Chapter 4

Firm Ownership and Value Creation

4.1. Introduction

Our main objective in this chapter is to search an answer for the third conceptual research question, which states: “Is there a comparative advantage of operational efficiency for value creation due to the type of ownership (government or private)?”

With this objective in mind section 4.2 covers the debate on ownership, market competition and operational efficiency. Section 4.3 is devoted to comparing the efficiency of government versus private ownership. Section 4.4 covers the issue of privatised firms and section 4.5 presents the case of firms in transition to privatisation. Section 4.6 relates firm ownership and value creation to inter-firm managerial control patterns (market, bureaucracy and trust) in the three transaction phases (contact, contract and execution). Section 4.7 concludes the chapter.

This research’s main objective is to study the internal and external working capital management in the context of a developing economy with particular reference to the government, transition and privatised firms in the manufacturing sector of Eritrea. It is therefore necessary to cover with some detail the current debate on firm ownership and value creation. We explore here the current debate on ownership (government, transition, privatised and originally private firms) and operational efficiency for value creation. However, our empirical study concentrates on the government, transition and privatised firms. We exempt the study about the originally private firms in order to concentrate on the comparative effect of ownership change on management policy from government (and transition) to privatised.

4.2. Ownership, market competition and operational efficiency

A firm’s transfer from the government to the private sector implies a change in the allocation of property rights and the relationship between those responsible for the decisions and the beneficiaries of a firm’s profit inflows. This in return leads to a different structure of incentives for management. The relationship between management and the owners (who are ultimate recipient of residual profit) can be considered from a particular set of agency problems. The general agency problem is characterised as a situation in which a principal seeks to establish incentives for an agent (who takes decisions which affect the principal) to act in ways that contribute to the maximum possible to the principals own objective. The difficulties to establish such an agent-principal relationship arises from two factors (a) the objectives of the principal and the agent differs, (b) the information available to the principal and agent the differs. Within this framework the management of firms can be regarded as agents acting for shareholders (in private firms) or for the government department to which they are responsible (in government firms). Ultimately government managers are responsible for the public in general. As owners and managers have different objectives, their incentives also differ. Contractual agreements are made between the managers and owners so that the managers give priority to the objectives of the
owners and act according to their contractual agreement. Moreover, incentives of both depend on many factors including the incentives given to the managers so that they act to achieve the objectives of the owners and the level of economic efficiency that results in a firm’s profit inflows. Economic efficiency according to Vickers and Yarrow (1988) is considered in terms of allocative efficiency in the market - which depends on the output levels of the firms and internal efficiency – which depends upon the total cost of producing certain levels of output. Three main factors influence economic performance Shirley and Walsh (2000): (a) ownership - publicly or privately owned, (b) competition - competitive structure of the industry that the firm is in and (c) regulation – legal constraint that the firm faces.

This section brings about the debate on ownership, market competition and operational efficiency. Based on these arguments the chapters in the empirical analysis are divided into internal and external working capital management of government, transition and privatised firms. However, an important question that needs to be cleared before discussing about the government and private ownership is whether it is ownership (government versus private) or competition (monopoly versus competition) that influences operational efficiency.

### 4.2.1. Where competition dominates ownership for efficient performance

Shirley and Walsh (2000) argue that market competition enhances performance in the form of operational efficiency while government ownership is more efficient in achieving the objective of equitable allocation of government resources. They find that when there is competition, price will tend towards marginal cost and resources will be allocated to their highest value, otherwise prices are raised and production is lowered relative to competitive equilibrium. The argument over competition’s impact on operational efficiency is based on agency theory’s incentive and information effects. Incentive effects in competition create threats to managers of inefficient firms, which have to be efficient otherwise threats of loss, bankruptcy and take-overs will force the firms to disappear from the market competition and this puts managers’ jobs at risk. Information effects in a competitive environment enable the owners of firms to know the costs of the firms’ operations and the managers efforts to reduce the costs. With these information owners are able to design a better system to control the managers and evaluate their efforts.

