Governance, organizational capabilities, and restructuring in transition economies

Igor Filatotcheva,*, Mike Wright b,1, Klaus Uhlenbruck c,2, Laszlo Tihanyi d,3, Robert E. Hoskisson d,4

a Bradford University School of Management, UK
b Business School, Center for Management Buyout Research, University of Nottingham, Nottingham, UK
c Department of Management, Texas A&M University, College Station, TX 77843-4221, USA
d Michael F. Price College of Business, University of Oklahoma, Norman, OK 73019-4006, USA

Abstract

This paper focuses on the links between governance, firm capabilities and restructuring following the large-scale privatization process in Central and Eastern European transition economies using an integrative approach. Restructuring in these countries has been motivated by political and institutional changes and less so by market forces. Accordingly, political processes have produced political solutions such as “give-away” privatizations to insiders. These privatizations, in contrast to divestitures to outside owners, have realized less substantive restructuring because non-market incentives, such as too much managerial equity ownership, have created managerial entrenchment. In addition, we propose a connection between governance and organizational learning suggesting that learning is inhibited by excessive managerial ownership and lack of board knowledge regarding its oversight function. Furthermore, this entrenchment and poor board functioning may be perpetuated in financial-industrial groups, which have emerged as substitutes for market intermediaries in emerging economies. Thus, we propose that outside ownership involvement and the development of organizational capabilities may facilitate restructuring in the Central and Eastern European context. Our theoretical arguments are supported by case study evidence from transition economies.

* Corresponding author. Tel.: +44-1274-23-4345; fax: +44-1274-54-6866.
E-mail addresses: i.filatotchev@bradford.ac.uk (I. Filatotchev), mike.wright@nottingham.ac.uk (M. Wright), kuhlenbruck@tamu.edu (K. Uhlenbruck), ltihanyi@ou.edu (L. Tihanyi), rhoskiss@ou.edu (R.E. Hoskisson).
1 Tel.: +44-1159-515257; fax: +44-1159-515204.
2 Tel.: +1-979-845-1445; fax: +1-979-845-9641.
3 Tel.: +1-405-325-5699; fax: +1-405-325-7688.
4 Tel.: +1-405-325-3982; fax: +1-405-325-7688.

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However, privatization of formerly state-owned enterprises alone is not a guarantee for performance improvements (Meggison & Netter, 2001). Greater performance in privatized firms, for example, can be achieved by the replacement of management and the development of effective governance mechanisms (Cuervo & Villalonga, 2000). Limited empirical evidence in transition economies indicates that evolving corporate governance is important for the outcome of firm restructuring at privatized firms (Djankov & Murrell, 2002; Filatotchev, Buck, & Zhukov, 2000). It is also likely that different privatization methods, such as the sale to strategic foreign investors, buyouts by local management, and “give-away” deals will be associated with different governance.

Transition markets present distinct settings and research results on the relationship of governance and restructuring from highly developed Anglo-American samples may not be applicable (Hoskisson, Johnson, Yiu, & Wan, 2001). The evolution of modern corporate governance in the former Eastern Bloc countries is characterized by learning at both ends; not only do managers need to satisfy the demands of multiple stakeholders, but they need to learn their role and develop monitoring systems (Filatotchev, Hoskisson, Buck, & Wright, 1996). Setting up efficient monitoring systems, however, is difficult due to the new “rules of the game” (North, 1990, 1994). Under these conditions, the capabilities of managers and their organizations will be relatively more important for firm restructuring (Lyles & Salk, 1996; Steensma & Lyles, 2000).

Our purpose is to examine corporate governance in a situation where managerial ownership is dominant and to examine the tradeoffs (costs) of such ownership relative to the benefits. We go beyond the traditional governance-strategy-performance framework by considering organizational capabilities as substitutes for managerial ownership. Accordingly, we link agency and learning theories through an integrated model on the effects of governance and organizational capabilities on corporate restructuring. Our analysis, therefore, considers the organizational level implications for restructuring of the differing corporate governance and learning associated with different forms of privatization, and provides a link between firm-level developments with systemic, national level privatization outcomes that applies across all firms.

2. The transition economy context

Derived from the principles of Marxism, previously planned economies were characterized by the exclusivity of state-owned property, resulting in acute inefficiencies at the firm as well as the macro level (Kornai, 1992). A major objective of reforms in countries undergoing transition to a market economy is to increase the efficiency of state-owned enterprises and to make their outputs competitive on world markets (Sachs & Warner, 1995). Privatization emerged as central to affecting such reform because of its sociopolitical importance and potential macroeconomic benefits (Meggison & Netter, 2001). It was designed to enhance restructuring in failing state-owned companies by eliminating the constraints on managerial strategic actions imposed by state ownership and central planning.

Although prior studies considered the general benefits of privatization, a growing body of research on transition economies suggests that different privatization methods may lead to different outcomes (see, Estrin & Wright, 1999; Hoskisson et al., 2000, for a comprehensive survey). Indeed, there has been a variation in privatization methods both within and across countries in Central and Eastern Europe, ranging from “give-away” privatizations through vouchers issued to the adult population (European Bank for Reconstruction and Development, 1998) to asset sales. Each method may have different implications for restructuring.

The newly independent countries emerging from the former Soviet Union, for example, have generally imitated Russia’s “give-away” privatization to incumbent management and through vouchers distributed to adult citizens. Vouchers are then used to bid for shares in enterprises as the main form of privatization (Estrin & Wright, 1999). The “give-away” method of privatization to incumbent management, as well as voucher privatization to other potential owners, such as domestic individual investors and institutions outside the enterprise, have been found to be passive regarding firm strategies in Russia and other Eastern European countries (Frydman, Pistor, & Rapaczynski, 1996). In most cases, “give-away” privatizations were accomplished without any additional infusion of new capital.

