Firm Performance and the Political Economy of Corporate Governance: Survey Evidence for Bulgaria, Hungary, Slovakia and Slovenia

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Working Paper Number 338

July 2000

William Davidson Institute Working Paper 338

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This paper was presented to the CEPR/WDI Conference Moscow in July 2000, the European Association for Research in Industrial Economics in September 1999 and the Dublin Economic Workshop in February 2000. We thank all participants for their comments. In addition many thanks are extended to Joep Konings for provision of the data and helpful comments and Frederic Warzynski for researching the extensive background literature. We acknowledge funding from Phare-Ace, Project 1997, *'The Impact of EU Trade on Firm Level Restructuring in Central and Eastern Europe'*.

Non-Technical Summary

The impact of privatisation on firm performance has generated a great deal of attention in transition economics. In particular, how did the new corporate governance structures that emerged in the transition process from centrally planned to market economies perform compared with state owned enterprises? Earlier empirical studies find that privatisation does not lead to better firm performance, while more recent studies find that only privatisation to outsiders is beneficial for performance. Most empirical studies to date develop a theme of insider rent seeking and corruption to explain the failure of privatisation to insiders to generate efficiency gains. In contrast to such a focus on political distortions, this paper provides strong evidence that insider privatisation is driven by political constraints, as modelled in Dewatripont and Roland (1995). Sequencing, or the gradual release of firms to outside ownership, is a market driven outcome, given the inherited market demand conditions that existed in Central Eastern Europe. It is part of a good and politically acceptable path that ensures the long-term success of the reform process.

An important emphasis in this paper is the role that inherited demand conditions play both in dictating the selection process of firms to privatisation, and on their subsequent performance. Within countries of CEE, strong trade links were developed with the EU. Coming out of planning firms inherited product lines designed to supply either the artificial CMEA market or the EU market. A detailed analysis of the Eurostat Trade data clearly illustrates, confirming the results of Rodrik (1994) and Repkine and Walsh (1999), that the reorientation of previously CMEA oriented products to the EU market was not an important feature of the transition period. Using survey data for Bulgaria, Hungary, Slovakia and Slovenia during the first seven years of transition, we examine the impact of various corporate governance structures on firm performance while controlling for the inherited demand conditions. The modelling of sequencing to outside ownership, the conditioning of our sequencing and performance regressions on the initial CMEA or EU trade orientation in 1988, and the inclusion of controls for time, country and narrowly defined sectors and regional locations of firms are all novel features of our empirical analysis in this paper.

Controlling for other factors, we find that firms that produce historically EU oriented products consistently outperform firms that inherited products historically produced for the CMEA market during the first seven years of transition across our four CEE countries. We provide evidence that while CEE countries were eager to restructure the best firms in historically CMEA markets under outsider ownership, they resisted privatisation to outsider ownership in historically EU markets.

In historically CMEA markets, outsiders were given the best firms to restructure during transition, while the state and insiders maintained control of the loss making and politically sensitive firms across our CEE countries during the first seven years of transition. This was done to build political support for the restructuring of previously CMEA market. The more problematic loss making firms would be dealt with later.

The political economy of privatising EU trade oriented state firms was more in line with that observed in western economies. We show that the state and insiders in such firms were reluctant to privatise these highly viable and expanding firms to outsiders. Politically, it was more beneficial to retain control, undertake restructuring, and support reforms that developed a properly functioning stock exchange, which would eventually allow a successful public offering to outsiders. This was done to build political support from populations linked to the previously EU market. The more problematic issue of selling valuable assets to outsiders, for efficiency reasons, would naturally happen at a later date.

As a result of the different political constraints imposed on the selection process to outside ownership, the effect of corporate governance on firm performance was shown to be different among previously CMEA and EU trade oriented firms. Majority outside ownership outperforms majority insider/state ownership, but only when we condition our regression on initial CMEA trade orientation controlling for a gradualist selection process, pre- and post- privatisation effects, amongst other factors. This results from the political incentives to preserve loss-making firms in the short-run. Majority outside ownership does not outperform majority state/insider ownership when conditioned on initial EU trade orientation. This result is not surprising given the political resistance to giving the best EU oriented firms to outsiders and the fact that such firms are subcontracted by foreign licence, face upstream competition in their EU market, do not have liquidity constraints and inherited mangers with experience in global markets.

It is our thesis that political economy considerations induced insider profit maximising considerations in historically EU oriented firms and insider cost minimising considerations in historically CMEA oriented firms to have an important impact on the privatisation process and its subsequent impact on firm performance. Throughout this paper we have provided empirical evidence that political *constraints* driven by market demand considerations, rather than political *distortions*, have imposed themselves on the privatisation process and its subsequent impact on firm performance in Central Eastern Europe. Insider ownership is an important political outcome, driven by market demand considerations, that builds up political support for market reforms during its initial stages, ensuring their long-term success.

Abstract

Using survey data for 220 traditional manufacturing firms over 7 years of transition and 4 CEE countries, we find firms that produced for the EU market under planning consistently outperform those that produced for the CMEA market. Within the previously CMEA market, the best firms were selected to outside privatisation and outperformed insider/state owned firms. Outside privatisation was resisted in EU oriented firms and ownership was found to have no effect on performance. We argue that insider/state ownership in previously CMEA and EU markets builds up political support for the market system during its initial stages, ensuring its long-term success.

Keywords: Firm Performance, Political Economy, Privatisation and Demand Shocks.

JEL Classification: P52

I. Introduction

The impact of privatisation on economic performance in transition countries has generated much interest. Stiglitz (1999) portrays the general consensus that mass privatisation, within a complementary package of “big bang” reforms, seems to have failed to generate the expected efficiency gains across transition countries.[1] One outcome of the privatisation programmes was that they somehow generated a bias towards insider (worker and manager) ownership. Boycko, Shleifer and Vishny (1994, 1996) argue that the allocation of property rights to inside control was an attempt by government to gain political support during privatisation which, as a consequence, in terms of economic efficiency, lead to the failure of the privatisation process. Most empirical studies develop this theme of insider rent seeking and corruption to explain this perceived empirical failure of insider privatisation.[2] Such political *distortions* may be an accurate description of the situation in Russia. However, in the Countries of Central Eastern Europe (CEE), we provide empirical evidence that insider ownership is an important political outcome that builds up political support for the privatisation process during its initial stages, and ensures its long-term success. As modelled in Dewatripont and Roland (1995), we argue that a gradual release of firms to outside ownership is a market driven outcome, given the inherited market demand conditions that existed in CEE and political constraints. This is a politically acceptable path that ensures the long-term success of the reform process. We show that political *constraints*, driven by inherited market demand conditions, have imposed themselves on the privatisation process and its subsequent impact on firm performance in CEE during the early days of transition. We do this using survey evidence for Bulgaria, Hungary, Slovakia and Slovenia during the first seven years of transition

The role of initial demand conditions on firm performance and ownership structure during the transition period is emphasised in this paper. Compared to CIS countries, CEE countries over the 1970s and 1980s developed strong trade links with the EU. Coming out of planning state firms inherited production lines designed to supply either the artificial CMEA market or the EU market. Due to a focus on scale economies and specialisation under central planning each country inherited different clusters of large monopolies producing for the EU and CMEA markets. Repkine and Walsh (1999) highlight the importance of these inherited demand conditions in determining the evolution of industrial output. They document the presence of exports to the EU in all

NACE Rev. 1 manufacturing sectors in Bulgaria, Hungary, Poland and Romania in 1988, and the extreme clustering of such within sectors into certain 5-digit products. Modelling the dynamics of industrial output across sectors of these countries, they estimate the recovery in industrial output to be driven by EU oriented output over the period 1990-96, within the same clustering of manufacturing products that were exported before transition in 1988. Alongside these developments, they estimate a continual decline of previously CMEA oriented output by sector of industry in each country. This is consistent with the data on exports, Hoekman and Djankov (1997), that documents the rapid decline in previously CMEA oriented trade and expansion in EU oriented trade in the first few years of transition up to 1996. Repkine and Walsh (1999) illustrate that the U-shape experience of industrial sectors across CEE countries resulted from path dependent investment demand shocks that induced a rapid decline in products traditionally producing for the CMEA market and a gradual expansion in products traditionally producing for EU market. The role of demand shocks challenges the thesis that supply side distortions were the sole determinants of the evolution of industrial output in CEE countries.[3]

Given the findings of Repkine and Walsh (1999), one might expect the ownership structures and the performance of firms operating in historically CMEA trade oriented production to be different compared to that observed in firms inheriting EU trade oriented production. The novelty of this paper is to examine the effects of inherited demand conditions on firm performance both directly and indirectly via their impact on corporate ownership. We provide evidence that initial demand conditions have a direct impact on firm performance during transition. Controlling for other factors, firms that produce EU oriented products consistently outperform firms that inherited products historically produced for the CMEA market during the first seven years of transition across our four CEE countries. This is due to the very different underlying conditions and growth prospects of these firms coming out of planning. In addition, inherited demand conditions impose interesting political constraints on the ownership structures of firms during transition. The presence of two fundamentally different species of firms under central planning is shown to have important implications for the political economy of corporate governance and its impact on performance in Central Eastern Europe.

