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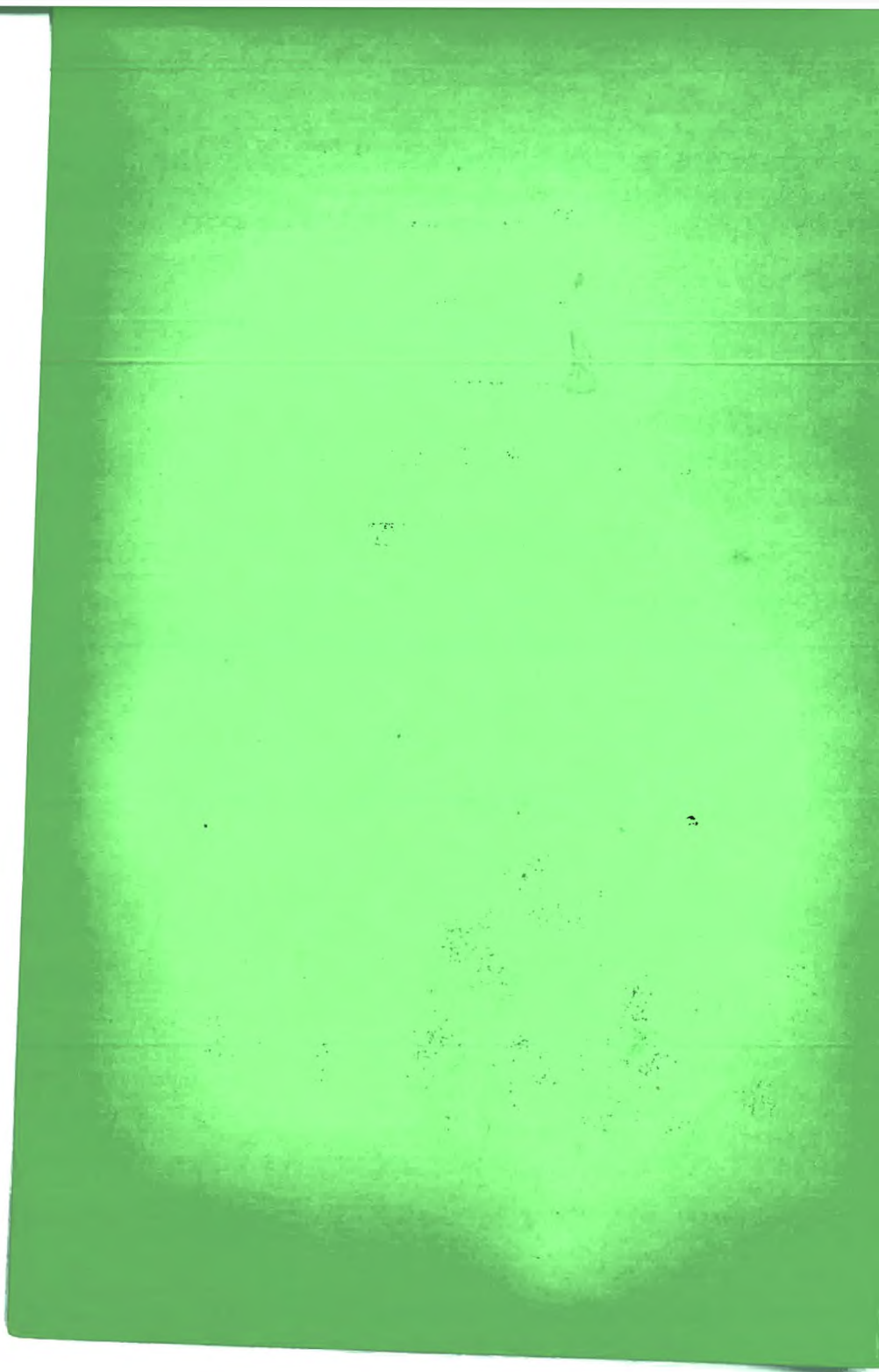
TO A FREE SOCIETY

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November 3 - 6, 1991

Prague, Czechoslovakia



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In Search of a Transition
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THE CONTROL OF THE LARGE
CORPORATION

by

Harold Demsetz

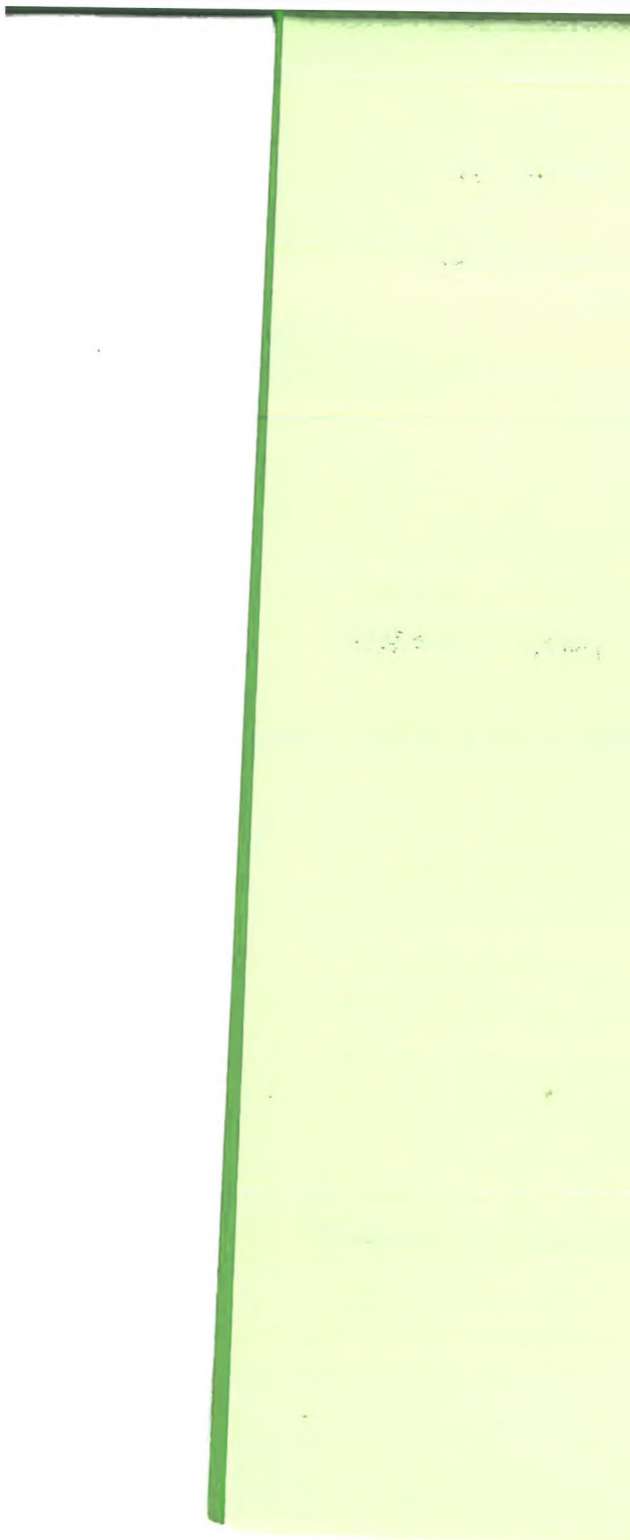
Session 5: Structure of Ownership of Business and Incentives

