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Corporate Governance in Transformation Economies: A Comparative Perspective

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Introduction

Standard economics has supposed for a long time that the economy is coordinated by the price mechanism and that no explicit governance problem is involved. However, Coase has proven that this description is only partial, Berle and Means have stressed that ownership and control of firms are often separated, and later on Williamson has demonstrated that hierarchies play a fundamental role. Coase's path-breaking contribution has been the starting point of a burgeoning literature on the nature of the firm. This literature splits the problem into two parts that concern first, the firm boundaries and their determination, and, second and given those boundaries, the way in which the different constituents of the firm are coordinated and the residual income or residual decision-making power (given incomplete or missing contracts) is allocated.

The latter goes to the core of corporate governance, but both boundaries and coordination are central to transformation countries. However, the prevailing mainstream literature presupposes a well working market context and this may raise both positive and normative problems in countries in transformation where that precondition does not fully held.

Corporate governance identifies how rights and duties are distributed within and around the firm. Rights and duties define how the distinct actors are organized, coordinated, and motivated, decision-making power and control are defined and allocated and residual income is distributed. In a dynamic perspective, corporate governance deals with the way in which those actors change their mutual relationship and promote and adapt to change in the context and within the firm. In transformation conditions, when rights and duties (property rights, to begin with) are subject to comprehensive and deep change, corporate governance must be considered in the context of rights and duties transformation, particularly privatization.

Corporate governance comprises formal and informal institutions, which together – i.e. in a coordinated way so to form a system – govern the relationship between the people who manage (managers, boards) and all those who invest resources (stakeholders) in the firm. These institutions include the country's company and securities laws, accounting rules, corporate governance principles, generally accepted business practices and prevailing business ethics (see also Oman *et al.* (2003, p. 6)).

In transformation countries corporate governance became important lately, when it was clear that privatization and liberalization alone were not enough to improve the performance of firms and in some cases were responsible for the dramatic worsening of performance due to 'transitional recession' (Kornai, 1994) or 'disorganization' (Blanchard & Kremer, 1997; Marin & Schnitzer, 2005). For Central European countries the access first and membership then to the EU were critical factors. For all the countries in general and Russia in particular the problematic outcome of privatization – particularly the 'loans for shares' schemes – and the 1998 financial crisis were important factors that prompted government authorities and firms alike to give proper weight to restructuring and corporate governance.

Corporate governance in economies in transformation should pursue three aims. First, it must support coordination and cooperation among the various components of the firm and lead the latter to take the best possible decisions in the most effective way. The decision-making process has to be as cheap as possible and give the best possible incentives to those who provide the firm with critical assets. Critical is in the sense that they are particularly important for the performance of the firm or difficult to control and keep loyal to the firm.

Second, corporate governance has to support the growth and expansion of the firm by adapting to changes in the firm environment and taking advantage of new opportunities. In this way good corporate governance supports economic growth and change. Third, it must foster transformation of the firm role in the economy and its relation to other firms. In this way sound corporate governance supports transformation. By structuring corporate governance along these three dimensions corporate management can effectively pursue its goals and avoid disruptive internal conflicts.

Dominant paradigms strongly influence corporate governance reform. However, in the next section we shall see that those paradigms have been identified looking at developed market economies, which may present context features, and policy goals not coinciding with those relevant in transformation economies. Section 1.3 deals with the particular context of corporate governance consisting of reforms under stress, i.e. under the pressure of prevailing reform paradigms. In section 1.4, I discuss the dilemma that has confronted transformation economies in choosing between reforms aimed at transplanting institutions known for having been successful in other cases (the 'Washington Consensus' reforms) and those reforms that can be considered as organic. Section 1.5 takes a more detailed consideration of the cases analysed in this book: those of Hungary, the Czech Republic and Russia. Indeed, it is more and more difficult to consider transformation economies as one case, since they have implemented different privatization solutions and corporate governance reforms. This section places corporate governance reform in the context of reforms under stress, with particular regard to privatization. Section 1.6 compares the three cases and derives some teachings on the constraints that corporate governance reforms have met. Section 1.7 concludes the chapter.

Corporate governance paradigms

The literature on corporate governance distinguishes three paradigms (Dallago, 2002). The distinctiveness of each paradigm lies in their considering the nature and functions of the firm in dissimilar ways and generating distinct governance choices.

The first paradigm, the standard shareholders' value, is based in the agency theory and concentrates on the consequences of dispersed ownership and the separation between ownership and control and of contract incompleteness. Most chapters in this book either are based on this paradigm or give it overwhelming importance, since this is formally – although not always actually – the dominant paradigm in most countries in transformation. As equity investors, shareholders are the only actors investing in the corporation without any contractual guarantee of a specific return (Williamson, 1985). Therefore, they have an interest in allocating corporate resources to the best possible use (Fama & Jensen, 1983). In this perspective, corporate governance concerns incentives to the suppliers of the mobile equity capital in the form of residual control rights and includes the set of conditions that shape the ex post bargaining over the quasi-rents generated by a firm with incomplete contracts (Grossman & Hart, 1988).

