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## **Decision-making and human factors in the context of privatization and transformation**

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Paul L. Koopman and Frank A. Heller

in co-operation with

Magdolna Adorján, Károly Balaton, Béla Galgóczi, Csaba Makó

and Ferenc Ternovsky

## **Decision-making and human factors in the context of privatization and transformation**

***Abstract.** This contribution is based on a longitudinal research project in six Hungarian companies. The field-work lasted two years and included four years of retrospective tracing of events, giving data covering six years during the transition from centralized state control to attempts at introducing a market economy. The project adopted a micro-economic decision-making perspective to discover critical intra-organizational factors that could account for successful or unsuccessful adaptation during the transition between two different external politico-economic systems. We reach four main conclusions: (1) privatization is multidimensional, being decisively influenced by the recent or even long-term history of identifiable organizational circumstances; (2) it is not evident, at least in the short run, that new organizational structures or leadership behaviour result from external pressures as theory tends to assume; (3) to understand managerial behaviour, one has to consider distinct phases of development from pre-privatization onward; (4) more generally, organizational adaptation tends to be slow rather than rapid; learning is influenced by an identifiable number of individual, group and sectorial circumstances that impede rapid adaptation.*

***Key words.** Central Europe – Decision-making – Privatization – Transformation*

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## Introduction

This research project was based on the assumption that, particularly under conditions of rapid change, conventional neo-classical economic analysis pays relatively little attention to decision processes at the organizational level. The neo-classical market theory of the firm under capitalism uses various objective functions to model and predict firm behaviour, essentially profit maximization, but sometimes qualified by other utility-maximizing behaviour by non-shareholding stakeholders (Williamson, 1983). In the West, these models provide stable functional explanations of why decisions are taken. What they do not explain is how decisions are made. This has been the domain of management and organization science (Cyert, 1988).

Intra-firm decision-making processes are still poorly understood, and it is a central assumption of this project that we cannot expect a priori that the introduction of new market structures in Central and Eastern Europe will of themselves produce optimal or even adequate decision-making processes at the level of the firm, and certainly not in the short to medium term (Vernon, 1977). In a market economy, decision processes are under the control of management, and it is hypothesized that the quality and timing of these decisions and their implementation will influence intra-firm efficiency and, when aggregated, sectorial economic performance.

Consequently, the thrust of an in-depth longitudinal case study is to examine micro-economic events and processes during the transition to a market economy. There are studies of the economic and social conditions of enterprises under state ownership, state planning and state control (Gabor, 1994; Grootings et al., 1985). There is also a substantial literature on the market economy and the profit-maximizing firm under various degrees of competition (for instance, Alchian and Demsetz, 1972; Bates, 1990).

These analyses are usually static rather than longitudinal. One interesting exception is a three-phase model presented by Estrin and Hare (1993). The three phases cover the periods from pre-transition via what is called commercialization to privatization.<sup>1</sup> Conditions are assumed on an a priori basis to exist in each phase. For instance, during the commercialization stage, prices are thought to have been liberalized, and organizations are expected to cope with “demand shock”, the sudden evaporation of some markets and changed conditions in others. Employment, that is to say over-

employment, is expected to be maintained. Under the final stage of privatization, it is assumed that the changes of ownership will create new organizational objectives which will bring about profit maximization and get rid of x-inefficiencies.<sup>2</sup> This phase model is interesting and an improvement over static models. The present project also adopted a longitudinal phase model influenced by earlier intra-organizational research (Koopman et al., 1984). As will be seen, our research does not support the theoretical assumptions of the Estrin and Hare model. At the same time our approach helps to fill in some of the unknown circumstances surrounding the major conditions specified by Estrin and Hare. For instance:

- Does “demand shock” operate on its own or is it preceded, accompanied or followed by other stress conditions during the transition period?
- What do firms do to cope with or overcome “demand shock”?
- Is the government in a position to help with this transition problem?
- What particular x-inefficiencies are critical during the pre-privatization phase?
- Are organizations aware of these inefficiencies and how do they respond to them?
- Privatization is a broad, multifaceted concept. It can, but need not, include competition; it often assumes a high degree of free trade and mobility of labour. What are the priority conditions that characterize privatization and which of them exert the pressure to bring about profit maximization and elimination or reduction of x-inefficiency?

It is unrealistic to expect complete answers to these questions in a single project, but we believe that our research demonstrates that progress can be made.

In general, our review of the literature suggests that very little work has been done from a micro perspective to map out the various issues dominating the transition from dirigisme to a free market, although the subject is now beginning to attract attention (see, for instance, Makó and Simonyi, 1995; Roe, 1995).

Organizational learning theory also seems relevant in studying strategic behaviour of companies in the transition period (Balaton, 1996). Learning can take different forms (Nadler and Tushman, 1996; Senge, 1996). Organizations faced with new environmental

conditions often try new ways of adapting. Distinguishing between “exploration” and “exploitation” (March, 1991) seems fruitful for acquiring more extensive knowledge of organizational transition. “Exploration includes things captured by terms such as search, variation, risk taking, experimentation, play, flexibility, discovery, innovation. Exploitation includes such things as refinement, choice, production, efficiency, selection, implementation, execution” (March, 1991: 71). A similar distinction is between first- and second-order change (Porrás and Robertson, 1992).

