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Corporate governance changes, firm strategy and compensation mechanisms in a privatization context

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Abstract

Purpose – The purpose of this paper is to analyze certain organizational changes that occur after privatization. More specifically, the authors analyze from an agency theory perspective how changes at the corporate governance level (ownership type/structure and board of directors) influence firm strategy, and what implications these issues have for the design of compensation mechanisms.

Design/methodology/approach – The methodology employed in the study can be described as a longitudinal multiple case study approach. A multiple case study enables the comparison of pre- and post-privatization periods in five Spanish companies. This methodology is especially suitable to track the organizational changes occurring in relation to the firms' internal management.

Findings – First, the variables that traditionally relate to greater board independence in monitoring do not suffer from variation after privatization. Second, the interests of the firms' new ownership have an impact on firm strategy after privatization. Finally, compensation system design clearly aligns with firm strategy after privatization.

Research limitations/implications – The research is based on a multiple case study approach, which limits the scope and generalizability of the findings.

Originality/value – Whereas research in privatization generally adopts a macroeconomic or political perspective, organizational and managerial implications are current aspects in need of further examination. This research offers a study that integrates three sets of variables (corporate governance, strategy and compensation) that have been rarely analyzed in this context.

Keywords Corporate governance, Strategy, Board of directors, Compensation, Privatization

Paper type Research paper

1. Introduction

Evidence over the last few years shows that privatization is a popular strategy for promoting national economic development as well as the center of attention in research from a macroeconomic or political perspective (Zahra *et al.*, 2000). In contrast, the organizational and managerial implications of privatization need further examination (Zahra *et al.*, 2000). Because privatization implies changes in corporate governance (or firm's ownership), owners' objectives should both translate into firm strategy and influence internal firm's management (Cuervo and Villalonga, 2000).

At an organizational level, some studies focus on analyzing changes in governance structure attending to board characteristics (Bozec *et al.*, 2004; Cabeza and Gómez, 2007; Megginson *et al.*, 1994; Omran, 2009; Peng *et al.*, 2003). Other studies focus on analyzing

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potential changes in strategy after privatization (Cuervo and Villalonga, 2000; Ghobadian and Viney, 2002; Goydke, 2009; Nestor, 2005; Voges *et al.*, 2009; Zahra and Hansen, 2000; Erakovic and Wilson, 2005). At the same time, the role of incentives for management during the process of privatization is also of interest in current research (Cragg and Dyck, 2000; Cuevas *et al.*, 2007; Schröder, 2003; Thompson, 1999; Wolfram, 1998; among many others). However, the emergence of such studies fall short in explaining holistic, multi-level analyses to show how governance structure in a firm – as well as firm strategy – relates to the use of incentives within the company (Cox, 2005; Shen, 2005).

Zahra *et al.* (2000) have examined the major organizational transformations that occur following privatization. In their model, these authors distinguish between first-order and second-order effects of privatization. Thus, privatization is expected to create a new context in which firms must compete to survive and succeed, requiring changes in the enterprise's structure, the way it is managed and the firm's culture. These changes are defined as first-order organizational changes (structure, incentives, culture). Within the second-order effects of privatization, Zahra *et al.* (2000) include those organizational changes that stimulate organizational learning and the acquisition of new skills to bring about the opportunities for firms to gain access to new technologies and networks (learning, opportunities and networks). Cuervo and Villalonga (2000) consider that management replacement is one of the major catalysts of the internal organizational changes in a privatization context. They consider that such management replacement is likely to be contingent on factors such as: the method of privatization used, the degree of prior restructuring and the deregulation and liberation of the economic environment. Both studies (Zahra *et al.*, 2000; Cuervo and Villalonga, 2000) have in common the consideration of the new owners and their objectives/interests as a key variable to understand the organizational changes provoked by privatization. In this sense, we focus our attention in the changes that occur at the highest level of the organization, the corporate governance (ownership type/structure and board of directors) to analyze internal organizational changes.

Thus, this paper aims to analyze, from the agency theory perspective, both how privatization influences corporate governance and firm strategy, on the one hand, and what implications these issues have for the design of compensation mechanisms, on the other. A multiple case study helps to compare pre- and post-privatization periods in five Spanish companies. This methodology is especially suitable for this research to track the organizational changes that happens in the firms' internal management.

This paper makes a contribution to the existing research literature by, first, highlighting which dimensions of corporate governance depend on privatization. The findings indicate high levels of block-holding financial institutions after privatization, but traditional agency theory variables that were supposed to change to increase board independence (firm leadership structures and outsider representation) do not show significant variation after privatization.

Second, the study reveals that once the new owners of firms in the post-privatization period link to firm strategy, the firm's interests become stronger than in state-owned enterprises (SOEs). In fact, although private firms maintain a similar strategic pattern, firms tend to place more emphasis on factors that relate to customer service and costs.

Third, the study shows stronger alignment between compensation systems and strategy after than before privatization of firms. This case study reveals preference for more risk sharing and emphasis on global vs unit performance that relates to compensation, as well as an increasing emphasis on the extent to which pay influences the labor market.

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Fourth, this research offers a study that integrates three sets of variables (corporate governance, strategy and compensation) that have been rarely analyzed in this context. Finally, the study focusses on the entire top management team rather than only the chief executive officer (CEO); on a sample of public firms that belong to the state, rather than the large influential corporations that are typical in the current literature.

This paper has the following structure. After presenting the theoretical framework that maps to this research and giving details on the research method, the study examines comparative case studies in five different companies. A discussion of the most relevant findings follows, along with the main conclusions and implications for future research.

2. Theoretical framework

Agency theory is arguably the dominant theoretical framework in corporate governance research (Lynall *et al.*, 2003). According to this theory, the two mechanisms that align the interests of owners with those of managers are the monitoring function of the board of directors and incentive alignment mechanisms, such as pay-for-performance schemes (Eisenhardt, 1989; Fama and Jensen, 1983; Jensen and Meckling, 1976).

