of nominal earnings. However, when EOE's were compared with the entire economy there was no significant differences in the dynamics of earnings growth.<sup>123</sup> In the EOE's there was at least until 1994 a constant increase of pay to total costs ratio. This may be explained by the lower elasticity in respect to employment and wages than in production in reaction to short run shocks.<sup>124</sup>

These firms face further problems when it comes to investment and restructuring. Excluded from outside investors and often of bank loans as well, these firm have to finance their investments from their retained earnings. The reasons for not financing through bank loans are high interest rates and the impossibility to use the real estate as collateral. In addition, these enterprises are deeply

<sup>116</sup> Christofides (1994, p. 58).

<sup>117</sup> Planecon, June 6th 1996.

<sup>118</sup> Pietrewicz (1994, p. 36) and Szomburg (1996, pp. 15–16).

<sup>119</sup> Woodward (1996, p. 29).

<sup>120</sup> Szomburg (1996, pp. 14–17); Pietrewicz (1995, pp. 24–25).

<sup>121</sup> Szomburg, Dabrowski and Kaminski (1994, p. 85); Pietrewicz (1995, p. 27–33).

<sup>122</sup> Dabrowski *et al.* (1992, p. 27).

<sup>123</sup> Pietrewicz (1994, p. 36–37).

<sup>124</sup> *Ibid.*, p. 29; Dabrowski *et al.* (1993, p. 36).

indebted because of the leasing arrangements. Usually the enterprises use bank loans as a last resort; only the enterprises with financial difficulties are taking bank loans. Recently, the situation seems to have changed somehow: due to improved profitability the firms in industry have raised their investment significantly.<sup>125</sup>

The leasing payments constitute a big financial burden for EOE. The decree from May 1993 somehow eased the difficulties of these firms, but the biggest threat to these companies still seems to be decapitalization and under-investment. The firms sell parts of their real estate to reduce the leasing payments. The sales revenues go to the state budget, because the firms do not have ownership rights to the real estate. This decapitalization indicates a short time horizon of the enterprises.<sup>126</sup>

#### 4.1.4 Ownership change in EOE

When we consider ownership change in insider-owned companies, we should separate two different cases: first, the concentration (or dispersion) of shares among the insiders, and second, the concentration of shares to outside investors. It should be remembered that from the beginning there emerged more or less dispersed ownership structures. Either the shares were quite equally divided among all employees, or then there was considerable concentration to some insiders, especially to managers. The structures also have changed in the process after privatization. According to one survey, at the end of the 1991, 90 % of the employees in these enterprises owned shares. In June 1994, the percentage of employee-shareholders had dropped to 72 %.<sup>127</sup> Although these figures do not tell us how the number of shares were divided among the employees, they still indicate a high dispersion of shares. It should be noted that the drop of the percentage of employee-shareholders were due to

lay-offs, not that the employees would have sold their shares in large numbers.

According to a survey by the Jarosz team with 200 enterprises, the shares are slowly concentrating in the hands of managers and the members of the board of directors. When these groups had in the time of the formation of the company in average 22 % of the shares, by mid-1995 they had 30 % of the shares.<sup>128</sup> The speed of the concentration is still quite slow, suggesting that the management has other means to control the company than through shareholding. A recent study shows that not only the management but also the administration workers are buying shares, especially in big companies in industry.<sup>129</sup> An interesting phenomenon is that the ownership structure is more dispersed in companies with good economic performance.<sup>130</sup> This may suggest that employees are more willing to hold their shares in better companies.

What it comes to outside investors, the far most numerous group of "outsiders" is made up of retired or dismissed employees of the EOE. It seems from the data that the employees are willing to hold their shares even after they have been dismissed.<sup>131</sup> This may, inter alia, suggest to a generous dividend policy. The appearance of real outsider investors has been rather limited. Gardawski reports that the appearance of the outside investors who are legal persons is "insignificant".<sup>132</sup> However, in an earlier survey by the same research team with 102 enterprises, Pietrewicz reported that there was seven enterprises in which there was outside investors who were legal persons and apparently owned a

<sup>125</sup> Szomburg, Dabrowski and Kaminski (1994, p. 60); Szomburg (1996, p. 22).

<sup>126</sup> Szomburg, Dabrowski and Kaminski. (1994, p. 57); Pietrewicz and Hedba (1996, p. 76).

<sup>127</sup> Gardawski (1995, p. 68).

<sup>128</sup> Gardawski (1996, p. 137).

<sup>129</sup> *Ibid.*, p. 138–139.

<sup>130</sup> Szomburg (1996, p. 30).

<sup>131</sup> Gardawski (1995, p. 67). Gardawski reports that in mid-1994, 16 % of the shares were owned by the outsider investors, who were individuals. Although he does not explicitly state that these are former employees, it is hard to imagine who else they could be (at least most of them are probably former employees). I owe this remark to Richard Woodward.

<sup>132</sup> Gardawski (1996, p. 134).

significant portion of shares in these enterprises.<sup>133</sup> An average of all enterprises in this survey, the outsiders who were legal persons owned 2.3 % of the shares.<sup>134</sup> This suggests that the outsider involvement was limited to few companies, whereas in other companies there was no real outside investors.

The limited appearance of outsider investor is to be explained by the various restrictions, by which the insiders prevent the rotation of shares to outsiders. Such are the employees' or shareholders' right to share buy-backs or the necessity to gain the acceptance of the management or the board of directors to buy the shares.<sup>135</sup> These restrictions are evidently designed to rule outsider takeovers. When shares are sold to outsiders, many times it indicates a last ditch effort to save the company from bankruptcy.<sup>136</sup>

The representation of management, employees and outsiders in boards of directors has been quite equally divided. Each group is having approximately one-third of the seats in the board (employees slightly less).<sup>137</sup> Empirical studies verify that the decision-making power in these enterprises is strongly concentrated to managers, and the influence of the board of directors or individual shareholders is limited.<sup>138</sup> This is hardly surprising or different from the practice of other countries, but it may be a disappointing fact for the supporters of industrial democracy. Still, it is worth paying attention to the fact that in many companies also the better-off employees are buying the shares, and the internal conflicts are significantly smaller in EOE than in other kinds of companies.<sup>139</sup>

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<sup>133</sup> Pietrewicz (1995, p. 16).

<sup>134</sup> Gardawski (1995, p. 67).

<sup>135</sup> Gardawski (1996, p. 138).

<sup>136</sup> Dabrowski *et al.* (1993, p. 44), Szomburg, Dabrowski and Kaminski (1994, p. 68).

<sup>137</sup> Gardawski (1995, p. 67).

<sup>138</sup> Szomburg, Dabrowski and Kaminski (1994, p. 68), Gardawski (1996, pp. 139–141).

<sup>139</sup> Gardawski (1996, pp. 144–145).

## 4.2 Russia

### 4.2.1 A brief history of Russian privatization

The first attempts to privatize state property in Russia were made already in the time of Gorbachev regime. Some reform proposals, like the famous 500 Days Program, were submitted in the beginning of the 1990s, but none of them was really ever tried in practice. More significance had the legislation in the Russian federal level. In June 1991 was adopted the Privatization Law in the Russian Federation, which has been the basis for the further legislation concerning privatization in Russia. Complementary legislation, which created the framework for Russian privatization, was done in 1991–1992. Most important of this legislation was the State Programme for Privatization from 11th June 1992. It introduced the Mass Privatization Programme (henceforth referred as MPP), which made possible the rapid transformation of the bulk of Russian enterprises.<sup>140</sup>

According to this legislation, the state property was parcelled out among municipal, regional or federal authorities. Most small-scale enterprises were privatized by local property committees. These were sold by tender or at auction, targeted mainly for local entrepreneurs or enterprise insiders. Most medium- and large-scale enterprises owned by regional and federal authorities were included under the MPP. For approximately 5,000 large enterprises privatization was mandatory.<sup>141</sup> For nearly 20,000 medium-scale enterprises, joining to the program was optional. For some enterprises the approval of State Property Committee (*Goskomimushchestvo*) was required; for others privatization was categorically forbidden.<sup>142</sup>

All the enterprises which took part in the MPP were to be corporatized, i.e. transformed into joint-stock companies with a legal identity. After

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<sup>140</sup> Frydman, Rapaczynski, Earle *et al.* (1993b, pp. 48–51).

<sup>141</sup> A large enterprise was defined as one which employs more than 1,000 employees or whose book value exceeded RUR 50 million as of January 1, 1992.