Within the artificially nurtured CMEA market, at the start of transition, some non-viable and inefficient firms will eventually have to exit, while those with long-term viability are likely to have to undertake some degrees of restructuring during transition. This is aptly summarised in the following: *"Among production activities, changes in relative prices and the loss of CMEA markets, imply that some are and will remain loss making and must therefore be closed. The others may be viable, but not without labour shedding and the infusion of new, more modern capital"* [Aghion, Blanchard and Burgess (1994), pp. 1330]. We provide evidence that CEE countries undertook a gradualist approach to privatisation, in the manner modelled by Dewatripont and Roland (1995), in historically CMEA markets. Building on the seminal work of Alesina (1987), they model a politically acceptable way of inducing reforms that are necessary in the transition to a market economy but have an overall negative expected outcome on the population ex-ante. Reforms yielding positive effects should be implemented first. The more painful reforms, necessary to sustain benefits from initial reforms in the long run and avoid reversal costs, become politically easier to implement at a later stage. *"This is the effect of building constituencies, using the 'sweet pill' of early reforms to have the population swallow the 'bitter pill' of less popular reforms"* [Roland, 1993, pp. 535]. In relation to privatisation of previously CMEA firms therefore, sequencing is predicted where the best enterprises needing restructuring with long-term growth opportunities should be privatised first. The closing down or imposition of hard budget constraints on loss-making previously CMEA firms should come at a later stage. We provide evidence that CEE governments allowed such a gradualist approach in the privatisation of previously CMEA firms. We show that in the previously CMEA market outsiders were given the best firms to restructure during transition, while the state and insiders maintained control of the loss making and politically sensitive firms across our CEE countries during the early periods of transition.

In contrast, within the historical EU market, at the start of transition, firms/workers inherited very different demand conditions. They produced viable high-quality goods at low cost, historically sold into competitive upstream markets, and subcontracted by western firms. Such firms operated in high growth areas and did not require a lot of restructuring or finance in order to survive the transition process to a market economy. The political economy of privatising EU trade oriented firms is more in line with that observed in western economies. We show that the state and insiders in firms were reluctant to privatise highly viable and expanding firms to outsiders in the early days of transition.[4] Politically it was more beneficial to retain control, undertake restructuring, and wait until the economy is more developed with a properly functioning stock exchange that would allow a successful public offering.[5] In relation to political economy of privatising previously EU firms therefore, sequencing is recommended where enterprises with growth opportunities should be allowed to wait before pursuing efficiency gains from outside ownership. The imposition of outside ownership on profit making previously EU firms should come at a later stage.

Inside/State ownership allowed issues such as bankruptcy of out-dated CMEA firms and the transfer of profitable EU oriented firms to outsiders to be dealt with at a later date thus ensuring political acceptability of the initial reforms. As a result of the different sequencing processes of firms for outside privatisation, the effect of corporate governance on performance is different between previously CMEA and EU trade oriented firms. A large literature exists on the effects of privatisation on firm performance both for western and transition economies.[6] While the results are mixed, many find that privatised firms outperform state owned firms.[7] In contrast to Frydman, Gray, Hessel and Rapaczynski (1999), we condition our firm performance regression on a privatisation sequencing process, both conditioned on initial trade orientation, while allowing for pre- and post- privatisation effects, amongst other factors. We estimate for our sub-sample of firms inheriting CMEA trade oriented production from central planning, even when allowing for sequencing in the selection process, that majority outside ownership outperforms majority insider ownership.[8] State and insider owned under performed relative to the outside owned firms due to the political incentives to preserve, with soft budget constraints, loss making firms in the short run [Kornai 1988, Berglof and Roland 1998]. This strategy was undertaken to gain long term political support for the restructuring process in the previously CMEA market, [Dewatripont and Roland (1995)].

In contrast, we estimate for our subsample of firms inheriting EU trade oriented production from central planning, that majority outside ownership did not outperform majority state or insider ownership. Given the political resistance to giving the best EU oriented firms to outsiders and the fact that such firms are subcontracted by foreign licence, face upstream competition in their EU market, inherited mangers with experience in global markets with no liquidity constraints, this result should not be surprising. If complete and enforceable contracts can be written between foreign and home firms then privatisation should have no significant effect on performance [Hart, Shleifer and Vishny1997, Shleifer 1998]. Moreover, competition is documented to be as effective as privatisation as a means of reforming state owned enterprises [Yarrow 1986, Kay and Thompson 1986, Vickers and Yarrow 1988, Bishop and Kay 1989, Beesley and Littlechild 1989, Caves 1990]. Finally, incumbent managers, for external finance reasons, had good incentives to engage in the development of their firm, which contrasts strongly with the incentives faced by insider mangers in loss making previously CMEA firms, [Roland 1996]. Hence, the positive effect on firm performance from privatisation is not found when regressions are conditioned on initial EU trade orientation, amongst other factors. State and insider control of viable firms can be seen as a strategy that gained long term political support for the restructuring process in the previously EU market. While insider/state ownership minimised the losses in populations linked to previously CMEA oriented firms; it maximised gains in populations linked to previously EU oriented firms. This had the effect of building up political support for the market system during its initial stages, ensuring its long-term success.

Frydman, Gray, Hessel and Rapaczynski (1999) in their empirical work claim to support the theoretical literature that see insider privatisation is a political *distortion* that blocks the long-run success of the market system during transition. One has to condition firm performance and the selection process to privatisation on initial trade orientation, among other factors, to have an accurate interpretation of the role of insider ownership in CEE countries. As modelled in Dewatripont and Roland (1995), we argue that a gradual release of firms to outside ownership should be an expected outcome of market forces under political constraints. Given the inherited market demand conditions that existed in CEE, it is the only politically acceptable path that ensures the long-term success of the reform process. Political *constraints*, and not distortions, driven by market demand considerations, have imposed themselves on the privatisation process and its subsequent impact on firm performance in Central Eastern Europe during the early days of transition.

Section II describes how we determine the historical trade orientation of firms. Section III provides a detailed description of the LICOS survey data used in our empirical analysis. The empirical modelling of the selection process to privatisation and firm performance is undertaken in section IV. The final section of the paper concludes.

II. Historical Trade Orientation of Firms

The *EUROSTAT TRADE STATISTICS* database is a high quality database providing annual data on trade flows by product categories between the European Union and some 200 non-European Union countries. From this database, we obtained data on exports to the EU from Bulgaria, Hungary, Solvenia, and Slovakia in 1988.[9] These export flows were retrieved in thousands of ECUs at the 3-digit NACE-CLIO product level, the lowest level of aggregation compatible with our survey data, and at the corresponding broad NACE Rev. 1 sector levels. A list of these 14 1-digit sectors and their CLIO 3 product components are highlighted in Table 1. Using these data we classify products on the basis of their historical trade orientation. Virtually all CLIO 3-digit products in 1988 exhibit some level of exports to the EU, but within broad sectors these are highly concentrated in a small number of products. Hence the criteria for classification of products by trade orientation is based on a Concentration Ratio of export flows to the EU. Products within 1-digit sectors of each country that account for the cumulative top 98 per cent of exports to the EU in 1988 are considered EU trade oriented products. Products exhibiting either no exports to the EU or accounting for an insignificant share of sector exports in 1988 are classified as being CMEA oriented products under the central planning regime.