In competitive markets private firms perform better than government firms because in the latter case there is no way to force a productively inefficient firm out of business. So in government firms, managers will have no incentive to raise efficiency. Therefore, introducing credible threats of bankruptcy and take-overs would produce the best efficiency results. However, the degree to which market competition influences operating efficiency depends on the relative vulnerability of government and private firms to political interference and success in creating effective governance. Many researchers have found that increasing competition (deregulation) rather than changing ownership (denationalisation) is an importance mechanism in stimulating performance. For example, Yarrow (1986) argues, it is the competitive and regulatory environment that determines the incentive to managers and concludes that reforms emphasising on ownership over market competition are misguided. A study in China by Li (1997) shows that market liberalisation (competition) has the
greater impact on productive efficiency compared to ownership. He finds that the Chinese economy demonstrated large efficiency gains through extensive market competition and freedom of entry of independent firms without rapid privatisation of larger government firms.

4.2.2. Where ownership dominates competition for efficient performance

There are theorists who argue that ownership has greater impact on operating efficiency compared to market competition. The basis of their argument is that government owned firms are more inefficient in both competitive and non-competitive markets. In addressing the effect of ownership versus competition, Shleifer and Vishny (1994) find that government owned enterprises are less efficient compared to private firms even in fully competitive markets. This is because political objectives in government owned firms are given more priority over competition and inherent difficulties in the government firms negate the effect of competition. Given political interference and poor governance in the public sector, government owned firms would perform poorly even in highly competitive markets and they may even cripple competitive markets in which they prevail.

4.3. Government versus private firms

The debate on government versus private ownership is intensified after the rise of Margaret Thatcher’s privatisation of public enterprises in the United Kingdom (Bishop, Kay and Mayer, 1994) and the emergence of Michael Gorvachev’s “Perestroyka and Glasnost” (Schroeder, 1991), which initiated the fall of communism in the former Soviet Union. Government ownership was very popular in the developing economies during the cold war. After the fall of communism the debate seemed to favour privatisation. However, it cooled down with the disappointing results of insider privatisation in Russia, voucher privatisation in the Czech Republic and infrastructure privatisation in many developing countries. Moreover, still there are quite a number of theorists who argue in favour of private ownership and others who support the government ownership under certain situations.

4.3.1. In favour of government ownership

According to Frydman et al (1997), developing countries justify the choice of government ownership in order to accumulate productive assets as well as control externalities, natural monopoly and price facilitate industrialisation through central planning, acceleration of technology transfer, increased employment, reduced inequality, and national security. Frydman et al (1997) find that when firms exist in an economy which is under crisis, that is, when there are shrinking markets and collapsing trade links, government ownership helps operational efficiency of firms by offering government contracts, protecting from import competition and participating in government subsidised programs. They also argue that governments can restructure better than highly distributed private ownership for two reasons. First, outsider private owners are too disbursed to impose meaningful control over the management. Second, insider private owners do not have the motive and the efficiency to effectively
restructure the firm. These shortcomings of private firms particularly are highlighted where the countries have underdeveloped legal and regulatory framework, unsound business environment and weak contract enforcement. Cook, Kirkpatrick and Nixson (1998) take the case of developing countries and conclude that public ownership is the best response to market failure. They argue that privatisation in developing economies may produce private monopolies, so promotion of competition in government ownership is the best remedy to market failure. The argument of Yarrow (1986), favouring improvement on competitive and regulatory environment rather than emphasising on reforms of ownership is another argument against privatisation.

Regulation in natural monopoly firms Shirley and Walsh (2000) have also argued that in case of a natural monopoly (such as water, electricity etc.), where indivisibility of networks or ever increasing returns to scale dictate the most efficient market, effective competition is neither possible nor desirable. The results of operational efficiency in government firms and regulated private monopoly depend on the legal point of view, that is, whether the contracts are complete or incomplete. If contracts are complete and define all aspects of performance and every possible eventuality, both private regulation and government ownership yield the same result of productive efficiency. Where there is a situation of incomplete contract and some aspects of performance and eventualities cannot be defined in advance, the result depends on the regulatory environment. If government firms have more autonomy both government ownership and controlled private ownership may end-up at the same efficiency levels. Otherwise Shirley and Walsh (2000) claim that the efficiency of government firms grows with the efficiency of political markets and the levels of autonomy of the government firms.

