# Property Rights, Managerial Strategies and Enterprise Adjustment: Bulgaria in Transition

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## Introduction

The question of how specific ownership and control structures impinge upon managerial behaviour and enterprise adjustment in the transition economies is clearly of considerable contemporary moment. Influential public bodies such as the World Bank (1996), the UN Economic Commission for Europe (1996) and the European Bank for Reconstruction and Development (1994-9), have consistently placed these institutional 'rules of the game' at the very heart of the agenda of reform.**[1]** However, despite its acknowledged centrality, the topic still remains somewhat in the academic shadows and has yet to command the amount of dedicated empirical research time and effort that seems warranted by the prescriptive interest shown by policy makers. Of course, in view of the veritable explosion of literature on 'Transition Studies' during the last decade, there are obligatory background chapters and informed commentary on several aspects of the topic, but there is little detail and the extent of our knowledge remains patchy.[2] Indeed for some countries

[1] World Bank, *Annual Development Report 1996*, 'From Plan to Market', OUP Washington and London; UN Economic Commission for Europe, *Economic Survey of Europe in 1995-96*, Geneva and New York; European Bank for Reconstruction and Development, *Transition Report(s), 1994-99:Enterprise, Performance and Growth*, EBRD, London.

[2] Many of the reputable UK and US-based publishing groups, including Longmans, CUP, Edward Elgar and MIT now produce specialist 'Transitional Studies' or 'Post-Communist Economies'

such as several Southern European and Balkan states, and for many important economic activities including the hitherto dominant secondary sector, we only possess rudimentary information and still less in the way of analysis.

There are several plausible explanations for this ‘sidelining’. To begin with, there is the rather familiar problem of a lack of data. Although property rights are a macro-level issue in the sense that the implications operate over the national economy as a whole, in order to monitor overall trends and tendencies it seems only sensible to build a picture from the bottom-up. This is a task that requires access to detailed and reliable information from individual enterprises that is often very difficult to obtain. Second, whatever the immediate urgency, there can be little doubt that designing an appropriate institutional infrastructure and establishing a clutch of relevant and smoothly functioning organisations in the different sectors and parts of the country is painstaking. Much as some politicians and civil servants would like, such an undertaking can scarcely be achieved over-night. Given the urgency of more immediate economic transitional pressures such as reducing unemployment, tackling inflation, stabilising the value of the exchange rate and the need to attract foreign investment, it is hardly surprising that these problems attract least attention.

Further, there is an implicit assumption that once a set of ‘Western’ institutions has been introduced, putative entrepreneurs and the nascent business community will eventually adopt standard, pro-market, modes of behaviour and quickly conform to the textbook code of management practice. It is then predicted that enterprises will come to

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series – often focusing on privatisation; and mainstream journals such as the *Economic Journal* and the *American Economic Review* contain regular features on the transition. Despite the burgeoning literature replicate the structural characteristics found in the 'advanced' countries. This, in turn, would enable the private sector to deliver the desired outcomes of enhanced growth and higher productivity.[3] It was, of course, realised that short- to medium-term disruptions consequent upon such a paradigmatic shift would be inevitable.[4] However, as Joseph Schumpeter warned many years ago, altering conduct and 'mental maps' usually involves both producers and consumers assuming rather novel personal and collective habits and to change embedded value systems; and new education and training programmes are seldom on-tap to accelerate this process.[5] Thus, even the most sanguine and confident of observers were taken aback by the extent and pervasity of the downturn experienced in many of the transition states.[6] Indeed, with the benefit of nearly a decade of hindsight, the extent of the decline of a whole array of sensitive economic and social indicators has been shocking: in Bulgaria, for example, there has been a dramatic rise in poverty. According to Ackrill *et al* (1999) the percentage of the population living below the poverty line increased from a fifth in 1992 to just under 70% in 1996 i.e., 5.88 million

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there remains serious lacunae regarding the problem under consideration, and for Bulgaria there are enormous gaps.

[3] See, for example, the studies by L. Brainard, *Transformation of Planned Economies*, OECD, Paris, 1991; O. Blanchard, A. Kenneth and J.D. Sachs, *The Transition in Eastern Europe, Country Studies* vol. 1, National Bureau of Economic Research, University of Chicago Press, Washington, 1994; M. Lavigne, *The Economics of Transition,* Macmillan, Basingstoke, 1995; J. Hausner, *Strategic Choice and Path Dependency in Post-Socialism*, Elgar, Aldershot, 1995; and D. Gross and A. Steinherr, *Winds of Change: Economic Reform in Eastern Europe* Longman, London, 1995.

[4]K. McDonald, 'Why Privatization is not Enough', *Harvard Business Review*, May-June 1993, pp. 45-59.

[5] J.A. Schumpeter, *Imperialism and Social Classes*, Meridian , New York, 1955.

