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CORPORATE GOVERNANCE IN TRANSITION ECONOMIES:
LESSONS FROM RECENT DEVELOPMENTS IN OECD MEMBER COUNTRIES

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FOREWORD

In 1995, the OECD, with the participation of the French Ministry of Industry, Postal Services and Telecommunications and External Trade and of the Corporate Governance Forum, Sweden, held a Conference on "The Influence of Corporate Governance and Financing Structures on Economic Performance". The Conference addressed corporate governance in transition economies, taking account of experience in OECD countries.

Participants focused on issues such as the relative merits of banks and securities markets in carrying out corporate governance, and assessed the impact of external forces, in particular the internationalisation of business activity and demographic changes. Trends in corporate governance in OECD countries suggest that owners are increasingly active in monitoring management's role in ensuring the competitiveness of individual firms.

This paper charts the development of corporate governance in the transition economies, showing how, in the initial phases of transition, the existence of hard budget constraints and the prospects of imminent privatisation typically led to management behaviour similar to that found in firms whose owners are exercising effective governance. The method of privatisation influences the subsequent evolution of corporate governance.

OECD experience shows that effective corporate governance is generally lacking in cases where the state remains a major owner of large firms. This phenomenon is most noticeable in countries where the scope for political change is limited. Privatisation methods that favour bank ownership and cross-ownership, while offering the advantages of a long-term perspective, might fail to address the immediate needs of firms to undergo restructuring.

Pension funds have yet to emerge as important players in corporate governance in transition economies. On the other hand, foreign direct investment has served to introduce new mechanisms such as management contracts to exercise control. An increasing use of foreign banks as a source of loan capital can be expected to result in improved corporate governance.

The paper was prepared by Prof. Josef C. Brada, Arizona State University, USA. The opinions expressed therein do not necessarily represent the opinions of the OECD or its Member countries and should therefore be viewed solely as those of the author. The paper is published on the responsibility of the Secretary-General of the OECD.

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CORPORATE GOVERNANCE IN TRANSITION ECONOMIES: LESSONS FROM RECENT DEVELOPMENTS IN OECD MEMBER COUNTRIES

by Josef C. Brada, Arizona State University

I. INTRODUCTION

On 23 and 24 February 1995, the OECD, with the participation of the French Ministry of Industry, Postal Services and Telecommunications and External Trade and of the Corporate Governance Forum, Sweden, held a Conference on "The Influence of Corporate Governance and Financing Structures on Economic Performance".

In his opening address to the Conference, M. Jean-Claude Paye, Secretary General of the OECD, stressed that product markets and capital markets are being rapidly liberalised and globalised. Many firms benefit from this process because they have a wider scope for their activity and a greater choice of sources of financial capital. At the same time, some firms suffer from these developments both because of more intense competition on product markets and because they no longer have easy access to domestically-generated savings due to the fact that financial intermediation can now place these funds in foreign capital markets if foreign firms can better utilise these funds. In such an environment, only firms that are well governed will be able to have access to capital markets, and only if there are well-governed firms will capital markets be able to finance adequately the corporate research, development, innovation and capacity expansion needed for long-term competitiveness.

Mr. Mats Isaksson, Chairman of the OECD Industry Committee Working Party on Framework Conditions for Industry, echoed these sentiments stating that "corporate governance is ...an important parameter shaping the quality of the business environment," and that "the...rapid international integration of economic activity and the striking diversity in national corporate governance practices" makes the issue of proper government law-making and regulation, jointly with the evolution of private-sector practices in the area of corporate governance, a particularly important one in the effort to maintain and improve national competitiveness in the global market.

Although the Conference dealt with governance issues in OECD countries, the themes sounded by the Secretary-General and Mr. Isaksson apply with equal, if not greater, force to the transition economies. If the pressures of the internationalisation of product and capital markets have come with some rapidity for the OECD countries, they have come with cataclysmic speed for the transition economies. The internationalisation of these economies, and the concomitant pressures to achieve competitiveness on global product markets and to gain access to foreign capital markets, have emerged in the space of a few years. Thus, if these countries are to prove successful in their efforts at transformation, there are important lessons about designing corporate governance structures that they can absorb.

The Conference was divided into four Sessions, each with a specific theme. Session 1 was devoted to an examination of trends in, and thinking about, corporate governance in OECD countries. Although practices differ between countries, and thus so do the views of appropriate changes and reforms, some general trends were evident. In most countries there is a perception that corporate governance can

and should be improved and that such improvements would have a positive effect on economic performance. In countries such as Japan, where banks had exercised a major role in governance, there was a trend toward the emergence of the capital market, that is non-bank equity holders, as a major force in corporate governance. The policy implications of such trends are*, inter alia*, the need to strengthen shareholder rights and to ensure that shareholders have both the desire and the means to play an effective role in corporate governance.

In countries like the United States and the United Kingdom, a similar trend toward rules and laws that strengthen the role of shareholders in the governance of firms could be seen. However, this should not be taken to mean that international pressure is working only toward laws that shift power from banks to the capital market. In the United States, and in some other OECD countries, there is also a trend toward strengthening the role of banks and other institutional investors by relaxing regulations that, in the past, excluded them from carrying out an effective corporate governance role. Thus there appears to be a measure of convergence in the mix of "suppliers" of corporate governance and perhaps, more importantly, an almost universal trend toward strengthening the influence of owners and creditors over the managers of firms.

This convergence of governance forms and the desire to strengthen governance over firms should be of interest to policy makers in transition economies. There the dangers of entrenched managers are perhaps much greater than in OECD countries, and owners are also weaker and less experienced. Thus laws to promote the transparency of governance mechanisms, to establish the independence of boards of directors or supervisory boards, to create shareholder democracy and to strengthen the ability of institutional owners and banks to act decisively are needed, and a reading of the papers in Session 1 provides a number of practical suggestions for steps in this direction.

Session 2 examined in greater detail the role of large institutional investors in governance. While institutional investors have the motivation to exercise effective governance, and while they may enjoy important advantages in the collection and utilisation of information in carrying out their governance activities, a number of participants raised the question of what the objectives of such institutional investors might be. That is, effective corporate governance assumes that the owner has as his objective wealth maximisation, and that he will, in his governance activities, seek to impose that objective on the firm's managers. Institutional investors may not behave in the same way. First, how they themselves are governed determines their effectiveness in governing other firms. Second, as institutions they may have objectives other than wealth maximisation. For example, a bank with both loans and an ownership stake in a firm may prefer corporate policies that slow the growth of profits but generate more cash or that are less risky, thus insuring the safety of its loan at the expense of the firm's long-term value. Similarly, a pension fund may prefer large dividends rather than growth and the associated capital gains if the stock market is thin.

Such considerations are also of importance in transition economies where, as we have seen, institutional shareholding is, either by design or by accident, very extensive. Again, the papers presented in Session 2 provide a number of practical examples or suggestions that should be considered by transition economy policy makers for reconciling institutional activism with prudential regulation.

Banks are, of course, a special type of institutional investor, and one whose role across OECD countries differs the most. Consequently, Session 3 was devoted to the evolution of bank-firm relations. There was general agreement that regulations for the extreme separation of banks from the ownership of company shares in the United States should be modified, as should regulations on other institutional investors, but in other countries there seemed to be no similar trend toward strengthening the role of

banks. In part this was either because existing arrangements for bank involvement were seen as more or less satisfactory or because, as in the case of Japan, the role of banks was expected to decline.

Given the major role of banks in transition economies and the fragility of their independence from the government and from their clients, there is much for policy makers in transition economies to ponder in this discussion. On the one hand, they are tempted to rely heavily on banks for governance, all the more because there are few agents in transition economies capable of providing effective governance. On the other hand, by linking banks and firms in a strong way, they expose banks to serious risks in what are still very volatile economies and firms to governance that may be too conservative to achieve the necessary restructuring and to build competitiveness.

The last Session was devoted to the role of pension funds which, mainly because of demographic and policy developments in OECD countries, have become major holders of company shares. A number of the papers brought out examples suggesting that pension funds were not entirely passive owners, but at the same time that they tended to intervene in the affairs of firms only in unusual circumstances. The transition economies do not as yet have large pension funds. However, these may come in the future, and in the meantime there are National Property and Restitution Funds, whose managers might well learn from the practices of pension fund managers in OECD countries.