However important for the success of the firm in a competitive market, this paradigm may shorten the time horizon of the firm and may decrease the importance of industrial goals to the advantage of financial strategies, also by illegitimate or illegal means. It disregards the external and internal consequences of the firm adaptation to the transforming context, the change this generates in the capabilities and competences that human actors contribute to the firm and the need to commit resources to transformation. Indeed, this paradigm says nothing on restructuring, production and innovation, nor does it consider the contribution of other parties in the firm activity.

According to the second paradigm of the stakeholders' interest, the firm is a coalition of different stakeholders with different competences, capabilities, roles and interests and who, in order to contribute to the firm's activity and value, have to implement some kind of risky firm specific investment, such as in human capital. Consequently corporate governance concerns incentives to and protection of these investments and how the allocation of residual rights of control, i.e. how power to different stakeholders affects economic performance (Aglietta & Rebérioux, 2005; Rajan & Zingales, 2000). The allocation of power depends on how valuable are in the firm the resources that individuals bring, i.e. how unique they are and how costly is to replace them. As a consequence, power relations and corporate governance should evolve with the change in the relative value of different resources. The greater number of stakeholders has some undesirable consequences (Tirole, 2001), which may have a critical significance in transformation economies: (a) incentives may be weakened because residual income has to be divided among a great number of claimants; (b) managerial incentives become less focused and less sharp; and (c) control may be divided and softened. Although it is necessary that corporate governance rewards particularly investment in firm-specific assets that support transformation, no stakeholders' interest theory exists of the process that generates adaptation to and learning from systemic transformation.

These two paradigms start from different views of the production process and the nature of the firm, lead to different explanations of how profit is maximized, and differ remarkably as whom the property rights over the stream of income generated should be allocated to. Since both paradigms focus on the governance structures that facilitate the optimal utilization of existing productive resources, they neglect the most fundamental issue of transformation: the governance of the process through which resources are transformed, increased, and utilized in the economy and through which the firms nature, role, and activity is changed and restructured.

The latter aspect is the main concern of the (post-)Schumpeterian innovative firm paradigm (Lazonik & O'Sullivan, 1997; O'Sullivan, 2000). This paradigm is largely based on the concept of the firm as a learning organization and deals primarily with governance solutions that support innovation, particularly in firms on the technological frontier. The approach can be easily extended to the case of institutional innovation so central in countries in transformation. A theory of corporate governance must create the developmental, organizational and strategic conditions pushing decision-makers to use resources to pursue innovation. The developmental dimension deals with resources commitment to irreversible investments with uncertain returns. In transformation countries one should add institutional and organizational uncertainty to the standard productive and competitive uncertainty, in the sense that firms must take decisions without knowing how the economic system will really be by the time when those decisions bear fruits. The organizational dimension consists of the complementarities of individual processes of learning, which is specialized and asset-specific, that are integrated as new collective knowledge in the firm. In such a way the firm develops integrated structures of capabilities and incentives for their participants that are unique to that firm and cannot be replicated through the market co-ordination of economic activity. Through the strategic dimension resources are allocated in a creative way to overcome market and technological conditions that other firms take as given and which, in transformation countries, firms inherit from the old system. Consequently, strategic control within firms must be in the hands of those who have the incentives and the abilities to allocate resources to innovative investments. Moreover, decision-makers must have firm control of resources in order to commit them to a developmental process until the learning process has generated the conditions for reaping higher returns. Finally, the firm must be organizationally integrated.

This third paradigm should be integrated with the significance of procedures and the fact that innovation processes vary greatly according to industry maturity and technology conditions (Dietl, 1998) and the features of industries in terms of visibility, novelty and appropriability of innovation (Tylecote & Conesa, 1999). Both issues put different requirements upon governance and the financial system and are particularly important during transformation. Although this approach has been unable so far to produce an operational theory of corporate governance that includes innovation and transformation, it has suggested some important features that corporate governance should have and has clearly presented the reasons why such innovative corporate governance is important. However, this paradigm was largely absent in the debate on transformation and corporate governance. There are various reasons for this, including the initial subalternity of the debate and reform implementation to the mainstream. This outcome has also to do with the rather mechanic conception of the transformation process, that was supposed to be based on standard policies and their proper sequencing and was aptly labeled as 'transition.' Another important reason is that innovation as an autonomous activity of the firm lost importance since it came largely under the influence of foreign investors or firms were simply trying to survive. Although this paradigm may become important as far as firms regain control over their production process, it is perhaps not particularly useful to explain what happened so far with corporate governance.

