Corporate Governance and Ownership Structure in the Transition: The Current State of Knowledge and Where to Go from Here[1]

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1. Introduction

Under the technological paradigm, including the neoclassical theory as propounded by Oliver Williamson (Williamson, 1990), it is generally believed that there is no pronounced relationship between the type of ownership and performance. Market structure and competition are thought to be much more important for an enterprise's performance than differences between the asset owners. As Yarrow argues, "the competitive and regulatory environment is more important than the question of ownership per se. In competitive markets there is a presumption in favor of private ownership. Where there is a natural monopoly, vigorous regulatory action is required" (Yarrow, 1986).

For that reason, the evaluation of advantages of private firms over state-owned enterprises has become a separate and critical issue. Defined more narrowly, it is a question whether there is a positive relation between privatization and enterprises' performance[6]. Most authors tend to answer this question in the affirmative, but (notwithstanding ample theoretical and empirical literature) there is no consensus on that issue yet. There are several arguments in favor of private companies:

– A social one: state-owned enterprises are a tool to remedy the faults of the market through a price policy taking account of social marginal costs (Shapiro, Willig, 1988). Such functions and costs have a negative impact on enterprise performance.

– A political one: political (bureaucratic) interference in the operations of an enterprise results in excess employment, non-optimal choice of products, non-optimal allocation and shortage of investments. These enterprises are more exposed to pressure from interest groups at the expense of profit maximization (Shleifer, Vishny, 1994).

– A competition-based one: privatization enhances competition, which makes enterprises operate more efficiently. Private companies are more subject to the discipline of commercial financial markets (Kikeri et al., 1992).

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[6] For details see: Perevalov et al., 1999.

– An incentive-based one: the managers of state-owned enterprises may not have the appropriate incentives to work efficiently, or there is no adequate control over their activities (Vickers, Yarrow, 1988).

It is conventional wisdom that privatized companies are more efficient than state-owned ones. Even the process of preparation for privatization may in some cases (for example, in Poland in the late 1980s and early 1990s) encourage the management to improve productivity, as this boosts economic growth and investment. This idea has directly or indirectly dominated the reports of international organizations on transition economies (EBRD, 1997; World Bank, 1996). But a closer look at the literature suggests that privatization — any kind of privatization — in and of itself may not be sufficient to improve company performance; that the *type* of privatization may matter.

In the early stages of the transformation of the majority of post-Communist countries, various types of privatization schemes were applied in order to speed up the privatization of the state sector and ensure social support for the privatization process. In addition to classic commercial privatization methods "imported" from the West, these schemes — based on the free or nearly free transfer of assets to certain segments of the population — took the form of mass (voucher) privatization and management-employee buyouts (MEBOs). Let us denote those schemes, which usually involved the transformation of the ownership of a large number of companies according to some general formula, by the term "wholesale privatization." The common denominator was the definition by the state (to a greater or lesser degree) of the ownership structures of privatized enterprises, both by identifying future types of owners and, in some cases, by determining the proportions of shares to be held by various types of owners. Additionally, there was often a high degree of state involvement in the creation of various types of investment funds, which became shareholders in privatized companies. As a result, in countries where efforts were made to determine ownership structures from on high, enterprises often found themselves with identical ownership patterns immediately following privatization, regardless of their size, the markets in which they operated, or other specific characteristics. For this reason, this method of privatization is often viewed as "artificial," unable to provide firms with "real owners" and to bring about improvement in firms' performance. One of the main criticisms is that wholesale privatization creates diffuse ownership structures, which lead to poor corporate governance and the lack of deep restructuring.

The question has therefore arisen as to what extent can wholesale privatization accomplish the expected goals of privatization. Of course, the answer depends, among other things, on how one defines these goals. The assumption behind privatization in many parts of the world is that private ownership improves corporate performance. The empirical evidence for this assumption comes from two kinds of studies. The first compares the pre- and post-privatization financial and operating performance. A good example is found in D'Souza and Megginson (1999). They compare the pre- and post-privatization financial and operating performance of firms in 28 industrialized countries that were privatized through public share offerings during the period from 1990 to 1996. They document significant increases in profitability, output, operating efficiency, and dividend payments, and significant decreases in leverage ratios of firms after privatization. These findings suggest that privatization yields significant performance improvements.

The second strand focuses on comparing the performance of state firms with either private (Boardman, Vining, 1989) or privatized (Pohl et al., 1997b) firms operating under reasonably similar conditions. Additional evidence has been obtained recently by a number of studies of post-Communist transition economies which, because of the presence of large numbers of both state and privatized firms, have become a favorable testing ground for the general claim that privatization leads to improvements in economic efficiency. And

if the aforementioned charges leveled against wholesale privatization are justified, then one might suspect that this form of privatization fails to pass this test.

Another approach to this question is possible, however. One might argue that we do not know what the characteristics of a "good" ownership structure or "good" corporate governance system are, and that it is the flexibility of the ownership structure, and not the structure itself, which is really crucial. In this view, it is important that the ownership structure be able to adjust to the firm's environment and characteristics. In other words, rather than considering ownership structure as exogenous and given, and looking at its impact on firm performance, we may view ownership structure as an endogenous outcome of the behavior of value-maximizing economic agents operating in a specific environment and subject to various constraints. This perspective could be traced back to Coase. According to Coase, the allocation of property rights has no effect on economic efficiency, provided they are clearly defined and there are no transaction costs, because under such conditions people can trade their assets in order to achieve efficient reallocations. A possible consequence of this approach could be that, in order to assess the efficiency of a privatization strategy, we should be mainly concerned with the extent to which the reallocation of property rights can take place.

The proponents of wholesale privatization could claim that their strategy relied on the Coase theorem. They could argue that initial ownership structure does not matter, and that what really matters is the agents' ability to freely reallocate property rights. However, the coasian result strongly depends on the availability of contracting and re-contracting opportunities, backed by an established legal system and law enforcement. In particular, the process of evolution of ownership structure is closely related to the ease with which the original owners can maximize their gains by selling their shares (or claims) to other potential buyers. Conditions of resale play a crucial role in enabling new owners to gain ownership and control of firms by buying the claims of incumbent owners.[7]

Following up this argument empirically, we note that in countries where the transformation process began relatively early, a "secondary" ownership transformation process has also been unfolding. (The terms "primary" and "secondary privatization" which we use here are inspired by the analogy to primary and secondary capital markets). Soon after the primary privatization, which was often of a very administrative nature, many enterprises experienced changes in ownership which were influenced more by market forces, the behavior of rational agents and newer, more sophisticated regulations. The observation of these changes can provide us with important criteria for evaluating the degree of maturity of the systemic transformation in those countries.

One can expect these secondary changes in ownership to occur in all privatized enterprises since they represent an entirely normal feature of private firms in market economies. Of particular interest, however, is the question of how these evolutionary processes are unfolding in "schematically" privatized firms where the ownership structure was originally set — to a greater or lesser degree — by the government. Can we observe any general trends or patterns in these evolutionary processes, or are they varied in different countries? Are new owners emerging in the secondary ownership transformation process? Are firms moving towards a more concentrated ownership structure? What factors determine the types of secondary changes? How rapid is the pace of ownership evolution? Under what conditions is the evolution particularly rapid (e.g., in cases of the appearance of a strategic investor)? If the pace of evolution is particularly slow, can we identify factors inhibiting it? To what extent is state regulation or the government itself the source of such

[7] Aghion and Blanchard (1998) implicitly take such a coasian view. They argue that while, *ceteris paribus,* outsider ownership is more conducive to restructuring than insider ownership, the important point is the ease with which the existing owners can transfer their ownership claims to others.

inhibiting factors, and to what extent are other actors — e.g., insiders — slowing the process down? Do secondary ownership transformations lead to changes in corporate governance (changes in management style or managerial staff) and the intensification of restructuring efforts? Do they affect the financial performance of the companies?

A number of related questions are also of interest. One of the most important issues is the problem of the mutual dependency of ownership concentration and structure on the one hand and economic performance on the other. Here, we are concerned primarily with the question of the endogeneity or exogeneity of ownership structure (i.e., is ownership structure a factor determining economic performance, or is it determined itself by performance and the factors which determine performance?). Another question is the search for an efficient ownership structure and corporate governance model. Finally, a very stubborn question concerns the role of governmental and quasi-state institutions in secondary privatization and the influence of the state policy and residual state property on the process.

In research conducted by the CASE Foundation (presented in Section 3), an attempt was made to answer the above questions examining the cases of three Central European transition countries — the Czech Republic, Poland, and Slovenia. Researchers were able to identify the new owners emerging from the secondary privatization process in each country examined, as well as to observe the trends in the evolution of ownership structure and the degree of concentration. Moreover, they highlighted the factors behind this evolution which lie within the regulatory environment of the companies. These findings were based on large data sets assembled for each country and for each type of large privatization scheme. The data sets, in turn, allowed us to assess the economic and financial performance of companies undergoing secondary privatization. The time period covered by these data sets, however, is too short to draw unambiguous conclusions concerning the relationships between ownership evolution and performance.