While the Conference was based on concrete practices of, and policy proposals under discussion in, OECD countries, it would be an underestimation of the Conference's achievement if the lessons for transition economy policy makers were to be limited to the mechanical or practical aspects of writing appropriate laws and imposing the necessary regulations. Indeed, perhaps the best lessons for transition economies come from the broader themes of the Conference: whether there is some discernible trend in the improvement of corporate governance mechanisms in OECD countries; whether such a trend, if it exists, has some common threads across countries; and whether there are forces other than internationalisation and competition that are at work altering governance practices. It is only by understanding these issues that policy makers in transition economies will be able to judge how active in forming governance practices they should be and how much of the task should be left to the emerging private sector.

However, before the lessons of the Conference can be drawn for transition economies, it is important to understand fully the situation in these countries. Therefore the following sections of the paper set out to describe who the actors in corporate governance are in these countries and their objectives and the legal and institutional constraints under which they function. Once this background has been set, the paper returns to an interpretation of the broader implications of the themes of the Conference for the design of corporate governance mechanisms in transition economies.

In market economies, the issue of corporate governance largely focuses on the mechanisms whereby owners of enterprises exercise their rights of control over the managers who run these firms. Because many large corporations are financed through both equity and debt, the rights of creditors to exercise a measure of control over managerial behaviour also form a central part of corporate governance. Although these two groups of stakeholders in the firm have partly conflicting and partly overlapping objectives, they face a common set of problems.[1] They require information about managerial actions and their consequences for the firm as well as about the environment facing the firm, and they use such information to evaluate managerial performance by adjusting the firm's performance for exogenous influences. Each group also needs to co-ordinate the actions of its members to make collective evaluations of managerial performance and to control managers' behaviour and tenure. Finally, both groups need to design mechanisms for rewarding and punishing managers to induce them to act in the interests of owners and to make strategic decisions.

The efficacy with which corporate governance mechanisms serve the interests of these two groups of stakeholders influences the quantity of equity and credit that will be available to the corporate sector. It also influences the nature of the corporations that will emerge. That is, different types of corporate governance structures are likely to provide different combinations of owner and creditor rights and managerial incentives and autonomy. These differences, in turn, have a systematic effect on the size, sectoral composition and behaviour of firms, and these outcomes consequently will influence the competitiveness of firms from one country relative to firms from countries with other forms of corporate governance.[2] The relationship between the nature of corporate governance and the size distribution, strategies and growth of firms is very clearly shown in the Conference papers by Barca (1995) and Kodaira (1995).

While both the conceptual framework for, and the consequences of the existence of effective corporate governance structures apply to the economies in transition from socialism to capitalism, the concept of corporate governance needs to be expanded to include a broader set of stakeholders in the firm and to take into account the non-existence or recent emergence of relevant institutions and market mechanisms. Due to the extensive changes that take place in the internal organisation of enterprises and in their interaction with outside agents and the environment in the course of transition, some systematisation of the elements of corporate governance is necessary. The framework employed here is that of decision-making-information-motivation (DIM)[3]. The decision-making component seeks to identify those who have some stake in enterprise behaviour and the right and ability to influence or control that behaviour. Information means identifying the nature and amount of information available to decision-makers about each other, about the firm and about the firm's environment and its effect on the firm's performance. Finally, motivation means both the objectives of decision-makers and the means by which they motivate or otherwise influence each other's behaviour.

II. CORPORATE GOVERNANCE IN CENTRALLY PLANNED ECONOMIES: LEGACIES FOR THE TRANSITION

Due to the fact that the transition is from more-or-less centrally planned economies with predominant state ownership to market-based private property economies, understanding the institutional and behavioural legacies of the old system on the emerging decision-making, information and motivational structure of corporate governance is critical. Equally critical to the understanding of issues surrounding the emergence of new forms of corporate governance in transition economies is the fact that many of the shortcomings of the former system were due to massive and pervasive failures in the system of corporate governance that existed under central planning and social ownership of capital.

In the classical command economy, enterprises were the property of their "founding organ," usually the ministry in charge of the branch of the economy in which the enterprise's chief activity lay. The ministry exercised control rights over the enterprise largely through the plans that specified the output to be produced and the human, physical and financial resources to be utilised. The ministry itself was subject to a similar plan for the entire industry in its charge. The ministry as owner could also abolish the firm or merge it with other units, and it had the right to appoint and dismiss the manager. The ministry's information set consisted of the aggregate plan of production and input utilisation to which it was subject, to the past outputs and input utilisation of the enterprises it owned and to firm-specific information about each firm's production potential provided by managers in the form of draft plans for their enterprise's future activities. The firm's information set consisted of its knowledge of its production possibilities, of the plan imposed on its ministry and of the input-output plan imposed on the firm by the ministry. Managers were motivated to follow the plan by considerations of tenure and career development and by bonuses paid for fulfilling and exceeding the output plan. The ministry, because it had no rights to the

profits of individual enterprises, was also motivated largely by considerations of plan fulfilment (Granick, 1980).

Serious problems of corporate governance are inherent in even this abstract model of the command economy, and these problems were amply evident in practice. To the extent that managerial rewards depended on fulfilling output targets and the targets themselves on information provided by managers and on the enterprise's past history of production, managers had an incentive to distort both. The former was achieved by overstating input needs and understating potential production, the latter by avoiding overfulfilling plans by excessive margins. Moreover, managers would eschew actions, such as the introduction of new technology, that could disrupt current production, and they sought to avoid interruptions to production by hoarding inventories and maintaining excess labour and capacity.

That these behaviours were wasteful and contrary to the objectives of the enterprises' owner, the state and its industrial ministries, was widely understood and addressed by a series of reforms, such as those proposed by Evsei Liberman (1962), which sought to devolve greater decision-making rights to managers while changing the incentive structure to elicit truer information from them so that planning and its implementation through more effective corporate governance could be improved. Other reforms, most notably the Hungarian New Economic Mechanism, also sought to increase managerial incentives, but not with a view toward improving enterprise responsiveness to the plan. Rather, the objective was to allow the enterprise to be guided by parametric prices, with profit playing a greater role in the objectives of managers, thus obviating the need for detailed plans and strengthening corporate governance through indirect incentives.

These reforms in corporate governance were only partially successful at best, because the conflict between the owner's desire to determine in some detail the output of enterprises conflicted with the greater autonomy assigned to managers. Moreover, greater autonomy, if it was to produce beneficial results, required the existence of functioning markets, banks and other institutions, and compromises between plan and market solutions led to new pressures for managers to avoid meeting the objectives of owners.

Reforms leading to greater managerial autonomy also exacerbated the shortcomings of the socialist model of corporate governance. Some of these shortcomings emerged due to the fact that reality was more complex than allowed for by the theoretical model. One such complication was the existence of stakeholders other than the ministry. These included the Communist Party and local governments, both of whom played a role in managerial selection. For local governments, the enterprise represented both a source of power and resources and a political asset to be nurtured and developed. Thus managers had to respond to Party campaigns and local government needs. Decentralisation also changed the role of banks from pass-through institutions for the provision of investment and working capital, but their ability to influence managerial behaviour remained constrained by the emphasis of ministries on increasing production, by the lack of bankruptcy provisions and by the easing of financial limits on enterprises by means of the soft budget constraint. Finally, in some countries, notably Poland and Hungary, workers also assumed a major role in corporate governance through worker councils that assumed the right to elect managers and to approve strategic and operational decisions.

The system also faced informational problems. The tautness of plans made it difficult to evaluate managerial performance because such exogenous shocks as non-delivery of inputs could disrupt production. For most enterprises, physical planning of outputs proved impossible, and thus targets were stated in monetary terms that aggregated outputs by means of arbitrary prices. This encouraged managers to manipulate the assortment produced for their own advantage: counter to the objectives of the ministry (Montias, 1977).

The socialist enterprise's multiple stakeholders often sought to impose conflicting objectives on managers. The state had a dual role to play: as the owner of the enterprise it should have sought to defend its interests in the enterprise's behaviour against the pressures of other stakeholders, but, as the final arbiter of social conflicts, it had to work for a broader reconciliation of social interests. The result was that the state often sacrificed its ownership interests in order to avoid or resolve social conflicts, for example by agreeing to higher wages or not shutting down inefficient plants in order to placate workers or local politicians. Thus, although the state was in theory a powerful owner, the inherent shortcomings of the system prevented an effective system of corporate governance from emerging. Efforts to grant greater autonomy to managers or to devolve a measure of control rights to workers failed to resolve the shortcomings of the system.

