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MANAGEMENT AND EMPLOYEE BUY-OUTS IN CENTRAL AND EASTERN EUROPE: Introduction

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INTRODUCTION: WHAT IS AN MEBO?

In a management buy-out or MBO, the buy-out group consists of the top managers of the company. When the buy-out is sponsored by the non-managerial workers (or their union), that is an employee buy-out or worker buy-out (EBO or WBO). When the managers and many of the non-managerial employees are included in the buy-out group, then it called a management/employee buy-out or MEBO. Unless otherwise specified, we will always take MEBOs as including MBOs and EBO/WBOs as special cases.

MEBO privatizations are mainly relevant for small and medium-sized firms (up to roughly 500 employees and only in rare cases in larger firms). Large conglomerates and combines often need to be massively restructured to be privatized. In many cases, the restructuring will include breaking the enterprises up into medium-sized units where MEBOs may again be relevant. Even if a large complex is to be kept largely intact, it might be slimmed down to a better size by spinning off or hiving off smaller ancillary units where, again, MEBOs may be appropriate.

MAIN SOURCES OF EXPERIENCE

Western Experience

There has been considerable experience with MBOs and MEBOs in the West. MEBOs have even been used as a means to "go private", to go from a broad "socialized" ownership to a concentrated form of private ownership. The widely dispersed shareholding in the large American public corporation creates a "separation of ownership and control" (see Berle and Means, 1932; 1968) and a system of "power without property" that is sometimes compared to the socialized ownership of the socialist world. During the 1980s in the United States, there was a Taking-Private Movement of leveraged buy-outs (LBOs) to pull together the dispersed shares into a coherent ownership group, often consisting of the managers and perhaps the non-managerial employees of the firm (see Jensen 1989, and Wright, Thompson and Robbie, 1989).

[1] The findings, interpretations, and conclusions expressed in this paper are entirely those of the author and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to the member of its Board of Directors or the countries they represent.

A leveraged buy-out or LBO is the purchase of the assets or shares of a business where the purchase is largely financed or "leveraged" by credits based on the assets and future earning power of the company being purchased. The taking-private transactions usually involved considerable leverage, substituting debt (e.g., junk bonds) for equity. The leverage acted like a huge lens to focus the gains (or losses) of the enterprise onto the new ownership group. The profits provided the carrot and the much increased debt payments provided the stick to concentrate the minds of the managers and employees on the tasks of restructuring the firm.

It is often stated that the West does not provide a privatization model for the massive task now facing the post-socialist world. But that claim is based on too narrowly interpreting "privatization" to mean one-at-a-time sell-offs of state-owned firms. The Taking-Private Movement, which turned many public corporations into closely-held private firms through leveraged buyouts, provides an alternative model.

For instance in 1988 alone, about 5 % of the entire U.S. stock market disappeared in taking-private transactions amounting to USD 130 billion (after subtracting out the new share issues). Such a volume of privatization transactions results from the "parallel processing" of hundreds of transactions being organized simultaneously by the participants; it could not be executed by a centralized privatization agency. That volume of transaction is quite comparable to the task facing post-socialist countries. For instance, the centralized privatization agency for East Germany, the *Treuhandanstalt*, has the task of privatizing 8,000 companies with an original estimated value of DEM 200 billion, about USD 130 billion. Thus the LBO-based model for taking-private public corporations could provide a time-tested model for part of the massive privatization needed in the post-socialist world.

While this Western experience is encouraging, it should not be overemphasized. The institutional and financial environment in the post-socialist world is very different. Little of the Western experience can be carried over directly. Part of our objective is to show how the basic ideas and principles might be adapted and are being adapted to apply in the newly privatizing economies.

Experience in Central/Eastern Europe and the Former Soviet Union

Germany

The German privatization program is, of course, a special case. The German privatization program is one program designed and implemented by a Western government. Thus the German emphasis on MBOs and MEBOs should help to address the concern raised in some post-socialist countries about MEBOs not really being a "Western model" for privatization. The *Treuhand* (the German privatization agency) has carried out over 2000 MBO or MEBO privatizations in industrial companies. If one includes small retail and service firms, then the *Treuhand* has had over 20,000 more MEBOs in that area. The *Treuhand* now explicitly encourages MEBOs as a policy instrument that supports the goals of creating *Mittelstand* companies (closely-held medium-sized and small companies) in the eastern states and of increasing East German ownership.

Poland

Poland was one of the first socialist countries to inaugurate a privatization program. Much of the international attention has focused on the various proposals for mass privatization that (at the end of 1992) have been stalled in Parliament. In a year-end review of Poland's economic reforms, The Economist (1993) noted that the real privatization has quietly taken place off the front pages and it has been largely by MEBOs.

