KRZYSZTOF LEWANDOWSKI

A Buy-out as a Form of Privatising Small and Medium-sized Enterprises. A Theoretical Attempt at Evaluating it[1]

The processes of acquisition of enterprises by their hitherto managerial staff (Management Buy-out, MBO) or their employees (Employee Buy-out, EBO) were known mainly from western economies as a phenomenon of a new way of shaping ownership relations occurring while dividing concerns or ameliorating the situation of ailing enterprises or in legacy regulations in the case of the owner's retirement.

These processes also became a considerable part of the privatisation programmes in the former socialist countries. The importance of that method is shown by the fact that it was used to privatise one-fifth of enterprises in East Germany, and twice as many enterprises in Poland and most of enterprises in the Russian Federation.[2]

Privatisation in the post-communist countries is accompanied by specific problems resulting from the special transformation conditions. They are the problem of blockage, secondly, the problem of control and thirdly, the problem of monopolisation.

1) The problem of blockage pertains to a danger that the entire process of privatisation and restructuring might be blocked. Contrary to the stable ownership relations in western countries, the countries of Central and Eastern Europe were characterised by unexplained and dispersed property rights in the period of real socialism. At the time of their systemic transformation, property rights undergo redistribution on a wide scale. This redistribution results in the occurrence of conflicts between different interest groups that come up with claims to certain property rights and the way of their allotment. In the struggle for the shape of property rights, the sides being in conflict can block each other. If the sides are strong enough to oppose any changes in the present structure of property rights, they can preclude the carrying out of restructuring efforts. In consequence, the excessive staff is not reduced, production is not changed, managers and employees do not alter their work style, and loss-making companies are not liquidated. The blockage of the privatisation and restructuring processes entails economic and social losses. They

[1] This paper constitutes a part of a broader study of privatisation in East Germany.

[2] M. Stahl, Buyout zur Privatisierung in den Transformationslaendern Mittel- und Osteuropas, Stuttgart, 1995, p. 1.

are related directly to the wasting of resources by the conflicting sides in the process of rent-seeking[3] while creating a new system of property rights. Secondly, they also follow from the persistence of inefficient allocation and production at the time of blockage.

2) The problem of control reflects the state of lack of discipline of the management in the context of systemic transformation. Unlike their western counterparts, managers of enterprises enjoyed almost unlimited autonomy at the time of transformation.[4] After the breakdown of the previous system of central planning and control, there were no fully fledged market mechanisms to ensure efficient allocation of resources. The consequences of that gap were arbitrary, lawless appropriation of state-owned assets by employees and managers (so-called spontaneous privatisation)[5], the shifting of economic risk onto the state and insufficient market adjustment of enterprises.

3) The problem of monopolisation is concerned with the economic structure left by the command-and-allocation-based system. In comparison with western countries where monopolistic structures exist in few sectors, the economies of the former socialist bloc were characterised by a high degree of concentration. This gave rise to a tendency towards monopolist behaviour, which could be even strengthened by liberalisation and privatisation.[6] Being also aimed at creating competition, privatisation is tied in a particular way to the demonopolisation issue in the countries of Central and Eastern Europe.

1. Buy-out as an instrument of overcoming the blockage problem

In order to overcome the problem of mutual blockage during the process of creating property rights anew, it is necessary to have instruments which will create incentives to joint action and reconciliation of the divergent interests. Such instruments are both spontaneous and state-controlled transactions of the buy-out type. The specific incentives which are created by those transactions stir managers and employees to co-operation. This in turn leads to a rank-and-file pressure on privatisation agencies.

1) By acquiring the firm's stock capital, managers obtain ownership position. After the collapse of the centrally planned economy, they were able to control the enterprises and derive profits from this. A decisive advantage of buy-out transactions is the legal sanctioning of ownership rights, which gives managers a possibility to protect themselves from claims of other interest groups. A reduction in managers' uncertainty as to their status of owners limits the

[3] The theory of rent-seeking assumes that interest groups use resources in order to achieve politically guaranteed monopolistic positions and the related incomes of the rent type. Owing to the fact that the state has a monopoly of authority it can sanction property rights and the grant of or change in the rights always has distribution implications. The state thus becomes the addressee of actions aimed by interest groups at changes in the distribution of property rights. J. Buchanan, R. Tollison, G. Tullock, Toward a Theory of the Rent-seeking Society, College Station, 1980.

[4] D. Lipton, J. Sachs, *Privatisation in Eastern Europe. The Case of Poland*, Brookings Papers on Economic Activity no. 2, 1990.