Reforms under stress

Institutions establish the 'rules of the game' (North, 1990), define incentives to actors, and address their activity to productive, unproductive or even destructive ends (Baumol, 1993). If institutional reforms are late to come, chances are that those who were able to inherit economic, political or social advantages from the position they occupied in the old system or took advantage of the first phase of transformation, unrestrained by institutions, will get windfall gains and conquer strategic advantages (Dallago, 1996).

Indeed, transformation is a non-routine event (Kornai, 2005, pp. 197–8) in the sense that transformation consists of a unique, not-recurrent event. Under these conditions, opportunism, grabbing and rent-seeking strategies (Fries *et al.*, 2003; Hellman *et al.*, 2000; Steves & Rousso, 2003) have no endogenous constraints and strategies based on reputation, trust or tit-for-tat are ineffective.

Most transformation countries privileged, in a constructivist way but in different measure, the privatization of state-owned enterprises (SOEs) over creating the institutional and practical conditions for starting and supporting new firms. Partial exceptions were Hungary and Poland. Under the influence of powerful interests and a simplistic interpretation of the Coase theorem, 'creative destruction' was seen as a more or less automatic outcome of privatization and reforms were implemented under stress.

According to the Coase theorem (Stigler, 1966), if there is a unique socially efficient allocation of resources, that allocation will be reached through the market independently from the initial allocation of property rights provided that rights are properly defined and enforced, actors are free to transact, and there are no transaction costs. However, if transaction costs exist (Coase, 1960), the possibility to reach an efficient (not unique) outcome through the market depends on the initial allocation of property rights. This stresses how important is the role of institutions and the state enforcing them, particularly so in countries in transformation. Indeed, these are characterized by particularly relevant transaction costs, the initial inability of the state to enforce rights, and the existence of a critical component of rights, particularly in unknown or undefined contingencies, that cannot be contracted and transacted simply because markets for rights are missing or contracts can only be incomplete. Consequently the assignation of residual rights of control over assets (Grossman & Hart, 1986; Hart & Moore, 1990) is fundamental to define who has right to what. Residual rights make the strategies of using the valuable assets inherited from the old system or those accumulated during the first stages of transformation (in particular, political capital) all the more important to acquire property rights through distributive strategies.

The stress of reforms derives from the perceived and politically motivated need to be fast in reforms implementation in order to capture a window of opportunity that may not last for a long time and make change irreversible (Gaidar & Pöhl, 1995); establish a private property regime with priority; respond to the supposed and revealed citizens' preferences for enjoying the advantages from the new system (see, however, Alesina & Fuchs-Schündeln, 2005); and avoid production disruption deriving from institutional and organizational change. The stress was embodied in the chosen method of transformation; the goals pursued and sequencing chosen, with institutional reform getting barely any relevance; the attempt to transplant institutions that were successful in different contexts.

However, implementing reforms under stress makes difficult implementing measures and devices (such as rules and control) to prevent grabbing and rent-seeking strategies from taking over. In addition, stress generates uncertainty, which shortens time horizon and pushes actors to rely on deeply rooted routines. Indeed, socialist firms had governance routines that descended from institutional features and adaptation to the centrally planned economy. These routines were quite different from those required in a market economy, with the partial exception of the relatively few cases of successful pre-transition reforms. Differences derived from operating in a shortage economy and the structurally different firm boundaries compared to market economies.

While shortage disappeared soon following transformation, firms boundaries could only be changed via restructuring, that was mostly supposed to follow privatization. Firm boundaries depend on institutions, human actors, policies, and technology, all bound to change during transformation. This makes effective corporate governance a moving target. Firms in foreign ownership may perhaps be different, in particular if they are part of transnational companies and produce for the foreign market.

Reform under stress have pushed governments to look for 'real' owners, i.e. owners supposedly endowed with market goals who could manage the firm independently from the government. Without proper market institutions, including competition, this may give opportunities to economic and political insiders, well introduced into the state and business machines, to capture state ownership without any commitment or pressure to accumulation, restructuring, competition and development (Scase, 2003; Smallbone, 2005). Reforms under stress often resulted in a ritual establishment of formal market institutions without much concern for their effectiveness. Although it was supposed that effectiveness would result from progressive adjustments through time by the action of market forces, this took place only where pre-transition reforms established basic institutions, the state took on the job, and the EU had a fundamental role or a threatening crisis revealed the unsustainability of the previous course. It seems that there is a kind of circular process here.

Reforms under stress, then, slowed down and distorted the development of effective market institutions in two ways: by establishing barriers to and compressing the time disposable for institutional development; and by transplanting institutions. The latter is well known in the literature. The former deserves some attention, since it has been noticed in more recent years. The attempt at implementing reforms alien to the existing context makes reforms ineffective, jeopardizes the firms activity and increases costs of adaptation and learning for firms (Berkowitz *et al.*, 2003; Djankov *et al.*, 2003). Corporate governance reform in the Czech Republic, Russia, and Hungary offer important examples.