III. CORPORATE GOVERNANCE IN THE EARLY PHASES OF TRANSITION: INSIDER CONTROL

The lamentable performance of state-owned enterprises (SOEs) prior to the start of transition gave rise to widespread expectations that the state enterprise sector would be utterly unable to respond effectively to a new market-based environment. Some observers doubted that managers whose skills had been developed primarily in production and in lobbying for subsidies and resources could develop new skills in areas such as finance, marketing and quality control. Others, Kornai (1990, p.62), Lipton and Sachs (1990 a, b), Aghion *et al.* (1993) argued that SOEs could not be weaned from dependence on the soft budget constraint and that the inevitable decline in the state's ability to exercise its ownership role would lead to a shift in power to insiders, either managers or workers.

Such a transfer of power to insiders was viewed as dangerous and incompatible with a successful transition for a number of reasons. First, SOEs were expected to remain inflexible in their reaction to developments on output markets, where, it was thought, they would exercise their monopoly power to raise prices, thus fuelling inflation, as well as on input markets where they would be unwilling to shed labour and adjust to higher energy and input prices. It was also believed that managers and workers would seek to decapitalise SOEs, using up the firm's assets to sustain unwarranted increases in managerial salaries and workers' wages. Finally, it was expected that managers would seek to gain ownership of the assets of SOEs by means of spontaneous or so-called *nomenklatura* privatisations that shift the SOEs assets, but not its liabilities, to a private firm owned by the managers or that they would attempt to collude with foreign buyers in selling off the assets of the SOE for low prices in return for promises of job security under the new foreign owner.[4]

While these expectations have to some extent been borne out in the Central European economies, certainly in Czechoslovakia[5], Hungary and Poland, and likely in a number of other transition economies, after some hesitation in the face of the initial shocks of transition and the collapse of CMEA trade, SOEs have responded flexibly and rationally, more or less along the lines expected of firms whose managers are responsive to the objectives of wealth-maximising owners. Before we turn to the evidence on SOE behaviour in this period and the reasons why such behaviour emerged, we first examine the changes in the role of insiders and outsiders in corporate governance in this period.

An important change in the status of SOEs in the early transition was corporatisation, which converted the SOE into a corporation, albeit usually one that was wholly-owned by the government. The shares of corporatised SOEs were held either by their founding ministries, by a Ministry for Privatisation, or by specialised ownership agencies -- such as the Czechoslovak Fund for National Property. As corporatisation was a prelude to privatisation, it proceeded more slowly in Poland, where workers resisted giving up the control rights vested in workers' councils, and more rapidly in Hungary and Czechoslovakia

where corporatisation likely strengthened the power of managers and reduced that of the government. This decline in government power occurred because corporatisation broke the direct bureaucratic supervisor-supervisee relationship that existed between a ministry and its subordinate enterprises and also because state ownership agencies or ministries were often unable, and in the Czechoslovak case at times openly unwilling, to exercise strong ownership prerogatives through supervisory boards of corporatised SOEs. The withdrawal of the government from an active role in the formal governance structures of SOEs thus strengthened the power of insiders, primarily workers in Poland and managers in Czechoslovakia and Hungary.

While the retreat of the state from a formal ownership role was in train, the role of banks was being strengthened, although to what degree is difficult to judge. In Czechoslovakia and Poland, the Communist-era monobank was broken up into a western-style central bank and a number of commercial banks in 1990 and 1989, respectively. In Hungary such a reform of the banking system had been carried out prior to the start of transition. The commercial banks were allocated corporate clients, along with their respective assets and debts, with an appreciable part of enterprise debt non-performing. Most of the commercial banks also remained state owned, and thus they likely experienced the same lack of state involvement in corporate governance that characterised the enterprise sector.

Worse yet, in the eyes of some observers, e.g. Phelps *et al.* (1993, pp. 23-28), this banking structure not only was incapable of exercising effective corporate governance over its clients, but it also tended to perpetuate the defects in corporate governance that had existed in the pre-transition period. Because corporate clients were assigned to banks and no effective bankruptcy legislation existed, commercial banks had no effective way to obtain an *ex ante* role in corporate decision-making or to punish ineffective managers *ex post* other than by refusing to lend to poorly-performing firms. A credit refusal was seen as unlikely given the symbiotic pre-transition relationship that had existed between bankers and SOEs. Moreover, bankers were likely to lend to customers who already had large debts to the banks in order to prevent default on these loans while at the same time awaiting a bailout of failing enterprises or a recapitalisation of banks with troubled portfolios.

Besides being ineffective decision-makers, Phelps *et al.* argue that the banks also lacked adequate information. Accounting practices were inadequate to deal with the effects of inflation on firms' accounts, the upsurge of interenterprise debt created assets and liabilities whose value was hard to judge, and banks lacked personnel trained in evaluating creditworthiness.

Under such circumstances, according to Phelps *et al.* (1993), the banks

> "were inevitably drawn into a process in which they became the main substitute for the previous budgetary subsidies provided by the state. To be sure, credit did become tighter..., but bank credits continued to provide an important way of postponing unpopular moves, such as cutting back production...or laying off workers. The further the process continued, the more dependent the banks became on the survival of their clients, and the more unable to refuse further rolling over of clearly bad debts" (p. 26).

While it is undeniable that ceding corporate governance to insiders has given rise to self-interested behaviour in a number of transition economies, including in the early stages of transition in Czechoslovakia, Hungary and Poland, and that much the same can be said for commercial banks' role in corporate governance and lending behaviour, when the record is viewed over a period of several years after the transition's start, none of these dire predictions hold for the three countries in question. Furthermore, it is likely that only lack of systematic evidence prevents other transition economies from being added to the

list of those where enterprises and banks responded rationally and with determination despite the seeming absence of owners and a role for banks in corporate governance.

The basis for the above assertion comes from an accumulating body of evidence based on surveys of firms in these countries. It includes studies of Hungarian firms by Brada, Singh and Török (1994), of Czechoslovak, Hungarian and Polish firms by Estrin, Gelb and Singh (1995) and Estrin *et al.* (1995), and of Polish firms by Pinto, Belka and Krajewski (1993), Pinto and van Wijnbergen (1994) and Pinto (1995). This body of evidence can be summed up in the following way:

- There was no wholesale decapitalisation of firms. In general, firms with positive profits tended to invest or to try to reduce debt. Neither managerial incomes nor the wage bills of SOEs have grown disproportionally; in many cases labour costs have decreased as a share of total costs,

- Managers have undertaken short-term adjustments in output and input levels that are broadly consistent with what would be expected of profit-maximising firms. Output, employment and capacity have been reduced in order to reflect the sharp fall in market demand. New marketing channels and export markets have been developed. Managers have attempted to reduce operating costs and to restructure financially so as to reduce the costs of borrowing and to reduce their exposure to the bad debts of customers, and:

- In addition to short-term responses, firms have begun to formulate long-term strategies for survival and expansion. Most notably in Czechoslovakia, large SOEs were broken up into constituent parts, with each then free to follow its own business strategy. In Hungary, many managers restructured multi-unit SOEs into a holding company and affiliates. The debts were concentrated in the holding company and available resources were concentrated on the affiliates with the greatest potential for survival. Major changes in product mix were introduced, often in strategic partnership with foreign firms. According to Estrin *et al.* (1995) and Estrin, Gelb and Singh (1995) these strategic changes were more evident in Czechoslovakia and Hungary, where insider power was in the hands of managers, than in Poland, where workers' councils limited managerial autonomy. Nevertheless, the work of Pinto and his collaborators cited above makes a strong argument that long-term adjustments were not uncommon among Polish SOEs.

The evidence on banks is somewhat sketchy, but Pinto and van Wijnbergen (1994) report that, by 1992, banks in Poland were directing credit toward profitable SOEs rather than keeping weak SOEs afloat with new loans. In a broader study, Dittus (1994) also finds evidence that the behaviour of the region's banks gives support to the belief that their behaviour was consistent with what one would expect if they were seeking to play an effective corporate governance role and that, over time, the banks were emerging as stakeholders who could play an effective role in corporate governance, at least through the allocation of credit if not through active involvement in corporate decision-making.

It now remains to explain why, in the three countries under review, despite the seeming weakening of the role of outside stakeholders in corporate governance, firms were not decapitalised or otherwise misused for the short-term gains of insiders. A large part of the explanation lies in the fact that the creation of a hard budget constraint for the enterprise sector and of functioning markets and competition represented an indirect, systemic form of corporate governance that also exists in developed market economies but that had been lacking in the centrally planned economies. A second reason is that the interests of insiders in the presence of a credible privatisation policy is to anticipate the objectives of future owners and to attempt to meet them even before privatisation takes place.