Speakers: Harold Demsetz

Ingemar Stahl

Discussants: Jean-Jacques Rosa

Dušan Tríska



THE CONTROL OF THE LARGE CORPORATION
with special reference to the
Effects of Ownership, Regulation, and Wealth

(Prepared for the 1991 Prague Mont Pelerin Meeting. Copyright by author.)

by

Harold Demsetz

As East Europe reorganizes it faces a long list of puzzles about which Western institutions it should emulate and which not. To cite one important example, should regulations like the U.S. antitrust laws be adopted to guide and constrain enterprise or should the West European approach be favored? Many of these institutional arrangements have been studied in the West, but these studies seldom voice the same conclusions. Informed discussions and analyses of important Western institutions may be useful during this reorganization. With this in mind, I speak today about the large, modern corporation and its control. The importance of this form of ownership is revealed by the extensive use made of it in the West. Notwithstanding this popularity, it is a form of ownership suspected of differing from true private ownership and accused of weakening the control that owners exercise over their resources. The East European transition is sure to come up against the puzzle of corporate ownership.

The basic concern about the corporation is, of course, the separation issue. It is asserted that stockholders, the joint owners of a corporation, possess little control over those who professionally manage corporate assets. This, because ownership is too diffuse to allow any one owner or small group

of owners to mount a meaningful effort to monitor and discipline management. Ownership is said to be separated from control. This, in turn, weakens the assurances we have that private ownership will put resources to their highest value uses.

The separation thesis has been around for some time. Even Adam Smith voiced an early concern in his The Wealth of Nations with this form of ownership, precisely because he believed that those who manage the funds of others cannot be expected to do as good a job as if their own funds were at stake. Its adherents, along with many contemporary economists, include T. Veblen (1921), Berle and Means (1933), J. K. Galbraith (1967).

The thesis appears to be much like that which popularly explains the failings of socialism. One of the central problems of socialism is that if all citizens are in principle owners of state property than no person qua citizen can exercise control over this property. Ownership is simply too diffuse to be effective. It then becomes the task of state bureaucracies to manage this property. State employees, however, have interests that do not coincide with those of the population at large. Hence, a separation between ownership and control arises and undermines the credibility of socialism. In the separation thesis, professional management substitutes for state bureaucracies.

However, socialized property and jointly owned corporate property are far from being equivalents. Socialized ownership is coerced into being, corporate ownership is devised voluntarily. Given the facts of economic development and per capita wealth in East and West, we can only surmise that if there is separation between ownership and control in the large private corporation it is less severe by an order of magnitude from what it is in the

socialist state.

Several studies of corporate takeovers, undertaken mainly in the U.S. during the 1980s, provide evidence of at least some instances of a separation between ownership and control. These studies show that shareholders of target companies benefit considerably from a takeover of their firm. Successful takeovers increase share prices of target firms on the order of 30% (Jarrell, Brickley, and Netter, 1988). The increase may derive in part from tax considerations, in part from changes in pre-existing arrangements with other input owners, particularly debt holders, and in part from over optimism on the part of bidders, but the dominant view taken by economists is that takeovers remove entrenched and inept managements.¹ The existence of entrenched, inept management is consistent with the separation thesis. It should be noted, however, that a very small fraction of corporate assets has become the target of takeover attempts. This can be interpreted as statistical support for a proposition contrary to the separation thesis -- that most modern corporations are not afflicted by significant separation between ownership and control.

The separation thesis is based on a view of corporate ownership that sees this as hopelessly divided among thousands of small shareholdings. All who endorse the thesis accept this view, either explicitly or implicitly. These thousands of shareholders are seen as turning control of "their" corporation over to professional management without possessing the means by which to influence what management does. No one such owner, or small group of

¹Evidence to date seems to indicate that target company gains do not derive from wealth transferred from bond holders (Jarrell, Brickley, and Netter, 1988), and, although management personnel are released in proportionately large numbers from target companies as a result of their takeover, the mass of laborers are not.

such owners, has the incentive and ability to do much controlling of professional management's behavior. Shareholders dissatisfied with management's performance, but incapable of affecting it, simply sell their shares. Professional managements, insulated from the wrath of shareholders, are inclined to use the firm's assets to serve their own objectives rather than those of shareholders, although their behavior in this regard may be tempered somewhat by the need to raise additional capital in the equity markets. Enterprise resources are put to uses that fail to maximize enterprise value.

This indictment of the modern corporation creates its own puzzle. Since the corporation, including its ownership structure, arises from contractual agreements voluntarily entered into, the separation thesis implies that serious, systematic, and persistent errors are made by those would-be owners of the shares issued to form the corporation. They fail to anticipate that they are abandoning control over their assets. This goes contrary to the beliefs generally held by economists that all parties to a voluntarily reached agreement expect to benefit from the agreement, and, if the agreement is used repeatedly and extensively this expectation is usually correct. At its core, the separation thesis rejects these beliefs.