[5] The problems of "spontaneous privatisation" was dealt with among others by H. Schmiedling (1991), S. Johnson, O. Ustenko (1993), I. Branuiczki, G. Bakacsi, J. Pearce (1992), D. Lipton, J. Sachs (1990).

[6] H. Schmiedling, *Issues in Privatisation*, Intereconomics, volume 26, no, 3, 1991, p. 105.

blockage of the privatisation processes and allows the undertaking of long-term restructuring investment.[7]

Beside the aspect of protecting the actual ownership rights, managers get financial incentives which encourage them to initiate and speed up privatisation actions. The incentives are relatively low purchase prices which result from officially granted discounts and managers' ability to avail themselves of different kinds of facilitation. Profits obtained legally by managers attract imitators. This in turn increases the demand for state-owned enterprises, which contributes to acceleration of privatisation processes.

The management's participation in privatisation is usually supported by the employees. When the enterprise is sold to an unknown investor, the employees respond negatively because they do not know him or his behaviour and are afraid of his interference into their positions. When the buy-out method is applied, the partner and his behaviour are well known to the employees and therefore can be evaluated properly by them.[8]

The taking over of the shares of the enterprise by members of the former *nomenklatura* and the possibility of deriving big benefits cause political opposition in society. The so-called nomenklatura privatisation threatens with a loss of social confidence in the reforms conducted and may have a negative impact on the speed of privatisation. Contrary to spontaneous buy-outs, public programmes present a relatively clear-cut and just framework for conducting the transactions, as a result of which social protests are kept under control.[9] Furthermore transactions of the buy-out type are concerned mostly with small and medium-sized enterprises the privatisation of which does not rouse much interest among people. All in all, people's preferences as to methods and conditions of privatisation are not organised, contrary to the interests of the members of the enterprise.

2) When the employee buy-out method is used, capital shares are allotted to the employees, too. In this way - contrary to spontaneous privatisation, the ownership position of the employees enjoys a special protection, which does not lead to the employees' opposition to privatisation processes. The employees' actual influences together with their property rights are sanctioned and their resignation from opposition to privatisation is compensated for.[10] The higher this compensation e.g. through a sale of shares at lowered prices, the greater the employees' willingness to co-operate and thereby the greater the speed of privatisation. Another good point of granting property rights to the employees is the transition to more effective conflict-resolving methods. Earlier conflicts took the form of strikes and other ad hoc intervention. After privatisation conflicts run in accordance with the generally accepted rules between the two interest groups, which as a rule makes it easier to resolve problems. This is compounded with the employees' greater awareness of the importance of the owner's function.

---

[7] S. Datta, J. Nugent, Transaction Cost Economics and Contractual Choice: Theory and Evidence, New York, 1989, p. 34-79.

[8] A. Franz, A.Schipke, M. Groszek, *Privatisation in Poland. A Property Rights Approach,* in M. Kremer, M. Weber, Transforming Economic System. The Case of Poland, Heidelberg, 1992, p. 72.

[9] F. Dhanji, B. Milanowic, *Privatisation: Objectives, Constraints and Divestiture Models* in P. Marer, S. Zecchini, The Transition to A Market Economy, vol. 2, OECD, Paris, 1991.

[10] T. Buck, S. Thompson, M. Wright, *Post-Communist Privatisation and the British Experience,* Public Enterprise, vol. 11, nos. 2-3, p. 191. London, 1991

The employees' participation is connected with problems related to the speed and extent of restructuring actions when they entail lay-offs and wage cuts.[11] The question asked in the privatisation practice is not whether the employees should participate in privatisation but how this participation should proceed. According to Svetozar Pejovich, preference should be given to a type of employees' ownership with transferable property rights and dominance of vertical control structure (the American type) rather than to the Yugoslav model of employee democracy.[12]

Another socio-political problem is related to the distribution effects of EBOs which bring benefits only to certain groups of society. Furthermore, politically undesirable distribution effects follow from differences between employees working in profit- and loss-making enterprises as well as between senior and junior employees.[13] These problems can decelerate the speed of privatisation because of the social protests connected with them.

3) The administration at a lower level can be particularly predisposed to privatisation of small and medium-sized enterprises which qualify for privatisation by means of the buy-out method. The regional administration often holds considerable actual influence in the enterprises under privatisation. Its actions, however, will not be aimed at accelerating the privatisation processes whenever this is related to a loss of the rent source and incomes from privatisation go in full to the central budget.[14]

Accordingly, co-operation of regional offices in privatisation would be probable only when their resignation from the influence entailed appropriate compensation. If the compensation took the form of a transfer of shares in the enterprise, then there would be a danger that regional bureaucracies would try to control them again. That is why compensation should take the form of incomes from privatisation which - taking into account the generally small size of the enterprise - would not cause much reduction in the revenues of the central budget.