[6] L. Csaba, *The Capitalist Revolution in East Europe*, Elgar, Aldershot, 1995; I. Kearns, 'Eastern Europe in Transition', in I. Gamble and A. Payne, *Regionalism and the World Order*, Macmillan, London, 1993; and J. Elster, C. Offe, and U.K. Preuss, *Institutional design in Post-Communist Societies: Rebuilding the Ship at Sea*, CUP, Cambridge, 1996; and, most recently, UNDP, *Privatisation and Transformation in Eastern Europe and the former USSR*, UN Publications, New York, 1999.

people out of a total population of just 8.4 million.[7] Partly as a consequence of this, life expectancy over the decade 1987-97 has fallen (as indeed it has in three other of the transition states, Albania, Russia and Ukraine).[8] These alarming results suggest that 'quick fix' solutions to reforming the wealth-creating sector are illusory and that there are many pitfalls *en-route*; obviously moving from a situation of planning and controls to a market-oriented form of management presents complex problems of adaptation. Of course, in the short-term, Bulgaria experienced huge difficulties – partly because of unusually unfavourable initial conditons, a severe and damaging bout of political instability and a confusing and hesitant privatisation programme.[9] In these circumstances after the fall of Zhivkov in November 1989 and the enactment of the Transformation and Privatisation Law of 8 May 1992, an environment of opportunism and shirking flourished. In 'normal'circumstances theory predicts that these traits are difficult enough to counter; [10] but in transitional economies in general, and in Bulgaria's case in particular, the problems were compounded many times over. Such dangers alert us of the need to tread cautiously and examine the evolving situation with care and with due attention to what is actually occurring on the ground. This is precisely our intention in this paper.

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[7] R.W. Ackrill, R. Dobrinsky, N. Markov and S.E. Pudsey, 'Social security, poverty and economic transition: an analysis for Bulgaria 1992-96', University of Leicester, Centre for European Economic Studies working paper, 1999.

[8] *Economist*, 'Ten Years On: What Communism Left Behind', 6-12 November, 1999, pp.16f.

[9] For early assessments of the initial period of reform see R.Frydman, A.Rapaczynski, J.Earle *et al*, *op. cit*., 'Bulgaria', pp.3-37; and D.Jones and C.Rock, 'Privatization in Bulgaria' in S. Estrin (ed.), *Privatization in Central and Eastern Europe* Longman, London, 1994, pp.311-324

[10] For a basic discussion of these features see A.A. Alchian and H. Demstez, 'Production, Information Costs and Economic Organization', *American Economic Review*, 62, December 1972, pp. 777-95; O. Williamson, *The Economic Institutions of Capitalism*, Collier Macmillan, New York, 1985.

Our aim is to present a critical account of the transformation of ownership, control and governance structures on the behaviour of enterprises in Bulgaria. The World Bank has positioned the country in the second tier (of four) of transition states with respect to economic liberalisation: indeed, in 1995, the weighted average estimates of domestic and external transactions and the index of new firm entry - a rough proxy for privatisation, put Bulgaria almost exactly in the middle of the 28 countries included (World Bank, 1996: Figure 1.22, p.14). At the end of the decade this relative position remained the same (*Transition Report*, 1999). Income *per capita* remained at just over $1,000 between 1992-96, and at the century's end is $1530, that is roughly on a par with neighbouring Romania, above that of Moldavia, Armenia and Azerbaijan, but well below that for Hungary, Estonia, the Czech Republic and Poland *(Transition Report*, 1997, Table 7, p.536, and the *Economist*, 'The World in 2000', 1999, p.95), and Greece and Turkey (World Bank, *Annual Development Report, 1998*, Appendix 2). The growth performance has been unremarkable. GDP expressed in constant prices, fell between 1990-93 (by almost a third), then registered very slow progress over the following two years (up by 4%), fell back again in 1996 and 1997 (by 18%), but has now become positive (3% in 1999). Trade inside CEFTA has become mired with complications, especially with neighbouring Romania, and there are further difficulties ahead as enlargement questions become more urgent. The wars in the Balkans have caused considerable damage to the fragile economy. There has also been little structural change: industry accounted for 32% of GDP in 1996 (down 3% on 1992). Within this unpromising context we identify recent forms of business organisation in newly established private firms, privatised firms, and incorporated state-owned firms. After outlining our methodology we describe the main forms of ownership. We then present evidence of the specific property-rights, control and governance structures prevailing in the industrial sector. We conclude on a positive note, but one tempered by an acknowledgement of how far there is to go before a 'modern', flexible and responsive managerial system can take root given the macro-economic circumstances.

## Methodological framework

In the transition economies there is now a mounting body of evidence that many business managers (sometimes referred to as the 'insiders') often exhibit inefficient behavioural traits, and therefore any general tendency towards opportunism and shirking needs to be properly monitored and ultimately constrained.[11] This realisation is grounded in, and informed by, agency theory, and the associated literature on the separation of ownership from control.[12] The East European practice of the various types of privatisation that have been used, including the so-called 'spontaneous' arrangement, also provide the conditions for the emergence of ineffective managerial behaviour.[13] However, the more usual type of management mirrors the specific distribution of economic power prevailing in the

[11] R. Frydman and A. Rapaczynski, 'Insiders and the State: Overview of responses to Agency Problems in East European Privatisation', *The Economics of Transition*, 1, No.1, 1993, pp. 39-61.

[12] A useful starting point for the agency approach is E. Fama, 'Agency Problems and the Theory of the Firm', *Journal of Political Economy*, 88, 2, April 1980, pp. 288-307; and for the separation issue see A. Fama and M. Jensen, 'Separation of Ownership and Control', *The Journal of Law and Economics*, XXVI, June 1983, pp. 301-50.

[13] Cf. the studies by R. Frydman, E. Phelps, A. Rapaczynski and A. Shleifer, 'Needed Mechanisms of Corporate Governance and finance in Eastern Europe', *Economics of Transition*, I, No.2, 1993, pp. 171-207; E. Voszka, 'Spontaneous Privatization in Hungary' in J. Earle, R. Frydman and A. Rapacznski (eds), *Privatization in the Transition to a Market Economy*, Pinter, London, 1993.

particular country under consideration. In Hungary and Russia, for example, managers generally have greater discretion than in either Poland, where employees have more influence, or in Romania, where the state bureaucracy is strong.[14] To date, few researchers have dealt systematically with discretionary managerial behaviour in the actual conditions of transition.