All adherents to the separation thesis accept as fact that corporations are owned in the diffuse fashion required to undermine the incentive and power of shareholders to influence management. This fact simply is incorrect. That thousands of shareholders jointly own the typical large corporation is true, but recent studies (for example, Demsetz, 1983, and Demsetz and Lehn, 1985) show that not every owner of corporate stock owns an insignificant number of shares. A few of the thousands of shareholders usually own a relatively large

fraction of the firm's equity. The typical large corporation has a more concentrated ownership structure than serves the separation thesis well. For U.S. corporations as large as the Fortune-500, the five largest shareholders, taken as a group, own approximately one-fourth of outstanding equity. For Japanese and several important European countries, this fraction is much larger. The general case, then, is one in which a relatively small number of shareholders have well focused interests and non-trivial blocs of votes. Facing such concentrated share holdings, professional management cannot be as unguided by shareholder interests as the separation thesis supposes, although there surely are some cases in which ownership structure has become too diffuse to serve shareholder interests well. When this is the case, ownership should be restructured.²

Restructuring takes place in two ways. Corporate takeovers provide a dramatic mechanism for converting diffuse ownership structures into highly concentrated ownership structures. Less dramatically but more continuously, ownership is restructured through the normal issuing and purchasing of equity shares. At any given time the diffuseness with which shares of firms are held varies across corporations, but restructuring should adapt ownership

²There are several ways by which professional management can be guided to serve shareholder interest in the modern corporation -- concentrated ownership (achieved through the normal financing of corporations or through corporate takeovers), the consequences of the capital market's measurement of management performance, legal proceedings, and compensation systems. Unfortunately, time and space allow me to consider here only concentrated ownership. This is unfortunate especially in regard to executive compensation, for there are new empirical results to report about this. It is improbable that all these mechanisms transform the modern corporation into a precise analog of the firm pictured in neoclassical theory, but they do raise serious questions about the Berle and Means thesis.

structures to the different situations confronted by different firms. This implies that observed structures should bear a sensible relationship to these situations. More specifically, we may posit that variations in ownership structure reflect the benefits and costs to shareholders of controlling professional management more tightly. The pattern that is revealed is consistent with this. Ownership structures are more concentrated when the benefits to shareholders of tighter control are higher and the costs are lower. This suggests that ownership structures are devised to maximize profit, even for the large corporation's shareholders.

Concentrated ownership (and, therefore, tighter control over management) comes at a cost. If this cost is high, the ownership structure that is truly profit maximizing cannot not look much like that of the single-owner firm. This is the case in particular for very large firms because size of firm correlates with one of the major costs of concentrated ownership -- the bearing of firm-specific risk. Because controlling shareholders tend to have a large fraction of their wealth invested in a single firm, they are exposed to firm-specific risk. The larger the firm the larger is the wealth they must commit to own a controlling share of equity and, hence, the greater is their exposure to firm-specific risk. The risk adjusted profit maximizing ownership structure for large firms, contrary to what is suggested by the separation thesis, is not the single owner firm.³ It is a more diffuse ownership

³I speak somewhat loosely in reference to risk-adjusted profit as the goal of controlling shareholders (who bear firm-specific risk). Suppose a real corporation is owned by a single person, and suppose further that he guides his professional managers without error to pursue his chosen ends. While risk-adjusted profit always looms important to this owner, it need not be his sole concern. He might derive satisfaction from owning a larger firm even if it is less profitable, or from using the firm's assets to otherwise cater to personal utility maximization. The reduction in profit he thereby bears must not be thought of as a loss sustained because an agency problem

structure because the cost of bearing firm-specific risk should be reflected in the optimal ownership structure. Nonetheless, this structure should be one in which enough shares are owned by a few shareholders so that they can exercise more than a modicum of control over professional management. The data reveal precisely this -- greater diffuseness in ownership structure for larger firms accompanied by enough concentration of ownership to imbue large shareholding interests with influence over management. Moreover, the pattern exhibited by ownership structures in the U.S., which suggests that shareholders choose ownership structures that maximize the value of their firms, has been confirmed for Swedish firms (Bergstrom, C. and Rydqvist, K., 1990), Japanese firms (Prowse, 1991 (2)), and South African firms (Gerson, J., 1991).

Of course, management cannot be disciplined so thoroughly by controlling shareholders, and by the threat of corporate takeovers, that ineptness is "dethroned" at once wherever and whenever it exists. Nothing is certain, even ineptness and its undoing. It is important to remember that ownership is not structured exclusively for the purpose of dealing with ineptness. Other things matter to ownership structure, such as the avoidance of firm-specific risk. If ownership is structured to maximize risk adjusted profit it must not be so tightly structured that all error in judging professional management is eliminated. Moreover, since there is a cost to altering the structure of ownership quickly, profits are also maximized by tolerating a

separates his interests from management's behavior. There is no agency problem here, there is simply the recognition that in cases such as this profit maximization for the owner does not equate to utility maximization for the owner. This may also hold for degrees of ownership concentration less than the 100% just assumed.

lag between evidence of ineptness and altering ownership structure appropriately. Things will get "out of whack" on occasion, and when they do for a long enough period, dramatic restructuring of ownership is more likely to be called forth in the guise of the corporate takeover. Corporate takeovers, like ownership structures, also are not random. Target firms generally are those that have not been performing well, that have unwisely acquired and retained assets through prior mergers (Mitchell and Lehn, 1990), and that have ownership structures too diffuse to link management behavior tightly enough to shareholder interests.

All of this evidence does not mean that corporations are run the same as they would be in a riskless, perfect information world. It means that the separation thesis is suspect in the real world of corporate control.

