



Center for Social & Economic
Research

Management- Employee Buyouts in Hungary and Poland

by

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"Privatization in Post-communist Countries"

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Work on this project, financed by the Committee of Scientific Research (KBN), began in December 1994 and consists of research focusing on legal and institutional aspects of privatization as well as the courses and outcomes of privatization processes under way in the countries of Central and Eastern Europe. In the first stage of the project, country reports on privatization in those countries where the ownership transformation process is most advanced were prepared. In the second stage, reports are to be prepared on particular aspects of the privatization process. Foreign participants in the project include scholars from the Czech Republic, Slovakia, Hungary, Slovenia, Russia, and Germany. Publication of the papers prepared during the course of the project in the *Studies and Analyses* series is currently under way. The publication of a book is also intended to conclude the project. In November 1995 a two-day seminar was held on voucher privatization and management-employee buyouts. An international conference is being planned for April 1996, in which experts in privatization policy and practice will participate in a discussion of the research results, which we hope will facilitate their dissemination both in countries which are leaders in the systemic transformation process and those which are less advanced. Conclusion of the project is planned for June 1996.

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MANAGEMENT-EMPLOYEE BUYOUTS IN HUNGARY

1. Statistical data

In Hungary, by May 1995, 209 employee buyouts took place altogether in the Employee Share Ownership Program (ESOP). During the same period the total number of companies which were transferred to over 50 per cent private ownership, was 923; thus, the ESOP accounts for 22.6 per cent of the sales. The companies sold under the ESOP construction make up 11.3 per cent of the 1,848 state-owned companies designated for privatization in 1989.

Examining the assets involved we find much lower figures. The assets of the companies privatized under the ESOP represented only 7.3 per cent of the total (the nominal value of the assets of ESOP companies was 38.94 billion forints altogether; the global asset-value of companies transferred to majority private ownership was 534.37 billion forints.) The average asset-value of ESOP companies was only 32 per cent that of the total of companies transferred to majority private ownership; thus, generally speaking, the ESOP was applied in less capital intensive firms. (The data on which this conclusion is based are from December 1994, but on the basis of anecdotal knowledge about particular cases we can safely state that this trend was also characteristic of the 1995 privatization.)

We have to handle the data with care because the records of the state property agencies include ESOP cases with both minority and majority employee ownership, while companies transferred to majority private ownership serve as a basis for comparison. However, the data can be used, since as much as 80 per cent of ESOP cases in 1993, and 66 per cent up to September 1994 were majority buyouts. (More recent data are not available.)

The statistical data cited above concern only ESOP deals registered by the State Property Agency and the State Holding Company. Consequently, they do not include bankruptcy proceedings, liquidation that led to privatization, or employee and management buyouts concluded outside of the ESOP framework. This causes some bias mainly in the case of MEBOs that took place between the end of 1989 and June 1992, when the ESOP law was passed (according to experts' estimates, this concerns approximately 30 companies). These data also do not concern those companies sold under the so-called "management leasing construction." Through December 1994 such leasing contracts were signed in the case of a total of 24 companies. The total nominal value of the assets of these companies was 6 billion forints.

For the whole period examined, there are no records of actual MEBOs in which the managers and/or employees purchasing the firm were registered as outside - anonymous - investors. (From the records of the state property management agencies it is not clear whether employees or managers of the firm are represented among the members of a group of investors.) It is most likely, however, that the number of such MEBOs was very low after the passing of ESOP law, which offered extremely advantageous conditions.

2. Legal, institutional, and historical background

Hungarian employee ownership does not have such historical antecedents as the Polish or the former Yugoslavian "labor self-management" model. In the development of the autonomy of economic organizations, an important step was the 1985 institutionalization of corporate governance, the introduction of "Enterprise Councils" and "General Assemblies." In the second half of the 1980s, these "self-governing" companies accounted for three-quarters of state enterprises. In this period company managers were the real actors in strategic decision making, eventually becoming "quasi-owners" of the companies.

Naturally, in the beginning, the legal provisions and institutions that started the transformation of the ownership structure were based on the "self-government" system. The company law and the 1989 Law on Transformation (commercialization) made it possible for state firms to initiate their own transformation, so that they could make their own decisions concerning the new ownership structure. (The state as owner could not intervene in privatization at that time; it could intervene only occasionally on jurisdictional grounds.)

Thus, during the period of so-called "spontaneous privatization", company managers could operate as the quasi-owners, executives and actors of privatization at the same time. In some companies certain groups of employees and managers used their savings and/or the assets of the company in order to establish limited liability companies ("acquisition companies") which they then used, with the help of loans, to gradually obtain majority ownership.

Since 1988, different forms of employee ownership have been institutionalized. There was a hope that the incentives of employees to participate in privatization would be increased by giving them "property notes" in the beginning, and later by offering discount prices for employee shares at firms still owned by the state but transformed into limited liability or joint stock companies.

In 1990, the new law on the State Property Agency and the protection of state assets set the legal terms of centrally governed and supervised privatization. The curtailment of "quasi-owner" rights of "self-governing" companies and their managers' authority over state assets began. The State Property Agency personified the state as the owner of the companies; thus, privatization activities above a certain threshold could no longer be undertaken without its control and approval.

Centralized privatization, which was "tailored" mainly for big companies, assumed the presence of foreign investors. Based on the assumption that state assets represent the

collateral for foreign state debt, of the manifold possible aims of privatization, maximization of state revenue became the prime criterion in the evaluation of bids. The unrealistically high figures in revenue plans and the cumbersome central controlling of affairs slowed down the privatization process significantly.

During the lagging process of privatization, the economic situation of more and more state companies worsened. Small and medium sized companies suffered particularly from the centralized administration of privatization. For this reason, in 1991 a decentralized process, the so-called "self-privatization" project, was launched. In this procedure an consulting firm chosen by the state enterprise acted as a liaison of the State Property Agency. Mainly small companies could use this method. (Later on, some medium sized companies could legally use this privatization technique as well.) In the course of the program a total of 478 firms were partly or wholly privatized (out of 841 companies owned by the state at the time). The majority of MEBOs were accomplished in the framework of the self-privatization program.

The ideology of privatization - aiming to develop a broad middle class - emphasized in the programs of the parties governing between 1990 and 1994 was to be realized through the use of the "existence loan" (E-loan), first in the course of "pre-privatization" (or "small" privatization of retail and service outlets). The preferential E-loan introduced in 1991 had, no doubt, an important role in the financing of MEBOs. Later, we will give more details on its legal construction, its applicability, and the characteristics of the "wide owner stratum" that formed as a result.

Since 1990, the Property Policy Guidelines, which were supposed to determine yearly privatization policy, has also supported employee purchases of 10-15% of equity or business shares.

Between 1992 and 1994 a privatization strategy intended to develop a domestic owner stratum came to the forefront, and the number of decisions preferring Hungarian investors and employees increased. This tendency was obviously connected to political considerations (in addition to economic arguments such as the slack privatization market and increasing unemployment). This preference necessitated new solutions and means for artificial stimulating the demand and supply sides of the privatization market. One of the elements of this policy was the Act on the Employee Share Ownership Program passed in June 1992.

The ESOP is a complex technique, including credit, tax and organizational provisions. It is aimed to help employees to buy the whole or a part of the shares of their company; therefore, it allows them to act as collective buyers. The assets of the company serve as collateral for the bank that gives the necessary loan for the purchase, and not the personal property of the employees. Besides a very low (characteristically 2%) down-payment, the purchase of the company is financed mainly by loans with preferential interest rate, and the source of debt servicing is the future profit of the company. The owners' rights are exercised by the ESOP organization, which is similar to the ESOP trust in the USA. The by-laws of the ESOP organizations are supposed to define rules determining the amounts of individual shares, the techniques for distributing and trading shares among individual accounts, the internal organizational structure, the rights of employees as owners and a number of other issues.

We also have to mention the so-called "privatization leasing" institutionalized in 1993. At that time this was the only privatization technique devised for MBOs. Under its rules, the purchase price of the company is supposed to be paid back in installments by the manager or the managing team, and its source is the "management fee" paid by the company to the management.

In 1994-95, the new governing coalition obviously wanted to reorient privatization policy. The new privatization law prefers acceleration of ownership transformation and increase of revenue from sales, or rather cash return from sales. (Currently state revenue from sales is supposed to be an important source of financing the budget deficit.)

The new privatization strategy narrows the ground of centralized privatization to large enterprises - mainly public utility companies - while entrusting the sale of companies with less economic importance to the local management. (During the preparation of the law in the autumn of 1994, there were 300-400 companies designated for privatization in which the shareholders' rights could be obtained - because of their smaller size and lower efficiency - by their employees and managers in accordance with the idea of the policy makers.)

The new privatization law, passed in May 1995, maintained the ESOP construction; thus, the highly advantageous conditions for employee buyout instituted earlier have been maintained. However, the new law, in accordance with the new policy preferring cash paying buyers, contains some restrictions; for example, it reduces considerably (by 50 per cent) the portion of the purchase price that can be covered with a loan.

A completely new element in the 1995 privatization law is the statutory reinforcement of the management buyout technique. It requires acquisition companies formed by the management to pay 20 per cent of the market value of the company immediately after winning the tender; then, in the following five years, they have to obtain the majority of shares. It is an advantage for the buying management that the State Holding Company waives its voting rights to the state's share for the first five years.

We know little about the application of the new law and the new techniques. Regarding the fact that this new law offers less advantage to the management compared to the old ESOP construction (because of the larger down-payment), one can assume that the earlier Hungarian practice (acquisition of owners' rights by managers through the ESOP devised originally for employees), remains unchanged.

3. Share concentration

The partly or totally employee-owned companies can be considered democratic in the sense that the majority of employees are involved. In the early MEBOs 70-80% of the employees took part. Of the employees of 168 companies sold by May 1994, as much as 68 per cent of the employees were ESOP members.

However, examining the "contents" of this high level of participation, it turns out that employee shares mean management shares in reality. The practice of implementing management buyouts disguised as ESOPs was able to develop as a consequence of the law, which failed to regulate some important issues, leaving them to be determined in the by-laws of the ESOP organization. Such issues include the size of the down-payment of individual participants, the principles and methods of distribution of shares among the participants, the rules for buying employee shares back, preemptive rights in the case of trading, the rules for alienation of shares after paying the loan off, and the rules for splitting up the assets after the ESOP organization is dissolved.

The so-called "fairness" rules used in American ESOPs are also missing from the law. Such rules could limit the management share, so that, for example, it could not exceed the management share in the company's wage bill. (The 1995 privatization law failed to provide the Hungarian ESOP with such rules; however, it instituted changes concerning the composition of committees of ESOP organizations.)

In the companies examined, the company management was the central actor of privatization, either if we consider initiation, implementation or "operation" of the assets. Whether openly confessed or not, the main aims were always the maintenance of the company's unity, avoidance of outside owners' control, and preservation of the autonomy of management in decision-making.

Generally, management could easily obtain the desired extent of share ownership. Wherever the portion of the shares acquired depended on the down-payment, domination by the management was obvious. The usual internal regulation was also favorable to the management; namely, the link between rights to obtain shares on one hand and wages and positions on the other. The pattern of tight interdependence between the wage hierarchy and share ownership was broken only by the preferences extended for length of service (to the advantage of the senior staff). By the time the debt is paid off, these regulations will lead to a share distribution which closely resembles the organizational hierarchy.