Agency theory promotes high levels of board oversight after privatization (Young *et al.*, 2000), since "core" shareholders will emerge while holding a sufficiently high proportion of a company's shares to justify combining ownership with some degree of board control. In turn, SOEs feature dispersed shareholders (Shleifer and Vishny, 1986). Agency theorists explain the promotion of this monitoring/control board function when boards are independent of top management. Traditionally, the variables that measure board independence (Coles *et al.*, 2001) are: first, firm leadership structure or the relationship of the CEO with the chair of the board of directors; combining these titles into one position may be an inappropriate method of power concentration that allows the CEO to make decisions in their own self-interest and at the expense of shareholders. Second, outsider representation is more likely to carry out oversight responsibilities effectively than insiders, owing to the fact that their interests align more closely with those of the corporation's owners. Third, ownership structure, such as higher proportions of stock ownership, translates into shareholder pressure for the board of directors (Yuan *et al.*, 2009). This pressure may actively prevent managers from engaging in certain practices (Michael and Pearce, 2004, p. 1172). As Dharwadkar *et al.* (2000) suggest, it is important to analyze the effectiveness of this board control function as an internal control mechanism in the context of weak external control mechanisms (i.e. market-based control as hostile takeovers or mergers) typically of emerging economies.

These arguments inform the following proposition:

P1. Board independence increases after vs before privatization, promoting the separation of CEO and board chairman positions, greater outsider representation and higher proportions of stock ownership.

Theoretically, greater board independence should translate into a stronger ability for the board to monitor firm management. Privatization leads to depoliticizing the decision-making process and to clearer firm strategy definition (Hassard *et al.*, 2002). Specifically, after privatization, the company and its management are beholden to the forces of the market because this is the context in which the company must survive and be successful. Therefore, managers must develop strategies based on their analysis of the industry and market conditions (Zahra *et al.*, 2000). Nestor (2005) suggests that in SOEs, managerial decisions are often the result of political rather than an orientation

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toward imperatives. Boards are formed/constituted by either political appointees, civil servants or managers. Managers of SOEs have particular limitations to initiate strategic activities (Cragg and Dyck, 1999), and they operate under bureaucratic restrictions in relation to their activities and authority (Parker, 1995). Other possible obstacles to managerial discretion include the maintenance of a certain level of employment, the choice of suppliers or the sale prices of products or services (Cragg and Dyck, 2000). Wright *et al.* (2000) also defend the idea of a higher managerial discretion after privatization due to a cognitive shift from a managerial to an entrepreneurial mindset. So, managers would benefit from their individual beliefs and use of heuristics to quickly interpret the complex and changing business (entrepreneurial cognition), while decisions of managers in public sectors are usually based on accountable and quantifiable information and corporate procedures (managerial cognition) mainly. These arguments are in line with the new public management (NPM) approach that defends a set of administrative reform doctrines to apply in the public sector. This approach proposes the adoption of a professional management and private-sector styles of management practices, emphasizing the use of output controls, explicit standards and measures of performance (preferably expressed in quantitative terms) and greater flexibility in hiring and rewards, among other issues (Hood, 1991). As a whole, NPM implies a new style of governance of the modern state (Wettehnhall and Thynne, 2002), and privatization has been one of the most common initiatives within this movement of public sector reform (Polidano and Hulme, 1999).

Changes on the strategy of privatized firms are also expected because of new ownership structure. The firm's ownership structure is recognized as an important determinant of firms' strategic decisions and general investment policies (Tirole, 2001; Lee and O'Neil, 2003). For example, Tribo *et al.* (2007) discuss the impact of large shareholders on R&D investment, suggesting that this relationship depends on the number and type of blockholders (e.g. banks, non-financial corporations or individuals). Thus, banks are usually conservative investors concerned with protecting the quality of their loans, which is translated into higher cash reserve requirements on the client's balance sheet. Nevertheless, non-financial stockholders, such as industrial ones, want to stabilize supplier-customer commitments or the strategic complementarity of their affiliated firms. This explains why different shareholders with different strategic objectives would attempt to influence where and when managers invest on the firms' resources (Yoshikawa and Phan, 2005). Other researchers have also analyzed the link between corporate structures and firm's diversification (Denis *et al.*, 1997). Consistent with the model of Amihud and Lev (1981), these studies conclude that ownership concentration reduces the propensity of the firm's managers to diversify. Then, it is expected that firms initiate certain changes in their strategies to pursue their new owners' objectives after privatization occurs.

Agency theory posits that outcome-based contracts are positively related to the outcome measurability (Eisenhardt, 1989). In this sense, some studies that focus on incentives document bureaucratic compensation systems (i.e. lack of pay-for-performance programs and implementation of systematic pay increases in terms of age instead) in SOEs, as well as post-privatization increases in executive salaries and observable measures of firm performance (Cragg and Dyck, 2000; Francis and Minchington, 2002; Schröder, 2003; Thompson, 1999; Wolfram, 1998; Zabalza and Matey, 2011). These fuzzy missions make difficult both the use of incentives and board monitoring in SOEs (Tirole, 2001). Besides, the disciplinary power of capital markets is absent in SOEs, which worsens the problem of managerial control.

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This discussion informs the following proposition:

P2. Greater board control of firm management translates into a clearer definition of firm strategy and a higher use of incentive alignment after privatization.

This empirical research thoroughly explains how corporate governance influences firm strategy and internal compensation systems in the Spanish privatization context.

3. Research methodology

To analyze the effects of corporate governance and strategy on compensation practices, we employ a multi-case research method. Table I details a description of the five companies under analysis. The five case companies have been labeled Alpha, Beta, Gamma, Delta and Sigma.

In line with Yin's (1994) suggestions, the five cases that this study examines are not an arbitrary selection but aim to include all possible combinations of three control variables, namely, the industrial sector (because companies should belong to different industries), company size and privatization methods. In addition, two additional restrictions in this case study framework include the fact that the companies under examination are large enough to guarantee the existence of formal corporate governance and that these firms were privatized after 1996 because of two reasons:

(1) The last wave of privatizations in Spain began after 1996 with the "Modernization Program of the Public Sector." This program encourages the privatization of efficient SOEs and focusses on non-efficient SOEs to prepare them for privatization.

(2) This study uses questionnaires by which the members of the top management team of each company may provide information regarding the five years before and after privatization. Thus, the managers in this study have enough history and experience within the company to compare the pre- and post-privatization periods.