> In the event, privatisation has worked, but not in the way that free-market purists and Western advisors envisaged. Privatisation by liquidation, worker/management buy-out and joint venture have proved much faster and more successful. They could be conducted by local authorities, and were therefore much less affected by the vagaries of Polish politics. By the end of 1992, over 1,500 privatisations of this sort were either completed or in progress, away from the hassles of Warsaw ministries.

In terms of completed deals, there were over 600 asset deals (called "privatization by liquidation") and 80 % of them were MEBOs.

Hungary

Hungary has a decentralized passively-regulated program called "self- privatization" which has supported many MEBOs. Now a number of programs are being designed specifically for MEBOs and MBOs. A special law for ESOPs or employee stock ownership plans has been passed (based on the American and English experience with ESOPs) and new forms of seller finance are being developed to support MBOs and MEBOs.

Russia, Belarus, and other Former Soviet Republics

One of the main forms of actual privatization in Russia and in Belarus as well as in the other former Soviet Republics is the lease enterprise with the option to buy—which is a type of MEBO.

In 1991-92, the EBRD completed two pilot privatization projects in Moscow to illustrate Western techniques. Both were MEBOs.

In the Russian Privatization Law, one of the main options, Option II, is for a majority management/employee buy-out. For instance, the much-publicized first public sale of shares at the Bolshevik Biscuit Factory was in fact a MEBO; the managers and employees purchased the majority of the shares.

Croatia

Of the about 700 small and medium-sized firms privatized in 1992, almost all were MEBOs (with 70 % the average insider ownership) because of employee discounts, five-year seller financing, and the relative absence of foreign buyers due to the conflict in part of the country. In the about 50 large privatizations, the average was 30 % purchased by the management and employees.

Slovenia

Prior to the passage of its privatization law at the end of 1992, Slovenia saw many partly regulated spontaneous privatizations, mostly as MEBOs. The new law provides a central MEBO option for 60 % of the shares at about a two-thirds discount with a 4 % cash downpayment. There is little doubt that most companies will try to exercise that option.

Germany, Poland, Hungary, Russia, Croatia, and Slovenia have privatization programs where a significant portion, if not a majority of the actual privatizations, have used the MEBO technique. Belarus represents the former Soviet republics where MEBOs in the form of lease buy-outs have been the primary method of privatization prior to new legislation. Other countries, such as Estonia and Romania, have experimented with the technique on a smaller scale, e.g., as pilot projects. The country papers describe this experience in detail and present cases of MEBO privatizations.

BENEFITS AND RISKS OF MEBOs

The Pragmatic Argument: Insiders as the Buyers of Last Resort

Foreign buyers are likely to bring much needed capital, expertise, and markets to an enterprise. But all the post-socialist countries have had far fewer foreign buyers than expected. Domestic buyers with capital, expertise, or markets are also relatively rare, or would rather start their own new private businesses. With no outside buyers of an enterprise, the State Property Agency[2] faces a choice:

- to maintain state ownership and keep looking for outsider buyers,
- to give it for free to the citizens,
- to sell it to the insiders in an MEBO, or
- to liquidate it.

In particular, it may be very difficult to liquidate an enterprise and put the workers on the street without giving them some chance to run the firm themselves.

In the post-socialist countries—as in the West—the insiders are often the buyers of last resort. But this also creates a problem of adverse selection for MEBOs. If the seller only sells to insiders when there are no other buyers, then MEBOs will come only when it is too late, when the firm would fail no matter who is the owner. Thus if an SPA is going to promote or subsidize MEBOs, it should allow the transaction to take place in a timely manner, before the enterprise has slid into bankruptcy.

[2] We will use "SPA" as the generic acronym for the privatization agency or state property agency of a post-socialist country.

Speed is of the essence. Rather than allow enterprises to drift into bankruptcy while the government waits for rich foreign buyers, who most likely will not come, the small and medium-sized enterprises should be privatized quickly to active owners (outsiders if possible in a management buy-in, but insiders if necessary in a MEBO). If the first group of active owners invest their own money and cannot make the firm profitable, then they will have the financial incentive to find another owner who can do a better job and save some of their investment (and jobs).

The pragmatic case for MEBOs also has a political side that might be recognized. In past waves of socialist reforms, managers and workers acquired certain "social" or *de facto* quasi-private rights in the enterprises. Now in the post-socialist era, governments might find themselves trying to take back those rights in order to put the enterprises up for auction or tender. But managers and workers often see this as akin to putting social apartments up for auction without allowing the sitting tenants to buy them at a discount—or to putting agricultural land up for auction without allowing the working farmers the first right of purchase at a deep discount.

This political side to the privatization problem is nowhere more evident than in Poland. The workers, through the Solidarity union, led the fight against communism. In the course of their struggles, they acquired certain "rights" in the state enterprises. When the Government wanted to take back those rights and pass a mass privatization program, Parliament was deadlocked on the issue for years.