### **The conceptual design of the study**

The research was conceived as an attempt to study micro-economic events from the point of view of psychology and in this way to test claims by economists that their models are capable of dealing adequately with virtually all social science issues (Barney, 1990; Buckley and Casson, 1994; Olson, 1990; Ordeshook, 1990).

The traditional macro-economic model tends to treat organizations as black boxes that respond to exogenous variables like monetary and fiscal policy. The results of these exogenous variables can therefore be ascertained directly from outputs of the whole system, like economic growth or decline, without paying any attention to what happens inside the black box. Since Central and East European countries are advised to take a range of important policy decisions by western macro-economists, it seems important to look closely at this model and to open up the black box to see whether intra-organizational events are as inert as is claimed.

Several successful attempts to open the black box have been made, most notably by Herbert Simon (1983) and March and Simon (1958). Some economists have challenged macro-economic theory (Sen, 1984), its forecasting ability and the validity of its models (Ormerod, 1994). Nevertheless, as the economist John Kay (1996) has observed, “most people – including many economists – still think that macro relates to the big issues and micro to the small” (1996: v). Kay illustrates why this approach is mistaken by pointing to what he describes as “the greatest of all economic experiments – the fifty year division of Germany into two economic zones”. Clearly, he argues, the reason why income levels in the West were more than twice as high as those in the East was not the interest

and exchange rate policy of the Bundesbank. Rather, it was the “different ways in which two zones organised their industries and their markets”. Kay’s analysis is situated at the meso level, operating above the level of the individual firm, and therefore makes up the black box’s environment which is also relevant to our own project framework.

### **Field methodology**

Four factors underpinned the research design: time, context, change and principal actors (or leadership). It will be seen in the case studies that these factors overlap or are intertwined, but each makes a critical contribution to the complex process of transition from state to private ownership and from protection to competition.

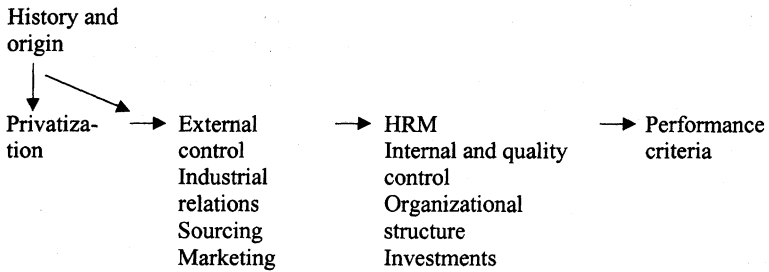
Under the concept *time* we not only cover six years (four of them retrospectively) in a longitudinal design, but we group the data in three phases: pre-privatization, the period around privatization and post-privatization.

Under *context* we look for factors external to the organization which could be hypothesized as acting as facilitators or constraints on the privatization process: access to finance, access to markets and competitive factors such as technology, as well as laws and economic factors including taxation, rate of interest and political stability.

Under *change* we include existing knowledge about resistance and the conditions or incentives which help to overcome resistance to change or moderate it. If new methods, ideas and behaviour are required to optimize the advantages of economic liberalization, should the change be incremental or rapid?

Under *principal actors*, the case studies have attempted to assess how owners, senior managers and lower levels of employees or their trade-union representatives participated in the decision-making process in the three transition phases. To the extent that the responsibility for action rests with senior management, at least in the first two phases, the project looks at the role of leadership, both inside the organization and in the handling of the uncertain context.

A general assumption was that history would influence the form the privatization process would take and co-determine the effects



**FIGURE 1**  
**Heuristic model at the beginning of the research**

it would have on changes in external control, industrial relations, sourcing and marketing. These last developments were expected sooner or later to have an impact on the organization structure, investments, internal and quality control, and the human resource management systems (see Figure 1).

In designing our field-work, we took account of the arguments advanced by Williamson (1990), referring with approval to Herbert Simon’s claim that there are circumstances in organizational research when statistical methods are inappropriate because errors of measurement are very high. Instead it is necessary “to find techniques for observing the phenomena at a higher level of resolution”. From this, Williamson goes on to argue that economists should collect “new kinds of data at the micro level” (1990: 179). However, there are different ways of interpreting the micro level. Economists often take it to mean the level of an industry or sector, or the totality of an enterprise, while psychologists and other behavioural scientists identify the micro level with intra-organizational dynamics. We have taken this latter approach and, in this context, the decision process is seen to be the appropriate unit of analysis.

Our project was sponsored by the EC-ACE programme of the European Union. Two countries from the West were expected to co-operate with partners in Central or Eastern Europe. The initiative came from the Tavistock Institute in London. Working together with the Free University in Amsterdam, a cross-national team was formed with three groups of partners in Budapest. The fieldwork and the basic interpretation of data were carried out entirely by the three Hungarian groups.<sup>3</sup> This aspect of the research design



differentiates it from many other East–West projects where researchers unfamiliar with the culture and language of the host country take an active part in the fieldwork, interpretation and analysis. We felt that research in culturally and politically sensitive areas cannot always be carried out appropriately by researchers from other countries. However, as in all research design choices, there are also limitations to this division of responsibilities since it significantly reduced the non-Hungarian researchers' opportunity to interrogate the emerging data.