Therefore, the success of privatising natural monopolies depends on the regulatory capacity of the government (Vickers and Yarrow, 1991). Thus countries with more developed regulatory bodies are better able to privatise and regulate than countries with weak regulation. So, in more regulated and developed countries, privatisation coupled with regulation is preferred to continued public ownership. Moreover, developing countries may be less able to manage potentially competitive government firms and hence benefit more from privatisation despite poor regulation because privately regulated firms perform better or the same as government firms. Shirley and Walsh also find that, if public monopoly is to be replaced by private monopoly, government monopolies out-perform private monopolies. However, generally performances of firms depend on management culture and clarity of objectives. When objectives are vague and contradictory and the management culture does not value efficiency, performance objectives will not be achieved.

As far as the design of a regulatory framework and its effective implementation is concerned the behaviour of governments play a very crucial role. The behaviour of governments depends whether political markets work efficiently or inefficiently. If political markets work efficiently, rational governments (social welfare maximising governments) have incentives to maximise social welfare. With a social welfare maximising government, the bureaucrats and politicians act as loyal agents of the citizens due to competition among them for the voters and align their interests with those of the voters or else leave the job. This assumption argues in favour of government ownership of firms. It is based on social welfare maximising government and efficient (transparent and accountable to voters) political markets. However, if the
political markets are inefficient and self-interested government employees are able to maximize their utility, the common good can be suppressed and government ownership may be worse.

Finally, the failed privatisation in some transition countries (the former Soviet Union and the Czech Republic), and the relative success of gradual government reform in China, has strengthened the argument for privatisation alternatives. The Chinese experience has brought two insights here. First, the entry of new private firms is crucial because they reduce the scope of government firms and enhance competition. Second, non-privatisation reforms like market liberalisation, increased autonomy of government firms and retention of profits can motivate efficiency of government firms. If managers of government firms are made to compete with the private firms without any government interference or unfair support, the government firms can be more efficient and value creating. The risk that the government firms may go bankrupt and get out of business will expose the managers of government firms to face the risk similar to the managers of the private firms.

4.3.2. In favour of private ownership

The idea that government owned firms are inherently less efficient than private firms is based on the government firms’ failure to achieve operational efficiency as much as the private firms. This is mainly because the control of government firms is difficult for three reasons: first, failures in the political market, second, government monitoring with self-serving political interests and third, the existence of highly distorted market for public managers. However, there are controversies around the idea that public ownership is the best solution to market failure, even with a welfare maximising government for two main reasons. First, market failures can be addressed in private firms by more efficient means and second, even benevolent government can have incentives to distort efficiency of distribution of social welfare. Thus even when government maximises social welfare, public ownership may not be the best solution to market failure. In this situation Shirley and Walsh (2000) argue that the choice between public and private ownership depends on the ease with which contracts are monitored and enforced and the degree of potential competition among firms.

Based on theories of self-interested governments, Shirley and Walsh (2000) argue that there are no efficient political markets as such, particularly in non-democratic systems, which face little competition aside from the occasional threat of a coup by another would be dictator. Therefore, a self-interested government in an inefficient political market has more scope for intervention in government firms than in private firms. Vickers and Yarrow (1988) trace the cause for governments self interested character to three reasons. First, information asymmetry between voters and politicians, second, elections being poor mechanisms for producing information on voter’s preferences, and third, benefits of welfare enhancing policy being widely dispersed but losses are concentrated in terms of time. However, in terms of those affected, the losses are also dispersed into the general public and will not be easily felt as with the case of private firms. In a world of limited information politicians may use government firms to produce potential benefits for themselves at the cost of inefficient and distortionary government firms. Thus government firms may be
inferior to private firms not only on operational efficiency but also on allocative efficiency.

The principal-agent relationship can also be applied to this argument. Principal-agent relationship favours private firms because the principal (voters) in government firms can impose less control over agents (politicians and bureaucrats) compared to the principals over agents in private firms. This argument is based on the fact that government managers and politicians interact in ways that benefit themselves at the expense of general welfare. These inefficiencies result from political meddling in the firms, which take the form of excess employment, prevention of layoffs, above market wages, investment in projects that benefit the politicians rather than consumers, and allocative distortions resulting from skewed pricing systems. This “politicisation” of government firms makes restructuring more difficult. Shleifer and Vishny (1994) argue that “politicisation” depends on five factors. First, the degree of political market imperfection (the more the political markets are distorted the further the politicians deviate from the social welfare). Second, the ease with which budgets and regulations can be manipulated. Third, the nature of the institutional relationship (autonomy) between the government and the government firm. Fourth, the existence of corruption and bribes, fifth, the low opportunity cost of inefficiency of government firms to the politicians.

