Corporate governance in transition economies[1]

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Abstract

The transition economies in Central and Eastern Europe have privatized their economies at an unprecendented speed in the 1990s. The expectation was that under private ownership, formerly state-owned firms would act as dynamic, profit-oriented players driving economic restructuring and growth. Yet, the expectation has rarely been fulfilled, and lack of effective corporate governance is often seen as a culprit. Transfer of ownership to private hands does not suffice to create powerful incentives for managers to engage in the market economies along the objectives of the new owners. This articles outlines the methods of privatization used in Central and Eastern Europe, and their consequences in terms of corporate governance. Many stakeholders acquired shares in ownership, which enhances their ability to influence management and creates complex challenges for managers to coordinate influential stakeholders. Central and East European economies may thus develop unique forms of capitalism, especially with respect to corporate governance systems.

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Corporate governance in transition economies

Corporate governance is often seen as a major obstacle to business in Central and Eastern Europe (CEE). Corporate governance refers to mechanisms that ensure that managers act in the owners' best interest. In the transformation from central plan to market economy, privatization had a central place in policy agenda, yet the transfer of ownership alone does not suffice to create appropriate incentives for managers. The theory of property rights, primarily the principal-agent model, has been the ideological foundation of the privatization policy. However, many firms did not, as presumed by the model, end up in outside control but under the governance of a variety of stakeholders, including managers, employees, and the state.

Throughout the capitalist world, governance systems are evolving towards the Anglo-American model, separating the shareholder function from that of other stakeholders, and monitoring firms through equity markets. Managers have to serve shareholders' interests, who monitor them through the stock market, while other stakeholders normally have comparatively little influence. Shareholders' lack of direct influence is compensated for by efficient stock markets. In particular, stock options provide powerful incentives for managers to act in shareholders' interest. Moreover, takeovers provide a mechanism by which widespread equity ownership may rapidly become concentrated. Managers act in anticipation of potential hostile takeover and thus aim at keeping the share price high. In continental Europe and Japan, corporate governance systems assign banks and/or non-managerial employees a formal role in governance. In different ways, these systems of governance prevent self-serving managerial behavior.

Yet, not only shareholders matter. Many groups or individuals can affect or are affected by the achievement of the firm's objectives. The stakeholder literature questions the predominance of one stakeholder group - that is, shareholders - and assumes that the interests of all stakeholder groups have intrinsic value. Stakeholders can use both 'voice' and 'exit' strategies to influence the firm. The ability to exit strengthens effectiveness of the stakeholders' voice within the firm, as does a financial stake. As a consequence of diverse forms of ownership in CEE, and diffuse control structures, theories considering stakeholders received considerable interest by analysts of corporate governance in transition economies [Buck et al. (1998), Mygind (2001)].

In this article, I briefly review the privatization process in CEE to show how diverse new ownership forms and stakeholder roles have evolved. On this basis, I outline some obstacles to effective corporate governance in the region.

How, and to whom, to privatize?

	To the general population	To current managers and/or workers	To previous owners	To outside investors, such as foreign or domestic private firms	
By sale	**Stock market flotation:** from mid 1990's only	**MBO, MEBO:** e.g. Poland, Romania	—	**Auction:** everywhere for small business	**Negotiated sale, tender:** e.g. Hungary, Estonia
By free distribution	**Voucher privatization:** most countries	—	**Restitution:** e.g. Bulgaria, East Germany	—	—

Figure 1: Alternative methods of privatization

Methods of privatization

Privatization schemes in CEE were implemented under less favorable conditions than those in the Western European countries, such as the U.K. in the 1980s. Some of the standard methods were not transferable to the transition context because capital markets were underdeveloped and private wealth was insufficient for citizens to buy large firms. Therefore a range of innovative methods of privatization have been developed and employed in the region. Figure 1 provides an overview of the methods of privatization, distinguishing recipients of the ownership titles, and whether or not they receive the ownership title for free.

The most common method of privatizing large firms worldwide is stock market flotation, i.e. the general population would be invited to buy shares in an 'initial public offering' (IPO). Theoretically, this method has many advantages: it generates revenues for government budgets, it is generally transparent and thus perceived as fair, and it tends to create a dynamic process of change, which also eases the access to new resources. In practice, however, IPOs were not feasible in the transition context because they require developed stock markets, where the capital can be raised. Yet, investable financial assets were small in CEE, stock market regulatory institutions had not been established or there were no stock markets at all, and most crucially potential investors lacked detailed financial information on the state-owned firms.