Table 1 details the classified trade orientation of 3-digit NACE-CLIO products for each country based on our criteria. While in many instances the trade orientation of products is similar over each of the countries in our analysis, there are also some marked differences. In the Food, Beverage and Tobacco sector for example, the Mineral Water and Soft Drinks product category (CLIO 427) is only considered EU trade oriented in Slovakia, while Animal and Poultry feedings (CLIO 422) is EU trade oriented in all countries except Slovakia.

Table 2a reports the percentage of CLIO 3-digit product categories in a sector that are classified as being EU trade oriented by country in 1988. While all manufacturing sectors exhibit some degree of trade with the European Union in 1988, for many sectors this is fairly clustered within 3-digit products. For example, only 26 per cent of products in the Food, Beverage and Tobacco sector of Bulgaria and Hungary explain 98 per cent of its total exports to the EU. Table 2b documents the annual average growth in sector exports over the period 1988 through to 1996. All sectors over time in each of the countries exhibit positive growth in exports to the EU, although clearly intersectoral differences emerge. Despite the explosion in exports to the EU, exports remain within the same clustering of manufacturing products that exported to the EU before transition. The degree of persistence in product exports over time is indicated in Table 2c, which describes the share of 1996 exports accounted for by those products identified as being EU oriented in 1988. Invariably, 1996 exports of products that were traditionally EU trade oriented under central planning explain fully or the vast majority of EU exports in 1996.[10] Confirming the results of Rodrik (1994), the reorientation of previously CMEA oriented products to the EU market was not an important feature of the transition period. These findings mirror those of Repkine and Walsh (1999).

The survey data do not enquire into the historical markets of traditional firms. Yet, we do know the CLIO 3-digit product category of traditional firms, which can be identified as historically EU or CMEA trade oriented product during the planning regime. The specialisation of large monopoly firms in products and markets, a core feature of planning, ensures that the tagging of firms into historical markets by their CLIO 3-digit product category proves to be a sensible control for a firms initial trade orientation.

III. Data Description

Overview of the Data

The core data used in our analysis are derived from the LICOS firm level surveys conducted in early 1997, which provides detailed firm level information for Bulgaria, Hungary, Slovakia and Slovenia.[11] This database was compiled on the basis of personal interviews with the general manager and/or some other key managers of 513 individual firms over our candidate countries. The firms were selected from different business registers as well as from address books and databases from local research institutes, and included a stratified sample of 50 per cent *de novo* firms in manufacturing, trade and services and 50 per cent traditional firms, mainly selected from the manufacturing sector. *De novo* firms are those that have been private since establishment and began operation after 1989, while traditional firms describe those that existed under central planning.[12]

In this paper we are solely interested in analysing the relative performance of traditional manufacturing firms by different ownership types. We obtain a cross-section of 220 traditional manufacturing firms for Bulgaria (68 firms), Hungary (67 firms), Slovakia (48 firms), and Solvenia (37 firms) which successfully survived the transition process to a market economy and were still operating at the time of the survey.

These traditional manufacturing firms provide detailed information on their ownership structure in 1996. This enables us to examine the issues of corporate governance. Firms are classified by region according to the level-3 Nomenclature of Territorial Units for Statistics (NUTS). In addition, firms are classified by 3-digit NACE-CLIO code on the basis of their main production. Knowledge of the primary product categories in which a firm produces allows us to identify whether it inherited EU or CMEA oriented production from the central planning regime on the basis of our analysis in the previous section.

The survey asks retrospective questions on employment levels, dating back to 1990. While some firms do not report employment for the earlier years, the resultant database is extremely rich: an unbalanced panel of 220 traditional manufacturing firms over 7 years and 4 CEE countries with detailed information on employment, ownership, regional and product classification. Before turning to our microanalysis of these data, we first assess whether the data are representative of the manufacturing sector in terms of official statistics on the evolution of manufacturing employment in each of our candidate countries.

The Evolution of Manufacturing Employment

Industrial employment data by NACE Rev. 1 sectors of manufacturing is obtained from official statistical yearbooks. Table 3 describes the actual evolution of manufacturing employment in each of our 4 countries over time using an index of these data, where employment is normalised by initial manufacturing employment in 1991. With the exception of Bulgaria, the trend over the other CEE countries is one of declining employment at a decreasing rate over time. This can be compared with the evolution of manufacturing employment for the 220 firms in our survey, which accounts for 10 per cent of 1996 total manufacturing employment in these countries. We observe similar trends for each of the countries, but the rate of decline in the firms surveyed is lower than the actual rate of decline in the country. Examining the evolution of employment for CMEA compared with EU trade oriented firms in our survey, it is clear that while both follow the overall trend in employment, the rate of decline is greater for CMEA oriented firms. Firms that historically traded with the EU under central planning clearly outperform those previously oriented to CMEA in terms of employment. In the case of Slovenia for example, by 1996 manufacturing employment in CMEA firms declined to 63 per cent of its 1991 level while that of EU oriented firms fell only to 90 per cent. The differential between the employment performance of CMEA and EU oriented firms and the overall lower decline in our survey data compared with actual employment trends indicates a bias in our sample towards surviving EU oriented firms. This is evident in table 4.

Sector and Trade Orientation of Survey Sample

A decomposition of data by sector and initial trade orientation of products within the 14 broad sectors of manufacturing for each of our candidate countries is provided in Table 4. Examining firstly the total number of firms in each country by sector, it becomes apparent that there is a reasonably good spread of surveyed firms over the 14 broad sectors of manufacturing. With few exceptions, every sector is represented in each country with some inter-country and inter-sector variation. The percentage of EU trade oriented firms (70 per cent overall) is highest in Slovakia (80 per cent) and lowest for Hungary (64 per cent). While the EU oriented firms tend to have a good spread over manufacturing sectors in general, CMEA oriented firms tend to be more clustered into traditional sectors such as the Food, Beverage and Tobacco sector.

Regional Dimensions of Surveyed Firms

Regional differences in factor endowments, infrastructure and distance from EU borders can result in differences in firm performance. Thus, while the speed and success of firm restructuring in industrial sectors is dependent on the inherited trade orientation of firms, in addition it may depend on regional specific factors. For this reason, it is important to explicitly control for regional differences in the location of firms when analysing ownership and performance in the transition to a market economy. Table 5 illustrates the regional classifications according to the level-3 Nomenclature of Territorial Units for Statistics (NUTS) available from Eurostat, and the distribution of firms over these regions. Virtually all regions are represented in our sample. Moreover firms in general and by trade orientation can be seen to have a good geographical spread.

Corporate Structures of Surveyed Firms

The three main methods of privatisation include public offering through share issue, asset sales and mass privatisation. In contrast to western economies, privatisation in transition countries tends to be restricted to either asset sales or mass privatisation programmes due to the low stock of private savings [Estrin, 1994] and the absence of a developed stock exchange [Megginson, Nash, Netter and Poulsen 1998]. Mass privatisation programmes, involving the transfer of vouchers into private hands for the purchase of state assets, were initiated in waves in Bulgaria and Slovakia in 1995 and 1992, respectively, and continuously in Slovenia in 1994.[13] Privatisation in Hungary was undertaken by asset sales in three phases, “Top down sales” in 1990, where the government selected the firms, “Bottom up sales” in 1991-92, where firms selected themselves and a final phase “Bottom up sales” from 1993 that focused on asset sales to domestic outsiders. In all cases either the state or insiders dictated the selection of firms for privatisation to outsiders. Pohl, Anderson, Claessens and Djankov (1997), using 6,300 firms across seven CEE countries during the period 1990-95, while controlling for the fact that the best firms were selected first, find the method of privatisation (voucher or asset sale) did not effect the likelihood of a firm undertaking successful restructuring. For these reasons we model the ownership structures observed across our countries as an outcome of initial trade orientation and sequencing issues, amongst other factors. The country specific privatisation programmes are not considered formally, but are implicitly controlled for by the inclusion of country dummies in our selection and growth equations.