Our primary data were collected from 18 interviews with top management teams (four managers were interviewed in Alpha, two in Beta, five in Gamma, three in Delta and four in Sigma). Interviews had a structured part (with questions explained below), open-ended areas for relating personal opinions and rich descriptions of the research topics. We contact with firm's CEOs to confirm their firms' commitment to this research. As the validity and reliability of case studies rest heavily on the correctness of the information provided by the interviewees and can be assured by using multiple sources or "looking at data in multiple ways" (Eisenhardt, 1989; Yin, 2003), several secondary sources with pieces of evidence were employed to supplement the information gathered in the interviews: internal documents – strategic planning documents, archives, memos, internal newspapers – and public information such as articles in the press, annual accounting statements, the Spanish Central Bank's database and reports from the "Sociedad Estatal de Participaciones Industriales" (Spanish Society of State-Owned Companies, or SEPI). This combination of sources allowed obtaining "data triangulation," which is essential for trustworthiness in qualitative research (Bonoma, 1985). The whole set of data covers ten years (the five years before and after privatization) although the period under consideration varies according to the time each company was privatized.

The overlap of data collection and analysis were highly iterative processes in this research (Yin, 1994). Staggering the volume of data in this study was possible by focussing

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Sector	Alpha Telecommunications	Beta Gas	Gamma Electricity	Delta Airline	Sigma Fuel
Year of complete privatization	1998	1998	1998	2001	1997
Times of privatization, percentage sold and privatization method	1997: (60%) direct sale (DS) 1998: (40%) public offering (PO)	1994: (91%) DS 1998: (9%) DS	1988: (20.4%) PO 1994: (8.7%) PO 1997: (25%) PO 1998: (41.1%) PO	1999: (10%) DS 1999: (30%) DS 2001: (48.51%) PO	1989: (4.2%) DS 1989: (26.4%) PO 1990: (2.9%) DS 1992: (2.1%) DS 1992: (10%) bond issue 1993: (13.9%) PO 1995: (19.5%) PO 1996: (11%) PO 1997: (10%) PO
Major shareholders	Endesa (28.7%); Union Fenosa (13.5%); Telecom Italia (28.7%); BBK (3.5%); Unicaja (3.5%); Euskaltel (3%); Kutxa (3.5%); CAM (3.5%); Caja Navarra (2.8%); Ibercaja (1.4%)	Gas Natural (40%); Bancaja (5%); CAM (5%); Cajastur (5%); Sagane (5%); BP (5%)	Caixa (5%); Caja Madrid (5%); BSCH (3%); BBVA (3%)	NEWCO (10%); Caja Madrid (10%); BBVA (7.3%); Logista Aeroportuaria, S.A (6.7%); Corte Inglés (3%); Ahorro Corporación S.A (3%)	Caixa (5%); BBVA (7%); PEMEX (5%)
Financial institutions (stock participation over 5% after privatization)	Total = 0%	Total = 15% Bancaja (5%); CAM (5%); Cajastur (5%)	Total = 10% Caixa (5%); Caja Madrid (5%)	Total = 17.7% Caja Madrid (9.8%); BBVA (7.9%)	Total = 15.7% Caixa (10.7%); BBVA (5%)
Stock controlled by major shareholders (%) (ICON)					
Before privatization	100.00	100.00	66.95	92.18	76.97
After privatization	74.22	81.51	15.22	39.56	23.53
Company size (year complete privatization)					
Sales (in millions of euros)	364.2	2,680.5	6,836.5	4,581	19,287.2
Employees	1,909	985	19,479	27,523	21,440
Profits (in millions of euros)	(42)	348.6	1,097.2	29.4	757.9

Table I.
Main characteristics of firms analyzed

(*continued*)

Sector	Alpha Telecommunications	Beta Gas	Gamma Electricity	Delta Airline	Sigma Fuel
Market share (year complete privatization)	3.28%	100%	43%	70.4%	53.5%
Strategic changes	Service modernization; R&D; price reductions	R&D; diversification; expansion; profitable investments; efficiency	Efficiency, internationalization; diversification; quality of customer service	Expansion; efficiency	International expansion

Table I.

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on three dimensions or variables: the company's governance structure, company strategies and managerial compensation systems. Narrative descriptions with extensive graphs and information about each case show the organization of the longitudinal data. Thus, not only initial interpretations of the data, but also additional data serve to confirm or invalidate these interpretations. Finally, a cross-case pattern looks beyond individual cases and searches within-group similarities and inter-group differences.

Regarding specific measurements for our first variable, the company's governance structure, we use (Coles *et al.*, 2001; Hsu, 2010): the existence of separate positions for the CEO and the chairperson of the board, board composition and ownership structure and concentration.

For the second variable, company strategies, we use Dess and Davis' (1980) measures. As these authors state, classifying firm strategies into one generic Porter's typology (cost leadership, differentiation and focus strategy) is a valuable tool, but also implies an atomistic view of strategy because each firm is unique in all respects. Alternatively, Dess and Davis (1980) propose a new view that supports the recognition of commonalities among firms regarding the higher/lower importance of a set of strategic choices. This notion of strategic choices helps track the role that corporate governance (and firm ownership) plays in pursuing a purpose, making decisions and adopting competitive methods, all of them inherent in the concept of strategy (White and Hammermesh, 1981, p. 216). Thus, managers had to score a total of 20 items (strategic choices) using a five-point Likert scale on which 1 implied a low level of relevance of the strategic competitive item and 5 indicated high relevance. As with other variables, each item refers to both pre- and post-privatization periods.

Gomez-Mejia's (1992) and Gomez-Mejia and Balkin's (1992) works are the bases to measure the third variable, compensation design. These authors distinguish two basic compensation patterns, namely, "algorithmic" and "experiential." Algorithmic patterns use formal rules and procedures that make pay decisions routine and that apply uniformly across an entire organization, with minimal attention to mitigating circumstances, exceptions to the rule and external contingency factors. Experiential patterns are more flexible and adaptive because they respond to varying conditions, contingencies and individual situations. As with the previous variable, managers had to score 23 items on a five-point Likert scale for both pre- and post-privatization periods.

4. Findings

Below, the examination of the firm governance structure, strategic orientation and compensation systems follows. Data from the five case studies allow comparing these

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variables before and after privatization. Finally, we present an analysis of the sectors to which the companies studied belong. This will allow us a better understanding of changes in the companies after privatization.

Firm governance structure

Three factors measure company governance structure (Young *et al.*, 2000): first, the existence of separate positions for the CEO and the chairperson of the board; second, the board's overall composition; and finally, ownership structure and concentration.

