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**Corporate Governance Methodology and
European Transition Countries:**
Paradigms, Critical Views and New Challenges

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Corporate Governance (CG) in the Context of Central and Eastern Europe (CEE)

Ownership change

EU integration

Transition from a state-oriented CG model to a new CG model since 1989

PRIVATE SECTOR SHARE OF GROSS DOMESTIC PRODUCT

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Czech Republic	10	15	30	45	65	70	75	75	75	80	80	80	80	80	80	80	80
Hungary	25	30	40	50	55	60	70	75	80	80	80	80	80	80	80	80	80
Poland	30	40	45	50	55	60	60	65	65	65	70	75	75	75	75	75	75
Slovak Republic	10	15	30	45	55	60	70	75	75	75	80	80	80	80	80	80	80
Slovenia	15	20	30	40	45	50	55	60	60	60	65	65	65	65	65	65	65
Estonia	10	10	25	40	55	65	70	70	70	75	75	75	80	80	80	80	80
Latvia	10	10	25	30	40	55	60	60	65	65	65	65	70	70	70	70	70
Lithuania	10	10	20	35	60	65	70	70	70	70	70	70	75	75	75	75	75
Bulgaria	10	20	25	35	40	50	55	60	65	70	70	70	70	75	75	75	75
Romania	15	25	25	35	40	45	55	60	60	60	60	65	65	65	70	70	70
Russia	5	5	25	40	50	55	60	70	70	70	70	70	70	70	70	65	65
Ukraine	10	10	10	15	40	45	50	55	55	55	60	60	65	65	65	65	65

Source: European Bank for Reconstruction and Development *Transition Reports*.

Scientific paradigm

Thomas Kuhn ([The Structure of Scientific Revolutions](#), 1962) :
"universally recognized scientific achievements that, for a time, provide model problems and solutions for a community of practitioners:

- *what* is to be observed and scrutinized
- the kind of *questions* that are supposed to be asked and probed for answers in relation to this subject
- *how* these questions are to be structured
- *what* predictions made by the primary theory within the discipline
- *how* the results of scientific investigations should be interpreted
- *how* an experiment is to be conducted, and *what* equipment is available to conduct the experiment