To overcome these obstacles, an innovative approach was developed, the 'voucher privatization'. The basic idea of this approach is that all citizens receive a voucher, which they then can use to acquire shares in firms. Hence the basic idea of an IPO, the public bidding process, was created artificially without requiring domestic savings. Voucher privatization has been implemented in different ways across the region. Most transition countries, with the notable exception of Hungary, have implemented a voucher scheme as a main pillar of their mass privatization [World Bank (1996), Estrin (2002)].

The second major method of privatization has been the sale to outside investors. Auctions have been used extensively to sell smaller firms. This method leads to efficient outcomes if information on the firm is readily available and several potential buyers are interested in bidding. Larger firms have been sold through a tender process, in which a round of bidding is followed with direct negotiation with the winning bidder. Due to the complexity of tender processes, some businesses have also been sold through direct negotiations. However, considerable resources and time are required to assess each individual firm, and to negotiate with potential buyers. Hence, ownership transfer to the private sector has been slower in countries emphasizing this case-by-case approach, such as Hungary, Estonia, and Poland (East Germany is an exception due to the resources provided by West Germany to fund the process).

Many privatization schemes also provided insiders of the firm access to ownership through management-buy-out (MBO) or management-employee-buy-out (MEBO) schemes. In some cases, this was combined with other methods to provide employees with a minority stake in the firm, as often seen in Poland. Elsewhere, managers and/or employees could acquire equity in the voucher privatization as in Russia, or with the help of financial incentives provided by governments, for instance access to loans under favorable conditions. MEBO-type privatization has been the most important method in countries, such as former Yugoslavia, where labor management had a long tradition going back to the special Yugoslav form of socialism, and in several countries of the former Soviet Union. In Hungary and Poland it was the second most important method of privatization.

Last, in many countries where property had been expropriated after World War II, ownership titles were restituted to previous owners or their descendants. However, the clarification of ownership titles has in many cases been lengthy and cumbersome. This left many assets unattended while ownership conflicts were being settled.

The choice of privatization method, and the selection of potential investors, is not a straightforward process that is implemented on a master plan. Political institutions, mostly the parliament, take basic decisions and privatization agencies or other governmental authorities take administrative decisions. Many stakeholders in the firm, or individuals and organizations that wish to take a stake in the firm, aim to influence these decisions in their favor. This makes the decision processes often very complex and subject to political interferences.

Stakeholders may gain influence based on legal rights, including equity stakes, or by using their control over resources needed by the organization as bargaining leverage [Mygind (2001)]. They may participate in formal negotiations and decision-making processes, or seek to influence the process by informal means, including politicking. This may involve appeals to public opinion and the media, or through internal tactics, such as manipulations of interests, information, or time [Antal-Mokos (1998)].

In the short run, intense politics divert managers' attention from running the business. Instead of developing products, pleasing customers, and trying to gain market share, managers will be preoccupied with 'doing the deal' [Antal-Mokos (1998)]. This eventually hurts corporate health: market positions may erode, and the financial situation may weaken. In the long run, some otherwise viable firms may go under, and some stakeholders are able to formalize and retain their influence, for instance by 'converting' their stake to equity.

Foreign investors have to take these complex negotiation processes into account when considering a bid, which may lower their interest in becoming involved. The more the local firm is drifting before a foreign investor can take over control, and the more agents are involved in the process, the more difficult it becomes to turn the firm around to become a profitable affiliate of the investor [Meyer (2002)].

Governance under different forms of ownership

The problems of governance in the transition economies vary with the ownership, which in turn are an outcome of the diverse methods of privatization employed in the region. New owners include dispersed individual shareholders, investment funds, foreign investors, the state, management, and employees (Figure 2). Often, several of these groups obtained equity stakes, which may lead to stakeholder conflicts as their objectives vary. Moreover, new forms of private ownership create very different mechanisms of control over management.

	Outside owners				Inside owners	
	Individuals	**Investment funds**	**Foreign investors**	**State**	**Managers**	**Employees**
Sources of equity stakes	Vouchers	Vouchers	Direct sale	Inherited	Preferential vouchers, MBO, direct sale	Preferential vouchers, MEBO
Objectives	Profits	Profits	Profits, integration with global strategy	Social objectives, profits	Profits, salaries, fringe benefits, job security	Profits, wages, job security
Means of influence	Exit	Voice and exit	Voice and exit	Voice	Operational control and inside knowledge	Voice
Governance obstacles	Efficiency of stock markets	Who monitors the monitor?	Protection of minority shareholders	Conflict between profits and social objectives	Protection of outside shareholders, access to finance	Dependency on managers, protection of outside shareholders, access to finance

Figure 2: New owners

Dispersed outside ownership

The voucher-based mass privatization has led to severe and often unforeseen corporate governance problems. Policy makers and their advisors who designed these schemes generally had in mind to create Anglo-American types of governance systems. However, the practice has shown that this model depends on sophisticated institutions that were not in place at the time. With dispersed ownership and indirect control structures, many shareholders have the right to monitor the firm. Yet few, if any, may have the necessary power, incentives, and capabilities.