It may be particularly true in the former USSR that MEBOs offer one of the best chances to form an effective social coalition.

> "Indeed, the collapse of the USSR as the state owner of assets has shifted responsibility for the administration of state-owned enterprises to managers and employees. Moreover, the governments of the newly independent states urgently need to secure the support of workers' unions who have often built up powerful positions within enterprises. The development of management and employee buy-outs may be one means of forming a key coalition of interests between bureaucrats, workers' collectives, managers and political leaders" (Filatotchev, Buck, and Wright, 1992b, 11).

These are among the pragmatic reasons why the first two EBRD pilot projects in Russia were MEBOs.

The Efficiency Argument: MEBOs Connect Equity and Effort

It is sometimes argued that insider ownership (ownership by managers and workers) is "inefficient" because it may foster labor immobility. A firm with substantial employee ownership might provide more job security and job stability. It would not lay off or fire workers in bad times and then hire them back in good times, so it would impair labor mobility—which is commonly thought to be essential for efficiency.

But there are other viewpoints on efficiency. By providing job security, the large Japanese firm gains the core employees' trust and identification with the firm. The employees and the firm are each willing to invest more effort and resources in education and training ("human capital investment"), and that seems to give the firm a competitive edge over firms where disinterested and unmotivated workers shuffle in and out of the door with the ups and downs of the business cycle.

Economics usually focuses on "allocative efficiency," the most efficient allocation of resources between competing uses. But experience often shows great variation in the efficiency of a given resource in a given use—particularly when that resource is human labor. A machine will operate the same under any incentive and ownership structure, but human motivation and effort are very elastic. The potential efficiency gains from unlocking human effort within a firm may turn out to be much larger than the allocative efficiency gains of shifting labor between firms. This efficiency based on increased motivation and effort is sometimes called "X-efficiency" since the "X" of human effort seems to be an unknown in the usual elementary treatments of efficiency (see Leibenstein, 1976, 1987).

The efficiency potential of insider ownership lies in X-efficiency or effort-efficiency. A person is "effort-relevant" to an enterprise if he or she can—by improved effort and motivation—increase the efficiency of the resources employed in the enterprise. If the profit/loss incentives of equity ownership are in the hands of effort-relevant people, then the X-efficiency of their resources employed in the enterprise will probably be improved.

A "spectator" is not effort-relevant. A spectator who has bet on a race horse has plenty of incentive for the horse to win but this incentive is irrelevant. An absentee and passive owner of shares is like a spectator who has placed a bet on a race horse. He has incentive to increase profits, but he cannot do anything about it. He is not effort-relevant.

By the same reasoning, the insiders (managers and workers) are the people who can use the profit/loss incentives to improve the efficiency of the enterprise. To extend the metaphor, they are the jockeys and race horses who are in the race (not just spectators), and they are the ones who can use the incentives. Insiders without equity ownership represent a wasted opportunity to improve the efficiency of the firm (see the related distinction between "punter capitalism" or spectator capitalism and "proprietor capitalism" in *The Economist*, May 5, 1990).

Thus X-efficiency argues for the correlation:

effort-relevance <==> equity.

Some discussions of privatization make the implicit assumption that the value of the privatized firm can only be represented by common voting shares. But there are many financial instruments that can represent the value of the firm. In fact, financial instruments can be divided into two broad classes: the "active" instruments such as common voting shares (equity), and the "passive" instruments such as bonds, debentures, and non-voting preferred stock (debt and quasi-debt).

The above correlation implies that the active equity instruments should be held by active effort-relevant owners while effort-irrelevant people should only hold passive debt-like instruments:

active instruments <==> active owners,
passive instruments <==> passive investors.

The insider ownership that results from an MEBO will marry equity ownership to effort-relevance for the firm and thus will optimize the potential for X-efficiency within the firm.

When Avis and Hertz were first locked in battle for dominance in the rental car market, Avis popularized the slogan "We try harder." Later when Avis became an almost 100 % employee-owned company, it changed the slogan to:

Owners
~~We~~ try harder.

Insider Ownership Internalizes Agent-Principal Externalities

The effort-efficiency argument for insider ownership (and for MEBOs as a means to that end) is closely related to an argument about internalizing some of the externalities associated with the agent-principal relationship. With substantial insider ownership, the insiders are in effect jointly self-employed. In terms of the agent-principal relation, they are their own principals.

In an absentee-owned firm, the managers and employees are agents who act on behalf of and in the name of the principals or employers who are the external owners. Yet the actions of the agents are very imperfectly monitored by the principals. The agents will tend to opportunistically exploit this imperfect monitoring by expending less than full effort on the assigned tasks and by pursuing their own interests. These unmonitored actions are hidden actions that are, by their nature, not accounted for in the employer-employee contract. By choosing hidden actions in their own interests, the agents are imposing a cost on the principals that is not part of the contract. That is a negative externality (with the usual adverse implications for efficiency).