<sup>142</sup> Lieberman and Rajuha (1994, pp. 10–12).

corporatization, the enterprise ceased to be under the authority of sectoral ministry. Before corporatization each enterprise had to prepare privatization plan, asset valuation and corporate charter. These tasks were performed by privatization commission, nominated by the chief executive of the enterprise and dominated by insiders. This gave tremendous power to insiders, especially to managers. The asset valuation was done by this privatization commission. Because insiders had the right to buy enterprise shares in closed subscriptions, it was clear that they had the incentives to underestimate asset values. The asset valuation was based on 1992 book values and it has been frozen ever since, without any inflationary corrections. Under Russia's high inflation conditions, it is clear that the prices insiders paid for corporate shares were far lower than the real value of the shares.<sup>143</sup>

In the MPP, the shares of the enterprises were to be distributed in three rounds. In the first round, the insiders were entitled to acquire shares in closed subscriptions according to the option they chose (see below). In the second round, investors were to purchase enterprise shares at market prices, as determined in auctions. Typically 29 % of the shares were reserved for the second round. Shares were sold for vouchers and cash in auctions. The auctions were conducted by local governments under the supervision of the State Property Committee. At least 20 % of the shares were reserved for the third round, where the remaining shares were to be sold by cash only.<sup>144</sup>

Privatization vouchers were distributed to the public between October 1992 and February 1993. Voucher auctions were conducted until June 1994. Every Russian citizen was entitled to purchase voucher for 25 rubles, which means that they were almost given away. Vouchers were used as payments for corporate shares. Vouchers were also freely transferable. A special institution emerged in the voucher markets - the voucher fund. Citizens were allowed to exchange their vouchers for shares in voucher funds. In the thought of Russian reformers vouchers were the main tool, through which state property should be

turned into citizens' property.<sup>145</sup> Because the resulting distribution was heavily biased towards insiders who effectively blocked outsider influence in most cases, the resulting outcome was not as egalitarian as earlier thought.

The realization of Russian MPP reflects not only the thoughts of Russian reformers, but the power of various interest groups involved. In the political level, there was a fight in 1992–1993 between reformers, headed by President Yeltsin, and the conservative parliament. While the reformers certainly opposed strong insider control, some gradual reformers and conservatives supported it, as did the Speaker of the Russian Parliament, Ruslan Khasbulatov. The 1992 government programme was a compromise between these views. The Parliament continued its support for insider ownership and in 1993 proposed a scheme, whereby 90 % of the shares would have been purchased by insiders at prices not adjusted to inflation. Since the dissolution of the Parliament in September 1993, there have been no further serious attempts to change the process to make it more insider-oriented.<sup>146</sup>

The dominance of enterprise's privatization commission and preferential access to shares were concessions made to insiders, but other players got their share as well. Local governments, which were very powerful and enjoyed considerable independence from the Moscow Government were given extensive autonomy in executing privatization and a share of privatization revenues. Central ministries got a special concession when some enterprises were declared strategic, and thus excluded from privatization.<sup>147</sup>

The most consistent strategy of the reformers was to depoliticize enterprises and drive them rapidly through the voucher programme.<sup>148</sup> In the latter aim they clearly succeeded. When the voucher programme ended in the end of June 1994, over 100,000 enterprises were privatized, with approximately 18,000 of them transformed in

<sup>143</sup> *Ibid.*, p. 13.

<sup>144</sup> *Ibid.*

<sup>145</sup> Boycko, Shleifer and Vishny (1995, pp. 81–85).

<sup>146</sup> Bim, Jones and Weisskopf (1994, pp. 262–264); Blasi (1994, p. 129); Sutela (1994, p. 12).

<sup>147</sup> OECD (1995, p. 68).

<sup>148</sup> Boycko, Shleifer and Vishny (1995, pp. 9–14).

joint-stock companies.<sup>149</sup> Separating enterprises from state control has forced managers to shift their emphasis from bargaining for subsidies to market-oriented strategies. The downside is that the government has either kept controlling interest or a "golden share"<sup>150</sup> in hundreds of quasi-privatized joint-stock companies. The state still kept controlling interest in 330 joint-stock companies privatized in 1995, i.e. 33 % of the total number privatized that year. In 1992–1994 the state kept controlling interest in only 8 % of the companies (i.e. 1,976 companies).<sup>151</sup> In other words, either more of the firms privatized in 1995 were considered strategic by the state, or there has been a change in the attitudes of the government. Perhaps both explanations are correct to some extent.

The demise of branch ministries has been partially offset by the rise of financial-industrial groups, which are collusions of enterprises acting in the same branch. These groups are usually headed by enterprise directors and former *nomenklatura* members, and they have been created both spontaneously and government-organized since the legislation on them was approved in December 1993. These groups form a powerful lobby for state subsidies, especially because they can (with good reason) claim to be too large to let go bankrupt.<sup>152</sup>

After June 1994, the tempo of privatization slowed significantly. It was due to the expiration of the voucher programme. After that, the enterprise shares were sold for cash. This has in practice excluded citizens from further privatization. In cash auctions have participated mostly legal persons and, significantly, enterprise managers.<sup>153</sup>

The State Property Committee published in April 1995 a list of more than 7,000 enterprises to

be privatized. These enterprises were previously excluded from the MPP programme. But the sale of these companies proceeded slowly: less than 150 of these came to sale in autumn 1995.<sup>154</sup> Another important phenomenon in Russian privatization was that the government took a loan from some major Russian banks using shares of some corporatized companies as collateral. With this loan it was originally intended to cover budget revenues from privatization, which were in 1995 lower than expected. Due to the juridical and technical problems, the income from this approach proved to be lower than expected.<sup>155</sup>

#### 4.2.2 The Role of employees in Russian privatization

Part of the Russian economic reform under Gorbachev was the attempt to reorganize enterprise management. In the 1987 Soviet Law of State Enterprises, the role of the sectoral ministries were reduced. Employees were given a considerable amount of power. The employees had, for instance, the authority to elect the enterprise manager. In practice, the real power in the enterprises was concentrated to the managers. The industrial lobby, which became a powerful player in the Russian privatization in the early 1990s, originated in this period.<sup>156</sup>

At the end of the 1980s, business organizations other than state enterprises were established. The Law on Cooperatives from 1988 and the Decree on Lease Enterprises from 1989 allowed the establishment of such organizations, and they became popular in the last years of Soviet rule. Cooperatives and leaseholds were usually subunits of state enterprises. Leasing contracts usually contained a redemption provision which allowed the lessee to purchase the property at the end or during the leasing period. Leaseholds were among first privatized units in Russia in 1991, when the leaseholders used the option to buy leased enterprises at book value,

<sup>149</sup> Moscow News 8.–14.7.1994.

<sup>150</sup> The golden share entitles the state the right of veto in important strategic issues up to three years after privatization.

<sup>151</sup> Radygin (1996c, p. 7).

<sup>152</sup> OECD (1995, p. 94–95).

<sup>153</sup> Radygin (1996c, p. 9)

<sup>154</sup> *Ibid.*, p. 8.

<sup>155</sup> Bank of Finland 1.12.1995.

<sup>156</sup> Frydman, Rapaczynski, Earle *et al.* (1993b, p. 19); Lieberman and Rajuha (1994, p.8).

which were arbitrarily low.<sup>157</sup>

Due to their significant power in enterprises, managers and employees could not be omitted in the privatization process. Therefore, insiders gained privileged access to the shares of privatized enterprises. Before corporatization, the worker council and the managers had to choose from three options, according to which the insiders were entitled to buy shares. In the first option, insiders were given 25 % of the shares in the form of preferred, non-voting stock. They were also able to buy 10 % more with full voting rights, at a 30 % discount. Management had the option buy 5 % more at book value. In the second option, insiders were entitled to buy 51 % of the shares 1.7 times book value. The third option was rarely used. In numbers of privatized enterprises the second option was most popular; however, more total capital was held by those enterprises which chose the first variant.<sup>158</sup> During the voucher programme, which ended in summer 1994, 70 % of the enterprises chose the second variant. In 1995 only 48 % chose this variant.<sup>159</sup> All this suggests that in larger companies the insiders were unable to buy the shares using the second variant, and they had to adopt the first one, where the privileges for the insiders were smaller. This applies especially to 1995, when the insiders had to pay with cash instead of vouchers.

The insiders usually completed their holdings in voucher auctions and they usually succeeded in getting the majority of shares. Moreover, in many cases it was not necessary for them to acquire the majority of shares to gain voting control. Because the stock which the local property funds were holding carried voting rights only up to 20 % which otherwise was non-voting, a sizable minority holding was sufficient for insiders to gain control. In addition, employees could subscribe up to 5 % of shares after the voucher auctions using employees' share funds (FARP).<sup>160</sup>

The Russian approach towards employee ownership could be described as pragmatic. The head of the State Property Committee, Anatoli Chubais, openly resisted give-aways to employees.<sup>161</sup> The aim of Russian privatization policies was not to promote employee ownership as such but to use it as a mean to further ownership change. The priority was given to rapid transformation, and employee ownership was used because of the reasons of political necessity. By creating secondary markets for shares, it was hoped that the employees would sell their shares to outsiders.<sup>162</sup>

#### 4.2.3 Patterns of ownership

Enterprises taken into mass privatization are, in principle, organized as open joint-stock companies. In practice, openness is far from reality. The strategy of insiders was to get majority holding in their companies. Once this is achieved, insiders have been reluctant to give up their positions. Insiders usually got the majority holding independently of which variant was chosen.<sup>163</sup> After the original distribution of property rights, there has occurred some changes in ownership patterns. Among insiders, there has been share trade from rank-and-file employees to managers and upper level employees.<sup>164</sup> This is clearly consistent with the theory - the poorest employees sell their shares in discounted prices, whereas managers and top employees, whose wealth constraint is not so binding and who have a clear interest in managing the company, concentrate shares. In the second half of the 1994 there was a rapid concentration of shares into the hands of outsider owners, whose average stake in companies rose to 30 % by the end of 1994 from around 20 % at the beginning of the year. By the end of 1994, there was no state ownership in the majority of enterprises in Blasi's and Shleifer's

<sup>157</sup> Frydman, Rapaczynski, Earle *et al.* (1993b, pp. 20–22, 26–27); Lieberman and Rajuha (1994, pp. 8–9).