It is fairly difficult to obtain exact data on concentration of management share ownership. Managers can become owners of their companies through several channels, partly in the framework of ESOP, partly - especially since the middle of 1993 - by shares bought directly through their acquisition companies. (The latter organizations are called MBOs in Hungary, but they resemble their western counterparts only in the mere fact that managers become owners through these organizations.)

Research data on particular companies show without doubt the development of a definite majority management share. Even if the management share did not reach 50 per cent within the ESOP, it always exceeded the 25 per cent minimum which is necessary to veto decision-making in vital issues. In many companies the shares bought through MBOs reinforce the influence of management by assuring further votes at the shareholders' General Assembly.

The ESOP law leaves the question of the conditions under which those who will be eligible in the future to join the ESOP organization to the by-laws or the General Assembly of the ESOP. The companies usually do not provide for the down-payments of late-comers.

The rules containing stricter entry regulations than required by the law (for example, specifying extreme length of service) lead to an "exclusive" ESOP organization. It is very rare that internal regulations create some reserve for supporting purchase by new employees by discounts or through special shares held as common property of the organization.

The transfer of shares within the ESOP organization is regulated by the law. Until the end of the repayment period the members of the organization are responsible for the debts to the extent of their own share bought with the loan. The ESOP organization has an exclusive purchase right to the shares of employee owners leaving the company, and a right of preemption in cases of retirement or death.

In many cases we can conclude from the internal regulations that the management will obtain a share greatly exceeding its share in employee incomes by the end of the repayment period. The majority of the rules allocate shares totally and automatically according to the proportion of down-payments; thus, in fact, they transform ESOP organization into investment companies promising good yield. There are few examples of ESOP regulations containing restrictions in advance to prevent excessive management share ownership.

MEBOs endeavored to obtain exclusive, or at least majority, share ownership. The early MBOs became owners of 85 per cent of their company on the average, while ESOPs became majority owners in two thirds of the cases. (The exceptions are bigger companies with more than 500 million forints of capital, where buyers targeting greater share ownership face financial difficulties.) The owners of the remaining minority shares are mainly local governments or the State Property Agency. Later, and mainly in bigger companies, a consortium formed by the ESOP, MBO or individuals on the one hand and/or financial investors on the other gained share ownership.

At the majority of ESOP companies the ownership structure has not changed since privatization took place. One of the reasons for the low level of trading is that shares - mainly in the ESOP cases - are mortgaged. In extreme cases - in companies close to liquidation - employee ownership ceased.

We found many examples in which that portion of the shares not acquired initially by the employees also became the property of employee owners in a later stage of privatization. Employee owners - more precisely managers - want to be assured that their ownership and their position remain dominant if the company increases its capital. This is made possible by the right of preemption assured by the law and specified in the sales contract.

Domestic or foreign outside investors did not appear in MEBO firms following privatization - not even in those companies which obviously needed fresh capital. In the cases examined, the managers (due to their interest in avoiding real outside owners' control) treated the possibility of outsider participation as a last resort to solve the company's crisis. At the same time, MEBO companies did not appear as attractive investment possibilities in the eyes of outsiders because of the large number of owners, which slows down decision-making, and the significant debt burden stemming from the buyout.

We will be able to answer the question who will be the "final" owner (with the exception of some extreme cases) only at the end of the repayment period. It is clear from the facts mentioned above that the position and intentions of the incumbent management are a decisive factor in further developments in the ownership structure.

4. Corporate governance

As in other Hungarian companies, the most important governing body in ESOP firms is the shareholder's General Assembly. In the General Assembly the employee shareholders are represented by an official elected in accordance with the internal regulations of the ESOP organization. Consequently, it depends on the by-law of the ESOP organization how employee owners can defend their interests.

The ESOP law provides ESOP organizations with maximal autonomy in forming their own internal regulations. The General Assembly of the ESOP organization determines the principles of the representation of the employee owners. Most rules stipulate that votes on most questions will be allocated according to the ratio of shares (either the actual vested shares or the expected value by the end of the repayment period). The "one member - one vote" principle is a rare exception.

The regulations for representation of small shareholders as well as for protection of their interests are often missing from the rules of ESOP organizations or company by-laws. Sometimes ESOP organizations do not have a definite description of the decision-making mechanism. Typical flaws in the ESOP rules are the omission of regulations concerning appropriate authorization of ESOP representatives in the shareholders' General Assembly and of regulations concerning democratic procedural rules for the formulation of opinions to be presented at meetings of the General Assembly. We even found an example of an extreme solution that tied the decisions of the ESOP organization to the approval of the current management of the company.

The dominance of managers is also obvious when their real share ownership is not dominant, but the internal regulations (or rather the lack of regulation) of the ESOP organization allow the management to keep its prerogatives in exercising the rights connected to employee shares.

The regulations which reproduce the administrative hierarchy of the company in the ownership ratios and voting rights cause an overlap between the firm and the ESOP organization. This protected position of managers easily results in their entrenchment. As for the employee owner, he or she is not in a position to confront the incompetent manager, as the employee does not want to take the risk of losing the job. The apparently secure employment in the slack labor market is more valuable for the employee than the possible return stemming from the tiny employee shares.

In the majority of cases we examined, the management was not threatened by real control exercised by the employee owners, because the manager, his deputy or somebody else in his confidence was a dominant personality within the ESOP organization. In practice, employees are unable to act in their role of owners if the presence of the management is decisive in the ESOP organization. (To correct this loophole, the 1995

privatization law stipulates that the CEO of the company or his deputy cannot be a member of the elected administrative body of the ESOP organization.)

In Hungarian companies the role and composition of the Supervisory Board (SB) and the Board of Directors (BD) is different from those in Western European practice. Here, the employees of the company cannot be members of the SB due to provisions for true representation of (outside) owners' interest through supervision. (The only exception is the mandatory employee delegate in companies with more than 200 employees.) Because of this rule the members of the SB are characteristically former managers. In many places (demonstrating the importance of relationships to the government) a cadre of state officials who know the company well are also members of the SB. (On the other hand, if the government's privatization agencies establish the company, then the appointment to the SBs and BD is an important means of developing the political clientele.) However, the significance of the Hungarian SBs cannot be compared with, for example, the powerful German Supervisory Boards. In most cases in Hungary, they have only a passive, formal role in corporate governance.

The other body representing owners is the Board of Directors, which actually makes strategic decisions. The Hungarian company law gives a free hand to majority owners in composing the Board of Directors. Thus, majority owners can enforce their will practically without restriction, while a balance between various owners in the BD is a result of "self-restriction" or typically the outcome of a special agreement between the founders of the company. While the BDs are elected by the owners of joint stock companies, in the smaller limited liability companies, owners exercise their rights through the managing director. In most of the BDs at ESOP companies, managers were elected as the delegates of employee owners, so that these bodies resemble the former Enterprise Councils in their composition.

As it turned out above, the position of competent management has been strengthened through its owner position. Knowing the general weakness of employee representation in Hungary, the reinforced managerial position is favorable to company effectiveness. Without doubt, participation and cooperation of the management in the privatization process are a necessary condition for successful ESOP privatization. On the other hand, the entrenchment of an incompetent, weak management can endanger the development and the recovery of the company.

5. The role of credit

In most cases of employee buyouts, the source of financing for the purchase was the "existence loan" (E-loan) obtained from commercial banks. The advantages of this type of loan included the extremely low down-payment, the long period of debt service and the grace period.

Originally, the 1990 law required the down-payment to be a percentage of the per capita purchasing price (2 per cent for up to 5 million forints, 15 per cent for between 5 and 10 million forints and 25 per cent for over 10 million forints). It defined the interest rate as 7 per cent, with 4 per cent to cover handling costs and the 3 per cent basic interest rate, which

did not even reach one fourth of the current market rates. Originally the period of the E-loan could be 10 years, of which the grace period made up at least 2 years. The modifications of the law between 1990 and 1994 improved the conditions, especially in the case of bigger E-loans, by increasing the time span and the grace period and decreasing the necessary down-payment. The situation also improved considerably with the passage of the ESOP law. The down-payment represented only 2 per cent of the loan, the company shares themselves were acknowledged as collateral and the source of debt service was the pre-tax income of the company (up to 20 per cent). Between 1992 and 1994 employees could become owners without placing their personal funds at risk, as the source of the down-payment was the savings of the company in almost every case.

The conditions of the E-loan for ESOP organizations were significantly modified by the new privatization law enacted in May 1995, which required half of the purchase price as down-payment.

The risk to the lending commercial bank was minimized due to the fact that the E-loans were refinanced by the central bank and not from the banks' own resources. Furthermore, their rights to foreclosure and confiscation could be enforced easily if the buyer (i.e., the company) was unable to pay. Besides, the banks insisted on signing the rules of procedure connected with the E-loan if it contained a state guarantee for any loss caused by bad E-loans. (The State Property Agency covered this guarantee with a special reserve fund formed from the collected down-payments.)

The volume of E-loans grew dramatically, reaching a cumulative total of 62 billion forints by the end of 1994. (It should be noted that this sum includes loans for so-called "pre-privatization" deals, the volume of which was much smaller than that of MEBO financing.) In 1994, E-loans occupied second place among the privatization techniques supporting domestic owners, after the restitution notes (amounting to 63.5 billion forints). The volume of E-loans grew from 1.1 billion in 1991 to 9.07 billion in 1992, 21.7 billion in 1993, and 30.23 billion in 1994. In contrast to the original aim - facilitation of the purchase of many smaller companies - in a few cases certain favored companies were able to raise greater and greater sums. The average E-loan was for 200-500 thousand forints in 1992 and rose to 5-150 million forints in 1993. Beginning in the second half of 1993, companies worth 500-700 million forints, and even commercial chains, were privatized through the E-loan. (In these data we cannot distinguish loans made to ESOPs from those made to MBOs.)

In the 20 companies we examined, the purchase price was 50 to 98 per cent of the subscribed capital; most frequently the buyers paid 60-64 per cent. The size of the loans raised for privatization ranged from 13 to 630 million forints, with an average value of 207 million forints.

Banks financed 66-78 per cent of the purchase price. The ratio of bank financing shows a correlation with the economic situation of the company. In the purchase of heavily indebted companies, banks either refused to participate at all or did so only to a small extent. Due to the general economic situation of the companies, very few ESOP organizations managed to pay only 2 per cent as a down-payment, as banks required more than the mandatory terms, namely mortgage right over the purchased assets and the cash-paying guarantee of the company.

The lending banks used manifold means to increase their security. Generally, they insisted that the company in question hold its general bank account with them, wanted the right to supervise the company's business, demanded much higher collateral than normal, and insisted on the condition that the acquisition of a new loan from another bank be subject to their approval. Sometimes it happened that the banks wanted the managers to take personal risks, too. There were also cases of tying the financing to acquisition of a certain extent of shares.

6. Financial situation

The information on the economic situation of ESOP companies is scarce and often inconsistent. The impact of employee ownership on companies can be measured only after some years, mainly because of the delaying influence of the grace period.

ESOP supporters argue that the efficiency of the companies increased since these firms' profitability and cash flow is better than the average. The majority of MEBO companies have managed to reach an average profitability level which gives them a better chance to pay off their loans than the majority of the privatized companies, and the new owners are interested in keeping the production facilities open. It is worth noting that the profits of the ESOP companies can be used only for debt servicing, while in companies acquired by outsider cash-paying buyers they can be withdrawn from the firm in many ways.