The participation of the regional administration in incomes from privatisation is also necessary for another reason. If the participants in the process of specification and new creation of property rights are the sides that do not derive benefits from this, then there is a strong tendency towards rent-seeking efforts wasting the resources.[15] If e.g. regional offices are responsible only for conducting the privatisation processes, then they would strive to increase bureaucracy which will cause a considerable waste of resources in the negotiation processes. This problem does not occur in spontaneous privatisation because all the sides are interested in an efficiently conducted negotiation process. For this reason the regional administration should have a right to share in incomes from privatisation, which would minimise the rent-seeking type of outlays.

Summing up, transactions of the buy-out type are a method which, firstly, can reconcile the competitive claims of the interest groups to property rights and in this way can relatively quickly end the "tug of war" at small costs. It is possible to overcome the blockage because the

---

[11] B. Frey, *Issues in the Transition from Planning to the Market*, commentary in Journal of Institutional Theoretical Economics, vol. 148, no. 1, 1992, p. 123.

[12] S. Pejovich, *A Property Rights Analysis of the Yugoslav Miracle*, Annals of the American Academy of Political and Social Science, no. 105, New York, 1990.

[13] F. Dhanji, B. Milanovic (!991), p. 28.

[14] B. Krug, Die politische Oekonomie der Wirtschaftstransformation - Ueberlegungen aus Sicht der vergleichenden oekonomischen Theorie von Institutionen, Marburg, 1991.

[15] T. Anderson, P. Hill, *Privatising the Commons: An Improvement?*, Southern Economic Journal, vol. 50, no. 2, 1983, pp. 438-450.

application of the buy-out method allows sanctioning the actual property rights of the well-organised sides to the conflict.

Secondly, the buy-out method allows to reconcile the contrary claims of the conflicting sides that pertain to a whole set of rights in the negotiation process. The claims to the particular component rights are exchangeable so that they are separated, which has a positive impact on the speed of restructuring and privatisation. This concerns especially the right to management which the employees and state administration transfer to the managers in exchange for the rights to obtain income.

Thirdly, the management and employees are provided with incentives to initiate and speed up the privatisation process. In this way, the pressure arises in enterprises on privatisation agencies to conduct the so-called privatisation from below (the Bottom - Up approach). Privatisation imposed from above (the Top - Down approach) is less effective because it always leads to the owner - manager problems and to the blockage of the privatisation process.

2. Buy-out as an instrument of creating effective control

The break-down of the system of motivation and control of the centrally planned economic system resulted in the lack of effective control mechanisms at the time of transformation. This gap entailed negative consequences. They were the persistence (and even deterioration) of inefficient allocation and production, a lack of necessary market adjustments, a lack of innovation actions and others. Furthermore, they were compounded with the negative macroeconomic effects - growth of the budget deficit, rising inflation and underutilisation of factors of production.

In the face of the negative effects of the lack of control, the introduction of efficient control and motivation structures is of particular importance. In the case of small and medium-sized enterprises such structures can be created by means of the MBO/EBO privatisation method. Transactions of the buy-out type combine managerial functions with ownership functions and simultaneously create a personal union between the principal and agent. The new principal-agent relations produced by these transactions have advantages over other privatisation methods (the so-called agency costs are lower).[16] They result from certain specific features of the buy-out transactions - the hitherto managers', active inventors' and employees' participation in stock capital and an increment in the amount of debt.

[16] The choice of an ownership structure is made by comparing the benefits and losses from specialisation of the managerial and owner functions. Optimum is reached when marginal benefits from specialisation are equal to marginal costs of specialisation (agency costs). Marginal costs from specialisation are dependent on the size of the enterprise. Contrary to large enterprises, small and medium-sized firms have relatively small benefits from specialisation. The level of specialisation related costs is dependent on efficiency of capital markets. When capital markets are highly competitive, benefits from specialisation exceed costs. At the time of systemic transformation when capital markets are at the stage of nascency, the situation is quite the reverse.