The imposition of credible hard budget constraints by eliminating subsidies, restricting credit and introducing, albeit slowly, bankruptcy legislation made both workers and managers aware that decapitalising their enterprise would lead to its eventual demise. In the face of high and persistent unemployment, it is unlikely that workers in potentially viable SOEs would prefer higher wages in the short run -- if they were to lead to the decapitalisation of the firm and its eventual demise -- over the long-term job security implied by a viable profit-maximising firm. Managers facing a job market no longer based on Party favouritism well understand that driving their present firms into bankruptcy is not a springboard for success in a market for managerial talent that is becoming more competitive over time. Pinto (1995) emphasises the importance that the managers he interviewed placed on their professional reputation and on the direct relation they make between their firm's financial status and this reputation.

The creation of functioning markets presented managers with the opportunity to respond to their new environment and in this way to secure their job tenure and develop their reputation. The realisation of a need to respond may not have been as swift among workers and the upside benefits of adjusting not as great, but even in firms where workers' councils were strongly entrenched a, sometimes grudging, acceptance of the need to react to new conditions was evident. The credibility of government policy, cutting subsidies, restructuring banks to restrain them from excessive lending to SOEs, and avoiding bailouts also played an important role in forcing adjustment, even if through the emergence of tax arrears and interenterprise debt some measure of this credibility was lost. Foreign competition, brought on by trade liberalisation and the introduction of convertibility also introduced an important element of competition; Brada and Singh (1994) document the upsurge in foreign competition encountered by Polish SOEs between 1989 and 1993.

In sum, so long as insiders were concerned with the survival of their firms, in the difficult environment of the early transition they had little choice but to react in a way that effectively mimicked the behaviour of firms whose owners are exercising effective governance. No doubt, under easier conditions where survival was assured, insiders' incentives to increase their incomes at the expense of profits would have asserted themselves more strongly. Further, it is true that insiders in firms that were unsalvageable did react in a passive way, living off the ever-shrinking assets of their firm.[6] Nevertheless, the majority of firms perceived that they did have a future that could be assured through appropriate adjustment.

The second element promoting rational behaviour on the part of managers or at least serving as a check on their willingness to utilise insider power to their own short-term advantage was the credible prospect of privatisation in the near future. Brada, Singh and Török (1994) report a number of cases of Hungarian managers who strove to improve or maintain the financial viability of their firms so as to make them attractive to foreign investors whose purchase of the firm was key to the privatisation process. Estrin, Gelb and Singh (1995) conclude that the credible prospect of privatisation was a key inducement for managers in Czechoslovakia and Hungary to formulate and begin implementing long-term strategies of adjustment and restructuring. Such long-term strategic thinking can be viewed as being consistent with, and necessary for, long-term wealth maximisation for the firm's owners. In Poland, because the privatisation program was less credible and managerial autonomy was weakened by the power of workers' councils, Estrin, Gelb and Singh report a weaker strategic response. Nevertheless, Pinto (1995, p. 25) argues that, in well-run Polish firms, "the *de facto* balance of power has shifted in favour of the manager, not surprising in view of the scarcity of managerial talent...and the rising fear of unemployment."[7]

Such long-term strategic behaviour is, of course, likely to emerge only under specific circumstances. The first of these is that managers believe that they are likely to retain their tenure once privatisation occurs. Pinto explicitly queried managers to determine that this was, indeed, their expectation, and the case studies in Estrin *et al.* (1995) support the finding that managers believed that

evidence of capable performance would make it likely that they would remain with the firm after privatisation. They also expected that evidence of good performance would help them in seeking other managerial jobs if that proved necessary or desirable. The likelihood of retaining tenure after privatisation would seem to be relatively high for managers of well-performing firms in the Czechoslovak voucher privatisation. Stock ownership was expected to be widely dispersed, and investment funds, which could hold larger blocs of shares, were expected to concentrate their efforts at dismissing managers of unsuccessful firms. In Hungary, where privatisation through sale to strategic, usually foreign, investors was favoured, retention of local managers was common. Moreover, given the slow pace of sales and lack of active exercise of ownership rights by the state, tenure for managers of firms not yet privatised also seemed secure.

The second necessary condition to induce managers to signal their ability by means of rational activity is that the economic environment is such that potential owners have some confidence that there is a relationship between the manager's ability and supply of effort and enterprise performance. If markets do not function well, allowing firms to prosper on the basis of price distortions, monopoly power, and connections or administrative and bureaucratic favours, then enterprise performance is unlikely to yield much information about managerial capabilities in a market environment. Similarly, large price swings, inflation and other random factors that influence profits tend to reduce the information that the enterprise's financial situation provides about managers. Therefore, under such conditions, managers benefit less from rational wealth- and profit-maximising behaviour and have a greater incentive to engage in self-interested behaviour at the expense of objectives that current or future owners would want the firm to follow. Thus the rationality of prices, the absence of government controls and subsidies, the existence of competition from domestic or foreign sources, and macroeconomic stability all serve as important underpinnings for keeping managers from engaging in self-serving behaviour that is harmful to the interests of the firm.[8]

The foregoing should not be taken to mean that an optimal form of corporate governance has emerged in these countries, or even that corporate governance is as good as it is in developed market economies. Given the informational, organisational and incentive problems inherent in any form of governance, optimality is too much to hope for. What can be asserted, however, is that a system of corporate governance for SOEs has emerged in these countries that does seem to encourage profit and wealth-improving, if not maximising, behaviour on the part of managers. Because the effectiveness of this system depends in a crucial way on the imminence of privatisation, it cannot, of course, be retained as a long-run mechanism for governing SOEs. Either SOEs must be privatised or a new system of corporate governance for the unprivatised SOEs must be created.

The argument that the creation of a stable macroeconomic framework, hard budget constraints, domestic and foreign competition and expectations of privatisation, in other words, of a workable economic environment, can do much to promote rational managerial behaviour and thus to limit the ill-effects of insider control of enterprises is also supported by the quite different experience of the USSR and, subsequently, of Russia. There, prior to privatisation, such a stable economic environment did not exist, and, as a result, the available evidence suggests that insider control of enterprises led to more opportunistic and self-interested behaviour by workers and managers.

The take-over of Soviet enterprises by insiders began under *perestroika,* which, through the Law on State Enterprises and the Enterprise Law, gave considerable formal power to workers' councils. At the same time, both the moral and political power of the Party as well as the bureaucratic control that had been exercised by the industrial ministries began their steady decline. At first, workers' councils appeared to have the upper hand and at "the end of the 1980s, many managers were sacked" (Åslund 1995, p. 225). Given this uncertainty as well as the lack of effective control by government and Party, it is not surprising

that managers would seek to transfer enterprise assets to their own use and to strip the assets of the enterprise in order to meet workers' demands for higher wages.

The period of worker control lasted for some time, but gradually managers began to gain the upper hand so that, by 1992, "the general directors (in Russia) were effectively in control of the state enterprises" (Åslund 1995, p. 234). Nevertheless, their position remained tenuous (Litwack 1995, pp. 102-103) and depended very much on their ability to satisfy workers' wage and job security needs and the desire of local governments for revenues and resources as well as on their skills in maintaining relations with customers and suppliers and in obtaining access to government subsidies and low-interest credits. With growing power also came more spontaneous or *nomenklatura* privatisation as managers used the chaotic situation to protect their interests by stripping the most desirable assets from state-owned enterprises in order to ensure their future in an increasingly uncertain environment (Boycko, Shleifer and Vishny, 1995, pp. 172-173).

The absence of profits or even of positive cash flow and asset positions in enterprises mattered little to managers. Kleiner (1995) provides econometric evidence from a sample of Russian firms demonstrating that managers were not seeking to maximise profits. Boycko, Shleifer and Vishny (1995) argue that the low value of Russian firms in the privatisation process reflects the knowledge by outside investors that insiders are stripping assets and appropriating current income for themselves. The need to maximise profits, or at least to generate a positive cash flow, did not exist in the Russian environment. Subsidies, ostensibly for investment, amounted to over 20 per cent of GDP in 1992, and low interest rate credits from the central bank were almost as great.[9] Bankruptcy law was rarely invoked, and the available rehabilitation procedures left incumbent managers in place. The inability of the state to set a hard budget constraint for itself meant that it could not credibly set one for the enterprise sector, and, thus, it continued to subsidise enterprises, to pay workers' wage arrears and to countenance tax and interenterprise payments arrears.

