Privatization And Entrepreneurial Transformation: The Role of Developmental Financial Institutions

By

Gerard George*
Ganesh N. Prabhu

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Please address all correspondence to:

Prof. Ganesh N. Prabhu
Assistant Professor
Indian Institute of Management
Bannerghatta Road
Bangalore – 560 076
India
Fax: (080) 6644050

*School of Management, Syracuse University, Syracuse, NY.

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GERARD GEORGE
School of Management
Syracuse University
Syracuse, NY 13244-2130
gegeorge [illegible] edu
(315) 443-3391 (voice)
(315) 443-5457 (fax)

and

GANESH N. PRABHU
Indian Institute of Management at Bangalore
Bannerghatta Road, Bangalore 560076 India

(91-80) 6632450 Ext 3047 (voice)
(91-80) 6644050 (fax)

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ABSTRACT

With ongoing privatization efforts in emerging economies, governments have supported developmental financial institutions (DFI) to spur entrepreneurial activity in the absence of private venture capitalists. DFIs are quasi-governmental financial institutions with independent managerial control that often act within the constraints of a rapidly changing environment to support and accelerate privatization. In spite of their critical role in economic transformation, DFIs have received little attention in the management literature. We draw on two theoretical frameworks to develop an initial process model of DFI involvement with privatized firms in emerging economies. First, we use stakeholder theory to argue that post-privatization stakeholders differ in their motives to initiate organizational restructuring which is required for drawing DFI support. Second, we evoke the relational view of the firm to posit that DFI involvement generates relational rents that create value for the privatized entity. We discuss theoretical implications of including DFIs in privatization and management research in the emerging economy context.

The privatization movement has gained considerable momentum across the world. Governments of Central and Eastern Europe, the former Soviet Union, and non-communist emerging economies like Brazil, Chile, Egypt, and India have undertaken expansive privatization efforts. The amount raised from privatization programs around the world is estimated to be $62 billion in 1995 and $85 billion in 1996 (OECD, 1998a). After privatization, the firm is exposed to competitive pressures in domestic and international markets while experiencing a decline in government resource support. In order to remain competitive, the privatized firm seeks out new partnerships and resource bases (Uhlenbruck & De Castro, 1998). Given the relatively low availability of private venture capital in emerging economies, developmental financial institutions (DFIs) assume an important role as resource providers (Kane, 1975). DFIs can fill an important investment gap in emerging economies by encouraging investment in some high growth-high risk areas, where private enterprises are unable to take the entire investment risk. Though, DFIs are quasi-governmental organizations, they tend to behave as large institutional investors with independent managerial control (Bhatt, 1993; Jequier & Hu, 1989).

DFIs provide access to capital through loan disbursements or by assuming minority equity positions. They also provide valuable advisory services in terms of management development, industry information, as well as help seek out alliance partners for the newly privatized firm (Bhatt, 1993). DFIs therefore can play an important role in helping firms build resources, increase their utilization of available resources, and facilitate the emergence of new ventures (Jequier & Hu, 1989). While there are different kinds of DFIs[1], most tend to be country-specific organizations. For example, the Industrial Development Bank of India has an

[1] In this article, we examine DFIs that lend directly to firms. We specifically exclude organizations that lend to countries during economic crises such as the International Monetary Fund (IMF). The IMF does not directly interact with firms even though they advocate loan recipients' (a country) fiscal initiatives to include privatization.

asset base of $10 billion allocated in different core sector projects (IDBI, 1998). There are several DFIs that participate in the privatization process of their respective countries with nearly 80 DFIs in the Asia-Pacific region alone (ADFIAP, 1998). However, a few regional and international DFIs do exist. For example, The International Finance Corporation, is a World Bank subsidiary and an international DFI, with investments of $8 billion in different privatization programs (IFC, 1998a). Also, regional DFIs like the Inter-American Development Bank have mobilized financing for projects that represent a total investment of $206 billion in the region (IDB, 1998). DFIs play a major role in providing financing and privatization advisory services to state-owned enterprises. In several emerging economies, DFIs hold substantive equity stakes in private entities that they shepherded through the privatization process (IFC, 1998a,b). By aiding in the transition process, DFIs play an important role in the survival and growth of recently privatized entities. In spite of their importance, the role of DFIs in emerging economies is not adequately theorized and has not received systematic empirical attention (Bhatt, 1993; EBRD, 1998; Jequier & Hu, 1989).

The purpose of this article is to explain DFI involvement with newly privatized firms and its effect on value creation. First, we highlight the facilitating conditions for DFI involvement with newly privatized firms in emerging economies To accomplish this we evoke stakeholder theory (Donaldson & Preston, 1995; Freeman, 1984; Jones & Wicks, 1999) to explain that stakeholder motivation for organizational restructuring will influence the newly privatized firm's motivation to seek DFI resources. Second, we explain the Firm-DFI interaction process and its outcomes. To accomplish this we use the relational view of the firm (Dyer & Singh, 1998; Gulati, 1998; Koza & Lewin, 1998) to argue that relational rents accrue to firms that enjoy DFI support. The basic premise of the relational view is that a firm's critical resources and value creation spans the boundary of the firm and may be embedded in interfirm routines and processes (Dyer & Singh, 1998). The relational view draws on multiple theoretical bases such as transaction cost economics, institutional theory, trust and social exchange, and the resource-based theory to explain that relational rents can be a source of competitive advantage (Dyer & Singh, 1998; Koza & Lewin, 1998). The relational view allows us to better explicate the relationship between the DFI and the newly privatized firm. The drawback, however, is that we do not constrain ourselves to a single theoretical focus or domain. Klein, Tosi and Cannella (1999) suggest that research would benefit by using multilevel and multifoci insights to advance management theory building. By using the stakeholder theory and the relational view as our theoretical underpinning, we capture the newly privatized firm's motivation to seek DFI resources as well as to tap into the dynamics of Firm-DFI interaction and value creation process in the emerging economy context.