Direct sales to inside management and employees as “privatization buy-outs” or to domestic and foreign investors as “privatization divestments” have also
been used but as secondary privatization methods of transfer to the private sector in most countries of the former Soviet Union. Of these countries, only Estonia has pursued a policy primarily focused on direct sales. In the countries of Central Europe (e.g., Hungary, Poland, the Czech Republic, etc.), direct sales or voucher privatizations, often in favor of owners outside the firm, have predominated as the main privatization method (European Bank for Reconstruction and Development, 1998). These different privatization modes are associated with different governance and learning, which in turn have implications for the nature of enterprise restructuring. In the next section, we discuss the influence of these different approaches to privatization on governance and learning in the context of enterprise restructuring.

3. Integrated theoretical framework

3.1. Problems of governance in transition economies

A number of studies link corporate governance factors, such as ownership structure and board characteristics, with firm restructuring (see, for example, Bergh, 1995; Bethel & Liebeskind, 1993; Johnson, Hoskisson, & Hitt, 1993). In emerging economies, important contextual factors may contribute to explanations of firm restructuring. These factors include the development of market institutions, (high) levels of government involvement, industry structures, ownership patterns and enforcement of business laws (Chang & Hong, 2000; Khanna & Palepu, 1997, 2000; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; North, 1994).

Restructuring of formerly state-owned enterprises in the transition economies of Central and Eastern Europe has often resulted in the emergence of different organizational forms, such as networks or “recombinant properties” (Peng & Heath, 1996; Spicer, McDermott, & Kogut, 2000; Stark, 1996). These organizational forms represent the recombination of previously state-owned organizational assets, blurring the boundary between public and private property in transition economies (Stark, 1996). An important reason for these restructuring outcomes might be that managerial opportunism is not controlled effectively by the owners of the firm (Filatotchev et al., 2000). Monitoring activities may be constrained by difficulties in gaining board seats in insider dominated firms, by weak legal enforcement and by a weak external capital market. These sub-optimal outcomes of firm restructuring are often explained by the fluid state of the institutional environment in transition economies (Newman, 2000; Whitley & Czabanska, 1998). Thus, governance problems in firms in transition economies accentuate problems with enterprise restructuring because monitoring is not adequate or because managers have too much ownership (Morck, Shleifer, & Vishny, 1988).

3.2. Learning and capabilities

The privatization of state-owned enterprises through insider “give-away” privatization programs has resulted in a general lack of working capital in firms since no new finance is introduced under this method of ownership transfer. Moreover, because Central and Eastern European economies have undeveloped capital markets and can offer only limited legal protection to foreign investors (European Bank for Reconstruction and Development, 1998), for most privatized firms, substantial, new capital investments are not usually possible. While firms in developed economies may hire human capital or acquire other organizations in order to obtain necessary resources, this is largely impossible for firms in transitional countries. Consequently, organizational restructuring in Central and Eastern Europe needs to be accompanied by internal firm resource development and learning (Lyles & Salk, 1996; Uhlenbruck, Meyer, & Hitt, 2003).

To be implemented effectively, restructuring should also be supported by an organization’s “ability to change,” which is a function of the firm’s resources (Barker & Duhaime, 1997). These organizational capabilities are particularly important in firms in Central and Eastern Europe. Further obstacles in this organizational learning process come from the characteristics of Central and Eastern European firms, in particular their limited absorptive capacity. Absorptive capacity is the ability of firms “to recognize the value of new information, assimilate it, and apply it to commercial ends” (Cohen & Levinthal, 1990: 128). Absorptive capacity is crucial because it provides firms with the degrees of freedom and strategic flexibility to adapt and evolve in changing environments, such as transition economies (Puffer & McCarthy, 2001). Absorptive capacity, nonetheless, depends on
firms’ prior related knowledge. Yet, the socialist experience in Central and Eastern Europe has equipped firms with little prior knowledge of how to adapt to a market environment (Newman, 2000). Knowledge needed to fulfill plans designed by the central planning bureaucracy varies significantly from recognizing and meeting demand in a competitive environment. Accordingly, the learning process of how to restructure a privatized firm in Central and Eastern Europe presents significant challenges. These firm level issues have system-wide implications, since they interact with the development of general governance factors underpinned by privatization modes and jointly affect the process of restructuring and modernization in a particular economy.

3.3. Inter-relationship between governance and learning

Restructuring of firms in Central and Eastern European transition economies may not only be constrained by the lack of effective governance mechanisms, but also by managerial unwillingness and/or lack of ability to undertake change (Mahoney, 1995). Although managerial abilities may improve as firms adapt to a changing environment, the learning pace is generally slow compared to the magnitude of change in the environment. When managers fail to respond to the adverse effects of rapid economic and social change, effective corporate governance can significantly influence strategic flexibility in terms of managerial ability and willingness to undertake restructuring (Hoskisson, Johnson, & Moesel, 1994; Johnson, 1996). This ability to change is, in turn, underpinned by managers’ knowledge and learning capacity that directly affects the quality and timing of their strategic decisions. It is associated with such factors as managerial expertise, flexibility, learning capacity, ability to make unorthodox, risky decisions, etc. (Mintzberg & Westley, 1992; Pettigrew, Ferlie, & McKee, 1992; Rajagopalan & Spreitzer, 1997).