In addition to a lack of a hard budget constraint, Russian enterprises did not face a competitive market. The Russian market remained cartelised and controlled by means of informal agreements and ties among producers. The liberalisation of foreign trade was incomplete at best and continued to be more a means of encouraging rent-seeking than as a source of discipline for domestic firms (Åslund, 1995, Chapter V). The soft budget constraint for state-owned enterprises, coupled with the lack of domestic financial assets that yield a positive rate of interest, encouraged capital flight (McKinnon, 1994), thus further limiting the volume of imports and raising their price and so reducing competition for domestic suppliers.

The inability to create an environment that would impose constraints on the self-seeking behaviour of insiders in state-owned enterprises has had a further negative consequence. This is that, unlike in Central Europe where local managers viewed privatisation favourably and worked to promote it, in Russia both managers and workers resisted privatisation. As a consequence, the design of privatisation programs differed between Russia and Central Europe. In the latter countries, privatisation was designed to grant control over the firm, at least formally, to outsiders. In Russia, privatisation could be carried out only by guaranteeing insider control because the failure to do so would, it was thought, lead to further insider looting of assets before privatisation could be implemented. Thus, the potential benefits of creating competitive markets and of stabilising the Russian economy would appear to be limited because there is little likelihood that outsiders will gain the power needed to evaluate and possibly oust managers because the possibility of future privatisation that would pass such control to outsiders seemingly has been foreclosed.

IV. ESTABLISHING A ROLE FOR OUTSIDERS: PRIVATISATION AND CORPORATE GOVERNANCE IN TRANSITION ECONOMIES

Czechoslovakia and Hungary were able to develop privatisation programs relatively quickly, even though the scope and strategy differed significantly between the two countries. In Czechoslovakia, mass privatisation through vouchers was the principal means for privatising state-owned enterprises (Mládek, 1995). The requirement that enterprises draw up privatisation plans and that these plans would be judged by the authorities against competing privatisation proposals that could be submitted by outsiders both required managers to think strategically about their firm's future and forced them to develop privatisation proposals that held out long-term benefits for future owners.

By distributing privatisation vouchers to citizens and giving them the right to bid for shares of specific firms, the framers of the Czechoslovak voucher privatisation program appeared to be aiming for an Anglo-Saxon model of corporate governance with relatively dispersed share holdings and control over managers emerging largely through the workings of a stock market. The rather unexpected popularity of investment funds, which garnered nearly three-quarters of all vouchers, thus had important and perhaps unintended implications for the structure of corporate governance that emerged from mass privatisation.

Since each fund could own no more than 20 per cent of the shares of any company, it appeared that the funds could not obtain a controlling interest in enterprises being privatised, thus preserving reliance on the stock market and diffuse shareholders as the source of discipline for managers. However, a number of investment companies formed several funds; this was also true of some of the commercial banks who were the main sponsors of investment funds. Thus what emerged was a situation where the 14 largest investment groups were able to obtain over 50 per cent of all vouchers. Since some of these groups had been organised around commercial banks, which were also partially privatised in the first wave of voucher privatisation, the pattern of shareholding that emerged was superficially similar to the Japanese or German model of corporate governance. Commercial banks and firms were connected through both credit relations and shareholding. Moreover, there is considerable cross-ownership among the banks themselves. At the same time, the government remained, through the Property Fund, the largest single owner of many banks and companies, and neither the banks nor the funds appeared to be very active in corporate governance (Coffee, 1994 and Kenway and Chlumský, 1995): although the findings of Session 4 of the Conference suggest that ongoing activism by funds, as opposed to crisis intervention, is perhaps not to be expected.

As is to be expected, given the predominance of institutional holding of shares, the two stock markets that have developed in the Czech Republic have not been the principal venues for trading shares. Rather, direct transactions between investment funds are the main means for changing ownership of shares. This, of course, creates a rather thin public market for shares and thus limits the role that the stock market can play in exercising control over managers (Triska, 1995). Consequently, the role of corporate governance has increasingly fallen to banks in their dual role of creditors and owners of stock through their investment funds and to investment funds that are not affiliated with banks. In some cases, these funds have been passive, choosing not to exercise control over enterprises, but some funds and also banks have taken a lead role in corporate governance in problem firms. Also strengthening outsider control over Czech firms is the inflow of capital from abroad; in 1994 some 20 per cent of corporate credit came from foreign banks who ought to have greater leverage over, and more skill at evaluating the risks of, Czech firms than does the nascent Czech banking sector.

The principal negative aspects of the evolution of bank control over industry in the Czech Republic are the possibility that banks as both owners and creditors will prove unable to impose financial discipline on ailing enterprises and that corporate policy of industrial firms will become excessively

controlled by the interests of creditors at the expense of entrepreneurial drive and vision and wealth maximisation for shareholders. The example of Japan discussed by Kodaira (1995) in Session 1 and Kwano (1995) in Session 3 of the Conference are instructive in this regard.

In Hungary, privatisation has proceeded more slowly, with an emphasis on sales of firms to strategic owners, i.e. owners who are willing to acquire a controlling interest in a firm. While the desire for such sales was driven in part by the financial situation of the Hungarian government, such an arrangement does result in relatively effective monitoring and control by a majority shareholder. At the same time, the existence of a majority owner diminishes the importance of take-overs and of the stock market as sources of outside discipline. Moreover, it encourages passivity on the part of minority shareholders. Thus provisions for the protection of minority owners, perhaps by laws requiring independent outside directors, as mentioned by Cadbury (1995) and Blanquet (1995) in their Conference contributions, are in order in the Hungarian case.

The key defect of this approach to creating effective corporate governance through privatisation is that it is slow. Only a relatively small number of Hungarian firms has been sold to strategic investors. The remainder continue to be controlled by insiders with weak inputs from the agencies that represent the government's ownership stake and from the banks. In some cases, banks have acquired the sort of dual status of owner and creditor that was described above in the case of Czech banks through debt-equity swaps, but because such swaps apply to troubled firms, the additional leverage gained by the banks in Hungary is offset by the danger that they may become captive creditor-owners of these poorly-performing firms.

Although early efforts at privatisation in Poland were similar to those of Hungary, the fact that workers rather than managers were the dominant insiders led to a form of adverse selection. In Hungary, managers expected to retain their positions after privatisation, and thus they sought to have their firms demonstrate good financial performance, and, indeed, foreign investors were attracted mainly to well-performing firms. In Poland, workers expected that private owners would likely reduce the size of the workforce, and thus such sales to strategic investors were resisted where possible and accepted only as a last resort when no other hope for survival was evident. Dabrowski (1994) notes that Polish firms privatised through sale to foreigners fared quite badly, largely because of their already poor profit performance when they were sold.

The fact that insider control of Polish state-owned firms lay with the workers not only adversely influenced the character of the firms undergoing privatisation through sale to outsiders, but it also influenced both the timing and the design of the Polish mass privatisation program. This program had been widely discussed from the start of the transition, but it was not until October 1994 that the government finally approved it.

State-owned firms to be privatised through mass privatisation first will be corporatised and then their shares will be distributed. Sixty per cent of each firm's shares will be given to National Investment Funds (NIFs), which will be organised as closed-end mutual funds. For each firm being privatised, a lead NIF will be selected; it will receive 33 per cent of the firm's shares and obtain four of the nine seats of the firm's supervisory board. This block of shares can be sold or traded, but only in its entirety, thus ensuring the continued existence of a large or strategic shareholder. The remaining 27 per cent of shares will be distributed to the other 14 or so NIFs. The firm's employees will receive 15 per cent of the firm's shares gratis; this is widely acknowledged to be a pay-off to the workers to compensate them for their loss of control over the firm. Their shares, like those held by NIFs who do not have controlling interest, can be sold. The remaining 25 per cent of the shares will, in the near term, be held by the government.

Polish citizens will have the opportunity to purchase the shares or certificates of the NIFs for a nominal price. These shares will eventually become tradable on the stock market, and, in the interim, their holders may hope to receive dividends. The objective of the managers of the NIFs then should be to maximise the price of the shares of their NIF on the stock market. This can be achieved presumably by both astute portfolio decisions and by active management of those firms in which the NIF has a major position.