<sup>158</sup> Radygin (1996a, p. 6).

<sup>159</sup> Goskomstat (1996, p. 125).

<sup>160</sup> Lieberman and Rajuha (1994, p. 14).

<sup>161</sup> Sutela (1994, p. 9).

<sup>162</sup> Shleifer and Vasiliev (1994).

<sup>163</sup> Blasi (1994, p. 127).

<sup>164</sup> Blasi and Shleifer (1995, pp. 19–20); Radygin (1996a, p. 10).

survey.<sup>165</sup> According to the statistics of the State Property Committee, the same trend continued in the first half of 1995. In relation to authorized capital, large outsider shareholders considerably increased their stake until June 1995. They bought the shares from state, which reduced its holdings significantly, and from employees. In managerial ownership there was a slight increase, and small investors holdings stayed constant.<sup>166</sup> According to further studies by Blasi and Shleifer, a reverse trend occurred in the second half of the 1995. For the first time since the beginning of the transformation, insider ownership grew relative to the outsider ownership. This is due to growing concentration of shares in the hands of management. At the end of 1995, 5 % of the enterprises in their survey managers owned majority stake. Outsider ownership is on average around 30 %. 17 % of the enterprises are majority outsider owned.<sup>167</sup>

Managers are in enterprises firmly in control in corporate boards and other levels of decision-making. Corporate boards have in average seven members, from which four are members of management, two represent outsider shareholders and one represents the state. Rank-and-file employee representation is insignificant. Board representation does not correspond with outsider shareholding.<sup>168</sup> These facts are strongly in contradiction with the presidential decree of 1994, which mandated that no more than one third of the members of corporate boards should be employees or managers, and cumulative voting should be implemented (i.e. number of votes should correspond number of shares).<sup>169</sup> The first issue is universally ignored, but cumulative voting has received considerable attention. By the beginning of 1996, 39 % of enterprises had adopted cumulative voting. The outsider representation in Russian boards has also increased significantly

since 1994, although it seems that this has occurred through private negotiations with management and not because of cumulative voting. Only 7.5 % of outsider board members got their seat through cumulative voting.<sup>170</sup>

As argued in the previous section, the emergence of large shareholder blocks is crucial for ownership change to occur. In this respect, there have been changes in shareholding patterns. In Blasi's and Shleifer's survey, over half of all enterprises has at least one shareholder owning more than 15 % of the total stock. In this survey, 39 % of the companies had more than one outsider blockholder (blockholder is defined to own more than 5 % of the total stock). There is a strong relationship between the blockholding and number of board seats held by outsiders. However, different groups are treated differently in this respect: Commercial firms and business partners get their representatives in board more often than voucher funds and banks.<sup>171</sup> This indicates that those outsiders who get their representatives to the board are in good relations with the management.

So what do employees actually gain from their ownership status? The fact that employees own a majority of shares may have little effect on profit allocation if they cannot influence real decision-making in the enterprise. Surveys by Blasi and Shleifer show that there is almost no non-managerial employee representation in the corporate boards of Russian companies (although according to the company law there should be at least one representative of rank-and-file employees in boards of privatized enterprises) and employees have no influence in profit allocation.<sup>172</sup> This contradicts the findings of another survey of 439 enterprises, where the degree of employee ownership was correlated with the power on profit allocation.<sup>173</sup> Other surveys have stated that wage increases in Russian

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<sup>165</sup> Blasi and Shleifer (1995, pp. 2, 21); GKI, cited in *Rossiyskaya ekonomika* (1995, p. 162).

<sup>166</sup> GKI, cited in Radygin (1996b, pp. 10–11).

<sup>167</sup> Blasi and Shleifer (1996).

<sup>168</sup> *Ibid.*

<sup>169</sup> Blasi and Shleifer (1995, p. 15).

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<sup>170</sup> Blasi and Shleifer (1996).

<sup>171</sup> *Ibid.*

<sup>172</sup> Blasi (1994, p. 138) and Blasi and Shleifer (1995, p. 27).

<sup>173</sup> Earle, Estrin and Leshchenko (1995, p. 15).

enterprises usually follow the pace of inflation.<sup>174</sup> Because Russian firms pay miniscule dividends (indeed, only a third of privatized joint-stock companies paid any dividends in 1993)<sup>175</sup>, security benefits should not motivate employees to hold their shares. Employment is still relatively high. There may, of course, be other explanatory factors, which may be more powerful than employee ownership, such as tax treatment, bargaining power in relation with local authorities and socio-cultural tradition.<sup>176</sup> As Blasi and Shleifer state, it would be employees' advantage, if there would be in the enterprise "some independent activist board representation by outsiders who have the skills to protect the workers' investment (from the expropriation by managers – P.K.)"<sup>177</sup>.

Still, the employees are not left without benefits. A Russian peculiarity is that fringe benefits are the most important of private benefits. Russian enterprises spend 21 % of their net profits on maintenance of kindergartens, day care centres, canteens, health care etc. Employees wages are difficult to estimate, because they get substantial part of their wages as products.<sup>178</sup> These benefits essentially increase the value of being employed in an enterprise. Employees use also their shareholding as a defence against dismissals - when fired, they can sell their shares to outsiders.<sup>179</sup> This indicates that employees value the private benefits of shareholding over security benefits.

According to commonly held view, Russian privatization has extremely entrenched the managers. According to the evidence, managerial wages have risen much faster than wages of other persons employed in companies.<sup>180</sup> Managers

during the whole privatization process have been a significant group of owners, and have constantly increased their proportion of shares held. The true extent of managerial ownership is extremely difficult to estimate because the managers control shares owned by enterprise's privatization funds (FARPs) and also perhaps certain outsider holdings. Nevertheless, the numbers still do not the disproportionate powers of Russian managers. A deep underlying factor in manager's position is their inherited power from communist times. Although employees had their co-determinative institution, worker council, real decision-making power belonged to managers.<sup>181</sup> Workers new position as largest group of shareholders has not led them to adopt more active strategies in corporate policies, perhaps because they have not yet learned to use their new position. Another factor may be that in Russian circumstances, managers are the group who have good relations with suppliers, banks and customers. In Russian transitional circumstances the relevance of these relations is emphasized, and managers are for sure able to exploit this advantage in order to stay in control.<sup>182</sup>

How might outsider ownership be promoted in Russia? According to the statistical estimates, 33 % of the enterprises are very profitable, 44 % are in the need of outside capital, and 23 % are not viable.<sup>183</sup> The challenge of Russian privatization is to get for those 44 % outside capital. Share trade does not seem to lead to major ownership changes at least for some time. Better strategy would be to impose hard budget constraints to Russian enterprises. In 1995, when the government transferred fewer subsidies to enterprises, many enterprises were forced to restructure and pushed towards outside capital.<sup>184</sup> There is also evidence from Russia that some of the worst firms have been sold to outsiders.<sup>185</sup> Similar effects were presented in another survey, which stated that

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<sup>174</sup> Bim (1996, p. 31).

<sup>175</sup> Rossiyskaya ekonomika (1995, p. 160).

<sup>176</sup> OECD (1995, pp. 111–113).

<sup>177</sup> Blasi and Shleifer (1995, p. 27).

<sup>178</sup> Blasi (1996).

<sup>179</sup> *Ibid.*

<sup>180</sup> OECD (1995, p. ).

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<sup>181</sup> Bim (1996, p. 22–23).

<sup>182</sup> Kuznetsov and Kuznetsova (1996, p. 20).

<sup>183</sup> Blasi (1996).

<sup>184</sup> *Ibid.*

<sup>185</sup> Earle, Estrin and Leshchenko (1995, p. 26).

changes in market environment (factor supply, competition, hard budget constraints) explained adjustment measures, whereas ownership structure did not.<sup>186</sup>

#### 4.2.4 Corporate control: managers vs. outsiders

It is argued that from the corporate governance point of view, outsider owners should be those whose interests are closest to profit maximization. However, according to some surveys, the performance of the enterprise in Russia seems to be quite independent of the outsider involvement in the enterprise.<sup>187</sup> Outsiders are reported to be passive monitors. This is contrary to common reasoning in economics. According to theory, shareholders are passive in monitoring, when the benefits from monitoring are small relative to costs. When shareholding is dispersed, the shareholders face the free-rider problem (i.e. it pays nobody to engage in monitoring, since the active shareholder would gain only a fraction of the improvement, while bearing the full cost of monitoring). In the Anglo-American model, the stock market takes care of the monitoring. In transition economies the situation is different. The stock markets are underdeveloped, so the shareholders cannot free-ride at the expense of active monitors. Shareholder activism is also necessary for protecting minority rights, because their legal enforcement is deficient. Activism is also often the only way to achieve information of the condition of the enterprise. Finally, because of the potential mismanagement, the gains from monitoring and restructuring are considerably large.<sup>188</sup>

There are various explanations why outsiders are unable to monitor the management. Blasi and Shleifer suggest that the outsider shareholders are too small and too fragmented. In many companies, there are all kinds of outsider owners (voucher funds, individual citizens, commercial firms) represented and there will not arise any important

blockholders.<sup>189</sup> They also state that the level of board representation is correlated with blockholding so that in enterprises where outsider ownership is dispersed outsiders do not get representatives to the corporate board.<sup>190</sup> If this is the reason for inefficient monitoring, we must conclude that outside owners are incapable of acting in cooperation to defend their common interests.