Table 1
Corporate governance and learning capacity

<table>
<thead>
<tr>
<th>Learning—low absorptive capacity</th>
<th>Quadrant 1: Stuck privatization</th>
<th>Quadrant 2: Privatization to domestic institutions</th>
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<td></td>
<td><strong>Organizational characteristics:</strong></td>
<td><strong>Organizational characteristics:</strong></td>
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<td></td>
<td>Managerial incentives reduced</td>
<td>Managerial incentives but poor wealth</td>
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<td></td>
<td>in absence of purchase</td>
<td>diversification lead to low risk behavior</td>
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<td></td>
<td>Low managerial turnover</td>
<td>Monitoring by outside investors</td>
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<td></td>
<td>Resistance to outside board members</td>
<td>Limited access to outside networks</td>
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<td>Entrenchment of traditional networks</td>
<td>Important role of bank-led financial-industrial</td>
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<td>groups producing financial reallocation but also private appropriation</td>
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<td></td>
<td>Low learning and weak governance</td>
<td>Ambiguous efficiency of governance, may be traded off for low learning</td>
</tr>
<tr>
<td>Strategic outcomes:</td>
<td>Likelihood of low corporate restructuring effectiveness</td>
<td>Strategic outcomes:</td>
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<td></td>
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<td>Likelihood of moderate corporate restructuring effectiveness</td>
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<th>Learning—high absorptive capacity</th>
<th>Quadrant 3: Privatization buy-outs</th>
<th>Quadrant 4: Privatization to foreign investors</th>
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<td></td>
<td><strong>Organizational characteristics:</strong></td>
<td><strong>Organizational characteristics:</strong></td>
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<td></td>
<td>Managerial incentives</td>
<td>Effective boards</td>
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<td></td>
<td>Passive monitoring by financiers</td>
<td>Managerial turnover</td>
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<td></td>
<td>Limited access to outside networks</td>
<td>Break-out from traditional networks</td>
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<td></td>
<td>High learning is traded off for weak governance</td>
<td>High learning complements high efficiency governance</td>
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<tr>
<td>Strategic outcomes:</td>
<td>Likelihood of moderate corporate restructuring effectiveness</td>
<td>Strategic outcomes:</td>
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<td>Likelihood of high corporate restructuring effectiveness</td>
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Table 1 provides a two-dimensional matrix summarizing our framework on the interaction between governance and learning capacity as drivers of restructuring. We differentiate between insider and outsider governance modes, which are, in turn, associated with the type of privatization. Insider governance develops when incumbent management and employees obtain dominant ownership through either “give-away” voucher buy-outs (e.g., Russia, Slovenia, Ukraine) or the purchase of a firm through a management-employee buy-out (e.g., Hungary, Poland). Outsider governance is associated with situations when corporations and financial institutions from outside the firm obtain dominant ownership and includes the divestment of state-owned assets to domestic institutions such as investment funds, banks and industrial partners (e.g., Czech Republic, Russia, Poland) and privatization through sales of state property to foreign investors (e.g., Estonia, Hungary). These types of governance associated with privatization are widely acknowledged in the economics of transition literature (e.g., Filatotchev et al., 2000; Hoskisson et al., 2000; Puffer & McCarthy, 2001). Building on this research, we argue that each privatization mode not only creates a legal basis for emergent governance systems in newly privatized firms, it also influences the nature and efficiency of the firm’s governance systems.

Post-privatization dynamics also depend on the extent of the learning/absorptive capacity of newly privatized firms. Thus, the second dimension of the table differentiates between low and high absorptive capacity. As Table 1 suggests, we argue that corporate governance and learning may be traded off or complement each other. Therefore, we suggest that the organizational outcomes may be dependent on the dynamic interplay between two sets of organizational context factors. We now develop each quadrant of the framework in Table 1.

3.4. “Give-away” (“stuck”) privatization (Quadrant 1)

3.4.1. Governance

“Give-away” privatizations have been used as the primary method privatization in Russia as well as in Georgia and Moldova. “Give-away” privatizations are unlikely to create efficient governance systems since they tend to promote managerial entrenchment and opportunism. A survey from Russia indicates that managers use their equity as a deterrent against investors from outside the firm who may threaten them with dismissal (Filatotchev et al., 1999). The give away nature of the distribution of equity may indicate that insiders (i.e., management and employees in the firm) have not made a significant investment in the firm to protect their investment, thus further encouraging shirking (Filatotchev, Wright, & Buck, 1995). The concentration of ownership among insiders and underdeveloped capital markets in Central and Eastern Europe limit the prospects for realizing efficiency gains and incentive effects that insider ownership may potentially create. In addition, diffused share ownership among inexperienced shareholders is unlikely to provide an effective constraint on self-serving behavior by former, so-called “Red Directors.” Where budget constraints remain relatively soft, the governance pressures on insiders in privatization buy-outs who purchase the firm’s assets and thus take on a commitment to reimburse outside funding may be weakened.

In Central and Eastern European transition economies, incumbents in “give-away” privatizations have the power to prevent minority shareholders from outside the firm to obtain board seats or even accessing information. These outsiders may be domestic or foreign financial institutions or corporations. Where outsiders do have board representation, they may not be able to represent their interests due to possible insider domination of the board (Frydman et al., 1996). Unless a close relationship can be developed between the outside investor and management, outsiders may need to have majority stakes in order to obtain strong influence on the strategic direction of the enterprise (Wright, Buck, & Filatotchev, 1998). Hence:

**Proposition 1:** “Give-away” privatizations are more likely to be associated with corporate governance that is less effective at generating corporate restructuring than are other forms of privatization.

3.4.2. Organizational learning

Traditionally, managers in Central and Eastern Europe used their formal and informal relationships with political authorities to achieve planned targets and obtain resources (Ledeneva, 1999). Furthermore, the stability of central plans did not require major organizational restructuring to adapt to a changing
environment (Blasi, Kroumova, & Kruse, 1997; Newman, 2000; Wright et al., 1998).