One way to eliminate the external effects would be through perfect monitoring, but that does not seem to be possible. The other strategy to eliminate the externality is to internalize the costs by unifying the principals and agents. Insider ownership internalizes the costs of subnormal effort (shirking) on the insiders to eliminate the externality.

Will Managers or Workers Put Too Many Eggs in One Basket ?

One common argument against MEBOs is that managers and/or workers will be investing both their capital and their labor in the same enterprise. They may be putting too many eggs in one basket. A more prudent strategy for risk-adverse people would be to diversify their "portfolio"—to diversify their capital and labor investments.

To understand this argument, we must consider the notion of "moral hazard", a term taken over from insurance where it denotes the tendency for some people to have more accidents if they are heavily insured. Insurance pools (statistically independent) risks and greatly reduces the risk to individuals. But there is "over-insurance" in the sense of moral hazard if the risk reduction through pooling begins to be out-weighed by the increase in risk due to more risk-taking behavior by the over-insured individuals. Moral hazard would be impossible if the probability of accidents were entirely independent of human effort (care or lack of care taken in actions).

The argument for diversifying capital and labor investments would be perfectly valid if the outcomes of an enterprise (profits and losses) were independent of the "given" human effort of the managers and workers in the enterprise. But effort tends not to be a "given"; it may be quite dependent on the risks to which the individual is exposed by having capital invested in the enterprise. In that case, the eggs-in-one-basket argument is not always valid. It is a matter of degree. If human effort tends to be inelastically given, independent of the risk of capital loss, then there would be little point in investing both capital and labor in the same enterprise. But if people work harder and better when they have more to lose and to gain, then the portfolio-diversification argument has limited applicability. For instance, family farmers and active owners in small and medium-sized firms (as in the German Mittelstand) have much of their capital and labor tied up in the same enterprise. Yet few would argue that the economy would be improved if family farmers and other active owners "diversified their portfolios."

Will a MEBO Solve the Firm's Problems?

One very simple and often quite effective argument is that a MEBO may not solve the particular problems facing a distressed firm. New management, new capital, new technology, and drastic restructuring may be the prescription needed to restore a firm to health. A MEBO by itself will not supply the needed changes and it may even slow down the changes. Thus a MEBO may only seal the fate of the firm, and the managers and workers will lose both their jobs and their invested capital.

Given that powerful caveat for a MEBO privatization strategy, what should be the reaction of the government? Should the government adopt the posture of the benevolent parent deciding when to allow the managers and workers to undertake risks, or should the government depend more on decentralized market-based decision making? For instance, the government might require that the managers and workers raise a certain cash down payment in order to qualify for the deal. If the managers and workers could raise the money and were willing to take the risks given their knowledge of the business, then the government would have few grounds (other than paternalism) for any second-guessing.

MEBOs Should Not Entrench the **Nomenklatura**

The effort-efficiency argument for MEBOs does not assume that the post-buy-out managers were the previous managers. The efficiency argument holds for buy-ins as well as buy-outs. To allow buy-ins as well as buy-outs, there needs to be transparency and competition built into the buy-out process. For instance, there is the competition of the MEBO against other forms of privatization. In theory, there could be competition between managerial groups in a MEBO, but that is very difficult to arrange in practice.

To avoid past managers having a buy-out simply on the basis of their position, it is a good idea to require particularly heavy financial investment on the part of the management team. A top manager should be willing to invest significant personal wealth in the buy-out; otherwise the manager does not have the self-confidence for the job. A variety of arrangements will be considered in the section on "Leveraged Equity Purchase Plans" in our overview of MEBO techniques (see next paper). A caveat however is in order. Some managers will insist that if they are going to invest heavily in the buy-out, then they want majority control. That would, of course, entrench them in their jobs. It may be better to keep the management team in a minority position but to give them a multi-year management contract that would give them some job security for a few years to implement their program.

The concerns with the *nomenklatura* or "red directors" should also be considered from the political viewpoint. Some post-socialist governments have enacted screening legislation to punish certain classes of individuals on the basis of their past involvement in the Communist Party or specific Party-controlled organizations. These laws have been criticized as being relatively indiscriminate and as involving guilt by association (instead of guilt based on individual responsibility).

Statutory or regulatory opposition to privatization by MEBOs out of fear of entrenching "red directors" would amount to a particularly indiscriminate form of screening legislation. It would deny managers the possibility of organizing an MEBO regardless of whether the managers were non-communist or communist (and regardless of whether the ex-communist managers were communist first and managers second, or vice-versa). Some governments are also against the employee-ownership aspect of MEBOs because they see the "workers" as the "beneficiaries" of communism (at least in rhetoric). However, it could be argued that a privatization program would be rather short-sighted if it treated managers and workers as a "defeated enemy population" to be denied access to private ownership in the "post-liberation" economy.