2. Privatization and Enterprise Performance: Theory and Evidence

Before the aforementioned research was conducted, there was already a rich body of research in the broad area of privatization, enterprise restructuring, and corporate governance in Central and Eastern Europe (for surveys see Carlin et al., 1995; Carlin, 1999; Havrylyshyn, McGettigan, 1999; Nellis, 1999; Djankov, Murrell, 2002).[8] However, it is very difficult to compare or to generalize the outcomes of these studies since they used different methodologies and samples (often non-representative) in different time periods and countries with different environmental and regulatory conditions. However, one interesting and surprising result of research conducted during the *early phase of transition* was that privatization by itself seemed to have little influence on the adjustment and restructuring patterns of enterprises. Whether privatized, state-owned or commercialized, the key factors affecting the enterprise adjustment process seemed to be the degree of hardening of budget constraints and increase in competition on product markets, and not the form of

[8] Some studies on the countries examined in the research presented here include the following: for Poland, a series of papers published by the Gdańsk Institute for Market Economics (Dąbrowski, Federowicz, Levitas, 1991, 1993; Dąbrowski, Federowicz, Levitas, Szomburg, 1992; Dąbrowski, Federowicz, Szomburg, 1992; Dąbrowski, Federowicz, Kamiński, Szomburg, 1993; Szomburg et al., 1994; Dąbrowski, 1996); Pinto et al. (1993); Belka et al. (1995); Bouin (1997); Kamiński (1997); Błaszczyk et al. (1997); Jarosz (1994), (1995), (1996), (1997); for the Czech Republic, Mladek and Hashi (1993); Brom, Orenstein (1994); Coffee (1996); Katsoulacos, Takla (1995); Kotrba (1995); Marcincin, Wijnbergen (1997); Matesova (1995); Mejstrik (1997); Mertlik (1997) and Zemplinerova et al. (1995); and for Slovenia, Bohm, Korze (1994); Kanjuo-Mrcela (1997), and Simoneti, Triska (1995).

ownership (Carlin et al., 1995). In the *later stages of reform* in the more advanced transition countries (especially since 1994), a gradual differentiation in the restructuring patterns of enterprises has been more and more visible. By 1997 there was evidence that privatization mattered: the differences between privatized and state enterprises, measured by any financial and economic performance indicators, were constantly increasing to the benefit of the former (Błaszczyk et al. 1999, Pohl et al. 1997a, b). Differences between state and privatized enterprises have emerged with respect to deep (strategic) vs. defensive restructuring (Grosfeld, Roland, 1996). Most research has shown that the strategic restructuring process, involving large investments and innovative technological changes, has been possible only in privatized enterprises (especially those with foreign strategic investors). There is also some evidence that non-privatized enterprises tend to consume the largest part of labor productivity increases in wages while the privatized enterprises use it for further investment (Grosfeld, Nivet, 1997).[9] However, there is some controversy about whether — and in what ways — the method of privatization used is a significant factor differentiating the performance of privatized companies.[10]

A more detailed discussion of the literature on the effects of primary privatization on enterprise performance follows below. However, we want to note here that little work has been done on the post-privatization developments in ownership (i.e. secondary privatization) and their impact on enterprise performance. The research summarized in Section 3 seeks to address this gap in the literature. What did we know about secondary privatization before embarking on that research? Literature on the beginning of secondary privatization in the Czech Republic, largely consisting of trading of shares by investment funds and often called the 'Third Wave' (following the first and second 'waves' of the voucher privatization program), was largely limited to anecdotal evidence (Mladek, 1996). In Poland, virtually the only research done in this area concerned the gradual increase in concentration of shareholding in companies privatized by management-employee buyouts (Jarosz, 1995,1996). In addition, at the time this project was designed, too little time had elapsed since the initial privatization of many enterprises to allow for a detailed evaluation of secondary transformations (and to some extent, this continues to be the case in many enterprises). In the countries under consideration, the transformation was already ten years old, and in most of the companies studied at least five years had elapsed since privatization. This period of time was considered sufficient for analyzing trends in the ownership changes which were underway. However, it is questionable whether it was also sufficient to analyze the relationship between those ownership trends and their impact on economic and financial performance. Moreover, it is clear that not all the 'battles' over ownership in the companies we studied have been won and lost. Therefore, our report provides a picture of secondary privatization in an advanced, albeit not yet completed stage. This fact should provide a stimulus for the continuation of research in this area in the near future. Such research may indicate not only further developments in the evolution of ownership structures, but additionally shed more light on the relationship between the evolution of ownership structure and enterprise performance.

We now turn to a more detailed review of the literature on the relationships between the immediate post-privatization ownership structure and corporate performance, focusing

[9] For research showing positive effects of foreign investors see Smith et al. (1997), Błaszczyk et al. (1999) and the aforementioned papers published by the Gdańsk Institute of Market Economics.

[10] The difference between the conclusions of Pohl et al. (1997a, b) on the one hand and Błaszczyk et al. (1997) (as well as most other research done in Poland) on the other is that the Polish research finds that not privatization in and of itself but rather the methods of privatization have a strong influence on the quality of the restructuring process.

on certain critical issues such as the role of ownership concentration, the type of dominant owner, and the regulatory and institutional environment, as well as methodological issues.

2.1. Ownership Concentration

Beginning with the early work by Berle and Means (1932) and continuing into the 1980s, the literature studying the impact of ownership structure on corporate governance[11] and firm performance has focused on the advantages of ownership concentration. This question has important implications for privatization policy, as policy makers must decide whether it is better to distribute the shares of firms to large numbers of individuals (as in the voucher method) or to concentrated groups of owners or even single owners (e.g., through direct sales). The main concern was the cost of the separation of ownership and control, or agency costs (e.g., Jensen, Meckling, 1976; Fama, Jensen, 1983). The idea is that dispersed ownership in large firms increases the principal-agent problem due to asymmetric information and uncertainty. Because contracts between managers and shareholders are inevitably incomplete (future contingencies are impossible to describe fully), shareholders must monitor managers. There is a widespread consensus that a greater degree of control by an external shareholder enhances productivity performance: more monitoring presumably increases productivity (Shleifer, Vishny, 1986). When the equity is widely dispersed, however, shareholders do not have appropriate incentives to monitor managers who, in turn, can expropriate investors and maximize their own utility instead of maximizing shareholder value. Finally, concentrated ownership in the hands of outsiders is also often advocated on the ground that it facilitates the provision of capital.

In transition economies, conflicts between managers and outside (large and minority) shareholders are on the rise. Problems and costs of shareholders' control over the managers in the framework of principal-agent relations (Hart, 1995) are aggravated by the fact that managers — directly or through intermediaries — act as both insiders and outsiders, in all possible meanings of these terms. One of the key problems here is that of the share issuer's transparency to potential investors as well as incumbent outside shareholders. It should also be noted that in an illiquid emerging market the issue of a choice between the "voice" mechanism and the "exit" mechanism (Hirschman, 1970) is no longer a dichotomy. In fact, there are no alternatives here: if one cannot sell his or her shares, then the role of the "vote" mechanism has to be enhanced.

More recently, the focus of the literature has shifted, and several theories have been proposed to show the ambiguity of the effect of ownership concentration (Grosfeld, Tressel, 2001). One of the obvious costs of concentration is the ability of the holders of majority stakes to extract private benefits of control (Barclay, Holderness, 1989). La Porta et al. (1998a) show that, in most countries, large corporations have large owners who are active in corporate governance. Therefore, the main problem of corporate governance is not monitoring the managers; the real concern is the risk of the expropriation of minority

[11] There are various definitions of corporate governance. It can be defined narrowly, as the problem of the supply of external finance to firms (Shleifer, Vishny, 1997). It can also be defined as the set of mechanisms which translate signals form the product markets and input markets into firm behavior (Berglöf, von Thadden, 1999), or as the complex set of constraints that shape the ex-post bargaining over rents (Zingales, 1997). The control of the firm does not necessarily equate with equity ownership; it also depends upon control exerted by debt-holders. So, corporate governance may affect firm performance directly, via ownership and control, but also indirectly, through the financial structure of the firm. According to an even broader view of corporate governance, managers in firms characterized by the separation of ownership and control are constrained from taking actions that are not in the interest of shareholders by several disciplining mechanisms, such as the threat of takeovers, bankruptcy procedures and the managerial labor market. Competition on the product market is often considered as another disciplinary device.

shareholders. The same authors, in a comparative study of the effectiveness of legal systems in 49 countries from the perspective of investor rights protection, find that ownership concentration is a reaction (adaptation) to weak protection of investor rights under the national corporate governance models (La Porta et al., 1998b).

A similar view has been expressed by Becht and Röell (1999), reviewing of corporate governance in continental European countries where ownership structures differ significantly from those of Anglo-Saxon countries, well known for their dispersed ownership patterns. In most of the countries studied, companies tend to have large shareholders, and the main conflict of interest lies between them and minority shareholders.

Second, concentrated ownership may negatively affect firm performance through its impact on managerial initiative. If concentrated ownership provides incentives to control the management, it may also reduce the managers' initiative or incentive to acquire information (Aghion, Tirole, 1997). In this perspective, Burkart et al. (1997) view dispersed ownership as a commitment device ensuring that shareholders will not exercise excessive control. If the principal is concerned with providing the manager with the guarantee of non-intervention, he may choose to commit not to verify the action of management. Such inefficient monitoring technology may stimulate managerial activism (Cremer, 1995) creating, ex ante, powerful incentives for the management. When managerial initiative and competence are particularly valuable (which may occur when firms face high uncertainty), concentrated ownership may thus turn out to be harmful.