RESEARCH QUESTION

This paper contributes to theory development and furthers our understanding of privatization processes in two specific ways. First, we provide a theoretical underpinning for different stakeholder motivations based on the privatization mode[2]. The topic of privatization mode and its effects on governance mechanisms is just beginning to receive attention (Djankov, 1999; EBRD, 1998; OECD, 1998b). Recent work also points to differing motivations of stakeholders, i.e. politicians, managers, and private investors, involved in the privatization

[2] Privatization mode refers to the divestiture process adopted by the government to dispose its interest in a state enterprise. Popular privatization modes include partial or complete sale of assets, transfer of partial or complete ownership to employees, transfer of partial or complete ownership to private investors, and transfer of partial or complete ownership to domestic or foreign entity (Frydman & Rapaczynski, 1992; Mathur & Lodha, 1991; OECD, 1996, 1997; Vickers & Yarrow, 1988; Yarrow, 1986).

process (Shleifer & Vishny, 1998, Spulber, 1997). We integrate these two research streams using stakeholder theory to suggest that different privatization modes create stakeholders with differing motives that influence organizational restructuring initiatives and resource-seeking behavior. We posit that not all post-privatization stakeholders share similar motivations to undergo organizational restructuring, defined as a change in constitution of business areas in which the firm operates and change in top management (Barberis, Boycko, Shleifer & Tsukanova, 1996; Djankov, 1998). Since privatized firms that undergo organizational restructuring are more likely to increase efficiency than firms that continue to behave as state-owned enterprises (Halachmi & Boorsma, 1998), DFIs are likely to initiate and support organizational restructuring in order to protect their self-interest in these privatized firms. A firm's dependence on the resources of an external organization or stakeholder gives that entity the power to influence the firm's strategies (Frooman, 1999; Pfeffer & Salancik, 1978). Since privatized firms that seek DFI resources will be influenced by the DFI' s inclination to restructure the firm, not all privatized firms will attempt to seek DFI resources. This leads to our first theoretical question: ***how does the privatization mode affect the privatized firm's motivation to seek DFI resources?***

Second, we posit that DFI involvement will act as a catalyst that helps the privatized firm forge new relationships and attract alliance partners with positive consequences for value creation. A newly privatized firm increases its reputation by associating itself with established institutions such as DFIs. We argue that this reputation allows the firm to attract alliance partners who share high levels of initial trust based on institutional cues (McKnight, Cummings & Chervany, 1998). Privatized firms, with inadequate resources, often find that alliances with foreign or domestic firms give them access to resources that allow them to be competitive

(Uhlenbruck & De Castro, 1998). Several emerging economies, especially the newly independent states, suffer from weak legal foundations, i.e. a weak legislative, judicial, and enforcement infrastructure (EBRD, 1998). In such cases, alliance partners would hesitate to commit additional resources without adequate control mechanisms that protect their interests. We posit that initial trust, due to the DFI involvement, decreases the partner's need for elaborate control mechanisms. Also, as the alliance evolves over time and subsequent interactions, the exchange parties (privatized firm and alliance partner) build a relational trust that reduces transaction costs and fosters investment in relationship-specific investments that generates relational rents[3] (Bhattacharya, Devinney & Pillutla, 1998; Dyer & Singh, 1998; Nooteboom, Berger & Noorderhaven, 1997). Hence, DFI involvement has more important implications from a relational perspective than as a pure financing vehicle for capital resources. This suggests a second theoretical question: ***how does DFI involvement help newly privatized firms in value creation?***

We address these two questions in the next four sections of this article First, we provide background information about DFIs and their services. We propose that the benefits that accrue to the privatized firm are related to the scale and scope of Firm-DFI interaction Next, we develop arguments using the stakeholder theory to answer the first question on privatization mode and firm's motivation to seek resources from DFIs. Then, to answer the second question we draw on the relational view of the firm to help understand the Firm-DFI interaction process and its outcomes. In Figure 1, we illustrate the DFI involvement process that includes (1) the facilitating conditions for DFI involvement, (2) the interaction process, and (3) value creation

[3] We adopt Dyer and Singh' s (1998) definition of relational rents as "a supernormal profit jointly generated in an exchange relationship that cannot be generated by either firm in isolation and can only be generated by joint idiosyncratic contributions of the alliance partners" (p. 662).

Finally, we discuss the implications of DFI' s role in the entrepreneurial transformation of emerging economies.

Insert Figure 1 About Here

DFIs AND THEIR SERVICES

DFIs provide financing for capital intensive ventures of national importance that would otherwise not receive funding due to the low rates of return or the high level of risk involved. In an underdeveloped economy, there is a general paucity of capital due to lower savings rate coupled with higher consumption. A desire for quick returns also makes the few private venture investors and venture capitalists reluctant to tie-up their limited capital in long term projects, especially those that deal with tertiary industry and infrastructure development (Krishnamachari, 1962). Hence DFIs are important capital and resource providers in emerging economies.

DFI Services and Resources

DFIs are specialized institutions that provide long-term financing. They usually have a staff of bankers, investment analysts and advisors operating from several geographically dispersed offices in their area of operation. Their staff develop a good grasp of contextual knowledge required to operate in the local business environment and are also aware of the local financial and legal systems (Bhatt, 1993; Jequier & Hu, 1989). To provide financial support, the DFI may opt between equity and debt instruments or a combination of the two. DFI financing provides the capital liquidity that would allow the firm to be competitive by making strategic investments in technology and in developing core competencies (Kane, 1975; Pandey, 1990; Uppal, 1984). DFIs also help develop a firm's networks and provide access to other industry players. Network development support is an important secondary activity offered by DFIs (Jequier

& Hu, 1989). In facilitating boundary spanning processes, the DFI plays the roles of *connector* between various interested organizations and *arbitrator* of disputes between participants (Prabhu, 1996). For example, International Bank for Reconstruction and Development facilitates network development by compiling a list of developmental projects and bringing together suitable investors or corporations (IBRD, 1998). Also, DFIs help in identifying emerging technologies in home country and abroad for efficient product or process development. For example, CSITIC, a Chinese DFI, helps identify and provide financing for commercialization of research in high-technology projects.