One plausible explanation is that these "outsiders" are in fact no "real" outsiders. Significant blocks of the company shares are held by the company's suppliers and customers, holding companies, friendly banks or other related establishments.<sup>191</sup> Moreover, significant parts of some companies are owned by voucher funds created by companies themselves.<sup>192</sup> These loyal outsiders were created by the initiative of the managers. The reason for this kind of holding is to prevent the firm from sliding into the hands of "hostile" outsiders. Because these loyal outsiders may have quite an important stake in the company, we must be careful in interpreting any figures concerning outsider involvement in companies. Such holdings may, in fact, be supplements to managerial stock.

A second possible explanation is that the investors prefer quick, speculative capital gains to profit through restructuring. This applies especially to investment funds. First, the shares of many privatized companies were extremely undervalued at the early stages of privatization, so the shareholders were able to make easy profit through selling their shares in market prices.<sup>193</sup> Second, the funds need to restore a high degree of liquidity.<sup>194</sup> Given the insider domination exit may often be for the funds more attractive strategy than voice. Originally, the ownership by the funds was

<sup>186</sup> Ickes, Ryterman and Tenev (1995, pp. 11–22).

<sup>187</sup> Earle, Estrin and Leshchenko (1995, p. 26).

<sup>188</sup> Frydman, Pistor and Rapaczynski (1996, p. 211).

<sup>189</sup> Blasi and Shleifer (1995, 1996).

<sup>190</sup> Blasi and Shleifer (1996).

<sup>191</sup> Frydman, Pistor and Rapaczynski (1996, p. 209), Bim (1996, p. 33).

<sup>192</sup> Radygin (1996a, p. 12).

<sup>193</sup> Frydman, Pistor and Rapaczynski (1996, p. 225).

<sup>194</sup> Bim (1996, p. 21).

even restricted to 10 % in any company. Because many funds simply ignored these restrictions, the limit was later raised to 25 %.<sup>195</sup>

A third explanation is that managers discriminate against outsider shareholders. Using the terminology of Blasi and Shleifer, discrimination may occur in external or internal markets of corporate control. External markets of corporate control is share trading. As we noticed, in principle Russian enterprises privatized through MPP were formed as open joint-stock companies. In practice, managers are able to control share trade to a certain extent. Because share trading is often not confidential, managers may threaten to dismiss those employees who sell their shares to outsiders. Managers also use share buybacks and targeted share issues for insiders to ensure that they will retain their domination in companies.<sup>196</sup> Internal markets of corporate control implies minority shareholder rights and possibilities to participate in decision making. When the external markets of corporate control affect on supply of shares, internal markets affect on demand of shares. Because of the fear of expropriation, outsiders do not buy corporate shares. Weak law enforcement in Russia obviously makes this fear more prevalent. Besides such an obvious method than not paying dividends, other methods which violate minority owners rights (e.g. manipulation of voting procedures, not inviting outsiders to shareholder meetings or not calling shareholder meetings at all). Additional difficulties create that there has not been central share register in Russia, and the firms do not give information of the enterprise's financial condition even to shareholders.<sup>197</sup>

All this suggests that even if outsider shareholders constantly increase their stock in corporate shares, they may be unable to effectively exercise control rights in enterprise. Therefore, the positive development in share trade is not sufficient to change corporate policies. It is obvious that those outsiders who have most conflicting preferences in corporate governance with managers will be further discriminated

against. These outsiders may be those most inclined to real restructuring, at least when the managers wish to pursue other strategies. Therefore, we may conclude that for ownership change to bring effective results, both external and internal markets of corporate control should be given attention.

#### 4.3 Summary

Both Polish and Russian privatization programmes are characterized by high degrees of insider participation. The objectives and methods of insider privatization differed considerably in these countries. In Poland, the emphasis was in market orientation and selectivity. Employees had to pay full estimated values of their enterprises during the lease. Enterprises were selected in such a way that only those enterprises, which were believed to be self-reliant in financing, were selected to the programme. Relevant attributes were the company size and financial standing. Little emphasis was given to secondary market for shares.

In Russia, the main emphasis was on rapid depoliticization of the economy. For this reason, enterprises were chosen for the Mass Privatization programme. The criteria for exclusion of enterprises were not economic, but rather if the Government considered an enterprise strategic or the enterprise had powerful lobby groups behind it. Another important facet of Russian privatization was to create outsider minority shareholding, which was expected in time to transform into majority holdings.

In both countries, enterprise adaptation is more to be explained by changes in the market environment than by ownership structure. Competition and hard budget constraints forced enterprises to restructure and downsize. A good example is the Polish experience where there has been substantial reducing of work force despite the employee share ownership. On the other hand, the low level of investments may be due to other factors than risk aversion: profit allocation to wages or dividends may be interpreted as a response to a high-uncertainty environment and difficulties in obtaining bank loans. Evidence from Poland suggests that when profitability increases, the investment rate also increases significantly.

<sup>195</sup> Lieberman and Rajuha (1995, p. 18).

<sup>196</sup> Blasi and Shleifer (1996).

<sup>197</sup> Frydman, Rapaczynski and Pistor (1996, p. 204).

Management in EOE's has been paternalistic and not participatory. Employees have been unsuccessful in policing management. As the Russian example shows, also outsiders have been unable to affect on corporate governance. Managers have let the boards admit outsiders who share common interests with them. This indicates that in transition something more is needed besides the presence of institutions of corporate governance.

Ownership change has proceeded at a slow pace. This is disappointing especially in Russia, where much hope was placed in gradual ownership change. The reason for the slow pace is foremost the obstacles to share trading imposed by managers. Most enterprises have opened for outside capital only when facing the threat of bankruptcy. This underlines the meaning of hard budget constraints and argues for further development of bankruptcy institutions.

## 5 Ownership change in employee-owned enterprises<sup>198</sup>

### 5.1 Introduction

One often mentioned argument for insider privatization is that when there exists a secondary market for shares, the market will take care of efficient allocation in the long run.<sup>199</sup> If some shareholders are less prone to bear risk, they are willing to sell their shares at discounted prices (market value minus risk premium) to other investors, or so the argument goes. This argument looks like another case of the Coase Theorem, which says that the initial allocation of property rights does not matter from the efficiency point of view as long as those rights can be freely exchanged.<sup>200</sup> My purpose in this section is to provide a counter-argument and explain how the

private benefits from control may make the socially efficient outcome unreachable in the case where outsider ownership would be more efficient.

The crucial question is whether insider ownership is a temporarily phenomenon in transition or is it going to be a permanent arrangement. Following Blanchard and Aghion (1995), I try to describe the ownership change-process with a model borrowed from the literature of takeover markets.<sup>201</sup> At a first glance it may look strange to apply takeover literature to transition economies. It is well known that takeovers are outside the United States relatively uncommon control device because they require a well-developed secondary markets for corporate shares. Takeovers are also an extremely costly control device. However, we are going to describe a situation where there are three groups owning shares (employees, managers and outside investor), and try to find out the conditions under which there are gains from sale for these groups. To keep matters simple, we assume perfect information and use a static model; uncertainty and dynamics are discussed in section 5.5.

### 5.2 Takeovers as controlling mechanism

Grossman and Hart presented the free-rider paradox associated with takeover markets, arguing that under perfect information conditions, a takeover can never take place if there are takeover costs, no matter how small these costs are.<sup>202</sup> This prevents also the value-increasing takeovers: shareholders are unable to reach an agreement which would raise their own welfare. The argument goes as follows: assume that the present market value of the firm is  $Z$ . A take-over would

<sup>198</sup> Writing this chapter, the author benefited greatly from comments made by Alberto Chilosì.

<sup>199</sup> Chilosì (1996, p. 88).

<sup>200</sup> Cooter (1992, p. 457).

<sup>201</sup> Blanchard and Aghion build on a model by Grossman and Hart (1980). Here, I rely more on a later paper by Shleifer and Vishny (1986).