This study set out to overcome our lack of knowledge of managerial behaviour and enterprise adjustment in Bulgaria by the adoption of two separate but inter-connected approaches. The first was to survey longitudinal data available from the Central Statistical Office on ownership and forms of organisational control. The second was to conduct a first hand empirical investigation of the property rights, governance structure and managerial behaviour of a selected number of Bulgarian enterprises. In total, 127 firms were surveyed, including 24 SME's, over a five year period. The theoretical base of the study was the recent property-rights literature.[15]

Our principal objective was to identify company control structures and, in particular, to consider who actually owned company assets, who precisely assumed the residual risks of operation, who were the key decision-makers and, last but not least, who possessed the power to nominate members of boards of directors. We quickly realised that some of the standard criteria relating to the types of control identified in the existing literature does not adequately reflect the reality of enterprise transformation in Bulgaria

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[14] M. Boyckom, A. Shleifer and R. Vishny, *Privatizing Russia*, MIT Press, Cambridge Mass, 1997; J. Earle and D. Sapatoru, 'Incentive Contracts, Cooperate Governance and Privatization Funds in Romania', Seminar Papers Series No.22, The Cracow Academy of Economics, May 28 1993; M. Belka, S. Estrin, M. Schaffer and I. Singh, 'Enterprise Adjustment in Poland: Evidence from a Survey of 200 Private, Privatized and State-Owned Firms', CEP Discussion Paper No.233, April 1995; and M. Bornstein, "Russia's Mass Privatisation Programme", *Communist Economies and Economic Transformation*, 6, No.4, 1995, pp. 419-56.

over 1992-96. The formal ownership of a block of company shares, for example, is only one indicator of several, and does not automatically determine who wields real decision-making authority within a given company. The more important criteria for the types of control in enterprises are qualitative. As far as governance structures were concerned, two features of the standard approach are worth mentioning at this stage. First, in order to grasp the trajectory of possible future governance structures after the privatisation of state enterprises, a standard economic efficiency assumption is useful to bear in mind. Second, abstract reasoning for and against one or other governance mechanism can yield helpful templates.[16] These theoretical considerations also enable us to view the evolution of Western corporate governance structures as possible exemplifies or reference points. However, any serious attempt to explain the rather unusual situation pertaining in many post-communist enterprises must always allow for national, regional, local and sectoral differentiation. In this respect dedicated empirical studies are essential and, although the transitional time frame has been short in Bulgaria, they need to be informed by an appreciation of institutional dynamics.

Our survey covered the pivotal early period of transition extending over 1992-96, and was conducted under the auspices of the Bulgarian Academy of Sciences. Since data collection is difficult to organise in current circumstances it was necessary to phase and chronologically space the investigations as follows:

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[15] A good starting point is: E. Furubotn, and S. Pejovich, 'Property Rights and Economic Theory: A Survey of Recent Literature', *Journal of Economic Literature*, X, December 1972, pp. 1137-1162.

[16] Z. Acs, and F. Fitzroy, 'A Constitution for Privatizing Large Eastern Enterprises', *Economics of Transition*, 2, No.1, 1994, pp. 83-94.

(1). To begin with, information was obtained from 82 incorporated state-owned firms (of which 15 were SME's) between 1992-94; and was then followed-up by enquiry of different ownership regimes over the succeeding financial year.

(2). Concurrently, but with a focus on the base transition year of 1992, ten incorporated industrial joint-stock companies were surveyed. The sample included enterprises of different capital sizes: 'small-scale' i.e., those with an authorised capital of under 10m. *leva* (to $428,000 at the current exchange rate); 'medium-scale', of 10-20m. (to $857,000); 'large-scale', 20-100m. (to $4.3 m); and 'very large-scale' with over 100m. The capital of these companies was determined according to their book value before any (artificial) asset revaluation. The companies represented 5% of all registered small-scale industrial joint-stock companies; 14% of the medium-sized; 10% of the large-sized; and 11% of the very large-scale in their respective sectors. The study took the form of structured interviews with managers. Detailed information was collected on five major subjects: ownership and methods of management; the motivation of key shareholders; the power and influence of the board of directors; the limits of managerial discretion; and the conduct and performance of the companies.

(3). To extend the range of enterprises covered, a further study was conducted in 1993. This examined two large sole-trader, industrial, joint-stock companies. Here we relied upon a standardised interview with the key managers. The emphasis was placed on unravelling ownership structures, the effect of 'shocks' caused by reforms to the legal system, and an identification of short- and medium-term business strategies.

(4). In 1994-95 we were able to increase coverage of industrial enterprises to 23 sole-traders and 47 sole-trading limited-liability companies. Of the 70 firms represented

14 were SME’s. A questionnaire was drawn up which addressed a broad spectrum of problem areas including ownership and market structure, the influence of state regulation, the mode of governance and plans for company restructuring. The respective managing directors were requested to complete the document in person.

(5). The final study was conducted at the end of the period under review, i.e., 1996. We collected data from a random sample of 45 industrial firms of different types including state-owned; incorporated state-owned; former state-owned firms which were subsequently privatised; and newly established private firms. In the sample were 9 SME’s. The information we requested was of two main kinds. First, quantitative, i.e., data from the income statements and balance sheets of the companies, and other statistical information supplied routinely to the Central Statistical Office. Second, qualitative, i.e., data on ownership and control; governance mechanisms for settling conflicts of interest between owners and managers; the composition of the board of directors; market power and government control; the extent of the influence exerted by different economic actors on the decision-making process regarding sales, employment and investment; and, finally, different aspects of enterprise behaviour, including policy on sales, employment and exports. The questionnaires took the form of a series of iterative consultations with the managers.