Participation of hitherto managers in stock capital

The principal-agent problems between owners and managers can occur in different forms. The first point of contention between them follows from the consumption of non-pecuniary benefits by managers (so-called fringe benefits).[17] These benefits are enjoyed only by the managers (consumption on the job) and the entailed costs are borne by the enterprise (or owners of the enterprise). By means of the MBO privatisation method, managers considerably increase their share in the firm's stock capital and thereby wasteful consumption is restricted. The problem of consumption on the job is particularly important at the time of systemic transformation because managers enjoy considerable freedom of action without any sufficient control by privatisation agencies or the nascent capital markets.[18]

The second source of conflict between the principal and agent pertains to managers' involvement in work.[19] If they do not participate in the enterprise's stock capital then they have no incentives to exerted efforts and innovation actions. Managers' capital participation augments their involvement in work and innovation activity because their share in stock capital is closely related to participation in the firm's profits. Furthermore, managers' accountability for inapt decisions and inefficient management is increased.

The third point of contention is concerned with avoidance of risk by the management.[20] If managers invest their knowledge and experience in the enterprise and simultaneously do not share adequately in the effects of their activity, then they prefer investment projects that entail small risk and consequently yield relatively lower incomes. Accordingly, managers' participation in stock capital increases their orientation at more profitable investment projects.

The fourth contention point arises from the asymmetrical access to information between managers and outside investors. Managers most often have better information on profitability of long-term investment projects than outside investors. That's why they may give preference to projects that are more clear-cut for the outside investor but do not yield the highest profits.[21]

Managers' participation in stock capital gives outside investors a positive signal about the quality of an intended investment or research project. Owing to considerable information problems at the stage of systemic transformation, many a time managers' participation is a necessary condition for a purchase of shares in the firm's capital by outside investors. This concerns those cases in particular when success of an undertaking is dependent on managers' knowledge and experience (human capital). Manager usually have ties with suppliers, buyers, state institutions and managers of the corporation from which their firms were separated. Managers' departure from the firm can cause a decrease in the value of the enterprise, which is anticipated by investors and has a negative impact on their propensity to undertake investment.

---

[17] M. Jensen, W. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, Journal of Financial Economics, no. 3, 1976, p. 312.

[18] J. Winiecki, Privatisation in Poland. A Comparative Perspective, Tuebingen, 1992, pp. 68-71.

[19] M. Jensen, W. Meckling, 1976, p. 313.

[20] A. Bruce, T. Buck, J. Coyne, M. Wright, Incentives for Senior Managers: Share Options and Buy-outs, London, 1990.

[21] J. Weston. K. Chung, S. Hoag, Mergers, Restructuring and Corporate Control, Englewood Cliffs, 1990, p. 408.

The hitherto managers' participation in stock capital causes that their "human capital" stays in the firm for good and creates a necessary safeguard and a positive signal for investors.

Participation of active investors in stock capital

Intensity of control is a function of specific ownership relations. If e.g. the number of investors is high and the value of their shares is relatively low compared with the value of the enterprise, then the information-obtaining costs are higher in the case of a small shareholder than the income he derives thereby. Then there arises a problem of creation of coalition of owners in order to change the firm's policy or to make corrections in the composition of the managerial group. This problem can be solved by concentrating the hitherto dispersed capital among active institutional investors e.g. venture capital funds, joint stock companies and so on.

Concentration of the stock capital of the firm under privatisation leads to a replacement of the hitherto passive control on the part of small shareholders by active control on the part of large shareholders and relatively high effects of control correspond to the information-getting costs. Concentrating the stock capital in the hand of a few investors rather than dispersing it among society is especially advisable at the period of transformation when information problems and the related information-obtaining costs are particularly high.

Control over MBO/EBO enterprises by active investors provides for three important instruments which allow harmonising the interests of managers with the interests of the owner.

Firstly, thanks to rules agreed on with the investors, managers can acquire further shares in the firm at privileged prices if the enterprise is successful. When its effects are poor, managers are deprived of that possibility.

Secondly, active investors reserve for themselves a wide right to information, which permits a steady and careful supervision over the financial results (cash flow, liquidity, profits).

Thirdly, managerial contracts provide active investors with considerable possibilities of interference which allow them to make fast corrections in the possibly inapt decisions of the management.[22]

Beside the effective external control of the enterprise, active investors' participation yields benefits in the form of know-how transfer to MBO/EBO enterprises. Thanks to the transfer of highly specialised knowledge especially in the field of organisation, finance and taxes, the firm can raise its efficiency and market value.[23]

Participation of employees in stock capital

The principal - agent problems pertain not only to relations between owners and managers but also to relations between investors and employees. Transactions of the EBO type can alleviate the principal - agent conflicts in different ways.[24] Firstly, they create incentives to

[22] U.Graebner, Die Auseinandersetzung um Leveraged Buyouts, Frankrfurt, 1991.

