CORPORATE GOVERNANCE IN TRANSITION ECONOMIES

Summary

In developed market economies, a system of corporate governance has been built gradually through centuries, and today it can be defined as a complex mosaic consisting of laws, regulations, politics, public institutions, professional associations and ethics codes. However, in transition economy countries a lot of details of the mosaic are still missing. Trying to develop a system of good corporate governance in these countries is made difficult by problems such as complex corporate ownership structures, vague and confusing relationships between the state and financial sectors, weak legal and judicial systems, absent or underdeveloped institutions and scarce human resource capabilities.

This research brings an often-overlooked governance problem in transition economies to the attention of management researchers. Three key areas deserve concerted research attention in order to develop a sound corporate governance system for transition economies: the corporate governance framework, the appropriate corporate governance model and the specific corporate governance settings in transition economies.

Key words: corporate governance, agency theory, stewardship theory, resource dependence theory, transition economies

INTRODUCTION

Research in the area of corporate governance covers multiple disciplines, including finance, strategic management, sociology and political science. The state of current knowledge is such that we need to have an
interdisciplinary approach to studying the problem of corporate governance. The study of corporate governance can involve the problems of corporate decision making, strategic management, leadership, organization theory, and the sociology of elites. It can also be related to a whole range of other broader subjects, including macroeconomic policy, the level of market competition and political science. The framework of corporate governance also depends on the legal and regulatory environment. In addition, the factors of corporate responsibility and ethics are significant aspects of the problem of corporate governance. Thus one must first recognize the complexity and interdisciplinary nature of corporate governance before attempting to research its problems in a transition economy.

The literature on the topic shows disagreement about the scope and boundaries of the corporate governance. The viewpoints differ depending on if the primacy is given to owners (shareholders) and the modalities of use of their power; the formal structure of the board of directors or the social responsibility of the corporation towards the numerous stakeholders.

Depending on the situation in which the conflicting interests are present or not, two viewpoints towards the relations of owners, top management and the board of directors have emerged - the conflicting or the consensus-inclined one (O’Neal and Thomas 1996). Another perspective in corporate governance is called path dependence. Central to the idea of path dependence is that initial historical conditions matter in determining the corporate governance structures that are prevalent today. In order to understand the problem of corporate governance it is most important to stress that it is, first of all, dependent on the political system of any country and the country’s historical and cultural characteristics.

There are two basic dilemmas connected with the corporate governance problem in transition economies. First, is it possible to have the identical framework that has evolved over centuries in developed market economies for the emerging markets, or is it better to adapt the system of corporate governance to the specific circumstances of a transition economy.

The second dilemma involves the question of the appropriateness of the mechanism used for corporate governance. The existing corporate governance literature is almost exclusively concerned with external mechanisms—the well-developed stock market or the monitoring role of the banks. Unfortunately, in transition economics these mechanisms of market discipline hardly work because of the lack of such institutions as stock markets and an efficient banking sector.

To summarize, although there are considerable differences between the corporate governance systems in developed economies, they all share the luxury of defining the subject of corporate governance within the context of functioning market systems and highly developed legal institutions. However, many developing and emerging economies lack or are in the process of developing the most basic market institutions. That is the main reason why corporate governance problems in the contexts of transition economies require a much wider range of issues.
THE BASIC VIEWPOINT OF THE CORPORATE GOVERNANCE

The Agency theory. In its basic shape, the agency theory is connected with the problems which can be found in any cooperative relation, when one side (the principal) has a contract with the other side (agent) to make the decisions on behalf of the principal, or, in other words, the agency theory explains the best way of organizing relations in which one side (the principal) determines work that should be done, and the other side (the agent) does the work (Eisenhardt 1985). The agency theory has been used to a great extent in the strategic management as a convenient conceptual framework for corporative governance problem analysis, manager compensation, firm performance, risks and strategic decisions about mergers and diversification (Lubatkin et al. 2001).

According to the agency theory, in terms of incomplete information and uncertainty, two problems may occur: the negative selection and the moral hazard. The negative selection is a problem which occurs because the principal cannot know if the agent always has the capability to do the job he or she is paid for. The moral hazard refers to the risk that the agent will not always put maximum efforts into accomplishing principal’s aims (Eisenhardt 1989).