Problems of separation of ownership and control: Both “owners” of government and owners of private firms rarely manage the day-to-day operation of the firms. Therefore, they face the problems of separation of ownership and control. Managers have every incentive to use their control to serve their own interest at the expense of profitability and owner welfare. In this case, Shirley and Walsh (2000), argue that there are important differences between government and private firms, which affect their performance. These differences emanate from the differences in controlling, legal constraints as well as threats of take-overs and bankruptcy.

When private ownership and control are separate, owners write a contract with managers so that managers make their income and continued employment dependent upon performance. Control by owners will be weak when information asymmetry gives managers undue advantage in writing the contract and when the ownership is distributed among many small owners. Contract enforcement is based on the assumption that owners can turn to the court system if they believe that the managers have violated the contract by failing to maximise the owner’s welfare. However, the outcome of this approach depends on the strength of the government’s legal system. Where neither monitoring nor legal regulation of the owner-manager relationship brings about efficient manager behaviour the risks of take-over bring a possible tool of corporate governance in private firms. In a take-over the owners of the acquiring and target firms benefit as a result of efficiency rather than from increased market power (Jensen and Ruback 1983). However, unlike the private firms, government firms are immune from take-overs.

If the corporate control mechanisms of take-overs, contract enforcement and monitoring by owners fail to promote efficient management, a private firm in a competitive market cannot continue making losses forever because after sometime it will go bankrupt. Bankruptcy implies a change in management, liquidation of assets and restructuring of debt. Because of difficulty of collecting debts in bankruptcy both
owners and creditors prefer that bankruptcy functions as an ex-ante threat to management, rather than ex-post remedy (Shleifer and Vishny, 1995). An ex-ante threat of bankruptcy (which is effective only where there are efficient court systems and well-designed laws) to management is effective in boosting managers performance and thus owner value. However, whenever the political cost of bankrupting a government firm exceeds the political cost of subsidising it, politicians will extend subsidies (Sheshinski and Lopez-calva 1999) and this everlasting subsidy can be reduced by privatising the government firm. Therefore, loss making government firms will be subsidised by the government directly or indirectly in the form of unpaid taxes and overdraft from government directed banks. Hence, managers of government firms have little incentive to improve efficiency or avoid unprofitable investment. In this sense it can be concluded that competition cannot substitute for private ownership because politicians in inefficient markets may distort operations of government firms for their own interests and the task of motivating the managers is more difficult in the public sector than in the private sector.

4.4. Privatised firms

This section refers to the comparative efficiency between government firms and privatised firms, that is firms which have moved from government to private ownership. The distinction between government and privatised firms is particularly relevant in developing countries where mostly governments are self-interested (not social welfare maximising). This case is argued with two reasons. First, regulatory institutions and market structures can play a major role in privatisation outcomes. Second, political objectives and motivations of policy makers can be causes to design sub-optimal privatisation plans. Both of them are not favourable in most developing countries.

An immediate consequence of privatisation will be some shift in the objective of principals and incentives to be offered to the agents. Privatisation tends to improve internal efficiency but at the expense of allocative efficiency unless checked by some competitive or regulatory constraints. According to Bennel (1997), privatisation is justified on the grounds that state owned enterprises are invariably inefficient and without decisive intervention in the form of privatisation they will continue to drain on the extremely limited public resources. Privatisation mostly includes the full or partial transfer of either ownership rights or management control of government firms to the private sector. The sales of government firms to private investors can take the form of private sales on competitive bidding, pre-emptive sales, sales/auction of assets or public flotation. Megginson, Nash and Randenborgh (1994), found out that after being privatised firms increase real sales, become more profitable, increase their capital investment spending, increase their operating efficiency and increase their work force.