In choosing our sample of companies, relevant selection criteria were: variance in the amount of success or failure, variance in sectors (service versus production companies); different stages of development; inclusion of companies obliged to change from the former COMECON orientation to the advanced capitalist economies; accessibility of companies for a longitudinal empirical study.

### **Some historic circumstances**

In Hungary, the 1989 privatization wave was preceded by decade-long reforms and decentralization measures through which some elements of property rights were delegated to insider groups (Kornai, 1990; Nayshul, 1992). Some 50 percent of state enterprises were directed by “company assemblies” (based on the 1984 Enterprise Law), where the management and the employees enjoyed extensive property rights (free decision on the use of profits, decision right to bring company assets into private business partnerships from 1988, including joint ventures).

The existence of strong insider groups (unlike in the German Democratic Republic and the Czech Republic) substantially limited state control over privatization. The first effect of this was the so-called “spontaneous privatization” of 1989–90 – also referred to as “nomenklatura privatization”. The existence of strong insider groups stamped its mark on privatization practices in Hungary. The impact was seen in two characteristics: in some cases privatization was slowed down substantially through decision deadlock, although privatization in general occurred by diverse decentralized privatization measures. Second, the Hungarian government was able to avoid privatization deadlock by giving wide-scale concessions to insider groups.

## **Description of cases**

### *Clothing company A*

Company A is one of the leading clothing factories in West Hungary, with decades of experience. It has undergone major changes over the past period and, unlike many other clothing companies, it has survived. The number of employees has decreased from 2173 to 1688 between 1988 and 1993. In the same period, the sales turnover increased from DM 27.3 million to DM 32.3 million, mainly due to enlarged export sales. The fully state-owned company was privatized in 1990 and in 1993 had moved into majority foreign ownership.

The dominant pattern of the organizational development of the company was its cumulative character. The managers and employees were able – sometimes through periods of intensive conflict – to adopt and combine new patterns of work organization with the old ones. This approach of “recombination” of old and new patterns in the modernization of production systems was visible during the early 1970s, when this typical large state-owned company’s management was the first in Hungary to rationalize the production system, according to the Fordist organizational paradigm.

This accent on continuous improvement had a strong impact on the introduction of information technology and innovation in production (for instance, a computer-aided design and cutting system, automation of stock control and the introduction of statistical quality control during the 1980s). These changes gave the company a competitive edge on comparable clothing firms in the former socialist countries of Central and Eastern Europe.

This recombination approach was reflected in market policy as well. The company successfully used the “market triad” of the ex-COMECON, the national market and the market of the developed countries. These were the key factors – compared with other state or co-operative-owned clothing companies – in the successful shift of production capacities from the collapsed market segment of the ex-socialist countries to the market of the developed countries. This shift is clearly reflected in the radically increased number of important foreign customers of the company: from 12 in 1988 – just before the collapse of the COMECON market – to 29 in 1993.

As a result of this permanent development of production and diversification of market relations – mainly in the form of sub-

contracting – this clothing company became one of the most attractive large state-owned firms for professional foreign investors at the end of the 1980s.

The privatization with the aid of professional foreign investors undoubtedly helped this company to substantially modernize its production system by important annual investment. The amount of the investment after privatization has increased several times compared to the previous years.

The overall positive impact of privatization (in 1990) was the result of the combined effects of the following factors: (1) a tradition of continuous improvement in production methods and management tools; (2) the capability of the company management – especially in the 1970s and 1980s – to anticipate new developments in production technologies and customer requirements; (3) a long history of production co-operation (in the form of subcontracting) with foreign manufacturing and trading companies operating in developed countries; (4) continuous transfer of managerial know-how since the beginning of the 1970s and the possibility to compare the requirements of Soviet-type customers with customers in market economies; (5) relative stability of the firm and national-level labour relations. Firm-level labour relations are characterized by a long period of co-operation and loyalty.

### *Clothing company B*

This company was established in 1952 to manufacture women's clothes. Since the 1970s it exported to the Soviet Union and to Arab countries in the Middle East. Privatization began in 1988, when it was transformed into a shareholding company. The management formed a strategic alliance with foreign investors, who made a major financial contribution to the newly privatized company. The volume of sales increased from DM 32.6 million to DM 40.9 million between 1988 and 1993. The company forms one of the few examples where the number of employees increased during the transformation period: from 1586 in 1988 to 2398 in 1993. In 1991 the company's shares were floated on the Budapest Stock Exchange and in 1993 the company was 97.7 percent foreign-owned.

Which factors were important in this successful privatization process, leading to organizational renewal? First, a clear export orientation was characteristic of the firm since the 1970s. Decreasing

profitability in the market of the Soviet Union and decreasing demand in the Middle East Arab countries induced the company to re-orient towards West European markets. Meeting the needs of western markets required improved product quality and technical changes. Professional investors from Western Europe were invited to form a strategic alliance with the company, which started sub-contracting for its West European partners. Most of them had by that time become shareholders. The firm was transformed into a shareholding company in 1989. Privatization had been realized in three steps involving introduction of shares at the Budapest Stock Exchange in 1991.