Third, concentrated ownership implies lower levels of stock liquidity which, in turn, weakens the informational role of the stock market (Holmström, Tirole, 1993). This may, again, be more valuable in an uncertain environment (Allen, 1993), or when it is essential to ensure that the management of under-performing firms changes hands. Finally, concentrated ownership is costly for large shareholders because it limits diversification and reduces the owners' tolerance towards risk (Demsetz, Lehn, 1985; Heinrich, 2000). Ownership dispersion allowing greater risk diversification may positively affect investment decisions. Overall, Allen and Gale (2000) conclude that in the second best world of incomplete contracts and asymmetric information, separation of ownership and control can be optimal for shareholders.

What do we observe in practice in the transition economies? Practically all of them demonstrate a trend towards *high ownership concentration* in the course of privatization (a point to which we will return in Section 3, particularly in the conclusions). In the Czech Republic, Hungary and Poland, 98% of medium-sized companies surveyed in the mid-1990's had a dominant shareholder (Frydman et al., 1997), with the average stake owned by the main shareholder varying from 50% to 80%. In the former USSR republics there is also a trend towards concentration. Data available on six countries show steady growth in the managerial shareholdings (Djankov, 1999).

Concentrated ownership is closely related to outsider ownership. In 1998, according to the data of a Russian survey conducted by the Higher School of Economics in Moscow, on the average, the largest shareholder's stake was about 28%, and the largest three shareholders owned 45% (up from 41% in 1995). Moreover, in 43% of the companies, three shareholders held over 50% (Dolgopyatova, 2000). According to the data of a survey of 437 Russian enterprises conducted in 2000, in 85% of the enterprises of the sample, none of the shareholders had even a blocking stake immediately following privatization. In 38% of enterprises dominated by outsiders, two or three shareholders had a more than 50% interest in 2000 (Bevan et al., 2001). However, the most obvious trend that Russian companies show is an increase in stakes held by other industrial companies. As a result, a majority stake in every tenth company is held by other industrial companies (Simachev, 2001).

One of the most peculiar features of Russian industry is the combination of ownership concentration with partial ownership dispersion (Dolgopyatova, 2000). Hence a certain dualism of corporate ownership characteristics cited by various authors (as compared to similar data on Western countries and other transition economies). The fact that Russia lags somewhat behind the Eastern European countries may be due to some provisions of anti-trust legislation (affecting acquisition of over 20% of shares) and corporate legislation (affecting acquisition of over 30% of shares).

As for the relationship between concentration and economic efficiency, an example of a formulation — and test — of the hypothesis of the effect of ownership concentration on performance is found in McConnell and Servaes (1990). They examine the impact of ownership structure on company performance in the largest European companies. Controlling for industry, capital structure and national effects, they find a positive relationship between ownership concentration on the one hand and the market-to-book value of equity and profitability of firms on the other.

In a similar study for a transition economy, Grosfeld and Tressel (2001) test the hypothesis of the ambiguous relationship between ownership concentration and performance. For a sample of Polish firms listed on the Warsaw Stock Exchange, they found that there is indeed a U-shaped relationship. Firms with relatively dispersed ownership (no shareholder with more than 20% of voting shares) and firms in which one shareholder has more than 50% of voting shares were found to have higher productivity growth than firms with an intermediate level of ownership concentration. In Section 3, we will review some studies of Central European data which show no relationship between concentration and performance.

Other studies have found a less ambiguously positive relationship between concentration and performance. For example, data from surveys of Czech firms provide evidence that managers who were brought to privatized companies by outside owners operated much more efficiently than those appointed by government agencies (Claessens, Djankov, 1999a). Data on the operations of 706 Czech enterprises in 1991-1995 suggest that concentrated ownership boosts the market value of a company, thereby increasing its profitability. The authors of the paper in question also find that the company's main bank has a positive impact on the company's performance through indirect control over its investment fund (Claessens et al., 1997). In the Russian case, if we assume (based on the findings of Leontief Center, 1996) that the earlier companies were privatized, the higher the level of corporate ownership concentration (which is generally consistent with the Russian trend), this constitutes evidence that companies with concentrated ownership are more efficient.

Perhaps in the end the most appropriate view is the more nuanced one of Bolton and von Thadden (1998), who argue that it is not simply a question of whether ownership should be concentrated or not, but rather whether there are different levels of concentration most appropriate for different stages in the life of the firm. We hope that the research presented in Section 3 may shed some light on this question.

2.2. Type of Dominant Shareholder

Some authors do not find any consistent relationship between the post-privatization ownership structure and the intensity of change (Linz, Krueger, 1998; Earle, Estrin, 1997, based on surveys of Russian enterprises). Data on Ukrainian enterprises do not confirm the existence of a clear relationship between the ownership structure and change/restructuring either (Estrin, Rosevear, 1999). A paper on recent surveys of about 3000 companies in 20 transition economies analyzed the impact of privatization and ownership structure on enterprise restructuring but found no clear answers. This is attributed to

the lack of information about enterprises before privatization (Carlin et al., 1999). Interim data from an analysis of over 7,500 Russian industrial enterprises (Brown, Earle, 1999) suggest that restructuring is in general very slow in companies of all forms of ownership, and slower in private companies than in state-owned ones. The authors find that privatization has an adverse effect on performance, but at the same time point out that it would be wrong to attribute it solely to privatization, as state-owned enterprises' performance is not much superior to that of other types of companies.

A number of authors have asked whether or not the *type* of owner who acquires a firm in privatization is of any significance. A number of related questions have been posed, and dealt with, in the literature: Are employees bad owners? Are foreign strategic investors the best owners? What about investment funds?

In their study of some 700 Czech firms, Weiss and Nikitin (1998) showed that ownership concentration by strategic investors other than investment funds has had a positive impact on performance, while this has not been the case with ownership concentration by bank-sponsored investment funds. Similar conclusions have been drawn by Claessens and Djankov (1999b) in their study of a cross section of over 700 Czech firms between 1992 and 1997.

In their above-mentioned study dealing with the effects of concentration, McConnell and Servaes (1990) also test the hypothesis that the identity of large owners — family, bank, institutional investor, government, and other companies — has important implications for corporate strategy and performance. They find support for this hypothesis. In contrast, the study by Grosfeld and Tressel (2001) mentioned earlier examines these questions for a sample of Polish firms listed on the Warsaw Stock Exchange and finds that the type of controlling shareholder does not affect the correlation between concentration of ownership and productivity growth.

The beneficial role of foreign strategic owners in privatized firms has been highlighted in many studies. In an early survey of Czech, Hungarian, Russian and Bulgarian companies, Carlin et al. (1995) show the positive impact of foreign ownership on productivity growth, a finding which has been confirmed by many later studies (including, for example, Carlin, Landesmann, 1997). While Djankov (1999) found evidence that ownership by domestic outsiders is not significantly correlated with depth of restructuring, he also found that the positive impact of foreign ownership on restructuring only makes itself felt when the foreign-owned stake is relatively large (over 30%). Smith et al. (1997) examine the relationship between employee and foreign ownership and firm performance in a sample of Slovenian firms. In addition to the unsurprising finding of the strong positive effect of foreign ownership, they also find a positive (though much weaker) relationship between employee ownership and enterprise performance. A percentage point increase in foreign ownership is associated with about a 2.9% increase in value added, whereas a percentage point increase in employee ownership increases value added by about 1.4%.

However, most available data suggest that difference between companies owned by domestic insiders (employees and managers) and dominant outside investors is small (Carlin et al., 1995). Frydman et al. (1997) found that in the Czech Republic, Hungary and Poland private companies have made more progress in restructuring than state-owned firms; however, firms controlled by outsiders are more or less on the same level as those dominated by insiders. Brown and Earle (1999), analyzing the survey of over 7,500 Russian industrial companies referred to above, find that, on the whole, companies with large insider stakes and stakes acquired through voucher auctions show a much slower pace of restructuring than firms with stakes owned by holding companies and foreigners and "golden shares" held by the state. However, the influence of vouchers, holding companies and foreigners is highly uneven, and the impact of holding companies and foreigners does

not increase with an increase in their stake. According to Kuznetsov and Muraviev (1999), their survey of the 103 best known Russian share issuers in 1995-1997 shows that the larger the stake of outsiders (both domestic and foreign), the higher the productivity growth. By contrast, insider and state ownership results in low productivity. Ownership by a state-owned holding company impedes productivity growth, though to a smaller degree than state ownership.

A couple studies of Russian data find evidence which reflects more favorably on insider ownership. In a detailed study by Bevan et al. (2001), the main finding as regards the ownership-performance relationship is that difference in restructuring (performance) between outsider- and insider-controlled companies is negligible, with the exception of profitability, which is considerably higher in companies with insider ownership. This might be explained by the fact that outsider dominance (especially if a company is part of a vertically integrated group) often results in the switching of financial flows to other entities and persistent (declared) losses. Similarly, Muraviev (2001), exploring the relationship between ownership structure and data on financial performance (return on equity, return on sales), finds a direct relationship between the insiders' stake in the company and its performance (no difference is found between management and employee ownership). In contrast, there is an inverse relationship between performance on the one hand and outsider-owned stakes (with the exception of foreign outsiders, for which the relationship is positive) and the stakes of regional and local governments on the other.

In addition to the type and concentration of ownership, the replacement of old management by new may be of crucial significance for the improvement of corporate governance and enterprise performance. Investigating the relation between profits and privatization, Claessens and Djankov (1999a) found that profitability and labor productivity are both positively related to the appointment of new managers, especially those appointed by private owners. Additionally, they find the equity holdings of general managers to have a small positive effect on corporate performance. A study of the transformation of Russian shops by Barberis (1996) confirms the positive impact of the appointment of new managers on the restructuring process. The main conclusion is that enterprise restructuring in transition countries requires new human capital, which can best occur through management changes.