4.4.1. Regulatory institutions and market factors

Shirley and Walsh (2000) argue that privatisation and regulation of natural monopolies can present a viable alternative option to government ownership. In developing countries it is highly likely that monopolies exist because of market failure, lack of information, high entry costs, underdevelopment of capital markets,
bankruptcy procedures and court systems. Thus privatisation in developing countries may simply replace public monopoly by private monopoly, as a result of which allocative and operational efficiency suffers relative to the competitive market outcome. However, since competition prevails over ownership (section 4.2.1.), a private (and by extension a privatised) firm, even in an imperfect market may perform better than a government firm. Overall, in developing economies, institutional problems can weaken corporate governance by preventing take-overs and softening budget constraints (government subsidies, granting government subsidised projects and other privileges), which can result in sub-optimal performance. However, since the main issue is whether government ownership produces better results compared to privatised firms, the argument is that institutional weaknesses do not prevent privatised firms from increasing their performance compared to government firms. This is because underdeveloped markets, poor information and weak and poorly enforced bankruptcy and take-over laws do not necessarily mean that privatised monopoly will under-perform government firms. It is also possible that privatised (or newly formed) banks allocate credit more efficiently in developing economies and are better able to break themselves free from old lending habits and that they achieve a more efficient allocation of credit than government institutions.

4.4.2. Political objectives and privatisation

Privatisation indicates a change of government goals and policy. This change may be due to an external economic factor due to increased opportunity cost of inefficiency of government firms or a change in the make-up of the government. Where in the latter case the new government places a priority on efficiency rather than maximising its own interest. The objectives of privatisation according to Shirley and Walsh (2000) can be enterprise efficiency, private sector development and budgetary relief. Therefore, which objective the government pursues is of utmost importance. Governments may also seek to maximise government revenues from the sales of government firms. In the process, governments may distort the efficiency potential of the firm by limiting competition, distributing ownership shares as widely as possible and dilute ownership among many small owners with negative consequences on monitoring.

Shirley and Walsh (2000) find also that private ownership can be as inefficient as government ownership, unless there is vigorous competition. They are critical of privatisation without competition because they say the gains of privatisation are lost if a public monopoly is simply replaced with a private monopoly, which is more likely in the self interested governments of developing countries. The argument here is not whether the performance of privatised firms is optimal but whether it is better than under government ownership. Their empirical studies reveal that even in imperfect markets of developing countries privatised firms can show better performance compared to government firms. Privatisation can be implemented through insider or management sell-out (selling the government firm to its managers and/or workers) and outsider privatisation (transferring ownership to small shareholders outside the firm or the wider public). Management sell-out may eliminate the ownership-control gap but capital infusion is limited, in addition to this, managers and employees are less likely to engage in effective restructuring and they may maximise their own objectives. Wider public sell-out may also bring the principal-agent problems.
As a result of their empirical study, Sheshinski and Lopez-Calva (1999) arrived at a number of conclusions in favour of privatised firms. They find that privatised firms in competitive environments perform better than government firms in terms of productivity, competition and profitability. Their research applying different profitability indicators and different market structures showed that privatised firms improve their profitability after the sales. However, they also find that partial privatisation has a smaller effect than full privatisation. Changes in ownership from government to private result in increased productivity, competition and profitability but first the firms in regulated markets have to go through restructuring after sale and they may show lower increases in productivity as compared to those firms that exist under competitive market conditions. Elimination of restrictions on foreign direct investment, trade barriers and government controls on prices and quantities may also help privatised firms to be more competitive and to increase productivity and profitability. In non-competitive markets profitability increases more than productivity. If loss making government firms are privatised they may turn profitable and increase the financial health not only to themselves but also to the government. This is because government may end-up at less net transfers to the privatised firms and get positive transfers by collecting taxes from the privatised firms in the long-term. According to Sheshinski and Lopez-Calva (1999), financial sectors also benefit from privatised firms because the firms after privatisation have lower deficits and lower unpaid debts to the financial sector. Finally, though privatisation may have a negative effect in the short-term due to measures of restructuring during the transition period, it results at a positive effect on employment in the medium and long term.