Paradigms: The Last 40 years

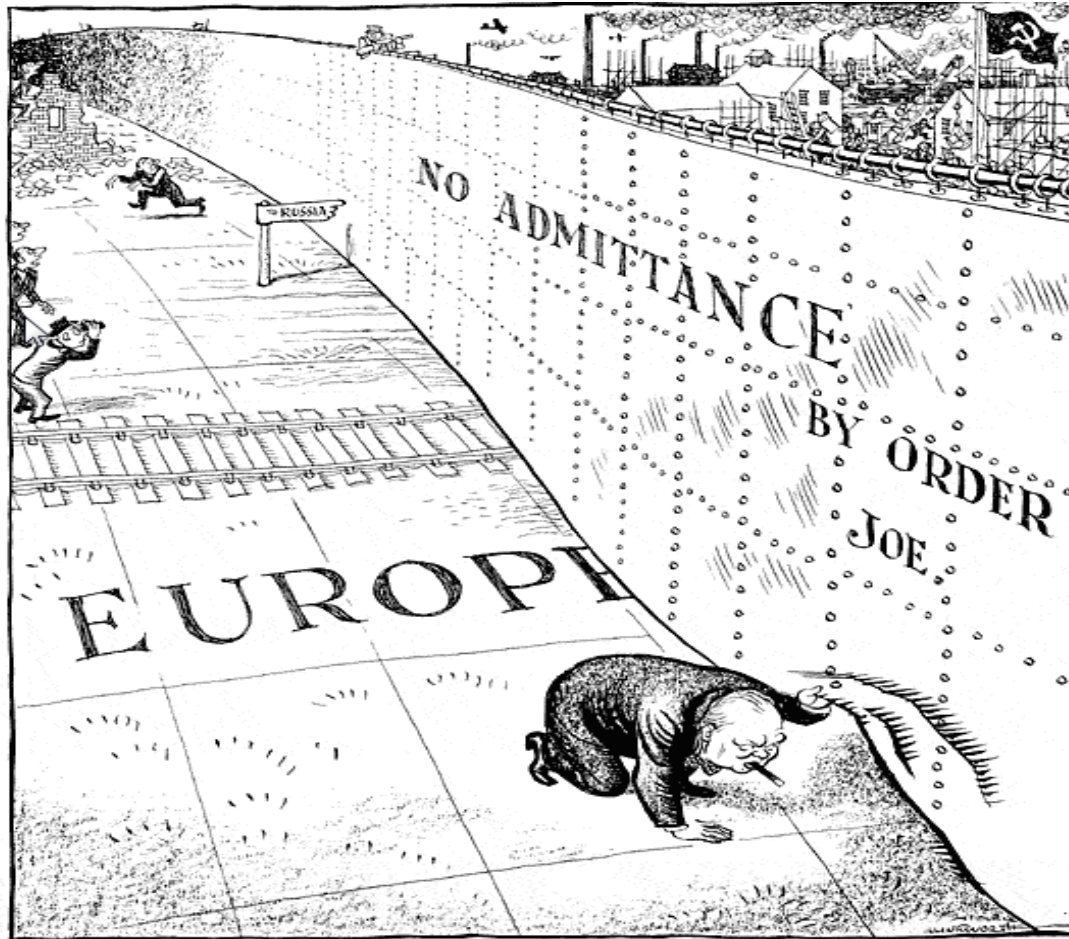
Before 1989 : Marxist Ideology

Early Transition (1990-1996) : The Washington Consensus

Late Transition (1997-2007) : The Law and finance literature and convergence to the Anglo-Saxon CG model

Since 2008: ?

Behind the iron curtain (1944-1989)



I. State-Oriented CG Model Before 1989

The dominant paradigm

Marxist ideology: 100 % of state ownership in manufacturing and financial sector

The socialist system, state ownership and the plan are better than the capitalist system, private ownership, and the market coordination

Critical Views

Kornai, Janos. The Socialist System. The Political Economy of Communism, 1992, Oxford University Press.

State Ownership in the Main Line of Causality

Kornai, 1992 (ch. 15)

(see Figure 15.1)