Given their lack of prior experience, managers in “give-away” privatizations are likely to have little knowledge of how to adapt their organization to be competitive. The propensity of firms to explore and acquire new knowledge is influenced by the exposure to diverse, external sources of knowledge (Zahra & George, 2002). Yet the tendency to stay within established networks and the little impetus from the firm’s governance body to seek diverse knowledge limits absorptive capacity. Furthermore, the firm’s ability to overcome competency traps based on capabilities that were of crucial value in the past may also decline, hindering the successful adaptation in the changed environment (Ahuja & Lampert, 2001; Levinthal & March, 1993).

**Proposition 2:** “Give-away” privatizations are more likely to result in low absorptive capacity that is ineffective at generating corporate restructuring than are other forms of privatization.

Propositions 1 and 2 suggest that there may be a negative complementarity between poor governance and low managerial absorptive capacity. “Give-away” privatizations result in insider control and managerial entrenchment that undermine successful restructuring strategies. As a result, they restrict the firm’s ability to adapt to a rapidly changing environment and learn from past strategic mistakes. As such, “give-away” privatizations may create a “vicious cycle” where poor governance undermines learning that further reduces strategic flexibility. These issues are illustrated in the example of Gorky Automobile Plant in Russia (see text box).

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**Case Study: Gorky Automobile Plant (GAZ, Russia)**

Gorky Automobile Plant (GAZ) was founded in 1930 with the support of the Ford Motor Company and the then-friendly US government, and its first product was a version of the Ford “A” truck in 1932. Later, it developed independently into a fully-integrated vehicles complex, making its first Volga car in 1956 plus a range of medium and small trucks and Jeeps. Upon privatization in 1993, GAZ had its main assembly lines in Nizhny Novgorod covering 450 hectares and nine suppliers of components in surrounding towns. By 1995, GAZ had virtually abandoned medium and large trucks (401,500 produced in 1993), concentrating on Gazelle small trucks (73,000 in 1995) and had increased annual production of Volga cars from 108,000 in 1993 to 157,000 in 1995. Although the original Volga design does not approach world standards of build quality or design, it is sturdy, sells cheaply at well under half the price of Western imports of the same size, and offers cheap parts and good after-sales service.

Although listed in the Russian Trading System, in 1998, 20% of GAZ’s voting shares were in the hands of outsiders, with fewer than half that number (i.e., 10% of the total) being freely tradable: managers openly retained 13% and other employees the remaining 67%. With 10% of GAZ shares in free-float, it is relatively easy for foreign investors to obtain a toe-hold stake in the company, but until recently, they could only consider a stake in the whole company, including substantial liabilities. Even when outsiders have been able to acquire shares, however, obstructive registration procedures give outsiders, as minority shareholders, insecure property rights over shares acquired, and make them reluctant to make deeper commitments. GAZ itself is one of the largest corporations in the world, with low labor productivity, despite massive scale economies in vehicle manufacture. Faced with such combinations of low productivity and high country risks, foreign investors generally decided, until recently, not to attempt any substantial investments in GAZ, and they cite GAZ’s social liabilities as the most important barrier to foreign investment. These liabilities include subsidized company housing for 106,000 employees and their dependants in over one thousand tower blocks of apartments, and childcare, healthcare, etc. Until recently, incumbent GAZ managers, other employees and their political supporters, with majority stakes in the company and control of the Board, were unwilling to allow outsiders to “cherry pick” the most productive assets in a JV with GAZ, without assuming responsibility for the overall level of GAZ wages and employment, and for the social liabilities and non-performing assets of the integrated company as an entity. As a result, GAZ was forced to restructure its output without...
significant recourse to foreigners. Its product range was transformed during the period 1990–1995, away from large and medium trucks towards the light Gazelle product range. Although the old Volga continues to be produced and sold in large numbers, a new Volga (model GAZ-3111) has been developed and launched early in 2000 after four years of postponements. GAZ’s Russian-financed restructuring program was facilitated through political contacts rather than serious market appraisal. Neither the Gazelle range nor the new Volga has achieved significant export sales and the new Volga has enjoyed the benefit of government decrees forcing government agencies at all levels to favor it in preference to imported models. Despite being unrepresentative in the sense of being a most-favored company, GAZ, together with manufacturing industry in general, has nevertheless so far been unable to achieve combinations of price, product design and build-quality demanded by world markets.

In privatization buy-outs in Hungary, both banks and private equity firms have the power to obtain informational and control rights in the company. Banks may be more likely to monitor investments through receipt of regular reports than through active board involvement (Karsai & Wright, 1994), leaving board composition weak. In contrast, private equity firms typically obtain board membership (Karsai & Wright, 1994; Wright, Hoskisson, Busenitz, & Dial, 2000) that facilitates substitution of managerial and oversight competence for managerial ownership (Karsai, Wright, & Filatotchev, 1997), which formerly was too costly because of the under-diversification of wealth by managers. However, the effectiveness of private equity firm monitoring may be reduced as they lack expertise in Central and Eastern European markets. Contextual factors, such as insiders’ entrenchment may also lead to the reduction of the board’s role (Karsai et al., 1997). Thus:

**Proposition 3:** Privatizations to domestic institutions are more likely to be associated with corporate governance that is effective in generating corporate restructuring than are “give-away” privatizations.

3.5.2. Organizational learning

Managers in domestic external privatizations may still have a traditional managerial mindset (Wright et al., 2000). By managerial mindset, we mean that decision-making is highly systematic with management using mechanisms such as structured coordination of business activities, quantifiable budgets and detailed analysis of trends to justify future developments. While some learning may be achieved via training programs, other aspects are difficult to achieve due to the required shifts in managers’ cognitive frameworks. Therefore, the changes in the environment of firms in Central and Eastern Europe may be too complex for managers to comprehend and thus they would be largely unable to transform their firms accordingly (Carlin & Aghion, 1996; Newman, 2000; Whitley & Czaban, 1998).