Three key advantages are seen for this arrangement from the perspective of corporate governance. By creating a large shareholder, the problems of co-ordination and the cost of monitoring managers by diffuse share holders is reduced. Because the primary NIF has a large stake but lacks control of the supervisory board, its policies must also serve the interests of minority stakeholders, that is of the other NIFs, the workers and the government, who are all represented on the board.[10] Finally, control passes from insiders to outsiders who have an equity interest in the firm.

Whether these advantages will give rise to effective corporate governance depends on a number of conditions. First, it is assumed that the NIFs will be disciplined by the stock market and NIF managers judged and rewarded on the basis of the price of the NIFs shares. Whether the market for these shares, as well as for the shares of the corporations that make up the NIFs' portfolios, will be sufficiently broad and active to provide meaningful information is unclear. The experience of Hungary and the Czech Republic are not encouraging in this regard. A second condition for the provision of effective corporate governance by the NIFs is that the NIFs themselves are efficiently governed. If the stock market is unable to exercise efficient control over NIF managers, then the task will fall to the supervisory boards of the NIFs. These supervisory boards, however, are to be appointed by the Prime Minister from a list of candidates drawn up by a commission consisting of individuals appointed by the government and by the trade unions. Whether supervisory boards constituted along these lines are likely to represent the interests of the shareholders of the NIFs is doubtful.

If the Polish privatisation represents a successful transfer of power from insiders to outsiders, albeit at the price of distributing some shares to the workers, the Russian privatisation can be seen as the ratification of existing *de facto* insider control. The Russian voucher privatisation provides for three ways of privatising state-owned enterprises that have been corporatised. Of these, two methods provide for majority control by insiders.

The only method that does not provide for a continuation of worker control is one that gives the workers 25 per cent of the shares for free, although the shares are non-voting. They may also purchase an additional 10 per cent of shares with voting powers at a price based on 30 per cent of the firm's book value. The book value, fixed at the beginning of the privatisation process, quickly becomes very small due to the high rate of inflation. Managers can purchase an additional 5 per cent of the shares at a higher price than charged to workers. Ten per cent of the shares are retained by the enterprise. The remaining 50 per cent of the shares is available for outsiders. Thus, in this variant, a large outside holder, say an investment fund, could conceivably obtain a working majority of shares and therefore control of the firm. Despite the favourable terms on which the workers obtain their shares, this method of privatisation has not been one chosen by many workers' collectives who, as the controlling insiders determine the privatisation method to be used. Rather workers have opted for a variant that enables them to purchase 51 per cent of the shares at a price equivalent to 170 per cent of the firm's 1992 book value. Remaining shares are available for sales to outsiders.[11]

Since it is the workers who select the privatisation method to be used while, in recent years, the power of managers has increased, the desire to maintain insider control must rest on collusive behaviour between workers and managers. The benefits at issue are tenure and managerial rents and perquisites on

one side and wages and employment security on the other. Since there are neither markets nor hard budget constraints to discipline firms whose insider-owners engage in self-seeking behaviour, it is easy to see why insiders are willing to pay a relatively high price to retain control of the firm during the privatisation process. Moreover, Akamatsu (1995, pp. 147-158) documents the resistance of workers and managers of Russian firms to the participation of outside owners in corporate governance; such resistance often taking the form of actions that are illegal or incompatible with the firms' own rules.

The experiences of these four countries both pre- and post-privatisation suggest that forces and factors that may in some sense appear to be outside the traditional frame of discourse about corporate governance are, in fact, perhaps more crucial to creating effective control of enterprises than are the details of who outside owners are and how they carry out their roles. Thus in the Czech Republic, Hungary and Poland, despite different approaches to privatisation and to the ultimate identity of key outside stakeholders, given the existence of competition, of a hard budget constraint and of an economic environment in which both owners and their agents can correlate outcomes with managerial skill and effort and in which they take a long-term approach to utility or wealth maximisation, the emergence of effective corporate governance structures can be seen. It seems virtually impossible that corporate governance mechanisms can be designed that could effectively overcome the lack of such prerequisites, and this is evident in the weak governance over the corporate sector evident in those transition economies where these prerequisites are lacking.

V. TOWARDS A SOCIOLOGY OF CORPORATE GOVERNANCE

The foregoing discussion of the establishment of corporate governance in transition economies has tended to focus on a neo-classical framework that ignores the social context in which corporate governance takes place and the identity of those who participate in governing corporations. A number of papers presented at this Conference stress the importance of these sociological aspects of governance, and, while it is beyond the scope of this essay to deal with these issues in depth, a number of observations on these more sociological aspects of privatisation and the management of firms may well provide a broader perspective from which to consider developments in the transition economies.

Perhaps the first question to ask is whether the current privatisation processes are adequate to create a clear distinction, in an operational sense, between state and private property in the minds of agents, managers, workers and new owners. In many privatisation schemes, the government remains as a minority shareholder but often as a very large, if not the largest, one. Banks, who are both creditors to, and shareholders in, firms are also often owned and certainly are regulated by the government. Although the government has generally played a passive role in corporate governance, its desire to retain holdings, often with extra-ordinary rights over some aspects of corporate governance, creates a condition where state intervention, while not currently evident, could become a dominant force in many firms in the region.

A second question deserving attention is the relationship among firms and between firms and banks. Many new privatised firms are spin-offs of former SOEs. Although now legally autonomous units, it may well be that they continue to interact and collaborate in numerous ways due to continuing influence of "network capital" on managerial behaviour. Such "network capital" encourages managers to continue pre-reform relationships with customers, suppliers, workers and sources of capital, thus limiting enterprise responsiveness. In other cases, private firms were created to serve as sub-contractors to SOEs, and the extensive ties among these firms may create corporate networks akin to the Japanese *keiretsu* system. The role of inter-enterprise shareholding, creating ownership links between suppliers and buyers or between potential competitors, also deserves attention, as does the use of interlocking directors by banks and investment funds to co-ordinate the actions of firms whose shares they hold.

Finally, the rate of managerial turnover has differed considerably among the transition economies. Old-line managers have many personal connections to other managers, to local authorities, and to government officials, especially to those with economic policy roles. The extent to which these old informal links can substitute for, or even subvert, new forms of corporate governance is a key question. Such networks exist in developed market economies and to some extent play an important and useful role. At the same time, they can become a way of bypassing legitimate means of exercising control over the corporate sector by shareholders, creditors and society.

A key theme that is common to both the economic aspects of creating corporate governance that were discussed in previous sections of this paper and to the sociological issues raised here is that the success in creating effective corporate governance in transition economies depends as much on the path by which policy makers proceed and on the social and economic milieu in which governance takes place as it does on the specific modes of governance adopted.

VI. LESSONS FOR ECONOMIES IN TRANSITION FROM CORPORATE GOVERNANCE DEVELOPMENTS IN OECD COUNTRIES

As mentioned in the Introduction to this paper, the papers presented at the Conference as well as the ensuing discussion brought out many examples of specific measures being taken by firms and governments in OECD countries to strengthen corporate governance. Certainly a compilation of such measures would be of benefit to policy makers in transition economies, forming a sort of arsenal of laws and regulations that could be adopted by transition economies to strengthen their own corporate governance mechanisms. However, the Conference also raised broader, more philosophical concerns. The first of these was that there was an interaction between changes in corporate governance brought about by competitive pressures and those that were brought about by other, exogenous, factors such as demographic change and technological progress. The second was that there was an interaction between the roles of government policy and evolutionary institutional development under the pressure of competition. These issues form the conceptual framework for any policy on corporate governance and thus underpin the choice of specific measures for strengthening governance in any, not just a transitioning, economy.

In a strict neo-classical framework it might be argued that the corporate governance arrangements emerging in transition economies should not be subject to extensive efforts by policy-makers to influence the actual arrangements employed by firms because an evolutionary process will lead to the success of well-governed firms over badly-governed firms and that such an evolutionary process eventually will lead to the emergence of governance mechanisms that are effective and appropriate to the social and economic conditions of these countries. Schleifer and Vasiliev (1994), for example, propose that effective outsider control over Russian firms will emerge in this way.

While it may be true that some evolutionary process will separate out poor and efficient models of corporate governance, an understanding of the forces that influence this evolution nevertheless would be of value to policy makers in transition economies. In part, the need for this understanding, even if one accepts the evolutionary hypothesis, is that through decisions about the process of privatisation as well as through the laws and regulations on corporate governance that are enacted, each transition economy is selecting a different starting point for the evolution of its system of corporate governance. Also, as the papers in Session 1 of the OECD Conference suggested, convergence of corporate governance practices can not be guaranteed.