Detailed information on the ownership structure of surveyed firms in 1996 enables us to classify firms by majority ownership type. State owned enterprises is defined in World Bank (1995) as *“government-owned or government-controlled economic entities that generate the bulk of their revenues from selling good and services”*. We model state owned as 50 per cent or more majority state ownership. The state often retains a significant and often decisive influence in privatised firms in transition economies.[14] Even after privatising, the state invariably retains some control of the firm as a consequence of the firm being cash starved [Bolton and Roland 1992, Sinn and Sinn 1993] or a desire for risk sharing in order to induce greater restructuring by the private holder [Bennet and Maw 1998, Demougin and Sinn 1994, Cornelli and Li 1994]. Thus, partial state participation is a phenomenon of transition economies and our data.

When majority control is in the hands of managers or workers we define the firm to have majority insider ownership, as defined in the literature. When majority control is in the hands of foreign or other domestic owners we define the firm to have majority outside ownership. The governance structures in 1996 of the firms in our sample are defined on the basis of the above classifications. Firms are grouped into their endpoint ownership structure in the analysis of their performance over the transition period. As in Frydman, Gray, Hessel and Rapaczynski (1999), we assume that firms selected to state, inside or outsider ownership in 1996 have unobservable group characteristics, or fixed effects, that impacts firm growth over the entire transition period and not just from the date of privatisation. This controls for both pre- and post- privatisation effects in our empirical modelling.

Table 6 decomposes our sample of firms by ownership status and trade orientation in 1996. Overall, we have 35 per cent state owned traditional firms, with 40 and 25 per cent respectively being classified as majority outsider and insider owned. These relative shares by ownership type are similar for both traditionally EU and CMEA oriented firms, and so there is a good representation of each type of firm in our sample.

Employment Size and Firm Growth

In this paper we measure firm performance in terms of employment growth. This circumvents many of the difficulties inherent in measuring performance in terms of revenue, productivity or profitability in transition economies.[15] The employment effects of the privatisation process is a crucial policy variable. Retrospective questions on employment size provide us with details of total numbers employed by firms from 1990 through to 1996. The effect of privatisation on employment across various countries has tended to have an ambiguous effect. Boubakri and Cosset (1998) find that privatisation of firms in developing countries improves performance measures in terms of employment. On the other hand, D'Souza and Megginson (1998) find that privatisation reduces employment in both developing and developed countries. Frydman, Gray, Hessel and Rapaczynski (1999) find no employment effects from privatisation in CEE transition countries.

The summary statistics on average firm size and employment growth over the transition period grouped by ownership type in 1996 and trade orientation in 1988 are presented in Table 7 both for the initial and later years. We note that the sample consists of large firms that were continually downsizing over the first seven years of transition. In our regression analysis we will need to control for the effects of downsizing. This is particularly true for firms selected to majority outsider control by 1996, which tend to be larger on average than firms that remain state over the period in question. Taking the CMEA oriented firms, it is clear in the raw data, that firms selected to outsider control perform better than either firms selected to insider control or those that remained in state hands in 1996. This is very evident in the initial period, when the average growth of outsider firms is –0.02, as compared with –0.11 and –0.12 for insider and state owned firms respectively. Regarding the EU trade oriented firms, the performance of firms over transition does not seem to differ dramatically over the different ownership groups observed in 1996. In the latter period of transition, the average growth rates are –0.02, -0.01 and –0.03 for majority state, outsider and insider firms, respectively. These statistics are in line with the theoretical predictions outlined in the opening section of this paper. Privatisation to outsiders in the previously CMEA trade oriented firms seems to have had a better employment performance when compared to the state or insider owned firms during the transition period. No significant effect of ownership structure on the evolution of employment is observed during transition in historically EU trade oriented firms. We now proceed to verify these conclusions in an econometric model that controls for sample selection issues amongst other time, country, sector and region specific factors.

IV. Empirical Modelling

In this section we undertake an empirical modelling of firm performance and the political economy of corporate governance for traditional manufacturing firms in Bulgaria, Hungary, Slovakia and Slovenia. This analysis extends the approach taken in Frydman, Gray, Hessel and Rapaczynski (1999). They use a sample of 218 small and medium traditional firms for the period 1990 through 1994 in Poland, Hungary and the Czech Republic, to examine the effects of insider and outsider ownership on various measures of firm performance, including employment. They control for pre-and post –privatisation effects on firm growth using group effects, as in this paper. We extend their analysis of insider and outsider corporate governance by using a richer panel database on 220 traditional manufacturing firms spanning CEE countries over a longer time span, 1990 through 1996. The novel features of our approach include the modelling of sequencing to outside ownership in 1996, the conditioning of our sequencing and performance regressions on the initial trade orientation of firms in 1988, and the inclusion of controls for time, country and narrowly defined sectors and regional locations of firms. These novelties have a significant impact on our results and add to our understanding of the impact of ownership structures on firm performance during the early stages of transition in CEE countries. In particular, insider ownership should not be seen as a bad thing, per se, but rather an outcome of market forces and political constraints that ensures the long-term success of the privatisation programme.

The Selection Process to Privatisation

We now proceed to empirically model the selection process to ownership groups in 1996. Our key explanatory variables include a dummy for inherited trade orientation in 1988 and sequencing effects, among other factors. To capture the effect of the best firms being selected for privatisation first, we include the employment growth rate of a firm in an early period of transition, 1991-1992. Most firms in our sample were state owned during this period, the exception being a few firms that may have been involved in the first wave in Hungary. Thus we estimate the probability of firms being privatised in 1996 in the following equation,

$$Ownership_{i,96} = \beta_0 + \beta_2 Growth_{i,t-4} + \beta_3 Trade_i + \beta_4\ Controls + \varepsilon_i \qquad (1)$$

The ownership structure firms is defined for 1996. The growth performance in 1992, rather than 1991, is selected since this has the advantage of maximising the number of survey responses while allowing three years for state firms to restructure during transition. Following the growth of firms literature, in the spirit of Davis and Haltwinger (1992), we compute growth in a discrete way for firm i, bounded in the interval –2 and +2, by the following,

$$Growth_{it} = \frac{Emp_t - Emp_{t-1}}{(Emp_t + Emp_{t-1})/2} \qquad (2)$$

The variable *Trade* indicates the trade orientation that the firm inherits from central planning. This is equal to 1 where firms are primarily producing in NACE CLIO 3-digit products that exported to the EU in 1988, as described in section II of the paper. Other controls include country and regional level-3 NUTS dummies. It is very important to control for regions in modelling the selection process to privatisation given the regional differences in development. Since ownership structures do not vary greatly within individual 3-digit products but there are variations in ownership structures across broader sectors, we include sector controls at the 1-digit level.

The first specification of this model defines *Ownership* equal to 1 where firms are majority privatised (insider or outsider) in 1996 and 0 otherwise. The results of the logit regression are presented in the first column of Table 8.[16] The overall explanatory power of the model is high, R^2 of 0.63. Although not reported, country, sector and regional controls are strongly significant indicating differences in the probability of a firm being privatised over these variables. For example, compared to the default category, Bulgaria, firms are more likely to be privatised in each of the other candidate countries.

The inherited trade orientation of firms has a negative and significant, at the 5 per cent level, effect on the selection process. This indicates that firms that were previously EU trade oriented under central planning are less likely to be privatised by 1996. The state is less likely to privatise highly viable and expanding firms compared to previously CMEA trade oriented firms that require restructuring. As highlighted in the introduction, they find it more profitable to retain control of the EU oriented firms, undertake restructuring, and wait until the economy is more developed with a properly functioning stock exchange to allow a successful public offering.