Outside investors may be able to exert control over the manager(s) (Spicer et al., 2000; Wright et al., 2000). However, they have to establish a board that is involved in the selection of additional managers, setting of strategic goals, providing contacts to alliance partners, etc., to contribute to the learning of the privatized firm.
and its restructuring efforts. Otherwise, lenders are relying on the managerial talent of former managers who now also may have become significant owners. The presence of insiders as significant owners may make it difficult for investors from outside the firm to hire new managers with greater absorptive capacity. Hence:

**Proposition 4:** Privatizations to domestic institutions are likely to be associated with low absorptive capacity that is ineffective at generating corporate restructuring.

In essence, we suggest that there is a trade-off effect for privatizations to domestic institutions between governance and learning. That is, these firms are more likely to have effective restructuring due to governance compared to learning effects. These issues are illustrated in the case of Polish Elektrim (see text box).

### Case Study: Elektrim (Poland)

Elektrim was established in 1948 as a foreign trade organization in Poland. Until 1989 it was a monopolist selling electrical equipment and turnkey power systems produced by Polish enterprises internationally. This led to an early accumulation of expertise about the operation of foreign markets. With the loss of its monopoly position and the dismantling of trade barriers with the advent of transition, the company lost its privileged position. The company was the first to be listed on the Warsaw Stock Exchange in 1992, providing it with access to cash in addition to existing reserves generated from foreign trading. Using this cash and in the uncertain market environment of the early 1990s Elektrim embarked upon a strategy of conglomerate expansion through acquiring manufacturers primarily in cables, power, lighting equipment, electrical machinery and telecoms. Management argued that to stay in business in this environment they had to vertically integrate backwards to obtain control of what they had been selling. At the end of 1993, Elektrim had a stake in 87 companies in five sectors. It also had acquired assets in food processing and cement and construction. Elektrim also acquired interests in seven different banks to help finance acquisitions. The company had preferential access to bureaucrats and policymakers that gave it advantages over independent firms, for example in succeeding against a bid from Siemens to acquire Poland’s third largest cable producer. This strategy was seen as a preemptive defense to prevent foreign firms from acquiring the company. The aim was to become a restructuring agent by pursuing a hands-on approach to restructuring new subsidiaries. However, the strategy also had elements of empire building over the profitability or exploitation of synergies between operations.

This strategy was found not to be sustainable and began to change in the late 1990s. In 1999, the company shifted its emphasis to consolidation and focusing. This shift was driven by the lack of transparency in the business group, inefficiencies in the allocation of capital among different businesses, lack of expertise in newly acquired business segments, changes triggered by disclosure problems and by investors demanding streamlining and focusing. The largest investors were now foreign institutions. By this time the company had a new CEO who set out to refocus the firm on three core businesses: telecoms, power generating equipment and cables. As part of this strategy, the firm divested over 70 non-core subsidiaries in 1999. The looser holding company structure of the company has now shifted to a more formalized multi-divisional form (based on Radošević, Yoruk, & Dornisch, 2001).

### 3.6. Privatization buy-outs (Quadrant 3)

#### 3.6.1. Governance

Privatization buy-outs, the direct sale of enterprises to inside management and employees, have been used as the primary privatization method in Poland, Romania, Slovenia, Slovakia, Croatia, Macedonia, Tajikistan, Ukraine and Uzbekistan. Privatization buy-outs should lead to profound improvements in inefficient firms, as prior literature identified managerial equity ownership as a crucial aspect of managerial willingness and capacity to implement strategic change (Daily & Johnson, 1997; Finkelstein, 1992). Furthermore, the private nature of shareholdings provides manager-owners with the incentive to consider the consequences of their actions on the market value of their property rights. The proper motivation of managers through incentive alignment may also prove a powerful mechanism to ensure that managers implement value-enhancing restructuring actions (Jensen &
Meckling, 1976; Tosi, Katz, & Gomez-Mejia, 1997). However, managerial shareholding may lead to entrenchment in a risky environment where managers have undiversified investment portfolios (Meulbroek, 2001; Morck et al., 1988). Managers in privatized firms in transition economies are likely to have large portions of their wealth in firm equity because of the lack of opportunities for investing in other alternatives. As managerial opportunity to diversify wealth goes down, the efficiency of awarding equity-based compensation declines. In such cases, a precondition of successful turnaround may be the replacement of top managers rather than their endowment with equity (Andrews & Dowling, 1998). However, the very nature of insider privatization substantially limits the scope for effective corporate governance based on monitoring and control by shareholders external to the firm. Therefore:

**Proposition 5a:** Privatization buy-outs are less likely to be associated with corporate governance that is effective at generating corporate restructuring than are privatizations to outside investors (both domestic and foreign).

**Proposition 5b:** Privatization buy-outs are more likely to be associated with corporate governance that is effective at generating corporate restructuring than are “give-away” privatizations.

### 3.6.2. Organizational Learning

Although enterprises in transition economies may be dominated by entrenched Red Directors and lack the stringent systems for monitoring and control, there is likely to be some heterogeneity with respect to managers’ skills and mindsets (Puffer, McCarthy, & Zhuplev, 1996). Being a dominant owner does not necessarily mean that a manager or a group of managers are entrepreneurial (Wright et al., 2000). In contrast to Red Directors, some managers in transition economies may indicate that they have some absorptive capacity in that they recognize the need to acquire knowledge as a foundation to create value, understand the complex relationships between the firm and its market environment and decide to enter into the transaction. This entrepreneurial talent provides the foundation for effective restructuring of the privatized firm. Managers signal their ability to do this by their willingness to take on the commitment to service external finance. Hence:

**Proposition 6:** Privatization buy-outs are more likely to be associated with absorptive capacity that is effective at generating corporate restructuring than “give-away” privatizations or privatizations to domestic institutions.