In this determination of the starting point and the workings of the evolutionary process, there are three actors:

Government: The methods of privatisation are a key determinant of the identity of the new owners, and this, in turn, is a major influence on how owners organise and exercise their role in corporate governance.

Governments also play a key role in setting the macroeconomic policy within which corporate governance takes place. As Michel Albert (1995) noted at the Conference, such macroeconomic conditions are a critical component of the viability of effective corporate governance, a point that is clearly underscored by the experience of transition economies described above. Much the same can be said regarding the opening of the economy to foreign competition and to foreign capital.

Managers: One of the striking aspects of privatisation in transition economies is the central role of managers in determining the way in which their firms are to be privatised and, subsequently, governed. Even in cases of a clear government program, such as the Czech voucher privatisation, managers determined, with the concurrence of higher authorities, many of the key aspects of the privatisation of their firms including the percentage of shares offered to investors, spin-offs and break-ups of the firm prior to privatisation, etc. In countries where sales to outsiders or insiders were the prime means of privatising firms, the role of managers was likely even greater.

A valuable lesson for transition economies that was present in a number of the contributions to the first Session of the Conference is that, in many OECD countries, dispersed ownership or, in the case of Italy (Barca, 1995), ineffective government ownership left much of the practical design and implementation of corporate governance to insiders. Consequently, much of the discussion of possible reforms in corporate governance that emerged from Sessions 2 and 3, especially in the United States (Hughes, 1995) and the United Kingdom (Cadbury, 1995), but also more generally in the European Union (Blanquet, 1995), aims at restoring or strengthening shareholder rights vis a vis insiders. When one considers that in OECD countries founders of firms did have the opportunity to design what they considered effective means of governance at the time that their firms were founded, the perception of an undesirable imbalance between managers' and owners' power should be a cause for serious concern for policy makers in transition economies. This is because in those economies, most owners, with the notable exception of foreigners who obtained controlling interest in SOEs being privatised, have inherited and, for all practical purposes, have to live with, corporate governance structures that are largely designed and made operational by managers. Of course, national laws and regulations provide some support for owners, although these laws are flouted by managers in some countries such as Russia, but such laws in transition economies do not appear to be stronger or more favourable to owners than similar laws in OECD countries.

Owners: The new owners have had more of an indirect than a direct influence on the pattern of corporate governance. The most striking example of this is the Czech voucher privatisation, where the decision of voucher holders to make investment choices for themselves or to entrust their vouchers to investment funds effectively determined whether corporate governance would proceed along the US-UK model of many small holders or along the lines of the German-Japanese bank-centered model. Similarly, whether insiders retain control of Russian enterprises will depend on whether workers who now own the majority of shares in their firms will be willing to sell them in the future.

In both transition economies and OECD countries, it is in part the portfolio choices of owners that influence the nature of corporate governance. Thus, in the Czech voucher privatisation, it is unclear whether investors opted to entrust their vouchers to investment funds because they believed that dispersed stock ownership was not a good mechanism for corporate governance and that a Japanese-German model would prove superior, or whether they opted to give their points to funds in order to obtain the benefits of

the greater information that the funds had about firms being privatised or to achieve the optimal level of portfolio diversification with little thought regarding the effect of this choice on corporate governance.

Much the same phenomenon is evident in OECD countries, as the presentations in Session 4 made quite clear. That is to say, in OECD countries, portfolio choices of savers are increasing the potential role of pension funds, mutual funds and other large institutional investors in corporate governance. Thus, major changes in who owns corporate shares are emerging not from considerations of the ownership structure that would be best from the standpoint of corporate governance, but rather from savings and portfolio decisions of individual investors. Through this mechanism the nature of ownership, and thus the process of corporate governance, is changing (Artus, 1995; Rössler, 1995). As the Conference discussions made clear, the implications of these trends for corporate governance in OECD countries are controversial, and their long term consequences are difficult to predict. Nevertheless, the discussion regarding activism by pension funds in Session 4 suggests that regulations to allow, and incentives to encourage, activism by institutional holders should be considered by policy makers in transition economies. However, as the discussion in Session 4 of TIAA/CREF activism indicated, and as Swedish experience confirms (Skog, 1995), such institutional activism is costly and infrequent in most OECD countries.

If, then, in the words of Isaksson (1995), "...the quality of corporate governance and hence long-term performance of the business sector also depend on the legal and regulatory framework in which companies operate," it is clear that the evolution of ownership and corporate governance in transition economies is strongly shaped both by the process by which privatisation takes place and by the legal and regulatory framework that is put in place in these economies.

The foregoing description of privatisation procedures in transition economies makes amply evident the fact that approaches used to date differ widely; corporate law and regulation of firms differ much less from country to country. The possibility thus exists that there will be a convergence in corporate governance practices based on the similarity of laws, especially because many transition economies are adopting the laws and practices of the European Union. This hope, however, should be seen as a slim one based on the Conference presentations by Gilson (1995) and Roe (1995), who suggested that, in the evolution of corporate governance structures, there is a strong element of path dependency. Roe argued that the conditions under which corporations arose in the United States, specifically the existence of relatively small banks, then determined the diffuse nature of stock ownership. While the specifics of the United States case do not apply to all transition economies, the main principle of path dependency is critical in that it suggests that a convergence of governance practices on the basis of similarities in legal, technical and economic forces that come into play post-privatisation is unlikely, at least in the short and medium terms. While those transition economies that have already more or less completed privatisation can benefit little from this insight, those that are drafting privatisation programs or are in the early stages of their implementation should recognise that the design of these programs will have profound and long-lasting effects on their international competitiveness and domestic welfare.

Understanding the consequences for corporate governance of different privatisation strategies is also important for policy makers, even if privatisation has been completed to a large extent. The experience of OECD countries brought out in Session 1 is germane in a number of ways. For example, in a number of transition economies, the government remains a major, if not controlling, owner of many large firms. The experience of Italy described by Barca (1995) is particularly relevant to this situation. Barca argues that, in Italy, the effectiveness of government as an owner was subverted by political failure, specifically the inability of voters to monitor and exercise governance over politicians. This suggests that, especially in those transition economies where regular changes in the party or coalition in power are less likely, state ownership should be kept to a minimum. An alternative formulation of this concept is that

corporate governance by the state will be weak in countries where there is little scope for political change. Regrettably, in the spectrum of transition economies, high government ownership shares seem to be positively correlated to single-party domination of politics.

The key role of banks as owners, through investment funds, and as creditors, in countries such as the Czech Republic, has already been noted. The Conference report on the Japanese experience by Kodaira (1995) is especially relevant to those transition economies where banks are assuming a major role in governance. He points out that the Japanese main-bank system emerged under conditions of a predictable growth in demand and of technological improvements. Thus high autonomy for managers and a long-term perspective were both desirable and possible under the governance system that emerged, even if at a cost to shareholder interests. Much the same might be said for Germany and France as some papers from Session 2 suggest. Cross-ownership, another feature of ownership patterns in transition economies, also led to stability in shareholding and a long-term approach to corporate governance in Japan.

One question arising from this analysis is whether the same business and technological forces that favoured the emergence of the Japanese-style form of governance now exist in transition economies. It is not clear that the restructuring and rescue of firms in transition economies is best served by investors who give management great leeway and opt for a long-term perspective, in part because, without decisive action, many firms may have no long-term future. Moreover, it is unclear whether banks in transition economies have the financial means to act as "lenders of last resort" to their troubled industrial clients in the way Kodaira pictures Japanese bank-firm relations.

Nevertheless, as the Italian experience discussed at the Conference suggests, weakening banks is not the solution to this problem, and the evolutionary development of stronger capital-market influences, especially in providing venture capital and support for entrepreneurship in small and medium-sized firms, as suggested by Thomas (1995) in his introduction to Session 2, is likely a better policy approach to resolving the problems that dynamic firms and nascent entrepreneurs face in an environment dominated by large banks and firms. Thus, policy makers in transition economies should pay particular attention to OECD countries' measures to develop adequate mechanisms for the provision of venture capital.