[23] L. Bull, Management Performance in Leveraged Buyouts: An Empirical Analysis, Ann Arbour, 1987.

[24] M. Conte, J, Svejnar, *Productivity Effects of Workers Participation in Management, Profit- Sharing, Worker Ownership of Assets and Unionisation in U.S. Firms*, International Journal of Industrial Organisation, no. 6, 1988, pp. 144-141.

increased involvement in work and accomplishment of goals oriented at owners because a tie is created between employees' productivity, the enterprise's profits and employees' profit-sharing.

Secondly, employees' participation makes control by managers easier and lowers control costs. Control from above, or by managers is complemented with control from below, by rank and file. This increases employees' motivation and voluntary transfer of information about particular workplaces and possibilities of increasing the production potential.

Another merit of EBO follows from the firm-specific human capital that vanishes when employees leave the enterprise. Long-term creation of that capital is supported by employees' participation in assets. It protects employees' investment in human capital and focuses their attention on long-term strategic aspects and decreases ad hoc intervention in everyday activity of the management.

However, considerable problems are related to employees' participation. Firstly, it is the problem of risk. Employees are confronted with the possibility of losing their jobs and losing their shares. That's why they display a tendency to avoid risk, which has a negative bearing on the level of investment.

Secondly, there arises a problem of financing. Employee-owned enterprises are dependent on employees' shares, and employees' financial resources are on the whole limited.[25] On the other hand, it should be noted that EBO enterprises are as a rule small-sized firms acting in labour-intensive sectors. Furthermore, employees' participation does not exclude outside investors' involvement and a change in the ownership relations in the future.

Thirdly, the problem of opportunism may occur. Capital institutions shun enterprises in which employees can absorb all of the firm's revenues in a opportunist way, by awarding themselves higher wages or voting for greater social expenditure and in this way block the restructuring processes.

Fourthly, the problem of distribution may occur. Employees' participation entails unequal distribution, for a greater fraction of society is excluded from privatisation.[26] Moreover, distribution problems arise as a result of different profitability of candidates for privatisation.

A high indebtedness level

Conflicts between the principal and agent occur also between owners and outside investors. Generally speaking, three categories of agency costs of outside capital can be distinguished.

- Agency costs connected with underinvestment. With an increase in the degree of indebtedness, owners of the firm's own capital are ready to invest in risky projects, for in case of success they will cash the main part of income and in case of failure losses will be largely suffered by creditors. Because creditors anticipate such behaviour, they respond with an increased interest

[25] C. Fanning, T. McCarthy, A Survey of Economic Hypotheses Concerning Non-Viability of Labour-Directed Firms in Capitalist Economies, Aldershot, 1986.

[26] D. Lipton, J. Sachs, 1990, p. 309.

rate or credit-rationing, which in effect leads to a sub-optimal level of investment or to distribution of incomes in favour of creditors and at the cost of the stock capital owners.[27]

• Costs connected with the firm management's behaviour inconsistent with creditors' expectations. This follows from the fact that managers can carry out their own goals e.g. raise their position in the firm. Creditors limit such behaviour by restrictive credit and control clauses which involve costs. On the other hand, managers undertake actions to pass these burdens onto the enterprise, which also entails costs.[28]

• Costs connected with the firm's insolvency. Probability of the firm's insolvency is a positive function of the debt degree. Because insolvency also entails costs, a greater degree of indebtedness leads to a higher cost of insolvency proceedings which is expressed e.g. in a higher control cost.[29]

The increase in the degree of indebtedness, which is a rule in the cases of transactions of the buy-out type gives grounds for expectations of increased agency costs of outside capital. These costs, however, can be levelled by compensation effects.

Firstly, the managers' and employees' own resources burdened with greater indebtedness alleviate the differences in interest between managers and outside investors. Furthermore, the management's potential is more efficiently used, for in the case of bankruptcy the managers are threatened not only with the loss of the capital contributed by them but also with loss of the firm-specific human capital and their own reputation.

The second compensation effect is connected with utilisation of the so-called free cash flow. This notion means a flow of payment which is at the firm's disposal after making all the necessary investment promising a positive capital value.[30] Agency costs arise when this amount is not paid to owners but invested in unprofitable or not very profitable projects. The raising of the share of outside capital emerges here as a way of compulsory payment of a free cash flow rather than investing it in unprofitable projects. Financial resources for new projects have to be obtained additionally from outside investors, which leads to growth of their impact on the extent, kind and structure of investment decisions and in this way agency costs of outside capital are reduced.