The Anglo-American model requires credible threats of takeovers, and thus efficient and liquid markets for equity, which are rare in emerging markets. The nascent stock markets lack efficiency and transparency, and the legal requirements to involve outside shareholders and to publish relevant information are established only gradually, and implemented even more slowly. Even basic accounting and auditing practices have not been implemented everywhere. Hence outside shareholders face considerable asymmetric information problems.

In many transition economies, investment funds have sprung up, like in the Czech Republic, or been created by the privatization authorities, like in Poland. They became major stakeholders in voucher-privatized firms. Yet this raises the issue of who controls the controller? In other words, do the managers of these funds have appropriate incentives to act in the interest of the shareowners whose shares they administer?

The Czech scheme - the first and most publicized - privatized a major share of the country's assets in several waves of multiple-auction bidding processes. Investment funds attained considerable power through the accumulation of vouchers and bidding on behalf of individuals. They control major Czech businesses, but in turn are often owned by banks that were largely still state-owned, even ten years after the onset of transition. This creates interdependent firms without clear monitoring and control structures, but with multiple agents that have hold-up power. The lack of effective corporate governance structures has frequently been blamed for the slow progress of enterprise restructuring in the Czech Republic.

In Poland, mass privatization was delayed due to political conflicts over its conditions, while policy makers tried to avoid the pitfalls of the Czech scheme. In 1996, shares of some 500 enterprises were allocated to government-sponsored investment funds, which in turn were privatized through vouchers. Each enterprise was initially owned by a fund holding 33% of equity, plus minority shareholdings by the other funds, workers, and the government. Each fund had a supervisory board appointed by owners, who in turn recruited international financial service firms or consortia as management firm. The funds would manage the stakes like a closed-end investment fund, and trade shares in individual firms as they found appropriate, including sale to foreign investors [Lawniczak (1997)]. While overcoming the corporate governance problems of the Czech voucher privatization, the Polish scheme still suffers from conflicts among the different control institutions, including the funds' supervisory boards, the management firms, and the state representatives on either board.

In Russia, the voucher privatization of 1993 has mixed elements of ownership transfer to insiders and to the public at large. Although the policy advisors intended to create dispersed ownership and a liquid stock market along the Anglo-American model, most firms ended up under the control of insiders [Estrin (2002), Buck et al. (1998)]. Outside shareholders have in particular experienced obstacles to gaining a fair share of the economic return of the firm in the absence of legal institutions to enforce their claims.

Thus, the voucher schemes of CEE have been a large social experiment, with long-term implications that are yet to be seen. Many expectations have not been met, but they may have been overly optimistic. Throughout CEE, voucher-privatized firms have been struggling with creating effective mechanisms of governance, and defining the role of diverse stakeholders. In many cases, investment funds are the dominant stakeholder, acting on behalf of shareholders, whereas elsewhere managers are effectively in control.

State ownership

In China and Vietnam public ownership still dominates many sectors of industry. Administrative units of the state, such as central ministries and local authorities, hold equity in firms. The vast majority of Chinese firms traded on the stock exchange still have the state as a dominant owner, or even as majority shareholder, which creates potential conflicts of interest between minority shareholders and the state as owner [Tian (2002)]. Also in Eastern Europe, the governments still hold, directly or indirectly, partial ownership in about one fifth of privatized firms.

Firms in state ownership generally under-perform compared to privately owned firms in terms of profitability and growth, but partially state-owned firms may perform well if the state takes a passive role [Djankov and Murrel (2002)]. Autonomy, effective control and monitoring mechanisms, and clearly defined objectives increase performance of state-owned firms, as seen in some Chinese state-owned enterprises. Yet the improvement is less than what would be expected under private ownership.

The underperformance, in financial terms, of state-owned firms may in part be due to the fact that they pursue additional social, rather than economic, objectives. But there is also evidence suggesting that state-owned firms are particularly resistant to change, which undermines their ability to react to a volatile environment. This resistance to change may arise from the large number of inside and outside stakeholders taking an active interest in state-owned firms, including politicians, bureaucrats, the media, and various interest groups [Antal-Mokos (1998)]. Managers are subjected to these pressures, while at the same time being able to play off different stakeholders against each other. Major change in state-owned firms may be subject to approval by political institutions, which in turn may only approve a new strategy if none of the key stakeholders in the political process objects. Hence, several stakeholders may be able to block change. In consequence, managers' ability to win broad support among stakeholders may often be a precondition for implementing strategic change in state-owned firms.