The problems of negative selection and moral hazard are not the only problems which occur in agent-principal relations. Hendry (2002) points out two more problems related to the agency theory: the problem of limited competence and the problem of complex and multi-tasking goals of the firm. The implicit presupposition of the agency theory was that individuals are completely competent for performing their jobs. The fundamental presuppositions of this kind are suitable for the development of mathematical model for expressing simple principal-agent relations, but it seems as though they are not real when we transfer them to other conditions in which management functions. The owners’ complex and multi-tasking goals additionally complicate agency relations, because it is not easy to define in the contract the possible way of fulfilling and measuring of such goals.

Jensen and Meckling (1976), define the expenses of the agency as a sum of the four components: costs of making the agreement between the principal and the agent, costs of monitoring agents’ work, additional costs caused by the need for providing stimulation for agents and their work, according to the interests of principals and residual lost. Although the agency theory’s costs are important for understanding the contemporary cooperative forms, there are also other institutional mechanisms, which additionally ensure managers’ responsibility: developed capital market, product market, employees’ market; legal system and finally, the system of responsibility and control which is represented by board of directors, chosen by the owner. The board of directors has the most important role in application of these mechanisms and that is why it is believed
that its role is tightly connected with the imperfection of the agency’s problem which can arise between the owner and the managers. It’s the fundamental structural mechanism for the prevention of the managers’ opportunist behavior, but provided that there is no dual role, i.e. that the chairman of the board isn’t the CEO at the same time.

The Stewardship model. In the former agency theory model the starting assumption was that the actors are interested for their own interests and that they operate according to the model of economical rationality, which means that they want to maximize the economic profit. In the organizational psychology this kind of behavior is known as Mc Gregor’s theory X. However, in the domain of organizational psychology and sociology there are other explanations of motivation factors, for example, Herzberg two-factor theory or McClelland’s theory according to which individuals can acquire and develop three essential kinds of needs: the need for achievement, the need for power and the need for affiliation.

Therefore, the managers are motivated by the need for taking over the responsibility, for self-fulfillment, the need for pleasure for doing the challenging job right, the need for acknowledgment. That is one of the arguments which Donaldson and Davis (1994) use while developing the stewardship model of corporative management. Apart from that, they think that managers, even when they are estimating that the course the company has taken can be confronted with their own personal interests, accomplish their roles because of the obligation they took, and according to Etzioni (1975) it is ‘normative induced conformity’.

Stewardship model starts from the assumption that managers are good stewards for the corporation and that their aspiration is to accomplish their obligations in the best possible manner. The level of accomplished performances is determined by the capability of Chief executive officer (CEO) to design the structure of organization in accordance with the demands of the situation and strategic activities of the corporation. The successful formulation and implementation of the strategy depends on clearly defined roles and shared authority and responsibility of managerial structure on corporative, business and operating level. In order to meet the conditions for clear and unambiguous definition of managers’ roles it is necessary to unite the position of the Chairman of board of directors and the (CEO) (Donaldson and Davis 1994) so that this power and authority are concentrated in one person. This duality leads to strong leadership position of CEO and is less confusing for the employees and the members of the board. Thus, stewardship model prefers the application of traditional organizational principles, unity of direction and unity of command proclaimed earlier by A. Fayol in his ‘administrative doctrine’.

Donaldson and Davis (1994) believe that ‘managers are mostly motivated by the need for accomplishment and responsibility’ and that the organizations can be guided better if they are left to managers moti-
vated in that way. That is why it is suggested that the role and the purpose of existence of the boards should be examined. The argumentation against the outside members of the board is given and it is believed that they are not efficient in controlling the managers. In some extreme interpretations of this model, the bare existence of the boards is questioned and it is suggested that only formal committees for determined areas should exist. The dilemma about the need for boards is especially present in the cases with existing dominant active owner, like family or the state. The boards are then formed to simulate serious business situation, or because there is a need to stay in the frame of cultural values and rules.

**The Stakeholder model.** The stakeholder approach to management emphasizes the importance of developing relations with all those who have a certain interest related to company and vice versa. Managers have to formulate and implement the processes with which they make their stakeholders satisfied. The main assignment is to articulate relations and the interests of the owners, employees, consumers, suppliers, local community, financial institutions and other interested groups in the way which is suitable for the fulfilling of long term sustainable development of the company. Within the limits of corporate governance, the stakeholder model was created out of an aspiration to create an alternative approach in relation to traditional agency approach (Turnbull 2000).