Apart from providing these specialized inputs, the DFI adds value by collaborating with the firm by providing managerial support throughout the product development and market launch period in a manner similar to a venture capitalist (Lam, 1991). For example, the Industrial Development Bank of India's role statement exemplifies the larger role of a DFI in an emerging economy. It defined its role as "identification of project ideas, preparation of preliminary feasibility studies, search for managerial and entrepreneurial talents, preparation of detailed project reports, managerial, technical and financial assistance for project implementation, critical evaluation of projects from the national point of view and finally project supervision" (IDBI, 1972:1). DFIs, therefore, have the potential to be a viable resource base for the newly privatized firm by providing resources such as capital, network development, technology identification, and project management.

Though DFIs can potentially provide all these services, the services offered greatly differs among countries and DFIs within these countries. All DFIs provide long-term financing but not all offer the substantial support services discussed. Some DFIs offer simple financial alternatives (combinations of loans) while others offer sophisticated financial structuring alternatives (loan, equity, debenture/preferred stock combinations). Also, not all DFIs offer the comprehensive support services such as technology identification, network development, and project management. Therefore, the comprehensiveness of support services provided by DFIs is an important determinant of the resources to which a newly privatized firm can gain access. Resource-based theory (Miller & Shamsie, 1996; Pensrose, 1959; Wernerfelt, 1984) suggests that firms that are able to accumulate resources[4] that are rare, valuable, non-substitutable, and difficult to imitate will achieve a competitive advantage over competing firms (Barney, 1991). Therefore, the amount of resources that the privatized firm can access through DFIs is related to the comprehensiveness of DFI support. Therefore:

Proposition 1a: The greater the resources accessible through a DFI (i.e., more comprehensive the range of support services offered), greater will be the potential benefits that accrue to the newly privatized firm

Scale and Scope of Firm-DFI Involvement

Relational rents are more likely to accrue to firms that are highly involved with the DFI and actively seek their support. The ability to generate relational rents is related to the total volume (scale) and breadth (scope) of transactions between exchange partners (Dyer & Singh, 1998; Koza & Lewin, 1998). Similar to production economies of scale, economic rents accrue to partners in an exchange relationship based on the increased scale and scope of transactions (Holm, Eriksson & Johanson, 1999; Ramirez, 1999). DFIs possess considerable expertise in guiding the newly

[4] There have been different schemes to classify organizational resources as either physical, human, and capital (Barney, 1991), technological, financial and reputational (Grant, 1991). Also, Miller and Shamsie (1996) propose a more comprehensive framework of classification based on property-based and knowledge-based resources that exist in systemic or discrete forms. Our consideration of resources includes all of the above. We look at resources as supporting and strengthening a firm and helping it attain a competitive advantage.

privatized firm into potentially profitable business areas and in identifying potential sectoral problems and their solutions. This expertise is developed through their experience in guiding other firms concurrently or in the past in the local environment and through their internal and external industry networks. As a financing pre-requisite, the DFI gathers substantial industry-related and firm-specific information. This information combined with its expertise allows the DFI to potentially provide the firm with considerable professional advice. DFIs provide this advice in order to protect and improve the efficiency of its investment in the firm (Prabhu, 1996). The DFI can also connect the firm with potential buyers and suppliers, providing the firm opportunities to access industry networks. Therefore interaction with a DFI can possibly generate relational rents of considerable value to the firm. Specifically, newly privatized firms are likely to gain greater benefits from DFI involvement when they interact more often (scale) and utilize the extensive support services (scope). Therefore:

Proposition 1b: The greater the scale and scope of interaction with a DFI, greater will be the potential benefits that accrue to the newly privatized firm

FACILITATING CONDITIONS FOR DFI INVOLVEMENT

Researchers have defined privatization as transfer of controlling interest[5] (i.e., majority equity ownership) from the state to private investors (Boycko, Shleifer & Vishny, 1996; Grossman & Hart, 1986). Though the intent of privatization is to transfer ownership, other factors such as political coalitions and capital market liquidity affect the selection of privatization modes. Political desirability strongly influences the government's choice of

[5] This is similar to management theorists who define the market for corporate control as transferring of managerial control to new capital providers through acquisitions, divestitures, and other control transfer mechanisms (Hitt, Hoskisson, Johnson & Moesel, 1996)

privatization mode, especially in emerging economies with weak ruling party government coalitions. In order to please their constituency, politicians may favor some privatization modes that do not involve employee layoffs (Ramanadham, 1989; Shleifer & Vishny, 1998; Spulber, 1997). Sophistication of capital markets is another significant factor in choice of privatization mode (EBRD, 1998). Some emerging economies with developed capital markets, e.g. Mexico and Brazil, possess the liquidity to absorb large initial public offerings of equity (Lopez de Silanes, 1997). However, others with weaker capital markets, especially in former communist Soviet Union, are unable to absorb large equity offerings and therefore restrict the government's ability to transfer ownership immediately to private investors (Carlin & Aghion, 1996; Willer & Nash, 1996).

These two factors, i.e. political desirability and capital market sophistication, may affect the selection of privatization mode wherein privatization does not necessarily result in a complete transfer of ownership to investors with several firms having hybrid ownership structures with the government still retaining a majority equity stake (controlling interest)[6]. In Table 1, we summarize some of the popular privatization modes in emerging economies and their effects on controlling interest. We see that differences in privatization modes create different ownership structures with transfer of controlling interest (majority equity stake) to certain stakeholder groups. We now highlight some motivational differences between these stakeholder groups.

[6] For example, the Estonian Privatization Agency favors public offering of shares of major companies that are expected to generate public interest. Firms that are privatized through private placement of stock usually transfer equity controlling interest, i.e. greater than 50% of common stock, to the private investor or corporation. The same country using a different privatization mode, public auction, of two of its six biggest privatization transactions in 1997, sold 34% interest in AS Estimpeks and 19.5% in AS Hotell Olumpia to private investors (EPA, 1998). In these two firms, private investors were still minority shareholders in the firm. This example illustrates two different scenarios of controlling interest within the same country following different privatization modes, i.e. private placement and public auction.