In addition to the starting conditions imposed by the choice of privatisation program and the direction imposed by laws and regulations, there are exogenous factors that impinge on the evolution of corporate governance structures and their efficiency. This is a key issue because evolutionary pressures to change corporate governance in ways that improve its efficiency may be offset by, or may collide with, changes in these exogenous factors, with consequences for the efficiency of corporate governance that are difficult to predict. Among the exogenous factors identified by the Conference were:

Demographic Change and Associated Portfolio Choices of Investors

In OECD countries there is a trend toward the ageing of the population coupled with longer life expectancy. The precursor of this development was the build-up of savings in pension funds, life insurance companies and mutual funds (Artus, 1995). Thus, in many OECD countries, these institutions took on a larger role in ownership of corporate stock and with it an obligation to pursue an appropriate role in corporate governance despite various restrictions on their ability to hold large blocks of any one firm's shares, as described by the papers in Session 4.

The goals that such newly-emerging institutional players pursue reflect in part the demographic structure of their clients and in part the regulatory constraints under which they function. Regulation may influence the extent to which these funds choose to exercise "exit" and "voice" options *vis-à-vis* the firms

whose stock they own. To the extent that funds choose to exercise the option of "voice," their attitude toward corporate policy will reflect the regulatory pressures on the funds, the demographic structure of their client base and their cash inflows and outflows. Consequently, over time and across countries, the effect of fund involvement in corporate governance may differ, because, as Tsuno (1995) suggests in the case of Japanese and United States pension funds, the sort of policies they urge management to follow may reflect the different objectives and constraints that funds in various countries face. In contrast, "exit" options depend critically on the existence of well-functioning capital markets.

Transition economies face a broader range of demographic situations, although in Central Europe the demographic trends parallel those in OECD countries and are exacerbated by early retirement ages for workers. Moreover, there are few funded pension programs in transition economies, suggesting that here the lessons from OECD experience are largely macroeconomic, because pensions will have to be funded mainly from current government revenues. Nevertheless, in setting up new, private pension schemes the transition economies would do well to observe their effects in OECD countries on saving and financial intermediation and on the role of pension funds in corporate governance. In particular, transition-economy policy makers will have to weigh very carefully the need for prudential regulation in an environment where pension funds themselves may suffer governance problems and where investing entails high risks.

Internationalisation

The transition economies are somewhat behind the OECD countries in terms of their openness to international forces and especially to capital flows, although this gap is closing rapidly. Thus, the competitive pressures faced by OECD firms from foreign competition are now stronger than those evident in transition economies, but as greater openness in commodity trade occurs in transition economies, pressure to improve corporate governance will increase correspondingly.

Although the opening of capital markets lags behind that of goods markets in transition economies, the effects of capital mobility on corporate governance are more easily discerned. First, the effect of foreign direct investment on governance is significant (Estrin *et al.*, 1995) because foreign investors generally acquire a controlling interest in transition economy firms and then structure governance to permit effective control by the parent firm. Indeed, control by means outside normal corporate governance mechanisms, such as long-term management contracts, often combined with minority ownership by the foreign firm, testifies to the belief in many transition economies that foreign investors will provide the human skills and resources as well as incentives for effective corporate governance. The experience of OECD countries in the treatment of foreign direct investment should be carefully studied by transition economies, because serious mistakes and misunderstandings between host countries and foreign investors should be anticipated and avoided wherever possible.

A second aspect of openness to capital flows involves portfolio investment. Here the consequences for corporate governance are more ambiguous. Because foreign investors are less "tied" to firms in a country than are domestic investors, foreign buyers of equities are more likely to be interested in the short-term performance of firms and also to prefer "exit" to "voice" in corporate governance. Counter to this tendency is the fact that, given the high transaction costs of international portfolio investing and a lack of information about foreign investment opportunities, those seeking to make foreign portfolio investments will tend to use financial institutions such as funds or banks, thus strengthening the potential role of these institutions in corporate governance.

In the case of loan capital, lending by foreign banks to transition economy firms has the potential to improve corporate governance. First, foreign banks may be more skilled at monitoring their clients'

managerial performance than are the relatively inexperienced domestic banks. Second, foreign banks, because they are not burdened by old debts of former SOE clients, are less likely to be "captive lenders" who fear to take action against poorly-performing management. Of course, if foreign banks lend unwisely, then their funds provide a breathing space for poorly-performing firms and undercut the leverage of domestic owners and lenders over management, but this possibility has not yet emerged as a serious problem in transition economies.

Despite the urgent need for foreign capital, the recent imposition of controls on portfolio capital inflows by the Czech Republic, although prompted mainly by macroeconomic concerns, does indicate that such inflows are of a magnitude as to cause concerns regarding the effects of internationalisation of capital markets on domestic firms. If the transition economies are to progress in the opening of their economies and capital markets, the experience of OECD countries in dealing with the above-mentioned problems should be studied.

The confluence of these and other exogenous forces, of the evolutionary improvements in corporate governance fostered by competition, and of changes in laws and regulations have, according to many participants in the Conference, led to a convergence in corporate governance structures in OECD countries. In Japan, Kawano (1995) and Kodaira (1995) argue, the role of the main-bank in corporate governance has declined, and will continue to decline, presumably with a stronger role being assumed by shareholders. In the United States and the United Kingdom, on the other hand, the regulations imposed on banks and other financial institutions are being reduced, and in Italy policy measures are strengthening the role of banks in corporate governance; thus shareholders and creditors are more likely to exercise "voice" rather than "exit" approaches to corporate governance.

A key question for transition economies is to determine whether this trend, if one accepts its existence, is due to pressures for the emergence of more efficient corporate governance in OECD countries or whether it is the result either of accident or of the workings of exogenous factors such as those mentioned above. The arguments that this trend is the result of responses to the need for better corporate governance were given considerable support at the Conference. For example, Dietsch (1995) argues persuasively that there are strong theoretical reasons for the superiority of banks as providers of governance, thus suggesting that the above-mentioned reforms in Italy, the United Kingdom and the United States will improve the level of corporate governance. At the same time, measures for greater shareholder rights, such as those contained in the Cadbury Report, are intended to strengthen the ability of shareholders to monitor and discipline managers, thus improving corporate governance via capital markets. Finally, Japanese corporate governance reform seems driven by the effort to make up for the failures and mistakes made by banks and firms in the past.

If, indeed, these changes do reflect responses to pressures for more effective corporate governance, then policy makers in transition economies may find useful models to follow in the experience of OECD countries. Nevertheless, there are large differences between the business, macroeconomic, and cultural environments of transition and OECD countries, and firms in transition economies need to undertake major restructurings, not minor corrections in strategy. Therefore, OECD experience cannot be taken over without taking these differences into account. Moreover, it may be that some of the changes in the corporate governance practices of OECD countries are due not to a governance-improving evolutionary process but rather the result of other, exogenous factors, and thus they may have ambiguous effects on the effectiveness of corporate governance. Nevertheless, it seems safe to suggest that the measures adopted by OECD countries to increase the transparency of corporate behaviour and to assure owners both the responsibility for corporate governance and the means to exercise this responsibility would serve the objectives of transition economies well.

NOTES

[1] The common objective is to ensure that managers do not act in a self-interested way to the detriment of either wealth-maximization (in the case of owners) or of the likelihood of repayment (in the case of creditors). At the same time, the two groups of outsiders may have conflicting interests, for example in choices of managerial actions with differing risks and returns.

[2] For example, if governance structures make it difficult for owners to determine the extent to which exogenous events have influenced outcomes or to act on such determinations, then investors may prefer to place their assets in sectors where exogenous events have a relatively small effect on outcomes because this defect in corporate governance will be less costly in such sectors.

[3] For a more extensive discussion of the DIM approach, see Montias, Ben-Ner and Neuberger (forthcoming).

[4] For a case study of such behavior see Crane (1991) p. 88.

[5] Except where expressly indicated, Czechoslovakia refers to the period prior to the separation of the country into two constituent Republics.

[6] See Török (1993) for a discussion of the behavior of such firms.

[7] Pinto also reports that in firms not doing well, there was considerable managerial turnover and that the workers' councils impeded restructuring. He attributes the reluctance to restructure to the consequences for workers. In such cases, the exercise of insider control to decapitalise a firm that is unlikely to be viable in the long run may be a best option for the workers.

[8] As Boycko, Shleifer and Vishny (1995) point out, "hardening the budget constraint of firms requires macroeconomic stabilisation" (p. 158).

[9] Litwack (1995) reports that many loans are used to finance home building and that a large share of the bank credits go to loss-making firms.

[10] The government is expected to take a neutral stand on company policy. This, of course, raises the question of why it should then seek representation on the supervisory board at all.

[11] The third method, relatively infrequently used, is a more-or-less standard management and employee buyout (MEBO).

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