CORPORATE GOVERNANCE IN THE TRANSITION ECONOMIES

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Abstract
Corporate governance has been an important issue in the economic literature of the last decades, a strong corporate governance framework being extremely important in order to increase the confidence of the stakeholders. Also, the transition economies are an important issue of research, especially after the 80’s. The aim of the present paper is to see which are the main theories regarding the corporate governance and how they can be described, as well as which are the main corporate governance systems put into place in the transition economies. Our paper also focuses on the particular characteristics of the transition economies and what impact they have on the quality of the corporate governance. These aspects are important in the context of a larger research through which we try to establish ways of evaluating the quality of corporate governance practices and systems.

Key words: corporate governance, transition economy, governance structure, privatization process

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1. Introduction

One of the significant events that has taken place in the last century was the decision of many states (in most cases imposed by violent social events) to pass from centrally planned economies to market economies. This involved important economic reforms that took place in a non prepared environment lacking a stable institutional order. Therefore, large-scale institutional restructuring and policy reforms took place. The experiences of these countries were very different, leading to the idea that prescriptions for “good governance” must become a key ingredient into such reforms. The main problem is to identify what “good governance” means and how it can be achieved.

Many theories about corporate governance have emerged. Still, not all researchers consider corporate governance more than a “fashion” meant to disappear in a short while [22]. Still, even these authors agree that corporate governance is a supervising and control process that makes sure that the management acts according to the owners’ interests.

Even though corporate governance has become an important issue, no general accepted definition was provided. Tricker [23] considers that corporate governance is concerned with the shareholders, managers and board, most of the corporate governance codes and regulations being concerned with these categories of stakeholders. Others consider that corporate governance is a way for the capital suppliers to make sure that they are going to get back these capitals plus a supplementary payment for their investment [21].

Even if the definition of corporate governance is not a generally accepted one, its importance is not under question. Corporate governance models that are used by different companies have an important impact on the business environment as well as on the transactions that take place on the different financial markets. The choice of a certain approach in corporate governance is motivated by different aspects and one should be aware that certain models are more fit for certain countries, due to their specificity.

2. The corporate governance models

In 1992, the Cadbury Report gives a definition of the concept, saying that corporate governance is “a system through which companies are managed and controlled” and gives only some essential advice about the corporate governance (importance of the control and monitoring of the management by the board, need for the independent members of the board, etc). The Hampel Report (1998) promoted the investors protection, the audit importance and the...
need for more responsibility. A few years later, OECD states that the corporate governance makes clear the distribution of rights and responsibilities of people involved in the life of the entity and identifies the connections and exchanges that exist between these stakeholders, in their activity of contributing to the fulfillment of the company’s objectives.

The literature on the corporate governance in emerging countries became abundant in the last few years, most of the studies being studies on one country [6, 15, 25] but also multi-country studies [17, 2, 18].

All the research in this field has generated a few major theories:

- the agency theory which analyzes and tries to solve the conflicts that can appear between the owners of the companies and their agents (the top managers). Managers have access to more internal information than the owners (especially if the owners are not a compact group) and therefore have a better chance of fulfilling their own interests and ignore the fundamental theory that the companies’ main objective is to maximize the wealth of the owners (Blair, 1995).

- In solving the agent problems, the codes of corporate governance, the stock exchange’s regulations, all the audit and transparency requirements become significant and highly important [23].

- the stewardship theory stipulates that the managers are going to act in the interest of the group and not in their own interest and therefore are going to act towards the interests of the organization and its owners. At the basis of this theory stands the assumption that the manager is aware of the fact that his prosperity depends on the prosperity of the company.

- the stakeholders theory stipulates that the manager should be interested not only in the well-being of the shareholders but in the well-being of all other categories of stakeholders as well, as the success of a business can be obtained only if all the “actors” in its life are interested in fulfilling the same objectives, namely creating value for all of them. All stakeholders are important for the success of a business because together they can create what they cannot create separately.