<sup>202</sup> Shleifer and Vishny showed later that this is strictly true only in cases where raider does not previously own company stock or his stake is negligible. If the raider owns initially a sufficient large stake of shares, he can make profit with positive takeover costs. See Shleifer and Vishny (1986, p. 466).

raise the value of the firm to  $X$ ,  $X > Z$ . The future value of the firm after the takeover is known with certainty. Moreover it is assumed that all bids are successful with certainty. Let us denote the share values with symbols  $x$  and  $z$ .<sup>203</sup> Then the lowest share price, which the shareholders are willing to accept, is  $x$ , because this is what they would get for certain once the takeover has taken place. That means that the dispersed shareholders extract all the benefit from the takeover. Because takeovers are costly, there will be no raid (because there is no way how the raider could make a profit) and the shareholders position is unchanged, i.e. the value of their shares remains at  $z$ .<sup>204</sup>

Grossman's and Hart's proposed solution to this free-rider problem was that the shareholders would voluntarily give up some of their claims to the benefit of the raider. Another solution is that the raider is initially holding a significant part of the company shares. Let us assume that the raider gets a controlling position in the company, if it succeeds to get 50 % of the company shares. Thus, we assume an "one share – one vote" voting system. Now we should introduce the symbols used throughout the chapter (some of them were already mentioned).

$X$  = pre-takeover value of the firm

$Z$  = post-takeover value of the firm

$S$  = total number of shares

$a$  = raider's percentage stake of company shares

$x$  = pre - takeover value of one share

$z$  = post - takeover value of one share

$d$  = a premium the current shareholders require in excess of the current share price

$C$  = takeover costs

Furthermore, we use following notations:

$$S * x = X$$

$$S * z = Z$$

$$S * d = D$$

Thus, the raider needs  $(0,5 - a)S$  shares to get a

majority of votes. Using the symbols above, we can write the condition that raider's profit must be non-negative as follows:

$$(2) \quad 0,5X - (0,5 - a)S * (z + d) - aZ - C > 0.$$

We can transform equation (2) into the following form

$$(3) \quad 0,5(X - Z) - (0,5 - a)D - C > 0.$$

In this case the price  $z + d$  can be even greater than  $x$  and the raider will still make a profit. This is due to the fact that the raider will get a capital gain of those shares he already owns. The probability of the occurrence of a raid is the greater, the greater is  $a$ . This is seen from the equation (3); bigger values of  $a$  allow greater values of  $D$  and the condition will still be satisfied.<sup>205</sup> It must be noted that because any raid is successful by definition, the question is whether it is worthwhile for the raider to attempt it.

### 5.3 Insider control and private benefits

Blanchard and Aghion focus more the situation where the employees are acting in collusion rather than selling their shares individually. Their main result can conveniently be represented in the framework used above. Let us temporarily ignore the restriction that the aim of the raider is to get hold of only half of the shares, and let us further assume that the raider is not initially holding any shares (Grossman–Hart -framework). Let us assume that every worker is having one share. Blanchard and Aghion assume that the workers will accept an offer if they are under the new situation at least as well off as before. Under their assumptions, the employees of the firm are laid off with certainty and new employees will be hired to replace them. Then the price of the share  $z + d$  must be at least as great as the current price of the share plus future value of the difference of current wage  $w$  and reservation wage  $r$ :

<sup>203</sup> Thus, capital letters refer to the market value of the firm and small letters refer to corresponding share values, i.e. market values divided by the number of shares.

<sup>204</sup> Grossman and Hart (1980, p. 44–45).

<sup>205</sup> Shleifer and Vishny (1986, pp. 465–470).

$$(4) \quad z + d > z + w - r.$$

But now, if

$$(5) \quad (z + w - r)S > X,$$

the trade will not take place.<sup>206</sup> Notice that this result follows from the assumption that every worker owns an equal share of the company and the raider not owning any of the shares. In the Blanchard – Aghion -model, if the workers expect to get dismissed after the takeover, they would require a premium to the sale price, which is equal to the difference of current wage and reservation wage (The difference of current wage and unemployment benefits, if the probability of finding a new job is low). Shareholding is then a kind of employment insurance for the workers, which prevents the transition to more efficient ownership structures (to higher market value). In other words, external effects of control prevent efficient outcome from trade.

Overemployment is not the only kind of private benefit which the employees get from their control rights. Others are excessive wages, more relaxed working conditions, fringe benefits (subsidized canteens, holiday resorts) or subjective satisfaction from the status of the owner.<sup>207</sup> As could be seen, not all these private benefits create negative externalities. Satisfaction from the ownership status probably raises the productivity, and the effect of fringe benefits is ambiguous. Indeed it is possibly in theory, that worker ownership creates greater social welfare, and then it of course would be a desirable phenomenon. Managers extract as well various private benefits from the process. They can use their controlling position to guarantee their continued employment in the firm. They may enjoy overly salaries and consume perquisites. What is worse, they may be engaged with various rent-seeking, like buying enterprise assets at discounted prices or borrowing from the enterprise at low interest rates, thereby undermining the

financial viability of the enterprise.<sup>208</sup>

#### 5.4 Analysis of the ownership change

In the following analysis we inspect the outcome of the share trading process. We first introduce the general framework and notations, and then the assumptions associated with the model. Let us denote the function of the market value of such an enterprise as  $V(F; B_L, B_M) = Z$ , where  $F$  stands for the production function of the firm,  $B_L$  stands for the employees' private benefits derived from ownership, and  $B_M$  for the managers' private benefits. We thus assume that managers are able to extract private benefits also under majority employee ownership. In the case where the managers have the majority of shares, we denote the function of the market value as  $V(F; B_M) = Y$ . We assume that in this case the employees are unable to influence the firm's wage / employment policy. For simplicity, it is assumed that the manager's private benefits are the same as in the former case. The market value of the company under outsider ownership would be  $V(F; A) = X$ . With  $A$  is expressed outsiders' greater capacity to carry restructuring measures. The meaning of  $A$  is that even if the insiders were not extracting their private benefits, they could not raise the market value of the company as much as outside owners. The outsider-owned firm is then (organizationally) more efficient in the sense that it produces the same output with lower costs. It is assumed that all benefits the outsiders get from shareholding are security benefits.

We assume that originally employees are holding the majority of shares, but also the managers have essential control rights. We refer to this situation as *status quo*. We assume then that both the employees and managers are able to extract private benefits. As noted earlier, this pattern of ownership is most common in privatized companies in Poland and in Russia.

We assume that the market value of the firm is greater under outsider ownership than under insider ownership, and greater under managerial

<sup>206</sup> Blanchard and Aghion (1995, pp. 7–8).

<sup>207</sup> Chilosi (1996, pp. 79–80).

<sup>208</sup> Clarke and Kabalina (1994, pp. 10–11); Bim (1996, p. 10–11).

ownership than under employee ownership. Thus, the ordering of the market values is  $X > Y > Z$ . This may follow from various reasons. As noted earlier in this thesis, insiders' risk aversion and shorter time horizons may lead to under-investment. The insider-owned firm may also find it difficult to raise capital, and as a consequence of that it may be incapable to restructure.<sup>209</sup> Employees may oppose reductions of work force. The assumption that the market value of a firm is higher when owned by managers than owned by employees is based on the assumption that manager-owners will eliminate overemployment or excessive wages, and do not have collective choice problems in decision-making like employees.<sup>210</sup>

We assume that there is always one group which is holding the majority of shares, so we do not have to consider strategic interactions between groups. We ignore as well collective choice problems inside the group.

Originally, the shares are divided among employees, managers and outsiders, and the majority of the shares belongs to the employees. Furthermore, shares are divided equally among all employees. We also assume that private benefits from ownership are divided equally to all employees. Private benefits accruing to individual employee is denoted by  $b_I$ , which is  $B_L$  divided by the number of employees.

We assume that employees act individually, whereas managers act cooperatively.

To avoid problems of diverse preferences and different degrees of risk aversion, we assume that all employees are risk-neutral and share the same attitude towards outside opportunities.

We assume perfect information and rational expectations, so that market values under different ownership structures are known in advance for all parties. Moreover, we assume that all bids will succeed with certainty and thus eliminate stochastic outcomes. Thus, the outcome of share trading process is known in advance. Though these assumptions may seem strange and restrictive, they are the same which Grossman and

Hart used in their paper.<sup>211</sup>

We assume a static model of share trade, so all transactions take place at the same time. All shares sell at the same price.

We assume that private benefits are derived from the status of majority ownership and if there are private benefits, they are always the same; in other words: the amount of private benefits are the same for employees in the case that the employees own 100 % or 51 percent of the shares, but when the employees do not any more have majority holding, they do not any more enjoy private benefits. Thus, the amount of private benefits does not vary proportionally with shareholding. One could claim that this leads to free-riding: an employee could sell his share and still continue to enjoy private benefits from share ownership. However, our assumptions 7) and 8) eliminate this kind of free-riding. When we assume that all transactions happen at the same time and all bids are successful with certainty, it means that if any trade takes place, all employees lose their private benefits and no-one is able to free-ride.

We assume that if the employee is indifferent between selling and not selling, he always sells.