In general, post-socialist governments should use the "privatization program" as a tool to develop a market economy, not as a tool of social engineering. A privatization program should not be freighted with the hidden political purpose of anti-communist filtration. The program should, as far as possible, be designed on the basis of sound market-oriented business principles. Harden the budget constraint and then let the market mechanism hold the private owners accountable for their own losses or profits.

MEBOs Should Not Perpetuate Collective Ownership

The former Yugoslavia made the transition from state ownership to collective social ownership over thirty years ago. Today, the former Yugoslav republics such as Slovenia and Croatia are making the transition from social ownership to genuine private ownership. The Yugoslavs successfully used social ownership to start the process of decentralization and marketization of the economy, but social ownership did not prove to be a long-term viable form of enterprise ownership. Yugoslavia was delayed so many years with this intermediate ownership form because the political authorities would not allow normal private ownership. Today there is no need in the other post-socialist countries, or in the former Yugoslavia, to stop the process of privatization with some form of collective or social ownership. With very little extra effort, state firms can be privatized to full private ownership by the insiders or outsiders with stopping at an economically inappropriate intermediate form that will have to be privatized again in the future.

Some examples of stopping short at an intermediate form of collective ownership have been the "privatization" of lease enterprises with the option to buy-out in the former Soviet Union. Often when the buy-out option has been exercised, the new enterprise has been organized as "collective ownership." Yet with little additional effort the new firm could be organized as a joint stock company or a company with limited liability (or closed joint stock company). For instance, two EBRD pilot privatization projects in Moscow went from lease enterprises with the option to buy-out to private joint stock companies (see the chapter by Richard Lloyd). Other lease enterprises found the same path on their own. For example, the former lease enterprise *Gomellift* in Gomel Belarus exercised the buy-out option with at first a form of collective ownership but with computerized individual "capital stakes" (so the ownership was not really collective). Then as soon as legally feasible, they reincorporated as a joint stock company and turned the "capital stakes" into shares in the company (see the chapter on Belarus).

Finance: Bank or Seller Financing?

It is a common observation that managers, workers, and other citizens in the post-socialist economies do not have the cash to purchase the state/social enterprises. Some Western advisors have argued that since the citizens don't have the cash, the firms must be given away for free in a mass privatization program. This is unusual logic, since the same advisors are often buying their own homes on credit with a home mortgage, are paying off a car loan, and have a pocket full of credit cards. Clearly there is a third possibility in addition to buying firms for cash or giving them away for free, namely purchasing firms on credit.

The next question is the source of the credit portion of the leveraged buy-out. If a third party, apart from the buyer or seller, makes a loan to the buyer then the seller receives cash and is not later involved in the loan repayments. The buyer must make the loan payments to the financial source or sources. In the American LBO movement of the 1980s there were two novel sources of credit, the new market for "junk bonds" and the recently deregulated savings and loan associations. But in Central and Eastern Europe (CEE), the banking systems are clogged with non-performing loans and need to be rehabilitated. There is little immediate prospect for fresh foreign capital to finance LBOs. Therefore it is unlikely that third party or bank finance will be available for LBO activity in CEE in any significant quantity.

With the near-collapse of the junk bond market and the bankruptcy of many savings and loan associations, leveraged buy-outs and other M&A (merger and acquisition) activities have been reduced in the America of the 1990s. Moreover, seller financing has now become a prominent part of American LBO activity. In these circumstances, it is not surprising that seller financing is and will probably continue to be the main source of finance for leveraged buy-outs in CEE and other post-socialist economies.

Outside Shares: Will MEBOs Prevent Foreign Direct Investment ?

It is sometimes argued that majority insider-led LBOs should be avoided because there is a conflict with a potential foreign investor who wants majority ownership. But this argument does not apply only to domestic insiders. Foreign majority ownership is incompatible with any majority domestic ownership. Thus if the argument is taken seriously, it would be against any majority domestic private ownership. Few governments would want to base their privatization program on avoiding majority domestic ownership.

There are several ways in which a foreign investor can get majority ownership:

- buy it from the government,
- buy it from the existing domestic owners,
- buy enough new issues of shares from the enterprise, or
- buy a majority interest in a new company while assets are contributed from the old enterprise in return for a minority interest.

All options except the first are compatible with initially privatizing to majority domestic ownership. Given a potential foreign investor who wanted majority ownership, the majority domestic owners (insiders or not) would face the challenge of seeing if they could work out a mutually agreeable arrangement. That is normal in a market economy. What are the relative gains and losses to persuade a majority owner to yield in favor of a different majority owner? There seems to be little basis for privatization legislation to decide in advance and for all cases that majority foreign ownership is preferable and therefore that majority domestic ownership (insiders or not) should not be allowed. (Indeed, with an eye to future cooperation within the firm, the foreign investor would probably prefer to pay his capital to the employees or at least into the company rather than to the State Property Agency.)