Buyout privatizations are more likely to create both positive governance and learning effects for post-privatization restructuring. These issues are illustrated by the case of Ikarus in Hungary (see text box).

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**Case Study: Ikarus (Hungary)**

One of the icons of Hungary’s socialist past, Ikarus manufactured buses for other CMEA nations and other developing countries. In 1989, the company’s production was about 12,000 units with an employment of 8,000 people. Ikarus became bankrupt by 1993 due to the collapse of its traditional markets and its outdated product line. By 1995, Ikarus employed less than 3,000 people and made about 1,300 buses. In the meantime, the company’s debt service was about 13.1 billion Forints annually. To save the company and its markets, the Hungarian government sold 30.4% of the firm to Atex, an interest group of Russian transportation companies for $50 million. Hungarian government bureaucrats hoped that the Atex’s stake in Ikarus would guarantee the sale of between 5,000 and 6,000 units in the Russian market. However, due to the lack of demand in the Russian market and the continued organizational problems this plan became unrealistic. The government and Atex decided to sell 80% of their stake in Ikarus to private investors. The initial interest by potential buyers, such as Volvo, Scania, and Daimler Benz, was shadowed by the excessive debt and modernization costs. The prices offered by foreign investors were below the expectations of the Hungarian Privatization Agency. The agency decided not to sell the company.

In 1996, Gábor Széles was named as Chief Executive Officer of Ikarus. Széles, an electronic engineer by training, was a successful entrepreneur under the last decade of socialism. His management experience included the successful turn-around of Videoton, one of the largest electronic
3.7. Privatization divestments to foreign investors (Quadrant 4)

3.7.1. Governance

Privatization divestments to foreign strategic investors that have been used in countries such as Hungary and Estonia, provide an opposite case to “give-away” buy-outs in terms of their governance and learning characteristics. When entrenched former Red Directors are unable to introduce painful restructuring measures, changes imposed by powerful outside shareholders may be the only way to bring the organization back into fit with its environment (Boeker, 1997; Gunz & Jalland, 1996; Holderness & Sheehan, 1988). There is strong evidence from turnaround research that recovery from decline is often facilitated by replacing the Chief Executive Officer and other top managers (Barker & Duhaime, 1997; Pearce & Robbins, 1993).

Evidence of the greater extent of lay-offs by outside acquirers in the privatization of Russian shops (Barberis, Boycko, Shleifer, & Vishny, 1996) suggests that privatization to outside institutions and strategic investors could be followed by the development of more effective systems of corporate governance than privatization to insiders. Therefore:

**Proposition 7:** Privatization divestments to foreign investors are more likely to be associated with corporate governance that is effective at generating corporate restructuring than are other forms of privatization.

3.7.2. Organizational learning

Privatization divestments create the opportunity for major change in the governance as well as the management of the privatized firm. Foreign strategic investors, for instance, have often replaced the Chief Executive Officer and Chief Financial Officer of the former state-owned enterprise with new management brought in through the support of outside investors (McDonald, 1993). In some cases, they have created a heterogeneous top management team consisting of managers with market experience as well as those with local experience. These teams can use their complementary knowledge to facilitate their firm’s adaptation to market forces and local and internal firm conditions. Foreign investors have also contributed complementary managerial and technological know how to privatized firms in Central and Eastern Europe (Uhlenbruck & De Castro, 2000). Such activities should lead to the development of absorptive capacity of the firm (Zahra & George, 2002).

There has been significant learning success for firms involved in joint ventures with firms outside their traditional network in Central and Eastern Europe (Lyles & Salk, 1996; Steensma & Lyles, 2000).
Significant acquisition of managerial, as compared to technical, knowledge was identified where existing Hungarian firms cooperated with foreign partners. Managers can thus improve learning and absorptive capacity within their organizations through cooperation outside the traditional network. Hence, FDI privatizations are likely to be associated with inter-firm networks outside traditional networks, raising absorptive capacity.

Strategic investors have also affected learning at lower levels in the organization via exchange of personnel, training, adaptation of the organizational structure, and systems and resource upgrades (Uhlenbruck, 2000). In effect, such changes substitute managerial and board competence for managerial ownership incentives to create complementary governance (more effective boards) and scope for enhanced learning. Hence:

Proposition 8: Privatization divestments to foreign investors are more likely to be associated with absorptive capacity that is effective at generating corporate restructuring than are other forms of privatization.

Propositions 7 and 8 suggest that, in contrast to give-way privatizations, divestments of state ownership to foreign strategic partners may create a positive complementarity between governance and learning. Foreign ownership and control may impose stringent and robust check on managerial discretion and improves the prospects for a successful restructuring. At the same time, outside investors may provide knowledge and expertise that are necessary for designing and implementing restructuring strategies.

These issues are illustrated by the case of Bolshevik in Russia.

Case Study: “Bolshevik” (Russia)

“Bolshevik” was the largest producer of cakes, biscuits and pastry in the Moscow region, with annual output amounting to 50,000 tons of different food products. All major suppliers of the factory are located in Russia, so “Bolshevik” did not suffer from the collapse of the USSR and the disintegration of former centralized economic mechanism. The company employs 2,176 workers, and its fixed assets include 58 industrial buildings and workshops that occupy 5.6 hectares of land in the center of Moscow. The company was privatized by the Moscow Government during the first wave of voucher privatization in 1992. The company’s employees bought 51% of the total number of voting shares, and managers were able to buy a further 5% of shares. To finance the buy-out, the Company Workers’ Shareholding Fund with explicit ESOP characteristics was created before privatization was capitalized through deductions from the company’s profits. The remaining 44% of shares were transferred to the Moscow State Property Fund that subsequently sold them at a number of voucher auctions in Moscow.