This conclusion may have important implications for privatization policy: if a privatization method leads to the entrenchment of incumbent managers as holders of significant blocks of shares, many necessary changes may be stifled. And such entrenchment does indeed appear to be problematic in many transition countries. Research has shown that groups that have obtained relative control over privatized enterprises because of the particular design of privatization schemes may be more or less willing to allow new dominant owners to emerge. In their study of ownership change in privatized Estonian firms, Jones and Mygind (1999) argue that the initial dominant ownership group is associated with a great deal of inertia, i.e., that the dominant group retains its dominant position for quite a long time. A study of the role of managers and employees in the development of ownership in privatized Russian enterprises has also shown that managers have been hostile to outsiders and colluded with workers to keep the outsiders out of their companies (Filatotchev et al., 1999). The question of management entrenchment was of particular interest in the CASE research presented here.

An important feature of voucher privatization in the Czech Republic, Poland and Slovenia was the collective investment opportunities offered by numerous privatization investment funds. Due to the activity of these funds, enterprise shares were, to a large extent, not distributed amongst a large number of individual citizens, but rather concentrated in the portfolios of the funds. In the Czech Republic, for example, one third of the invest-

ment funds gained control of over two thirds of the total enterprise shares obtained by all funds. Mergers and acquisitions of funds resulted in further ownership concentration, and in an environment of lax regulation (as in the Czech Republic), this afforded ample opportunities for the creation of very non-transparent equity networks and thereby for the abuse of non-insider shareholders (Hashi, 1998).

In fact, while the Czech mass privatization was ostensibly designed to make outsider ownership the rule, in practice management was often able to use voucher privatization and the involvement of investment funds to retain a privileged position.[12] Moreover, Kocenda and Valachy (2001) offer further indirect evidence of significant insider involvement in Czech voucher privatization, noting that Czech privatization investment funds were often founded by manufacturing enterprises (it is reasonable to infer that many of these enterprises set up funds in order to acquire shares in themselves, as it were). An OECD report sums up this post-privatization situation when it states that the Czech voucher approach to privatization produced ownership structures that were not conducive to either efficient corporate governance or restructuring (OECD, 1998).

For these reasons, many conclude that Czech firms privatized through vouchers, in which investment funds held the controlling stakes, have not been sufficiently or consistently restructured. Weiss and Nikitin (1998) looked at financial performance in a set of Czech firms and concluded that the concentration of ownership has significant positive effects on performance except in the case of the funds, whose share in ownership has no positive effect on performance. Mertlik (1997), highlighting the dual role of partly state owned banks as owners (through bank-sponsored investment funds) and creditors of voucher-privatized firms, argued that a large number of these firms had not been subjected to the genuine rigor of market forces and not undergone serious restructuring.[13]

2.3. The Regulatory and Institutional Environment

One area in which there is growing agreement is that privatization in and of itself is not sufficient to bring significant change to companies; the environment (regulation, macroeconomic stability, etc.) is also of critical importance. Shleifer and Vishny (1997), for example, survey research on corporate governance, with special attention to the importance of legal protection of investors and of ownership concentration in corporate governance systems around the world. Estrin and Rosevear (1999) explore whether specific ownership forms have led to differences in enterprise performance in Ukraine. Using profit, sales, and employment as performance proxies, they find that private ownership per se is not associated with improved performance, suggesting that the insufficiently reformed Ukrainian environment is at fault. Similarly, Djankov and Murrell (2002) argue that the fact that it is more difficult to identify the effect of privatization on firm performance in CIS countries than in CEE countries may be attributed to the lack of some of the necessary complementary factors (e.g. in the regulatory environment) which make privatization work.[14]

Drawing attention to the role of the general economic environment in which privatization takes place, Nellis (1999) argues that the poor performance of mass (voucher) privatization was related to environmental factors in the following ways:

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[12] See evidence cited in Woodward (1996).

[13] Since then, the four largest Czech banks have been privatized, though the problem of enterprise debts has not been completely resolved.

[14] For an analysis of the complementarity between ownership and competitiveness of the firm's environment, see Grosfeld and Tressel (2001).

– Investment funds tended not to punish poor performance of firms, since pulling the plug would diminish the value of the assets of the funds' owners — banks — if the latter were forced to write off bad debts lent to those firms.

– Even though they did not own the firms to which they were lending, the partially state-owned, state-influenced, weakly managed and inexperienced banks tended to extend credit to high-risk, low-potential privatized firms and persistently roll over credits rather than push firms into bankruptcy.

– The bankruptcy framework itself was weak and the process lengthy, further diminishing financial market discipline.

– The lack of prudential regulation and enforcement mechanisms in the capital markets opened the door to a variety of highly dubious — and some overtly illegal — actions that enriched fund managers at the expense of minority shareholders, and harmed the health of the firm; for example, by allowing fund managers to load firms with debt, then lift the cash and vanish, leaving the firm saddled with debts it had not used for restructuring a practice that became known as tunnelling.

2.4. Methodological Issues

Any attempt to review the empirical literature on the effects of initial ownership and control structures on corporate restructuring and performance in transition countries would be incomplete if it did not take note of serious problems with the comparability of various studies. These studies employ different methodological approaches, different performance measures, different time periods, etc. Moreover, a number of methodological problems, notably that of selection bias, often do not receive sufficient attention. This can lead to the formulation of conclusions on the basis of evidence that is often questionable.

One example is Claessens and Djankov (1999b), who concluded that the more concentrated the ownership, the higher the firm profitability and labor productivity, in spite of the fact that the coefficient on profitability was found to be insignificant. Another oft-quoted example is Frydman et al. (1999), who compare the performance of privatized and state firms in the transition economies of Central Europe. While they do control for various forms of selection bias, some of their conclusions become doubtful when one looks at the makeup of their sample. For example, they argue that privatization to outsider owners has significant positive performance effects, whereas enterprises privatized by MEBOs do not differ from state enterprises in performance (i.e., the latter form of privatization brings absolutely no benefits in terms of restructuring). However, in their sample of 185 firms from three countries (Poland, Hungary, and the Czech Republic), only 10 are majority-owned by non-managerial employees, and all 10 are from Hungary. There were none from Poland, where this form of privatization was applied to a much larger number of firms, and where employee-owned firms have been much more thoroughly researched.

3. Research Results for Three Countries

As mentioned above, the CASE Foundation carried out research on secondary privatization in three Central European transition countries.[15] With the knowledge presented in Section 2 as a starting point, three central goals were formulated for this research. The first

[15] This research was undertaken with support from the European Union's Phare ACE Program 1997, project P97-8201 R "Secondary Privatization: The Evolution of Ownership Structure of Privatized Companies", coordinated by Barbara Błaszczyk of the CASE Foundation in Warsaw. The content of the conclusions presented here is the sole responsibility of the authors and in no way represents the views of the Commission or its services.

was to analyze the secondary ownership transformations of enterprises privatized through wholesale privatization schemes in the three countries, focusing in particular on:

– The scope and pace of secondary ownership changes;

– Trends in secondary ownership transformations (e.g., identification of types of emerging new owners, changes in levels of concentration, etc.);

– Factors affecting the scope and pace of secondary ownership transformation as well as selection processes for agents involved in those processes;

– Barriers to secondary ownership changes, especially those resulting from institutional patterns and state regulations, and

– The effects of the regulation of primary privatization schemes on secondary privatization processes.

The second goal was to formulate and examine (using statistical methods) hypotheses concerning:

– Relationships between changes in economic performance and primary and secondary ownership transformation, and

– Relationships between changes in corporate governance and secondary ownership changes.

The third goal was to formulate recommendations for regulatory changes in the countries studied and more general recommendations concerning the utility of various alternative privatization schemes for other countries.

The research focused on three countries: the Czech Republic, Poland, and Slovenia. Large enterprise-level databases each country were used to examine ownership changes that had occurred since wholesale privatization was implemented. These were supplemented by the analysis of the relationship between performance and ownership changes in each type of wholesale privatization and in each country. Effort was made wherever possible to ensure the maximum possible methodological uniformity across countries, though for a variety of reasons (such as country specificities and data limitations) this was not always possible.

3.1. Slovenia[16]

Under Slovenia's mass privatization model, 20 percent of shares went to para-state funds (the pension fund and the restitution fund), 20 percent of shares to privately managed privatization funds in exchange for ownership certificates collected by them from citizens, and most of the remaining shares were distributed to insiders (managers and current and former employees). Of approximately 1,500 companies which were privatized under this program, only a few dozen acquired strategic owners, and very few were privatized using initial public offerings.

As a consequence, three typical groups of companies were formed:

– *public companies* quoted on the stock exchange;

– *non-public internal companies* not quoted on the stock exchange, with employees holding majority stakes, and

– *non-public external companies* not quoted on the stock exchange, with employees and funds holding comparably large shareholdings.