Yet, there is a puzzle in the data. Even for given values of variables, such as firm size and firm-specific risk, that sensibly influence the ownership structure of corporations, there exist large differences across countries in the mean level of ownership concentration. Ownership is noticeably more diffuse in U.S. corporations than in Japanese, European, and South African corporations. In the typical large corporation in the United States the top five shareholders, as a group, own about one-fourth of the typical large firm's outstanding voting stock. Most corporations traded on the South Africa's Johannesburg Stock Exchange are controlled by smaller shareholder groups who own fifty percent or more of voting stock (Gerson, 1991). Ownership structures in Germany and Sweden (Sundqvist, 1986) are more like South Africa than the United States. In Japan, the five largest shareholders own about thirty-three percent of voting shares (Prowse, 1991(2)). These differences are so large, especially between the U.S. and

these other countries, that we must suspect something is missing from our analyses, and that this missing explanatory variable varies in strength across countries. If a five shareholder group owning one-fourth of the voting equity of the typical large corporation is a suitable ownership structure in the U.S., why is it not in other countries?

Shareholder control seems more costly to establish in the typical large U.S. corporation than in the typical large non-U.S. corporation. A plausible source of this difference lies in the variation across nations in regulations that impinge on ownership structure.

Consider the Glass-Steigal Act. This U.S. law has been "on the books" since the years of the Great Depression. Its avowed purpose is to insulate banks from losses suffered by other types of businesses. There is no counterpart to this law in South Africa and much of Europe, and only recently has Japan adopted a similar law. Glass-Steigal bars U.S. banks from investing in stock equities, thereby forcing corporations to raise equity funds from other sources. This prevents banks from directly controlling business firms. More generally, it raises the cost to firms of acquiring equity capital because banks would be natural conduits of this capital. In fact, banks play important equity roles in other nations, where they supply enough equity to own sizeable positions in corporate ownership structures. Glass-Steigal raises the cost of maintaining corporate control and may be an important explanation of the fact that large U.S. corporations have ownership structures much less concentrated on average than foreign corporations. This connection is not generally recognized (but see Prowse, 1991(1), and Gerson, 1991).

U.S. laws also hamper the ease with which insurance companies and

pension funds can establish and maintain controlling ownership positions. These laws generally put pressure on institutions to maintain diversified portfolios and to avoid taking large positions in a single company. The rationale for this pressure is to reduce the risk to persons whose funds are housed in these institutions. The cost of creating and maintaining control in U.S. corporations is raised again in the U.S., but I have no knowledge as to whether other countries have similar laws.

There is another clear difference between the U.S. and the other countries. The major stock trading market in the U.S., the New York Stock Exchange, requires that the firms that it lists raise their equity capital on a one-share, one-vote basis. The NYSE did not always use this standard but adopted it during the decade of the 1920s under considerable pressure from government and intellectuals who feared that the growing use of stocks carrying differing vote entitlements was disenfranchising considerable numbers of providers of equity capital. Non-voting equity shares are used much more extensively in other countries. This makes for a lower cost of establishing controlling equity positions in a company because only voting shares must be reckoned with when considering the direct control of management.

However, since holders of small positions in the voting equity structure of even NYSE listed corporations do not play an active role in corporate governance, their stock is de facto non-voting stock under normal circumstances. But, there always exists the potential for a contest for control, and when one takes place the voting privilege latent in non-controlling shareholdings becomes a problem for controlling owners. Because of this, the presence of diffusely owned voting shares raises the cost of

maintaining a controlling position in the ownership structure of the corporation, a cost that would not be borne as heavily if a portion of the firm's equity could be raised through the sale of non-voting shares.⁴

Public interest arguments can be made to support and oppose reliance on voting shares to obtain equity capital. Similarly, there undoubtedly exist arguments pro and con in regard to the various legal hurdles that keep important conduits of capital from easily accessing the equity markets.

Whatever the truth in this regard, I do not believe that the impact of these legal hurdles on ownership structure and control is taken into account sufficiently. Taken by itself, the problem created for control by these hurdles offers a novel basis for opposing the one-share, one-vote standard and legislation such as Glass-Steigal.

A final issue remains. It is more subtle and possibly more important than those already considered. I refer to the level and distribution of wealth in a nation, and to the impact of these on the control of large corporations.

Private control relies on the use of private wealth. The level and distribution of wealth in a nation affects the ease with which controlling shareholder positions can be established when corporations must be large to compete effectively. If a society were vastly wealthier than any that has yet existed, there would be many individuals who alone could provide the

⁴The value of the vote will reflect itself in a difference in price between voting and non-voting shares, and to the extent of this difference the cost of owning voting shares is increased even if equity is also raised through sale of non-voting shares. Even so, the existence of non-voting shares makes it possible to maintain a controlling position more cheaply in large corporations under normal circumstances.

entire equity of large firms and still maintain a portfolio of their remaining wealth sufficiently diversified to reduce the firm-specific risk they bear by virtue of holding this controlling interest. No real issue of separation between ownership and control would exist. To the extent that it does exist, it is partly a product of poverty. The poorer is a society and the more it desires to rely on domestically supplied capital, the greater is the reliance it must place on joint ownership to supply capital to large firms. A society so poor that this equity must come from thousands of small holdings shareholders is one that cannot successfully control large enterprises. Either ownership is separated from control because the ownership structure is precisely like that imagined by adherents of the separation thesis or it is separated because ownership is socialized. In poor societies such as this, firms that rely on large amounts of equity capital cannot survive competitively because effective control is lacking unless capital is secured internationally. Hence, developing nations either must welcome foreign investment or must be comprised largely of small enterprise and agriculture.

This imperative is all the stronger if these nations implement policies that equalize the distribution of wealth. Toleration of a degree of inequality in the distribution of wealth enables a given total wealth to achieve more control over large enterprises. It does this by allowing wealthier persons to retain the means by which to establish controlling shares in at least some of these enterprises while relying on small holdings shareholders to supply additional equity. A fiscal policy that significantly levels the distribution of wealth undermines this path to effective control. The quantitative significance of this is important. If net wealth in the

U.S. were equally distributed across families, no five families could provide funds anywhere near the amounts now used by the five largest shareholders to maintain a one-fourth stake in the equity of Fortune-500 type firms. Even if this calculation is repeated for only the top five individual and family shareholders, thus deleting institutional investors, an egalitarian distribution of net wealth still makes the wealth that could be aggregated over five such families fall far short of that which would be needed for them to own the one-tenth of equity in large firms that they presently own. The resolution of the separation problem, even in a country as rich as the U.S., is enhanced considerably by tolerating a degree of inequality in the distribution of wealth.