The probability of being privatised is positively related to firm performance in the early years of transition, but only in the subsample of CMEA firms. This sequencing effect is completely offset in our subsample of EU oriented firms. Within the previously CMEA market there was a sequencing of firms in the privatisation process, with the best performers more likely to be privatised first. In contrast, there is no apparent sequencing in the privatisation of historically EU trade oriented firms, where all firms seem equally viable but collectively less likely to be privatised when compared to historically CMEA firms.

The second specification of the selection model decomposes the average ownership effect further into majority insider and outsider ownership. The results of this multinomial logit regression analysis are presented in the final two columns of Table 8, which illustrate the probability of firms being outsider or insider controlled in 1996 compared with the benchmark case of majority state ownership. Rather interesting results emerge. Column 2 reports the probability of firms being outsider owned compared to state owned in 1996. CMEA firms are more likely to be privatised to outsiders than EU oriented firms, and there is apparent sequencing in the privatisation of CMEA firms to outsiders, as the best performers in 1992 had a higher probability of being selected. In contrast, there is no apparent sequencing in the privatisation of EU trade oriented firms to outsiders.

These results contrast greatly with those relating to the probability of firms being majority insider owned in 1996 when compared with the benchmark case of majority state ownership. In column 3 of Table 8 we observe evidence of sequencing in privatisation, irrespective of the inherited trade orientation of firms. Firms that perform better relative to state firms in 1992 are more likely to be selected to insider control irrespective of trade orientation. In addition trade orientation is not an important factor in the selection of state firms to insider ownership during transition.

These results suggest that the state and insiders did not have a desire to release control of the EU trade oriented firms during transition. They prefer to wait until the stock exchange is adequately developed to ensure a maximum return for these profitable firms in a public share offering. In contrast the state and insiders did have a preference to retain control of poor performing firms with a previously CMEA orientation. Such insider/state control across markets was done to minimise the losses of populations involved in previously CMEA markets and maximise the gains of populations historical involved in EU markets. Given market demand considerations, these outcomes paved a politically acceptable path for the reforms during the early days of transition and ensured long term political support for privatisation and the market system.

Firm Performance, Ownership and Trade Orientation

We are now in a position to model firm performance, in terms of employment, during the period 1990-96 across our 4 CEE countries. The basic growth model we estimate is as follows,

$$\begin{aligned} Growth_{it} = \quad & \beta_0 + \beta_1 Initial\ Size_i + \beta_2 Ownership_{i,96} + \\ & \beta_3 Trade_i + \beta_4 Controls + \varepsilon_i \end{aligned} \tag{3}$$

The employment growth of firm i is computed once again as in (2), where t is defined annually from 1991 through to 1996. From Table 7 the need to control for firm downsizing becomes apparent, and so we include *Initial Size*$_i$ which measures the size of firm in 1990. We firstly examine the average effects of firm types grouped by ownership structure in 1996, *Ownership*$_{i,96.}$, on firm performance during the transition period, which controls for pre-and post-privatisation fixed effects of our firm groupings. Ownership is initially defined as being equal to 1 when a firm is majority private owned and 0 when majority state owned. We first estimate the average effect of privatisation. We initially take ownership structure as a given variable, an assumption that is relaxed later when we instrument ownership structure using the predicted values obtained from our selection equations reported in Table 8. The variable *Trade* indicates the trade orientation that the firm inherits from central planning as before, being equal to 1 in the case of EU trade oriented and zero otherwise. *Controls* include country, year, 3-digit product, and regional level-3 NUTS dummies. The results of various specifications of this model are given in Table 9.

The first column reports the results without conditioning our independent variables on the inherited trade orientation of firms. Country, year, regional and product controls, although not reported here, are highly significant factors in determining firm performance. Initial size is not statistically significant. What is of primary interest is the fact that majority privatised firms do not perform significantly better than state owned. In the second column we introduce the trade orientation of firms in 1988. Neither ownership nor inherited trade orientation is significant at the 5 per cent level. This specification however, fails to recognise that the impact of ownership on firm performance may depend on the trade orientation, EU versus CMEA, of firms. In column three we condition each of our independent variables on the inherited trade orientation of firms. The results are striking. Firms that are EU trade oriented perform significantly better than those firms producing products that were previously direct to the CMEA. Ownership is now positive and significant at the 5 per cent level for the subsample of CMEA oriented firms – privatised CMEA firms performed significantly better than non-privatised firms did over the transition period. However, examining the interaction effect of ownership with EU trade orientation, we observe that the benefits of privatisation are not present in the sample of EU oriented firms. There are no advantages to privatisation in historically EU trade oriented firms. The above results may be a result of the selection processes modelled in Table 8 since both historical firm performance and trade orientation played a role in the determination of firm structure in 1996. Thus, in our final specification we instrument the ownership variable in order to correct for such sample selection problems. The final column of Table 9 documents the results of the growth models using the predicted values of ownership from Table 8. Our results are robust to such instrumentation. Firms that are EU trade oriented perform significantly better over the transition period than those firms producing products that were previously directed to the CMEA, but there are no benefits to the privatisation of such, while CMEA firms reap benefits from privatisation. These results hold even when conditioned on the fact that all EU firms were less likely to be privatised, while good firms from a CMEA background were more likely to privatised.

From the above, it is clear that the average effects of private ownership had a positive effect on performance during the entire transition period amongst firms coming from a background of producing a product for the CMEA market, even when we control for possible endogeneity in the ownership structure. We now decompose the average effect into its two main components: that determined by privatisation to insiders and that due to outsider privatisation. The results are documented in Table 10. Once again, country, regional, product and year controls are highly significant, although not reported here. In columns 1 and 2 the benefit of outside ownership is significant even when we do not condition the effect of ownership on firm performance on inherited trade orientation.

Conditioning ownership on inherited trade orientation in column 3, we find that firms which are EU trade oriented perform significantly better than those firms producing products that were previously directed to the CMEA. Outsider ownership is positive and significant at the 5 per cent level, but only in the subsample of CMEA oriented firms. Once again, the benefits of outsider ownership are completely offset in the sample of EU oriented firms. This contrasts greatly with the effects of insider privatisation on firm performance. Insider controlled firms do not perform statistically better than majority state owned firms, irrespective of their inherited trade orientation. To correct for any possible endogeneity in ownership structure, the final column uses the predicted values of ownership from Table 8. The results are duplicated even when using instrumented ownership.

Conclusions

In this paper we use representative survey data, a rich unbalanced panel of 220 traditional manufacturing firms over 7 years and 4 CEE countries with detailed information on employment, ownership, regional and product classification, to model the determinants of firm performance and ownership structures during transition. We highlight the role of historical firm trade orientation, whether producing for the EU or CMEA market under planning, on the determination of firm performance during transition and the political constraints it imposes on the determination of ownership structure and its subsequent impact on firm performance, among other factors.

Controlling for other factors, firms that produce historically EU oriented products consistently outperform firms that inherited products historically produced for the CMEA market during the first 7 years of transition across our 4 CEE countries. We provide evidence that while CEE countries where eager to restructure the best firms in historically CMEA markets under outsider ownership, they resisted outsider ownership in historically EU markets. In historically CMEA markets, outsiders were given the best firms to restructure during transition, while the state and insiders maintained control of the loss making and politically sensitive firms across our CEE countries during the first 7 years of transition. This was done to build political support for the restructuring of previously CMEA market. The more problematic loss making firms would be dealt with later.

The political economy of privatising EU trade oriented state firms was more in line with those observed in western economies. We show that the state and insiders in such firms were reluctant to privatise these highly viable and expanding firms to outsiders. Politically, it was more beneficial to retain control, undertake restructuring, and support reforms that developed a properly functioning stock exchange, which would eventually allow a successful public offering to outsiders. This was done to build political support from populations linked to the previously EU market. The more problematic issue of selling valuable assets to outsiders, for efficiency reasons, would naturally happen at a later date.