In their analysis of ownership changes in Slovenian companies privatized under the mass privatization program, the authors first presented concentration indices for those companies at two points in time: the end of primary privatization and end of 1999. The indices are: shares held by the single largest shareholder, the five largest shareholders, and the ten largest shareholders (denoted as C1, C5, and C10 respectively) and the Herfindahl

[16] See Böhm et al. (2001).

index.[17] Then, using a sample of 183 mass-privatized companies, they presented the weighted averages of shares of various types of owners (state funds, investment funds, managers and employees, domestic and foreign external investors) at the time of completion of primary privatization at the end of 1999. They concluded with a transformation matrix showing the transformation trajectory of firms grouped with respect to their dominant shareholders at the time of privatization, i.e. how the number of firms in each dominant ownership group has changed over time. They found that concentration had been occurring, especially in companies held by insiders: between the completion of privatization and the end of 1999 almost 40% of initial shareholders had exited the companies privatized through mass privatization. Small shareholders, the state and para-state funds had reduced their ownership stakes in these companies while managers and strategic investors have increased them. But both of the latter groups were accumulating their shares more intensively in companies not traded on the stock exchange. And these were transactions made on informal markets, with limited competition and transparency.

Another central problem that had emerged was the conflict between large shareholders — para-state funds and privatization funds, lacking both the ability and motivation for proper corporate governance — and small shareholders (largely insiders). In many medium-sized firms these two groups had entrenched their positions and were battling each other for control. There often seemed to be no way out of this battle, which was distracting the attention of company actors from restructuring-related issues. A further problem lay in the fact that the secondary privatization process had attracted too few foreign investors, who had been deliberately excluded during primary privatization.

To examine the relationship between ownership and performance, the authors used a database containing financial and ownership information on 426 mass-privatized companies for the period 1995-1999. These companies were divided into groups depending on whether they were publicly traded, owned primarily by internal owners (management and employees), or owned primarily by external owners (for the most part, state and investment funds), and whether they had switched from one of these categories to another in the period under consideration. In their analysis the authors were particularly interested in identifying what they call the “owner effects” (the performance effects of staying in one ownership category) and “agent/seller effects” (the performance effects of moving from one ownership category to another). Performance indicators used in this analysis included the growth in the labor force, sales and assets, and productivity, and the ratios of operating profit, operating profit increased by depreciation, and net profits to sales revenues. Correcting for selection bias, the authors regressed measures of performance on various factors not related to the ownership structure which were thought to have an impact on performance as well as dummy variables for different ownership groups of companies.

The authors found the secondary privatization process in Slovenia to have been seriously flawed. It had had practically no positive effect either on economic efficiency or on financial performance in the 1995-99 period. On the basis of their analysis, they concluded that the major problems with the post-privatization ownership consolidation had been the quality and transparency of the process and not its slowness. Factors that prevented fast, transparent and effective secondary privatization stemmed from the corporate governance and finance regime established in mass privatization. The legal and regulatory framework adopted to guide secondary privatization postponed transferability of large volumes of shares and applied standard rules for ownership concentration and consolidation of control to privatized companies with tradable shares, even though only a fraction of them were quoted on the stock exchange. Though presented as protection of small shareholders, such

[17] The Herfindahl Index is calculated as the sum of the squared shares of each owner.

restrictions and rules in fact hindered taking publicly traded companies and privatization funds private (that is, buying out small shareholders and removing their shares from public trading) in an orderly fashion. They were flagrantly abused in practice, while rules for voting on legal changes and reorganizations of corporations (which, under the circumstances, may be a better protection for small investors) had not been established.

3.2. Poland

The Polish privatization program included two "schematic" or "wholesale" methods: MEBO and the National Investment Funds Program. Why, in our research, did we treat MEBO privatization as a wholesale scheme, despite the fact that it was a bottom-up privatization procedure, initiated by the managers and employees themselves? We did so because the legal framework for this method was highly regulated by the government and fairly strict criteria concerning the structure of ownership had to be met (specifically, it was required that at least 50% of the employees of the state enterprise become shareholders in the new company). Also, the preferences given for insiders in this type of privatization influenced the lease/sale contracts to a great extent. For these reasons, the ownership effects of this privatization probably diverged considerably from the ownership structures that would have emerged without government regulation, supervision and preferences. On the other hand, it should be noted that this privatization path required much organizational and financial input from the buyers and differed considerably in this respect from give-away methods. More importantly, the ownership structures established by this procedure were simple and did not include the artificial constructions of mass privatization schemes (e.g., the National Investment Funds).

3.2.1. Companies Privatized by Management-Employee Buyouts[18]

The vast majority of employee buyouts in the Polish privatization process have been generated via the leasing variant of direct privatization, in which at least 50 percent of the employees of the state enterprise being liquidated had to form a new company to lease the assets of the old enterprise. By the end of 1998 lease-leveraged employee buyouts represented about one third of the completed privatizations carried out under the supervision of the privatization ministry, thus constituting the single most frequently used privatization method in Poland (in terms of the numbers of enterprises privatized). Most of the firms in this category are small- to medium-sized firms, usually with less than 500 employees.

In this study, 110 firms privatized by the lease-leveraged buyout method between 1990 and 1996 were analyzed. First, weighted averages of the shares of various groups of owners (strategic investors, other domestic and foreign external investors, and various groups of insiders) at the time of privatization and in 1997, 1998 and 1999 were presented and analyzed. These changes were summarized in a transformation matrix. Next, the evolution of C1 concentration was presented.

The ownership structure of Polish employee-leased companies, especially immediately after privatization, was characterized by large holdings of dispersed insider owners. Subsequently, the shares of non-managerial employees gradually declined, while those of outsiders grew. The concentration of shares in the hands of managers was expected from the very moment of privatization, although managerial holdings later stabilized and even decreased somewhat in favor of outsiders.

In general, however, change was found to be incremental. Radical changes in the ownership structure had been rare, and ownership structure seemed to be fairly inert. It would, nevertheless, be wrong to conclude that significant change was not possible when

[18] See Kozarzewski, Woodward (2001).

it was in the interests of the incumbents, as new strategic investors had appeared in about 10 percent of the sample by 1998. (It is, however, worth noting that there was a negative relationship between the size of top management's share and the appearance of strategic investors; it appears that once managers had decisive control over the ownership structure of a company, they were reluctant to relinquish it.) The most important factor influencing the direction and the dynamics of ownership change was the economic condition of the company, which, when it was poor, favored concentration and "outsiderization" of ownership (as well as changes in corporate governance).

In an attempt to analyze factors affecting ownership changes generally, the authors considered trends in ownership evolution by initial ownership structure, branch (industry, construction, services, and trade), size (employment), and profitability. Next, they looked at the relationship between ownership and the companies' development prospects, examining various measures of development-oriented activities, including investment activity, expansion into new markets, etc., with particular attention to the correlations between these variables and ownership variables.

There was some slight evidence that the extent of non-managerial employees' share in the ownership of the firm had a negative effect on economic performance in the early 1990s. In particular, there was a case — albeit a weak one — to be made for the claim that companies whose employees constitute the dominant owners followed a policy favoring consumption (wages, dividends and the like) over investment and development. However, the situation in the companies is likely to be differentiated, with the relationships between ownership structure and economic decision-making dependent on many factors that the authors were unable to analyze here.

Finally, corporate governance in the employee-owned companies was examined, with special attention devoted to the role and composition of the supervisory board and the role of owners and top management in decision-making processes. Executive board membership was found to be dominated by persons who had managed the companies before privatization. Changes in top management had occurred most frequently in firms in which over 50 percent of the shares were in the hands of outsiders.

Contrary to what one might expect from the process of ownership "outsiderization", the position of insiders in supervisory boards was markedly strengthened in 1998-99. However, supervisory boards tended to be rather passive, not using all the powers they were entitled to by law and company by-laws. The small role of owners in the decision-making process was also striking. The owners most frequently acted as decision-makers where ownership was concentrated in the hands of a strategic outside investor. The general picture that emerged was thus one of consolidation of management's power and even managerial entrenchment.

3.2.2. The National Investment Funds and their Portfolio companies[19]

The initial ownership structure was identical in each of the 512 companies privatized in the National Investment Fund Program, so data analysis was not needed to describe it. Ownership changes in the 1995-2000 period were analyzed by looking at how many companies in the NIFs' portfolios were sold to what types of investors (i.e., domestic corporate, domestic individual, employee, foreign, other NIFs, public trading) in which years. A great deal of attention was paid to the issue of changes in the ownership of the funds themselves as well as the issues of corporate governance in the funds (management costs, strategies, etc.).

Finally, the economic performance of NIF portfolio companies was compared with other groups of companies in the Polish economy. NIF companies were also broken down

[19] See Błaszczyk et al. (2001).

with respect to the type of owner that acquired (or kept) them and then compared with each other using annual sales as the basis for comparison.

The authors demonstrated significant shifts in the ownership of the funds in the secondary privatization stage and a strong tendency to ownership concentration. The share of the State Treasury and small investors decreased significantly, while cross-holdings between the NIFs and the shares of institutional domestic and foreign investors increased.

The decreasing share of small investors (both individual and institutional) — i.e., those holding less than 5% of the shares of a given NIF — was noted. At the beginning of the program they had held 85% of the NIFs' shares; by the beginning of 2001, their share had dropped to 41% — less than half of its original level. By contrast, the share of large investors had been rising. The share of institutional investors had jumped to 46% by the end of 2000, mainly through the involvement of foreign investors. These trends were found to reflect the progress of ownership concentration. Over a period of 2.5 years (from June 1998 to December 2000), the C1 index (that is, the share of the single largest shareholder) had increased from 5.41% to almost 24%, and the C3 index (the share of the three largest shareholders) had increased from almost 7% to 42%.