Insert Table 1 About Here

Post-Privatization Stakeholders with Equity Control

Stakeholders in an organization have been broadly defined as "individuals or groups who can affect or are affected by the achievement of the organization's objectives" (Freeman, 1984: 46). This definition, though popular, is ambiguous with regard to the concepts of legitimacy, power, and basis of relationship between stakeholder and organization (Mitchell, Agle & Wood, 1997). In contrast and probably more relevant in the emerging economy context, stakeholders have been more narrowly defined as voluntary or involuntary risk-bearers (Clarkson, 1994) where voluntary risk-bearers have invested some form of capital (financial or human) in the organization and involuntary risk-bearers are those that are placed at risk as a result of the firm's activities. Clarkson' s definition, in principle, allows the organization to take into account stakeholders who have legitimate claims and can influence managerial decisions (Mitchell et al, 1997). Private controlling interest of equity would entail a transfer of decision-making rights to private investors or corporations that assumed majority equity stake. For the four privatization modes described in Table 1, there are four distinct stakeholder groups by virtue of possessing controlling interest are voluntary risk-bearers: (1) employees, (2) government, (3) domestic or international corporations, and (4) investors through capital markets. We now discuss the differing motivations of these four groups and their implications for organizational restructuring and motivation to seek DFI resources.

Employees and Government. Research on the politics of privatization suggests that these two stakeholder classes have similar risk preference functions or similar ideologies (Spulber, 1997). More specifically, politicians and employees share similar ideological platforms on labor spending and foregone profits, i.e. employees and politicians are more likely to sacrifice organizational profitability in favor of continued employment and higher compensation. The primary stakeholder motivation, for both groups, is continued employment. Employees are likely to favor management decisions where the organization retains all its existing employees. Politicians are also likely to favor the status quo, especially in the emerging economy context, because they depend on employees and their unions for political support and electoral stability (Becker, 1984). Hence, in spite of privatizing the firm by distributing shares to the employees, the government is likely to continue soft subsidies to the firm because of similar preference functions (Shleifer & Vishny, 1998). Therefore, when the employees or the government retain controlling interest of the equity, organizational restructuring is unlikely to occur and therefore unlikely to change the way the enterprise is managed.

Corporations (domestic or international) and Individual Investors. These two groups have radically different risk preference functions than existing employees or the government. The primary motivation, for corporations and investors, is to increase organizational profitability. For domestic corporations, the privatized firm may allow access to property-based resources, established brand image, or entry into previously regulated markets. For large international corporations, diversification is an important strategic alternative for continued growth (DeCastro & Uhlenbruck, 1997; Hitt, Hoskisson & Ireland, 1994). Though implementation is complex, international diversification can have a positive effect on innovation and performance (Hitt, Hoskisson & Kim, 1997). Governments, with the hope of accessing new capital and fostering innovation, may offer stock partnership to a large international conglomerate. In the Organisation for Economic Co-operation and Development countries, approximately half of the privatization offerings in 1995 were sold to international conglomerates with the partner assuming equity controlling interest or a minority interest (OECD, 1998b). When a domestic or international corporation gains controlling interest, they are likely to favor organizational restructuring (Djankov, 1999). Similarly, the stakeholder group composed of investors through the capital markets can exercise their ability to control the organization and its activities. Threat of activism by shareholders can force managers to reorganize the corporation (Jensen, 1991; Manne, 1965; Shleifer & Vishny, 1986).

From the preceding arguments, we posit that corporations and investors are likely to restructure the newly privatized firm when they possess controlling interest. However, when employees and government stakeholder groups retain controlling interest, they are unlikely to restructure the firm. The privatization mode through the transfer of controlling interest influences stakeholder motivations to initiate organizational restructuring activities. Therefore:

Proposition 2a: Privatization modes with transfer of controlling interest to private corporations or investors are more likely to result in organizational restructuring than privatization modes with the employees or government retaining controlling interest

DFI as Stakeholder

Newly privatized entities in emerging economies often face resource limitations and may have to find innovative means to leverage existing resource availability. In some countries, for example Kenya and Swaziland, minimal resources of newly privatized organizations create a challenging environment for the firm that now has to depend on its networks to access resources (Diomande, 1990; Sonko, 1994). Czechoslovakia and other Eastern European countries face an acute shortage in managerial and technical labor force (DeFillippi, 1995). Even when capital and skilled labor were available, state-owned enterprises in India were stranded with obsolete technology in steel and petrochemicals sectors (Garg & Handa, 1991). The level of resource availability becomes a crucial factor for the survival of the newly privatized entity. DFIs, by contributing financial capital, are voluntary risk-bearers (Clarkson, 1994). Further, by providing resources to the privatized firm, the DFI becomes a primary stakeholder (Donaldson & Preston, 1995). DFI as a stakeholder is motivated to protect its own investment in the privatized firm. By protecting its investment, the DFI ensures repayment of loans and distribution of shareholder dividends, both of which can be done only by profitable firms.

Privatization and Organizational Restructuring. There is evidence that organizational restructuring follows radical changes in corporate control (Bethel & Liebeskind, 1993; Liebeskind, Wiersema & Hansen, 1992). Privatization is essentially a process where there is a transfer of corporate control[7] (Yarrow, 1986). Studies on organizational restructuring in emerging economies point to the increased efficiency and profitability of the firm when organizational restructuring follows private ownership (Megginson, Nash & Van Randenborgh, 1996) As noted earlier, we define organizational restructuring as (1) change in portfolio of businesses (Djankov, 1998), and / or (2) change in the top management team (Barberis, Boycko, Shleifer & Tsukanova, 1996)

First, restructuring through change in portfolio of businesses can lead to two different outcomes. Viable firms would increase their productivity and market share, attract more resources, upgrade their production process, and diversify into productive businesses. On the opposite end, non-viable firms would shrink to a viable core business through divestitures. Thus organizational restructuring in the privatization context would mean a shift of organizational

[7] This may not always be the case as shown in Table 1 and discussed in preceding propositions

resources to more productive uses (Djankov, 1998). Second, restructuring through change in top management team implies a change in the strategic orientation of the firm. Top management teams of state-owned enterprises are usually political appointees known for their ability to interact and coordinate their firm's strategies with political motives. In contrast, chief executives in private corporations are hired for their ability to provide direction, articulate a vision, organize, and make changes with the objectives of increasing performance and shareholder value. The underlying assumption is that new management is likely to be less committed to existing strategies and, therefore, more likely to embrace changes that make more productive use of limited resources (Barberis et. al., 1996).