Organic and transplanted institutions

Transformation economies were confronted with the choice between reforms aimed at transplanting institutions known for having been successful in other cases and those reforms that, following Hayek, can be considered as organic.[1]

The supporters of a liberistic approach to transition, who prevailed in many countries including the Czech republic and Russia, but not Hungary,[2] apparently preferred the latter choice. In their view the state was unable to play any significant role due to: the Hayekian failure to manage dispersed information; the grabbing propensity of politicians (Shleifer & Vishny, 1998); the low legitimacy and the discredit of the state when transition started; and the existence of various obstacles to the rapid emergence of an appropriate and effective legal infrastructure during transformation (World Bank, 1996).

In this view, the rapid creation of institutions is not a priority because they would remain ineffective lacking the support of market processes based in an already functioning private property regime. Institutional development is in fact the unconscious outcome of individual actions in market competitive processes (Frydman & Rapaczynski, 1994; Pejovich, 1994; Rapaczynski, 1996; for criticism see Nivet 2004). The necessary priority to rapid privatization follows suit.

A variant of this approach considered that, due to the particularly unfavorable features of transformation countries there is a (transitory) need for a strong role of politics, possibly curbed by international influence. The goal is to establish and enforce few institutions. These are prohibitions, private enforcement of public rules, voluntary compliance, self-protection and self-discipline, intended to support direct action by private actors without reliance on specialized public organizations such as courts. Privatization can start based on those rules (Black *et al.*, 1996; Hay & Shleifer, 1998).

Quite predictably this approach met disappointment soon and looked for more radical measures (Black *et al.*, 1999). Indeed, given the ailing power of the state, the nature of actors, and their 'old boys' (and new boys) networks, the outcome was bound to be far less virtuous than desirable. The problem with privatization has been that someone decided which was the best privatization type and privatization strategy and who was to become owner. If this was not explicitly decided, it came out of pre-existing asymmetries of information, knowledge, and bargaining power. In both cases there were no guarantees that the outcome was the most favorable for the performance of the economy. Even when privatization was carefully designed, as in former Czechoslovakia, a highly concentrated control of the economy resulted.

Organic processes necessitate mechanisms of inter-firm relations to function, like reputation, trust and authority mechanisms. However, during the first critical stages of transformation the fear of losing reputation and the prospective advantages of long-term cooperation are uncertain, and the advantages of gaining by breaking the rules are sizeable, since the game is not repeated. Sooner or later this situation requires the intervention of the state to be fixed.

However, in most cases, including Russia, the actual strategy was institutional transplantation (see Chapter 11 in this volume), or so it ended up. Since no theoretical blueprint existed, the debate failed to generate a shared one, the public hand was in disarray, and strong established interests pushed in that direction, ready-made recipes were the easiest solution and many politicians and experts thought they were the most reliable ones since they were tested, albeit elsewhere. However, such strategies imposed high adaptation and learning costs upon actors since they were mostly based in alien institutions.

Under these circumstances, corporate governance is not a priority issue for reform policies, since it is considered to be in the interest of private actors to take and implement the best possible decisions and protect the most critical providers of inputs. Adaptation and learning processes are considered relatively unimportant and capital is the most critical factor, being dramatically needed to implement transformation and being less specific and more mobile. Hence the typical and dominant paradigm of corporate governance in this strategy is shareholders' value. However, actors must interiorize corporate governance mechanisms to make the latter effective. This may require a long time and may be individually and socially costly in a stress context.

This approach disregards the complexity of transformation processes. Within a truly organic strategy, corporate governance must address firms to pursue efficiency and innovation by supporting learning, adaptation, and commitment of resources to transformation and innovation. Much of this investment has the nature of sunk investment in human and organizational capabilities and competences. The corporate governance paradigm best apt to pursue these goals is the innovative enterprise one, although also the stakeholders' interest paradigm can be useful. This is a demanding aim in transformation conditions that require a competitive context and an authoritative and technically skilled role of the state, albeit mostly indirect. Obviously, this situation should not be mixed up with the laissez faire and neglect that was found in various transformation countries.

Organic processes may leave firms in a corporate governance limbo for some time, due to their length. However, organic developments give incentives to transformation and predictability to adaptation and learning costs, and allow actors to better internalize the new (formal) institutions and support their interaction with informal institutions. Such developments also offer less and more modest opportunities for grabbing and rent-seeking strategies. Yet the core of organic processes is the foundation and development of new firms, be they domestic or the result of foreign investment. Being new, they may embody the new market institutions and corporate governance since the beginning, getting an advantage in the market game. Their competitive pressure will force other firms to adapt.

Comparison of three transformation strategies

Different countries in transformation chose to follow different strategies (Andreff, 2005). The outcome is quantitatively similar in the three countries considered: three quarters to four fifths of the economy belongs in the private sector (Vagliasindi & Vagliasindi, 2003). In this and the following section I sketch the basic features of the post-transformation development that are useful to understand the present situation as depicted in the following chapters. The three cases can be summarized as follows.