Here, then, is a direct connection between the productivity of enterprise and the level and distribution of wealth. It runs through the enhancement in productivity that can be achieved in large firms when professional managements are disciplined efficiently to serve owner interests.

The constraint imposed by the level and distribution of wealth can be modified by innovative institutional arrangements for aggregating the wealth of the non-wealthy, but it cannot be eliminated. The role played by institutional investors is subtle enough to warrant examination here. The very large aggregations of wealth collected from diffuse sources by institutional investors allows them to own controlling positions in the equity of even the largest corporations, while still maintaining fairly diversified portfolios. The potential for exercising control without bearing great firm-specific risk exists within some types of institutional investors. These investors are partly inhibited from realizing this potential because of

current fiduciary standards and legislation, but let us ignore these impediments here. Even with these hurdles present, today's institutional investors frequently acquire fractions of equity on the order of 5 percent of the outstanding stock of large corporations.

The subtle issue is whether institutional investors can be relied upon to perform the ownership function well. Since their capital comes from diffuse sources, it would seem that their own operations are subject to the separation problem that is believed to plague large corporations. If so, institutional investors holding controlling positions in the equity structure of large corporations cannot be expected to perform the duties of owner as well as if this position were held by a person whose own wealth is at stake. To understand why the severity of the separation problem is likely to be considerably less for a subset of these institutional investors, it is necessary to consider again the separation problem.

Two conditions must exist for the separation problem to be severe. One of these is the generally recognized condition that the ownership structure be diffuse. The other is that the assets made available to a corporation by shareholders must belong to it, not to shareholders. This condition has not been noticed explicitly in the literature, but it is very important. It refers to the fact that the shareholder in a typical corporation may sell his shares if he is dissatisfied, but he cannot insist that the corporation be the buyer of his shares. Thus, the corporation, not the shareholder, has title to the productive assets it has purchased with the funds it has secured from its initial issue of stock. Subsequent sale of shares by shareholders has a depressing effect on the price of the corporation's stock if enough shareholders offer to sell, and this has some disciplining effect on

management, but, even so, the corporation remains in control of the assets it has acquired. Errant executives can use these assets to serve their own rather than shareholder interests even when faced by declining share prices. If shareholders could reclaim these assets, the severity of the separation problem would be lessened even if the ownership structure were to be very diffuse. It would be lessened even more if share ownership were concentrated, because shareholders with much at stake will be more attentive to what management has been doing with the firm's assets.

In the general case of the business firm, it is not practical to allow shareholders to reclaim their share of the firm's assets. The typical corporation makes commitments to supply goods and services that, if they are to be dependably honored, require the corporation to have continuing control of its assets. A steel company can not reliably stand by a commitment to fill an order for steel if its shareholders could force it to sell its assets to purchase back their stock. The typical corporation, therefore, must be organized in a way that bars investors from reclaiming their fraction of the firm's assets. Indeed, once a new issue of shares has been sold by the typical corporation, the funds it acquires belong to it not to those who purchased the shares.

Continued control by the firm over its assets is not, however, prerequisite to doing business if credible commitments of this sort are not necessary. Consider the open-ended mutual stock fund. This firm gathers capital from investors and uses its skill to place these funds in the shares of other corporations. These shares can be sold by the mutual stock fund on a moment's notice should it decide to do so, and in doing so it will not be jeopardizing any business commitments. Consequently, investors who place

their capital at the disposal of open-ended mutual funds can withdraw their pro-rata share of the value of the fund's assets should they become displeased with the fund's performance. De facto, the open-ended mutual fund is obligated to "re-purchase" pro-rata investment positions. These investors are not shareholders, they are purchasers of investment services, but they are providers of the capital that is in turn invested in shareholdings of other companies. In the absence of the Glass-Steigal Act, the same arrangement could work for banks who reinvest depositor funds in the shares of other corporations, but not for that part of bank investments that constitutes time-commitment loans to business firms. Should those depositors who have made no commitment to keep their funds with a bank decide to withdraw deposits, the bank could sell its shareholdings in other corporations to cover the withdrawals.

It is this characteristic, the ability of investor-depositors to reclaim capital from a firm, that distinguishes these institutions from others for our purposes. The closed-end fund does not have this characteristic. It is organized like the typical corporation. It issues shares which, once purchased by investors, converts these funds into assets that belong to it. Dissatisfied shareholders may sell their shares, but they cannot force the closed-end fund to be the purchaser. This allows the fund's management to make its investment plans without fear of being forced to alter them should investor desires for cash or beliefs about the investment environment change, but it also eliminates a threat to management that it will lose control of its assets.

It is this threat in the case of the open-end mutual investment fund that reduces the severity of the separation problem. Should investors become

dissatisfied in large numbers, mass withdrawals would diminish the assets available to a fund's management, forcing it to sell the shares they own in other companies. This reduction in the wealth available to the managements of these institutions can take place even if no single or no small group of investors has provided the lion's share of the capital they invested. This disciplines the managements of these institutions in a way not available to stockholders when they are disappointed with the managements of typical corporations. The large scale sale of shares in the typical corporation depresses share price but does not reclaim assets from the control of management.

What this means is that managements of institutional investors of the open-ended mutual fund variety can be disciplined directly by providers of capital even when there is no concentrated provision of this capital. The diffuse "owner" problem is ameliorated, but only to some extent. Remember, it is more effectively defused if capital is provided in concentrated fashion to the institutional investor, for concentration of rewards and penalties makes the large shareholder more attentive and astute. Now, suppose that this type of institutional investor has taken controlling positions in the equity of the firms whose shares it has purchased. The ability of even diffuse contributors of its capital to withdraw their assets surely makes the institutional investor represent its investors' interests better than if the threat of withdrawal did not exist. Because of this effect, capital secured from even diffuse sources can be combined without suffering fully from a

separation between ownership and control.⁵

In this way, institutional investors of the type described can loosen the linkage between the exercise of effective control over large corporations and the wealth of a nation. Poorer nations following egalitarian policies will not be as limited in the sizes of the viable firms that can populate its economy. The linkage is only loosened, however. It is not broken.