We now compare three possible combinations: Outsiders buy shares from employees, or managers buy shares from employees, or outsiders buy shares from managers. We exclude the possibility that individual employees would increase their stakes, or outsider holdings would decrease. The trade will take place, if at least a party gains from it and the other party do not lose, i.e. there is possibility for a *Pareto improvement*. We are not interested, which is the final equilibrium price; the thing which interests us is *if there is a set of prices which leads to a Pareto improvement*.

Let us first consider the share trading process in our model more in detail. First we discuss the case where outsiders buy shares from employees. Because we assumed that bids are successful with certainty, employees take this into account when making their sale decision. They do not sell their shares if they would be worse off after ownership change. The raider knows that. Given the employees strategy, it makes a bid if it can cover its takeover costs. A share is worth for every

<sup>209</sup> As stressed by Blanchard and Aghion (1995).

<sup>210</sup> Earle and Estrin (1995, p. 36).

<sup>211</sup> Grossman and Hart (1980, pp. 44–45).

employee in the next period  $z + b_I$ . An employee must get at least that much when selling his share. On the other hand, if the future value of the share after the take-over  $x$  is higher than  $z + b_I$ , under perfect information a rational employee would require at least  $x$ . Using inequality (2) and substituting  $d$  with  $b_I$  or  $x - z$  we get the following conditions for the trade to occur:

$$0,5X - (0,5 - a)S * (z + b_I) - aZ - C > 0, \\ \text{when } z + b_I > x.$$

This can be written as

$$(6a) \ 0,5(X - Z) > (0,5 - a)S * b_I + C, \\ \text{when } z + b_I > x.$$

Respectively,

$$0,5X - (0,5 - a)S * x - aZ - C > 0, \\ \text{when } z + b_I < x.$$

This can be written as

$$(6b) \ a(X - Z) > C, \text{ when } z + b_I < x.$$

We see that it is now optimal to an employee to sell his share under above conditions. In the case (6a), the employee gets from his share the same price as he values his share under majority employee ownership, and, according to the assumption 10) above, he then sells his share; moreover, he gets from his share more than its value after the take-over. In this case the employees who sell their shares are better off than those employees *who fail to sell their shares to the raider*; we assumed that the raider buys only  $(0,5 - a)S$  shares. Here naturally arouses the question by which criteria it is determined who sells his share and who does not. Unfortunately, we are not able to answer this from the basis of our assumptions. In the case (6b), the employees get a higher price from their shares as they currently value them. In this case, the employees who sell their shares or hold their shares are equally well off: both get  $x$ , which in this case is higher than  $z + b_I$ . It is optimal for an employee to sell his share because she is fully compensated, and the question is now

whether the trade will be beneficial for the raider as well. From inspecting inequalities (6a) and (6b) we see, that this depends from the magnitude of  $a$ , i.e. the raider's initial stake in the company shares. The more the raider initially owns shares, the more probably a take-over will occur.

We could now compare these results to the earlier literature. (6a) is the collusive outcome suggested by Blanchard and Aghion. Employees require full compensation of their private benefits in exchange from their shares. (6b) is similar to the free-rider problem suggested by Grossman and Hart. Even when employees would be better off trading their shares to the raider at some price equal or above  $z + b_I$ , they require full compensation for their shares, which may prevent value increasing takeover. (6a) is naturally more stringent condition for a takeover to occur than (6b). Thus, we may conclude that the size of private benefits affects negatively on the probability of the occurrence of a takeover.

Let us similarly inspect the case where managers buy shares from employees. We denote the managers' stake from company shares with  $b$  and their transaction costs from buying shares with  $C_M$ . In *status quo* the management gets  $bZ + B_M$ . By acquiring the majority of shares, the management could raise its income by  $0,5 Y - bZ$ . Similarly as above we have (we assume first no outside raider competing from shares)

$$(7a) \ 0,5(Y - Z) > (0,5 - b)S * b_I + C_M, \\ \text{when } z + b_I > y, \text{ and}$$

$$(7b) \ b(Y - Z) > C_M, \text{ when } z + b_I < y.$$

If these conditions are not satisfied, *status quo* is optimal for the management. However, the situation changes when there is an outside raider competing from shares. If the transaction costs for acquiring shares would be the same for the outside raider and for management, one would perhaps first guess that the outside raider would always outcompete the management, because  $X > Y$ . However, when the raider gets the majority of shares, the management benefits  $b(X - Z)$  and loses  $B_M$ . This has interesting consequences. Let us assume that  $B_M > b(X - Z)$ . The management is not constrained to offer  $y$ . Let us denote the bid by

the management by  $g$ . Then it would be rational for the management to bid as long as  $(0,5 - b)S * (g - y) < B_M$ . This means that the management would be willing to bid as long as it can protect its private benefits. The competition would yield a more efficient outcome than *status quo* (if the trade is taking place), because the market value of the firm is assumed to be higher in managerial ownership than in *status quo*. In addition, this competition would yield especially high capital gains for those employees who sell their shares. However, it is more plausible that the management would try to raise to the transaction costs of outsiders. Then the managers will themselves lose nothing. This practice leads to economic inefficiency. Sadly, this is exactly what has happened in Poland and Russia.

But, if  $b(X - Z) > B_M$ , the management would benefit from a take-over. In this case, there would be gains from trade both for the management and outsiders. However, because of the assumption that the employees are having the majority stake, the management cannot simply free-ride at the expense of the employees; this means that condition (6a) must still be satisfied. (6b) will be satisfied, if the outside owner is willing to buy the shares at the price  $x$ ; the management would not either accept a lower price. However, when the management and outsiders have together a stake big enough, it would probably not be a problem to pay few employees excessive prices from their shares, and thus free-ride at the expense of other employee-shareholders.

We can draw two conclusions from the above analysis: 1) Firms with a large potential for growth and need for external financing (a large difference between  $X$  and  $Z$ ) would be bought by outsiders. This may apply as well to companies which have good financial standing, but in the absence of outside capital are not expanding as rapid as would be their potential, or to companies, which need fresh capital in order to survive. 2) Assuming that the management is able to control the trade with the company shares, a bigger stake owned by the managers makes the ownership change more probable.

## 5.5 Further considerations

In the above analysis I wanted to show that the external effects of control may prevent the trade to occur even when it would be optimal from the point of view of social welfare. There simply may not be a price which the parties would agree, but this does not mean that the existing allocation would be socially optimal. What is interesting that this happened because of the externalities, not because of the public good, imperfect information or transaction costs. To be sure, transaction costs are present and they are large; but they are artificial, in the sense that they could have been largely avoided. Large transaction costs are not the reason for market failure, they are a consequence of the externalities control rights generate. Transaction costs are raised in order to protect the private benefits from control.

What happens if we relax our assumptions? Very restrictive was the assumption that all bids are successful, and the employees have rational expectations on this. If we drop this assumption, dispersed employee-shareholders do not any more maximize their utility on that basis, and there is room for free-riding. An employee may sell his share for a price slightly higher than  $z$ , but he continues to enjoy private benefits from majority shareholding and then he is better off than those shareholders who do not sell their shares, as long as the ownership change has not taken place. If all employees reason like this, they will eventually lose control in the enterprise.<sup>212</sup> But there is a defence for such free-riding: If it is possible for other insiders to observe this behaviour, employees who sell their shares may be fired. It is reported from Russia that in such a way the managers prevent employees selling their shares.<sup>213</sup> As we stated in section 4, ownership change is taking place slowly, which indicates that insiders have colluded in some degree to protect their private benefits. This collusion may have been in some cases initiated by employees, but more likely it is usually held up by managers.

In transition economies, not only the future

<sup>212</sup> Chilosi (1996, p. 79).

<sup>213</sup> Frydman, Pistor and Rapaczynski (1996, p. 227–228).

value of the firm  $X$  is unknown, *but also the current value of the firm  $Z$  is difficult to estimate*, at least for outsiders. This has led some economists to suggest that the insiders are selling their shares only when the firm is in trouble and outsiders do not know that, i.e. asymmetric information leads to adverse selection, and this would dry up the market for corporate shares.<sup>214</sup> For sure, asymmetric information in many cases prevents outsiders from attempting takeovers. But in reality, the asymmetry of information has not always prevented ownership change. In Poland and Russia large outsider ownership has occurred in companies mainly when the enterprise has been in financial troubles, and these troubles have been no secret to outsiders (see section 4). Asymmetric information may lead to different behaviour, namely that by offering their shares the insiders actually signal the profitability of the enterprise. This is because we assumed that the insiders sell their shares only when they expect to gain more from the rise in firm's value than from their private benefits. The signalling may in turn happen by introducing developed accounting practices or by share issues targeted for outsiders, for instance.

In our model, we assumed that the employees always require the full value of their shares. In reality this probably is not the case: Because of the wealth constraints and shorter time horizons, the employees may sell their shares at less than the full value of the shares. Then the employees who have the shortest time horizons are probably selling their shares first at lowest prices. Because these employees are probably those associated with lowest wages, as a result income differences in the firm will increase.<sup>215</sup> The resulting share concentration may however lead the firm to adopt more profit maximization-like policies. The employee shareholders have incentives to exploit outsider investors only as long as their share in excessive wages or employment is higher than their share in equity, in other words, when their private benefits exceed their security benefits. When shares are concentrating to fewer insiders, they will prefer to allocate profits rather to

dividends than to wages, and the problem of profit extraction would eventually vanish.<sup>216</sup>

Share concentration promotes ownership change in our model in two ways. First, when shares are concentrated to fewer insiders, their potential security benefits may exceed their private benefits. Then they are able to get from share trade more revenues than from profit extraction. Second, when shares are concentrated to fewer individuals, it is cheaper for potential raider to obtain these shares, so that the takeover costs are lower.