4.5. The case of firms in transition to privatisation

Now we take the case of firms in transition to privatisation. Firms face a period of transition to privatisation from the time the government officially declares its intention to sell the firms to the time they are fully privatised. Transition firms encounter a number of problems during the period of transition.

According to Bennel (1997), the success of privatisation depends on the extent of opposition to privatisation and the saleability of the government firms. Opposition to privatisation can take the form of political factors such as lack of commitment at the highest political levels, public managers and workers in fear of unemployment, nationalistic feeling against foreign buyers, payment of high terminal payments by investors to the workers. The saleability of the firms is subject to factors affecting the economy as whole or specific firms. The overall factors include the government’s creditability: investor assessment of government’s creditability regarding its economic policies and privatisation program, transparency and corruption in the management of the privatisation process, success of attempted privatisations etc.

Factors affecting the government firms include difference in determining the price between the government and prospective investors. Governments use political or financial criteria such as asset-based valuation to maximise the net proceeds from the sale while prospective investor’s evaluation is based on business. According to Bennel (1997) the transition period is identified by political and economic crisis, hastily implemented privatisation programs, weak and unmotivated management, obsolete technology and inadequate working capital as well as government
maintaining overall control (though some autonomy can be given to the firms’ management). The privatisation process is another factor that affects the saleability of the transition firms because once the privatisation is announced it is difficult for the firms to do business. This is mainly because the diminishing trust of suppliers and customers. Suppliers will not allow credit to the firms and customers will be hesitant to do business on a long term.

4.5.1. The problems of transition firms

The problems of transition emanate from the firms’ historical origin as government owned firms of which the effects spill over to the period of transition. In order to solve the problems of government ownership, the firms have to undergo restructuring before they are fully privatised, which also brings with it problems that have to be tackled. These problems refer to issues such as organisational structure, employment policy, sources of finance, operational set-up and uncertainty of employment both to managers and employees.

Organisational structure and managerial empowerment As originally government firms the organisational structure of the transition firms is dictated by government regulations, which is mostly set-up to enhance the political and social objectives of the government more than the firms’ operational efficiency and profitability. These objectives increase allocative efficiency, accountability to central authorities and custodial-control of assets and operations. To this end the organisational structure is designed and implemented. In the process of restructuring the firm’s management policy may have to be changed so that it reflects policies of operational efficiency and profitability. During the process of privatisation much of the managerial decision may be shifted from the management of the firms to higher government officials (or privatisation agencies). This may negatively affect the managerial empowerment and confidence of the managers. As a result the operations of the transition firms may be crippled and lack both short and long term vision (Hailemariam, 2001).

Employment Particularly with self-interested governments in developing countries, political objectives dictate the organisational structure and the employment criteria of government managers and other employees. The managers are handpicked from government on the basis of their political affiliation rather than on their professional qualification and practical experience, which are relevant to the objective of the firms’ value creation. Employees are hired not only on their productive potential but also on political and social grounds. This results in less quality and excessive number of managers and employees. As a solution to this problem the government may after a privatisation deal transfer the firms to their new private owners free of any labour commitment. All workers may be paid their severance allowances and officially laid-off from their jobs at the time of transfer from government to private investors, so that it is up to the new bosses to rehire them or not.

The problem of uncertainty The environment of transition is characterised by a high degree of uncertainty and deep institutional change (Frydman et al 1997). Both management and the workers as a whole are faced with an uncertain future as far as maintaining their job is concerned. This decreases their confidence and affects
efficiency. As a result competitive managers and workers who can get employment opportunity elsewhere leave the transition firms and worsen the manpower problems. Therefore, unless the period of transition is cut short the firms will continue to loose value (Hailemariam 2001) and become more unattractive to prospective buyers.

**Financial problems** As government firms, transition firms may be accustomed to financing their financial deficits not only through government subsidies but also with loans in the form of short-term debts and overdrafts from government banks as well as credits from related government firms. These financial obligations are mostly used as permanent sources of working capital financing regardless of their cost-benefit justification. Usually the costs of these short-term financing do not warrant their benefits. During restructuring, the transition firms may have problems of working and fixed capital investment and financing. This is because the firms may be required to pay dividends to the government while at the same time they may be forbidden by the government from making new capital investments and financial commitments with a long-term effect. This implies that the firms’ value creating potential is severely affected in the long-term. Though the attractiveness of the government firms to private buyers basically depend on the long-term cost-benefit analysis; transition firms with higher debts will have problems of getting private buyers because buyers do not like to acquire highly indebted firms. As a solution to this, governments may as a privatisation deal assume the accumulated debt in order to attract buyers.