The establishing of effective relations with strategic stakeholders is more significant than simple participation in deciding and controlling of firm's work. Effective stakeholder management influences the creating of intangible social resources, which can contribute to better competitive position and creating of long-term values. Resource-based view of the company starts from the fact that company’s competitive position depends on the unique utilization of human, organizational, and physical resources during the time. It is believed that intangible resources, hard for imitating, represent the basis of the value for the owners. The resources which contribute to competitive advantage have to be valuable, rare, imperfectly imitable and not substitutable (Barney 1991). According to these criteria, even complex social resources, such as reputation, corporative culture, knowledge, and long-term relations with consumers and suppliers represent competitive advantages. By developing of long-term relations with the primary stakeholders, company expands the collection of transactions in which the value beyond the collection limited by market transactions is created. The value is created in interactions between the company and strategic stakeholders, which can be marked as relational, and which are hard to copy, and that is the way they give competitive advantage.

There are two extreme points of view in the evaluation of the stakeholder theory. Newer speculations of stakeholder model (Freeman and McVea 2001) are trying to expand its importance and pronounce it ‘the central paradigm’ which connects the agency theory, the theory of
transactional costs and the theory of agreements into coherent entity. Since its frame is very adjustable, stakeholder model gives the possibility of creation of comprehensive theory which bonds different concepts: the agency theory, the transactional costs theory, the human relationship theory, ethics and the environment. Critics of the stakeholder theory believe that it doesn’t give theoretical basis for the explanation of reality in which corporations do business. The assumption that the allocation of resources is individual and optimal, and that as the result of it company isn’t anything else but the combination of physical and human resources which are marked as ‘distinctive competence’, indicates the need for explanation of causes and consequences of strategic control of one group of individuals over learning abilities and development of the other, while considering the problems of corporate governance (O’Sullivan 2001).

**INSTITUTIONAL THEORY AND CORPORATE GOVERNANCE**

The institutional theory of organization explains the origin and the stability of a certain strategy by a number of cognitive, bureaucratic and political processes which hinder the free adjustment of the organization to the conditions of the surroundings. North (1990) invents the term of *institutional matrix* in order to explain the legal, cultural and normative components of the surroundings. The significance of the institutional matrix lies in the way it shapes the strategic choices and enhances economic activities. The institutional matrix develops and changes according to the path-dependence model. This means that once the development path has been chosen, the forces which strengthen the use of the original model start working. The values, viewpoints, behaviour and the practice which had been defined in the initial phase grow stronger and become institutionalized over time, while at the same time the values, viewpoints, behaviour and practice which are inconsistent are rejected. This leads to the mutual adjustment of the institutional frame and the business model and the strategic response which reflects the specific administrative heritage.

The kind and the quality of the institutions, or the national institutional frame is one of the more important factors of the economical performances in the long run. The way the institutions are being founded, their evolution, the consistency and the system by which the respect of the institutional rights is provided make the critical social capital or the software by which the interactions of the individuals are streamlined and the development of the society is determined (Hoskisson, Johnson, Yiu and Wan, 2001). The existence of the *soft* infrastructure (laws, regulations, financial mediators) is as important as the existence of the *hard* infrastructure (the roads, ports, telecommunications).

There are two different kinds of risks for the investors. One is that the resources will be irrationally used on the part of the entrepreneurs,
and the other is that the political magnats will confiscate the gained profit. Historically speaking two institutional approaches are applicable in order to provide the conditions for ensuring the investors that their assets will be used in the proper manner – the private or informal approach and the legal or the formal approach. Both approaches provides us with the information necessary for the investors in order to follow the efficiency of the firms where they invested their capital doing business and in order to achieve the control over the work of the insiders.

The institutions of the corporate governance represent a system by the means of which the companies are guided and controled (Babić 2004). There are two ways of carrying out the protection of the investors’ interests or there are two institutional approaches to this problem. One is formal and includes the legal institutions of corporate governance and the other is informal and includes the private institutions of corporate governance. Both approaches ensure the flow of information and make a framework within which the investors are able to monitor the work of the insiders with relatively low transactional expenses. The formal approach came about during the 19th and 20th century, gradually since the times of the industrial revolution and is based on a number of laws and regulations by which the investors’ rights are protected in relation to the arbitrary behaviour of the individual and the state. The institutions of the corporate governance developed in such a way stimulated the development of the market and the economical development. It has been proved based on the research that was carried out that the countries with the higher level of formal protection of the investors have a bigger income per capita.