DFIs and Organizational Restructuring. Researchers have extensively documented the outcomes of organizational restructuring through divestitures or acquisitions and their effects on innovation and firm performance (Hitt, Hoskisson & Ireland, 1994; Hitt, Hoskisson, Johnson & Moesel, 1996; Hitt, Hoskisson & Kim, 1997). Organizational restructuring can help refocus a firm's businesses around core capabilities by developing businesses related to the firm's primary competence (Bowman & Singh, 1990; De Castro & Uhlenbruck, 1997; Jensen, 1991; Shleifer & Vishny, 1990). Also, research on top management points to the importance of upper-level managers on strategic change (Boeker, 1997; Goodstein, Gautum & Boeker, 1994). Upper-level managers have a definite impact on organizational effectiveness because of the decisions that they are empowered to make (Grimm & Smith, 1991; Hambrick & Mason, 1984; Miller, Burke & Glick, 1998) such as innovation adoption (Bantel & Jackson, 1989) that eventually affects firm performance (Smith et al., 1994).

When DFIs invest in equity of the privatized firm, they become institutional investors who have the incentive and power to monitor firm strategy. Institutional investors can effect restructuring initiatives that result in higher firm profitability (Chaganti & Damanpour, 1991; Hansen & Hill, 1991; Pound 1992). Stakeholders on whom the firm depends upon for its resources can exert their influence to change the firm's strategies (Frooman, 1999; Pfeffer & Salancik, 1978). As a stakeholder who has the power to influence the firm, DFIs are likely to favor organizational restructuring to increase efficiency of its investment and make productive use of scarce resources in emerging economies. Therefore:

Proposition 2b: In order to protect their investment and make more productive use of resources, DFIs will initiate and support organizational restructuring in privatized firms

Stakeholder Preference for DFI Support

In a study of 960 privatized firms in Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, and Ukraine, Djankov (1999) found that when the government retained controlling interest restructuring never occurred but restructuring was inevitable when foreign corporations held majority controlling interest. The results are, however, mixed when employees retain controlling interest. Restructuring occurred only when employees and managers bought out the firm through a leveraged buy-out but not when it was given free through the voucher system (Djankov, 1998). In this case, existing employees behave similar to private investors because of their motivation to protect their investment and increase profitability.

As these results indicate, not all stakeholders favor organizational restructuring. When employees retain controlling interest they are unlikely to favor organizational restructuring because it would inherently affect their employment status. Politicians also prefer the status quo because their constituency and political candidacy may be affected by unemployment created during such restructuring initiatives (Shleifer & Vishny, 1998). Therefore, when employees and government retain controlling interest, they are unlikely to favor organizational restructuring. Since DFI support would almost necessarily require restructuring, they are unlikely to seek DFI support. An exception is the case when employees act as private investors and use debt in a leveraged buyout of the firm. Here the managers (new owners) can potentially access and leverage additional resources to develop the firm through DFIs and are likely to be inclined to seek DFI resources. On the other hand, when private investors or corporations possess majority controlling interest, they are likely to favor organizational restructuring in order to increase the economic efficiency of their investment. Since this group of stakeholders has similar motivations as those of the DFI, they are likely to seek DFI resources. Therefore:

Proposition 2c: Privatized firms where stakeholders (with controlling interest) desire to restructure the firm are likely to seek DFI support whereas privatized firms where stakeholders (with controlling interest) prefer the status quo are unlikely to seek DFI support.

VALUE CREATION OUTCOMES OF FIRM-DFI INTERACTION

Emerging economies often experience periods of radical change in economic policy when macroeconomic variables, such as currency valuation, may change rapidly and their combined effect on the operations and profitability of domestic firms may be difficult to predict by potential private investors and alliance partners (Murtha & Lenway, 1994). As state-owned enterprises undergo privatization, their industry may also be simultaneously opened up to new private sector investments from domestic and multinational corporations (OECD, 1997) resulting in an industrial regeneration and an increased competitiveness of firms within these industries

(Francis, 1992). Multinationals seek out credible alliance partners who would hasten access into previously regulated industrial sectors as well as portend stability in the changing economic context (Khanna & Palepu, 1997; Uhlenbruck & De Castro, 1998).

The newly privatized firm, by operating in a previously regulated environment, may hold a significant advantage over new entrants into the market because of their knowledge of the market, established customer base, or existing facilities such as production and distribution systems. Privatized firms become potential suitors for multinational or domestic corporations because of such resources. However, these private investors may be reluctant to make substantial investments until they receive signals of the privatized firm's legitimacy and reputation. Legitimacy is a generalized perception that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions (Suchman, 1995). Such legitimacy could be of an institutional nature gained from the firm's association with a well-respected organization or a network of firms in an industry (Khanna & Palepu, 1997; North, 1990; Oliver, 1997, 1991). In emerging economies, there are few institutions such as DFIs that can engender trust in their operations. Association with a DFI could bestow institutional legitimacy and improve the reputation of the firm (Pandey, 1990). Within the resource-based theory (Penrose, 1959; Wernerfelt, 1984), reputation is an intangible asset of substantial value (Hall, 1992). The reputation of the firm is a crucial factor that affects a prospective partner's decision to establish an alliance (Dollinger, Golden & Saxton, 1997). Therefore, DFI involvement would signal the firm's legitimacy and reputation, which in turn, facilitates alliance formation.