The opinion of those who are committed to privatization through instant cash purchase is absolutely different. Their claim is that the impact of preferential loans on the viability of companies is very doubtful. No fresh capital comes into the enterprise; instead, it necessarily becomes indebted, and its income is inevitable soaked up by debt service. They cannot raise further loans for development due to their already mortgaged properties, and have difficulty in obtaining even the revolving loans which are necessary for their continuous operation. Many experts and consulting firms suspect that E-loans are ticking "time bombs" among the stacks of loans in banks. The ESOP companies will not be able to pay off their debts, so a new wave of bankruptcies will begin, resulting in a "secondary" ownership transformation.

For the time being, the majority of ESOP companies are able to pay the interest and have not yet faced the difficulties of repaying the principal. The predicted wave of ownership change may (or may not) occur when the grace period expires.

According to a third, more complex approach, majority or exclusive employee ownership can be an effective solution only in organizations employing less than 200 people. Only these companies are able to operate without a strategic investor, and the incentives of employees as "owners" can play an important role here. Indeed, their economic results are much better than the average for the Hungarian economy. Besides, there is a better chance for success in less capital-intensive ESOP companies because of the ample trade-off possibilities between capital investment and efforts of the workforce.

The data of a telephone survey made in May 1995 with 17 majority ESOP companies show that the pre-tax profit increased in 10 companies and fell in 7 companies in comparison with the period before privatization. There were altogether four companies in the sample that did not face significant financial difficulty after the buyout. Liquidation proceedings were initiated against two companies, and in one case the employees had to sell their shares to a venture capital company. (This was an exceptional case, as it is the only such case we are acquainted with.)

In another research project we dealt with a representative sample of 20 companies. We divided the firms into different groups according to their efficiency, profitability and the size of the loan. Two companies showing extreme results set the two poles of the scale as well. The negative path was shown by the company which had a debt identical to the size of its subscribed capital, with a profitability steadily falling since 1989, and making losses since 1992. Last year liquidation proceedings began against this firm. On the other hand, the example for the positive path was a steadily effective company, which also had good profitability records. One half of the companies had some profits, their profitability is improving, and their loan is minimal. The other half of the companies have a decreasing profitability, and the ratio of their indebtedness to their subscribed capital is high.

We know from case studies that the majority of the companies had already made certain measures for the sake of structural change as well as cutting costs, and to improve liquidity prior to privatization. Nevertheless, the greatest problems of MEBO companies - and especially of the ESOP firms - appear in the area of cash flow. As we already mentioned, ESOP buyouts were aimed at the obtainment of a majority share, and this fact almost totally excluded the chance of attracting outside capital. In these firms, the generally high rate of debt was exacerbated by the E-loan. What is more, the down-payment was made from the reserves of the company, and in many cases, it made impossible even the management of working capital. These companies could not raise further loans for the improvement of competitiveness or for development or marketing. Consequently, the resources and creditability of these companies are exhausted by the privatization rather than recovery efforts.

Finally, we can also say that the success of the companies largely depends on the quality of the management, which was not altered by the sheer fact of privatization.

7. Supporting institutions

The most important supporting institution for MEBOs is a state institution, the "Loan Guaranty Joint Stock Company," which is supposed to provide a part of the guarantee for commercial bank loans for buyers unable to provide sufficient collateral but having otherwise good records. Since the beginning of 1993, this company has underwritten guarantees for up to 100 million forints and up to 80 per cent of the demanded collateral. When using the services of this new institution, the buyout organization has to provide coverage amounting to 70 per cent of the loan instead of the usual amount of approximately 150 per cent. (As 70 per cent of the risk is underwritten by another state fund, eventually the state itself assumes the risk.) To date, employee-buyers have received the largest amount of

loan guaranties provided by this institution, which underwrote a total of 7.8 billion forints' worth of loans through April 1995, mostly for employee buyouts.

There are hundreds of private consulting firms dealing with privatization. They are assigned by the company management to design and implement the concept of the buyout. The desire of the management for "minimal investment - maximal share of property" demanded creative consulting work, consisting of the search for optimal legal solutions and sometimes regulatory loopholes. The result could be, for example, a combination of different preferential forms of employee ownership. The other role of the consultants was to lobby state authorities and bodies on behalf of the company. The means used to do this certainly include parliamentary interventions and the printed and electronic media.

We could call the 1991 self-privatization program "consultant" privatization. The formerly clear-cut buyer-side position of the consultant was made difficult in these cases, as they also negotiate against the company on behalf of the seller, the State Property Agency, so the two positions are mixed up.

Obviously, expectations concerning the consultants depend on who hires them. In theory, the company (or rather the management) and the ESOP organization should hire separate consultants who could adopt different positions on certain questions. (The two parties' positions vary most clearly on the issues of accountability and replacement of incompetent management.) The activities of the ESOP consultants should include the preparation of financial feasibility studies and, what is more important, developing democratic procedures for employee participation. But our experience shows that the consultants hired by company management (understandably) clearly served management interests.

In addition to company assignments, many consultants lobbied for institutionalization of employee ownership in the various national forums for interest representation and negotiation as well as in the parliament. This lobbying activity led to the ESOP law. We have to mention the Share Participation Foundation (Rész-Vétel Alapítvány), operating since 1989, and the ESOP Association, created by the Foundation in 1991. They had the lion's share in lobbying and informing management, the public, management and employee owners concerning matters related to MEBOs.

8. Trade unions

When judging the work and influence of trade unions, we cannot disregard the fact that interest representation in the Western sense of the word is currently in an embryonic phase in Central and Eastern Europe. In connection with the legitimacy crisis of the former union organization, reform movements and totally new trade unions were formed, and the first stage of the new era of industrial relations, which lasted until the 1992 national works council elections, was characterized by the power struggles between different trade unions. These were mainly engaged in national politics. Privatization and employee ownership were central focal points for trade union activity on this ground. Interestingly, with respect to

privatization, the demand for preferential employee shares was the number one union demand at national level consultations.

Since May 1994 the successor of the former single trade union federation has been a component of the governing party again. Political analysts consider the "relaxing" of the cash privatization concept contained in the government's program, according to which purely market methods were to be used, to be a result of the socialist and trade union position. The ESOP privatization technique continued to be available as a result of the unionists' influence.

Company-level trade unions' rights in connection with privatization were regulated late and incompletely. According to this regulation, management is obliged only to consult with the union and inform it. Union representatives are not involved as equal negotiating partners, and collective agreements do not include provisions for privatization and its direct results. For example, the modification of the 1995 law on the obligation to inform employees stipulates that in the case of the so-called "simplified privatization," unions have to be informed by the State Property Agency one month before the tenders are invited.

The bidders have to make employment guarantees as a part of the business plan, but this duty remained a formal obligation in reality. The employees and unions are vulnerable to the new owners because the above promises can easily be broken due to the lack of provisions for sanctions in the privatization contracts.

The real problem is that trade union activity at the company level is meaningless. Local union officers often simply approve management's plans and reports. Collective agreements do not have an important role in regulating wages, hours, terms and conditions of employment. The role of the newly introduced works councils is also unclear, and their authority is confined to marginal issues. In 1990-1991, trade unions were activated in a few cases of special challenges; e.g., in order to make a factory unit independent of the headquarters, to avoid closure of a factory, or to protest when the employer did not meet his wage obligations. But in these cases as well we could find an interest group - either the managers or skilled workers in good bargaining positions - which used the special occasion to make an alliance with the trade unions.

The MEBO companies do not differ from other companies with respect to their collective agreements, unions and works councils. More specifically, MEBO companies are usually small or medium sized firms, where trade unions are weak. (We found trade unions completely absent in the smallest firms, which were governed by autocratic managers.)

Although trade unions supported employee ownership at national level, their company chapters are surprisingly passive regarding privatization issues. At best, local trade unions announced the need for employee buyouts, but they had a very limited role in the actual implementation. Rather, they observed the actions of the management with tacit consent.

Workers generally consider the ESOP to be a means for preserving their workplace. As in most cases, no personal financial sacrifice was needed; thus, neither the workers nor their representatives seriously take into consideration the advantages and disadvantages of the action. The ESOP by-laws exclude the possibilities of big differences in share

ownership between employees in similar positions. The real inequality in allocation of shares and the fact that the MEBOs are characterized by dominant management ownership is often unknown to most of the workers. However, in other cases, a management buyout disguised as an employee ownership program can be a source of significant tensions. Even if the challenge of centrally commanded privatization led to a marriage of convenience between management and employees, this coalition proved to be very fragile later.

In companies where workers lost their shares because of a flawed ESOP construction or sheer mismanagement of the firm, they felt that their fate had been decided "over their heads"; they did not get the information necessary to make real decisions, and they were not in a real decision-making position. Even if the company prospers well, we cannot speak about the emergence of a new "owner-consciousness." In these companies there are no organizational changes that would introduce the practice of employee participation in the everyday work. As we have already mentioned, employee owners are hardly able to exercise their rights properly. Thus, the mere fact that workers had become formal co-owners of the companies did not open up a new channel for workers' interest representation.

9. Wage growth and employment reductions

In the MEBO companies, the 1990-1991 wages corresponded to the average of the given industry. In the following years, regardless of their activity, wages in the majority of the companies rose 15-17 per cent, which was hardly enough to offset price inflation. When central regulations on wages were phased out, profitable companies with low historic wage levels tried to catch up with big jumps, and these steps had an obvious effect towards leveling out wages. On the other hand, wages in loss-making companies rose by 10-11 per cent. In many MEBO companies, there was a small fluctuation in wages due to the fact that, prior to privatization, the financial base for personal down-payments was created by wage increase or extra bonuses. (That is why reported incomes modestly fell after privatization in some of the ESOP companies.)

It is also known from case studies that many companies reshaped their wage and incentive system after privatization. In many places they endeavored to build the prospective dividend into the bonus system in the form of advance payment. (Naturally, this type of incentive is only possible in those companies where the laws do not require the use of profits exclusively for loan repayment.)

In the cases known to us, the form of ownership played no important role with respect to wage increases. There were no unreasonable increases at MEBO firms, and most of the ESOP organizations acknowledged that in the present pressing circumstances the company could not afford higher wages. It turns out from the interviews that the existence of high unemployment moderates employees' wage expectations.

The number of employees decreased in the whole national economy in the 1989-94 period, and this is also true for most of the MEBO companies. In the latter the most frequent rate of yearly decrease was 15-18 per cent; however, this range of shrinkage was rarely due merely to usual turnover. (For the sake of comparison, it is worth noting that companies with majority state ownership also reduced their staffs by 15-20 per cent in 1993.)

An analysis of staff reductions in MEBO firms does not show any connection between either industrial branch or company size on the one hand and extent of reduction on the other. Large companies (with more than 1,000 employees) remained large despite their streamlining, and the size of the other companies did not change either. The only exception is the very rare case of privatization linked with decentralization. (The companies seldom engage in very extensive lay-offs [over 20 per cent of staff] because of the burden of severance payment.) Surprisingly, in the examined companies, we could not find any correlation between economic performance and the change in employment.