Soon after the voucher auctions a number of problems developed that were associated with employees being in control of the company. For example, under the pressure of workers, the company made a decision to buy-out several “social objects,” such as a social club and a sports center. Instead of reducing some of the obsolete work force the managers had to introduce an additional night shift. Their expectations of state subsidies, which were meant to support this flagship of Moscow’s food industry, did not materialize and the company was gradually sliding into bankruptcy. At the same time, the investment fund “Alfa-Capital” started a campaign of purchasing shares from the disgruntled employees and managers, eventually amassing a controlling stake in the company. Subsequently, this stake was sold to Danone, the French multinational food company. 1990 marked the launch of the Groupe Danone’s expansion in Central and Eastern Europe, where it quickly reached the rank of leader in fresh dairy products. The acquisition of Bolshevik provided a unique strategic opportunity to enter the Moscow market first, and then to expand in Russia and the former Soviet Union. Bolshevik joined a network of producers and distributors in CEE (Poland, Czech Republic, Hungary, Romania and Bulgaria), that are manufacturing and selling dairy products with the Danone brand, and cereal biscuits and snack foods under the Opavia and Bolshevik labels. As a result, Bolshevik’s production facilities underwent complete refurbishment, although the factory continues to use its old site in Moscow. A new management team has been installed by the parent company, with expatriates being responsible for strategic decisions, and local managers being involved in operating issues only.
4. Discussion

Firms in transition economies have been privatized to generate various macro and microeconomic benefits. Recent studies in Central and Eastern Europe suggest that these improvements have been limited (Djankov & Murrell, 2002) and that firm performance may depend on additional factors (Frydman, Gray, Hessel, & Rapaczynski, 1999; Sachs, Zinnes, & Eilat, 2000). This underlines the importance of continued contextual examination of privatization (Cuervo & Villalonga, 2000). However, restructuring processes are not yet fully understood (Ramamurti, 2000; Spicer et al., 2000). This is an important limitation considering the growing body of evidence on the role of different institutional environments for firm strategies, including restructuring (Chang & Hong, 2000; Hoskisson et al., 2001; Khanna & Palepu, 1997, 2000). The framework developed in this paper addresses this limitation and has a number of implications for the development of enterprises in transition economies.

4.1. Privatization mode and strategic flexibility

By combining agency research with the organizational learning perspective, this paper develops an integrated organization level framework that may shed light on the trade offs of two important context factors related to the strategic restructuring process in transition economies: corporate governance and managerial absorptive capacity. Unlike the majority of previous studies that are focused on the restructuring and performance effects of ownership change, this paper suggests managers’ cognitive abilities and learning are also important for restructuring. These two contextual factors may complement each other creating positive or negative effects on restructuring following privatization programs.

Firms privatized through “give-away” schemes are highly unlikely to have efficient corporate governance systems and their learning capacity is limited by a leadership inherited from the past (Quadrant 1). As a result, the strategic flexibility of these firms is rather limited. Firms’ prospects for pro-active restructuring are rather uncertain. Privatization to domestic institutions and firms may realise relatively weak governance traded and low managerial learning (Quadrant 2). Privatization buy-outs with relatively high learning capacity may be traded off for weak governance (Quadrant 3). Organizations privatized through divestments to foreign partners or other strategic investors are more likely to have a higher degree of strategic flexibility owing to relatively higher levels of corporate governance efficiency and learning capacity (Quadrant 4). Here, high learning and absorptive capacity produce a complementarity with high efficiency governance.

Our framework thus suggests that insider ownership is not necessarily associated with entrenchment and lack of restructuring. In entrepreneurial buy-outs, weak governance may be compensated by a relatively high learning capacity of managers. By the same token, outside control may not necessarily promote restructuring if it is not followed by an increase in managerial capacity to change, as may happen in outside privatizations to domestic financial institutions and holding companies.

4.2. Implications for management

In Central and Eastern Europe at the start of the reform process, with a general absence of sufficiently skilled managers in existing businesses trained to compete in a market-based economy, there was little managerial ability to change (Puffer, 1994). As managers were largely chosen by the “negative selection” of the former regime, they were less likely to possess sufficient restructuring expertise and display entrepreneurial drive. Since the present generation of managers in former planned economies developed their careers in a central planning bureaucracy where meeting output targets and organizational growth were considered to be a major feature of managerial success, it is clear that restructuring requires dramatic change in managerial mind-sets and priorities (Tichy, 1983). In addition, managerial incentives may still be based on previous stereotypes of success, such as their position within the hierarchy of power, rather than factors related to the firm’s performance and shareholder value. Thus restructuring in the region is likely to be impeded by the lack of entrepreneurial orientation as a consequence of the specific characteristics of the managers of the former system (McCarthy, Puffer, & Shekshnia, 1993).

Although enterprises in transition economies may be dominated by entrenched Red Directors, there is
likely to be some heterogeneity with respect to managers’ entrepreneurial skills and mindsets (Filatotchev et al., 1995; Krueger, 1995). By entrepreneurial mindsets we mean that decision-making in uncertain environments and incomplete information is based on simplifying strategies or heuristics. If there are fundamental differences in the ways such managers think and make decisions, these differences may lead to a greater willingness on the part of some managers to undertake privatization buyouts that involve the purchase of equity. In comparison to divestments to foreign firms, such managers also benefit from knowledge of the privatized firm and its local environment. However, in the highly uncertain and dynamic environment that characterizes transition economies, incumbent management with an entrepreneurial mindset, able to use simplifying heuristics to identify upside opportunities to enhance the performance of the business, rather than simply attempting to entrench themselves and preserve their jobs (Wright et al., 2000), are likely to be a very rare commodity. This suggests that an emphasis on learning is likely to be more fruitful in generating more effective corporate restructuring.