The third compensatory effect follows from internalisation of "privatisation of bankruptcy".[31] In the case of highly indebted enterprises it is more probable that possible insolvency will entail reorganisation rather than the destructive liquidation procedure. The earlier the creditor intervenes, the fewer the mistakes and losses that the management can make, which favourably affects the reorganisation. With growing indebtedness, the propensity to increased supervision over the enterprise by the managers and investors, thanks to which the economic risk is identified earlier.

Against the background of the compensatory effects, the agency costs of outside capital grow less than proportionately to increments in indebtedness, which together with a simultaneous

---

[27] S. Myers, *The Determinants of Corporate Borrowing*, Journal of Financial Economics, no. 5, 1977, p. 172.

[28] M. Jensen, W. Meckling, op.cit., p. 339.

[29] M. Jensen, W. Meckling, op.cit., p. 341.

[30] M. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, American Economic Review, Papers and Proceedings, no. 76, 1986, pp. 323-329.

[31] M. Jensen, *Active Investors, LBOs and the Privatisation of Bankruptcy*, Journal of Applied Corporate Finance, no. 1, 1989, pp. 35-44.

fall in agency costs of own capital allows expecting a reduction in aggregate costs. These positive aspects are accompanied by negative aspects of high indebtedness: an increased risk of bankruptcy and concentration of the firm's policy not on long-term investment projects but on short-term efforts to get resources for servicing increased debts.

Summing up, in the light of the theory of the principal - agent, the relations between owners, managers, employees and creditors are ordered through the transactions of the buy-out type so that conflicts of interests between these groups and thereby control costs are reduced. In the context of systemic transformation, self-control is of greater importance than in western countries, for capital markets are less developed and control by these markets reveals limited efficacy. For this reason, instead of dispersal of ownership, concentration of capital among several active investors is postulated and in this way advantages are gained from specialisation of the control function.

Employees' participation can alleviate the principal - agent problems between outside investors, managers and employees and consequently increase the enterprise's efficiency. However, employees' participation in the firm's assets causes new problems - risk, financing and especially opportunism which contribute to lower investment and too high wages. A high indebtedness level of MBO/EBO enterprises can discipline managers' actions because creditors will fulfil the control function.

The increased degree of indebtedness of these firms entails also negative effects. The are connected with an increased probability of bankruptcy and with the firm's concentration on short term policy.

3. Buy-out as an instrument of breaking up monopolist structures

Breaking up the monopolist structures is one of the form of restoring the conditions of competition to the economy. The process of dividing the combines in the countries of Central and Eastern Europe encounters an essential problem - creation of an optimum size of enterprises. The state possesses neither market criteria nor sufficient knowledge of local conditions, which in the case of administratively conducted demonopolisation can lead to the creation of structures that are far from optimal ones.

In spite of problematic efficacy of deregulation conducted by the state, this does not mean that this should be given up. The experience gathered so far shows that large combines are more difficult to privatise and restructure than plants separated from them.[32] Moreover, demonopolisation seems necessary because privatisation of great concerns maintains a high level of concentration of industrial structures. A division of a private enterprise having a monopolist position encounters great barriers. Furthermore, in conditions of systemic transformation such a move can undermine investors' trust in stability of the institution of property rights and in the enterprise's autonomy.

The state's privatisation policy is aimed at releasing concomitant initiatives whereby certain parts are automatically separated from the combine at the time of privatisation. This initiative requires catalysts which would develop and accelerate this process. Transactions of the buy-out type are such catalysts. Their catalyst function in solving the problem of the left-over

[32] Frankfurter Allgemeine Zeitung, *Investoren kamen erst nach der Aufspaltung*, no. 138, 16 June 1992, p. 24.

monopolist structures consists in using the opportunity to lower transactions costs (which are identified by firm directors who through MBOs can appropriate the resultant benefits for themselves).

Through transactions of the buy-out type there occurs a transition from the strictly hierarchical ties in combines to market relations which initially take the form of bilateral co-operation with the separated units. This co-operation allows gradual decentralisation without the occurrence of problems related to purely market transactions. The transition to market allocation is not a single act but a gradual process of separation from the combine. Also after privatisation by means of MBO/EBO, the separate parts of the combine are not fully independent partners, for the mutual dependence relation still continues. This on the whole favours fulfilling market contracts and thereby lowers **transactions costs.**

In the initial phase of transformation, economic units encounter relatively high transactions costs in market relations. There are different reasons for that state of things. Firstly, the market infrastructure (the legal system, the regulations concerning the goods and services, capital and labour markets) which is indispensable for conducting market activity in market conditions is in the state of nascency.[33] Secondly, the uncertainty concerning the stability of the direction of reforms is high. Thirdly, entrepreneurs have no sufficient information about trustworthiness of partners and about consequences and conditions of transactions. Fourthly, in the face of lack of market institutions and high uncertainty, there exists a danger of opportunist behaviour on the part of the new market partner.