As a result of the different political constraints imposed on the selection process to outside ownership, the effect of corporate governance on firm performance was shown to be different among previously CMEA and EU trade oriented firms. Majority outside ownership outperforms majority insider/state ownership, but only when we condition our regression on initial CMEA trade orientation controlling for a gradualist selection process, pre- and post- privatisation effects, amongst other factors. This results from the political incentives to preserve loss-making firms in the short-run. Majority outside ownership does not outperform majority state/insider ownership when conditioned on initial EU trade orientation. This result is not surprising given the political resistance to giving the best EU oriented firms to outsiders and the fact that such firms are subcontracted by foreign licence, face upstream competition in their EU market, do not have liquidity constraints and inherited mangers with experience in global markets.

It is our thesis that political economy considerations induced insider profit maximising considerations in historically EU oriented firms and insider cost minimising considerations in historically CMEA oriented firms to have an important impact on the privatisation process and its subsequent impact on firm performance. Throughout this paper we have provided empirical evidence that political *constraints* driven by market demand considerations, rather than political *distortions*, have imposed themselves on the privatisation process and its subsequent impact on firm performance in Central Eastern Europe. Employment gains from privatisation are evident in historically CMEA oriented firms. Similar gains from privatisation are not present in historically EU oriented firms, but their inheritance ensured that such firms performed relatively well in terms of employment creation during transition and irrespective of whether they were privatised or not. Clearly trade liberalisation and history rather than privatisation induced these employment gains.

The conditioning of our analysis on initial demand conditions greatly helps to unravel puzzling empirical outcomes in relation to issues of corporate governance in CEE. The established literature sees insider privatisation as a political *distortion* that blocks efficiency gains from the privatisation programme during transition. Yet if one conditions firm performance and the sequencing process to outside privatisation on initial trade orientation, among other factors, one gets an accurate description of the role of insider ownership in the countries of CEE. Insider ownership is an important political outcome, driven by market demand considerations, that builds up political support for market reforms during its initial stages, ensuring their long-term success.

Table 1: 1988 Trade Orientation of Manufacturing Products

1-Digit Sector	Clio3 Products	Bulgaria EU Trade	Hungary EU Trade	Slovakia EU Trade	Slovenia EU Trade
1. Food, Beverage and Tobacco	411	0	0	0	1
	412	1	1	1	1
	413	1	1	1	0
	414	1	1	1	1
	415	1	0	0	0
	416	0	0	0	0
	417	0	0	0	0
	418	0	0	0	0
	419	0	0	0	0
	420	0	0	0	1
	421	0	0	1	1
	422	1	1	0	1
	423	0	1	1	1
	424	0	0	0	0
	425	0	0	0	0
	426	0	0	0	0
	427	0	0	1	0
	428	0	0	0	0
	429	0	0	0	0
2. Textiles and Textile Products	431	1	1	0	1
	432	1	1	1	1
	436	1	1	1	1
	438	1	1	1	0
	439	0	0	1	0
	453	1	1	1	1
	455	1	1	1	1
	456	0	1	0	0
3. Leather and Leather Products	441	0	1	0	1
	442	1	1	1	0
	451	1	1	1	1
4. Wood Products	461	1	1	1	1
	462	1	1	1	1
	463	0	1	0	1
	464	0	0	0	0
	465	1	1	0	0
	466	1	0	0	1
	467	1	1	1	1
5. Paper, Printing and Publishing	471	1	1	1	1
	472	0	0	0	1
	473	1	1	1	0
	474	0	0	0	0
6. Fuels Production	120	0	0	0	0
	140	1	1	1	1
	152	0	0	0	0
7. Chemicals, products, fibers	252	1	1	1	1
	253	1	1	1	1
	255	0	0	0	0
	256	1	1	1	1
	257	1	0	0	0
	258	0	0	0	0
	259	0	0	0	1
	260	0	1	1	1
8. Rubber and Plastic Products	481	1	1	1	1
	482	0	0	0	0
	483	1	1	1	0

1-Digit Sector	**Clio3 Products**	**Bulgaria** EU Trade	**Hungary** EU Trade	**Slovakia** EU Trade	**Slovenia** EU Trade
9. Mineral Materials and Products	241	1	0	0	0
	242	0	1	1	1
	243	0	0	1	0
	245	1	1	0	1
	246	0	0	0	1
	247	1	1	1	1
	248	1	1	1	1
10. Basic Metals and Fab. products	221	1	1	1	1
	222	1	1	1	1
	223	1	1	1	1
	224	1	1	1	1
	311	0	1	0	1
	312	0	0	0	0
	313	0	0	1	0
	314	0	1	1	1
	315	0	0	0	0
	316	1	1	1	1
11. Machinery, excluding Electrical	321	0	1	1	1
	322	1	1	1	1
	323	0	0	1	0
	324	0	1	0	1
	325	1	1	1	1
	326	1	1	1	1
	327	0	1	0	1
	328	1	1	1	1
12. Electrical and Optical Equipment	330	1	0	1	1
	341	0	0	1	1
	342	1	1	1	1
	343	1	1	1	1
	344	1	1	1	1
	345	1	1	1	1
	346	1	1	1	1
	347	1	1	1	0
	371	1	1	1	1
	372	1	1	0	0
	373	0	0	0	1
	374	0	0	1	0
13. Transport Equipment	351	0	1	1	1
	352	0	0	0	1
	353	1	1	1	1
	361	0	0	0	0
	362	1	1	1	0
	363	0	0	1	1
	364	0	1	0	1
	365	0	0	0	0
14. Other Manufactured Products	491	0	1	1	0
	492	0	0	0	0
	494	1	0	1	1
	495	1	1	1	1

Table 2a: Share of EU Oriented Clio3 Products within Sectors in 1988

Nace Rev 1 Digit Sector	# Products per Sector	Share of EU Trade Oriented Products			
		Bulgaria	Hungary	Slovakia	Slovenia
1. Food, Beverage and Tobacco	19	0.26	0.26	0.32	0.37
2. Textiles and Textile Products	8	0.75	0.88	0.75	0.63
3. Leather and Leather Products	3	0.67	1.00	0.67	0.67
4. Wood Products	7	0.71	0.71	0.43	0.71
5. Paper, Printing and Publishing	4	0.50	0.50	0.50	0.50
6. Fuels Production	3	0.33	0.33	0.33	0.33
7. Chemicals Products, Fibres	8	0.50	0.50	0.50	0.63
8. Rubber and Plastic Products	3	0.67	0.67	0.67	0.33
9. Mineral Materials and Products	7	0.57	0.57	0.57	0.71
10. Basic Metals and Fabricated Products	10	0.50	0.70	0.70	0.70
11. Machinery, excluding Electrical	8	0.50	0.88	0.75	0.88
12. Electrical and Optical Equipment	12	0.75	0.67	0.83	0.75
13. Transport Equipment	8	0.25	0.50	0.50	0.63

Table 2b: Annual Average Growth in Sector Exports, 1988-96

Nace Rev 1 Digit Sector	Bulgaria	Hungary	Slovakia	Slovenia
1. Food, Beverage and Tobacco	0.09	0.07	0.16	0.11
2. Textiles and Textile Products	0.28	0.24	0.31	0.21
3. Leather and Leather Products	0.37	0.32	0.38	0.14
4. Wood Products	0.17	0.14	0.21	0.15
5. Paper, Printing and Publishing	0.06	0.19	0.19	0.15
6. Fuels Production	0.09	0.15	0.18	0.63
7. Chemicals Products, Fibres	0.17	0.12	0.26	0.22
8. Rubber and Plastic Products	0.15	0.19	0.29	0.19
9. Mineral Materials and Products	0.21	0.14	0.22	0.21
10. Basic Metals and Fabricated Products	0.23	0.16	0.31	0.20
11. Machinery, excluding Electrical	0.15	0.23	0.29	0.27
12. Electrical and Optical Equipment	0.16	0.35	0.41	0.21
13. Transport Equipment	0.29	0.58	0.59	0.22

Table 2c: 1988 Trade Oriented Products: Exports in 1996 as a Share of 1996 Exports