**Operational problems** The purchases and sales operations of government firms (and by extenuation transition firms) are oriented towards (less quality) mass production in order to help achieve the objectives of allocative and control efficiency rather than the operational and profitability efficiency. Mostly purchases are made from government and transition suppliers and sales are made to government and transition buyers in a non-competitive manner. In order to solve these problems during transition firms have to change their internal and external management of the operations.

The conclusion in the ownership and value creation argument is that external objectives and underdeveloped markets and regulatory institutions can introduce distortions in the privatisation process that cause transition firms to perform less than privatised firms and privatised firms to perform less efficiently compared to purely private firms. Overall, in terms of their operational efficiency and value creation we can list private firms, privatised firms, government firms and lastly transition firms. Hence in order to minimise the value that may be lost by the transition firms during the period of their transition, the transition process has to be well prepared and systematically managed.

**4.5.2. Preparing transition firms for privatisation**

The problems of transition make the transition process very difficult particularly if the government itself manages it. If it is to be successful carried out some remedies have to be taken place before the firms are declared for privatisation. Some alternative ways to prepare the firm’s transition to privatisation may include the following measures. (a) Make internal restructuring before announcing the privatisation. (b) Give the management of the privatisation process to private firms. (c) Give full
responsibility not only limited autonomy to the firm’s management. (d) Increase ownership involvement of citizens (local investors, the public, and management and employee buy-outs) in order to reduce political opposition. (e) Where governments are reluctant to privatisé, use the non-asset privatisation approach such as performance contracts and leases. (f) Make serious restructuring of the firms including taking over debt, modernisation of the technology and sub-contracting the management of the transition process to private consultants. (g) Decrease the bureaucracy and time it takes to privatise.

4.6. Firm ownership and inter-firm trust

This section relates the debate on firm ownership (government, transition and privatised) and value creation to inter-firm managerial control patterns (market, bureaucracy and trust) in the three transaction phases (contact, contract and execution). We consider that the transaction characteristics covered in chapter 3 (section 3.5.3 to 3.5.5) closely relate to private firms. So, we emphasise here on government, transition and privatised firms. How government, transition and privatised firms interact in an inter-firm transactional relation depends on their control pattern, which in turn depends on how closely the firms are related and upon the confidence or trust they have in each other. It also depends on the character of the inter-firm transactions, the parties and their environment (Van Der Meer-Kooistra and Vosselman, 2000).

In a buyer-supplier relation the important issue is what factor determines how close an inter-firm transaction relation can be. According to the transaction cost theory and the insights of trust this is determined by the potential occurrence of the human characteristics of opportunistic behaviour of a supplier and bounded rationality of a buyer and possibly vice-versa. The existence of these human characteristics combined with the transaction characteristics of asset specificity, transaction duration, repetition and measurability of activities and outputs determine the risk of loss to the parties’ ex-ante and ex-post transaction agreement. We claim here that these characteristics also differ on the basis of ownership.

Inter-firm transaction relation is influenced by the ownership status because firms with a similar ownership status will also have similar objectives and control patterns. Generally, government firms will reflect a common objective of enhancing political, social and allocative efficiency. Privatised firms will have operational efficiency with a firm’s value creation as the ultimate objective. Transition firms reflect characteristics of both government and privatised firms. They reflect the objectives of the government firms because they still remain under government ownership and control (though temporarily on transition basis). They also reflect the characteristics of privatised firms because they have to transform their policies and practices to that of privatised firms if they are to be attractive to private investors. Therefore, in order to approach the salient features of these three groups of firms we divide this topic into three sections. First, we cover the inter-firm transactional relationships with government firms, second we deal with the inter-firm transactional relations with the transition firms and lastly we consider the inter-firm transactional relations with the privatised firms.
**Government firms** The objective of the government owned firms is not necessarily to increase the monetary value of the stakeholders. The government as an owner will have a policy of job creation, continuity of employment, safeguarding consumer interest, maximising the government’s returns rather than retaining profits in the firm. These factors will deter the firm’s management from searching only for approaches that would result in higher profits and risks to the firm. Therefore government firms have a low risk, low return environment. Management will not necessarily go for the best approach of working capital management, value chain linkages management and transaction cost management for increasing the value to owners, because other priorities surpass the objectives of these approaches to shareholder value creation.