THE MAIN LINE OF CAUSALITY

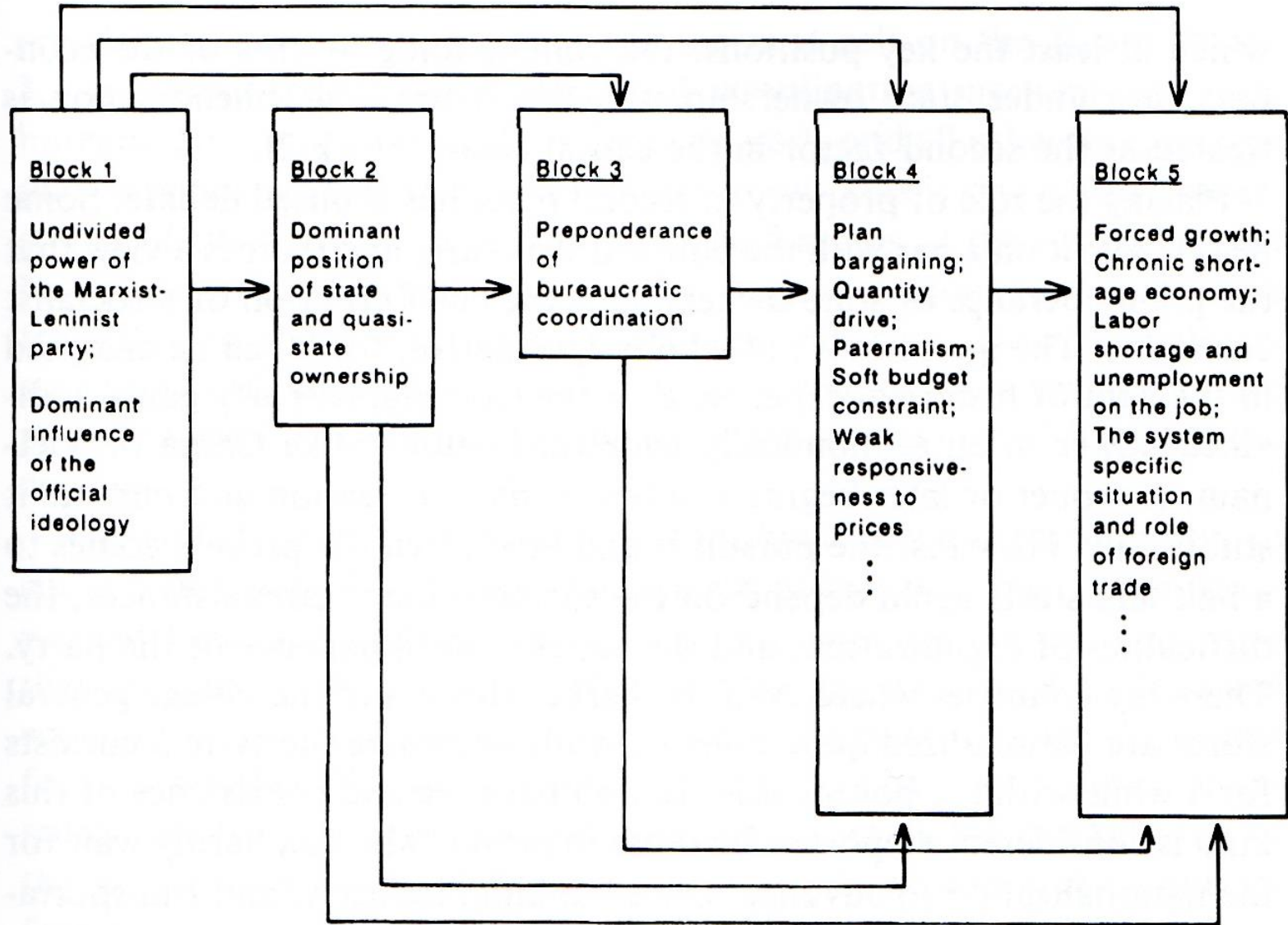


FIGURE 15.1 The Main Line of Causality

Paternalistic Motives Model: The State-Owned Firm in Planned Economies

BC-organization (state-owned firm) – S-organization (state agencies)

Key features of the SBC

(1) The motives of government:

Inconsistency in objectives of government

- to have profitable state-owned firms
- to preserve social security
- paternalism

(2) *Ex-ante*, **S-organization** would *not wish to commit* itself contractually to provide support; its incentive to bail the BC-organization out arises only *ex-post*.

(3) SBC rescues include **prolonged** support of organizations suffering from persistent financial problems.

(4) Managers of **BC-organization** *expect* that to be rescued from trouble, and these expectations in turn affect their behavior.

2) The roles of managers

The **managers** of state-owned firms remain members of the communist *nomenclatura*. Their behavior reflect several roles:

- (i) **Bureaucrats** at a middle level in the hierarchy
- (ii) **Co-owners**, who receive a share of the residual income
- (iii) **Technocrats** interested in production and technical development
- (iv) **Elected self-management leaders** who represent their employees' interests.

Question 1: Which is the relevant CG agenda in CEE before 1989?

- *Unit of analysis*
- *Questions*
- *How* these questions are to be structured
- *What predictions* made by the primary theory within the discipline
- *How* the results of scientific investigations should be interpreted

II. Changing CG Model in the Early Transition Period (1990-1996)

The Washington Consensus

Privatization, liberalization, and stabilization

- *Unit of analysis* : SOE, CE, PRE
- *Questions*: Insiders and the state

Frydman R., & Rapaczynski A. (1993). Insiders and the state: Overview of responses to agency problems in East European privatizations. *Economics of Transition*, 1.

- *What predictions*: Privatization to Outsiders, Foreigners (EBRD Transition Report, 1995)

Critical Views

Rodrik Dani, Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in the 1990s: Learning from a Decade of Reform, *Journal of Economic Literature*, Vol. XLIV (December 2006), pp. 973–987.

Murrell, Peter, Institutions and Firms in Transition Economies, in *Handbook of New Institutional Economics*, Kluwer Academic Press, 2005.

CEE context

Domestic outsiders

Primitive accumulation of capital → oligarchs? (World Bank Report, 2000)

Former communist party activists → new capital owners (Olson, 2000)

Ownership diversity: Myging (1994) on the Baltic States; ; Peev (1995) on Bulgaria

Foreigners

Agency problems of MNCs (CG literature)

Privatization is political process with economic consequences – **quality of government institutions matters**

Question 2: Which is the relevant CG agenda in CEE (1990-96)?