Nace Rev 1 Digit Sector	Bulgaria	Hungary	Slovakia	Slovenia
1. Food, Beverage and Tobacco	1.0	0.9	0.6	0.8
2. Textiles and Textile Products	1.0	1.0	1.0	1.0
3. Leather and Leather Products	0.9	1.0	0.9	0.9
4. Wood Products	1.0	1.0	0.8	0.9
5. Paper, Printing and Publishing	0.8	0.7	0.8	0.9
6. Fuels Production	1.0	1.0	1.0	1.0
7. Chemicals Products, Fibres	1.0	0.9	1.0	0.9
8. Rubber and Plastic Products	1.0	1.0	1.0	0.6
9. Mineral Materials and Products	0.9	0.9	1.0	0.9
10. Basic Metals and Fabricated Products	1.0	1.0	0.9	0.9
11. Machinery, excluding Electrical	0.9	1.0	0.9	1.0
12. Electrical and Optical Equipment	0.8	0.7	1.0	1.0
13. Transport Equipment	0.2	1.0	1.0	1.0

Source: EUROSTAT Trade Data, 1988

Table 3: Evolution of Manufacturing Employment

	1991	1992	1993	1994	1995	1996
Bulgaria						
Actual	1	0.83	0.70	0.67	0.75	0.79
Survey – All	1	0.84	0.74	0.69	0.76	0.74
Survey – CMEA	1	0.83	0.68	0.62	0.67	0.65
Survey – EU	1	0.84	0.76	0.71	0.79	0.78
Hungary						
Actual	1	0.85	0.74	0.68	0.65	0.63
Survey – All	1	0.94	0.86	0.79	0.75	0.71
Survey – CMEA	1	0.94	0.86	0.78	0.72	0.63
Survey – EU	1	0.95	0.87	0.80	0.77	0.76
Slovakia						
Actual	1	0.87	0.78	0.75	0.75	0.74
Survey – All	1	0.98	0.93	0.87	0.86	0.85
Survey – CMEA	1	0.99	0.96	0.82	0.82	0.81
Survey – EU	1	0.97	0.92	0.88	0.87	0.86
Slovenia						
Actual	1	0.89	0.81	0.77	0.74	0.69
Survey – All	1	0.95	0.90	0.91	0.89	0.86
Survey – CMEA	1	0.91	0.78	0.73	0.71	0.63
Survey – EU	1	0.95	0.92	0.95	0.92	0.90

Source: LICOS Industrial Database and LICOS Survey Database

Table 4: Number of Firms by Sector and Trade Orientation

Nace Rev 1 Digit Sector	**Bulgaria**			**Hungary**			**Slovakia**			**Slovenia**		
	# firms	EU	CMEA	# firms	EU	CMEA	# firms	EU	CMEA	# firms	EU	CMEA
1. Food, Beverage and Tobacco	18	7	11	26	12	14	1	1	0	7	2	5
2. Textiles and Textile Products	13	12	1	11	10	1	12	10	2	5	5	0
3. Leather and Leather Products	3	2	1	1	1	0	0	0	0	2	2	0
4. Wood Products	9	8	1	2	2	0	3	2	1	5	5	0
5. Paper, Printing and Publishing	2	0	2	1	1	0	0	0	0	3	2	1
6. Fuels Production	0	0	0	0	0	0	1	1	0	1	1	0
7. Chemicals Products, Fibres	2	1	1	5	1	4	8	4	4	1	0	1
8. Rubber and Plastic Products	3	3	0	2	2	0	2	2	0	0	0	0
9. Mineral Materials and Products	2	0	2	1	1	0	3	3	0	2	2	0
10. Basic Metals and Fabricated Products	2	1	1	7	2	5	7	7	0	4	2	2
11. Machinery, excluding Electrical	8	5	3	3	3	0	3	3	0	2	2	0
12. Electrical and Optical Equipment	2	2	0	6	6	0	6	5	1	3	3	0
13. Transport Equipment	3	2	1	1	1	0	2	1	1	2	2	0
14. Other Manufactured Products	1	1	0	1	1	0	0	0	0	0	0	0
TOTAL	**68**	**44**	**24**	**67**	**43**	**24**	**48**	**39**	**9**	**37**	**28**	**9**
Total Firms Overall = 220												
Total EU Firms Overall = 154												

Source: LICOS Survey Database

Table 5: Manufacturing Firms by Regional Classifications According to the Nomenclature of Territorial Units for Statistics (NUTS)[1]

Bulgaria	**EU**	**CMEA**	**Hungary**	**EU**	**CMEA**
Sofia – Capital City	5	3	Budapest	13	7
Dobrich	3	2	Pest	5	1
Veliko Turnovo	1	1	Veszprem	1	1
Gabrovo	3	0	Komaron-Esztergom	1	1
Lovech	2	1	Gyor-Moson-Sopron	1	2
Pleven	2	0	Zala	3	1
Vidin	2	1	Baranya	2	0
Vratsa	1	0	Somogy	0	3
Razgrad	2	3	Tolna	1	0
Rousse	1	1	Borsod-Abauj-Zempln	1	2
Silistra	1	2	Heves	1	0
Turgovishte	3	1	Nograd	3	0
Bourgas	2	0	Hajdu-Bihar	1	1
Sliven	1	1	Jasz-Nagykun-Szolnok	2	0
Yambol	2	1	Szabolcs-Szatmar-Bereg	2	2
Pazardjik	1	1	Bacs-Kiskun	1	0
Plovdiv	2	3	Bekes	2	2
Blagoevgrad	1	0	Csongrad	3	1
Pernik	2	1			
Kurdjali	3	1			
Stara Zagora	1	1			
Haskovo	3	0			
Total Firms	**44**	**24**	**Total Firms**	**43**	**24**
Slovakia	**EU**	**CMEA**	**Slovenia**	**EU**	**CMEA**
Bratislavsky	5	0	Pomurska	4	4
Trnavsky	2	1	Podravska	4	2
Trenciansky	5	4	Koroska	2	0
Nitriansky	4	1	Savinjska	4	1
Zilinsky	5	0	Dolenjska	3	0
Banskobystricky	8	0	Osrednjeslovenska	2	0
Presovsky	4	3	Gorenjska	6	1
Kosicky	6	0	Notranjsko-Kraska	2	0
			Oblano-Kraska	1	1
Total Firms	**39**	**9**	**Total Firms**	**28**	**9**

1. Regional Classification Level-3 NUTS

Source: LICOS Survey Database

Table 6: Ownership Structure of Survey Sample

	Total Sample	**EU Trade Oriented Firms**	**CMEA Oriented Firms**
Total Number of Firms	**220**	**154**	**66**
Majority State Owned	35 %	34 %	38 %
Majority Outsider Owned	40 %	39 %	41 %
Majority Insider Owned	25 %	27 %	21 %

Source: LICOS Survey Database

Table 7: Survey Manufacturing Employment Growth and Size

	Size 1990-92	Size 1992-96	Growth 1990-92	Growth 1992-96
Majority State Owned				
EU Firms	1045	833	-0.09	-0.02
CMEA Firms	652	622	-0.12	-0.07
Majority Privatised				
EU Firms	987	801	-0.05	-0.03
CMEA Firms	949	648	-0.03	-0.06
Majority Outsider Owned				
EU Firms	1252	967	-0.05	-0.03
CMEA Firms	1260	856	-0.02	-0.04
Majority Insider Owned				
EU Firms	685	594	-0.03	-0.01
CMEA Firms	395	320	-0.11	-0.06

Source: LICOS Survey Database

Table 8: Ownership Selection Logit Regressions: State and Privatised Manufacturing Firms 1996[a]

Ownership$_{96}$	Model I Logit: State vs. Private	Model II Multinomial Logit:	
		State vs. Outsiders	State vs. Insiders
Growth$_{t-4}$	34.6 (2.82)*	46.6 (3.00)*	33.0 (2.07)*
Trade Orientation	-3.98 (2.63)*	- 3.97 (2.35)*	- 2.99 (1.68)
Growth$_{t-4}$ X Trade Orientation	- 35.4 (2.77)*	- 51.0 (3.05)*	- 15.8 (0.94)
Constant	2.51 (1.36)	0.86 (0.50)	- 72.4 (0.00)
Regional Level Dummies	YES	YES	YES
Sector Dummies	YES	YES	YES
Country Dummies	YES	YES	YES
R^2	0.63	0.70	
Number Observations	176	176	