Taken together a good deal of company-level data centring on Bulgaria’s industrial sector and relating to property rights, managerial strategy and enterprise adjustment was gathered. Considerations of space have set limits to our description and analysis of the research. In the following sections we try to distil some of the essential points and to report the relevant findings of the panel survey. We commence with the changing nature of the patterns of ownership.

**Legal forms of Ownership**

The national context may be gleaned from the data presented in Table 1. In just five years the share of the private sector has doubled in size when expressed as a percentage of Bulgaria's (officially recorded) gross domestic product. By the end of 1996, private enterprises accounted for more than half of the total and this has continued to grow so that in mid-1999 it now stands at 60%.[17] However, notwithstanding the sustained growth recorded between 1992-96, the share of the private sector remains rather modest with regard to both national demand and in comparison with other East European countries.[18] Moreover, the private distribution, when considered by branch, is quite uneven. Not surprisingly perhaps, private retail trade with more than three-quarters of the total, and construction, with just under 60%, dwarf the still very minor share attributable to private industry. Thus, when our study began in 1992, the overwhelming ownership form in the industrial sphere was public, and even at the terminal point, 76% of secondary-sector output was accounted for by publicly owned enterprises.

If the creation of new private enterprises is the major factor which contributes to the development of the Bulgarian economy the overall picture is rather mixed. The share of privatised state-owned enterprises remains relatively small. Indeed, privatisation has

[17] NSI, Statistical Year Book of Bulgaria, Sofia, 1998, and *Transition Report, 1999*.

made relatively little progress, and up to the present has been applied mainly to small and medium-sized businesses. Only 1558 enterprises were privatised in the period 1992-95, the major number being municipal properties or single units carved out of large, unwieldy state enterprises. Substantial progress was achieved in 1996-97. This was connected with the 'finalisation' plans announced by a number of large-scale enterprises as well as the completion of the first stage of the so-called 'mass' privatisation scheme. About 1,000 enterprises were privatised through vouchers.

The main changes in state-owned enterprises are related to their transformation to corporate status. In general, this process has taken place mainly in the first year following the adoption of a new commercial code in 1991, but developed at a considerably slower pace over the years since then. Subsequent to 1993 the number of non-transformed state-owned and municipal firms halved. For a considerable period the government protected state enterprises which were - and still remain - in a deep financial crisis. Down to 1993 financial support for the state-owned firms mainly took the form of government subsidies. In spite of this, many of these state enterprises have been incapable of withstanding normal market pressures. In 1996, and under the influence of international financial institutions, especially the IMF, the government compiled an inventory of indebted state firms and divided them into two groups. First, there were the firms whose condition was considered 'hopeless' and needed immediate liquidation - with all the potentially disruptive consequences, which that step entailed. Second, there were the firms whose financial status was considered to be 'reasonable'. These were placed them

[18] IMF, Bulgaria – Recent Economic Developments**,** Staff Country Report, No.90/13, Washington, 1996. In mid-1999 the Czech Republic, Hungary, Albania, the Baltic States, Slovakia, Poland and even Russia were ahead of Bulgaria in this respect, see *Transtion Report, 1999*.

under a special regime so that eventually they could be stabilised. The programme of 'Financial Treatment of the State Enterprises' announced in the summer of 1996 was intended exactly for this second group. It is still early days to judge the outcome of these measures but both the IMF and the World Bank have not been slow to make this clear to the authorities (World Bank, 1996; and IMF, 1996). There is no doubt that each act of financial support for the state sector by the government means a transfer of real resources (directly or indirectly) from the private sector, and so leads to an increase in the national debt. In this sense the 'Law for the Un-serviced Credit Settlements of 1993', and the 'Law for the Financial Treatment of State Enterprises of 1996' is an indication of the price which the Bulgarian public have been compelled to pay for delaying much-needed structural reforms.

## The Property Rights Regime

The modern property rights literature seeks to examine the effects of ownership structures upon different kinds of business organisation. Our study of the industrial sector deployed such an approach to investigate the ownership structure of newly established private firms; former state-owned units which have been subsequently privatised; and incorporated state-owned firms.

### *(1) Newly established private firms*

Our findings suggest that the ownership structure of these firms can be placed in one of two basic categories. First, many are sole proprietorships. This means that the owner and the manager are invariably one and the same person so that there are few conflicts of interest over property rights. Such firms have similar property structures to the familiar capitalist firm, which dominate the Western economies and are often referred to as the ‘classical’ capitalist type. Second, as comparatively few private enterprises enjoy company status we have characterised their property rights in the following manner: (i), there is a high concentration of assets under the control of a single party; (ii), all the registered shareholders assume the residual commercial risk; (iii), large shareholders sit on the board of directors and have the right of appointment to vacant places; and (iv), the shareholders possess the right to dispose of their holdings by public offer. We found that the key operational property rights feature is that the substantial owners assume the greater part of the risk and so their personal welfare is connected closely with the viability of the concern. They therefore have a vested interest in setting realistic commercial targets and improving performance. Motivation here resembles that of the owner-entrepreneur of the capitalist firm. It is the entrepreneur who runs the risk and is the main initiator of the overall business strategy.