4.3. Implications for investors

Our model stresses the importance of the positive complementarity between governance and learning. Outside investors need to be able to obtain sufficient large equity ownership stakes and board representation to exert a governance influence. A key issue concerns the relative importance of tacit and explicit knowledge in the development of absorptive capacity (Grant, 1996) and the ability of outside investors to introduce the appropriate tacit knowledge. In addition, while divestment privatizations to foreign investors can enhance absorptive capacity, they may also impair such capacity due to the accentuated influence of both exogenous (political and institutional pressures) and endogenous (clashes of cultures etc.) factors. Unless these issues can be addressed, the performance implications of outside investors may be mixed.

4.4. Implications for governments

Our analysis also has policy implications at the national level. Countries that have relied more on privatization divestments (e.g., Poland and Hungary), may be able to generate firms with higher absorptive and organizational learning capacities than governments that have been hesitant to sell state-owned firms to foreign investors (e.g., Czech Republic, Russia, Slovakia, and Slovenia) and implemented buyouts and “give-away” privatizations. Buyouts and “give-away” privatizations may also lead to the formation of networks (Peng & Heath, 1996; Stark, 1996). However, in contrast to privatization divestments, these networks may be more defensive and may reinforce former non-commercial patterns of working that inhibit much needed learning and thus restructuring.

Improving the institutional environment by the State post-privatization may be important in enabling firms to improve their governance and learning capacity. In respect of domestic financial institutions, the State has a role to play in achieving improved governance of the banks themselves and in designing rules to compartmentalize and make transparent banking and investment operations within bank-led industrial groups. The State also has a role in setting and enforcing the governance framework within which enterprises operate, which may help encourage foreign investors to enter transition markets to bring both governance and learning capacity. As a significant residual shareholder in enterprises privatized through “give-aways,” governments may be able to encourage enhanced outsider involvement in preventing entrenchment behavior by management. While there are familiar issues concerning the skills of state bureaucrats and their potential for collusion with management, state involvement may be a transitory mechanism for counterbalancing undesirable behavior by managers in an environment where enforcement of governance legislation is presently problematic.

5. Limitations and further research

Further development is required to examine the precise nature of the links between privatization modes, governance, managerial and organizational capabilities and restructuring outcomes. First, our theoretical framework summarized in Table 1 provides a static perspective on different privatization and governance contingencies. As transition continues, the firms in all quadrants may gain incremental
knowledge and change their governance structures and top management teams. In a dynamic perspective, some firms in the same quadrant may fail while some may be more adaptive to the external environment. There is therefore a need for further longitudinal studies to assess the factors influencing failure and adaptation over time. Second, further analysis is required to examine how the problems of negative complementarity, where both weak governance and weak learning work together to exacerbate problems, as in the Gorky Automobile Plant, are resolved over time. Similarly, there is a need to examine how the trade off between governance and organizational learning takes place as in Elektrim in Poland and Ikarus in Hungary. Third, there is also a need for empirical research that compares those firms that had an infusion of outside talent such as through outside foreign investment or joint ventures with the entrepreneurial action and progress (learning) accomplished by incumbent managers. Fourth, for expositional purposes, and based on the literature on privatization in CEE (Djankov & Murrell, 2002), we have made a clear separation between privatization to insiders and privatization to investors outside the firm. In some cases, privatization may involve a hybrid of both insiders and outsiders (Wright, Buck, & Filatotchev, 2002). Further research needs to examine the extent to which the inclusion of outsiders can overcome some of the problems associated with weak governance and learning associated with pure insider privatization. To what extent are the appropriate outsiders available? To what extent are such outsiders able to influence insiders to change? Fifth, for expositional purposes we have referred to “outsider ownership.” Existing research has tended to focus on outsider ownership in terms of outsiders being the dominant, i.e., largest, ownership group (Djankov & Murrell, 2002), yet we have expressed concern that outsiders without majority ownership may experience difficulties in exercising control. Further research might usefully examine the levels of ownership required for outside investors to exert effective control. Sixth, we also consider restructuring as the main organizational outcome, with governance and absorptive capacity being important antecedent factors. In future research, it is important to differentiate between different aspects of restructuring, such as retrenchment and downsizing, mergers and acquisitions, etc. (Filatotchev et al., 2000; Hoskisson & Hitt, 1994; Hoskisson et al., 2001). Ultimately, future research should also explore links between restructuring efforts and post-restructuring firm performance. Finally, we have also distinguished high and low absorptive capacity. It is beyond the scope of this paper to operationalize these concepts but scales are being developed to identify the nature of the characteristics of absorptive capacity. The primary objective of this paper was to develop a conceptual framework that would help to map out possible avenues for future research that may translate our general propositions into more specific hypotheses that may be subject to empirical tests.

6. Prospects for restructuring enterprises

This paper has focused on the links between modes of privatization, corporate governance and absorptive capacity. These links suggest implications for different restructuring outcomes. Weak corporate governance combined with low absorptive capacity and defensive networks that reinforce behavior from the former regime and an absence of entrepreneurial mindsets, appear more likely in “give-away” privatizations. In this case, there is likely to be less improvement in strategic efficiency and low levels of strategic innovativeness. Reverse entrepreneurship may also result as incumbent managers entrench themselves and continue to engage in activities that subtract value from resource combinations. Privatization divestments may be more likely to lead to improved efficiency and strategic innovativeness as they introduce scope for the replacement of ineffective management and greater managerial and organizational capabilities that enhance learning. In general, privatization buyouts and sales to domestic institutions may be expected to lead to outcomes that are intermediate between those found in “give-away” privatizations and privatization divestments to foreign investors.

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