In the 17 companies in which we conducted telephone interviews, the size of staff reduction was smaller in the period after privatization because these firms were mainly earlier MBO cases. These companies prepared for privatization by developing the desired capital structure and reducing their debt burdens and employment. Staff reduction here meant mainly decentralization into spin-off limited liability companies, contracting out, or early retirement, rather than actual lay-offs.

Although some of the ESOP companies had already streamlined their organizations, staff reduction to a varying extent is still on the agenda. The ESOP owners did not object to the management concept for restructuring including employment reduction. However, buying back shares from employees leaving the company has not yet imposed a significant financial burden on the ESOP organizations. During the lay-offs ESOP membership was not a determinant criterion in choosing those to be dismissed.

So, in contrast with the negative predictions of much of the economics literature on employee ownership and workers' self-management, our research shows that ESOP organizations do not tend to maintain the employment level at any cost, nor do they place their highest priority on wage increases. However, it would be naive to suppose the development of a new kind of "consciousness" of common workers that offsets traditional employee motives. In most of the companies trade unions could not intervene against business plans including lay-offs even if their members were in favor of such a course of action. The activity of ESOP organizations is in a very early stage, and it is too early to expect them to have elaborated standpoints for managing the inherent conflict between owners' and employees' interests.

10. Sectoral distribution

Very characteristic of early MEBO cases was the strongly specialized work at these companies. Most of them were not very capital intensive and employed highly qualified workers whose expertise, skill and contacts in markets made up an essential contribution to the value of the firm. The necessary condition for success of the buyouts was the strong bargaining position of the employees, because without their special knowledge and skill the given company could not be sold. The early MEBO companies work mainly in trade and such services as engineering, consulting and research.

The majority of ESOP companies are in industry, mainly in the more labor intensive branches. According to the November 1994 data, half of the ESOP companies worked in manufacturing, with an extremely high number of companies in the food and the printing industry. A quarter of the companies operated in trade, and the rate of service companies

was also high (17%). (Within the latter group advisory and domestic services were most popular.)

The picture becomes a bit different if we examine the breakdown of employees involved. Out of the 86,535 employees working in ESOP companies (3.2 per cent of all employees of firms with more than 20 employees), 61% are employed in manufacturing, 18% in trade, 14% in construction and 5% in the services.

11. Average size

While the MBO acquisition companies affected mainly small firms with about 100 employees, the ESOP technique was characteristically used in medium sized companies. According to May 1994 data, the average size of ESOP companies was 276 employees. A quarter of the companies had less than 100 employee, 65 per cent were medium sized firms, and roughly 10 per cent were large, with more than 1,000 employees.

The ESOP companies also belonged to small and medium sized category according to their subscribed capital. According to May 1994 data, most of the companies were in the 200-500 million forint range, and only one quarter of them exceeded 500 million forints. The bigger the subscribed capital of the firm was, the smaller the share which could be bought by the employees. In the above-mentioned 200-500 million forint bracket in which ESOPs are concentrated, the average portion of shares held by the employees is 58.26 per cent.

12. Investment activity

The majority of the ESOP firms are profitable and so far they have been able to pay the interest on their loans. (Very few companies have begun to repay the principal.) This transitional period, however, does not provide them with real opportunities for significant savings.

According to the results of a telephone survey carried out in May 1995, only three out of the 14 respondents said that they had made significant investments. One commercial company supplementing its own resources with a loan bought a factory in a difficult financial situation. At two other companies undertaking investments, the pre-tax profit did not change; that is, they were also in a good economic situation before privatization. However, the rest of the companies (11 cases) could not afford substantial investments after the buyout. It is very rare in ESOP companies for their developments to exceed purchases of some machines or completion of ongoing building projects.

The relatively low frequency and small volume of investments can be understood if we consider the fact that no fresh capital has flowed to companies purchased on credit at the time of privatization and which no outside investor has subsequently joined. What is more, the owners of ESOP companies, according to the ESOP law, are obliged to use their profit for repayment of debts, even if development would be a more advantageous solution in the long run.

Richard Woodward

MANAGEMENT-EMPLOYEE BUYOUTS IN POLAND

Management-employee buyouts (MEBOs) are attracting more and more attention as a form of privatization in the post-communist countries. This form of privatization, consisting of the acquisition of a state enterprise's assets by the managers and/or employees of that enterprise, has been utilized in Russia and Poland (among other countries) from the outset of the privatization process and has emerged as an important form of privatization in Hungary and the former German Democratic Republic as well; in Slovenia, it is the preferred method of privatization, applied to the vast majority of the enterprises being privatized on the basis of the privatization law of November 1992. While tendencies to emphasize privatization techniques based primarily on sales to outsiders (either through voucher schemes or through public offerings) and skepticism regarding "insider-led" privatization initially dominated the formation of privatization policies in Poland and the Czech and Slovak Republics as well as in Germany, this form of privatization has enjoyed considerable successes in Poland, Slovenia and East Germany. In spite of these successes, many misconceptions and myths concerning this form of privatization continue to be quite widespread in influential circles in Poland. Typical formulations of these misconceptions are contained in the two following statements, the first made by former labor minister Jacek Kuroń, the second by Leszek Juchniewicz, deputy minister of ownership transformation. "Employee ownership ... has proven itself ... especially in the case of smaller enterprises."¹ "An employee-owned company is created, which leases property from the State Treasury. People have shares, but the company has no funds for development. Nothing has changed there. There is overmanning, but no one is laid off. And that is where the drama begins: people have taken their work place into their own hands, but there is no money and no prospects for the future."²

The purpose of this paper is to present a more informed picture of enterprises privatized by MEBOs in Poland. It includes a brief description of the legal, institutional, and historical background of this form of privatization, statistical information on the extent of its application in Poland, the size, sectoral distribution, ownership structure, and financial results of the firms in which this method has been applied, and information on adjustment activity being undertaken in these firms (particularly with respect to employment adjustment, investment, the evolution of labor relations). It concludes with a discussion of what developments can be expected in the near future with respect to the MEBO as a privatization method in Poland and for the firms which have been privatized in this manner.

¹"Własność pracownicza ... sprawdza się ... szczególnie w przypadku mniejszych przedsiębiorstw." See *Nowe życie gospodarcze* (no. 23), 26 October, 1995, 16.

²"Powstaje spółka pracownicza, która wydzierżawia majątek od skarbu państwa. Ludzie mają akcje, ale spółki nie mają środków na rozwój. W nich się nic nie zmieniło. Są przerosty zatrudnienia, ale nikogo się nie zwalnia. I tu zaczyna się dramat _ ludzie wzięli zakład w swoje ręce, ale nie ma tam ani kasy, ani perspektyw." See *Super Express*, 22 September, 1995.

1. The historical roots of insider-led privatization in Poland

The support for the employee buyout as a privatization technique in Poland has its roots in the worker self-management movement associated with workers' councils in state enterprises during the Communist era. This movement played an important role in the anti-Communist opposition movement throughout its history and was an important base of the Solidarity trade union. Its influence resulted in legal recognition of worker self-management in state enterprises in the 1980s, although the workers' councils in actuality had very little influence. After the fall of the Communist regime, when privatization not only became a real possibility but also a policy priority, the self-management movement began to support the concept of privatization by transition to employee ownership.³ However, many of the economic policy makers in the governments formed since the summer of 1989 shared strong misgivings regarding both workers' councils and employee ownership.⁴ In designing the privatization law, they had originally hoped that "capital privatization," modeled to a large extent on forms of privatization utilized in the West (for example, in Great Britain under Margaret Thatcher) and involving such techniques as public offerings, would be the dominant privatization method. (This hope is reflected not only in the large amount of space devoted to commercialization and capital privatization in the text of the act [Articles 5-36] in comparison with that devoted to liquidation [Articles 37-43], but also in the fact that the section concerning liquidation was a last-minute addition to the act.⁵) This turned out, however, not to be the case.

³For the role of the workers' councils and the self-management movement in the Communist era and the self-management movement's support for employee-led privatization, see Osiatyński et al. (1985) and Ruszkowski (1991).

⁴See Ruszkowski (1991), 24, Błaszczyk and Dąbrowski in Akyüz et al. (eds.) (1994), 87. Theoretical objections to worker ownership raised during the initial debates over privatization policy included the following: (1) The argument that a worker should not concentrate both his human and his financial capital in a single firm: since human capital is necessarily concentrated in the place where one works, one should, in order to diversify one's risk, invest one's financial capital elsewhere. In addition, it is argued that workers as partner/managers will seek higher payments for themselves at the expense of dividend payments to non-worker shareholders. See Lipton and Sachs (1990), 309-311, and Kawalec (1990), 86. (Later, however, Sachs appears to have modified his perspective, judging from the following statement: "The simplest methods of privatization - direct sales or transfers to the insiders - have been underutilized, while the harder methods [such as IPOs (initial public offerings)] have been overemphasized." See Sachs [1993].) (2) The argument that the limited or non-existent transferability of worker-held shares would impede the development of a capital market. See Lewandowski and Szomburg (1989), 262. (It should be noted that existing legislation in Poland does not limit the transferability of shares in employee-owned companies. See Section 4.) It is worth noting that there were exceptions to the negative attitude in government circles toward worker self-management institutions and privatization through employee buyouts; a notable exception was Marek Dąbrowski, deputy finance minister in 1989 and 1990 (see interview in *Życie gospodarcze* [no. 20], 15 May, 1994).

⁵See comment by Lewandowski quoted in Tokarzewski (ed.) (1992), 82. See also Błaszczyk (1993, p. 19), who criticizes the overemphasis on "selective" (i.e., capital-type) privatization in the early stages of privatization policy. See Section 2 below for an explanation of the term "liquidation" and "commercialization."

2. The role of MEBOs in Poland's privatization program

Under Polish law there are two principal methods of privatization, which I will refer to (following convention) as capital privatization and liquidation privatization.⁶ The principal difference between the two is that in capital privatization a state enterprise is transformed into a joint-stock company⁷ whose shares are subsequently sold to private investors, whereas in liquidation the state enterprise is dissolved and its assets transferred (by one of various possible methods) to the private sphere. In addition, it is important to note that there are two types of liquidation: the first I will call Article 37 liquidation (based on Article 37 of the 1990 Law on Privatization of State-owned Enterprises), and the second Article 19 liquidation (based on Article 19 of the 1981 Law on State Enterprises). Article 19 liquidations are applied to insolvent state firms and entail the dissolution of the enterprise and the sale of its assets, resulting in the end of the firm as a legal and economic entity. In Article 37 liquidations, the state firm ceases to exist as a legal entity; however, a new firm is created which then acquires the right to use the assets of the state enterprise. In this way, the state-owned enterprise continues to exist as an economic entity, but in the private sphere. Article 37 liquidations can be initiated by the state organization which acted as the "founding organ" of the state enterprise (usually a voivodeship or ministry) or by the workers' council.⁸ This type of privatization usually results in the formation of a company owned by the employees of the state enterprise being liquidated; such a company is generally referred to as an employee-owned firm (*spółka pracownicza*). Three types of Article 37 liquidation exist: leasing of assets, sale of assets, and "contribution" of assets to a company. Leasing decidedly dominates as the preferred form of Article 37 liquidation.⁹ Most employee-owned firms are created in the leasing variant of the Article 37 liquidation (although there are some that use other methods),¹⁰ and, basically, it is these leasing firms

⁶No separate law governed the small privatization process, which was basically carried out by local governments without supervision by the Ministry of Ownership Transformation (see below). The law on commercialization and privatization passed by the Sejm on 30 June, 1995 (which was, however, declared unconstitutional by the Constitutional Tribunal on 22 November of the same year) introduced new terminology with respect to the methods of privatization: capital privatization is referred to as indirect privatization, and liquidations on the basis of Article 37 of the 1990 law are referred to as direct privatization. This terminology is also used in Polish discussions of various privatization methods.