With regard to the first factor, one out of the five companies employs different individuals for the two positions after privatization. No changes appear in four of the five companies, and these companies are comfortable with not segregating the positions. Therefore, the majority of cases do not seem to be consistent with these theoretical expectations because agency theory predicts that different people hold the CEO and chairman positions after privatization in order to increase the control function of the board of directors over managers.

To analyze board composition, Baysinger and Butler's (1985), and Rutherford and Buchholtz's (2007) studies provide the basis to classify members of the board in this study. The term "insiders" refers to those members with a contractual relationship with the company while those board members who do not hold professional positions in the company are outsiders.

This analysis does not reflect a clear change in board composition before vs after privatization. Outsiders fill an average of 79 percent of board positions during the pre-privatization period, and this figure rises to 88 percent after privatization. However, Wilcoxon non-parametric test (Siegel and Castellan, 1988) shows no statistically significant differences ($p = 0.28$) in the ratio of outsiders before and after privatization. Besides, and contrary to the theoretical expectations in this study, one of the companies reconfigures its board to include a lower percentage of outsiders after privatization (83 percent) in comparison with the period before privatization (92 percent). The results may be consistent with Cabeza and Gomez's (2007) conclusions, which highlight the lack of independence of Spanish boards of directors after privatization at this time.

Although no changes result in terms of board characteristics (leadership structure and outsider representation), going further is necessary in order to analyze the individual members of each board and the roles they play. With this goal in mind, the results show that the government's involvement in the appointment of board chairmen vary from firm to firm in some occasions. In Gamma, for example, this appointment takes place in 1997, when the state is still the largest shareholder in the company. The firm considers this board chairman as the government's man in the company; he even proposes the names of the directors of the board (at that time, there is no objective legal criteria for defining an independent director). This chair has no previous experience in the electricity industry. Instead, he has experience working with experts and politicians in or close to the incumbent conservative party in designing the privatization strategy for the new government. Thus, he may fall into the category of quasi-bureaucrat whose most valuable assets are public relations and political skills. With regard to Delta, in 1996 (when Spain's conservative Popular Party comes to power), the company names a new CEO with the aim of leading the privatization of the company. The new CEO initiates in-depth processes of restructuring and reorganizing the business of the company to make the firm profitable and thus attractive to future investors. Similarly, in 1987, the socialist government names a new Sigma CEO to lead the privatization process. This executive

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remains in the company until 1996. Before he becomes CEO, he is already a key figure in the government and occupies positions of great responsibility in the National Institute of Industry and later in the Department of Industry and Energy.

The findings also show high board of director turnover rates. For example, Gamma added eight (out of 15) new directors in 1998 – year of its privatization – representing a turnover rate of 53 percent. In contrast, there was an addition of ten (out of 12) new directors in Delta in 2000, representing a turnover rate of 83 percent. A year later, in 2001, the level of turnover stood at 42 percent, that is, five new directors out of 12. In the words of the Delta chairman: "[…] all these changes represented a new way of board operating, a greater alignment of interests between the board and shareholders, and a greater control over management." New appointments were a great cultural change and implied greater attention to the interests of shareholders, people and institutions that, given the many options offered by the market to invest their savings, chose Delta. Regarding Sigma, privatized in 1997, there were also significant changes in the board. The company added 11 (out of 15) new members in 1996, representing a turnover rate of 73 percent. In 1997, turnover reached 31 percent, with the addition of five (out of 16) new directors. These changes, as in many other companies, happened to be more related to the ability and experience of the directors in the business world than to political criteria. In this sense, the adoption of a new regulation of the board in 1997 aimed at the search for greater efficiency in the management of the company, through professionalism, independence and accountability of directors.

Finally, we analyzed the ownership structures of the companies using the percentage of corporate stock in the hands of major shareholders, that is, those who own more than 5 percent of the stock (ICON) (Tosi and Gomez-Mejia, 1989).

Table I shows significant shareholders (ICON) for each company both before and after privatization. Figure 1 clearly shows high concentration of capital before privatization. This concentration is reasonable because before privatization, all or most of the shares in these companies are the property of the state. After privatization, although the concentration of capital generally falls, the average percentage in the hands of important shareholders is still high, reaching almost 47 percent.

In accordance with agency theory, core shareholders such as financial institutions hold at least 5 percent holdings of capital in four of the five cases. This figure implies some degree of control over the board in contrast to the dispersed shareholding and "free-rider" dynamics of state-owned companies. The proportion of shares that financial institutions own in each of the five firms after privatization oscillates between 10 and 18 percent (see Table I).

In general, the analysis of the case studies shows that regardless of the privatization method (e.g. direct sales, POs, issuing of bonds), the public sector ownership position

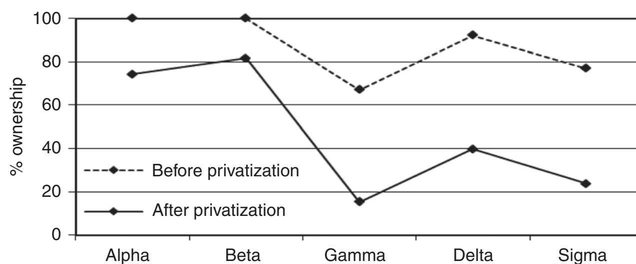

Figure 1. Evolution of stock controlled by major shareholders (ICON)

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largely replaces a dual ownership structure. On the one hand, most of the equity of firms after privatization is in the hands of investors who compose a "hard core." These "hard core" groups are generally reputable entities (see Table I), which have great ability to control and influence business decisions (Cuervo and Villalonga, 2000). The incorporation of these shareholders to the capital of the company attempts at ensuring continuity of the business project and maintaining national interests assumptions once the company goes into private hands (Cuervo, 2003; Vergés, 1999). In sum, this steady concentration of ownership gives new owners more power to monitor managers' behavior. On the other hand, the firms in the post-privatization period encourage the involvement of minority shareholders. This finding is consistent with the government objective of promoting popular capitalism.

Besides, although the state equity disappears after privatization, the Spanish Government decides to retain temporary golden shares in three of the companies under analysis to grant the state the right to veto certain strategic decisions as well as to block foreign shareholding.