In view of the relative lack of foreign direct investment, this problem is more hypothetical than actual. The overwhelming bulk of firms to be privatized do not have any potential majority foreign owner waiting on the doorstep.

In the few cases of majority FDI, the foreign owner might well be concerned that the workers and the union do not rush to the bargaining table determined to get a Western-sized wage out of the deep pocket of the foreign owner. Therefore many foreign investors are keen to have a minority MEBO of the remaining equity in order to get managers and workers to think as co-owners, not as employees.

In addition, a majority foreign investor would probably understand the lesson of the LBO movement in America, that equity by insiders (particularly managers) is not only desirable but crucial to the success of the enterprise.

> "Operating managers of LBO companies are usually given or allowed to buy between 5 and 20 percent of the common equity of the LBO company. This equity stake encourages managers to think as owners rather than employees, and it has been fundamental in changing the way they look at their businesses" (Whitman and Knowles, 1990, 242).

> "The critical transition, then, occurs inside the heads of these executives. Previously employees, they are suddenly owners. Professional managers with company-paid club memberships change mystically into personal entrepreneurs who scrutinize every expense. Participation and commitment grab the essence of motivation. It is a most remarkable transformation" (Kuhn, 1990, 228).

This would be even more true when a foreign investor is making an investment in an unfamiliar post-socialist country where, of necessity, more trust has to he placed in the local managers and subordinates running the company. Therefore a case can be made that pre-existing management and employee ownership in a privatized company may be more of an attraction than a detriment to foreign investment.

In some cases, foreign investors do not want to rush into a majority investment. They prefer a smaller "beachhead investment" with a contractual option to later upgrade their investment to a majority position. But minority owners must always be careful that the majority owner does not siphon the profits out some backdoor (e.g., salaries or some other trade relationship) leaving the minority owner with little return. Minority investors would typically be trade-related, and could use the trade relationship to establish an adequate return. The contract underlying the beachhead investment should build in the return to the investor through attractive pricing on the trade relationship (higher transfer price on inputs purchased from the minority owner or lower transfer price on outputs sold to the minority owner).

Labor: Role of the Unions?

In MEBOs where majority ownership is in the hands of the non-managerial employees, there is little scope for the traditional collective bargaining role of the union. Since the employees can directly change the firm's management and policies through the board of directors, a specific collective bargaining contract for the firm would be pointless. In such a majority employee-owned firm, the union could best serve as a "legitimate opposition", to give voice to the more inarticulate segments of the employee-owners, to see that new workers can also become owners, and to see that retiring workers are fairly paid out for their ownership interests.

The union has an important role prior to any buy-out, to see that the non- managerial employees are included in the buy-out. Most MEBO privatizations in CEE will have significant seller-financing on top of a relatively thin equity base. There seems to be little justification to, in effect, restrict seller financing to only a small managerial group by allowing only that group to contribute to the equity base. Yet since managers will typically take the lead in organizing the MEBO, the workers' representatives, either in the union or (where relevant) in the workers' council, will need to keep the equity subscriptions open to all employees of the firm.

Spontaneous Privatization: Is "Spontaneous" a Swear-Word?

Some post-socialist governments have legislated plans to be followed by the enterprises for privatization. These plans are often detailed social engineering schemes designed by Western advisors to determine who will and who will not be the owners of the privatized enterprises. Instead of following the government's plans, some managers have taken the initiative, using their insider information and finding loopholes so that they could structure the privatization of their enterprise to their own advantage. Governments typically responded by trying to stop all these spontaneous (enterprise-initiated) privatizations. From the government's viewpoint, the way to develop a private enterprise market economy was to curtail spontaneity in favor of following the government's plan.

Yet this governmental response seems to leave something to be desired. In view of Friedrich Hayek's life-long advocacy of spontaneous social orders, such as market economies, as opposed to planned and socially engineered regimes (viz. "*Cosmos* and *Taxis*" in Hayek, 1973), any government that seriously wants to create a market economy cannot treat "spontaneous" as a swear-word. Entrepreneurship is to be encouraged, not suppressed as being "inappropriate" until after privatization.

> "If the main purpose of privatisation is to make opportunistic entrepreneurs the decisive resource allocators in an economic system, it should not be expected that prospective new owners will voluntarily suspend their entrepreneurial instincts before, and during the process of privatisation" (Filatotchev, Buck, and Wright, 1992a, 4).

Instead of trying to suppress "premature entrepreneurship," post-socialist governments might develop multi-channel privatization programs that would leave open a channel for legitimate "non-wild" spontaneous (enterprise-initiated) privatizations.