- the politic model considers that the division of corporate power, privileges and profits among different stakeholders is a political decision. Factors like culture, preference for the market liquidity instead of the institutional control, the possibilities investors have to express themselves, to enter of exit the market, etc are influenced by law and regulations and make the object of public discussions for change and reform.

- the resources dependence theory considers that all stakeholders that do not have the essential resources try to establish connections with other people in order to get access to those resources. This theory focuses on the importance of the board in attracting the necessary resources for the activity of the company as well as on the fact that most companies try to reduce their dependence on others.

Corporate governance mechanisms are not identical everywhere and differ from country to country or from one governance regime to another. For example, there are states with a European-continental governance system (such as Germany), where the creditors play an important role in the entity monitoring. In practice it was proven that the corporate governance acceptance becomes a must as companies that have a well established corporate governance system seems to be more efficient.

Corporate governance can be classified into insider versus outsider corporate governance systems. The insider systems are characterized by listed companies, with few majority shareholders, where the system is based on very tight relations between the company and its shareholders. In this sort of systems, managers and owners are very close, in many cases owners also being the managers, so there are little or no problems of subordination or conflict of interests. In the case of the outsider systems, property and management are clearly separated. It is usually the case of big corporations that have external owners.

Another usual classification is that into the Anglo-American Model versus the Continental-European one.

In the case of the Anglo-American model of corporate governance, property and control are clearly separated and the exclusive objective is that of a better return of the investment. This model of corporate governance is specific for countries with well developed capital markets that allow investors to control the companies through the capital market. Still, as the shareholders are not concentrated and have little voting power, most of the decision making is done by the managers this implying that there is a high risk that managers can accept development in any circumstances, without taking into account the owners’ opinions. The most common effect is that managers will prefer to reinvest the profit instead of paying dividends.

In the case of the Continental-European model all stakeholders are important and not only the shareholders. In the case of this model, the shareholders are very compact and many times the institutional investors or other stakeholders have a voting majority.

A big difference between the two systems is that in the Continental-European model, the focus was to align the interests of the dominant shareholders with those of the minority ones, while in the Anglo-American system the focus was on limiting and solving the conflicts between the powerful managers and the owners.

3. Specificities of the corporate governance in transition countries

Even though all the transition countries have had to perform significant changes to their economic life, political life and administrative systems, these changes have affected them into very different ways, due to very
different backgrounds. Some of these countries, before the communist era, were developed countries that put a high value on private property that had a strong economy based on small or medium size companies while others were mainly rural. In this case, the transition from a centralised economy to a market economy was done in a very different way. Also, in some countries (mainly from East Asia), the transition was done only in the economic life, without political democratization.

Literature has shown that keeping the political promises is important for an effective economic transition. Also, the capacity of the state institutions, their connections with the economic entities as well as the technical and political capacity of policymakers to formulate and implement coherent policies are crucial. It is not the regime type (democratic or authoritarian) that generates the success or failure of the transition but the quality of institutions and networks.

There are certain characteristics of the governance structure that can provide the market enhancement, namely:
- The state needs to be strong enough to protect property rights and implement adequate policies
- The state needs to be able to eliminate corruption and predatory behaviour
- The public sector can provide the technical and administrative skills necessary to implement the policies and enforce the rules
- Strong economic institutions have to be set in place.

An interesting issue that has to be taken into account when dealing with transition economies, but not only for transition economies, is that the ownership patterns and the degree of separation of the ownership from the management, tends to influence the type of governance that is preferred. While Berle and Means (1932) assumed the prevalence of widely held firms, the empirical literature showed that in the case of emerging and transition markets, separation between the control and ownership is very rare [16, 3, 12].