However, some degree of inertia and path-dependence in the internal governance decisions of firms after privatization are also characteristic in the data: some board characteristics do not undergo any changes, and the government is in charge of board chair appointments. Thus, not only an analysis of corporate governance is relevant in order to understand these findings, but also the consideration of internal firms' management to understand whether changes take place within the firms.

Strategic competitive factors

In general, the strategies that companies follow after privatization reflect firm expansion and diversification into new sectors. Regarding Alpha, in 1997 the company develops the *Plan de Cobertura Integral*. This new plan encourages a new way of acting in the sector, promoting clarity, transparency and flexibility. During 1998, Alpha designs products and specific services to improve competitiveness and facilitate cost reduction. This plan also contributes to the company's internationalization, creating instruments to harness the potential of new information technologies. In addition, the company reinforces its strategic assets to pursue client loyalty, boost brand image, and increase network coverage and advance toward the attainment of a multi-service and multi-technology network.

Gamma, in turn, starts to operate more efficiently and with a management plan to achieve higher quality control and customer service. The most significant change in the management of the company is the board's implementation of a formal management-by-objectives program for middle and top managers in 1998. This program aims to stimulate the identification of management priorities (particularly financial ones) for the year, to direct managers' actions toward those priorities, and to push everyone who remains with the company into a higher gear.

With regard to Delta's strategy after privatization, one of the most important events is the implementation of a new strategic plan (2000-2003). This new plan gives priority to aspects such as reinforcing leadership in the strategic markets of the company, leading the development of new technologies, and improving client satisfaction and the use of resources. Additionally, the development of alliances and cost reduction are important objectives within the firm to increase competitiveness.

In 1996 (one year before the total privatization of the company), Sigma adopts an international strategy without precedent. The strategic priority deals with initiating its expansion in Latin America as a global energy company. The company adopts a new

model of management (RYS XXI) that proposes changes in the firm's culture; this change entails the transformation of many aspects of the company as a requirement to achieve real productivity, greater agility in making decisions and a substantive client service vision. At the same time, this new model of management promotes a more horizontal and less hierarchical firm structure, delegation and more fluid and transparent communication.

In this respect, the information that some executives provide about the companies under examination shows the changes in firm strategy once the company passes into private hands. An executive from Alpha said: "The most important change that followed privatization was the rethinking of the criteria used to guide strategic decision making. These criteria shifted from being linked to political aims to being related to the firm's efficiency, profitability and competitiveness in the market." The strategic change undertaken in Alpha led to an increase of up to 42 percent in the number of telephone customers just a year after privatization (1998). Delta's CEO emphasized: "Privatization made the firms feel freer. This inspired strong investments both nationally and internationally, with the aim of expanding the company and operating in global markets."

Dess and Davis (1980) measurement ensures a deeper analysis of the firms' strategies. Table II lists the average scores of the responses from top management teams regarding the 20 items that relate to strategic orientation. The comparison of scores for the pre- and post-privatization periods confirms that the weight or relative importance that the management of the different strategic factors assigns is quite similar in the two periods. In other words, the changes in the strategic pattern of the company are not significant. However, although companies do not change their strategic orientation, they do increase their emphasis on strategic factors after privatization. This fact reveals higher scores across all items (with the exception of item 13 – minimize the use of external financial support) after privatization (see Figure 3). In this sense, results suggest that the level of importance of minimizing the use of financial support remain almost constant. Nevertheless, the different origins of the financial sources in both periods should be highlighted. In the public phase of the companies, the state plays an important role providing funds, for example, through capital and current transfers, and loans made by public institutions. However, after privatization, companies' financial resources are provided mainly by private hands. Independent analyses of each individual company further support this fact. In addition, the standard deviations of more than half of the 20 items (i.e. 13 of 20) diminish after privatization, which suggests a tendency to value strategic items similarly and implies that companies converge toward a similar weighting of competitiveness with respect to other strategic factors (Figure 2).

This study also includes a Wilcoxon non-parametric test in order to test the existence of statistically significant differences between scores for strategic factors before and after privatization. The results of this test, as well as the results of a signal test, suggest statistically significant differences ($p = 0.00$). The t-test corroborates these results, which also leads to reject the null hypothesis of similarity among average scores before and after privatization ($p = 0.00$).

Although the companies' strategies apparently follow a similar pattern before and after privatization, there are larger differences in terms of customer service (item 2), cost reduction efforts (item 3), quality control for products/services (item 4), training and experience building for human resources (item 5), competitive prices (item 6), the development and improvement of existing products and services (item 8), the ability to create specific products and services (item 15), reputation within the sector (item 18) and foresight regarding market growth (item 19). Table III reflects the results of the Wilcoxon non-parametric test for each item.

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	Before	After	Difference
1. New product development	3.0 (0.71)	4.3 (0.82)	1.3 ↑
2. Customer service	2.7 (0.62)	4.7 (0.41)	2.0 ↑
3. Sustained effort toward cost reductions	2.9 (1.36)	4.7 (0.25)	1.8 ↑
4. Quality control of products/services	3.8 (1.10)	4.6 (0.31)	0.8 ↑
5. Training and experience building of human resources	3.5 (0.51)	4.3 (0.49)	0.8 ↑
6. Competitive prices	2.7 (0.94)	4.0 (1.20)	1.3 ↑
7. Wide range of products and services	2.3 (0.83)	3.3 (0.89)	1.0 ↑
8. Development and improvement of existing products and services	3.0 (1.22)	4.0 (0.64)	1.0 ↑
9. Brand	3.0 (1.22)	4.0 (0.72)	1.0 ↑
10. Innovation in marketing techniques and methods	2.3 (1.31)	3.6 (0.74)	1.3 ↑
11. Distribution channel control	2.4 (1.26)	3.7 (1.59)	1.3 ↑
12. Raw materials for products and services	4.0 (1.00)	4.4 (0.55)	0.4 ↑
13. Minimization of the use of external financial support	2.6 (0.55)	2.3 (0.60)	0.3 ↓
14. Specialization in geographical areas	2.5 (1.50)	3.2 (1.33)	0.7 ↑
15. Ability to make specific products and services	3.0 (0.71)	3.7 (0.50)	0.7 ↑
16. High-priced products and services in the market	2.4 (0.89)	2.8 (1.24)	0.4 ↑
17. Promotion and marketing in the media from other companies in the sector	2.3 (0.85)	3.2 (1.15)	0.9 ↑
18. Reputation within the sector	3.5 (0.65)	4.4 (0.28)	0.9 ↑
19. Foresight of market growth	3.5 (1.12)	4.6 (0.45)	1.1 ↑
20. Process innovation in products and services	3.1 (1.12)	4.2 (0.83)	1.1 ↑

Note: Standard deviations in parentheses

Table II.
Strategic competitive factors before and after privatization

At a whole, a comparative analysis across the five cases shows that firms initiate certain changes in their strategies to pursue their new owners' objectives once they fall under private ownership. This fact is consistent with agency theory, which encourages greater discretion on the part of the board of directors after privatization. In general terms, the strategies of these companies favor market growth after privatization and relate to expansion and diversification. The secondary data analyzed highlighted that customer service, efficiency and product innovation became key competition-relevant factors once firms pass to private hands.