***(2) The Privatised Firms***

The typical property rights structure of privatised enterprises may be described as follows: (i), a single party generally owns a large stake of the assets; (ii), all the shareholders assume the residual business risk; (iii), this dominant stakeholder has the power to appoint the board of directors; and (iv), the shareholders enjoy the legal right to dispose of their holdings by public offer. This structure is thus quite similar to that of the *de novo* category above in that in both types of property rights there is a concentration of assets in the hands of the largest shareholder. However, following on from the ‘mass’ privatisation programme alluded to earlier (1996-97), the structure of ownership has begun to alter. The key change is the dispersion of ownership amongst many small shareholders, fund managers and other financial institutions. In the new situation several novel features (i.e., for Bulgaria) may be identified: (i), there are now many asset owners so that no single agent can acquire dominant property rights; (ii), all the shareholders assume the residual risk-bearing responsibility; (iii), the shareholders enjoy the right of appointing board members; and (iv), the shareholders have the authority to sell off their holdings by public offer. This structure of ownership most strongly resembles the typical type of 'managerial firm' identified in the Western literature. Such enterprises encounter the familiar problem of the separation of ownership from control.[19] The main property rights are vested with the shareholders and managers. The function of risk bearing, at least according to the standard account, is assumed by the shareholders; and, likewise, professionals take on the role of management. Our investigation suggested that in practice, the owners tended to be highly risk-averse and generally large shareholders combined asset possession with managerial duties. When such enterprises are in private ownership the shareholders become the agents who must take the consequences of all managerial decision-making. In fact, as we discovered, the large shareholders invariably maintained very close connections with the managerial team.

***(3) The incorporated state-owned firms***

The property rights regime prevalent in the state-owned companies may be characterised in the following way: (i) there is, naturally, continued state ownership of the

[19] For further elaboration of this point see E. Peev, 'Separation of Ownership and Control in the

assets; (ii) the state assumes all residual risks of the undertaking; (iii) the state appoints the board of directors who then, in turn, designate the management team; and (iv) the state has the right to dispose of its central property owning status and risk-bearing for a term of up to five years. The sole-trader company, which is the most common incorporated state-owned firm, is a transitional form of business organisation standing somewhere between the former (Yugoslav-type) self-managed socialist enterprise and the modern corporation. There is a clear distinction between a sole-trader company and a self-managed socialist enterprise. In the former the employees tend not to hold any of the formal property rights, and this seems to be a rather distinctive feature of sole traders at work in Bulgaria. However, by way of contrast, in Hungary and Poland, workers' councils continue to exist even after the effective commercialisation of enterprises.[20] The similarity between a sole-trader company and self-managed socialist enterprise lies in the preservation of the state ownership of the assets. The main holders of the property rights in a sole-trader company are the government (as owners) and the managers.[21]

According to standard property rights theory state officials and the function of management assume the function of risk bearing by the professionals. However, we found that the state officials were in fact the risk-bearers due to their status as property owners. Following the collapse of CMEA and the transition in Bulgaria in the early 1990s, the actual bearer of the residual risk is the state as erstwhile owner. The managers

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Transition: The Case of Bulgaria', *Europe-Asia Studies*, 47, No.5, 1995, pp. 265-283.

[20] B. Pinto, M. Belka and S. Kraewski, 'Transforming State Enterprises in Poland: Evidence on Adjustment by Manufacturing Firms', *Brooking's Papers on Economic Activity*, No.1, 1994; and E. Voszka, 'Spontaneous Privatization in Hungary', in J. Earle, R. Frydman and A. Rapacznski (eds), *Privatization in the Transition to a Market Economy*, Pinter, London, 1993.

[21] P.Hare and E. Peev, 'The Sole-Trader Company and Managerial Behaviour in a Transitional Economy', Discussion Paper in Economics, No.94/12, Heriot-Watt University, 1994.

and the workers of particular enterprises have no liability with respect to any external difficulties, which are encountered. In practice, we found that state officials try to shift all the costs of transition to the enterprises themselves. The sole-trader company obtains ‘autonomy’ in the sense that it is henceforth free to determine its own product range, to decide which markets to enter or exit, and the scope and degree of its choice of investments. In practice, however, this is really only hypothetical freedom of action (quasi-autonomy). This is because, first, the state remains the ultimate owner of the assets but shifts commercial risk to the companies; and second, the risk-bearer is again impersonal, i.e., the managers or the employees of the enterprise at large.

**Types of control**

According to the tried and trusted classificationary schema originally devised by Berle and Means in the 1930s for the US economy, corporations may be conveniently grouped into five main types of control regime.[22] These are the companies under ‘private control’ - where a single individual, family or financial group owns at least half of the shares; ‘majority control’, where one interested party owns between 50-80% of the holding portfolio; ‘minority control’, where one party usually owns between 20-50%; ‘legal control’ which arises through the use of specifically designed legal devices; and, finally, companies under ‘managerial control’. In fact, as Williamson has shown, the main difference between firms by type of control is the degree of managerial discretion.[23]

[22] G. Stigler and C. Friedland, ‘The Literature of Economics: The Case of Berle and Means’, *Journal of Law and Economics*, XXVI, June 1983, pp. 237-259.

[23] O. Williamson, ‘Managerial Discretion and Business Behavior’, *American Economic Review*, December 1963, pp. 1032-57 and, more generally, *The Economics of Discretionary Behavior: Managerial Objectives in a Theory*, Kershaw, London, 1974.