Privatization has provided (1) access to Western European markets, (2) better product design, (3) inflow of new equipment, (4) managerial know-how, and (5) cash, the last giving the possibility of paying back (Hungarian forint) loans with a high rate of interest. As a consequence, the company almost succeeded in functioning without loans, which provided a competitive advantage compared to other Hungarian firms in the industry.

It is important to note that there was no major change in the work organization after privatization. The company has a relatively centralized functional organization structure and, except in the year 1993, managed to regularly increase its annual profit. It is generally agreed in Hungary that company B was probably the most successful firm in the clothing industry in a period when many other firms had to fight for survival.

### *Food-processing company C*

This company's business was based on poultry: the production of the raw foodstuff, processing and marketing. It was founded in 1920, nationalized in 1948 and taken over by the State Poultry Trust in 1960. It became independent again in 1980. In 1991, it was the second of 12 domestic poultry-processing companies to be transformed into a shareholding company. It accounted for approximately 10 percent of the domestic capacity; 50 percent of its production was exported. The company had gone through a radical downsizing in the period of transformation. The number of employees decreased from 1609 to 350 between 1989 and 1993, and the sales turnover went down from DM 95,000 to DM 11,000 in the same period.

The drastic decrease is due to several circumstances special to this particular sector of industry. The key factor is the transformation of the Hungarian agricultural sector after 1989, when large agricultural plants, which had been the sole suppliers of live poultry to the company, were closed. The plants were broken up and taken over by private small farmers who by 1991 had taken over 80 percent of the ownership of the original large farms. While the large farms had been able to finance the feeding of live animals for several months, the small private farmers were unable to supply this finance. At the same time, company C had no resources to cover this transition, and banks could not adequately back the company because of the unstable position of the individual farmers. Consequently, although at first the company had a market both at home and abroad, it was unable to meet the available demand because of the lack of bridging finance. Later, domestic demand decreased, while the cost of production increased and, most important, there was a drastic reduction of state subsidies for agricultural exports. The management of the company was slow to reach the necessary decision to find a foreign investor. One important factor in delaying the decision was the determined opposition of the trade union. If the privatization and capital injection had taken place in 1990, the transformation would have probably entailed smaller losses.

The history of this company demonstrates the struggle for survival, in which restructuring and downsizing were among the measures used, but brought only temporary relief. In such extreme economic circumstances, when not only a single company but a whole branch as well as the agricultural sector was disintegrating, solutions at the level of the company alone were inadequate, though they might have ameliorated the situation to some extent. It is the complex interaction of macro, meso and micro conditions following privatization that prevented a satisfactory solution at the level of the firm, even with the involvement of foreign capital. Foreign capital came too late to rescue the firm; the delay was caused by the slow decisions made in the company and the controversial behaviour of the banks. Looking back over three years, it becomes clear that the real conflicts always took place between the company and the banks, but the banks cannot be blamed either. Their actions were guided by their own logic, and they even lost money with the company during the last two years. The foreign investors remained steadfast during the whole procedure; they had misjudged the situation at the beginning, lacking insight into the diverse interest of the banks,

the management, the State Property Agency and a previous Hungarian investor. Later they were mainly concerned with recouping their money. In the end privatization led to liquidation. However, under these complex circumstances, it is possible that this was the only adequate solution and might offer the firm some viability in the future.

### *Repair and maintenance of electric appliances company Z*

This small company of 88 employees had been engaged in maintenance and repair of household equipment. Following 1989 its management was among the first to take the opportunity of the employees' pre-emption right which, with the help of an "existence" loan, allowed the employees to acquire 100 percent of the company. It had successfully diversified by taking up the assembly of different electronic systems and had a stable and developed market which expanded further as the demand for installation of satellite dishes started to grow.

While there has been no major change in the number of employees, the net revenue of the company increased from DM 2.4 million to DM 2.9 million between 1989 and 1993. Decision-making has been decentralized to relatively independent internal units. However, the company has made no major investments recently, which could put an obstacle in the way of further development. Being a small company and dealing with human capital intensive activities, the company is a good example of a successful employee buy-out, both with regard to the rationalization and restructuring of the company, as well as with the consolidated financial position and reliable debt servicing. The early privatization of the company was a rescue manoeuvre by the management to preserve the integrity of the company, and this was justified by the result, which allowed the economic situation of the company to be consolidated after privatization.

The firm was flexible in matching its profile to new market demands, as a result of which its output was diversified. The sales figures gained a more stable pattern after some major shifts in the preceding period. This was due primarily to a more conscious marketing policy, but also to consolidating customers' demand for repair and maintenance services.

The most important achievement of the management was the preserving of the financial equilibrium and solvency of the company in the very severe macro-economic environment. The weakest point is that no substantial investments have been made in the most recent period, although this has not threatened the development of the company so far.

### *Instrument-manufacturing company M*

This company is a medium-sized producer of simple medical instruments. It was one of the first companies to be involved in the system of spontaneous privatization and became the property of a holding company, which was owned by banks and some private individuals. The most important parameters, which had a major influence on the life of the company, were the new legislative provisions and the Economic Regulations of 1988–9. Until then, the company had a monopoly in the Hungarian market. Intense new competition emerged on the domestic market, partly from domestic companies, partly from new international competitors. The US dollar export subsidy had been ended (in 1989), so this kind of export activity became unprofitable.