Insider ownership

If managers own a firm, the principal-agent conflict between managers and owners is eliminated. Partial managerial ownership may help to align the interests of managers and owners, but under some conditions may raise concerns over the protection of minority shareholders. However, managerial ownership in transition economies can also pose problems for governance. Incumbent managers often hold on to their jobs throughout the privatization process. For instance, voucher schemes do not have a built-in mechanism to replace managers who may have held their position since being appointed during socialist times – the so-called 'Red Directors'. If the owner-managers control a large share of equity, and their outside career opportunities are lower than their current income, then they have strong incentives to retain their share to increase their job security.

The superior performance of private firms is, however, not only due to incentives for managers, but is also based on the ability of private firms to attract and select more qualified managers. The efficiency of mechanisms of replacing managers may be crucial for restructuring performance because lack of managerial qualifications for the market economy is a major source of poor performance. MBOs, and even more so Management Buy-Ins, contain a competitive element to select better-qualified manager-owners. Thus, the individual personality of the manager, in particular the qualification and the entrepreneurial talent, is crucial for performance of manager-owned firms.

Employee-ownership is common where the privatization gave insiders preferential access to ownership [Jones and Mygind (1998), Buck et al. (1998)]. Especially in Russia, the rapid mass privatization has been achieved by providing insiders opportunities to attain ownership rights and thus motivate their cooperation in the privatization process. However, the widespread employee-ownership may become an obstacle to enterprise transformation as workers may pursue motives other than profit maximization, complicate internal decision processes, and inhibit radical change in the organization. On the other hand, employee-ownership can have positive effects on productivity through motivation and a cooperative atmosphere that increases trust and information sharing.

The empirical evidence on performance implications is hotly debated as many Western advisors see insider ownership as a key obstacle to restructuring. Empirical studies find crucial differences for different proxies of performance, and between manager-owned and employee-owned firms. Most studies find beneficial effects from employee-ownership compared to the status quo of state-ownership. However, generally foreign- and managerially-owned firms outperform employee-owned firms [Djankov and Murrel (2002)].

Russia presents a special case, as employee-ownership is widespread but often does not give effective control to employees. Many firms are formally employee-owned, but managers dominate major decisions [Mygind (2001), Buck et al. (1998)]. The governance implication is that employee-ownership allows managers to pursue their personal objectives at the expense of the interests of the employees. However, employees often view their equity stakes as enhancing job security.

Kalmi (2002) analyzed the change of employee-owned firms over time. He shows that in a representative sample of Estonian firms, the percentage with dominant employee-owners declined from 19.8% at the time of privatization to 15.1% in 1995, and further to 7.5% in 1999. However, including managers and former employees, the proportion of firms in insider ownership stays roughly stable. Kalmi (2002), moreover, explores the dynamics of ownership changes. He finds that shares are rarely traded, and new employees are not offered the opportunity to acquire shares. Rather, ownership structures change by increased shareholdings by former employees, and via new share issues to raise fresh capital where employees do not buy new shares. If shares are traded, they tend to be acquired by managers. Since share-ownership is commonly seen as a means to increase job security, insider-owners collude to prevent sale of shares to outside investors. However, employee-ownership declines mainly due to attrition, as the institutional context does not provide mechanisms that would enable or encourage new employees to acquire shares.

In conclusion, through a variety of channels, employees have been able to attain formal ownership and/or control rights. In some cases, this translates to effective influence over strategic decisions made by management; in other cases, notably in Russia, managers are effectively in control. However, few, if any, firms appear to have adapted an organizational culture that would promote the democratic and motivational aspects of employee ownership; and over time, the share of employee-owners is declining [Kalmi (2002)]. This is a gradual process, and in the medium term, companies have to live with employee owners, for better or worse.

New forms of capitalism?

The transition economies have developed corporate governance systems that differ from those in mature market economies, even taking into account the variation between for instance the USA and Continental Europe. Some of the largest firms in the region are subject to weak governance while enjoying close contacts to government and, in some ex-Soviet Union states, considerable barriers to entry. Yet other firms have gone far in shedding these legacies of the 20th century. The emerging diversity of governance mechanisms and competition patterns is likely to be a continuing feature of the region for years to come.

New forms of corporate governance are emerging in CEE, which we may call stakeholder capitalism. This creates unique opportunities and challenges for managers and stakeholders. On the one hand, some managers are in effective control of the firm as shareholders and other stakeholders are too dispersed to monitor them. This creates corporate governance problems, as managers appear free to pursue their own objectives at the expense of others. On the other hand, some managers face multiple stakeholder interests with some degree of influence over their decisions, which creates unique challenges for leadership to coordinate diverse groups of people to pursue a common path of change. When faced with a need for radical corporate change, this task can be especially daunting. Thus managerial power may be too large in some cases, and too small in others.

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