Although this schema was constructed to provide a basis for studying the evolution of control structures in an increasingly sophisticated and mixed economy, it may also serve – at least as a starting point - for creating a corresponding classification of control in a transitional economy. There is, however, one important caveat. In a context such as that of Bulgaria the formal quantitative stake of corporate assets does not necessarily determine who possesses real control of any particular enterprise. Rather, we need to combine both qualitative as well as quantitative indicators. This is because control may be exercised through a variety of influences that are not obviously manifest through shareholding *per se*. Stemming from our research findings we have identified three basic and one emergent form(s) of control regime, and now proceed to discuss each in turn.

### *(i) Private and majority control*

It was clear from our survey that new private and privatised companies are subject to the control of *either* private *or* majority holdings. As far as the former are concerned, one group of companies we investigated was characterised by a dominant outsider stake of company assets. These 'institutional' shareholders wield considerable leverage of control over the managers; they also exercise control over those companies where there is significant managerial participation in share ownership.

With regard to the latter, i.e., where there is a clear majority regime in place, we found that most of the companies in the surveys were either enterprises with a dominant outsider stake and characterised by active managerial participation or, enterprises with a dominant managerial stake but where one party - invariably the managers themselves - is the largest shareholder. The control structures of these regimes have several key features in common. First, we found that the largest shareholder tends to exercise formal control over key aspects of management. This is accomplished largely through retaining the power to nominate the membership of the board of directors, having privileged access to sensitive company information, and the right to hire-and-fire the management team. This type of regime can well reduce the transactions cost of those responsible for managerial monitoring. Second, as the largest shareholder assumes the greater part of the business risk, he/she has, quite naturally, a strong vested interest in initiating strategies aimed at maximising returns on the capital investment.

***(ii) Control based on ill-defined, un-established property rights and interest groups.***

Despite full proprietary rights, we found that many incorporated state-owned companies are nevertheless under the effective control of the managers and various interest groups. This type of regime rests upon ill-defined property rights and informal influence exerted by groups other than the nominal owner. This appears to be a peculiarly transitional mode of control, and the initial evidence suggests that it is probably quite unstable.[24] The regime fails to determine clearly the identity of the ownership of company assets. It also signally fails to determine the risk-bearer, the effective decision-maker and who is responsible for nominating members of the board of directors. Clearly, in such a regime, there are different degrees of managerial discretion. Apart from the state, interest groups which control incorporated state-owned companies include trade unions, political parties, finance groups and other more indistinct and shadowy entities. As each exerts

[24] For an extended discussion see E. Peev and P. Hare, 'Corporatization and Control in a Transitional Economy', *Economic Systems*, 19, No.4, December 1995, pp. 265-83.

various forms of pressure upon the management team, at this point in time it is difficult to generalise about the actual effect of such mechanisms of control on performance.

***(iii) Retained and clearly defined government control***

Among the state-owned companies represented in our sample, we did identify units with purposefully retained and clear government control mechanisms in place. Good examples are to be found in the energy sector. But their number is still absolutely small and this control structure is by no means typical of the companies with full state participation.

Several specific features of control were observed during our investigation. First, in the private sector, there was evidence of strong forms of owner control. This is at the crux of constraining discretionary managerial behaviour. Second, a number of the standard ‘rules of the game’ explicit or implicit in the currently prevailing new quasi-market conditions do not seem to be properly observed. For example, it did not take us long to discover that with regard to the payment of taxes, and meeting promptly the obligations of social insurance payments, there were indications that managers were attempting to evade their responsibilities by late-, under- and, in some circumstances, even non-payment. Under these circumstances it is very difficult for owners to decide if poor enterprise performance is a result of managerial mistakes (or *vice-versa*). Third, in the state-owned companies, the formal governance structures revealed a lack of convenient institutional mechanisms for disciplining managers and defining the broad scope of their discretion. However, there are undoubtedly informal control mechanisms which influence the behaviour of the managers. One such is the in-built conflict between different interest groups for control over a given company. Indicators of this rather unorthodox ‘market for corporate control’ are the extent of involvement of entities - other than those nominally authorised - to appoint the board of directors; to hire managers; to become occasionally involved in the day-to-day routine of running of the company; and finally, and perhaps most sensitively, the high incidence of executive turnover. But the quasi-market situation continues to delay the process of privatisation and, by extension, maintains implicit forms of managerial control.

### *(iv) Managerial and minority control*

Although it is rash to anticipate future modes of control with any confidence, on the basis of experience elsewhere and, given what has transpired to date within Bulgaria, it seems reasonable to argue that a dispersed ownership structure will materialise once the forthcoming mass privatisation programme has been accomplished. The larger the enterprise the more likely it is that existing shareholders will lose their grip upon the asset base. In such circumstances managerial and minority types of control can be expected. Further, ownership may well become more attenuated from management – with both the positive as well as the negative effects of this separation becoming apparent.[25]

## Governance Structures

[25] E. Peev, *Europe-Asia Studies*, *op.cit.***,** pp. 265-283.

Agency problems are likely to arise between shareholders and managers as a consequence of conflicts over the choice of appropriate business strategy, and different degrees of risk aversion. Because owners generally assume the greater part of the commercial risk they are obviously interested in pursuing the most efficient ways of maximising returns on capital invested. They therefore try to put in place specific governance mechanisms to avert- or at least reduce- managerial opportunism and shirking. It was therefore necessary to identify which of the governance structures exert the most telling influence upon the disciplinary process. Part of our research was therefore directed to uncovering the most common governance structures put in place during this early stage of the transition.