⁷This transformation into a joint-stock company is often referred to in Poland as "commercialization." I shall refer to a state-owned enterprise transformed into a joint-stock company wholly owned by the State Treasury as a commercialized enterprise.

⁸The workers' council and the enterprise director enjoy veto rights over the liquidation. See the Law on Privatization of State-owned Enterprises, Article 37.

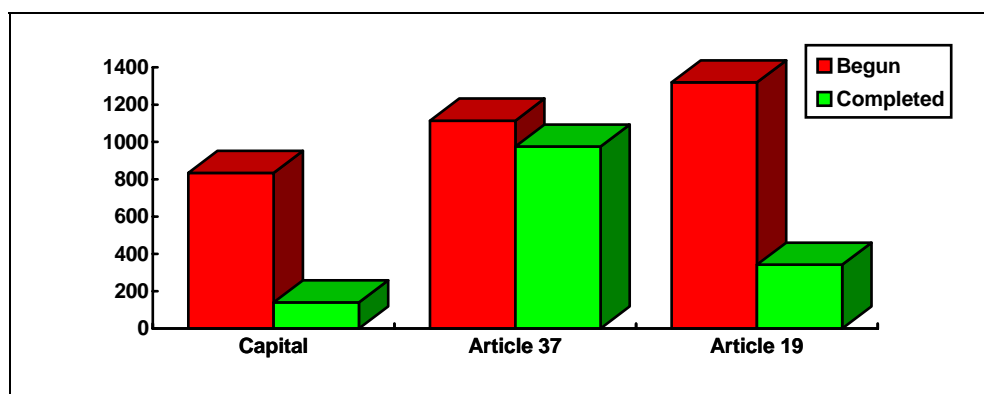
⁹At the end of 1994, 73 per cent of approved applications for Article 37 liquidation had been leasing cases. (See Ministerstwo Przekształceń Własnościowych [1995a], 4).

¹⁰The Ministry of Ownership Transformation estimated that about 800 employee-owned companies had been created through the end of 1994 on the basis of Article 37. (See Ministerstwo Przekształceń Własnościowych [1995a], 4). There have been isolated instances of employee buyouts in the capital privatization route, but these are marginal. In addition, the regulations concerning capital privatization provide for making shares available to employees at preferential rates; however, these provisions affect at most 20 per cent of the shares of firms privatized using this method. See Article 24 of the Law on Privatization of State-owned Enterprises. (According to the privatization bill passed by the Sejm on 30 June, 1995, employees and farmers and fishermen supplying enterprises with raw materials will have the right to acquire 15 per cent of the shares of enterprises undergoing indirect privatization completely free of charge.)

that we are concerned with in this paper. An employee-owned firm can privatize a state enterprise through the leasing method if it includes the majority of the employees of the state enterprise to be liquidated and is able to collect an amount of equity equal to at least 20 per cent of two funds (the "enterprise fund" and "founding fund") of the state enterprise being liquidated.¹¹

Of the state property which had been privatized in Poland through mid-1995, a very high percentage was privatized by the MEBO method. Liquidation privatization (which in most cases results in the formation of employee-owned companies) has, contrary to many of the initial expectations, turned out to be the most significant privatization method statistically. To quote Błaszczyk and Dąbrowski, "[t]he quantitative results from capital privatization are very modest in comparison with original expectations. Fears were confirmed that this is an exceptionally difficult, time-consuming, and costly method of privatization, especially when done through public offering."¹² The following statistics show the clear dominance of Article 37 liquidation over other forms of privatization: By 30 June, 1995, the privatization process had been launched in 3267 non-agricultural state enterprises. Of these, only 834 transformations (including commercializations) were of the capital type, whereas 2433 were of the liquidation type, with 1114 Article 37 liquidations and 1319 Article 19 liquidations. By the same date, privatization had been *completed* in 1457 enterprises, with 140 capital privatizations and 1317 liquidations (342 of the Article 19 type and 975 of the Article 37 type).¹³ Thus, given the fact that the vast majority of Article 37 privatizations take the form of leasing, almost two thirds of the completed privatizations carried out under the supervision of the Ministry of Ownership Transformation have been accomplished through management-employee buyouts.¹⁴

Figure 1. Privatization of state enterprises in Poland as of 30 June, 1995



Source: Ministerstwo Przekształceń Własnościowych (1995b).

¹¹See the Law on the Privatization of State-owned Enterprises, Article 38.

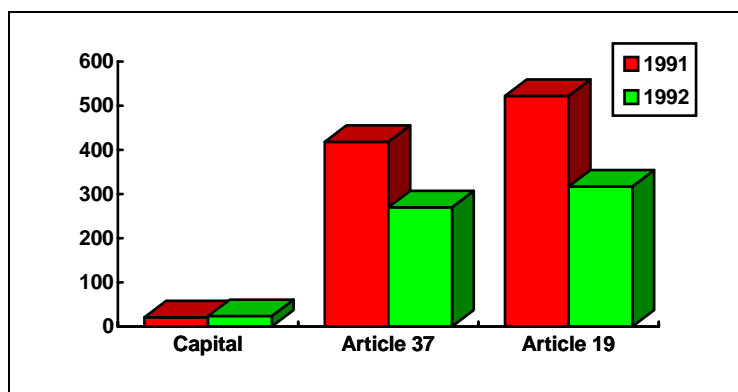
¹²See Błaszczyk and Dąbrowski, in Akyüz et al. (eds.) (1994), 101-102.

¹³See Ministerstwo Przekształceń Własnościowych (1995b).

¹⁴If one considers Central Statistical Office data on employment, Article 37 privatization does not outweigh capital privatization so strongly, as total employment in firms privatized by these two methods is much closer to being equal. See Central Statistical Office (1995b), 60.

The rate of privatization is also an important measure of progress in the privatization process. As the following charts illustrate, the rate of privatization peaked in 1991 and has declined significantly since then.

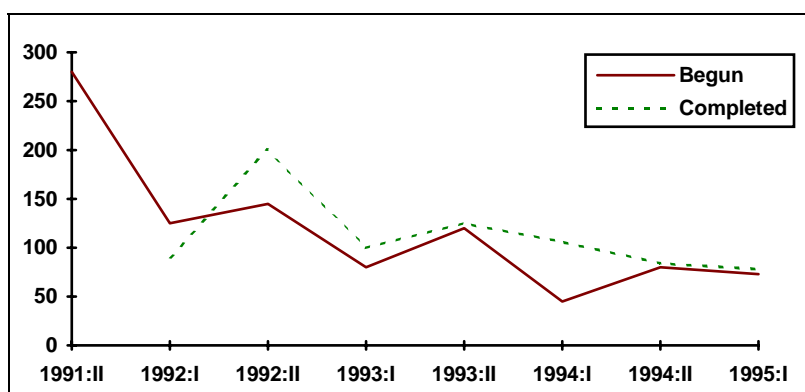
Figure 2. Completed privatizations (by method): 1991 and 1992



Source: Ministerstwo Przekształceń Własnościowych (1995b).

The following three charts illustrate the trends in number of privatization procedures initiated and completed in each half-year period for the last four years. (Data on completed privatizations for the second half of 1991 were not available.)

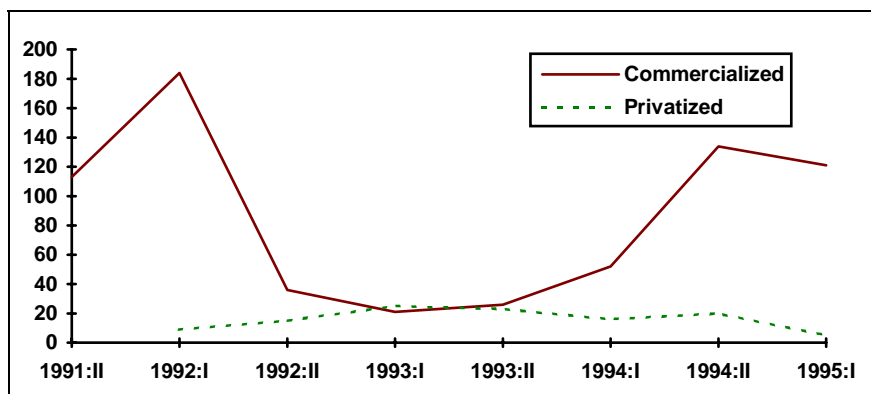
Figure 3. Article 37 privatizations



Source: Ministerstwo Przekształceń Własnościowych, *Dynamika prywatyzacji*, numerous issues¹⁵; Szomburg, Dąbrowski, and Kamiński (1994), 4.

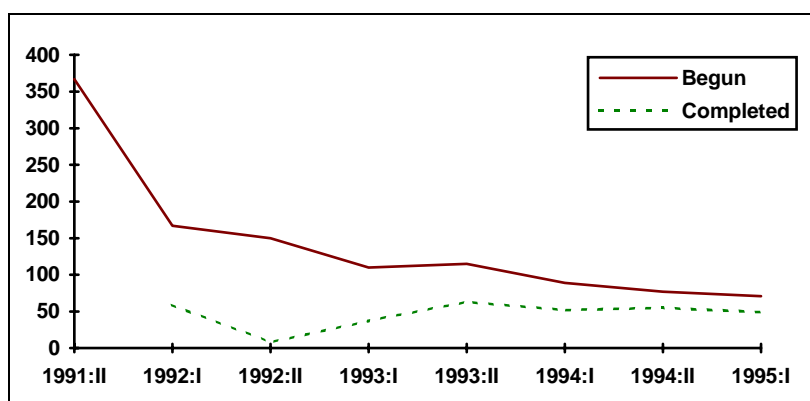
¹⁵The calculations on which these tables are based should be treated as approximations, as the data from successive issues of *Dynamika prywatyzacji* are inconsistent due to frequent revisions made by the Ministry of Ownership Transformation.

Figure 4. Capital privatizations



Source: See Figure 3.

Figure 5. Article 19 privatizations



Source: See Figure 3.

Among the most important reasons for the slowdown in privatization are the following:

- In many enterprises, changes _ both real and expected _ in the legal regulations affecting privatization have caused a wait-and-see attitude toward the initiation of privatization procedures. For example, it is well known that many firms put off decisions on privatization during the negotiation of the Pact on the State Enterprise, waiting to see how the end result would affect privatization (particularly with respect to the interest rates paid in the leasing variant of Article 37 privatization and regulations concerning shares designated for employee acquisition on preferential terms in cases of capital privatization).¹⁶ Negotiation of the pact began in the summer of 1992, shortly after Hanna Suchocka's government took office, and the pact had still not been passed by the parliament when the government lost a vote of no confidence in the early summer of 1993, resulting in the dissolution of the parliament. Subsequently, the status of the pact remained unclear, as the coalition government of the Democratic Left Alliance and the

¹⁶See "Prywatyzacja bez kapitału" (interview with Jan Czekał, undersecretary of state in the Ministry of Ownership Transformation) in *Nowe życie gospodarcze* (no. 16), 7 September, 1995, 28-29; see also Olko-Bagieńska et al. (1992), 42-43.