Economic Disintegration: Which Privatization Plans are Robust against Chaos?

Classical liberals in the Austrian tradition such as Ludwig von Mises, Friedrich Hayek, Karl Popper, and James Buchanan have developed general arguments against the feasibility of socialism. But the arguments are broader; they are addressed to the infeasibility of any planned and socially engineered economic regime. Yet many Western economists have taken these strictures as applying only to "socialism"—not to the grand privatization plans being devised in the West to be applied in the post-socialist world. These plans call for a "Great Leap Forward" over the chasm between socialism and capitalism—a "Big Bang" crash program to create a private enterprise market economy out of the economic disintegration and impending chaos of a post-socialist economy.

These grand privatization plans, like the five-year plans of socialism, should not be judged according to the outcome if they were perfectly implemented. The implementation will invariably be distorted even in a stable society—not to mention in highly unstable post-socialist societies. Grand privatization plans are likely to be frustrated by:

- quarrelsome members of parliament,
- foot-dragging ministries,

- stubborn local politicians,
- cautious and/or confused law enforcement authorities,
- opportunistic managers,
- entrenched unions,
- rebellious workers,
- sullen and resentful citizens,
- bankrupt companies,
- illiquid banks,
- revolving-door governments, and
- the general chaotic nature of post-socialism, plus
- an occasional *deus ex machina* (such as the Yugoslav wars, the ethnic conflicts in the former USSR, and the divorce of the Czech Republic and Slovakia).

How robust is a privatization plan against such distortions? If the plan's implementation is distorted, will the plan lose only a small amount of effectiveness or will the plan dissolve into a mess? This design criterion of robustness-against-chaos is quite important in Eastern Europe, but it is even more crucial in the former USSR.

To develop this notion of robustness-against-chaos, it might be useful to consider some extreme cases. At one extreme (the most robust) is what might be called "*laissez faire* privatization." In most of the post-socialist countries, there has been a *de facto* decentralization of authority from the central government and its ministries down towards the enterprises or associations of enterprises. A *laissez faire* privatization program would legitimize the *de facto* decentralization by awarding *de jure* ownership to the enterprise insiders while at the same time withdrawing government subsidies, soft loans, and other supports from the enterprises to harden the budget constraint. Legitimize the *de facto* property rights and let the market take over (see Bajt, 1992 for more arguments along these lines). Since this plan essentially legitimizes with ownership the *de facto* control structures that evolve out of the post-socialist chaos, it is clearly the most robust-against-chaos.

At the other extreme would be a plan to directly counter the *de facto* decentralization by renationalizing the enterprises and trying to reassert some strong form of central control (e.g., through public holding companies). However, when central governments are weakened by political gridlock in fragmented parliaments and by the centrifugal forces of regions and ethnic groups, then centralized privatization schemes stand little chance of being effectively implemented.

For example, consider the Polish holding company plan. At a Harvard seminar in March 1992, the ex-Deputy Prime Minister Balcerowicz (responsible for designing the stabilization and privatization plans together with Western advisors) stated that if he had it do over again, he would have immediately privatized the enterprises to the managers and workers (roughly the *laissez faire* plan). They could run the firms or sell the firms, but the important thing is that the firms won1d be private and the market incentives of private ownership would take over. Instead, Poland has had two years of political gridlock, with the major enterprises still under state ownership. Many of the lessons of the Austrian critique of socialism has yet to be appreciated in both the East and the West.

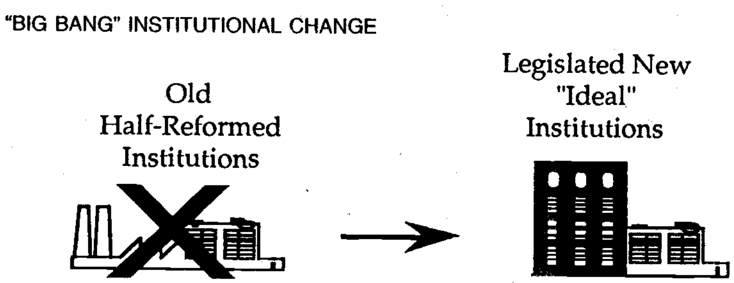
Strategies of Institutional Change: Big Bang or Incremental

Strategies of institutional change can be devised to channel, rather than simply frustrate, the entrepreneurial impulse towards spontaneous privatization. Strategies can also be designed to be more robust against the forces of chaos and entropy that are increasingly important factors in the post-socialist world. These themes can also be approached by considering two opposing strategies for institutional change: "Big Bang" or incremental.

There is little disagreement that a Big Bang shock therapy approach is necessary for certain types of macroeconomic stabilization such as stopping hyper-inflation. Flushed with success in macro-stabilization, many Western advisors have assumed that a Big Bang approach can also be effectively applied to comprehensive social change, e.g., to changing institutions that have been built up over 40 to 70 years of communism. But here the Austrian-conservative critique of "Great Leaps" (forward or backward) seems to be applicable.