Compensation systems

To analyze changes in the compensation systems of companies following privatization, the study comprises 23 items, each including 11 different dimensions, namely: the extent to which job definition, vs an individual's skills, influences pay, risk sharing, emphasis on global vs unit performance, the use of quantitative vs qualitative performance measures, short-term vs long-term orientation, the extent to which labor market influences pay, the size of differences in pay for different levels of the hierarchy, the communication of compensation policy vs secrecy, the degree of managerial participation in setting compensation policy, flexibility regarding the design of the compensation system and fixed pay vs incentives. Algorithmic and experiential pay patterns are two poles of a continuum. Thus, an algorithmic pay pattern features a heavy reliance on traditional job evaluation procedures, strong attention to base salaries and benefits in the pay mix with minimal variable compensation, a corporate and global strategic focus with an emphasis on internal equity and hierarchical positions as the basis for distributing incentives, the monitoring of behaviors rather

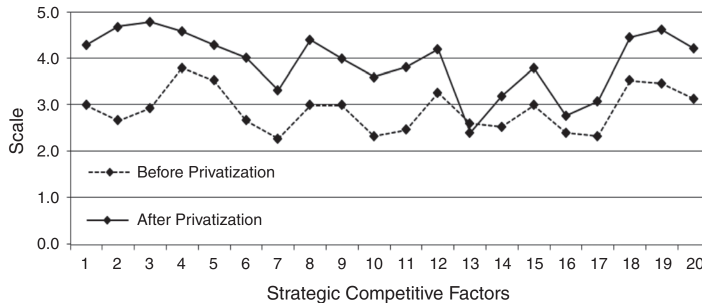

Figure 2. Strategic competitive factors before and after privatization

Table III. Wilcoxon non-parametric test for strategic competitive factors

	Z	*p*-value
1. New product development	−1.62	0.10
2. Customer service	−2.02	0.04
3. Sustained effort toward cost reductions	−2.02	0.04
4. Quality control of products/services	−1.83	0.07
5. Training and experience building of human resources	−1.84	0.07
6. Competitive prices	−1.83	0.07
7. Wide range of products and services	−1.21	0.22
8. Development and improvement of existing products and services	−1.83	0.07
9. Brand	−1.46	0.14
10. Innovation in marketing techniques and methods	−1.35	0.18
11. Distribution channel control	−1.60	0.11
12. Raw materials for products and services	−1.00	0.32
13. Minimization of the use of external financial support	−0.74	0.46
14. Specialization in geographical areas	−0.67	0.50
15. Ability to make specific products and services	−1.84	0.07
16. High-priced products and services in the market	−1.34	0.18
17. Promotion and marketing in the media from other companies in the sector	−1.46	0.14
18. Reputation within the sector	−1.84	0.07
19. Foresight of market growth	−1.83	0.07
20. Process innovation in products and services	−1.60	0.11

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than outcomes, short-term performance orientation, above-market pay with high-job security, pay secrecy and low-employee participation. The experiential compensation pattern is basically the opposite in each regard (Gomez-Mejia, 1992).

These 23 items allow classifying compensation patterns as algorithmic or experiential (Gomez-Mejia and Balkin, 1992). Average scores for these 11 compensation dimensions indicate the compensation patterns that companies follow after and before privatization. The *x*-axis represents various dimensions of a given compensation model, and the *y*-axis represents the average importance of these dimensions as managers perceived them. In the questionnaire, items with lower scores (from 1 to 3) correspond to an algorithmic pattern and higher scores (from above 3 to 5) correspond to an experiential pattern.

Figure 3 suggests the existence of two relatively similar compensation models before and after privatization. However, all scores before privatization are lower than the midpoint of the scale (i.e. 3), which indicates that these compensation systems are algorithmic. Privatization involves an increase in the scores of all items. Thus, although the scores are still quite close to the central value, they are slightly higher than the scores prior to privatization. The Wilcoxon non-parametric test supports these results, showing statistical differences ($p = 0.02$) between compensation systems before and after privatization. In this regard, the respondents stated that the change in strategy after privatization forced companies to rethink compensation packages to meet the new business objectives. As one manager of Beta declared, "privatization meant greater attention to human capital and its influence on the results of the company."

The results reveal a tendency toward a more strategic or experiential compensation pattern after privatization, with particular emphasis on aligning incentives with managerial contributions to the organization (dimension 11). In addition, managers' salaries increase to the same level as or higher than that of managers in other companies in the same sector, and risk sharing (dimension 2), as well as the emphasis on global vs unit performance (dimension 3), also increases. Finally, the results show a considerable increase in the extent to which labor market influences pay (dimension 6). To this regard, directors pointed out that, after privatization, companies mainly focussed on this situation and the external labor market behavior in order to attract and retain executives. The aim was to give major coherence to the compensation of the company in comparison with other companies within the same sector. For example, in 2003 Delta revised the programs of managerial compensation with external experts. However, despite the increased attention to the market to design compensation after privatization, results show that there are no relative differences in pay for different levels of the hierarchy. That is, although compensation increases

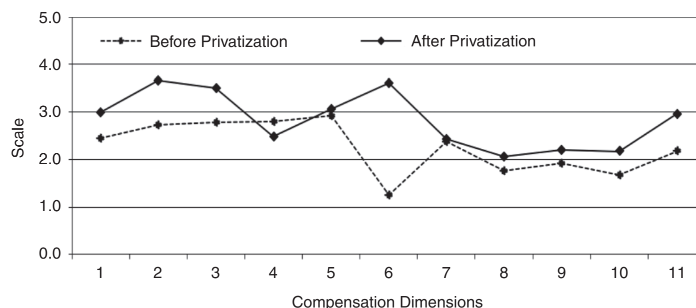

Figure 3.
Compensation patterns before and after privatization

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to achieve the same levels of the sector once firms pass to private hands, the differences between levels of hierarchy remain constant in both stages of the firm (dimension 7).