We first investigated the question of ownership concentration. A significant degree of concentration of company assets in the hands of a single party appears to be the most important governance mechanism in use in both newly established private enterprises and recently privatised firms. Concentration implies that significant shareholders are likely to receive reliable information on company performance. The shareholders have broad enough powers to remove awkward or recalcitrant managers. In their turn the management team feel under pressure to pursue maximising strategies which are in the best interests of the shareholders.[26]

Our results suggest, too, that conflict over corporate control between senior managers, employees, state officials and outsider interest groups generally ceases in state-owned enterprises once privatisation has been effected. The strong control exercised by large shareholders appears to transform the behaviour of the agents. In our view this has

[26] In a fully competitive environment, the primary role in disciplining managers falls upon the shareholding risk-bearers, see M. Jensen and W. Meckling, 'Theory of the Firm: Managerial Behavior

created a more effectual structure of governance prevailing in firms with full state ownership intact. If the government shifts responsibility onto state-owned enterprises to carry out reform, there is the possibility that the state itself becomes opportunistic. In such situations, there is plenty of room for managerial discretion but only within the confines of overall state directives.

A second governance structure revealed by the fieldwork relates to managerial ownership regimes in private and recently privatised firms. Here managers acquire the assets of companies via acquiring a stake in the share issue. This was seen to be an advantageous mechanism in that it clearly unites owners and managers into a single entity. There is evidence from elsewhere in Eastern Europe and Russia amongst both large-scale and small-scale enterprises that such a structure has generally efficient outcomes.[27]

In the private and recently privatised enterprises and which have already been established, we found that most boards of directors possessed real power and wielded considerable influence. Indeed our research indicates that this 'classical' body of governance does exercise significant influence upon the strategic direction of these enterprises. Senior managers have a seat on the board of directors in many of the companies surveyed. This suggests that their stake in the ownership help to motivate private sector managers. By way of contrast, in the state-owned sector, the composition of

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Agency Costs and Ownership Structures', *Journal of Financial Economics*, 3, October 1976, pp. 305-360, and E. Herman, *Corporate Control, Corporate Power*, MIT Press, Cambridge, Mass, 1981.

[27] Cf. J. Earle, R. Frydman and A. Rapaczynski (eds), *Privatization in the Transition to a Market Economy*, Pinter in association with the Central European University, London, 1993; R. Frydman, A.Rapaczynski, J.Earle *et al*, The *Privatization Process in Central Europe*, Central European University Press, Budapest, 1993; R. Frydman, *Small Privatization: The transformation of Retail Trade and Consumer Services*, Central European University Press, Budapest, 1994; K. Schmidt and M. Schnitzer, 'Privatization

the board of directors is determined by the government and, in certain circumstances, by other interest groups. There is therefore a tendency towards a ‘hands-off’ style of governance. Our research revealed that in these cases the role of the board is passive. Enterprise adjustment to new business conditions therefore depends more on the personal qualities of the management team and the specific set of incentives on offer, rather than the operation of clear governance mechanisms.

As a supplement to our investigations we sought to study the relationship between governance and the functioning of capital and managerial labour markets. As far as the former are concerned, senior managers in both private and state owned firms revealed few definite plans for active participation. Similarly the market for managerial services remains in a fledgling state. Both markets are still undeveloped and, and a result, there are few clear incentives to control management teams.[28] In the private enterprises, which were surveyed, transaction costs remain modest because of the relatively high degree of ownership concentration and the increasing extent of managerial participation in the share ownership. Transaction costs, however, may well rise in the near future subsequent to the planned mass privatisation’s. It seems likely that the more dispersed the asset base becomes, the greater the need will be for effective monitoring of management – especially by the smaller shareholders. If these trends do materialise, new governance structures are likely to be introduced in order to lower transaction costs. Of course, a key variable will be the general macroeconomic environment.

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and Management Incentives in the Transition Period in Eastern Europe’, *Journal of Comparative Economics*, 17, 1993, pp. 264-287.

[28]For an interesting discussion see E. Davila and V. Fleck, ‘Chief Executive Officers and Participation in Decision Making in the Enterprise Sphere’, *Eastern European Economics*, Spring 1992, pp. 73-90.

In our survey, managerial perceptions of this macro environment were investigated. The overwhelming view in the private and recently privatised firms was that the move towards an owner-manager regime would induce managers to pursue efficient, maximising strategies. Compared to the socio-economic situation in the period immediately prior to the transition, the current business climate has improved immeasurably. Many of our managerial respondents were looking forward to facing the competitive challenges of the new millennium, and the opportunities arising from Bulgaria's application for membership of the EU.[29]

## Concluding Comments

As the Bulgarian economy has been especially volatile throughout the 1990s, managerial motivation and behaviour was bound to fluctuate in a rather damaging fashion - at least in the short-run. The reaction of the different agents to this obviously unsatisfactory situation, as revealed in our investigation covering the pivotal early period of 1990-92, may be gauged, at least in part, by the following observations. First, managers who have invested their human capital into a single company, quite clearly obtain an income flow dependent upon the success or failure of the strategies adopted. They are highly motivated, hope to retain their jobs and therefore represent an effective set of agents.

[29] For an outline sketch of the immediate pre-transition period see R. J. McIntyre, *Bulgaria: Politics, Economics and Society*, Pinter, London, 1988; and for EU admission compare the *Economist* 18-24 December, 1999, report on the HoG Meeting in Finland which considered serious candidature with EUROP, 'Commission's Opinion on Bulgaria's Application for Membership of the EU', *Bulletin of the EU*, Supplement 13/97, Luxembourg, 1997.