- *Unit of analysis*
- *Questions*
- *How* these questions are to be structured
- *What predictions* made by the primary theory within the discipline
- *How* the results of scientific investigations should be interpreted

III. Changing CG Model in the Late Transition (1997-2007)

The mainstream literature : Law and finance

- *Unit of analysis*: legal investor protection; listed companies
- *Questions*: expropriation from insiders and the state:
- Twin agency problems (Stulz, 2005) ;

Agency problems between **Strong Managers** and **Weak Owners**
Roe (1994);

Agency problems between **Strong Insiders** (banks, labour, controlling owners, state;) and **Weak Owners**

- *Predictions*: Convergence to the Anglo-Saxon CG model
- Primacy of common law countries and inferior performance of the French legal origin countries (la Porta et al, 2008)

La Porta et al (1998) is the most cited paper in the economics and finance literature since 1994, Kim et al (2006)

The influential World Bank *Doing Business* reports in the 2000s

Critical Views

Critics on law and finance literature (see e.g. Centre for Business Research, University of Cambridge. CBR Extended Shareholder Protection Index).

CEE: emerging ownership structures

The growing irrelevance of CG in Transition Countries, Mihalyi (2000)

The agency problems: Managers and managers

Peev, E. Ownership and Control Structures in Transition to "Crony" Capitalism: The Case of Bulgaria, Eastern European Economics, 2002, Vol. 40, No. 5.

Question 3: Which is the relevant CG agenda in CEE (1997-2007)?

- *Unit of analysis*
- *Questions*
- *How* these questions are to be structured
- *What predictions* made by the primary theory within the discipline
- *How* the results of scientific investigations should be interpreted

IV. CG Model in the EU New Member States (2008-)

The dominant CG agenda?

- *Unit of analysis*: legal investor protection (?); listed companies
- *Questions*: expropriation from insiders and the state ?
- Twin agency problems (Stulz, 2005) ;
Agency problems between **Strong Managers** and **Weak Owners** Roe (1994);
Agency problems between **Strong Insiders** (banks, labour, controlling owners, state;) and **Weak Owners**
- *Predictions*: Convergence to the Anglo-Saxon CG model ?
- Primacy of common law countries ?

Predictions: Are corporate governance system in CEE is converging to the Anglo-Saxon CG model?

This did not happen in CEE

Why?

Possible explanation: path dependence theory (Bebchuk and Roe, 1999).

Legrand (1996) argue that it is impossible legal systems in the EU to converge because the differences arising between the common law and civil law *mentalities* at the epistemological level are irreducible.

But why not “great reversals” (Rajan and Zingales, 2003); “the total change of the system” (CEE in 1989)

Unit of analysis: Is listed companies-centered corporate governance model relevant to CEE?

Listed firms are less economically important than private firms in CEE but nevertheless they are the main focus of the most corporate governance studies. Why?

Questions: Which are the “weak owners”?

Twin agency problems (Stulz, 2005) ;

Agency problems between **Strong Managers** and **Weak Owners** (e.g. institutional investors) see Roe (1994);

Agency problems between **Strong Insiders** (banks, labour, controlling owners, state;) and **Weak Owners** (e.g. institutional investors);

Save Capitalism from Capitalists Zingales (2012)

Are the top 25 US institutional investors (1) the most powerful shareholders measured by financial resources they command,
(2) managing to capture their home state,
(3) establishing monopoly position in their home state,
(4) involved in the largest political spending (lobbying) for home political parties and politicians?

MNCs between 2 extremes:

- (1) Victim: Expropriation from the host state (e.g. recent political risk in Hungary) and
- (2) Predator: state capture by MNCs (see e.g. Siemens cases)

Emerging CG model in CEE

First, ownership structures of non-financial firms measured by the share of the *direct* largest owner have become **concentrated**. The private owners are prevailing.

Second, **listed firms** are not economically important.

Third, among the top 20 and top 100 firms, the prevailing owners are **MNCs**.

Fourth, financial sector:

(1) Prevailing foreign banks

(2) Major role of the European banking groups (e.g. banks from Italy, Germany, Austria, Sweden).

(3) Banks much more important than stock exchanges

(4) Emergence of a specific financial system: bank-based like in Western Europe (e.g. Austria, Germany) but with prevailing foreign banks.

Relevant CG agenda in CEE?

Unit of analysis: Large firms (e.g. European corporate group company)

Questions: Which are the *ultimate* ownership and control structures? The chain of agency problems between UBO and managers?

State regulations regarding large firms: (i) the state and domestic large firms; (ii) the state and large firms (MNCs); (iii) UBO (foreign states) and large firms.