The Wilcoxon non-parametric test corroborates these results for each of the 11 different dimensions (Table IV).

However, the scores along dimension 4 (compensation based on quantitative-qualitative measures) seem to contradict this shift toward more contingent compensation after privatization. According to Gomez-Mejia and Balkin (1992), the algorithmic model bases compensation on quantitative measures, whereas the experiential model also considers qualitative aspects of performance. A pre-privatization score of 2.8 along dimension 4 implies that both qualitative and quantitative criteria are necessary, but the post-privatization score of 2.5 implies that the quantitative criteria slightly outweighs the qualitative criteria, which means that before privatization the compensation model is more experiential. This result seems to show that there is a greater emphasis on aligning compensation systems with financial variables – such as cost control and efficiency – once firms pass to private hands.

The analysis of the information supports the positive effects of the use of quantitative variables in the design of compensation systems. For example, in Delta, after privatization, there was a significant cost reduction through standardization of the fleet, which also meant a more efficient use of the fleet. Similarly, in Sigma, exploration and production costs were reduced by nearly 10 percent. There were also improvements in productivity of between 5 and 10 percent. The information from the interviews also highlighted the difficulty of reducing costs and improving efficiency before privatization, because the decisions made were linked to political objectives rather than efficiency-related criteria and profitability investments.

In what follows, we discuss the most important developments in the five sectors to which the companies under analysis belong, namely, telecommunications, gas, electricity, airline and fuel. This will allow us a better understanding of the changes found in the companies.

Analysis of sectors

Telecommunication sector (Alpha). The telecommunications sector was liberalized in 1998 (the year of the privatization of Alpha) with the approval of the General Telecommunications Law. This involved a profound qualitative change in the sector and the end of monopoly in Spain. The liberalization of the sector implied, among

	Z	*p*-value
1. Extent to which job definition vs an individual's skills influences pay	−1.46	0.14
2. Risk sharing	−1.83	0.07
3. Emphasis on global vs unit performance	−1.83	0.07
4. Use of quantitative vs qualitative performance measures	−0.37	0.71
5. Short-term vs long-term orientation	−1.60	0.11
6. Extent to which labor market influences pay	−1.89	0.06
7. Size of differences in pay for different levels of the hierarchy	−0.45	0.65
8. Communication of compensation policy vs secrecy	−1.60	0.11
9. Degree of managerial participation in setting compensation policy	−1.46	0.14
10. Flexibility regarding the design of the compensation system	−1.34	0.18
11. Fixed pay vs incentives	−1.83	0.07

Table IV. Wilcoxon non-parametric test for compensation dimensions

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other issues, a reduction in the prices of services and market growth. From 1998 onwards Spanish citizens and companies had the opportunity to choose the operator through which to make phone calls. Alpha provided a new way of acting in the sector, with clarity, transparency and flexibility. It introduced a more dynamic market with attractive and innovative offers, as well as personalized and flexible attention to customers.

The analyzed data support the changes in the functioning of the company, both strategically and in the design of compensation. Thus, the company shows more concern for issues related to customer service and cost reduction. The company also has a more experiential model retribution after privatization.

Gas sector (Beta). In the case of the gas sector, Directive 98/30/EC was the first step toward liberalization. This first directive established a set of common rules for all Member States of the European Union with the primary aim of laying the foundations for the orderly liberalization of the gas sector. However, the real liberalization occurred in 2003, with the publication of the second Gas Directive (Directive 2003/55/EC). With this, effective liberalization and opening up to competition of national gas markets were achieved, thereby succeeding in creating an internal gas market in the European Union. In Spain consumers were able to freely choose their gas supplier since 2003.

The data analysis of Beta after privatization highlights the increased emphasis on various competitive factors and a greater tendency to a more experiential model retribution. However, these changes are not as dramatic as in the case of Alpha. This may be partly due to the fact that the real liberalization of the sector did not take place until five years after the privatization of the company (from 1998 to 2003).

Electricity sector (Gamma). In the case of the electricity sector, the passing of Law 54/1997, which came into effect in 1998, was the legislative framework of the liberalized Spanish electricity system. In that year, the electricity supply ceased to be considered a state-owned service. The basic characteristic of the new regulatory framework is based on the decentralization of decision making. In this sense, a wholesale electricity market was deployed. This enabled the establishment of the generation dispatch and the wholesale electric energy price. Also, the new right of the consumers to choose their supplier gave rise to the commercialization business consisting of the sale of electricity to qualified customers via freely established contracts between both parties, using the transport networks. The freedom of choice of installation for the production activity was also set up, so that any investors could install new generation centers as long as they provided proof of enough technical and economic capacity.

The changes observed in Gamma in terms of strategy and compensation are in line with those seen in the analysis of Alpha. Its strategy included a greater emphasis on customer service, innovation and quality control services. As for compensation after privatization, there was a greater involvement of the long-term compensation and greater weight given to incentives.

Airline sector (Delta). The airline sector, however, followed a different pattern from the above-mentioned sectors. In this case, the market was highly liberalized prior to the privatization of Delta. Specifically, the liberalization measures took place during the 1987-1997 period (Button, 2001), and experienced their greatest change in 1993. Although 1993 marked a turning point in the deregulatory process of the airline sector, after the privatization of Delta in 2001 there were also some deregulatory measures, even though these were considered to be minor. In practice, the liberalization process meant: first, the end of the public monopoly of providing the regular airline transport

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services of passengers, with the entry into operation of Air Europa in 1993 and Spanair in 1994; second, the possibility of freely fixing prices and schedules; and finally, a greater liberalization of the provision of ground handling services (State Aviation Security Agency).

Regarding the change occurred in relation to competitive factors and the compensation system after privatization, the results do not vary greatly. That is, before privatization, Delta already had great concern for the various competitive factors, and their compensation system had features taken from experiential model. One possible explanation could be that the airline sector's liberalization measures took place before the privatization of Delta and over a period of ten years (1987-1997).