Certainly in our survey there is robust evidence that the managers seemed to take their responsibilities seriously and were able to make a definite contribution to raising the efficiency threshold of their firms. In our view they would be the most appropriate organisational entity in the new rounds of privatisation that lie ahead.

Second, boards of directors of state-owned, joint-stock companies seem to lack the necessary authority so long as the government remains the ultimate asset owner. Proceeding from our observations based upon the fieldwork, it may be assumed that boards will be concerned with stalling the intended privatisation process or, in so far as this lies within their power, in directing the process in such a manner as to ensure that board members stand to gain personal advantage. A particularly retrograde position is occupied by non-executive board members - most state officials appear to perceive privatisation either as a means of perpetuating their position in future privatised enterprise, or of maximising any advantage which they personally can draw from the process of privatisation itself. The state officials who sit on the boards try to spread as much commercial risk as possible across the state administration – most usually their respective ministries, or across the economy at large. They are certainly less committed to the survival of any particular enterprise than the actual sitting management team.

Third, with respect to the various interest groups, especially the trade unions and political parties, under the prevailing circumstances of ill-defined and un-established property rights, although they have acquired formal ownership – it is without, however, assuming significant liability. Their role in management seems to be as damaging as that of existing boards of directors. The emergence of 'genuine' owners in a full privatisation process might restrict their control. It may therefore be predicted that, spurred by their own interests, the leaders of such groups - drawn from all colours and political persuasions – will either try to stall all radical change that comes on the horizon or to squeeze it into a mould that suits them best. The tactic could be to attempt to reserve a large portion of the property for ‘insiders’.

Between 1992-94, however, the picture of different control structures and management behaviour in state-owned companies became more diverse. In some enterprises we found that the battle for corporate control continued but, in others, the controlling party desperately attempted to ensure a continuation of future influence by undertaking a more active role in enterprise affairs. With respect to managerial initiatives for privatisation, in several of the companies we studied the managers did develop a coherent strategy for resolving the problems of ill-defined and un-established property rights by taking initiatives of their own. Despite all the difficulties of the quasi-market environment to which we have alluded, they have acted decisively to restructure and, indeed, some of the privatisation proposals originated from employees – although admittedly, most came from the managers.

As far as managerial initiatives for restructuring without privatisation are concerned, we found that there were several state-owned companies where managers were actively seeking adjustment to the new conditions but without proposing any initiative for privatisation themselves. This kind of managerial behaviour appears at least on the face of it, to contradict the conventional wisdom that only private owners can restructure former socialist enterprises.

Finally we evaluated ‘passive’ adjustment and management. In several of the companies, which we investigated, the managers sought extra-company services for marketing and financial advice in a bid to adjust to the new environment. However, the effectiveness of external service-providers is generally not considered to be very productive at this juncture in Bulgaria's transition. In these cases, then, the managers often seemed to expect ‘somebody else’ to take the initiative and set the business agenda. Within this category of enterprise the managers appeared to lack market initiative and indeed many tended to rely upon the government to bail them out of difficulty – and sometimes even to help solve outstanding commercial problems. The main strategy appeared to revolve around the retention of the existing labour force of the company in question and to reserve the managerial positions for those already in post. Any adjustment is therefore a consequence of the paramount need for survival rather than an outcome of any novel and path-breaking ownership and control structures being introduced.

Our overall assessment of the managerial behaviour of privatised firms does suggest that an optimistic outcome is possible. Of course more research is needed to validate this contention, but from our survey of 1995-96, there is evidence of active new investment programmes and technological acquisition. This indicates that the new private property rights regime is actually inducing novel modes of behaviour, and helping to create a more appropriate system of incentives.[30] This bodes well for enterprise adjustment in the medium to long run. Furthermore we found that there were managers of newly established private firms, and some state-owned companies, who are in pursuit of

[30] Such a verdict is broadly consistent with a recent IMF survey of all transition economies. See O.Havrylyshyn and D.McGettigan, “Privatization in Transition Economies: Lessons of the First Decade” *Economic Issues*, 18, August 1999.

enhancing unambiguously market-oriented strategies in terms of improving product quality, embracing fresh marketing initiatives, seeking new domestic and foreign outlets, and re-thinking their pricing policy in response to the behaviour of competitors. However these positive signals must be set against the enormity of the multi-faceted challenges of transition. The picture is still too confused and varied to draw robust general conclusions from a representative, but necessarily limited sample of enterprises. That acknowledged, very many hurdles and difficulties lie ahead. Indeed, if Phinnemore's gloomy prognosis that Bulgaria is far away from establishing even the 'easiest' of the conditions for EU membership – let alone putting into effect the stringent *Acquis Communautaire*, the entire liberalisation programme may be put into jeopardised.[31] This would have dire consequences for the fledgling modern business sector.

[31] D.Phinnemore, 'Association and Accession Partnerships – Steps Towards Membership or de facto Satelliisation', paper presented to the 4'th UACES Conference, Panel 27, University of Sheffield, September 1999.

**Table 1 The share of the private sector in the gross value-added of Bulgaria, 1992-96 (%, rounded)**

| | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|
| GDP | 26 | 34 | 40 | 48 | 52 |
| Industrial Production | 3 | 4 | 8 | 11 | 14 |
| Construction | 24 | 41 | 50 | 62 | 59 |
| Retail Trade (sales) | 46 | 57 | 69 | 76 | 77 |

Source: National Statistical Institute of Bulgaria, Sofia, 1998.

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