Czech Republic

When transformation started, the Czechoslovak economy was macroeconomically well balanced and firms, nearly all large and state owned, were disciplined under the control of central planners (Bönker, 2006). This created a favorable context for institutional experimentation, supported by the great democratic and theoretical tradition of the country. The primary method of privatization was mass privatization based on the free distribution of vouchers to all citizens. This was intended to do away with the intractable problem of market evaluation of SOEs and to disperse ownership of privatized firms. Direct sales were also used, but were less important. The typical method of insiders' privatization, i.e. management and employee buy-out, was not used.[3]

Voucher privatization is a sort of textbook experiment expected to have the benefits of a competitive market economy and to create a large class of share owners loyal to the government. The Czech experiment, then, can be seen as a kind of inductive transplantation of institutions, i.e. from a model. This was in contrast with the traditional concentrated character of the Czech economy and the population's lack of interest. The outcome has been consequently full of unwanted and unforeseen consequences (see Chapter 3 in this book). In spite of guarantees that the government wisely introduced (prohibition of secondary markets of vouchers), together with benign neglect of others (e.g. the original owners and capital of funds), large investment funds and banks have taken easily control of the firms, initially as proxies of individual citizens.

The advantage of this solution is to stop soon the uncertainty that typically dominates firms during the privatization process. The latter has been reasonably fast and orderly. The disadvantage is that it did not create true owners. The owners (the citizens) have been passive and interested in getting satisfactory rents, not competing for profit.

Prolonged fights have ensued for the control of firms among investment funds, banks and the firms' management. The numerous investment funds, often established by (state-owned) banks, started to specialize and restructure their control over the firms and increase their independence from the funding banks. They have become soon involved in mutual share trading to simplify their profile. The consolidation of the sector has decreased the number of investment funds and increased their size.

Banks have been interested in controlling the funds and cleaning their portfolio from the bad debts that the government left in the banks to avoid jeopardizing the privatization of firms. This prevented banks privatization and sound management for many years. So banks could only hope to solve the problem by keeping the control of investment funds and extracting rents from them, i.e. from the firms they controlled.

The firms' management has tried to reach independence from the controlling investment funds and strengthen their control over the firms. They also pursue a decent performance, but this is not their primary goal, since few shares are freely traded in the market and their controllers, the investment funds, have been short of the necessary control skills for time and have engaged in more essential games.

Economic performance has suffered from the prolonged uncertainty not over the ownership of firms, but over their control. Resources have been used to gain or strengthen control, not to finance investments and innovation. It has also suffered from the postponement of cleaning of the banks portfolio from bad debt, strengthening competition, delaying bankruptcies. Economic performance has remained a secondary goal until the primary issue of control was solved, which happened only in this decade.

Hungary

In Hungary deep reforms were implemented since the Sixties. Before transformation started, the most important market laws were approved and enforced, many institutions were already in place, actors were transacting in a quasi-market context and an entrepreneurial culture existed (Bönker, 2006, pp. 70–4; Laki, 2006). This made possible to use, and the large domestic and external debt prompted the country to choose, a piecemeal pragmatic process of privatization, close to an externally enforced organic process (see Chapter 6 in this book).

There has been also an important case of transplantation of institutions. Foreign ownership became very important since the beginning via privatization and even more so via greenfield investment. Indeed, direct sale particularly to foreign investors was the primary privatization method. Management and employee buy-out was also largely used, while mass privatization, although proposed and debated, was never implemented.

Foreign-owned firms have thus embodied the new quasi-transplanted institutions that have spread to a part of Hungarian-owned firms by means of competition and cooperation, including the establishment of joint-ventures and vertical integration. One important consequence of this development has been the establishment of a dualistic economy whereby competition and cooperation have remained primarily *within* each separate segment (Farkas, 2000; Szanyi, 2002; Tóth, 1998), although counterexamples can be found (Radosevic & Yoruk, 2001; Stark & Vedres, 2006). Apparently the fault line goes between branches more than ownership: expanding branches are increasingly integrated, while mature branches are dualistic. Thus the inflow of foreign capital has solved momentarily macro-imbalances at the cost of endogenous development opportunities.

The foreign sector has resulted exceedingly successful, and has pulled a dynamic growth path. However, this success is mostly limited to the foreign-dominated sector: the remarkable growth and export performance of the Hungarian economy since mid-Nineties is largely due to some 200 foreign owned companies. This massive and successful inflow of foreign capital has pushed the development of corporate governance in Hungarian firms both directly (in foreign owned or mixed firms) and indirectly in domestic owned firms operating in dynamic branches. The latter effect took place by means of competition, imitation, integration, cooperation, and a skilled governmental regulation. The development, hence, was mainly organic.