The former management left the company in 1991 and set up in competition, taking away major suppliers and customers. The breakaway company continues to be one of company M's biggest rivals. As company M is of modest size, the privatization of the market caused a severe shock. Sales turnover decreased from DM 6.75 million to DM 2.09 million between 1989 and 1993. The number of employees went down from 128 to 79 in the same period.

The new management faced an extremely difficult task to find new markets and to create new products, while the company had major financial problems. A strict cost-reduction programme was introduced, dismissing employees, selling buildings, reducing heating, and so on. To increase their capital and market share, management had been looking for foreign partners for some years, but a planned joint venture did not materialize in spite of efforts to improve the company's image.

Because of the financial restrictions, the new management changed the product mix to find a small group of products with which they hoped to achieve a leading position in the domestic



market. On the holding company's initiative, the new management bought shares, so that their interest in running the company increased. In the last two years of the research period, the company managed to show some profit, and now seems to be among the survivors of the critical transition period. It was made more flexible, information chains were made shorter and the decision-making process was made more rapid and efficient.

### *Appliance-manufacturing company R*

This company's history goes back a long time. It was already a major player in the Hungarian instrument market before the Second World War. Its products include sophisticated electric equipment. Apart from the Budapest centre, it had four factories. Until 1989 it had a stable market and occupied a monopoly position in Hungary. It also exported to COMECON countries, and the major portion of its revenues was generated from developing countries. The collapse of the COMECON markets, the liberation of the domestic market, the financial problems of developing countries and cuts in domestic spending on health caused a nearly simultaneous shock.

The company went through privatization quickly – in 1990 Hungarian banks and individuals bought it. No new capital was injected nor were new market connections formed. The situation deteriorated with the appearance of world-famous rivals in the Hungarian market, who enjoyed modern technology, favourable conditions of purchase (loans) and tax concessions offered to foreign investors. The owners of company R have been unsuccessful in trying to find capital and strong partners in the market. Its technology was old-fashioned, labour productivity low and supervision very inadequate. The factory had to undergo radical change. Sales turnover went down from DM 54.3 million to DM 12.9 million between 1988 and 1993. The number of employees decreased from 1416 to 120 in the same period.

Looking back to the parameters that had a major influence in this case, we believe that the market exerted the strongest effect. COMECON had collapsed and the markets of the developing countries started to require serious marketing and financial capacity. During the second half of the 1988–93 period the domestic market was subjected to a serious increase in competition. Furthermore,



government regulations had changed; in particular, export subsidies were reduced, leading to immediate deficits. There was no effective method of collecting debts. The bank and giro system did not work well, the stock exchange had barely been established. Privatization, which was supposed to be the major domestic driving force, did not bring new investors. Officially, the holding company was the owner, but behind it stood the state. The same was true for the banks. The technical life-span of the product is about 20 years, but it actually becomes obsolete much faster. The financial position of the buyers, however, limits the general demand for higher-quality products. The company is undercapitalized, running deeply in debt, and manpower productivity is low.

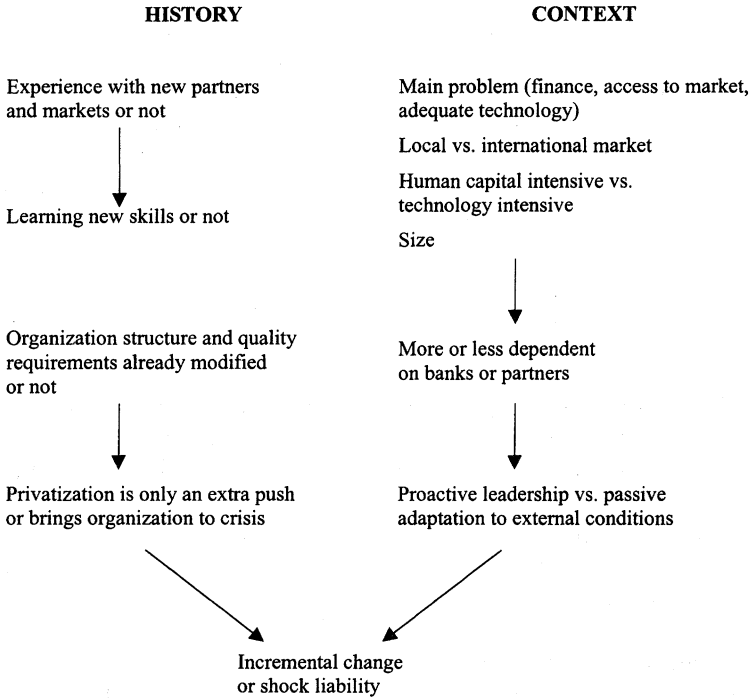
## **Discussion**

A first observation, after studying the cases, is that privatization is a multifaceted phenomenon. To understand its effects it is important to analyse events over time and to recognize critical contextual factors (see Figure 2).