The formal institutions relate to the laws and regulations by which the three relevant areas of corporate governance are defined and shaped. The first area is about the overcoming the information gap through suitable laws by which the obligations of right informing about doing business is defined as well as the ways in which the obligation is checked. The other kind of institution includes the legal regulations which specifies the course of bankruptcy and the mishaps in doing business are sanctioned. The board of directors comes within the third group of institutions and its role is to enable the necessary flow of information between the owner and the manager.

There are three types of the informal (private) institutions: the owner group, the business groups and the associations. Their role is to provide the necessary information, the respect of the contract obligations and the control of the managers’ work. If the formal institutional frame is underdeveloped, the informal rules become more important (Babić 2006). The formal and informal institutions act like linked vessels, and that is why when the formal institutions are lacking, the informal institutions based on the personal relations are more important.
CURRENT CORPORATE GOVERNANCE SETTINGS IN TRANSITION ECONOMIES

The recent experience of countries in transition shows that the assumption that a strong system of corporate governance will appear automatically as a result of ownership transformation is unrealistic. Even in developed market economies, differences in the ownership structure and level of concentration or dispersion of owners influence the selection and adjustment of corporate control mechanisms. For the countries in transition, the problem of good corporate governance development becomes more complicated due to the underdeveloped institutional infrastructure (Babić 2003). For this reason there is a need for a careful approach to governance restructuring so that a private sector can be formed, powerful enough to realize successful economic transformations towards a market economy.

In emerging economies, the term “corporate governance” is new, yet it has caught on rapidly. A set of formal legal frameworks, often modeled after the Anglo-American system, frequently exists. Nearly all firms have shareholders, boards, and “professional” managers, which are the components of modern corporate governance. However, the similarities in governance between emerging and developed economies are often more in form than in substance.

The countries in transition are facing the problem of corporate governance in a specific way. Their corporate sector consists of “instant corporations” formed as the result of mass privatization, without the simultaneous development of legal and institutional structures necessary to operate in a competitive market economy. Under the circumstances of diffuse ownership, it enables insiders to strip assets and leave little value for minority shareholders (World Bank 1999).

The business environment is without a lot of elements needed for making competitive relationships, which provides an advantage to old, large, dominant companies and discourages entrepreneurship and the appearance of new companies. Unstable macroeconomic conditions create a surrounding of great uncertainty and shorten the time horizon in business. Under unpredictable economic circumstances, managers see their positions as temporary and uncertain which leads to maximizing their own profit instead of maximizing the company profit.

The role of the state in the transition economies is ambiguous. On the one hand the role of the state in post-socialism should be limited. On the other hand, strong state power is needed to carry through the political programs required by economic transformation. Weak governments have proved to be incapable of economic transformation (Martin 2002). In reality, the state still has a great role in both the industrial and financial sectors. State authorities and company managers are tightly related, so that the line between the “controllers” and the “controlled” is unclear. In practice, informal constraints, such as relational ties and family and gov-
ernment contacts play a greater role, leading to different outcomes. The state gives subsidies to companies directly or indirectly while on the other hand, companies enable state representatives to have a certain amount of control over the process of making decisions and cash flow. Behaving in such a way, managers are constantly searching for new subsidies instead of looking for existing or potential strategic partners.

The creation of networks of linked enterprises, rather than of autonomous independent firms is a relationship characteristic of transition economies. Transactions between privatized enterprises become linked to each other, to banks and to the state through complex structures of cross-shareholding and corporate interlocks. Relationships between enterprises and banks are especially crucial in view of the shortage of capital and credit, and continue to be influenced by personal and institutional connections. Where credit is not available from banks, barter relationships amongst organizations known to and trusted by each other provide an alternative means of financing. So, the relationships between firms in post socialism are based on networks rather than Williamson (1990) markets or hierarchies (Martin 2002).