Russian Federation

The Soviet economy was apparently characterized by a high degree of centralization. However, in particular after Gorbachev's reforms individual managers had an effective control of enterprises, also by means of strong political and social interpersonal networks. Since enterprises were regionally concentrated and dominated the life of the locality, managers and local politicians shared effective autonomous power. Russia represents then a third important case, different in many senses from the preceding ones.

First, the Russian economy was in the most difficult situation, due to a prolonged stagnation, the destabilizing effects of Gorbaciov's *perestrojka*, and political fights. The macroeconomic situation was unbalanced, and the government's control over firms was nearly lost. The planning system became largely ineffective and no alternative coordinating mechanism replaced it.

Second, the beginning of transformation coincided with the disappearance of the Soviet state and the secession of all the non-Russian republics. This had dramatic implications for the economy that went beyond the need to rebuild public administration. Indeed, the huge monopolistic companies that characterized the Soviet economy had establishments dispersed in different republics. With the disruption of the Union, most companies were truncated of entire production processes or had the headquarters in other republics. The most urgent goal of Russian firms on the eve of transformation was to rebuild production chains or develop new trade ties to replace the lost parts.

Third, there was a urgent need to stabilize the economy. However, Yegor Gaidar's government implemented a harsh stabilization plan when the prevailing budget constraint was still soft. Increasing interest rates, introducing credit crunch, liberalizing foreign trade, pursuing exchange rate stability which led to real appreciation of the ruble without far-reaching institutional reform led to booming interenterprise and other types of arrears without changing substantially the behavior of companies. The economic situation worsened substantially.

Fourth, political and economic uncertainty and the negative consequences of macroeconomic stabilization policies discouraged foreign investment. With the important exception of the mining and energy industry, it was difficult for Russian companies to export, due to the low quality of their production and the strong ruble. At the same time, the important domestic market shrank due to: the critical situation of nearly all enterprises, lack of payment means, high unemployment and low incomes, the strong ruble, the preference of Russian consumers for imported goods. Only the 1998 financial crises have re-established a decent situation for Russian firms.

Fifth, the privatization process was more difficult, disorganized and corrupt (see Part IV in this volume). Two privatization methods stand out for their important consequences. One was mass privatization through vouchers and included management and employee buy-out. Contrary to the Czech approach, vouchers trading was allowed since the beginning on a secondary market. Due to high inflation the real value of vouchers diminished rapidly, managers could buy a great amount from other employees, and a concentrated control dominated by managers progressively replaced the initial widespread distribution of ownership among different types of insiders. Contrary to typical buyback operations in well-established market economies, whereby managers buy shares to gain control, in Russia managers used their control to acquire ownership and make their control undisputable. Until this process was over, however, owners remained weak and intent in dealings other than restructure and compete.

The other privatization method consisted of 'loans for shares' schemes. Due to the government's inability to repay the credit obtained by selected banks belonging in financial–industrial groups under the control of a core bank or an 'oligarch'[4] (i.e. a major shareholder of the group), the collateral, typically the shares of 21 among the most valuable firms in the mining and energy industry, was transferred to those groups for a cost that was a share of their value. Although the new owners were powerful and could provide firms with strong corporate governance structure, transparency was less then tolerable and the dealings under constant threat by justice, the press, and the government. The new owners were consequently intent in consolidating their control and protecting their ownership.

These developments led to the 1998 financial crisis, which has represented an important turning point in the Russian economy and corporate governance (see Part IV in this volume). As a consequence of the crisis, ownership redistribution and concentration have accelerated through different channels (including bankruptcy procedures, hostile acquisitions, corporate stock manipulations) and new market actors emerged, particularly business groups (holding companies). These business groups – including regional and local groups and also involving external investors – became the main buyers of shares in Russia, typically outside the stock market. Overall, through these processes dominant owners strengthened their dominance over minority shareholders, although the real nature of external investors and their relation to insider dominant shareholders remain to be clarified.

These developments have had important consequences for corporate governance in each of the three countries.

Corporate governance and transformation strategies: a comparative view

The three cases discussed in this book represent three different types of transformation. The Czech Republic offers a nearly textbook case of technically successful, nearly bureaucratic transformation ridden with unforeseen consequences. Hungary – similarly to Poland – represents a case of quasi-organic transformation with an embedded institutional transplantation via direct foreign involvement that was preceded by the enactment of new laws addressed to preventing, with partial success, the private misappropriation of public assets through self-dealings and sale to related parties. Finally, Russia is the prototype of disorganized transformation starting from orthodox macropolicies disregarding the institutional context. This situation was partially adjusted at a later time and made economically viable through the shock of the 1998 crisis. From these different strategies three different types of corporate governance derived.[5]

Corporate governance in the Czech Republic became a three level game. First was the issue of the governance of investment funds or, better, of who between investment funds and banks controls whom (Stiglitz, 2001). Investment funds were typically established by state-owned banks, thus had often a unique owner. However, they acquired soon dispersed ownership by voucher owners. They became the potential controllers of Czech firms, having concentrated about three-quarters of the vouchers that citizens preferred to redeem into shares through investment funds. However, their portfolio was initially dispersed due to the limitations that the law imposed against excessive concentration of ownership and control. This situation was unstable, since banks were bound to be privatized and their portfolio was ridden with bad debts of SOEs. Consequently, banks strategies were addressed to extract benefits from ownership to stabilize their financial situation. Investment funds strategies were to become independent or, during the banks' privatization, to reverse the ownership relation.