Unfortunately, if potential security benefits are low compared to potential private benefits, the process described above may not take place. This is the case in enterprises which are not viable under any ownership structure. Obviously profit expropriation by managers is then a more serious problem than by employees. The management may engage in illegal capital extraction, i.e. remove the firm's property into its own name and let the firm go bankrupt.<sup>217</sup>

Does the initial allocation of shares matter in the long run, then? A lot depends the macroeconomic and institutional environment, competition, hardness of budget constraints, bankruptcy procedures etc. Underdeveloped bankruptcy proceedings in these countries and state subsidies or soft loans allow unviable or mismanaged firms to continue their activity. In a competitive market environment no firm can be wasteful forever. But even after macroeconomic and institutional reforms ownership structure is not insignificant. Time has importance. The resources wasted in profit expropriation are wasted forever. Potentially viable companies may have been driven down by decapitalization. Therefore, if there are reasons to believe that insiders would not be profit maximizers, it is no real comfort that the market will finally take care of the share allocation.

<sup>214</sup> Frydman and Rapaczynski (1994, pp. 186–187).

<sup>215</sup> Chilosi (1996, p. 80).

<sup>216</sup> Nuti (1995a, p. 15).

<sup>217</sup> Bim (1996, p. 13–14).

## 5.6 Summary

This chapter presented the hypothesis that employee ownership would be a transient form of ownership. We showed that even in the case where outsider ownership would be more efficient, private benefits employees enjoy may prevent the ownership change. From this we concluded that ownership change would occur in cases where security benefits resulting from takeover would be greater than private benefits insiders currently enjoy. We also claimed that if managers are able to control share trading, ownership change could more easily occur in the situation where managers are holding a larger stake of company shares. If the insiders would benefit from takeover, they could signal the profitability of the investment by adopting advanced accounting practices or targeting share issues to outsiders.

These results were dependent on a number of restrictive assumptions. If ownership change is gradual and the employees do not consider the effect that their actions have influence on final outcome, they may make temporary profits in selling their shares with some price above  $z$ . This would eventually lead to ownership change. Another case where employees would be willing to sell their shares at lower prices would be that they are risk averse, so that they would prefer to invest their money rather to risk free deposits than to company shares.

Managers have potentially a larger stake in the companies than employees. If the managers would consider the ownership change to them as unfavourable, they could try to prevent it through imposing various restrictions on share trade. If they cannot prevent the trade directly, they can sanction those employees who sell their shares e.g. threatening to dismiss them.

Finally, a lot depends from the assumption that outsider owned enterprises are more efficient than insider owned. What is important here is that the enterprises should be subject to the market test. If employee ownership is efficient there should be no reason to oppose that. In long run hard budget constraints and appropriate institutions should correct distortions. Before these institutions are in place, some enterprises can continue wasteful practices, and this would

lead to social losses.

## 6 Conclusions

In Poland and Russia, employee ownership has been a dominant feature of privatization. This led us to ask what potential benefits and shortcomings employee ownership would have in transition. First, we presented the arguments both for and against employee ownership in itself and in transition process, and then we inspected the actual events in Poland and Russia. From the literature of employee ownership we concluded that major problems of employee ownership are limited supply of finance and decision-making problems in EOE's. Suppliers of external finance require some control rights in exchange for their capital to ensure that their investment is not expropriated. If they do not get sufficient guarantees, they either require higher rates of return or refrain from investing. Considering decision-making, diverse preferences of heterogeneous workforce may lead to policies which are not value maximizing. If this problem arises, it may be solved through centralized and independent decision management. Problems of finance and decision-making generate the paradox of employee ownership, i.e. for employees themselves it might be advantageous to transfer control rights to outsiders, but this sacrifices the idea of employee ownership. When the control rights are transferred, these enterprises are no longer employee-owned according to the definition in the introduction. These two problems may explain why employee controlled enterprises are rare in market economies. It must be remembered that employee shareholding without control rights may still have positive effects on productivity and effort. In profit sharing schemes such arrangements are common. The strong position of the management and the existing institutions of worker self-management were the main reasons why employee ownership was established in Poland and Russia. However, there are also other economic reasons for employee ownership in transition. Selling ownership claims to employees clarifies property rights. If insiders are already in control in enterprises, selling them rights to residual earnings gives them incentive to

increase firm value. Employee buy-outs are much quicker and cheaper to organize than mass privatization or privatization through sales. If the shares are tradable, employee ownership may also facilitate the development of capital markets. To promote these positive effects of employee ownership, shares could be sold to employees at discounted prices. The main problem of EOE is the lack of capital. If an EOE does not generate sufficient profits, internal financing won't meet capital needs, so that insiders either have to sell shares to outsiders or decapitalize the enterprise. Further, insiders may be unwilling to downsize their company. For employee ownership to be efficient, attention should be paid to selecting such firms for privatization which are viable for employee buy-outs. The relevant firm attributes are size, industry branch, labour-management relations, investment needs and monitoring costs. An eclectic and flexible approach is likely to bring best results. Both employee buy-outs with majority ownership and giving free shares with minority ownership should be used. Attention should be paid to free tradability of shares, so that share markets may correct the initial allocation. Employee participation in privatization process also eases employee opposition to restructuring and privatization in general. Poland and Russia chose completely different approaches into insider privatization. The Polish approach was to select those enterprises considered to be viable for employee buy-outs. Insiders had to pay full estimated values for shares in leasing period. In the Polish capital privatization programme, employees were sold enterprise shares at discounted prices. Under a mass privatization programme, employees were given free shares. Employee buy-outs proved to be the quickest way to privatize. Other methods of privatization have proceeded slowly in Poland. Little attention was given to secondary share markets for the shares of EOE. As the Russian privatization programme began two years after the Polish programme, Russian reformers were able to benefit from Polish experience. Whereas in Poland employee ownership took place largely by default against the original intentions of the reformers, the design of employee buy-outs in Russia resulted from conscious planning. Basically, the Russian strategy was to depoliticize the economy quickly. Shares were sold to insiders at highly discounted

prices and minority outsider shareholders were allowed to participate in privatization. The most important of these were commercial enterprises, voucher funds, banks and ordinary citizens. A clear shortcoming in Russian privatization was that citizens, contrary to initial promises, have benefited little from their shareholding in insider-dominated enterprises. Both programmes have proven to have merits and shortcomings. In both countries privatization halted significantly the illegal expropriation of company assets by managers and *nomenklatura*. Employee buy-outs resulted a quick transfer of property rights with low costs. The Polish approach adopts the eclectic elements, whereas Russian approach could be characterized as flexible (in theory, anyway). In Poland, leasing payments have driven many firms to the verge of bankruptcy. A more moderate approach towards leasing payments and the rights to use physical assets could have saved for many enterprises funds for investment and restructuring. Because the state still owns physical assets, there is the danger that these enterprises may fall back into the state ownership. The reluctance of state authorities to start liquidation procedures has led the state to tolerate arrears in leasing payments. Another shortcoming of the Polish approach is that ownership change was given little attention. Share trade is in control of insiders, and these enterprises are in practice closed joint-stock companies. Outsider ownership results only in an immediate threat of bankruptcy. In Russia, on the other hand, outsider owners have unable to turn their share ownership into control. Though the state has through legislation tried to force these companies adopt better governance practices, discrimination of minority owners has persisted. Mainly those outsiders who have common interest with managers have obtained board seats in privatized companies. The Russian example also shows that even when appropriate institutions of corporate governance are in place, deficient legal enforcement may prevent desirable outcomes.

As stated in the introduction, employees have both control rights and rights to residual earnings for an enterprise to be considered employee-owned. According to this definition, employee-buyouts in Poland and Russia have not resulted employee ownership. Employee influence on decision-making is minor, and these firms have strongly managerial characters. Despite the

theoretical advantages employees have in corporate governance, employees have been passive in monitoring. The reasons for this may lay outside the traditional domain of economics (for example, they could be in socio-cultural factors). Employees' passivity may also be interpreted as a consequence of decision-making problems discussed in section 2.3.