⁵In fact, a doctoral dissertation recently completed at UCLA (Clyde, 1990) gives evidence that institutional investors behave much as do individual and family shareholders who own controlling positions in the ownership structure of corporation.

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to a Free Society

November 3 - 6, 1991

Praha, Czechoslovakia

PRIVATIZATION AND THE REFORM PROCESS:
THE CASE OF POLAND

by

Gregory Jedrzejczak

Session 4: Privatization and the Reform Process

Speakers: Tomáš Ježek

Gregory Jedrzejczak

Discussants: Stuart Butler

Janusz Lewandowski

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"PRIVATIZATION AND THE REFORM PROCESS"
THE CASE OF POLAND

"Thus the alternative is still either
Socialism or a market economy"
Ludwig von Mises "Socialism: An
Economic and Sociological Analysis."

Methodological issues

The standard description (model) of the reform phenomenon in post-communist economy is usually constructed upon the assumption of reform as a process of transition from one system, which is Centrally Planned Economy (CPE) to another one, which is Market Economy (ME). In this model CPE can be described as a monocentric system whose characteristic features are:

- central control over an organization of economic and social life;
- social communication via formal network with dominance of vertical rather than horizontal channels;
- disintegration of economic system at the production (inter-firm) level due to the two, above mentioned features;
- domination of strong paternalistic patterns (as described by J.S. Mill) in relations between the state on the one side and households and enterprises on the other side;
- emergence of the second (shadow) economy as a compensation mechanism for inefficiency and incompleteness of central planning.

The market economy could be described as the system of independent actors, driven by their self-interests and equilibrated by the pricing mechanism.

Apart from the fact that CPE in above described, pure form has never existed in Poland and that the concept of market economy is disputable, the most important fact that has to be taken into consideration is that CPE had had its own, internal dynamic - reform process. Without knowing and understanding internal reform of CPE, and especially its results, its not possible to understand current efforts. Without this knowledge is not possible to understand elements of discontinuity and continuity of the system and, in the last group, elements which are positively and consciously accepted and elements, which are still present because of system inertia. On the one hand discontinuity of political forces governing Poland is beyond discussion. On the other hand one can easily indicate key elements of the new system, such as: state company as a legal form, excessive wages tax, or so called central bank refinancing credit, which have been simply adopted without any serious changes from the CPE period.

For these reasons it is necessary to make a distinction between:

- o internal reform of CPE and its final (from historical perspective) results;
- o transitional reform from CPE to ME, its first results and predictable perspectives.

Results of internal reforms of CPE in Poland

2

The results of internal dynamic of CPE manifest themselves not only in a static form (i.e. external debt) but in a dynamic form as well (i.e. patterns of behavior, expectations models).

The internal CPE's reforms in Poland can be traced as far as mid fifties and can be summarized as follows:

- o technological reform: especially seventies can be treated as a big experiment of importing Western technologies and their products without any other serious changes;
- o parametric reform: it has been long lasting big dream of Polish "progressive" economists to design and introduce parameterized and decentralized CPE with strong elements of

- shadow-pricing in accordance with Lange's theoretical work;
- institutional reform: endless institutional changes in the hope to improve control and efficiency of state-owned company;
 - property rights reform: within this area one can find thirty-five years lasting idea of self-governing state companies (with its ebbs and flows), and introduction of foreign capital in the form of joint-ventures in late eighties.

All these efforts can be treated as a substitute of deep changes, substitute based on the wrong theoretical assumption that it is possible to mimic the market without introducing real interest based on private ownership and without democratic consent for unavoidable hardship of reform. In result, the evolution of "genetically wrong" system led to disastrous effects although some positive results can be also seen.

Economic growth: After an economic collapse of the 1979-1982 period, starting in 1983 the Polish economy recovered its potential for economic growth. However, outstanding results of the first few years of "martial-law economy" due to the automatic reconstruction of the economic system and more severe social discipline had disappeared in the last years of this period with eventually negative growth rate (-2 percent) in 1989.

Inflation: Two features of inflation process were very characteristic in the 80-ties:

- for the first time in the post-war history the authorities had to admit that a centrally-planned economy is vulnerable to uncontrollable price changes; in other words inflation was "opened" after years of "hidden inflation".
- this "opening" was caused by the administrative rising of prices in 1982 and 1988 (rationalized by an attempt to achieve equilibrium of the consumption market), and in both cases this attempts were unsuccessful.

As a result, people in Poland got used to inflation as a constant phenomena, and at the same time became skeptical about the government's ability to fight it.

Balance of Payments and External Debt: The convertible currency external debt is the most visible heritage of the centrally-planned economy. Poland had the highest convertible currency debt in Eastern Europe, totaling about \$40 billion at the end of 1989, equal to 470 percent of the total exports of goods and services. In the 80-ties the debt almost doubled, from about \$26 billion at the end of 1981. This disastrous effect was due to many reasons, and among them to: the current account deficit, the structure of debt maturity, and the depreciation of the US dollar. More than two-thirds of Poland's convertible currency debt was owed to official bilateral creditors. Poland has run into substantial interest arrears with the Paris Club members, since 1981.

Ownership structure: The distorted ownership structure of the economy is the most difficult to overcome heritage of a centrally-planned economy, and consequently the change of this structure is seen as the most important factor of a successful transformation to a Western-type society.

The division of private and public sectors was not clearly defined in the CPE's economic and statistical terminology. To this day the colorful ideological and confusing terms "socialized and unsocialised economy" are being used. By those definitions the public sector can mean economic units placed at different stages of state control as well as differentiated legal forms.

The state-owned enterprise (SOE) was (and still is) the dominating organizational form of the national economy. Separate laws regulated the legal and financial statutes of the SOE, guaranteeing far reaching organizational and financial independence. The state's interests, within the territory of the state enterprise, were represented by the manager as well as the employee self-management. The interests of the state, as the owner of the enterprise, were represented by the so called founding organ. In other words, specific ministries represented the State Treasury in relation to the largest enterprises and local governing bodies in relation to the rest of enterprises. An

enterprise could easily have at its disposal all of its assets, and sell its assets to private parties, as well as, invest them in other companies. It could not, without the approval of the founding organ, liquidate itself or restructure itself into a joint-stock company.