Beginning with the time dimension, we have seen that the recent history of the companies (the last 10 to 20 years) has a big impact on the privatization process and its outcome. For instance, since the clothing companies A and B had access to Western partners and clients since the 1970s, it was possible and necessary for its managers to learn new skills, to adapt the production process to new quality requirements, and so on. At the same time the Western partners could learn about the possibilities of production in Hungary and about acceptable financial risks. In such a situation privatization, while being a necessity, was also an opportunity to adjust rapidly and did not bring the organization into crisis. On the contrary, it gave it the extra incentive to convert the Western partners into owners. The changes were incremental rather than abrupt, and it was possible to build up trust for the present and the future (cf. Porras and Robertson, 1992). The differences between these two clothing companies and the food company C and, to a certain extent, the medical companies M and R are quite striking. The latter companies had much more difficulty in creating a trustful relationship with Western partners who would have been prepared to invest money in new technology (companies M and R) or help

**PRIVATIZATION**

placed in time and context



**FIGURE 2**  
**History and context of privatization processes**

them to finance the input side of the company (company C), and at the same time guarantee export to Western markets.

This brings us to the context dimension. To understand the meaning of a particular privatization process more fully, the first question has to be: what is the main problem? Is it finance, access to new markets, new technology requirements or all of them at the same time? Other important questions are: is the production or service focused on a local market (company Z) or on an international market? What is the size of the company? Can the company be

characterized as human capital intensive (clothing, electrical maintenance) or as technology intensive (company R)? Depending on the answers to these questions, companies become more dependent on banks or partners (food processing company C), or less dependent on outside help (repair and appliance company Z). As a consequence privatization can sometimes take the form of proactive leadership (clothing companies A and B) or even charismatic leadership (repair and appliance company Z). In other cases, the adaptation to strong external conditions like privatization can lead to passivity or an attempt to seek rescue in the political arena.

### *Privatization in phases*

If we try to discover the more important factors of success or failure, it is important to differentiate between the phases of the process: the pre-privatization phase, the phase of privatization activities and the post-privatization phase (Figure 3).

The main factors in the first, pre-privatization, phase are to some extent shared by all companies, while others are company or sector specific. The shared conditions include the general developments in society and the economy and political changes, especially the abolition of the party state and the establishment of a pluralistic political system (Roe, 1994, 1995). In the economic sphere, the collapse of the COMECON market caused a formidable reduction in the foreign demand for goods. Unemployment grew quickly due to cutbacks in the already overstaffed labour force. The partial retreat of the state became visible in actions such as the reduction or elimination of export subsidies. The pressure to privatize and the phenomenon of shifting markets compelled most firms and state organizations to re-orient themselves in their markets. During the transition to a market economy, many of these companies were confronted with strong competition, because Western firms tried to penetrate the Central and East European markets as quickly as possible. Furthermore, higher-quality requirements for products to be sold in the West gave an extra incentive to bring production technology up to date.

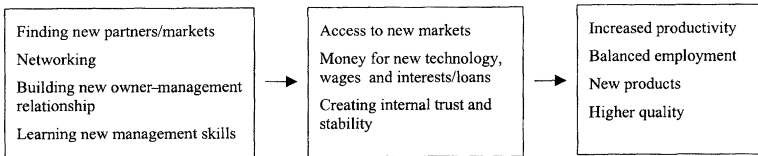
However, these factors do not work out in the same way in each sector. Not every company anticipated these developments in a proactive manner. In most cases, the developments in society also brought new requirements in terms of management skills (second

**First phase**—Developments in society and economy

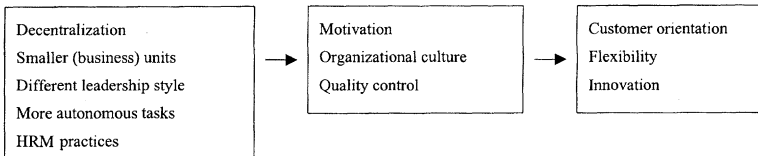
- Establishment of more pluralistic political system
- Transition to market economy
- Cutting off export subsidies
- Pressure to privatize
- Push to make technology more up to date
- Changing the legal framework
- Collapse of COMECON
- Partial retreat of state
- Shifting markets and stronger (global) competition
- Changing labour relations (independent partners, decline of unionization)



**Second phase**—New management requirements and performance goals



**Third phase**—If direct relation to customer is important



**FIGURE 3**  
**Privatization in three phases**

phase), such as finding new partners and markets, networking and building new owner-management relationships on the basis of trust and respect. These management skills are very important for gaining real access to Western markets. As we have seen, new owners are often inclined to invest money to bring in new technologies, pay wages and interest or buy off loans. By doing so, internal trust and stability in the organization can be created. These developments form important preconditions to improving productivity and the quality of products and services. Sometimes new product lines can be started. Employment has to be based on a careful analysis of needs, and this often leads to a reduction of manpower.

During the privatization phase of the process, the attention of management in most companies is focused on solving three important problems: (1) acquiring access to new markets, (2) financing of daily activities and investments and (3) improving the standards of technology. While company management plays a critical role in dealing with these areas, it should not be forgotten that the government too has an important role to play, particularly in relation to prioritizing financial support.

Over the transition period, most Hungarian companies that did not rely entirely on the home market lost their formerly important market segments in the Central and Eastern Europe region. The survival of these firms became dependent on rapidly finding new markets in other geographical areas.