[a] T-statistics in parentheses

* Significant at the 5 per cent level

Table 9: Ownership Regressions: State and Privatised Manufacturing Firms over the period 1991-1996 [a]

	State versus Private Ownership			Instrumented Ownership
Growth Firm $_t$	**Model I**	**Model II**	**Model III**	**Model IV**
Initial Size	- 0.00001 (1.50)	- 0.00001 (1.80)	- 0.00003 (1.56)	- 0.00002 (0.74)
Initial Size X Trade Orientation			0.00002 (0.98)	0.00002 (0.62)
Privatised Ownership	0.04 (1.70)	0.04 (1.75)	0.14 (3.00)*	0.22 (2.82)*
Trade Orientation		0.10 (1.67)	0.16 (1.98)*	0.22 (2.00)*
Privatised Ownership X Trade Orientation			- 0.12 (2.36)*	- 0.17 (2.08)*
Constant	- 0.16 (1.80)	- 0.27 (2.44)*	- 0.29 (2.61)*	- 0.47 (3.31)*
Country Dummies	YES	YES	YES	YES
Regional Level Dummies: NUTS level 3	YES	YES	YES	YES
Product Dummies: NACE CLIO 3	YES	YES	YES	YES
Year Dummies	YES	YES	YES	YES
R^2	0.28	0.28	0.29	0.28
Number Observations	1003	1003	1003	938
Heteroscedasticity	$\chi 2(137) = 146$	$\chi 2(136) = 121$	$\chi 2(136) = 126$	$\chi 2(128) = 110$
Autocorrelation, AR1	$\chi 2(1) = 8$	$\chi 2(1) = 8$	$\chi 2(1) = 10$	$\chi 2(1) = 9$

a T-statistics in parentheses

* Significant at the 5 per cent level

Table 10: Ownership Regressions: Majority State, Outside and Insider Owned Manufacturing Firms over the period 1991-1996 [a]

	State versus Inside and Outside Ownership			Instrumented Ownership
Growth Firm $_t$	**Model I**	**Model II**	**Model III**	**Model IV**
Initial Size	- 0.00001 (1.47)	- 0.00002 (1.94)	- 0.00003 (1.52)	- 0.00002 (0.91)
Initial Size X Trade Orientation			0.00002 (0.88)	0.00002 (0.75)
Insider Owned	0.004 (0.13)	- 0.01 (0.42)	0.08 (1.19)	0.05 (0.44)
Outsider Owned	0.05 (2.10)*	0.06 (2.40)*	0.14 (2.97)*	0.17 (2.32)*
Trade Orientation		0.15 (2.41)*	0.20 (2.37)*	0.21 (1.99)*
Insider Owned X Trade Orientation			- 0.11 (1.40)	- 0.07 (0.68)
Outsider Owned X Trade Orientation			- 0.11 (1.97)*	- 0.18 (2.23)*
Constant	- 0.18 (2.01)*	- 0.36 (3.10)*	- 0.39 (3.02)*	- 0.46 (3.16)*
Country Dummies	YES	YES	YES	YES
Regional Level Dummies: NUTS level 3	YES	YES	YES	YES
Product Dummies: NACE CLIO 3	YES	YES	YES	YES
Year Dummies	YES	YES	YES	YES
R^2	0.28	0.29	0.29	0.27
Number Observations	1003	1003	1003	938
Heteroscedasticity	$\chi2(136) = 120$	$\chi2(136) = 121$	$\chi2(136) = 125$	$\chi2(128) = 108$
Autocorrelation, AR1	$\chi2(1) = 8$	$\chi2(1) = 9$	$\chi2(1) = 10$	$\chi2(1) = 8$

a T-statistics in parentheses

* Significant at the 5 per cent level

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Endnotes

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[1] With regard to speed and the sequencing of reforms, the “Big Bang” approach stresses the complementarity of reforms for economic consistency, as in Blanchard et al 1991, Lipton and Sachs 1990, Newbery 1991, and Portes 1991.

[2] The apparent failure of privatisation to insiders, as defined by workers and managers of the firm, is found in Frydman, Gray, Hessel and Rapaczynski (1999), Earle and Estrin (1996), Blanchard and Aghion (1996), Murphy, Shleifer and Vining (1993).

[3] The emphasis on supply side distortions as the sole determinant of the evolution of industrial output in CEE countries is found in Atkeson and Kehoe (1996), Blanchard (1997), Blanchard and Kremer (1997) and Roland and Verdier (1997). While supply side considerations may be extremely relevant when explaining the evolution of historically CMEA oriented production during transition, [see Konings and Walsh (1999) for the case of Ukraine], their constraint on the evolution of historically EU oriented production is not evident.

[4] Cornelli and Li (1997) and Katz and Owen (1993) indicate that the state may be reluctant to privatise firms to outsiders in order to protect employment.

[5] Martin and Parker (1995) examine UK firms in the 1980s and find many improved in terms of performance before privatisation indicating a shake-out and restructuring of firms pre-privatisation. Li (1997) on a sample of 272 state owned Chinese firms show the benefits of the 1979 market reforms on firm performance during 1980-1989 in the absence of privatisation. Dewenter and Malatesta (1998) find that operating profits increase prior to divestiture but may decrease somewhat afterward. This is interpreted as evidence that governments efficiently restructure some firms before privatising in order to receive a higher price on privatising, although the actual change in ownership does not give rise to subsequent efficiency gains. Nellis and Kikeri (1989) suggest state restructuring pre-privatisation in order to eliminate distortions such as those arising from Trade Unions.

Megginson, Nash, Netter and Poulsen (1998) explicitly study the choice between asset sales and share issue privatisation. Empirically they find that state owned enterprises are more likely to be sold through a share offering the larger is the firm, when the company being sold is a telecom, and the more developed is the national stock market.

[6] For an excellent survey of empirical studies on privatisation, the reader is referred to Megginson and Netter (1999).

[7] Vining and Boardman 1992 show this in market economies, while Claessens, Djankov and Pohl 1997 illustrate this for transition economies.

[8] Many studies find no average effect of privatisation in transition countries. See for example Pinto et al, 1993.

[9] The first year of available trade data for Slovakia and Slovenia was 1993 and 1992 respectively. In order to derive the historical trade orientation of products for these countries therefore, it was necessary to trek the characteristics of those products exported in the first available year of data back to the corresponding trade data in 1988 for Czechoslovakia and Yugoslavia.

[10] The sole exception to this is the Transport Equipment sector in Bulgaria, where 1988 EU trade oriented products only account for 20 per cent of total exports to the EU in 1996. This would suggest that there has been a reorientation of products from the CMEA to the EU market over time in this particular case.

[11] For detailed information about the survey content, questionnaire and methodology see Bilsen (1997).

[12] *De Novo* firms are typically much smaller than traditional firms, private upon entry. We wish to focus on the impact of privatisation on tradition firms conditioned on their initial trade orientation. We therefore exclude them from our analysis. Konings (1997) using the same data undertakes a comparison of traditional and *de nova* firm performance during transition.

[13] See Estrin (1994) for details on the privatisation methods in Central Eastern Europe.

[14] See for example, Frydman, Pistor and Rapaczynski (1996), Blanchard and Aghion (1996), Pistor and Spicer 1997, and Meyendorff and Snyder (1997).

[15] Transition specific difficulties in such empirical measures of performance include the presence of high and volatile inflation rates, variations in accounting standards to conform with western norms, appropriate evaluation of inherited capital stock, and tax evasion. See Bevan, Estrin, and Schaffer (1999) for a more detailed overview of these issues.

[16] Note that only the ownership structure of a subsample of our 220 firms can be predicted due to certain firms failing to fill in employment levels for 1992.

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