As a rule, the NIF managers had not been particularly interested in restructuring their portfolio companies themselves, strongly preferring secondary privatization (i.e., sale to other investors). As of December 2000, over half of these companies (278) had found new investors, including companies quoted on the stock exchange (27) or over-the-counter market (12). In addition, at that time, 78 companies were under bankruptcy or liquidation procedures (of which nine had already been liquidated at the time of writing). Thus, in all, secondary privatization had affected 346 firms (out of a total of 512). The most numerous new owners were domestic strategic investors (large domestic companies), who had become shareholders in 134 companies. Foreign investors were in second place with 57 firms. Individual private owners had taken control of 48 firms, and employees had acquired 14 NIF companies

A more detailed examination of the ownership structure of NIF portfolio companies showed that the concentration of ownership had increased in these companies — more slowly than in the funds, but still at a remarkable rate. By the year 2000, the largest shareholders were in near-absolute control in about one third of the companies. The economic and financial performance of the NIF companies had deteriorated in the early stage of the program because of its delayed implementation and the lack of restructuring activities during the waiting phase. In 1995, profitability had fallen rapidly and never recovered. Much better results were achieved in 1999 by other groups of privatized enterprises, and even by State Treasury companies.

Using the ratio of sales in 1999 to sales in 1995 as their measure, the authors looked at the financial situation of NIF companies that had undergone secondary ownership changes (i.e., had been sold to new owners) and found that the drop in sales had been sharpest (ranging from 30 to 60%) in companies sold to domestic individuals and employees. A significant decline was also experienced by companies which had not been sold by the NIFs (i.e., where the largest block of shares still belonged to the leading NIF) and by most companies which were publicly traded. Both types of companies continued to lack a strong outside investor who could bring them capital, know-how, etc. The best results were found in companies sold to domestic corporations and foreign investors relatively early.

The success of the NIF Program, which in effect "privatized" the process of privatization of the portfolio companies, was thus limited to cases where medium-sized and large companies were rapidly sold to domestic corporations and foreign investors, which helped

those companies to at least maintain their market position. Where this had not occurred, it seemed rather to have been a failure.

3.3. The Czech Republic[20]

Using a relatively large representative sample of voucher-privatized Czech firms, the authors first showed the trends in these firms. The ownership data included the identity and the equity holdings of up to seven largest shareholders for each company since 1996. These owners were categorized into six types: other industrial groups or companies, investment funds, portfolio companies (companies engaged primarily in buying and selling of shares without any intention of interfering in management decisions), individuals, banks, and the state.

The primary changes in ownership structure in the 1996-1999 period were first calculated using three ownership concentration measures: C1, C5, and the Herfindahl index. The authors also calculated the mean ownership position for each of the categories of owners mentioned above. Additionally, the authors used density functions of ownership concentration indices to paint a broader picture of ownership structure and its changes during the period from 1996 to 1999.

To capture the relationships between the ownership changes described above and various aspects of enterprise performance such as profitability, strength and size of the firm, its financial position, and its scope of business activity, the authors carried out regressions employing the ownership variables described in the foregoing as well as various measures of profitability, financial strength, and sales. The performance variables were regressed on various ownership variables as well as industry and sector dummies.

The Czech voucher privatization took place in the years 1991-95. While it was only one of a number of possible methods of ownership transfer in the Czech privatization program, the voucher scheme led to the wide distribution of share ownership in the Czech Republic. Privatization Investment Funds (PIFs) had taken an active part in the implementation of the voucher scheme and become the most important owners of equity in the immediate post-privatization period. More than 400 PIFs had participated in the program. A significant number were founded by various types of financial institutions, mostly state owned at the time. Most of the rest had been set up by manufacturing companies. The 13 largest funds had obtained control over 56% of all voucher points invested in the PIFs by citizens. Foreign and domestic strategic investors had played a very limited role. This tendency toward overwhelming fund dominance decreased somewhat after the second wave of voucher scheme, when funds sold many of their shares to individuals and corporate entities.

In this early post-privatization period, heavy inter-fund trading rearranged the PIFs' portfolios. This was carried out under almost complete lack of government intervention by way of enforcement of legal provisions and regulations. The lax legal environment and the absence of any notification and disclosure requirements facilitated a wave of mergers and acquisitions, which contributed to further concentration of ownership. From 1996 onwards, ownership concentration in voucher-privatized companies continued to increase and reached levels which were extremely high in comparison with many developed countries. The most concentrated shares tended to be held by strategic investors (although the number of firms with foreign strategic investors was still relatively low in 1996-97), the lowest by banks and portfolio investment companies. PIFs had also begun divesting the firms in their portfolios.

[20] See Kočenda, Valachy (2001).

The authors examined shareholding patterns by investigating which of six types of owners (i.e., manufacturing companies, banks, investment funds, individual owners, "portfolio companies"[21] and the state) constituted the single largest shareholder of these companies. They found that manufacturing companies were the most stable type of largest owner, followed by individual owners. Manufacturing companies also recorded by far the largest ownership gains in this period. The most unstable type of owner was the portfolio company.

In an econometric analysis of the impact of ownership concentration and the type of dominant owner on firms' performance, the authors concluded that ownership concentration did not explain changes in company performance. Some positive correlations were found between performance and the holding of the largest block of shares by portfolio companies and individuals (as opposed to other types of owners).

3.4. Endogenous Ownership Structure and Mass Privatization in the Czech Republic and Poland[22]

While the three country studies discussed above treated ownership concentration as exogenous and tried to analyze its impact on firm performance, the authors of this research took a different approach. They considered ownership structure as endogenous and tried to determine how it adjusts to firm characteristics and to factors characterizing firms' environment.

The authors first presented the theory and empirical evidence showing the ambiguous relationship between ownership structure and firm performance. Then, given this ambiguous relationship, they argued that an assessment of the effectiveness of wholesale privatization should not refer to concentrated ownership as a benchmark. What is more relevant, they argued, is the possibility for the firm to adjust its ownership structure to firm-specific characteristics and to its environment. Thus, flexibility of the ownership structure is a virtue. The authors documented the significant reallocation of property rights since the initial mass privatization in Poland and in Czech Republic, showing that the ownership structure had evolved rapidly: it had become highly concentrated, and the identity of the largest shareholders had changed quickly. So, contrary to the concerns of the critics of mass privatization programs, the authors found the inertia of the initial ownership structure to be quite limited.

The authors also interpreted the significant evolution of ownership structures in firms privatized through mass privatization as an argument for treating ownership as endogenous. They cited several authors (Demsetz and Lehn, 1985; Himmelberg et al., 1999; and Demsetz and Villalonga, 2001) who have argued that even in more stable environments the usual regression of firm performance on ownership concentration would produce biased results. In firms privatized through wholesale schemes, this endogeneity problem is particularly important. So instead of treating ownership as exogenous, the authors considered various firm-specific characteristics and factors characterizing the firm's environment which might affect the evolution of ownership concentration and the change in the type of largest shareholder.

The authors re-examined the evolution of ownership structure in firms privatized through voucher schemes in the Czech Republic and Poland, focusing on the endogeneity of ownership structure and the effect of the companies' economic performance on owner-

[21] This term refers to a category of institutional investors whose strategy is solely to realize profits through dividend payments or — more frequently — through capital gains and who normally have an intention of participating in corporate governance.

[22] See Grosfeld, Hashi (2001).

ship changes. They showed that not only has there been a strong tendency towards the concentration of ownership in fewer hands, but also a large-scale reallocation of ownership rights has taken place among various types of owners. Starting from a highly dispersed ownership structure, the large majority of voucher-privatized Czech companies had found a dominant shareholder by the year 2000. In nearly half of them, the dominant shareholder owned more than 50% of equity and had absolute control over the firm. In Poland, too, the majority of companies involved in the scheme found dominant owners, some 10% of them being foreign investors. Furthermore, manufacturing companies and individuals had emerged as major dominant shareholders in both countries.

The authors maintained that ownership structure had evolved in response to competitive pressures and constraints in the environment of the firms as well as firm-specific characteristics. They saw the rapid increase in concentration as the owners' response to firms' conditions and their long-term prospects. In particular, they found ownership concentration to depend on the degree of uncertainty in the firm's environment. The riskier the environment, they found, the greater the tendency of firms to have more dispersed ownership. The authors suggested that these results could be interpreted in the light of theories of the firm stressing the trade-off between managerial initiative and shareholder monitoring and control. The greater ownership dispersion they found in riskier environments leaves greater room for managerial decisions. An important implication of this finding, they argued, is that concentrated ownership may not always result in better corporate governance and control.

4. Conclusions and Policy Recommendations

As the overview of empirical research of the 1990s shows, complete consensus has not been reached on any of the issues under consideration. Sometimes empirical data run counter to generally accepted theoretical approaches. It seems there are only two points where the results of almost all empirical research agree:

– the finding that there is a positive relationship between foreign investors' stakes and performance, and

– the finding that the role of employees as shareholders is neutral or negative.

Empirical results are mixed or inconclusive with regard to:

– the "contribution" of privatization to improvement of company performance (taking into account the time of privatization and the size of the government-held stake in companies with mixed ownership) and, in a broader perspective, the comparative efficiency of state-owned and private companies;

– the impact of ownership concentration levels on performance, and

– the nature of the relationship between the dominant owner type (managers, outside shareholders) and performance.

There are several reasons for this.