Before the political and economic changes, many Hungarian companies had to struggle with shortage of working capital. It was characteristic that they could not finance their daily activities without loans. But these became excessively expensive around the end of the 1980s. Parallel with inflation, interest rates rose to about 40 percent per annum. This resulted in losses, and many companies went into bankruptcy. Privatization was seen as a way of introducing new capital to eliminate the loans and reduce interest costs. This is indeed what happened in the case of the clothing companies, especially in company B. Privatization resulted in an important inflow of cash and gave them the possibility to pay back loans from Hungarian banks. At the same time privatization helped the company to get low-interest, government loans from Germany. These transactions radically changed the financing situation of the company. Their daily operations became more profitable and – what is probably most important – made it possible to invest in new technologies necessary to meet the requirement of Western markets. The crisis of food-processing company C was closely connected to their inability to obtain financing for their operations. Liquidation has eased the financial burdens, but the company barely managed to pay its obligations. There were no financial resources left for technological innovation.

With the emerging market conditions in Hungary, technological innovation is becoming a more important factor for the competitive position of firms. The success of privatization, therefore, depends on the extent to which it contributes to improving the technological level of the Hungarian companies. In the two clothing companies,

privatization directly improved the technological level. The new owners supported technological development with equipment and the transfer of technology. In that way the technological level has been improved and this strengthened their market position. In the other four cases, privatization has not resulted in the improvement of the technological level. It can be argued that this lack of technological innovation is one of the explanations of their lower level of success.

We were surprised that issues such as human resources management did not get much attention during the second phase. It seems that the concept of limited managerial attention (March and Simon, 1958) is important in explaining managerial behaviour, particularly during conditions of turbulence. Management has to focus on many different issues simultaneously: finance, marketing, technology, competition and human resources management. A phase model, more or less in line with the experience from the cases, would indicate the following sequence of priorities: (1) change of ownership, finding markets and appropriate incentives; (2) cost reduction, marketing, technical renewal, financing; (3) only later on – during the third phase – innovation, customer orientation and human resources management.

### *Reasons for success and failure*

The six companies we have studied can be divided into three that were fairly successful (A, B, Z) and three that were relatively unsuccessful (C, M, R) during the period of study. Of course, the classification of success and failure is not completely clear-cut. It is based primarily on economic criteria, and there was complete agreement among the seven researchers.

The reasons for success are not identical in all companies. For instance, there is clearly a need for coping with financial considerations in all organizations changing from state to private ownership. However, in the case of the clothing companies A and B the procurement of substantial new capital was paramount, because of their size and their need to export competitively to Western countries. In the case of the company Z, the nature of the task and the smallness of the organization meant that new investment capital was not immediately necessary and could be accumulated over time.

Another important factor was the willingness and ability of managers and other social actors, for instance the trade unions, to take part in an organizational learning process. The two clothing companies had, in the context of subcontracting work, introduced tighter delivery times, increased quality control and adopted a Fordist mass-production manufacturing system. As a result of these changes, they were able to keep a stable set of clients in the Western world who acquired a deep insight into the company. This made Western clients willing to finance the needs of the transition and to take an active role in ownership.

The repair and appliance company Z must be given credit for having acted quickly when the 1990s pre-privatization law (often referred to as the “small privatization”) was announced. To prevent the impact of this law on the company, the management decided to organize a 100 percent buy-out using the availability of a special type of credit.

Another characteristic common to the three successful companies was their flexibility in adjusting to changing market conditions. In the case of the company Z, management recognized that repair services were less in demand and that the company had to compensate for the lower volume by moving more aggressively into the cable-TV business.

The characteristic problems facing the three unsuccessful companies also varied. The sudden collapse of the COMECON market in 1990 played a role in all three and was of particular importance in the case of the food-processing company C and the medical equipment company R. Lack of capital for development and modernization was the second common factor in all three companies but, again, it was a particularly severe blow to company C because their privatization coincided with the break-up of the large agricultural co-operatives which had previously provided the transitional finance for the raw materials.

The rapid withdrawal of export subsidies was also a factor common to all three. Besides, all three were slow in their market orientation. With regard to these four main factors – the collapse of the East European market, lack of finance plus withdrawal of export subsidies and inadequate market orientation – the three less successful companies were probably fairly typical of a large number of medium- and small-scale organizations in Hungary.

*It takes time to learn*

We have seen that the recent history of a company co-determines the opportunities and flexibility of management. As a consequence the change process can have different characteristics, for instance: exploration vs exploitation (Balaton, 1996; March, 1991), shock/crisis vs step-by-step, accent on local vs international aspects.

The cases we have studied demonstrate that the same general economic conditions impinge quite differently on the companies. Food-processing company C was in a real crisis due to the collapse of the former East European markets and the disintegration of raw-material supply caused by the dissolution of the agricultural corporations (cf. Porras and Robertson, 1992). The learning pattern of a company can be described as “learning through crisis”, which can be seen as a special type of “learning by experimentation” (March, 1991). The company attempted to deal with the crisis by taking a variety of incisive measures which, however, did not prevent it from losing economic viability.

The successful clothing companies A and B reflect incremental stages of adjustment. Changes in markets and the search for new partners had started before privatization. The most important former buyers within the subcontracting system became the major owners of these companies. In their case, privatization can be seen as a natural next step in the transformation process. Exploitation of past experiences (so-called “learning by exploitation”, March, 1991) played an important role in the process of adaptation to new conditions. The accumulated knowledge in these companies helped them to change organizational strategy and behaviour during and after privatization.