Employee withdrawal from enterprise control may be viewed as positive or negative. The worst predictions of opponents of employee ownership in transition have not materialized. Employees cannot be blamed of expropriating profits on excessive wages or employment. On the other hand, employee passivity in monitoring has led to tremendous entrenchment of managers. Insider ownership has hindered the development of corporate governance mechanisms. Ownership change has proceeded slowly. This results from obstacles managers impose on share trade to protect their private benefits. This has deleterious effects for some companies, which would need new capital for survival. In any case, the trend in ownership change is clear: the holdings of employees and dispersed outsider owners have diminished, and the holdings of managers and large shareholders have increased. Stabilization of share ownership in some Polish enterprises may indicate that in these enterprises employee-shareholders get substantial security benefits, and these enterprises are probably well-suited for employee buy-outs. In other cases, concentration of shares to large shareholders and managers should according to our model indicate that the probability of ownership change has increased. The presence of large shareholders brings the system of corporate governance close to German-Japanese model. An additional element is the large managerial shareholding. Poor development of corporate governance and ownership change force us to assess more critically employee ownership in transition economies. The early hopes that employees would sell their shares rapidly to outside investors have

not been fulfilled. Because putting institutions of corporate governance in place is not sufficient for the efficient working of these institutions in conditions of deficient legal enforcement, more attention should be paid to market-based approaches. This means foremost hardening of budget constraints. Firms should be put to a market test whereby those firms that fail would be opened up to outside investors. Those which survive, would be appropriate for employee ownership, at least for some time. Unfortunately, this approach has also some problems. Because bankruptcy institutions are underdeveloped, hard budget constraints could lead into undesirable development. Enterprises may either fall back into state ownership or the management liquidates the firm assets to its own benefit. To be sure, there are a lot of enterprises in both Poland and Russia which are not profitable under any property structure. Liquidation of large enterprises creates social costs discussed in section 3.2. How to proceed with enterprises which are "too large to fail" provides a Gordian Knot of questions for economists to unsnarl. Bim has argued that the illegal asset stripping by managers is a quicker and more efficient method to liquidate enterprises than traditional bankruptcy methods.<sup>218</sup> Though this might be true, it is hardly acceptable from the legal point of view. Moreover, accepting or even tolerating this method would encourage also potentially viable companies to adopt similar methods, and this would have ruinous consequences for the entire private sector. Institutional changes and hard budget constraints should be viewed as complementary methods. Hard budget constraints create demand for more efficient and innovative bankruptcy procedures. They also leads enterprises to look for outside owners, which in turn, has positive impact on corporate governance and restructuring. These issues deserve top priority in further development of approaches to policing insider-owned enterprises.

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<sup>218</sup> Bim (1996, p. 14).

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## Appendix 1 Behaviour of the illyrian firm

- 1) There are two types of firms in the market, capitalist firms and Illyrian firms. We assume that both types of firm hire capital rather than own it (thereby ignoring potential agency problems). Both types of firm hire capital as long as the value of the marginal product of capital is higher than its price. Capitalist firms hire labour as long as the value of the marginal product of labour is higher than the competitive wage level. Illyrian firms, in turn, hire labour as long as the value of the marginal product of labour is higher than average earnings of existing employees. Under perfect competition, if average earnings are higher in some industry, employees from other lower-paid industries will form new firms in better-paid industries, and as a result profits in this industry diminish until the value of marginal product of labour is equalized in all industries.<sup>219</sup>
- 2) In order to study firm behaviour, we adopt the assumption that we have only one variable input, labour  $L$ . The quantity of capital  $K$  is held fixed in the short run. The profit function of the firm is

$$(1) \quad V = PQ(L, K) - Z - wL,$$

where  $P$  is the output price,  $Q(L, K)$  is output quantity as a function of labour and capital input,  $Z$  is the fixed cost of capital and  $w$  is the wage level.  $L$  is the only variable in the equation.

The earnings per worker consist of two parts, i.e. predetermined wage  $w$  and the profit of the enterprise per worker. The income of the worker is then given by

$$(2) \quad S = w + (PQ(L, K) - Z - wL) / L.$$

We assume that the productivity of each worker is the same. The earnings per worker in equation (2) can be divided into two parts, revenue function per worker ( $U$ ) and cost function per worker ( $K$ ).

$$(3) \quad U = PQ(L, K) / L,$$

$$U'(0) = c, \quad U'' < 0.$$

$$(4) \quad K = (wL + Z) / L = w + Z / L, \\ K' < 0, \quad K'' > 0.$$

The earnings per worker are maximized at the point where the distance between hyperbolas  $U$  and  $K$  is greatest, that is where  $dU/dL = dK/dL$ . This is the point  $e$  in the Figure 1. Because wages per worker are always the same, the difference is due to the revenue per worker and fixed costs per worker. If the fixed cost of capital is zero, the EOE would produce to point  $c$ . At this point the value of the value of the marginal product of labour is the same as the value of the average product of labour.

The peculiar reaction of the EOE to changes in input and output prices can be demonstrated in the following way. From the equation (2) we obtain that

$$dS/dL = [PQ' - w]L - (PQ - Z - wL) / L^2 = 0$$

from which we can transform

$$dS/dL = [P(LQ' - Q) + Z] / L^2 = 0.$$

By rearranging the terms and multiplying both sides with  $(L/P)$  we get

$$(5) \quad Q/L - Q' = Z/PL.$$

From equation (5) we see that when  $Z > 0$ , the value of the average product per employee is greater than the value of the marginal product of labour. The left side of the equation is a monotonically increasing function in relation to  $L$ , when  $[d(Q/L)/dL] < 0$ . In the figure this is at right from point  $c$ . From this we see that when  $P$  increases, the difference between average and marginal product diminishes, leading into contracting of  $L$  and  $Q$ . This is illustrated in figure 1. When  $U$ -curve shifts upward, this curve is now steeper than  $K$ -curve at the point  $e$ ; the new equilibrium is at point  $d$ . Respectively, when fixed input costs  $Z$  increase, the difference between

<sup>219</sup> Meade (1972, pp. 405–406).

average and marginal product increases, and so  $L$  and equilibrium output must increase. The new equilibrium is now at the point  $f$ .<sup>220</sup>

- 3) Equation (1) describes the profit function even in a monopoly situation. Consider, for example, that the firm maximizes its monopoly profits so that an infinitesimal change in  $L$  will cause no change in profits. This reduction however causes a rise in  $V/L$ . From

equation (1) we obtain

$$(6) \quad V/L = (PQ - Z)/L - w.$$

Because  $w$  is fixed, we see that an infinitesimal reduction in  $L$  leads to the rise in worker average earnings. Therefore, in each monopoly situation, the EOE uses less labour input and therefore produces less than a corresponding capitalist firm.<sup>221</sup>

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<sup>220</sup> Ward (1958, pp. 571–576).

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<sup>221</sup> Meade (1972, pp. 412).

Table 1 State Enterprises in Privatization Process in Poland 1990–1995

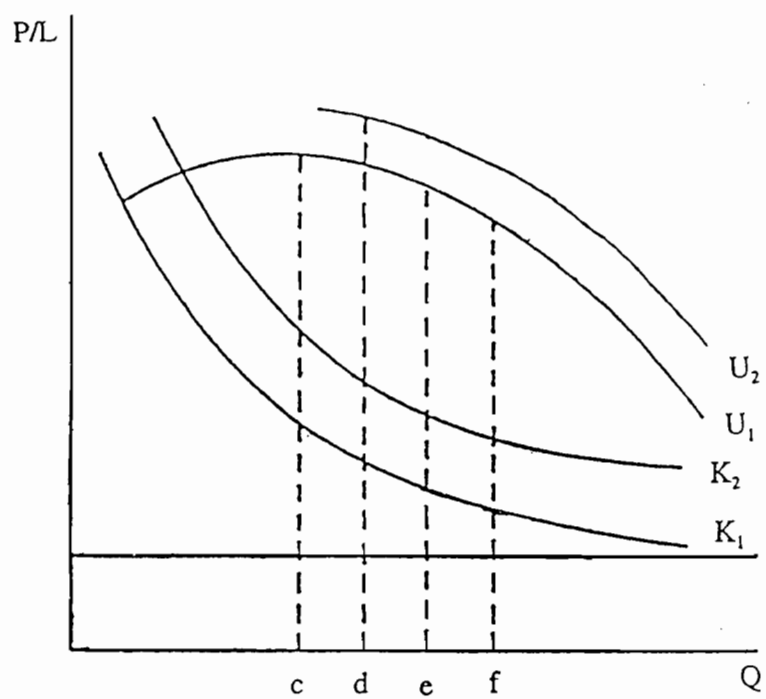
Year	1991**	1992	1993	1994	1995	Together
<b>Type of privatization</b>						
Capital Privatization	30	22	46	36	25	159
Corporatized (state owned)	278	150	110	172	208	918
<b>Subject to liquidation procedures</b>						
Liquidation acc. to Privatization Law*	416	246	203	120	113	1098
Liquidation acc. to Law on State Enterprises*	534	263	294	155	133	1379
<b>Liquidation completed</b>						
Liquidation acc. to Privatization Law	242	307	184	180	126	1039
Liquidation acc. to Law on State Enterprises	32	89	94	82	86	383

\* Liquidation according to the Privatization Law applies to enterprises in good financial standing, whereas liquidation according to the Law on State Enterprises applies to enterprises in bad financial standing.

\*\* The figures in this column refer to the years 1990 and 1991.

Source: GUS (1996).

Figure 1 Behaviour of the Illyrian Firm



Source: Ward (1958).

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