The control oriented government policy, organisational structure and managerial control as well as public ownership of the firms detract government managers from reflecting potential opportunistic behaviour. The managers personally have very little to gain from being opportunistic. However, they have much to loose if as a result of internal control or external audit it is found that they have acted against the stated government rules. Managers of government firms can be expected to reflect the highest possible honesty and to be trusted by managers of all the three groups of firms. Therefore, firms which get into inter-firm transactional relations with government managers can manage their inter-firm transactional relation on the basis of the trust right from the beginning regardless of the prevailing contingency factors in all the three phases of transaction. In fact the government ownership is the decisive contingency.

**Transition firms** Transition firms, while still in the hands of the government, are destined for privatisation. As a first step to privatisation the government may give these firms a certain degree of autonomy, so that they can run their operations as if they are privately owned. The government’s primary objective of creating and securing jobs as well as profit optimisation is sidelined in favour of market oriented value creation. The transition creates some kind of dilemma and uncertainty for the management of the firms. Special government bodies (privatisation agencies), which are formed for the purpose of selling the firms may administer them. The management of the firms is responsible and accountable to this governmental agency.

So long as they are not privatised, the transition firms remain under government ownership, organisational structures and control. Therefore, we could normally expect the control mechanisms of the transition firms to resemble that of the government firms. However, the objective of the transition firms (to remain profitable and attract private investors) and other transition problems such as uncertainty can introduce opportunistic behaviour to the transition managers. This can be a good reason for partners who get into inter-firm transaction relation with transition firms to exercise caution in their inter-firm relation. In addition, partners of transition firms will not enter into long-term transaction relation, because no one knows for sure when these firms are going to be privatised, who is going to buy them and what type of characteristics the new management will reflect. No matter the prevailing contingency factors, transition firms are unlikely to get into long-term trust with inter-firm transaction partners during the transition period.

**Privatised firms** Privatised firms are those firms, which have been sold to private investors and which are owned purely by non-governmental, private individuals or
shareholders. The objective of shareholder value creation and maximisation can best be applied here. In privatised firms, management policy can indicate some characteristic difference compared to that of government and transition firms.

The standard inter-firm managerial control patterns applicable to private firms are more appropriate to the privatised firms. However, privatised firms in Eritrea have a relatively short history and managerial experience. However, the duration and repetition of inter-firm transactional relations of the privatised firms can increase the trust in each other and in the long-term partners transacting with privatised firms can develop better managerial control patterns and trust.

4.7 Conclusion

The discussion in this chapter has centred on the effect of ownership status on value creation. We concentrated on the argument that, it is the competition not the ownership that determines the potential ability to create firm value. However, the possibility that government and transition firms can retain their ownership status and at the same time be competitive is hindered by political interference from the government. This political interference renders the firms unable to generate value enough to make them comparable with that of privatised and private firms. The private ownership status is divided into those firms, which are originally privately owned and those firms, which were originally government owned and then privatised. We find theoretical reasons that privatised firms perform better than government and transition firms but not better than the private firms.

We also introduced the issue of ownership and inter-firm managerial control pattern. We argued that the managerial control patterns that the firms could possibly apply in order to decrease inter-firm transaction costs are also affected by ownership status. We claimed that managers of government firms reveal the least opportunistic behaviour and that there is a higher possibility that these managers can be trusted because of the legal control factors that they are subjected to. Therefore, inter-firm transactional relation with government firms can be made on the basis of trust though the government may interfere in the relationship. On the other hand managers of privatised firms can reveal the standard behaviour of private firms and the managerial control applied depend on the contingency factors prevailing in the inter-firm transactional relation. The transition managers can reveal characteristics somewhere in between the government and privatised firms. However, they cannot be fully trusted on the long-term because their relationship is temporary and will be removed when the firms are privatised.