If we take the case of Latin America, the industry concentration, business group affiliation and family ownership are very common. Chong and López-de-Silanes (2007), consider that the ownership concentration in this region is a consequence of inadequacies of the legal institutions, showing that in this case the rule of “no minority shareholder protection goes hand in hand with no widely held firms” apply. Still, in order to increase the investors' confidence, reforms have been made, investments have been carried out, resulting in some increase in market competition and liberalization of the financial markets.

In the case of the former communist countries in Central and Eastern Europe, the passing from a centralized system to a free market, involved the transformation of property regimes. Easter European political transformations took place at the same time with privatization and globalization.

What differed was the speed of the reforms and the measurements used. The political, institutional and economic changes applied by Poland, Hungary, Romania or the Czech Republic, in order to get rid of the former planned economies and to pass to the market economies, were so different that the results vary from complete success to failure.

Even though, privatization was regarded as the solution for more efficient entities, this was rarely the case in practice. The new owners were not always able to ensure the right measures needed for a more efficient management and the lack of clear stated relations between the stakeholders became a problem. The new owners, having the power to influence the managers’ decisions, imposed their own rules, leading to very “special” corporate governance systems.

Poland, one of the success stories, started by privatizing the state-owned firms, in a three-stage privatization process:
- first stage: commercialization of a state-owned firm, which can take one of three techniques, initial public offering, direct sales to investors and a combination of bought.
- second stage: establishment of 20 National Investment Funds
- third stage: distribution of certificates to polish citizens who became indirect shareholders of the companies.

Grosfeld and Hashi (2007) consider that the Polish authorities centred on the proper development of the financial market and an adequate legal system that limits the concentrated ownership.

The Czech approach was different: the government used incentives to attract foreign investors and passed a Restitution Law. The privatization process was divided into three schemes: the natural restitution (small firms, stores, and real state were returned to the original owners or their descendant), small-scale program (small and medium-sized firms were privatized through auctions, sale in tender offers, or direct sales) and large-scale privatization (companies prepared privatization projects and presented them to the Ministry of Privatization; then potential owners competed and the Parliament made the final allocation decision).

The voucher privatization method was also used but only for a certain percentage of the companies’ shares. The rest of shares were distributed partly to the employees, partly to foreign buyers and partly were held by the State.

Hungary used another approach in transferring the property from the State to the private entities. The laws put into place allowed the management of the enterprises to take over the ownership functions of the ministries and also allowed state-owned firms to found limited liabilities firms. Small size companies and family owned entities were transferred into private hands through very simple procedures. Also, there were no barriers for the foreign investors in buying Hungarian companies, big or small. The only limits set were referring to the big companies where the price of a share was set at a million forints which was only accessible to corporate or institutional investors.
All of these peculiar aspects regarding the privatization process, have generated important differences, especially regarding the ownership structure, as well as the level of foreign implication in the new formed economy. For example, the Czech Republic companies remained at a high level in the hands of the State (that kept control over the main companies), while in Hungary, foreign investments were supported and facilitated, giving the economy a very quick start. These investors came with the good practices of their own countries, changing a lot the Hungarian environment.

As Botoc (2014) shows, the “different behavior between Central and Eastern stock markets lies in the size of such markets as well as the structure of the investors from the market”. Smaller markets (like Bulgaria or Romania) tend to react in the same way to good or bad news, while in the case of markets where there are bigger individual investors (like Poland or Hungary), the impact of good and bad news is very different. Therefore, risk-adverse investors would be interested in investing in stock markets with symmetric and low volatility whereas risk lover investors would be interested in investing in stock markets with asymmetric and higher volatility.

Despite the very different cases, at the beginning of the 90s’, most of the transition economies tried to apply the best-practices of other countries. The Washington Consensus was applied in these countries without taking into account that such policies just focused on liberalization and stabilization, completely ignoring the need for strong institutions to be put in place. This lead to major failures (such as the case of Russia) and to the need of a new generation of reforms that would focus on the political and societal conditions and on the institutional restrictions. According to Khan (2002), the key institutions needed included: the rule of law, the private rights protection, undistorted markets, independent judiciary institutions, sound corporate structures, etc.