Fuel sector (Sigma). In the fuel sector, Law 34/1998 meant a drastic change in the level of regulation in specific areas, such as the opening of the market of liquid fuel and the elimination of the maximum prices system. Furthermore, with this new legal framework the activities of the refining, transport, storage, distribution and commercialization of petroleum products ceased to be regulated. This simplified the process of authorization of installations concerning wholesale operation activities (Law 34/1998). The strong process of deregulation in the fuel sector significantly affected prices, production, purchases, investments, location policy and diversification of activities.

Finally, the data analyzed show the largest increase in Sigma's competitive factors after privatization (e.g. competitive prices, innovation, new product development) and a change from an algorithmic compensation model to an experiential one.

As a whole, the analysis of the information shows two clearly differentiated patterns: the electricity, fuel and telecommunications sectors on the one hand, and the airline and gas sector on the other. In this sense, there is a significant decrease in regulation and an increased level of competition in the sectors in which Alpha, Gamma and Sigma operate: electricity (Law 54/1997, regarding the electricity industry) fuel (Law 34/1998, regarding hydrocarbons) and telecommunications (General Law 1998, regarding telecommunications). The results show that companies in these sectors underwent higher changes in their strategy and compensation systems. Specifically, companies shifted to make greater efforts in the competitive factors analyzed, with a tendency toward more experiential compensation systems.

In contrast, the airline and gas sector showed no significant differences in regulation and competition in both periods (before and after privatization). Companies in these sectors (Beta and Delta) underwent changes in strategy and compensation systems in line with the three previous companies. However, it should be noted that these changes are not drastic. In the airline sector, this result could be because of the major liberalization measures implemented during the period 1987-1997, that is, before the privatization of Delta. In the gas sector, a possible explanation could be that the real, effective liberalization took place in 2003, that is, years later the privatization of Beta.

5. Conclusions

This study analyzes how changes in a firm's ownership after privatization can have an impact on the owners' objectives, the firm's strategy and other aspects in relation to managerial compensation systems. Based on agency theory, our main assumption is that after privatization new owners would monitor the actions of management and use incentive alignment to ensure goal congruence between principals and agents (Eisenhardt, 1989; Jensen and Meckling, 1976).

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Regarding corporate governance, and based on agency theory, we predicted more independent boards – separated from the political arena after privatization. However, our empirical findings suggest inertia in the corporate governance of companies after privatization in Spain, and the absence of change in the leadership structure and in outsider representation in the boards of these firms. We note an additional issue regarding corporate governance, the concentration of shares after privatization, a characteristic that has been suggested as typical of the so-called Latin corporate governance model (Aguilera, 2005). In fact, financial institutions that held more than 5 percent of the capital appear after privatization in our cases studies, with representatives having a seat on the board. The existence of large or majority owners assuming control of the firm could deprive minority owners the right to appropriate returns of their investments (Morck *et al.*, 1988). It is the so-called expropriation problem that transforms the traditional agency problem based upon principal-agent goal incongruence into principal-principal goal incongruence (Dharwadkar *et al.*, 2000). Then, it seems that specific characteristics of the institutional context and corporate governance system of each country could shed light on the adjustments made in the boards' configurations of privatized firms.

Regarding firm strategy, our results confirmed our proposition that the firm's strategy of privatized firms becomes clearly defined and linked with the objectives and interests of the profile of the new shareholders. The results show that although there are no changes in firms' strategic patterns, companies after privatization place more emphasis on specific factors that relate to customer service and costs. Also, increasing pressure from large blockholders – mainly financial institutions – and their directors on managers' responsibility to protect shareholders' interests appear after privatization. In fact, certain internal changes aim to both increase managerial oversight and foster greater accountability in terms of financial results.

Third, our findings suggest that there is a tendency to adopt a compensation system after privatization that is more contingent on performance, more risk sharing and with more emphasis on global vs unit performance related to compensation. Also, there is an increased emphasis on the extent to which the labor market determines pay. Related to this, our fourth conclusion is that compensation systems seem to be an internal governance mechanism useful for the board to translate ownership objectives to the firm management. When changes were introduced in the firm's strategy, they clearly turned into a new compensation design, what makes the new firm's interests more explicit.

Finally, our fifth conclusion refers to the sector analysis. We have found a certain moderator effect of the regulation level and the sector's competition on the number of changes in companies. In this sense, although the replacement of ownership appears to be the trigger of changes in companies after privatization, when the privatization processes are accompanied by liberalization of the sector, there will be a greater concern for the competitive factors analyzed. Likewise, greater deregulation and competitiveness of the sector will push companies to more experiential models of compensation. This highlights the need to take sector analysis into consideration to understand the changes in a privatization context.

Overall, this research clearly contributes to the literature in that it provides a comprehensive framework that analyzes the internal management changes of privatized firms. Also, this research highlights the limitations of traditional research variables in the context of corporate governance structure. These variables are not enough to explain board independence. In this sense, we highlight the role played by

different kinds of blockholders regarding firm management in a privatization context. Moving away from the standard agency theory view of shareholders that distinguishes between atomistic investors with no influence over management and concentrated ownership, we claim that future research lines should include the influence exerted by different stockholders in the boardroom through the nomination of directors who represent their interests after privatization. As Dharwadkar *et al.* (2000) suggest, the analysis of both ownership concentration and ownership type is crucial to understand post-privatization performance.

This research has some limitations. First, although this research provides a deeper understanding of the restructuring of the Spanish public sector through different privatization cases, an understanding of to what extent the organizational changes after privatization led to improved efficiency in the public service is beyond the scope of this study. It is true that we conclude from our results that the firm's ownership replacement was the catalyst of some organizational changes on both the firm strategy and compensation systems, but we wonder whether the adoption of this new management style (together with businesslike methods proposed by NPM) would be possible without a change regarding the firm' ownership. Second, apart from the analysis of certain organizational changes that occur following privatization (corporate governance, firm strategy and compensation), other internal changes (firm structure, culture, organizational learning and so on) could also be studied to fully understand the effects of privatization. Third, data do not reflect a number of other potential factors in the implementation of new compensation systems. In this sense, social, political and institutional implications may also be relevant in this context to analyze the managerial incentive systems used after privatization (Casanova, 2005; Zhu *et al.*, 2005). Finally, this study examines five Spanish companies, and thus the results and conclusions need not necessarily be relevant in other contexts.

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