In bilateral relations with the other parts of the enterprise, the combine maintains benefits in the form of lower costs (e.g. supervision, guarantee) than in contracts with unknown market partners. In relation to the starting situation, there also occur lower transaction costs, for the compulsion of transactions within the combine is liquidated and there is a possibility of transaction with an alternative partner.[34] This strengthens the position of the combine in relation to the privatised unit which is considerably dependent on it and in this way the privatised unit receives a special incentive to abandon its hitherto opportunist attitude in the mutual relations and to fulfil the undertaken contracts. This results in stabilisation of transactions and a reduction of transaction costs.

Low transaction costs for the combine result from small outlays incurred on search and identification of a proper partner because at first it co-operates with the separated unit which it knows and to a smaller degree with anonymous and unpredictable market partners.[35] Owing to high information-obtaining costs entailed by changing a contractor, the combine is initially dependent on the firm separated from it through a buy-out. In the long run, the particular firms that used to be parts of the combines reduce their mutual dependence and thereby contribute to further decentralisation.

The third merit of the separation of a firm through a buy-out is the fact that the human capital gathered in the firm is fully maintained. Outside investors do not have appropriate information when evaluating the non-material components of the enterprise - including managers'

---

[33] The economy of the former German Democratic Republic is an exception. In this case the market infrastructure of West German was extended over the new lands.

[34] M. Wright, B. Chiplin, K. Robbie, *Buyouts. From the State Enterprises and Elsewhere in the Public Sector.* CMBOR - Occasional Papers, University of Nottingham, 1988.

[35] T. Buck, *Control in Vertical Hierarchies, Soft Budgets and Employee Buy-Outs,* Economic Analysis and Workers Management, no. 4, 1990, p. 386.

knowledge and contacts, and they often undervalue them. Furthermore, outside investors have to reckon with the possibility that while they are taking over the firm, the management may leave i.e. with loss of valuable human capital.[36] Such a danger does no exist in the case of transactions of the buy-out type.

The fourth merit pertains to management and control over the separated part of the enterprise. With the collapse of the state bureaucracy and the emergence of the market, the conditions of economic activity became so complex and uncertain that the centralised form of management and control of all the departments of the enterprise fails to meet the new challenges - too high organisation costs arise. The new conditions are better matched with a decentralised form of organisation which can be achieved by singling out the particular plants through a buy-out.

Also state privatisation agencies derive benefits from transaction costs. They encounter the problem of identification of viable enterprises able to function, including their market potential and setting an optimum size structure of the enterprise. Buy-outs make it possible to use the knowledge of local units. Neither the employees of state agencies nor experts and investors are more familiar with the situation of the enterprise than the local managers.

Conclusion

The survey of the concepts does not exhaust the whole specific nature of problems occurring in the post-communist countries. The extent and course of privatisation via a buyout method showed differences among the particular countries. Divergences occurred also in evaluations of this privatisation method.

The critics of this method point out that members of the former nomenklatura appropriate public property without due payment and at mass protests of society, which delays progress in the whole privatisation process. They also think that employees' participation in privatisation entails a wage rise and a drop in the investment level. All in all, enterprises with a strong monopolist position are being privatised and in this way the monopolist structures left by the centrally planned economy are being perpetuated.

On the other hand, while perceiving the specific privatisation problems, the supporters of this privatisation method are of the opinion that employees' participation in privatisation will not slacken its speed but on the contrary, it will speed it up considerably. This follows from the fact that after the collapse of the centrally planned economy the actual property rights of the management and employees are legally sanctioned and in this way a co-operative and not a blocking form of the employees' behaviour is achieved in privatisation.

Secondly, privatisation through the MBO/EBO method allows eliminating the negative consequences of lack of effective control at the time of systemic transformation. Managers' and employees' participation in privatisation leads to the creation of self-control mechanisms that are effective because they result from the interests of the owner.

Thirdly, transactions of the buy-out type are catalysts releasing many managerial and rank-and-file initiatives aimed at breaking up the monopolies and separating autonomous enterprises from them.