Second was the issue of the governance of firms by investment funds. Investment funds were new actors without experience in controlling privatized firms in a new, market context. Their portfolio was initially dispersed among many firms, so their control was soft. Further on they started to trade shares to concentrate their portfolio and strengthen control.

Third was the issue of governance within firms. Firms were at the crossroad of complex relations among different powerful stakeholders. One should also remind that the firms' employees were often shareholders of those same firms or of the investment funds that controlled those firms. The dominant paradigm was therefore a rather complex version of the stakeholders' interest paradigm with secondary interest for growth and innovation issues.

In Hungary the most prominent feature is the dualism that developed between foreign-owned and those domestic firms that operate in the stagnating branches of the economy. The former group of enterprises is a remarkable success story, although corporate governance is largely outside Hungarian control (see Chapter 6 in this book). In these firms a rather normal shareholders' value paradigm can do a good job, supported as it was by a continuous and sustained inflow of financial resources, technical skills, and human capabilities. Although this success relies heavily on the outcome of economic reforms since the late Sixties, important aspects of the innovative enterprise paradigm have been introduced through foreign investors when some of them decided to base part of their innovative strategies in Hungary. In the stagnating domestic branches corporate governance remains a marginal issue, since survival is the dominant game together with the attempt at obtaining some form of government protection, and at least a benign attitude towards tax evasion. According to the finding of comparative research (Kaplan, 1997), in stagnating branches corporate governance may make the difference, but in Hungary the prevailing paradigm is a sort of entrenched stakeholders' interest, aimed at granting survival. The good news is that this weak sector is progressively shrinking, also thanks to firms restructuring.

During the Nineties, in Russia insiders (typically managers) and the financial–industrial groups dominated most firms and branches. The nature and role of corporate governance is different in these two cases. In insiders' dominated firms a kind of stakeholders' interest dominates, the fundamental stakeholders being managers and employees, but also regional and local governments. As far as managers are able to strengthen their position and new external owners enter, the structure and function of corporate governance change. Initially corporate governance was aimed at keeping the balance of the dominant insiders' coalition of managers and employees to protect employment by typically bargaining with governments, most often regional governments. As far as managers strengthen their position and control over firms, they concentrate more on extracting private gain, often in coalition with friendly outsiders. In the sector they dominate, oligarchs have no competitors for the control of the firm and corporate governance is entirely in their hands, except for the government, with which they have to find an accommodation. When the latter have become stronger and threatened the dominance of the oligarchs, the latter have used their control to transfer their assets in places and forms that provide better protection from governmental interference and justice prosecution. Therefore corporate governance in this sector is particularly attentive to the value of dominant shareholders, although hardly so to the needs of minority shareholders and innovation.

The situation changes considerably following the 1998 crisis (Iwasaki, 2005). The main changes are the selling of shares by employees; a significant increase of shareholding by external investors; and the weakening shareholding by the state. Notable are also the launching of initial public offerings (IPOs) by a number of Russian companies on Western stock exchanges, and high growth in the market of corporate bonds (see Part IV in this volume). However, as Dolgopyatova shows, there is a tendency to decrease the number of the board's members, insiders' representatives are predominant in the boards, and internal (workers' teams) and external (regional and local governments) stakeholders have important roles in corporate governance and often form coalitions with the management. As a consequence the monitoring role of boards remain largely formal.

Although ownership concentration after 1998 has had important positive consequences for corporate performance and restructuring, in particular in firms belonging in business groups, corporate governance remains problematic. Indeed, these developments pointing at a formal, more than structural evolution of corporate governance shed a shadow on the real meaning of external investors. Also the paternalistic and sometimes interventionist role of the state apparently pushes the latter's role beyond formal ownership in influencing the firms' governance. As a consequence, the critical issue of corporate governance is the relation between dominant (insider) shareholders and minority shareholders and the private gain from control to the advantage of the former, also by use of illicit or illegal means (Iwasaki, 2005, p. 7). The structuring of majority owners in multi-level chains strengthens their control, covers the true structure of ownership in many firms, and protects dominant owners from the threat of takeover. Managerial entrenchment is also pursued by the managers' representation within boards, which is typically higher than their shareholding. Since managers typically dominate boards, external suppliers of finance are extremely reluctant from financing firms, which have to rely on alternative channels and particularly self- and group financing. However, one should be careful and take in due consideration the different typologies of firms that are an important feature also of Russian capitalism (cf. Part IV in this book).