A part of the state's assets was at the disposal of budgetary units and non-profit organizations.

One must also include within the public ownership, service and production co-operatives. The activities of co-operatives were under strict control by the state, and the effects of their activities were defined in the states economic plans.

Forms of government ownership, that existed on a negligible scale, were joint-stock companies, with the state ownership playing a dominant role.

Symmetrically, the domain of the private sector was not clearly marked. Outside of a visible center - in which firms with sole proprietorship, as well as, small private limited companies, were placed - we had a gray sphere, which from the point of view of ownership, was diversified. A long period of political and fiscal discrimination against private ownership was the main reason for this situation. Moreover, in the last few years of CPE it became allowed to "mix" state and private (both Polish and foreign) capital in the form of companies, as well as through long-term leasing of state assets to private companies. This fact led to creation of so called 'nomenklatura limited companies'.

Apart from the expressed reservations, the public sector clearly dominated in the Polish economy. Table 1 shows aggregated figures characterizing this phenomenon.

As it is evident from the given data, the Polish industry was almost completely in the hands of the state, with a characteristic relatively small employment in relation to the share of GMP and to the stock of fixed capital. This evolves from the structure of the economy - the private industry was concentrated in labor-consuming, quasi-handicraft branches. As a result, the industry's private sector was characterized by a much larger organizational dispersion and a decidedly smaller average

employment for each unit of organization. The public sector of industry on the contrary, was much more concentrated what was a typical result of long-lasting, centrally-planned economy.

Agriculture has played an exceptional role in the Polish ownership structure but as in the case of the industry, the organizational structure, level of employment, and the overall assets structure (measured by the size of the farm) differentiated essentially through the state and co-operative ownership on the one hand, and the private on the other.

The building industry represented the second largest domain in the private sector. As in the case of the industry, there existed a definite difference in the organizational spread of activities.

The traditional area of activity of the private sector, was providing services for the households.

Banking and financial sectors were fully dominated by public ownership, however two important features of these sectors activity should be stressed. Firstly, mainly because of historical reasons, relatively big number of firms had form of joint-stock companies. Secondly, in 1988 general reform of banking sector took place resulting in separation of central bank and universal commercial banks.

Transitional reform to market economy

The take-over of the government by the new, non-communist political regime led in natural way to introduction of a radical reform. The reform process has been envisaged in two phases: stabilization of basic macro economic parameters; and micro economic changes at a company level, mainly oriented on privatization - ownership changes. (The phases of the reform were not strictly sequenced in time, actually they overlaped.)

The stabilization program was announced in October 1989 and introduced at the beginning of 1990. The philosophy of the program came from the recognition, that the Polish economy required

fundamental systemic changes, and that this would have to be achieved quickly, through radical actions, so that the transitional stage, so hard on the society, could be as short as possible. Selection of this way was also dictated by the fact that the program was launched under extremely adverse social and economic conditions. The economy was in a structural and functional disequilibrium: the ecological disaster, the housing crisis, the foreign debt burden, a rapid price climb linked with wage explosion, the zloty depreciation, the growing deficit of the state budget, a drop in output. What more, existing at that time system of policy making and company governance had completely failed.

It is obvious that the stabilization program, by its nature, could not cope with all of the above-mentioned disequilibria. The program first of all introduced measures to bring inflation and the balance of payments under control. Among the most important measures were:

- o the freeing of almost all remaining administrative price control,
- o rapid devaluation of the zloty close to the level of the uncontrolled parallel market rate,
- o relaxation of restrictions on trade and payments,
- o implementation of monetary and fiscal program reducing deficit financing of the government spendings and limiting monetary and credit expansion,
- o substantial increases in taxes especially in tax limiting wage increase,
- o monthly adjustable and positive real interest rates for zlotys balances.

Results of the Polish stabilization program, however controversial, are too well known to be discussed in details. Especially, a significant number of papers has dealt with statistical disparities of assumed targets and actual results. Having in mind these evaluations and taking into account visible deterioration of the program during the last few months, four significant results should be stressed:

- Stabilization of economic parameters: at the nominal level, price index has been radically curbed and the exchange rate of zlotys has been maintained at the same level from the beginning of 1990 till June 1991; at the real level, interest rate has been positive over the majority of 1990 and 1991.
- Switch from an economy of shortages to a standard (Walrasian) market economy: forty years lasting mechanics and rationale of Kornaian economy of shortage disappeared 'overnight' and rules of equilibrated market have been adopted with all consequences and first of all introduction of hard budget constrains.
- Emergence of entrepreneurial spirit: entrepreneurial behavior has started to manifest itself in rapidly expanding parallel markets, services and foreign trade. From this point of view sharp fall in real GMP, as presented in statistics, is rather in contradiction with common experience.
- Openness of the economy: internally as a free entrance of new players in production, services and trade, and externally as a liberalization of exports and imports.

All these factors when put together create a long term perspective for introduction of mechanisms typical for market economy.

The economic stabilization is only a prerequisite for success in pursuing systematic changes aimed at the transformation of the economic and social systems towards a market economy. In the long-term development private sector will play the critical role.

Privatization is a prerequisite and a stimulus for growth in the overall economy. The changes in the structure of ownership, in the Polish economy are aimed at transforming the existing structure into a system functioning in highly developed European countries. The comparison of this effort with the above described existing structure shows the scale of the assumed changes.

Effective privatization has been started in the second half of 1990. In the fifteen months since the passage of the "Law on Privatization of State-Owned Enterprises" Poland has achieved substantial progress in the process of privatization.

Privatization of seven enterprises by public offering is the most visible one. As a result of this the Polish capital market increased by the following amount of stock :

Exbud Kielce : 450 thousand shares bought by around 30 thousand investors. Apart from that, two control blocks of shares /15-20%/ were sold, to the management of the enterprise and to a foreign investor.