Polish Peasant Party also failed to pass the legislation contained in the pact, although the coalition has always claimed that it sees itself as being bound by the pact.

- In the absence of non-equivalent privatization methods (for example, voucher privatization), the limited savings of the population and limited attractiveness of most of the stock of state assets render the privatization process increasingly difficult with the passage of time. The most attractive state enterprises (i.e., those with the best financial results, which are relatively politically uncontroversial, etc.) can be privatized rapidly at the beginning of the process, but the privatization of the remaining enterprises poses more and more significant problems. (A good example of this problem can be found in the case of the Treuhand privatization in Germany.)

Although the MEBO method has been shown to be numerically vastly dominant in the privatization processes supervised by the Ministry of Ownership Transformation, this still does not give us a complete picture of the scale of "insider" privatization in Poland. One must also consider the results of ownership transformation processes outside of the jurisdiction of the Ministry of Ownership Transformation. These include the privatization of state farms which were taken over by the Agency for Agricultural Property of the State Treasury and of some enterprises undergoing bankruptcy proceedings in court as well as the entire "small privatization" program. The latter affected very small businesses in the areas of retail trade and consumer services (grocers' shops, restaurants, barber shops, etc.) and generally consisted in the sale or, more frequently, rent or lease of premises to private owners; the new owners were designated either competitively through public auctions or in a more or less administrative fashion through closed auctions or direct negotiations. Although MEBO programs have not been used explicitly in small privatization, insider ownership in businesses privatized in small privatization programs is very extensive; the vast majority of new owners who acquired titles in closed or semi-public auctions or through negotiations with local authorities can be presumed to be insiders.¹⁷ For methods used in Polish small privatization, see tables 1 and 2 below.

Table 1. Small privatization: methods (% of total units privatized)

Type of transfer (1992 data)	
sale	6.72
lease/rent	93.28
Mode of transfer¹⁸	
public auction	27
non-/semi-public auction (insiders only or with preferences for insiders)	12
negotiated or administrative transfer	61

Source: Earle et al. (1994), 211, 214.

¹⁷See Earle et al. (1994), 214.

¹⁸These are data from a survey of a random sample of 100 Polish municipal governments (*gminy*) carried out in March 1993. There are some indications that the percentage of units privatized by means of auctions reported here is higher than would be the case in a representative sample. See Tamowicz et al. (1992), 22.

Table 2. Central European University survey: Small privatization methods in 100 Polish small businesses (%)

Type of transfer (Response rate: 90%)	
sale	21
lease/rent	79
Mode of transfer (Response rate: 88%)	
auction	10.2
direct sale	11.4
directly negotiated rental agreement	78.4

Source: Earle et al. (1994), 254, 260.

3. Financing MEBO privatization

It is clear that privatization through MEBO in Poland represents a form of "privatization on credit," and the role of credit, both in the financing of the privatization process itself and in the financing of the investment activity of the firms following privatization, will be discussed at some length in this paper. With regard to the financing of the privatization process, there is no doubt that the state itself represents the largest creditor, with banks taking a distant second place. (On banks' role in MEBO privatization, see Section 5 below.) Thus, the question of the conditions set by the state for the payment of the leases are of crucial importance.

In spite of the above-mentioned negative attitudes toward employee ownership which have tended to dominate in government circles, several preferential conditions have been created to facilitate this form of privatization. Thus, for example, preferential interest rates are applied for the lease payments. The interest payment (referred to in Polish regulations as the "additional payment" [*opłata dodatkowa*]) was originally set by the Finance Ministry at 75 per cent of the central bank refinancing rate. (Moreover, the interest payments could, to some extent, be postponed during the first two years of the leasing period.) Finally, an additional preferential condition allowed the firms to include the lease payments as costs in their accounts, thus reducing their tax liability.¹⁹ Later, it was determined that if the central bank refinance rate were to exceed 40 per cent, the interest rate would be set at 30 per cent (75 per cent of 40 per cent).²⁰ In 1993, the interest rate was lowered again, to 50 per cent of the refinance rate.²¹ At the same time, further favorable conditions were created in order to stimulate investment in the leasing-privatized companies; these provisions, as well as the difficulties which continue to face leasing firms in spite of these measures, will be discussed in the remarks on investment activity in Section 4 and Section 5.

¹⁹Zarządzenie Ministra Finansów z dnia 10 listopada 1990 r. (*Monitor Polski* 1990 nr 43, poz. 334).

²⁰Zarządzenie Ministra Finansów z dnia 7 maja 1991 r. (*Monitor Polski* 1991 nr 18, poz. 123).

²¹Zarządzenie Ministra Finansów z dnia 13 maja 1993 r. (*Monitor Polski* 1993 nr 26, poz. 274).

4. Characteristics of firms privatized by MEBO

A review of various studies of MEBO privatizations in Poland²² reveals similarities in the following aspects of firms' characteristics:

1. Size. Most of the firms in this category are small- to medium-sized firms, usually with less than 500 employees. Average employment in the Jarosz sample was 285 in December 1991 and had fallen to 213 by the end of 1993; in 1994, the smallest firm in the sample employed two persons and the largest 1,170. Average employment in the first Zmiany sample was 292 as of September 1991. Of the 1041 enterprises which had initiated Article 37 liquidation privatization proceedings by 31 December, 1994, 569 (54.7 per cent) had up to 200 employees, 289 (27.8 per cent) had 201-500 employees, and 183 (17.6 per cent) had over 500.²³

2. Dominant sectors. Certain sectors tend to dominate in this form of privatization; basically, these are the construction, trade, and service sectors. 32.8 per cent of Article 37 liquidation processes initiated by 31 December, 1994, occurred in construction and 16.2 per cent in trade. Construction firms constituted 43.3 per cent of the Jarosz sample in 1992 and 44.6 per cent in 1993; firms in the trade and service sectors constituted 32.7 per cent of the sample in 1992 and 30.7 per cent in 1993. Of the first Zmiany sample, 58 per cent were in construction and 20 per cent in trade.²⁴

3. Profitability. The financial results of employee-owned companies seem to be generally fairly sound in spite of the burden of lease payments and the effects of the general recession which affected the country in the first three years of the economic transformation. The following data of the Central Statistical Office allow one to compare the financial situation in employee-owned companies and state enterprises preparing for privatization by the MEBO method with that in companies privatized by the capital method and two groups of commercialized companies (those designated for participation in the NFI program and those being prepared for capital privatization):

²²The information presented here concerning Polish employee-owned firms is based on eight studies of such firms which have been published to date. Two were carried out by a group of researchers led by Maria Jarosz (one carried out in June 1993 on a sample of 108 firms privatized before 31 December, 1991, and the second carried out in 1994 on a sample of 102 such firms). Two others were conducted by the Warsaw research and consulting firm Zmiany (the first of these _ conducted in 1991 _ contained a sample of 171 firms, the second _ conducted in 1993 _ 142; as in the case of the Jarosz sample, all had been privatized by 31 December, 1991). See Olko-Bagieńska et al. (1992, 1994). The Zmiany research was conducted on the basis of survey data; the Jarosz group's on the basis of both survey data and interviews. The other four, with much smaller samples, were studies of various types of privatized enterprises carried out by the Gdańsk Institute for Market Economics between September 1991 and mid-1994. The first study (see Dąbrowki, Federowicz, Levitas, and Szomburg [1992]) was conducted on a sample of 20 privatized and commercialized firms including 9 liquidated on the basis of Article 37 (of which 7 were leasing cases); the second (see Dąbrowski, Federowicz, and Szomburg [1992]) on a sample of 55 firms, including 24 liquidated on the basis of Article 37 (of which 19 were leasing cases); the third (see Dąbrowski, Federowicz, Kamiński, and Szomburg [1993]) on a sample of 61 firms, including 24 liquidated on the basis of Article 37 (of which 18 were leasing cases), and the fourth (see Szomburg, Dąbrowski, and Kamiński [1994]) on a sample of 95 firms, including 58 liquidated on the basis of Article 37 (of which 44 were leasing cases).

²³See Pietrewicz, in Jarosz (ed.) (1995a), 29, Olko-Bagieńska et al. (1992), 13, and Ministerstwo Przekształceń Własnościowych (1994), 57-58.

²⁴See Pietrewicz, in Jarosz (ed.) (1995a), 21, Olko-Bagieńska et al. (1992), 14, and Ministerstwo Przekształceń Własnościowych (1994), 54.

Table 3. Gross profitability (ratio of gross financial result to total revenues)

	1994 (1st half)	1994 (whole year)	1995 (1st half)
employee-owned companies	6.2	6.4	5.6
state enterprises currently undergoing Article 37 liquidation	-1.4	3.2	1.0
capital-privatized companies	6.0	4.9	5.9
commercialized companies designated for participation in NFI program	5.0	4.2	5.7
commercialized companies being prepared for capital privatization	10.0	8.2	12.5

Source: Central Statistical Office (GUS) (1995a), 65-68; Central Statistical Office (1995b), 66.

These data show that profitability indices for the average Polish MEBO are close to _ or even better than _ the average indices for firms privatized by the capital method and firms participating in the NFI program; in addition, they are much higher than those of state enterprises.²⁵ The Zmiany group found, moreover, that employee-owned companies in their sample had significantly better financial results than state-owned enterprises, both commercialized and non-commercialized, for 1991 and 1992. They write:

The commercialised firms were better placed to plunge into privatisation than the liquidated ones, which is illustrated by the level of profitability indices for 1990. However, after half a year of operation, the situation was reversed because already in the middle of 1991, the enterprises privatised by way of liquidation reported a higher rate of return. An analysis of the structure of their balance sheets showed that in the liquidated enterprises, the attempts to remedy the economic situation were more frequent, which is confirmed by shifts in the pattern of costs, the value of fixed assets and the smaller drop in the value of sales than among the enterprises that were only commercialized.²⁶

Similarly, the Jarosz group found that total profitability (ratio of gross profit to costs) in employee-owned companies was higher than the national average for 1992 and 1993 and net (after-tax) profits were rising; on the other hand, gross (pre-tax) profits were falling, whereas the national average was rising.²⁷ It is worth noting that financial results were the best for those types of enterprises which were least typical among the group of MEBOs; i.e., among large industrial enterprises employing over 300 persons.²⁸

²⁵See Ministerstwo Przekształceń Własnościowych (1995a), 3. The vast difference between reported financial results for firms preparing for liquidation privatization and those preparing for capital privatization may reflect the use of "creative accounting" due to the different incentives facing the two types of firms: while the managers of the former type of firms are, for the most part, preparing to purchase the firm themselves, they have an incentive to underreport the financial results and value of the assets of the firm with a view toward negotiating as low a price as possible with the Ministry of Ownership Transformation; the managers of firms being prepared for capital privatization, however, are looking for outsiders to purchase the firm and therefore wish to make the firm as attractive as possible.

²⁶See Olko-Bagińska et al. (1992), 11, 27.

²⁷See Pietrewicz, in Jarosz (ed.) (1995a), 24-26.

²⁸See Pietrewicz, in Jarosz (ed.) (1995a), 54. Similarly, the Gdańsk Institute's research team found that the weakest firms in their sample from a financial point of view were concentrated in the construction and trade sectors, and that the strongest were in industry and services. See Szomburg, Dąbrowski, and Kamiński (1994), 49.