The three remaining cases (Z, R and M) basically show the characteristics of “learning by experimentation”. The changes in ownership and market conditions forced these companies to implement radical strategic changes. The number of employees was drastically reduced (company R) and changes were necessary in the range of activities (company Z). In these companies the formerly successful practices had to be changed in order to assure survival of the company.

The role of management can be analysed from the point of view of coherence among the individual members of the management team and support from employees. In companies M and R, we cannot speak of a coherent team. In the case of C and Z the role of the



top manager stands out, while others did not influence events in an important way. The management teams of the textile companies A and B formed coherent groups and could muster the support of their employees. These cases suggest a connection between the coherence of top management and the success of privatization.

Privatization created a crisis situation for many companies (cases C, M and R), and history determined the flexibility in management response. Without organizational learning, one must expect rigidities in behaviour and resistance to change. A company cannot have market knowledge unless it has a real market. In the old situation, access to the ruling socialist party (and so to government, banks, etc.) was all-important. Now new skills are crucial, skills in the fields of technology, logistics, marketing, bargaining. The acquisition of these takes time (Pennings et al., 1996). Apart from new individual skills, co-operation and team-skills are necessary, especially to create sufficient coherence in management teams.

Employees have to learn, too. Their attitudes towards privatization are determined mainly by their prospects of future employment in the firm. Food-processing company C is an example of employees opposing privatization because of fear of losing employment. In the companies M and R, employees were passive players during the downsizing period. Wage levels can be regarded as another factor influencing employee behaviour. The employees of the company A supported privatization and actively participated in it, but showed resistance when they saw the increased differences in earnings between top management and the shop floor. All these experiences are new, and employees must learn how to react and adjust their opinions and actions.

It is important to mention that unions did not play an important role in any of the companies studied. They were unable to achieve influence during periods when unemployment was rising sharply. In some cases they accepted the strategies of management for lack of an alternative. In company B, the unions were satisfied with the actions of the management, and in this company both employment and wages increased.

### *Organizational change*

Contrary to expectations, privatization does not naturally produce adaptive changes in organization structures, decision-making

procedures, leadership styles and human resources management policy, at least not in the short term.

The managerial approach to privatization and the related organizational changes can be described as technology-oriented. In none of the companies did we find a tendency to use employee involvement and participation in solving the problems facing these companies. Perhaps this was due to the fact that the transformation process involved mainly technological, financial and marketing problems. It can be argued that human resources will be more important in the later stages of transformation, when productivity and quality control will require more attention.

In the textile companies, for instance, no important re-organization took place. The situation after privatization can be characterized by the key words centralization and Fordism. However, some flexibility was gained from the extensive use of information technology. Perhaps there is no reason to be surprised because the company continues to function under a form of concentrated external power (of the Western partners instead of the Hungarian state). The company is still an instrument in the hands of an external stakeholder that has concentrated power (Mintzberg, 1983). Further, lower-level employees do not have contact with clients, so customer-oriented behaviour is not seen as being necessary; the production process is fairly predictable and the work behaviour standardized. In such a situation there may be no clear need for a new leadership style or a different organizational culture (den Hartog, 1997). It also seems that not much flexibility and innovation is needed on the shop floor during this stage. The bottom part of the model presented in Figure 3 seems hardly applicable to our cases for the period under investigation.

## **Conclusion**

The evidence presented in the six case studies suggests that external factors like legislation, the role of banks, changes in ownership and changes in market conditions are the major factors of influence on the organizations and decide their future in what we have called the second phase in the privatization process. In the pre-privatization phase, a crucial factor seems to be the quality of the management to anticipate needs and risks. However, it must be admitted that the quality of these judgements is more easily assessed

after the events than during the time that the old economic-political system was still in control and reduced managerial options.

The third, post-privatization, phase had only a very short time-span in our research and should perhaps be subdivided in an early and late stage. We would expect the intra-organizational factors to become increasingly important as time passes (Heller et al., 1988; Hoogervorst, 1998; Simon, 1991). Quality became important in all six companies. Performance on the shop floor is likely to gradually require more attention.

To conclude, it seems that human resources issues like trust, morale, competence utilization, participation, job design and team work played a very small role in the companies studied. Since these issues receive a great deal of attention in most industrialized countries, it is worth speculating whether their absence in the companies studied is due to the unrepresentativeness of the sample, the phase of privatization they were in or other factors. This is one of the subjects that need further research, covering a larger sample and a longer time-span.

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## Notes

1. Privatization is the sale of government-owned firms to private entities or cessation of provision of certain services by government in favour of their provision by private entities (*Blackwell Encyclopedic Dictionary of Organizational Behavior*, 1995).
2. X-inefficiency is a technical term used by economists to describe aspects of sub-optimal efficiency ascribed to technical or managerial causes.
3. Basic interpretation consisted of the presentation by the Hungarian teams of their findings and the meaning they attributed to the accumulating data during the regular workshops with the British and Dutch researchers. Towards the end of

two years, when we attempted to obtain a global view of the emerging material, all members of the total team drew on theory and experience to interpret the findings. The final report to the European Union, from which this article derives its raw data, was written by the Hungarian team (Adorján et al., 1995; see also Adorján et al., under review). However, the content of the present article is primarily the responsibility of the two principal authors.

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