Country-specific DFIs are able to monitor changes in the economy and are well positioned to help multinational corporations assess their options to invest in newly privatized firms. DFIs can signal the legitimacy of the privatized firm by extending loans or owning equity in the privatized firm. Further, DFIs as stakeholders are motivated to protect their investments by extending credit to firms that are likely to survive changes in the economy and industry structure. The DFI' s investment history would indicate to potential investors and alliance partners that the DFI would take appropriate steps to build the privatized firm's competitiveness and thereby protect its own investment (Pandey, 1990). Therefore, in emerging economies, a newly privatized firm with ties to DFIs would signal increased stability and high likelihood of firm survival. This would act as a catalyst for attracting corporations and other investors to the newly privatized. Hence we posit that:

Proposition 3a: In emerging economies undergoing rapid change, a newly privatized firm with ties to DFIs would enjoy higher legitimacy and reputation than firms without such ties

Proposition 3b: Increased reputation and likelihood of survival of the newly privatized firm through DFI involvement will attract potential alliance partners more than firms without such ties

DFI Involvement and Trust

When firms forming an alliance have confidence in their partner's reputation, they are likely to trust each other (Das & Teng, 1998). Initial trust between parties is not based on any kind of experience with the other party but instead is based on institutional cues that enables one party to trust another without firsthand knowledge (McKnight, Cummings & Chervany, 1998). Consistent with researchers on trust, we define trust to mean that one party believes in, and is willing to depend on, another party (Mayer, Davis & Schoorman, 1995). In the emerging economy context, this initial trust based on institutional cues is a critical factor that influences partner selection and entry mode decisions of multinational corporations and private investors (Lenway & Murtha, 1994; Murtha & Lenway, 1994).

An institutional environment that fosters trust among partners facilitates the generation of relational rents (North, 1990; Fukuyama, 1995). At a macro-environment level, country characteristics and the government's ability to follow through with reforms and changes to legal frameworks helps alliance partners (especially international corporations) of the privatized firm repose greater trust in the domestic firm (Murtha & Lenway, 1994; Spulber, 1997). At the firm level, those firms that enjoy greater levels of trust among alliance partners can eventually generate relational rents through lower contracting, monitoring, and enforcement costs (Fukuyama, 1995; Bhattacharya, Devinney & Pillutla, 1998).

A stumbling block for private investment in emerging economies is the absence of effective governance mechanisms (OECD, 1998b). The weak legal and judicial systems of emerging economies may render contracts or agreements unenforceable or the sluggish process delays such enforcement to an extent that it makes such efforts costly and, in many cases, futile (EBRD, 1998; OECD, 1998b). However, when a DFI serves as a connector between firms, the alliance partners have more enforcement options available because the DFI can serve as a third party enforcer of the contract agreement. In the absence of strong legal systems, legitimate institutions can act as third party enforcers of agreements (Williamson, 1991). DFIs are primary stakeholders who can influence firm decisions through internal means such as voting or board representation. When stakeholders who have the power to control a firm's decision see that the firm is not behaving in its interest, they are likely to influence the firm's decisions by exercising its control by withholding resources (Frooman, 1999; Pfeffer & Salancik, 1978). DFIs are in position to exercise resource-withholding strategies as well as be proactive in exercising its shareholder rights to ensure appropriate firm behavior. Therefore, alliances where the DFI serves as connector of parties are likely to enjoy greater trust because of the importance of institutional context in emerging economies. On the other hand, firms with no institutional ties are unlikely to enjoy high levels of initial trust. Hence, we posit that:

Proposition 4: In emerging economies with weak legal foundations, newly privatized firms with DFI ties will inspire greater trust in their potential alliance partners than firms with no such ties

Governance and Relational Rents

When high levels of initial trust exist in a relationship, alliance partners may resort to self-enforcing agreements in which no third part intervenes to determine whether a violation has taken place (Telser, 1980). Use of self-enforcing governance mechanisms reduces transaction costs by: (1) cutting down contracting costs because partners trust that payoffs will be divided fairly, (2) reducing monitoring costs because self-enforcing mechanisms depend on self-monitoring rather than third-party monitoring, and (3) lowering enforcement costs because they are internal to the firm rather than through lengthy legal processes (Dyer & Singh, 1998).

In alliances with high initial trust, partners are likely to replace formal safeguards such as third-party or self-enforcing contracts with informal safeguards such as trust, goodwill or reputation (Fukuyama, 1995; McKnight et al, 1998; Weigelt & Camerer, 1988). The availability of multiple alternate governance mechanisms allows alliance partners to choose governance structures that reduce transaction costs related to bargaining, monitoring and enforcement, thereby enhancing performance over time (Barney & Hansen, 1994; Gulati, 1995). Further, the calculative trust, i.e. trust based on initial economic interchange, is likely to give way to relational trust, i.e. trust based on reliability and dependability of the firm over repeated interactions (Rousseau, Sitkin, Burt & Camerer, 1998).

In summary, when a DFI serves as connector, alliance partners are more likely to trust each other. Firms with no DFI involvement do not have access to DFIs as third party enforcers of contracts. When fewer governance options are available to alliance partners, they are likely to hold formal economic safeguards such as equity to control opportunism by aligning the economic incentives of the transactors, thereby increasing transaction costs (Klein, 1980; Williamson, 1983). The relational view of the firm posits that firms can generate relational rents when they lower transaction costs related to governance mechanisms (Dyer & Singh, 1998). DFI involvement engenders trust between exchange partners which, in turn, facilitates the adoption of self-enforcing governance mechanisms that lower transaction costs in bargaining, monitoring, and enforcing governance mechanisms. Hence, we posit that:

Proposition 5: Alliances of newly privatized firms where a DFI serves as connector between parties will have greater potential to generate relational rents due to lower contracting, monitoring, and enforcement costs than alliances of newly privatized firms with no such ties with DFIs