Socialism has not remained static over recent decades. Many of the socialist countries started a variety of reforms aimed at creating a "socialist market economy." These reforms did not create property rights in a Western form (such as joint stock companies), but they did create various quasi-property rights (such as in the Soviet leasehold enterprises or the Yugoslav self-managed enterprises) which could be described as "*de facto* property rights."

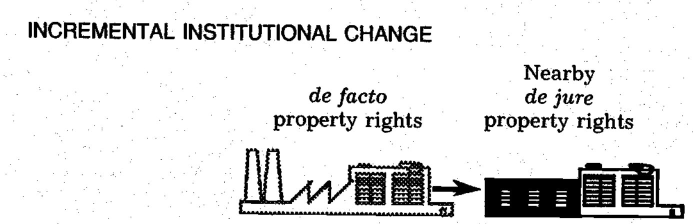
After the collapse of the socialist idea in the late 1980s and early 1990s, the question of institutional change strategies came to the forefront. Broadly speaking, two opposed strategies emerged. The Big Bang approach advocated just drawing a big **X** over the old half-reformed institutions and then legislating new "ideal" institutional forms.



The old *de facto* property rights embodied in the half-reformed institutions would not be recognized in any significant way, and the new *de jure* property rights would be legislated by the new "revolutionary" democratic government.

What is wrong with moving in one great leap to some desired ideal form? Nothing—if institutional change could actually take place in that manner. But it usually does not. People will resist and "drag their feet" in countless ways when their *de facto* property rights are canceled or trivialized. The imagined great leap breaks down in chaos. Instead of disappearing overnight in favor of the new ideal institutions, the de-legitimated old institutions break down in favor of a shadowy anarchy of *ad hoc* opportunistic forms. The Big Bang becomes a Big Bust.

The alternative is a strategy of incremental institutional change. Instead of an imagined great leap forward over the chasm between socialism and capitalism, incentives would be devised to move people incrementally but irreversibly from the existing quasi-reformed institutions towards the "ideal" institutions. Instead of just negating the *de facto* property rights of managers and workers, they can arrive at a nearby set of legitimized *de jure* property rights by moving in the right direction.



These two strategies are posed as opposites. No country would adopt a totally pure strategy, and one country might use both strategies in different parts of its reform program. For instance, the privatization-by-liquidation program in Poland is based on an incremental strategy while the Polish mass privatization plan originates from a Big Bang approach. The Czech voucher plan is a Big Bang strategy, while small business privatization in the Czech Republic (and in most other countries) is based on an incremental approach. Aside from the lease buy-outs and other MEBOs, the Russian mass privatization program is a Big Bang program, while the Chinese reforms in agriculture and industry are the clearest example of a thoroughgoing incremental approach.

Where there have been prior socialist reforms decentralizing much authority to the enterprise level, an incremental approach would favor completing the reform with a MEBO. For instance, instead of having the self-management rights of the Slovene managers and workers canceled by the corporatization and renationalization of a self-managed social firm, the managers and workers can, under the new privatization law, make a certain cash down payment (followed by installment payments in the future) and then convert the social firm into an employee-owned joint stock company. That is an example of how an incremental strategy of institutional change leans in the direction of MEBOs as a technique of privatization.

CONCLUSION

Many of the desired aspects of a privatization program in the post-socialist are satisfied by a regulated decentralized program based on leveraged buy-outs by the managers and employees of an enterprise.

- The problem of cash-poor domestic buyers is solved, since the bulk of the buy-out is based on seller-supplied credit to the insiders of the firm, if they can come up with a certain minimum amount of "earnest money" as a cash down payment.

- The program is relatively robust-against-chaos, since it does not try to counteract and reverse the de facto decentralization of property rights to the enterprises in recent years. It moves directly to nearby de jure private property rights and market incentives without attempting to recentralize power and to once again socially engineer a new economic power group.
- The program based on insider LBOs is compatible with Western investment (through debt, new equity issues, or the purchase of already issued shares from the managers and workers).
- The program puts the equity incentives in the most X-efficient hands. Equity ownership in the hands of effort-irrelevant people such as absentee owners is a waste of incentives, while insiders without equity ownership represent a wasted opportunity to improve the effort-efficiency of the firm.
- The LBO-based Taking-Private Movement in America in the late 1980s provides a model (in a rather different institutional setting) of massive privatizations on the scale needed in Eastern Europe and the CIS.
- The program creates a well-defined coherent private ownership group (the insiders) interested in the financial success and longevity of the firm.

While some blue-chip firms will attract Western investment, manager/employee buy-outs may be the best—if not the only—genuine privatization technique available for many of the firms in the post-socialist world.

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