In transition economies the most important firms, such as public sector companies that contribute more to the nation’s gross national product, employment, income, and capital use than private sector firms, are controlled by the state. Moreover, public sector companies often shape public policies. From a governance perspective, state-owned firms are controlled by bureaucrats with control rights but with no formal ownership. Although all citizens of a country own the firms, in practice control rights rest with powerful ministries. As a result, citizens subsidize state firms and end up as “minority shareholders” with practically no voice.

The missing element in the context of corporate governance development in transition economies is the lack of institutions associated with successful market economies. In the market economies there is a standard set of institutions that have been successful as the tools used to control corporations. Institutions are the “rule of the game” in a society (Yeager 1999). They are the rules that society established to reduce the uncertainty of human interactions. The institutional framework has three components: formal rules, informal rules and enforcement mechanisms. While both the formal legal environment and the informal institutional constraints affect corporate governance, institutional theory states that when formal institutions are weak, informal constraints play a larger role in shaping firm behavior.

The question is whether it is possible to reproduce all at once the institutions from developed market economies in transition economies. The standard institutional portfolio has evolved gradually in different circumstances. Merely transplanting these institutions is not possible because there are new conditions and many cultural differences. On the
other hand to develop entirely new institutions would be an unpredictable adventure. The transition economies cannot afford the luxury of searching for new third way between socialism and capitalism (Babić 2003). Instead, they have to find a way to accept the existing institutional portfolio and to make it work in the specific cultural, historical and economic environment. Each region is in a different stage of establishing a democratic, market-based economy and a corporate governance system. Hence, each nation has its own particular set of challenges.

CONCLUSION, DISCUSSION AND FURTHER RESEARCH

When talk about the problems of corporation governance we open the old problem of human existence – a tension between individual freedom and institutional power. During centuries institutional powers were concentrated in hands of various protagonists, but today’s most powerful institutions are corporations. That is the reason for which establishing compatibility between corporate governance and democratic society is the most important aim of 21st century. Primary challenge for corporate governance is to find a way to maximize wealth growing during time, and not to cause additional costs for others or society as whole. Hence, the system of corporation governance should be evaluated in respect to its capacity to protect individual freedom, to maximize wealth and at the same time to govern changes.

The theory and practice of corporation unitary control was developed on Anglo-American area and even with numerous flaws it imposed itself as a model for emerging countries. This is even more enchanted based on fact that countries with Anglo-American origin rules with international institutions, such as World Bank. In the worldwide expansion of corporative control model countries in transition were also included. Implementation of corporative control model in case when good system for ownership rights protection does not exist, laws and other regulatory rules can lead to the situation in which the board of directors and management structures gain absolute power to act based on its own interests, on the cost of owner and other stakeholders.

The problems of corporation governance in transition economies are more complicated and complex than problems in developed economies because the basic control mechanisms that would provide protection of investor’s interests do not exist. Assumption that transfer from state ownership to private sector would prevent grabbing from the state part is taken into consideration because newer polls have showed that privatization cannot prevent grabbing from the state part but even greater avarice occurs through insiders of privatized firms. Economic role of the state in transition economies must be reconsidered (Kuznetsov and Kuznetsov 2003). In order to attribute to more efficient privatization its role must
differ from the one in the era of socialism. It should be joined to the other stakeholders with an aim to increase the value of stakeholder’s shares. It can be managed by creating institutional and legal environment that would expose managers to the real competition and force them to apply reconstruction of business strategy in order to gain better competitive position instead of looking for subventions strategy.

A critical question for countries in transition is how to fulfill a vacuum that rises between the old system of state control and new system of private control, because the process of privatization and creation of institutions cannot be accomplished in short term. Experiences of the countries in transition show that a path from the old to new system is much more complicated and that turbulent transition flow cannot be achieved based on the model of developed countries because disposable time and primary conditions differ completely. Modifications of the existing system are also inapplicable because the specific economy system is developed in transitional economies where old and a source of new system exist at the same time. Besides, transition process occurs in whole spectrum of economic, cultural and social differences which determinate the potential of changes of some national economies.