Conclusion

In no country corporate governance has become really and fully sound. The best results have been obtained by foreign investors, including many transnational companies, although this is so when institutional transformation paved the way. Since foreign influence can hardly spread to the entire economy – except perhaps in the case of tiny countries – this development can create dualism within the corporate governance system of a country. When the domestic sector is stagnating and perhaps shrinking, firms find it impossible to imitate successful firms and competition loses strength.

The most problematic outcome is when the distance between existing (informal) institutions and the new (formal) institutions is great. In this case reforms and policies are either irrelevant, or actors in a favorable position use them to pursue their private goals. The Russian case has shown that corporate governance reform fails when the institutional framework is blurred. In this case the dominant game is either wait and see whether the government is willing to soften the budget constraint or use any opportunity to plunder the state through grabbing and rent seeking. Only a dramatic financial crisis could establish the conditions for partially streamlining corporate governance to the needs of a modern market economy.

An institutional game such as the voucher privatization in the Czech Republic has proven that there are no shortcuts even in this case and even starting from disciplined and macroeconomically favorable situation. The enforcement of new (formal) institutions can be relatively rapid, but a long time elapses until those institutions become actually effective, a period that is replete with complex and costly processes of adaptation and learning. Costs and difficulties may be higher if the initial success nurtures the illusion that the game is over. In this case unforeseen consequences may create uncertainty and make adjustment processes lengthier and costlier and related policies less effective. In this case careful policy guidance may be necessary to reach satisfactory corporate governance.

Another important comparative conclusion is that the paradigm that will prevail when the fundamental transformation processes are over depends upon the privatization strategy and policies, and the nature and capabilities of the new owners, given external influence. The most important of the latter is EU access and membership, since this gives standards and predictability. If privatization relies on organic processes, if the new owners have long run productive strategies, and if the external influence is virtuous (in the sense of pursuing an orderly corporate governance of firms in a competitive context), chances are that the new corporate governance system will be effective and will direct firms to innovate and compete.

A last issue remains: how stable are the three different types of corporate governance here considered? Are they transitory structures that converge towards a ‘Central Eastern European model of corporate governance’ (Andreff, 2005, p. 29). This is a complex issue that perhaps needs some maturation before an answer is possible. However, the convergence perspective underplays the role of institutions. Since institutions matter (Bennedsen *et al.*, 2005; Engerman & Sokoloff, 2003; Rodrik, 2003; Rodrik *et al.*, 2004; Rodrik & Iyigun, 2005), and differ among countries in transformation, chances are that no Central Eastern European model of corporate governance is likely to develop or that such a model is so differentiated that it loses any theoretical and practical meaning.

An obvious caveat regards the influence of the EU. Two of the countries here discussed are members of the EU and are adopting EU institutions. However, both present remarkable differences in their transformation and privatization paths, economic structure, firms size, role of foreign capital, nature and role of governments, economic and political culture, and their corporate governance systems must reflect these differences. Moreover, the basic EU principle of subsiadiarity does not require institutional uniformity. As to Russia, her size and culture makes quite unlikely that EU institutions will have any important influence. Convergence, if proper conditions do not exist, is a costly and ineffective game.

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Notes

1. According to Andreff (2005) the supporters of an 'organic development' strategy in transformation countries in early 1990s included himself, Wlodzimierz Brus, David Ellerman, János Kornai (1990), Kazimierz Laski, Ronan Mc Kinnon, Lubomir Mlcoch, Peter Murrell, Gérard Roland, David Stark and, later, Joseph Stiglitz (2001). This list also includes Hans-Jürgen Wagener and myself (Dallago, 1991).
2. For an interesting political economy interpretation see Müller (1999), Bönker (2006).
3. Management and employee buy-out is usually considered a sub-optimal strategy on theoretical grounds. There are also reasons to attribute this outcome to negative selection effects, since this kind of privatization is often limited to the most problematic state-owned companies. However, this is not always the case. The Polish case shows that this kind of privatization may have provided powerful incentives to critical stakeholders to increase their effort and employee ownership has protected many firms from asset stripping by incumbent managers.
4. According to Radygin (2000), by 1994 insiders controlled nearly two thirds of Russian industrial assets and outsiders a share between one eighth and one fourth. In 2000 these shares changed respectively to one-third and slightly more than half. Since outsiders are mostly financial-industrial groups, the two methods discussed above account for the large part of the Russian economy.
5. Andreff (2005, p. 27) adds a fourth, mixed model based on an 'employee and start up' control typical of Poland leading to capital and liquidation privatization creating new start ups and an inner supervision of the firm by its employees.

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