4. Investment, restructuring, and adjustment activity. How do Polish MEBOs behave with respect to investment? To what extent are they engaging in restructuring activity, and what are they doing to adjust to changing market conditions?

While the considerable imperfections which continue to flaw the Polish capital market render access to funds for the financing of investments difficult for practically all Polish enterprises,²⁹ one frequently encounters the claim that MEBOs in Poland are characterized by exceptionally low levels of investment activity. One group of researchers finds a tendency to low investment and decapitalization in employee-owned companies compared with the enterprise sector of the national economy³⁰; however, as Maria Jarosz emphasizes, Polish employee-owned companies are usually formed on the basis of a lease contract and are obligated to make regular – and rather burdensome – lease payments, to which a large portion of profits must be dedicated, thus limiting the possibilities for using retained earnings to finance investment; additionally, these firms have exceptional difficulty (in comparison with other privately-owned firms) in obtaining bank credits, since they do not own, but only lease, their physical capital and thus possess inadequate collateral.³¹ Moreover, the leasing method of privatization is explicitly intended for firms which are considered to require little investment.³² Finally, there is evidence that an "elite" of leasing companies is investing on a scale comparable with that observed in enterprises privatized by the capital method but without foreign investors.³³

Restructuring and adjustment activity in firms privatized by MEBO tends to be concentrated in increased promotional activity and adjustments of a simple, cost-reducing nature (e.g., employment reductions), involving little in the way of introduction of new products or significant improvement in the level of technology.³⁴

The evidence on changes in the structure of employment in employee-owned companies seems to be mixed. Olko-Bagieńska et al. (1992, p. 12) find that commercialized enterprises in their sample maintained the ratio of administrative staff to line workers, whereas liquidated firms reduced this ratio. However, no such change was found in the employee-owned companies studied in Jarosz (ed.) (1994).³⁵ Opponents of insider-led

²⁹See "Eyeing up the risk," in *Business Central Europe*, vol. 3, no. 25 (October 1995).

³⁰See Pietrewicz, in Jarosz (ed.) (1995a), 39-40.

³¹See Jarosz (ed.) (1995a), 16. See also Dąbrowski, Federowicz, Kamiński, and Szomburg (1993), 38, and Szomburg, Dąbrowski, and Kamiński (1994), 60.

³²See Najwyższa Izba Kontroli (1993b), 9, *Uchwała Sejmu Rzeczypospolitej Polskiej z dnia 12 lutego 1993 r. w sprawie podstawowych kierunków prywatyzacji w 1993 r. (Monitor Polski 1993 nr 9, poz. 64)*, and *Kierunki prywatyzacji majątku państwowego w 1995 r. (Dziennik Ustaw 1995 nr 27, poz. 142)*.

³³See Szomburg, Dąbrowski, and Kamiński (1994), 39, 54. Investment spending in capital-privatized firms with foreign investors was vastly greater than that in capital-privatized firms without foreign investors.

³⁴See Pietrewicz, in Jarosz (ed.) (1995a), 51-52. The Gdańsk Institute's research team reached similar conclusions, and found that large investments occurred only where there were foreign investors. See Dąbrowski, Federowicz, Kamiński, and Szomburg (1993), 29, 37, and Szomburg, Dąbrowski, and Kamiński (1994), 56-57.

³⁵See Jarosz (ed.) (1994), 19. (Later, the tempo of reduction of line workers was slightly higher than the average rate of employment reduction, but this did not lead to a significant change in the ratio. See Pietrewicz, in Jarosz [ed.] [1995], 30.) The Gdańsk Institute's research team found results similar to those of the Zmiany group: in their sample,

privatization have often expressed fears that it would tend to stimulate efforts to maintain employment at the inefficient levels of overstaffing typical in the command economy, and, in fact, employees themselves often hope that share ownership will be a guarantee of employment.³⁶ In reality, however, employee-owned companies have shown a great deal of elasticity in their employment policies, often engaging in significant layoffs (in firms that are on the average relatively small to begin with). Dąbrowski, Federowicz, Levitas, and Szomburg (1992, p. 34), state that the perception of share ownership as an employment guarantee is a fallacy, and report that the one enterprise in their sample in which this argument was used by the internal initiators of privatization to win over the workforce to the idea was also the firm which showed the heaviest job losses in the sample; terminations, moreover, were independent of shareholding. In general, their 20-firm sample (which includes firms having undergone all of the various types of ownership transformation, including Article 19 and Article 37 liquidation, capital privatization, and commercialization), contained no firms in which employment grew; employment in most firms in the sample fell by one fifth to one third.³⁷ (It is worth noting that, in their sample, large employment reductions _ and, in the cases of non-bankruptcy liquidations, the initiation of all types of restructuring activity _ occurred mainly *before* privatization, when the workers' council was still in existence, whereas large pay increases _ which occurred in almost all cases _ took place mainly *after* privatization.³⁸) Average employment in the Jarosz sample fell from 285 at the end of 1991 to 242 at the end of 1992 (i.e., a 15.1 per cent decrease) and to 213 at the end of 1993 (a 12.0 per cent decrease), stabilizing somewhat in 1994 (average employment in mid-1994 was 209).³⁹ Olko-Bagieńska et al. (1992, p. 36) write: "Privatisation usually involves a drop in employment, which is larger in the liquidated enterprises. It is worth noting that the drop in employment was the biggest in the firms in which the employees took over 100% of the stocks." They found average employment reductions of 28 per cent in their sample of firms for the period between privatization and the end of 1992.⁴⁰ Wage growth was fairly high in the period immediately following privatization but slowed down considerably thereafter, even failing at times to keep pace with productivity growth. Thus, for example, in 1993, average productivity growth in the Jarosz sample was about 2.9 per cent, but real earnings decreased by about 1.9 per cent, and by mid-1994 average earnings in the sample were below the national average.⁴¹

5. Concentration of shares. Although shareholding is, on the average, rather dispersed in Polish employee-owned firms, a certain degree of concentration can be observed. The second Zmiany study showed that members of the managerial staff had purchased 27.2 per cent of the shares at the time of privatization, that managerial employees

there was an increase in the ratio of production workers to total employment (especially in the financially weakest firms). See Szomburg, Dąbrowski, and Kamiński (1994), 64, 86.

³⁶See Gardawski, in Gilejko (ed.) (1995), 184.

³⁷See Dąbrowski, Federowicz, Levitas, and Szomburg (1992), 21.

³⁸Ibid., 26, 33.

³⁹See Pietrewicz, in Jarosz (ed.) (1995a), 29.

⁴⁰See Olko-Bagieńska et al. (1994).

⁴¹See Pietrewicz, in Jarosz (ed.) (1995a), 30, 34.

held at least 26 per cent of the shares in 47.8 per cent of the firms, and that, on the average, the largest ten shareholders together held 40.5 per cent of the shares of the firm.⁴² The Jarosz group made similar findings: as Juliusz Gardawski writes,

On the average, one quarter of the shares is held by an elite of some dozen or so persons concentrated in the managerial staff and the supervisory board, whereas a group of employees which is ten times more numerous has a total of half of the shares. Furthermore, the elite is constantly increasing its share, and the employees' share is declining.⁴³

Moreover, the percentage of employees who are shareholders is decreasing; in the Jarosz sample, this percentage fell from around 90 per cent to around 70 per cent during the period of study.⁴⁴ Interestingly, several studies have found some evidence of a positive correlation between *dispersion* of shares and the strength of the firms' financial standing. Thus, for example, the Gdańsk Institute's research team divided their sample into four groups with respect to financial standing and found that the majority of firms with the most dispersed ownership structure were in the two best categories of firms, whereas the ones with the most concentrated structure were in the two worst categories.⁴⁵ Similarly, the Jarosz group found that, in comparison with firms with outside investors and firms in which workers held over 80 per cent of the shares, firms in which the managerial staff and members of the supervisory board held over 20 per cent of the shares had the slowest revenue growth and were the only group in which cost growth exceeded revenue growth in the period 1993-1994.⁴⁶ While these facts should be interpreted with caution, it is probably safe to conclude that a dispersed ownership structure is not necessarily a barrier to the success of an MEBO.

6. Stability and strong position of management. A 1991 government report on privatization found that the management of the employee-owned companies was usually made up of the former management and workers' council members of the liquidated state enterprises.⁴⁷ Similarly, the Jarosz group found that about one half of the directors of the firms in their sample had been directors before privatization.⁴⁸ Moreover, management's control is diluted to a very limited extent; although the opinion that management shares control with the supervisory board (and not with any other persons or institutions) dominated among survey respondents in the Jarosz sample of firms, a large majority of management representatives themselves claimed that their decision-making power was not inhibited by any actors within the firm. Non-managerial employees account for between 20 and 30 per cent of supervisory board membership, and this proportion is declining. Thus, in

⁴²See Olko-Bagińska et al. (1994).

⁴³See Gardawski, in Jarosz (ed.) (1995a), 63.

⁴⁴Ibid., 64.

⁴⁵The highest level of concentration existed in the worst firms from the very beginning of their existence as private enterprises, and the concentration process subsequently occurred fastest in these enterprises. See Szomburg, Dąbrowki, and Kamiński (1994), 65-6, 86.

⁴⁶See Pietrewicz, in Jarosz (ed.) (1995b), 21.

⁴⁷See Najwyższa Izba Kontroli (1991), 16-17.

⁴⁸See Gardawski, in Jarosz (ed.) (1995a), 57-59.

spite of the ownership structure of these firms, the dominant management style seems to be more autocratic than participatory.⁴⁹

7. Labor relations and trade unions. There is a strong tendency for trade unions to vanish after a state enterprise is privatized by MEBO. In the Jarosz group's sample of firms, trade unions were absent in 40 per cent as early as the day of their registration, and unionization continued to decline. By June 1994, unions were present in only 53 per cent of the sample. (Similarly, trade unions were present in only 54 per cent of the Zmiany group's sample.) However, there seems to be a fairly strong correlation between unionization and firm size; in the firms in the Jarosz sample employing over 500 persons, unionization was much higher than the sample average.⁵⁰ A general state of industrial peace in these firms is frequently observed, and strikes are extremely rare.⁵¹

5. Common problems and support institutions for MEBOs

Firms privatized by MEBO face certain typical sorts of problems during the privatization process and afterward; certain institutions also exist to support MEBO privatization and MEBO-privatized firms.

Real estate. The problematic legal status of real estate (land, buildings, etc.) associated with the firm (connected with, for example, the question of restitution/reprivatization and the possible existence of various conflicting claims) is one source of problems for firms during the process of privatization, and its often high cost is another. Workers and directors of firms in which an MEBO is being planned often find that much of this property is of no economic use and rests, moreover, on plots of land which are much too expensive for them to purchase. Assessment of the value of the real estate presents a particular problem, as this process can be lengthy, expensive, and time-consuming.⁵²

Heavy debt burden and difficult access to capital. As mentioned above, the terms of leasing agreements in Poland have often been found to constitute a very serious burden for firms privatized by Article 37 liquidation, as they deprive the firms of funds which could otherwise be used for investment, thus adding to the difficulties of these firms in obtaining financing due to their lack of collateral and high degree of leverage.⁵³ Generally speaking, this debt burden must be carried by the employee-owners themselves without help from outside, as most banks are very reluctant to finance MEBOs. One survey of the nine largest banks operating in Warsaw found that, when assessing the risk associated with various privatization methods on a scale of AA to CC (i.e., from no risk to prohibitive risk),

⁴⁹Ibid., 60-63.