Investment in Specialized Assets and Relational Rents

An investment in specialized assets in conjunction with the assets of the partner is a necessary condition for the generation of economic rents (Amit & Schoemaker, 1993; Carney, 1998). Alliance partners improve their productivity when they make relationship-specific investments in site, physical asset, and human assets (Williamson, 1985). Site specificity refers to the successive production stages that are immobile in nature being located close to one another thereby reducing inventory, transportation, and coordination costs in the manufacturing sector (Dyer, 1996) or improved coordination in R&D and knowledge sharing routines in high technology industries (Nobel & Birkinshaw, 1998). Physical asset specificity refers to the investment in specialized physical assets such as capital investments in production and technology development that are tailored to increase productivity of the exchange partners. Investments in specialized physical assets have been found to have positive effects on product differentiation (Clark & Fujimoto, 1991) or performance (Holm, Eriksson & Johanson, 1999). Human assets specificity refers to developing know-how through repeated interactions between alliance partners. As partners work together, they increase efficiency by improving communication, knowledge sharing, and their relative capacity to absorb and utilize knowledge for innovation and product development (Lane & Lubatkin, 1998; Mowery, Oxley & Silverman, 1996). As the relationship develops, both alliance partners begin to invest in such relationship-specific assets that yield relational rents. Researchers have found that investments in such non-recoverable relational assets leads to improved performance of both exchange partners (Carney, 1998; Holm, Eriksson & Johanson, 1999; Parkhe, 1993; Saxenian, 1994).

A necessary condition for alliance partners to invest in relationship specific assets is the presence of effective safeguards against opportunistic behavior of the partner (Teece, 1987). Since relationship-specific investments create appropriable quasi-rents, transactors need to safeguard such relational rents (Klein, Crawford & Alchian, 1978). The ability to safeguard investments assumes far greater importance in the emerging economy context where there are frequent changes in the legal, political, and economic situation. As explained above, alliances where a DFI serves as a connector between the alliance partners provide more safeguards for the alliance partners. Therefore, partners (domestic or international firm) can choose among a range of enforceable safeguards in the emerging economy. The ability to protect their investment allows the alliance partner to invest in relationship-specific assets that generate relational rents (Dyer & Singh, 1998). Therefore:

Proposition 6: Alliances of newly privatized firms where a DFI serves as connector between parties will have greater potential to generate relational rents due to increased investment in relationship-specific assets

DFI Involvement, Relational Rents, and Value Creation

Thus far, we have evoked the relational view of the firm (Dyer & Singh, 1998; Koza & Lewin, 1998) to provide an integrating framework that helps explain that relational rents accrue to the privatized firm because of DFI involvement. We note that firms with DFI ties enjoy greater legitimacy and reputation (Proposition 3a). This legitimacy acts as a signal to attract potential alliance partners (Proposition 3b) who are likely to place high level of initial trust in the relationship with the privatized firm based on institutional cues of legitimacy (Proposition 4). The high initial trust enjoyed in the relationship allows the alliance partners to adopt governance mechanisms that reduce transaction costs (Proposition 5). When essential safeguards to protect firm interests are in place, alliance partners are likely to invest in more relationship-specific assets that provide the firm with a competitive advantage (Proposition 6).

The relational view provides a theoretical basis to explain the Firm-DFI interaction and its effect on value creation. Firms create value for their stakeholders through innovation and improved economic performance (Ghoshal, Bartlett & Moran, 1999; Rappaport, 1986). More recently, researchers have found that commitment to alliances and business networks creates value through workflow interdependence, co-production, and innovation (Gulati, 1999, 1998; Holm, Eriksson & Johanson, 1999; Ramirez, 1999). Through strong alliances, firms have been able to create value by reducing transaction costs (Gulati, 1998, 1995), increasing innovation (Lane & Lubatkin, 1998; Mowery, Oxley & Silverman, 1996), and differentiating their product or service from their competition (Bartmess & Cerny, 1993; Clark & Fujimoto, 1991).

More specifically, in the emerging economy context, DFI financing may also reduce the investment risk for resource-strapped newly privatized firms. Risk sharing between the firm and DFI creates an opportunity for the firm to make more aggressive decisions and take chances on investment in product pipelines or capital equipment. Alliances where DFIs act as connectors between parties have the potential to create value through effective governance mechanisms that reduce transaction costs and curtail opportunistic behavior of the privatized firm. Also, investments in relationship-specific assets allow the partners to develop capabilities that can be leveraged to create value through differentiation and innovation. Interactions between the firm and diverse sources of knowledge (from alliance partner and DFI) give the firm an opportunity to learn new skills (Grant, 1996) that expand its knowledge base (Kim, 1997). Acquiring knowledge through networks can improve the firm's ability to develop new products (Bartmess & Cerny, 1993; Clark & Fujimoto, 1991; Gulati, 1999), gain market share and improve economic performance (Buzzell & Gale, 1987). Therefore, we summarize that:

Proposition 7: Newly privatized firms with DFI involvement will have superior value creation compared to privatized firms with no such ties

FUTURE RESEARCH DIRECTIONS

This research provides some unique and valuable insights into privatization and management research in the emerging economy context. We see three major implications of this article for future research. First, this article stimulates an appreciation of the role played by DFIs in entrepreneurial transformation of emerging economies. Second, we consider the implications of DFI involvement for research on strategic alliances and partner selection. Third, we suggest future research on DFIs and the creation of an institutional context in emerging economies.

DFIs and Entrepreneurial Transformation. We refer to 'entrepreneurial transformation' as the renewal of existing organizations (Kanter, 1983) and the creation of a competitive environment where the organization influences the rules of competition within the industry (Schumpeter, 1934; Stevenson & Gumpert, 1985). In emerging economies, state-owned enterprises had earlier assumed the task of developing core industrial sectors because of the absence of individual entrepreneurial capacity, the lack of capital that allowed entrepreneurs to enter core industries, and the entrepreneur's inability to manage large investments (Ramanadham, 1989; Krishnamachari, 1962). In the transformation of privatized firms, DFIs play a prominent role by providing access to resources as well as increasing organizational effectiveness by supporting restructuring initiatives. By doing so, they play a substantial role in entrepreneurial transformation by creating a competitive environment and enhancing firm value through the generation of relational rents, innovation, and improved economic performance (Figure 1).