The Western-style best-practice institutions were used as models for the transition economies, but unfortunately, in many cases, without taking into account the persisting initial conditions or the manner in which such institutions would be developed, accepted and enforced.

In such a context, the Western-style governance model was considered a precondition to structural change and economic growth. The problem that soon arose was how to define the best-practice governance structure?

The success stories of transition countries are very different as the governance structure adopted should take into account the initial conditions, political and social preferences as well as the stage of economic development and economic structure. Still, what is common for all success cases is that the government’s credibility contributed to the increased interest of investors for the country.

The institutional restructuring has to be quite quick but not in a hurry and also has to be prepared well in order to be smooth. Of course that there are exceptions from the rule, as in the case of Germany after the fall of the Berlin Wall or China and Vietnam, where the institutional restructuring took place due to an institutional shock or in an authoritarian setting (in China for example, this took place without the parallel political transformation).

Many times, in Central and Eastern Europe, corporate governance was regarded as unnecessary, or even more, as an obstacle in the development of business. Privatization was not enough in order to provide a secure environment for the managers to take the best decisions as this process didn’t eliminate the interference of different stakeholders with the decision process but on the contrary, it has enhanced the power of employees, the State or different third parties. If we look at the 8 transition countries that have joined the EU in 2004, for example, we can notice that they have all shared similar backgrounds and the fact that they were having prospects of becoming members of the EU, made them act quickly in implementing economic and political transition. The EU provided the stability and also the guidance needed by the member states in the institutional restructuring, and this lead to an increased credibility of the countries through the adequate institutions and the elimination of discretionary policies.

Politics, law and economics are important factors to what concerns the different ownership patterns across countries [13, 1]. The participants to the economic life act very different due to the different impact the environment has on them but also due to their dimension of being a public or private entity. Especially in the case of emerging markets, they are very much influenced by the national models of capitalism adopted, models that include different forms of financial systems.

Certain studies have shown that companies owned mainly by domestic investors have lower leverage ratios [8], in case of Russia, which highlight the fact that in CEE countries leverage cannot be figured out as a corporate governance mechanism.

All of these aspects contributed to the very different cases of using corporate governance in UE. The privatization process, done in very different manners in different countries, was a significant factor in the development of the region. Each of the countries in the region experienced different solutions regarding the owners seeking, the forms of ownership, bonuses and so on. These differences in approaches and also in culture, led to the delay in putting into place the legislation concerning the corporate governance.

Even now, most countries in the region just use imitations of western models (Peev, 2002). The institutional framework is still weak in respect to corporate governance and therefore hinders the enforcement of property rights and of capital markets, allowing corruption to flourish. McCarthy and Puffer (2002) consider that in this region, business culture is still dominated by habits and traditions and not by the “best practices” established in the western companies.
In Romania, corporate governance is quite new. The first code was adopted in 2001, being replaced in 2008 by a new code that was based on the OECD principles. This code is applied on a voluntary basis by the companies traded on the Bucharest stock-exchange, and according to Feleaga et al (2011), in most cases the degree of transparency is lower than in other European countries and the independence of the directors and audit committee members does not meet the standards. Dragotă (2006) also shows that the protection for minority shareholders in the case of Romania is almost inexistent and the amounts distributed as dividends decreased.

4. Conclusions

The last few decades have showed that corporate governance can change the life of companies and even of global economies. We have been faced with new types of corporate governance models, more and more adapted to the economic environment where they were to be applied and transition countries have understood that they need to adapt their law systems as well as their institutions in order to be able to promote the “good governance”

What we have tried to do through this paper is to identify what corporate governance models are used in different countries and which are the particular aspects that influence the level of performance obtained by transition economies when applying different “good governance” practices.

The paper is just the first one in a study that aims to define and test a model that is going to determine the quality of governance.

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