The Silesian Cable Company : 830 thousand shares were bought by over 30 thousand people. Few-percent blocks of shares were bought by foreign investment funds and private persons from Poland.

Prochnik : 1200 thousand shares purchased by over 30 thousand persons, while the dozen-or-so percent, controlling block of shares was taken over by a Polish insurance company.

Tonsil : 750 thousand shares sold to 28 thousand persons. The controlling package of shares owned by a Polish bank, the state Treasury is searching for an investor for 30 % shares.

Krosno : 1100 thousand shares sold to 29 thousand persons. Also a Polish bank bought 10 % shares, and a foreign trade company a further 10 %.

Swarzedz: 1900 thousand shares sold to approximately 5 thousand people by public offer , 16% will be sold to employees.

Wolczanka: 960 thousand sold by public offer to 3 thousand investors, 15% to managers of the company, 20% to employees.

Zywiec: 1500 thousand shares sold by public offer to 19 thousand investors, 10% to managers, 12% to employees.

As a final result, shares of an issuing price of 700 billion zlotys were sold to the market, at a dispersion estimated for around 100 thousand people. During this year it is expected, that as a result of privatization by public offer, shares of the next 5 companies will enter the market.

Beyond this spectacular privatization, other important cases have been completed: four by direct sales to foreign investors, one through an employee/management buy-out, privatization of about 150 small and medium size enterprises through the liquidation route, 50 through sale of assets and almost 100 through capital leasing (with deferred purchase). In addition, 80% of retail and wholesale stores, more than 50% of transportation and more than 40% of

construction services are now in private hands. Further 140 enterprises have been commercialized, and now are joint stock companies, operating as commercial entities and supervised by their Boards of Directors.

Privatization has created only part, however significant, of a new emerging structure of Polish economy. Overall results, including spontaneously growing private enterprises are as presented in tables 2 and 3.

The government has also made considerable progress in the design and preparation of the proposed mass privatization program. As presently envisaged, this would include the establishment of a number of investment groups (funds) playing the role of intermediaries between Polish citizens and a significant number of companies privatized on this way. In result: on the one hand citizens would become co-owners of the funds by free distribution of funds shares; on the other hand, funds managers would play the role of active institutional investors.

In detail the key elements of the program can be characterized as follows:

Investment groups:

- o they will be closed-end funds with a legal structure based on the Polish joint stock company (which is close to German pattern);
- o the Supervisory and Management Boards will have Polish chairmen and majority of boards members;
- o a number of international investment banks, fund management firms and venture capital groups will be invited to carry out day to day management of the investment groups on the basis of management contracts;
- o the investment groups will be able to borrow money, to issue new shares and to make new investments.

Companies:

- o Around 250 medium and large size companies, presenting around 15 per cent of total industrial sales, will be included in this

program;

- o initial standard shareholding structure of companies is expected to be as follows: 33% lead shareholding transferred to one investment group, 27% distributed evenly among all investment groups, 10% (maximum) given free to employees, 30% retained by the state (possibly allocated to pension funds).

Distribution of ownership:

- o all Polish citizens resident in Poland who are at least eighteen years of age on 31 December, 1991 will be entitled to a participation in all investment groups (about 27 million people);
- o each person will achieve participation certificates in each fund, the certificates will be freely traded and/or converted into investment groups shares after first financial reports of funds are published;
- o shares of investment groups will be quoted on Polish Stock Exchange.

Conclusions

Privatization as a constituting factor of the post-CPE reform process is so dynamic and unpredictable that any conclusions can ridicule their author after just few months. It is safer to ask new questions, and the most puzzling among them is the question about privatization as a magnet for "the grand design" projects. From the very beginning this type of thinking about privatization accompanied the step-by-step and case-by-case privatization of individual companies. It is difficult to identify all the reasons of that fact, however, some of them can be mentioned:

- o frustration coming from privatization pace when compared with the number of companies waiting for privatization;
- o conviction that market forces are too weak to initiate and to hold transformation process;
- o the intellectual challenge of finding simple and universal solution for complex question - syndrome of "philosophical stone" (this attitude seems to be common feature of "fathers" of centrally planned economy and Western professors of economics).

Whether there is positive answer to that question or not there is no doubt that it is the most challenging problem of contemporary economics.

Table 1.

Public and private ownership in the national economy
(percentage share at the end of 1988)

Sectors of national economy	General	Forms of ownership	
		Public (State owned+ co-operatives)	Private
Economy, total	A 100	81.9	18.1
	B 100	85.5	34.5
	C 100	70.6	29.4
Industry	A 100	93.6	6.4
	B 100	88.3	11.7
	C 100	97.9	2.1
Agriculture	A 100	29.4	70.6
	B 100	21.1	78.9
	C 100	34.3	65.7
Construction	A 100	79.2	20.8
	B 100	79.3	20.7
	C 100	90.2	9.8
Transport	A 100	NA	NA
	C 100	95.9	4.1
	D 100	99.1	0.9
Commerce	A 100	NA	NA
	B 100	93.9	6.1
	C 100	96.8	5.2

Symbols : A - GMP 1988

B - Average employment in 1988

C - Net value of fixed assets (current prices) at the end of 1988

Table 2. Number of private firms

Legal form	On June 30, 1991	Net change/last 6 months
joint-stock companies	38516	8866
sole proprietorship	1272300	136800
joint-ventures	2840	1195
co-operatives	17308	658
others	2723	(-)36

Source: Statistical Office

Table 3. Activity of public and private sectors (as measured by sales of products and services)

Sectors	Dynamic (%)		Structure (%)	
	respective period 1990=100		half-year	
	I	II	I/90	I/91
Total industry	-5.5	-13.2	100.0	100.0
Public	-7.2	-16.9	83.0	80.6
Private	2.5	4.0	17.0	19.4
Total construction	-11.0	-5.7	100.0	100.0
Public	-19.5	-27.3	69.6	57.0
Private	7.3	46.4	30.4	43.0
Total transport	-21.3	-20.0	100.0	100.0
Public	-23.8	-23.4	88.2	83.6
Private	-1.9	5.0	11.8	16.4

Source: Statistical Office