DFIs are an infrastructure component supporting entrepreneurial transformation (EBRD, 1998; Jequier & Hu, 1989; Van de Ven, 1993). We see potential benefits to include DFIs in our research on entrepreneurship in emerging economies. Measuring DFI activity with proxies such as amounts of loans disbursed, number of projects in core sectors, and number of support programs for new ventures, among others, are indicative of the level of DFI activity. Scholars need to understand the key factors that influence success in an industry (Nelson, 1991; Porter, 1985; Vasconcellos & Hambrick, 1989) as well as the process by which firms access and deploy resources to attain superior performance (McGrath, MacMillan & Venkataraman, 1995; Teece, Pisano & Shuen, 1997). DFIs can potentially play an important part in developing favorable industry structures as well as in increasing the level of firm competitiveness. Government policies that succeed are more likely those that create an environment in which companies can gain competitive advantages rather than those that involve the government directly in the process (Porter, 1990). Understanding the reasons behind regeneration of national and industry competitiveness can be critical to strategic management research (Francis, 1992; Porter, 1990). DFIs, in general, being quasi-governmental organizations can be effective policy instruments through which the government can indirectly target priority areas for developing a national competitive advantage (Brahm, 1995).

DFIs and Partner Selection. We begin to explore the importance of institutions in partner selection and international joint venture evaluation. Relationships with large reputed institutions, such as DFIs, could help develop firm legitimacy that attracts alliance partners. The formation of cross-border alliances is a complex phenomenon due to differences in cultural practices and organizational policies (Parkhe, 1993). Proper partner selection is even more critical in emerging economies because multinational corporations face the challenges of structural reform, weak market structure, poorly specified property rights, and institutional uncertainty (Luo, 1997). Though these relationships can be of value to foreign firms by improving market expansion, mitigating operational risk, and providing country-specific knowledge, they are fraught with risks (Beamish, 1987; Luo, 1996). Signaling of firm legitimacy helps mitigate the foreign firm's concerns about the local partner's intentions or abilities, thereby aiding the alliance formation process. Therefore, future research on alliance formation in the emerging economy context could take into account the presence of institutional entities that act as catalysts that help generate relational rents from such partnerships.

DFIs and Institutional Implications. Our article holds important implications for future research on institutional theory in emerging economies. Though the argument that institutions provide legitimacy has existed for several decades (Meyer & Rowan, 1977; Parsons, 1960; Suchman, 1995), research tended to concentrate on understanding institutions and their environment in advanced economies such as the US, Canada, or Japan (DiMaggio & Powell, 1991; Fukuyama, 1995; Hill, 1995; Oliver, 1991). Also, the underlying processes by which institutions confer organizational legitimacy have not been adequately tested or theorized (Barley & Tolbert, 1997; Osborne & Hagedoorn, 1997). In this paper, we address the relational perspective of how institutions can act as catalysts of firm growth. Also, the rationale for institutional involvement in emerging economies may be much more important and follow a different dynamic than institutional involvement in advanced economies. The primary difference is that emerging economies are confounded with a weak legal foundation (EBRD, 1998). Investments in emerging economies are hampered by the lack of appropriate governance mechanisms (OECD, 1998b). In such situations, DFIs could act as third party enforcers of governance mechanisms such as contracts that would otherwise be unenforceable. Future research could address the dynamics of institutional involvement as well as its implications for generating relational rents in emerging economies.

In this article, we extend arguments to explain conditions that favor DFI support and the outcomes of Firm-DFI interaction. We explain DFI support as a catalyst that speeds up product innovation and financial turnaround of newly privatized firms. With approximately $100 billion in new privatization programs (OECD, 1998a), there is a need to focus research on firm-level characteristics and relationships with external organizations such as DFIs that can make these programs a success in fostering entrepreneurship. With the relative scarcity of private venture capital and the weakness of the banking sector in emerging economies (EBRD, 1998), developmental financial institutions can be a critical force in the entrepreneurial transformation of emerging economies. It is likely that we may understand a lot more of entrepreneurship as a national phenomenon and national competitiveness of emerging economies if we include in our research DFI activity in identifying and supporting priority industrial sectors.

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Table 1
Popular Modes of Privatization

Mode	Rationale	Controlling Interest	Organizational Restructuring	Example Country [A]	Firm Motivation to Seek DFI Support
Distribution of common stock to employees and existing management	Encourage employee commitment Also acts as deterrent to employee attrition during restructuring (important political agenda for labor-supportive political agenda)	Employees	No	United Kingdom, Newly Independent States	Unlikely to seek DFI support
Public stock offering	Spur productivity gains Reduce national debt Increase organization's capital liquidity	Immediate transfer to stockholders/ private investors if majority of stock is sold Over time interest transfers to stockholders if sale of shares is parceled out	Yes (Immediate change if complete public ownership at start) (Eventually if transfer of stock is over time)	Japan, India	Likely to seek DFI support if ownership transfer is immediate Eventually, if change occurs over time Unlikely if government retains stake
Private placement or sale of stock to private corporations (domestic or international)	Reduce national debt Improve infrastructure and tertiary industries Stabilize currency through foreign exchange inflows Increase organization's capital liquidity	Depends (If placement is majority of the firm's equity, then corporation gains controlling interest, else government retains control)	Yes, if private corporation gains majority No, if govt. retains control	Brazil, Chile, China, Costa Rica, Mexico, Russia	Likely, if transfer of controlling interest to private corporation Unlikely, if no transfer of controlling interest to corporation
Direct sale through tender process	Reduce government intervention and bureaucracy	Corporations Immediate transfer of equity controlling interest to new owners	Yes	Australia, Malaysia, North Yemen, several eastern European countries, South Korea, Venezuela	Likely to seek DFI support

Collated from Carlin & Aghion (1996), Frydman & Rapaczynski (1992), OECD (1996, 1997), Mathur & Lodha (1991), Ramanadham (1989), and Shirley (1994). [A] Countries may adopt multiple modes, examples are cited where available literature points to that mode as prevalent

Figure 1
Process Model of DFI Involvement in Privatization