In researches of complex problems of corporation governance within transitional economies starting point was to ensure effective use of the capital. Because of that control over corporation, besides manager and owner, must also be allowed to other internal and external stakeholders – employees, consumers, suppliers, financial institutions, local communities, media and group with special interests. Measurement of efficiency and effectiveness of the corporation must be the reflection of degree in which all those interests are satisfied. Time in which the effects of investment are expected is point where conflicts of interest occur in great degree. And exactly that long and short-term conflict is basic difference between two recognizable corporation governance models in developed market economies of outsiders and insiders. The conflict is more evident within countries in transitions because radicalism and comprehensiveness of changes can have effects in long term only, but from the other side poverty and social tensions require short-term results. Besides, current managerial and political nomenclature has short term orientation and tries to maximize their own interests, since the effects of promised “new” capitalism are uncertain.

At the same time, in the transition economies, the internal mechanisms- owners, board of directors and managers – differ significantly in comparison to the internal mechanisms of the developed market economies. First, the concept of ownership itself is problematic. Ownership of post-socialist enterprises was often shared between the state, public corporate bodies, banks, municipal bodies, managers, employees, other state or private companies, private individuals and foreign individuals and cor-
porations. The absence of ‘real owners’ leads to neglect of the interests of capital itself and thus to degradation of the quality of the capital, damaging the long-term interests of the firm (Babic 2001).

Second, the boards of directors fail to exercise a true monitoring role. Because the state is the main stockholder, there is an imbalance of power among the various stockholders. The members of the board of directors are usually the representatives of the state, the ruling party, public corporate bodies or even the banks. For individual board members the motivation to act is inhibited by their dependence on management for benefits such as lucrative appointments to boards of directors. Even if they have the motivation to exercise direct control over managers, they lack the knowledge to make managerial decisions. As a consequence, the role of the board of directors is reduced to financial control, which assumes maximization of the short-term results and evaluation of the managers' performance retroactively.

Third, the upper "echelon" of managers acquired their knowledge and skills in a business environment which did not require the development of the skills of transformational or strategic leadership. So, countries in transition have an archaic cadre of managers who do not possess a capacity for strategic thinking, vision creation, team work, risk taking and change management. Potentially new managers and leaders are facing a new challenge which comes from the Western countries in the form of ready-made solutions, but they are also facing a challenge to respond to specific requirements of the business environment encountered in particular countries. Another problem is related to the non-existence of a market for management talent and the difficulty of evaluating managers in an impartial manner.

Future researchers in governance issues in transition economies need to be aware of the above research areas. Solutions derived from a principal-agent perspective – while applicable to developed economies (especially the US and UK) – may fail to address the corporate governance problems in a different institutional settings. To develop another further perspective, integration with the stakeholder-agency theory may be helpful. The stakeholder-agency theory puts less emphasis on the rights of shareholders and instead recognizes several groups, which have an arguably legitimate claim on the firm. Therefore, future work may explore in more detail how organizations influence institutions, shedding light on how these two evolve together. Finally, it is important to point out that division of the world into two different camps, namely, “emerging” versus “developed” economies, risks over-generalization. National and regional cultures also generate idiosyncratic differences in governance across countries (Gedajlovic and Shapiro 2002). However, as a group, transition economies tend to exhibit governance characteristics that cluster around relatively similar dimensions.
REFERENCES


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КОРПОРАТИВНО УПРАВЉАЊЕ У ТРАНЗИЦИОНИМ ЕКОНОМИЈАМА

Резиме

У развијеним тржишним економијама систем корпоративног управљања је изграђен постепено кроз векове и данас може бити дефинисан као комплексан мозаик састављен од закона, регулативе, политика, јавних институција, професионалних удружења и етичких кодова. Међутим, у транзиционим економијама много детаља из тог мозаика још увек недостаје. Развој система доброг корпоративног управљања у транзиционим економијама је отежан због проблема као што су: комплексна власничка структура, нејасне и конфузне релације између државног и финансијског сектора, слаб законодавни и судски ситет, осдусто или неразвијене институције и оскудне способности људских ресурса.

У раду се истражује проблем корпоративног управљања у транзиционим економијама. Истиче се значај тро кључних подручја истраживања за изградњу поузданог система корпоративног управљања у транзиционим економијама: оквир корпоративног управљања, модель корпоративног управљања и специфични услови карактеристични за транзиционе економије.

Кључне речи: корпоративно управљање, агенцијска теорија, стјуардшип теорија, ресурсно базирана теорија, транзиционе економије.