⁵⁰See Szostkiewicz, in Jarosz (1995), 96-97, and Olko-Bagieńska et al. (1994).

⁵¹See Szostkiewicz and Kozarzewski, in Jarosz (ed.) (1995a), 88-91.

⁵²See, for example, Pańków (1993), 122, Dąbrowski, Federowicz, Levitas, and Szomburg (1992), 37, 39-40, Najwyższa Izba Kontroli (1993a), 34.

⁵³For the difficulties caused by leasing conditions, see Dąbrowski, Federowicz, Levitas, Szomburg [1992], 37, 40.

MEBOs were assessed as a C risk (unless a foreign investor was involved, in which case the assessment was improved to A).⁵⁴

In many cases, the debt problem is exacerbated by the fact that the lease itself is not the only liability incurred through privatization. Leasing privatizations involve the necessity, mentioned above (in Section II), of collecting a sum of equity capital equal to at least 20 per cent of two funds (the "enterprise fund" and "founding fund") of the state enterprise being liquidated. Very frequently employees had to take out loans in order to make the necessary share purchases to fulfill this requirement. These loans were usually made from the revenues of the state enterprise itself, although in rare cases banks provided funds (see discussion of the Employee Ownership Bank below). The Zmiany group found that 30 per cent of the firms in their sample used the state enterprise funds to collect the necessary capital, while 12 per cent obtained bank loans.⁵⁵ The practice of using the state enterprise funds often involved the creation of a foundation which received payments out of the state enterprise's profits; these funds were then designated for low-interest loans to be granted to employees for the purpose of share purchases. This practice was rather controversial and was criticized, for example, by the Supreme Control Chamber (NIK), which saw it as private appropriation of funds which belong to the State Treasury.⁵⁶ The loans made to employees were also sometimes subjected to the so-called *popiwiek*, the tax on wage increases exceeding certain centrally set norms, and in NIK's opinion this tax was sometimes unjustifiably avoided by the foundations.⁵⁷ The use of such foundations was, moreover, made legally complicated by the fact that their loan activities were legally required to be registered as economic activity and required a concession from the National Bank of Poland; furthermore, in 1991 certain tax breaks affecting gifts made by corporations were eliminated.⁵⁸ Another source of financing of loans for employee share purchases were the social and housing funds of the state enterprises, a practice which was also criticized by NIK before the courts recognized its legality.⁵⁹

Some of the consequences of the debt burden incurred as a result of the leasing construction of most MEBOs are investigated in the Jarosz group's research, which includes analysis of the liquidity indices for their sample of firms in comparison with national averages. The current ratio (i.e., the ratio of current assets to current liabilities) was, on the average, not particularly good, but better than the national average in 1993; in addition, the national average was falling at that time, while the index for the sample of MEBO firms was rising. (It should, however, be noted that the average current ratio in MEBO firms in the trade and services sectors was much lower than the sample average; the index for these firms was on the threshold of becoming threateningly low and was, moreover, below the national average.) The same situation was observed with regard to the quick ratio (i.e., the

⁵⁴See Jan K. Solarz, in Schliwa (ed.) (1994), 86-87.

⁵⁵See Olko-Bagieńska et al. (1994); see also Szomburg, Dąbrowski, and Kamiński (1994), 59.

⁵⁶See Najwyższa Izba Kontroli (1991), 6, 20, and Najwyższa Izba Kontroli (1993b), 15.

⁵⁷See Najwyższa Izba Kontroli (1993a), 46, and Najwyższa Izba Kontroli (1993b), 15-16.

⁵⁸See Masiukiewicz (1992), 22, 24. See also Najwyższa Izba Kontroli (1994), 55. It is, however, highly probable that many foundations operated in fact without a concession from the NBP.

⁵⁹See Najwyższa Izba Kontroli (1991), 6, 44, and Najwyższa Izba Kontroli (1993b), 18.

ratio of current assets minus average reserves to current liabilities). Similarly, the ratio of long-term debt to equity was found to be quite high, averaging 2.47 for the entire sample for 1993 (7.52 in firms employing 100 persons or fewer).⁶⁰

There have been some attempts on the part of various governments to alleviate this problem. The reductions of the interest rate paid on the leases have been discussed above, in Section III. In addition, a measure to stimulate investment was included in the 1993 regulatory changes. According to the new provisions, a leasing company can apply to its founding organ for a reduction of the interest payments owed by the company as a result of postponements during the first two years of the leasing period if its investment expenditures out of profits amount to at least 50 per cent of its net profit.⁶¹ The privatization bill passed by the Sejm in June 1995 also included a provision intended to enhance the creditworthiness of MEBO-privatized firms when applying for bank loans. According to Article 52, the title to the assets being leased may be transferred to the leasing firm after it has paid only one third of the obligations resulting from the leasing contract if two years have passed since the signing of the leasing contract; this term may even be shortened to one year if the firm has paid at least one half of those obligations. Although the bill did not go into effect as a result of a decision of the Constitutional Tribunal, it is likely that the Sejm will pass a law including a similar provision in the near future.

Controversy over the management's political past: a problem avoided. When the management of a state enterprise in a post-Communist economy purchases a firm and there is suspicion that its members may have politically compromised themselves under the previous regime, one hears complaints of what is often called "nomenklatura privatization." In East Germany, for example, deep distrust of managerial staff among members of the workforce sometimes rendered a management buyout difficult or even impossible.⁶² This problem has for the most part been avoided in Poland, as in Poland the shift of power to the workers' councils after the fall of the Communist regime brought a wave of replacements of old directors, sometimes referred to as the "red managerial class"; in fact, many old directors were replaced by members of the workers' councils from the former opposition (including Solidarity trade union activists).⁶³ This has undoubtedly been a factor in the success of the MEBO privatization method in Poland.

Support institutions. Institutions which have been founded to support employee-owned firms in Poland include the Union for Employee Ownership (*Unia Własności Pracowniczej*), the All-Poland Chamber of Employee-Owned Companies (*Ogólnopolska Izba Gospodarcza Spółek Pracowniczych*) in Poznań, and the Gdańsk Employee Ownership Bank (*Bank Własności Pracowniczej SA w Gdańsku*); however, their significance for the process of employee-led privatization in Poland has been rather limited. Thus, the Union for Employee Ownership, founded in the autumn of 1990, has only 76 member firms, some of which are still state-owned. In addition to lobbying activities and the organization of annual

⁶⁰See Pietrewicz, in Jarosz (ed.) (1995a), 43-48.

⁶¹Zarządzenie Ministra Finansów z dnia 13 maja 1993 r. (Monitor Polski 1993 nr. 26, poz. 274).

⁶²See Reicherzer, "Em-bi-ou im VEB," in *Die Zeit*, 24 May, 1991.

⁶³See Dąbrowski et al. (1991), 9.

conferences on the subject of employee ownership in Poland, the Union's activities include the provision of assistance to enterprises in the process of MEBO privatization and of legal aid and various types of training programs to member firms. The All-Poland Chamber of Employee-Owned Companies has 105 member firms (all of them privatized) and is also primarily focused on lobbying activity. The Employee Ownership Bank, which has been in operation since September 1990, has aided in 30 MEBOs (concentrated mostly in southern Poland) by means of so-called "privatization bonds." These bonds are sold to the state enterprise being liquidated; the money is then lent by the bank at preferential rates to the employees for the purpose of making share purchases. The bank is currently seeking a strategic investor who could increase the bank's capital by 10 to 12 million US dollars.⁶⁴

6. The future

Although it contains provisions which would presumably ease the access of MEBOs to outside capital (see above, section 5), the privatization act of 30 June, 1995, seems to indicate that the government is seeking to restrict this form of privatization somewhat. In Article 39, it states that enterprises employing 500 persons or less are eligible for "direct privatization" (that is, liquidation). Although it states that the cabinet may make exceptions for larger enterprises, it is clear that the authors of the act would prefer firms employing more than 500 persons to be privatized by indirect privatization, in spite of the fact, noted above (in Section IV), that it is precisely the larger MEBOs which have tended to attain the best financial results. In addition, the government is seeking to encourage enterprises using this method of privatization to find outside investors, and for this purpose, a clause was included in the act (in Article 51) which would make pure management-employee buyouts difficult or even impossible by requiring at least 20 per cent of the shares of a leasing firm to be purchased by persons not employed in the firm (although it also states that the Minister of Ownership Transformation may allow for exceptions). The government's view on the subject of MEBOs seems to be illustrated by the statement of Jan Monkiewicz (secretary of state in the Council of Ministers) that "direct" privatization is a "source that is drying up,"⁶⁵ although the statistics presented above (see Section II) cast doubt on the claim that this type of privatization is declining more rapidly than other privatization methods.

As discussed above in Section 4, MEBOs are characterized by some degree of concentration of shareholding in managerial ranks. It is worth asking whether we can expect an increasing concentration of shareholding among the firms' insiders (especially management) and an increase in the proportion of shares held by outsiders? Polish legislation does not restrict trade of shares in MEBO firms, but the by-laws of the firms often do. The main effect of the restrictions contained in the by-laws is to reduce access of outsiders to shares; however, trade among employees (including members of management, who often have special rights to share acquisition) is largely unrestricted.⁶⁶ And it is occurring: as the Zmiany group reports, in the period between the registration of the

⁶⁴On the Employee Ownership Bank, see Irena Dryll, "Kapitałiści bez kapitału," in *Nowe życie gospodarcze* (no. 19), 28 September, 1995, 42-43.

⁶⁵"Jest więc to wysychające źródło." See *Życie gospodarcze* (no. 8 [19 February, 1995], p. 40).

⁶⁶See Gardawski, in Jarosz (ed.) (1995a), 64.

companies in their sample and the end of 1992, a turnover in shares occurred in 68.1 per cent of those companies. On the average, 13.5 per cent of the shares changed owners. Turnover occurred most frequently among employees, although some shares were also sold to outsiders, and turnover chiefly resulted in increased concentration of shares in the hands of managerial staff.⁶⁷ Similarly, the findings of the Jarosz group show that the share of outside investors (both domestic and foreign) increased from about 8 per cent to about 18 per cent between privatization and 1994, and that members of management increased their shareholding at the expense of that of other employees.⁶⁸ On the average, however, this process is not taking place particularly rapidly, and it seems that one can expect a fairly high degree of dispersion to continue to characterize a large portion of MEBOs in Poland in the near future.

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⁶⁷See Olko-Bagieńska et al. (1994).

⁶⁸See Gardawski, in Jarosz (ed.) (1995a), 63-64. In the quotation in Section IV, Gardawski actually writes that the elite including both management *and* members of the supervisory boards has increased its shareholding. This is somewhat misleading, as the average share held by supervisory board members actually fell slightly (from 12.6 to 12.2 per cent). It is worth noting that the *average* increase of the share held by managerial staff was not especially large: from 10.9 to 13.7 per cent. In addition, when discussing the increase in shares held by outsiders, there is no mention of the proportion of these "outsiders" who are actually workers who have retired since the firm was privatized (in other words, former "insiders" rather than real outside investors in the usual sense).

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