[36] W. Wright, Redrawing the Boundaries of the Firm, Oxford, 1988, p. 200.

References

ANDERSON, T., Hill, P. (1983), *Privatising the Commons: An Improvement?*, Southern Economic Journal, vol. 50, no. 2.

BAKER, G., WRUCK, K. (1989), *Organisational Change and Value Creation in Leveraged Buy-outs. The Case of the O.M. Scott & Sons Company,* Journal of Financial Economics, no. 25

BENSON, B. (1984), *Rent Seeking from a Property Rights Perspective,* Southern Economic Journal, vol. 51, no. 2

BRANYICZKI, I., BAKACSI, G., PEARCE, J. (1992), *The Back Door: Spontaneous Privatisation in Hungary,* Annals of Public and Cooperative Economics, vol. 63, no. 2

BRUCE, A., BUCK, T., COYNE, J., WRIGHT, M. (1990), Incentives for Senior Managers: Share Options and Buyouts, London.

BUCHANAN, J. TULLOCK, G., TOLLISON, R. (1980), Toward a Theory of the Rent-Seeking Society, College Station.

BUCK, T., WRIGHT, M. (1990), *Control in Vertical Hierarchies, Soft Budgets and Employee Buy-Outs*, Economic Analysis and Workers Management, vol. 24, no. 4.

BULL, I. (1987), Management Performance in Leveraged Buyouts: An Empirical Analysis, Ann Arbour.

CONTE, M., SVEJNAR, J. (1988), *Productivity Effects of Workers Participation in Management, Profit- Sharing, Worker Ownership of Assets and Unionisation in U.S. Firms,* International Journal of Industrial Organisation, no. 6.

DATTA, S., NUGENT, J. (1989), Transaction Cost Economics and Contractual Choice: Theory and Evidence, New York.

DHANJI, F., MILANOWIC, B. (1991), *Privatisation: Objectives, Constraints and Divestiture Models* in P. Marer, S. Zecchini, The Transition to A Market Economy, vol. 2, OECD, Paris.

FANNING, C., MCCARTHY, T (1986), A Survey of Economic Hypotheses Concerning Non-Viability of Labour-Directed Firms in Capitalist Economies, Aldershot.

FRANZ, A., SCHIPKE, A., GROSZEK, M. (1992), Privatisation in Poland. A Property Rights Approach, Heidelberg.

FREY, B. (1992), *Issues in the Transition from Planning to the Market*, commentary in Journal of Institutional Theoretical Economics, vol. 148, no. 1.

GRAEBNER, U. (1991), Die Auseinandersetzung um Leveraged Buyouts, Frankrfurt.

JENSEN, M. (1986), *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers,* American Economic Review, Papers and Proceedings, no. 76.

JENSEN, M., MECKLING, W. (1976), *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure,* Journal of Financial Economics, no. 3.

JONHSON, S., USTENKO, O. (1993), Corporate Control of Enterprises before Privatisation. The Effects of Spontaneous Privatisation, Tuebingen.

KREMER, M., WEBER, M. (1992), Transforming Economic Systems: The Case of Poland, Heidelberg.

KRUG, B. (1991), Die politische Oekonomie der Wirtschaftstransformation - Ueberlegungen aus Sicht der vergleichenden oekonomischen Theorie von Institutionen, Marburg.

LIPTON, D., SACHS, J. (1990), *Privatisation in Eastern Europe. The Case of Poland*, Brookings Papers on Economic Activity no. 2.

MYERS, S. (1977), *The Determinants of Corporate Borrowing*, Journal of Financial Economics, no. 5.

PEJOVICH, S. (1990), *A Property Rights Analysis of the Yugoslav Miracle*, Annals of the American Academy of Political and Social Science, no. 105, New York.

SCHMIEDLING, H. (1991), *Issues in Privatisation*, Intereconomics, volume 26, no, 3.

STAHL, M. (1995), Buyouts zur Privatisierung in den Transformationslaendern Mittel- und Osteuropas, Stuttgart.

WESTON, F., CHUNG, K., HOAG, S. (1990), Mergers, Restructuring and Corporate Control, Englewood Cliffs, 1990.

WINIECKI, J. (1992), Privatisation in Poland. A Comparative Perspective. Tuebingen.

WRIGHT, M. (1988), Redrawing the Boundaries of the Firm, Oxford.

WRIGHT, M., CHIPLIN, B., ROBBIE K. (1988), *Buyouts. From the State Enterprises and Elsewhere in the Public Sector*, CMBOR - Occasional Papers, University of Nottingham.