First, there is still a great deal of disagreement even in the theoretical discussion of the issues. For example, while in 1999 Joseph Stiglitz wrote about the need to pay greater attention to the role of insiders, who, in the context of the relationship between ownership and management in transition economies can have a positive impact by shortening agency chains (Stiglitz, 1999), in the same year the EBRD called for fighting against the interests of the "entrenched insiders" (EBRD, 1999). And Oliver Williamson, in a recently published overview of institutional theory pointing to the problems engendered by privatization in Russia, links what he views as the flaws in the county's privatization strategy to

policy makers' adherence to the Grossman-Hart-Moore[23] theory of property rights (Williamson, 2000).

Second, the (corporate) ownership structure emerging in many post-Communist economies can still be assumed to be of a transitional nature; thus, it is too early to draw conclusions about its gravitation towards a particular classical model (ownership and corporate governance structure). In fact, various components of all traditional models can be observed in the transition economies at the moment: relatively dispersed ownership (but with an illiquid market and weak institutional investors, in contrast to the Anglo-Saxon countries where dispersed ownership is most typical), a clear and sustained trend towards ownership concentration (but without the adequate external financing and efficient monitoring mechanisms characteristic of the European economies with highly concentrated ownership structures), and elements of cross-ownership and emergence of complex corporate structures of various types (but without gravitation towards any particular type).

Clearly, this ill-defined character of the ownership and governance models evolving in the transition economies hampers decision-making in the law and policy areas. One example would be sufficient to illustrate this point. It is generally believed that a high need for company transparency (information disclosure) is reached if shareholder base is broad (i.e., concentration is low). If one assumes that the many stages of ownership redivision that are to follow will result in highly concentrated ownership, then the requirements of the law as to information disclosure (both current and new, more stringent ones) are groundless. Certainly they are not properly complied with now.

Third, the issue of relations between affiliated entities and beneficiary ownership is a difficult one. Given the actual ownership (control) structure and financial flows of many big Russian companies (see Radygin, Sidorov, 2000), practically all initial data used for empirical research — both in the issues of ownership (managerial as well as outsider) and financial performance — may be called into question. Managerial property is a special issue. It is clear that the managers' stake shown in all surveys is highly misleading. The actual power of managers in companies may be based on a relatively small stake (about 15% of shares is usually sufficient), even though there is an obvious trend towards maximization, part of which occurs through affiliated entities. In this situation testing classic hypotheses about the role of managers (e.g., the "convergence hypothesis" in Jensen, Meckling, 1976, and the "entrenchment hypothesis" in Morck, Vishny, 1988) is extremely difficult.

Fourth, there are serious difficulties associated with one of the classic econometric problems — that of causality (the "endogeneity problem"). The problem is that the choice of enterprises to be privatized cannot be considered accidental. Thus, privatization theory most often proceeds from the assumption that it is inefficient enterprises facing crisis that have to (should) be privatized (Vickers, Yarrow, 1998). But investors prefer to acquire shares in efficient companies. This consideration must have played an important role in the course of post-Communist privatization (Carlin et al., 1995). However, if there are any real grounds for such assumptions, this is evidence of the unequal initial conditions of the operation of privatized and non-privatized companies. Indirect evidence of the problem of endogeneity can be found in the extent of insider ownership in many transition economies. Russian survey data from 2000 demonstrate that insiders acquired larger stakes in companies that had been characterized by higher performance (higher labor productivity and profitability) in the pre-privatization period (Muraviev, 2001). Thus, given the asymmetry of information, better performance of the companies where insiders have larger stakes

[23] For details, see Radygin, Entov, Malginov et al., 2001.

could reflect "cherry-picking" by the insiders in the course of privatization rather than the superiority of insiders as a class of owners.

It is our hope that the research summarized in Section 3 can shed some light on these questions. The main findings of the studies presented there can, in spite of a number of differences between the experiences of the three countries studied, be summarized in the following generalizations about how the process of secondary privatization unfolded in those countries.

1. In the majority of enterprises privatized under mass privatization schemes in which insiders were not officially privileged, extensive secondary privatization processes have taken place (that is, new owners have taken control). The transfer of ownership to new owners in insider-owned companies like the Polish employee-leased companies and most privatized enterprises in Slovenia, however, remains limited to a minority of such companies.

2. There is increasing concentration of ownership in almost all enterprises under consideration.

3. Surprisingly, given the fairly broad, albeit far from universal, agreement among economists dealing with corporate governance and the theory of the firm, the aforementioned concentration process has not been accompanied by improvements in performance. Only some of the companies in the Polish National Investment Fund Program seem to exhibit such a relationship, and this was a relatively small group of companies sold by funds relatively early in the program to strategic (especially foreign) investors.

4. This result may be an indication that ownership evolution is first and foremost an endogenous process determined by, rather than determining, the economic performance of the enterprise. The concentration of ownership by large shareholders is influenced by a variety of firm level factors as well as competitive pressures and constraints experienced by them. The absence of a direct relation between ownership concentration and performance may of course also be explained by the short period of time which had elapsed between the acquisition of the companies by their new owners and the time of the research.

5. The type of owner (i.e., "insider", "outsider", strategic or portfolio investor, domestic or foreign) seems to be very important. A detailed analysis of the identity of the new strategic investors emerging in the secondary privatization process is needed. Are they foreign or domestic? Do they come from the same branch as the purchased enterprise (thereby representing examples of horizontal integration), or do they have supplier or customer relationship with the acquired company (thus constituting examples of vertical integration)? Are they financial investors? What connections have they had with the acquired firm in the past? What are the strategies underlying their acquisitions? These are some of the questions that will be very important in further research.

6. The regulatory and institutional environment of the privatized enterprises is also crucial — as crucial for the success of secondary privatization as it was for that of initial privatization. Does this environment impede the entry of new owners, or does it facilitate their appearance in the privatized companies? This is a very broad topic, which was dealt with often and from various angles in our work, and we believe that it, too, demands further, more systematic research in the future. When the legal, regulatory, institutional and general economic environment is highly unfavorable, we observe either blockages or pathologies in the secondary privatization process, as a result of which the end results of this process turn out to be very different from those expected by reformers. Some of these unexpected pathological results include the creation of monopolistic structures and the entrenchment of owners who are unwilling and/or unable to make the changes necessary to improve the economic viability of their companies. Poorly designed privatization institu-

tions do not fulfill the roles assigned to them, but rather take on lives of their own and begin to create new problems.

7. A cardinal example can be found in investment funds, which constitute one of the central legacies, and one of the greatest problems, created by the privatization schemes we investigated in this project. Emerging as a result of various mixtures of spontaneity and state design in all three countries, they were originally intended by the designers of privatization policies to solve the corporate governance problem in one of two ways. First, they were to solve the principal-agent problem of an enormous group of shareholders, extending to practically the entire population, by concentrating managerial control in enterprises with widely dispersed ownership. Second, quite the opposite, they were expected to sell their shares in companies quickly, allowing for concentration of ownership in new hands and the elimination of the principal-agent problem altogether. Investment funds have not lived up to either of these expectations. They have had neither the capacity nor the motivation to engage in active corporate governance, but instead have become major players in the economies of at least two of the three countries we studied. Far from delivering improved corporate governance and company performance, they have often been used in schemes to drain companies of their assets (most notoriously in the case of the Czech Republic, whose experience led to the formulation of the new concept of *tunnelling*).

8. Another important institutional factor is the regulation of capital markets. There has been much commentary on the poor regulation of the Czech capital market and the high-quality regulation of the Warsaw Stock Exchange (see, for example, Glaeser et al., 2001), and it seems that the Slovenian exchange bears a number of disturbing resemblances to the one in Prague. These problems often reduce the transparency of the secondary privatization process, making it difficult for companies to raise new capital and for the rights of minority shareholders to be protected.

9. The inertia of ownership structures frequently observed in our samples is not accidental, but rather results from the entrenchment of incumbent owners (particularly the insiders) that emerged in the primary privatization process and frequently bar entry to all outsiders. Since the state can no longer exercise influence on this situation from the position of an owner, it can only act through the creation of new regulation, which could at least partially reduce some of the barriers to the entry of new owners. On the other hand, with respect to the stability of insider ownership noted above, it is likely that such ownership structures will remain both stable and economically efficient in the case of small and medium-sized enterprises which make up the majority of insider-owned companies in both Poland and Slovenia. As Chandler (1996) notes, the separation of ownership from control was an efficiency requirement for very large, multidivisional firms whose production processes were characterized by significant economies of scale and scope, but was not necessary in industries whose technologies allowed for combining relatively small firm size and efficiency.

Another issue worth commenting on at this point concerns the debate about whether the ownership and corporate control structures emerging in the post-Communist countries of Central and Eastern Europe would bear a greater resemblance to those in Anglo-Saxon countries (where capital markets dominate) or to those of continental Europe and Japan (characterized by concentrated ownership and the strong role of banks in corporate finance and control). It seems that neither model is adequate to explain the directions of development in these countries. Capital markets (with the exception of Poland) lack the informational transparency provided by regulation in the Anglo-Saxon countries. The degree of concentration, and its increase, as well as the role of financial institutions, might suggest at first glance a similarity to the European or Japanese model. However, these financial institutions are portfolio investors — funds, not banks — with little or no interest in corporate

governance, a fact which strongly distinguishes Central Europe from Western Europe. In short, unlike either the Anglo-Saxon or the German-Japanese system, the institutional environment created in Central European wholesale privatization and its aftermath has brought neither the informational transparency necessary for efficient markets nor the additional capital necessary for restructuring.

It is clear that the establishment of an efficient system of financial institutions, primarily commercial banks, is crucial for the development of a national model of corporate governance and finance. The weakness of such institutions in Russia, which became obvious in the 1998 financial crisis, deprived earlier discussions of the nature of the national model of corporate governance (Anglo-Saxon or German-Japanese) of all meaning. In an environment with limited or non-existent mechanisms for inducing managers to act in any interests other than their own, the potential role of banks as an alternative mechanism of corporate control (Stiglitz, 1994, pp. 77-78, 189-190) becomes largely irrelevant.

It is also worth calling attention to some of the nuances which, to varying degrees, differentiate the three countries studied. The Slovenian situation presented here bears much resemblance to that of Polish MEBO and NIF companies. Similarities are especially striking with regard to the behavior of investment funds, managers and employees as owners in the post-privatization phase, as well as with respect to the behavior of the state (both as an owner and as a regulator). In the case of the latter, the Slovenian and the Polish experience shows that it is difficult, if not impossible, for the state to refrain from exercising the power it reserved for itself by maintaining residual property in the privatized enterprises, as well as via its influence in the investment funds themselves. The role of state golden shares in the Czech Republic and that country's delays in the privatization of banks are also evidence of a similar tendency. Both states have also shown a tendency to make too many promises that they cannot keep, and to try desperately to keep those promises by utilizing privatization revenues (which, ironically, gives the state an incentive to keep as much residual property as possible, in order to have a reserve from which it can deliver on such promises).

Moreover, in both Poland and Slovenia, generally speaking, weaker performers went into the portfolios of investment funds via voucher privatization, companies with more or less average performance became employee owned, those with the best performance were often sold in IPOs. This seems to reflect both the aforementioned fiscal approach to privatization and the attractiveness of such companies for investors; however, it is clear that such a privatization strategy fails to bring new capital to the firms which need it most.

Another similarity between Poland and Slovenia lies in the fact that in both Polish and Slovenian employee-owned companies we observe problems arising from the fact that many people keep their shares after leaving their companies (due to retirement or other reasons), and from the fact that shares are often not available for new employees hired after privatization. The problems are due to perceptions that the most consumption-oriented attitudes are exhibited by former (and not current) employees, and that new employees (young, well-educated persons hired in the 1990s) are often the most valuable in the firm. A possible solution is the creation of trust funds which would hold employee shares on behalf of the employees, issuing shares to new employees and purchasing them from those that leave the company.

Some important differences among the countries need to be mentioned as well. These are:

1. Slovenian "employeeism". The heavy emphasis on both codetermination (employee representation on supervisory boards) *and* employee ownership in Slovenia was not duplicated in any other transformation country. It seems that Slovenia has been unable to find an appropriate balance between the regulation for various forms of employee par-

ticipation — those based on ownership and those based on employment. Slovenia represents an extreme in this area. The Czech Republic, on the other hand, has enacted the least "employeeist" legislation of the three countries studied here. Poland lies in between these two extremes, having mandated employee representation on supervisory boards in state-owned joint stock companies and — in companies privatized by commercial methods — the allocation of 15 per cent of the shares to employees free of charge. These trends seem to be connected with historical differences between the respective countries reflecting the extent of workers' self-management ideology and practice under socialism. Workers' self-management was strongest in Yugoslavia, from which Slovenia broke away in 1991, somewhat less strong in Poland (self-management legislation concerning state enterprises was enacted in Poland in 1981, but workers' councils were not really allowed to operate freely in state enterprises until 1989), and non-existent in socialist Czechoslovakia.

2. The limited role of foreign investors in the Slovenian economy. This strongly differentiates Slovenia from transformation countries like Poland, Estonia, and Hungary (and, following the conclusion of voucher privatization, the Czech Republic). Perhaps in the 1990s, with Slovenia's GDP per capita being much higher than in other transformation countries, Slovene governments felt they could afford this. One can expect, however, that a failure to open the country more will have increasingly severe adverse effects. At any rate, such opening will be made necessary by the process of accession to the European Union.

3. There appears to be a difference between Polish and Slovenian employee-owned companies with respect to the ownership structure most attractive to potential strategic investors. As Böhm et al. (2001) write, strategic investors tend to be interested in acquiring companies in which the ownership structure is concentrated. It is probably safe to assume that such concentration means concentration in the hands of managers. In the sample of Polish employee-owned companies studied by Kozarzewski and Woodward (2001), the situation seems to be quite different. Here, there is a negative correlation between the entry of strategic investors and the concentration of shares in the hands of managers. In general, strategic investors seem to prefer companies where shares are dispersed among a large number of employees than those in which they are concentrated in the hands of a few managers (although it might not be strategic investors' preferences that are crucial here, but rather those of managers — once they have achieved control, they may be reluctant to give it up).

Finally, we present a few suggestions for policy makers which emerged from this research. First, a few remarks concerning investment funds and their role in privatization. It is best if such funds are not set up by the state, and if they are, the compensation of their fund managers should be strictly tied to performance. Given the scarcity of capital and shallowness of capital markets in transition economies, as well as the desperate need for pension reform in most such economies, privatization funds should not be kept artificially separate from pension funds; in fact, it would probably even be a good idea to encourage mergers between the two. In general, as much freedom as possible should be allowed for the transformation of funds created for participation in privatization — into open-ended funds, closed-ended funds, mutual funds, venture funds, etc. Policy makers should realize that funds, if left to evolve freely, will take various forms in response to different kinds of market incentives and varying preferences of their participants. This process should be allowed to occur with a minimum of constraint. We will return to this point in a moment.

Second, the importance of capital market regulation is paramount. Disclosure requirements (e.g., requirements to disclose the size of blocks of shares held at certain thresholds), strict bans on insider trading, mandatory bid rules (i.e., the requirement that

shareholders crossing certain thresholds should make offers to buy out other shareholders), and other forms of regulation are necessary to maintain transparency of the markets and transactions as well as protect minority shareholders' rights.

What about regulating the funds themselves (e.g., limiting the percentage of a given company that they can hold)? Having stressed the importance of capital market regulation but also the importance of allowing funds to evolve freely, we would add that certain regulations in force in more developed markets economies may be too restrictive in an environment where there is a need for rapid secondary privatization (which may involve, for example, taking companies private — that is, buying out the small shareholders in a publicly traded company and its de-listing). EU takeover regulations, for example, may be too restrictive for companies which are not publicly traded. It may also be useful to encourage off-market transactions in certain situations, though such transactions are generally strictly limited in strong regulatory regimes. In order to facilitate taking companies private, such transactions should serve to allow outside financial investors to exit in a fair and transparent fashion, and could include, for example, equity-to-debt conversions. Finally, given the fact that although most funds are typically portfolio investors, some have both the propensity and the competence to take active roles in the governance and restructuring of the firms whose assets they hold. Regulators should consider exceptions to the general practice of limiting the percentage of shares of a given company that a given fund may hold (Simoneti, 1995).

In the transition environment, it is important that regulation take into account the fact that there are different kinds of minority shareholders. While most such shareholders are individuals with small stakes who cannot defend themselves, some minority shareholders, with stakes of 10 to 40 per cent, are serious players battling for control over firms, sometimes to the detriment of those firms. Some observers consider the potential for abuses by large minority shareholders to have become a serious problem in Russia in recent years.[24] While these sorts of abuses are uncommon in Poland, some recent events show that even well-regulated Central European markets like the Polish one are not immune to such abuses.[25]

How, in such cases, is the regulator to protect the majority of shareholders from a minority shareholder's abuse of his rights? Is cumulative voting, which allows strong minority shareholders to appoint directors and is a standard measure used to protect minority shareholders' rights, perhaps inappropriate in transition environments? We believe this troublesome question requires further investigation.

Another point concerns employee ownership. Given that this has tended to become a fairly widespread feature of privatized companies in almost all transition economies, it might be a good idea to provide for employee trust fund mechanisms which would hold employee shares on behalf of the employees, issuing shares to new employees and purchasing them from those that leave the company. Such a mechanism might resemble, for example, the Employee Stock Ownership Plans in the United States. The Slovenian authors report that while a similar mechanism has been introduced in Slovenia, it has not

[24] Some possibilities for hostage-holding are discussed in Radygin et al. (2002), pp. 70-71.

[25] One such example is the case of Wólczanka, one of Poland's leading clothing manufacturers (Michałowicz, 2002, 2003). An investor who had consolidated a block of 16 per cent of Wólczanka's shares in 2000 had his representatives on the supervisory board elect a new vice president for capital investments. This vice president, in turn, was responsible for the creation of a Wólczanka subsidiary called WLC Inwest, which managed financial investments. WLC made a number of bad investments, leading to significant losses. The vice president claimed that these poor investment decisions were in fact made by the investor who had nominated him, who had conflicts of interest resulting from his shareholding position in companies whose shares were purchased by WLC. Investigations were later initiated by both the Securities Exchange Commission and the public prosecutor's office.

been availed of in a significant number of companies, and point to the lack of promotion of the mechanism via tax incentives. However, tax incentives are not the only means of promoting this sort of arrangement (and it is debatable whether they are a desirable one).[26] Public education campaigns and training programs (e.g., for trade unionists) might well prove to be sufficient in raising public awareness concerning the advantages of such arrangements.

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[26] Certain tax incentives might be advisable when employee stock options are used as a form of retirement insurance, but this would have to be part of a comprehensive pension reform.

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