CORPORATE GOVERNANCE IN CENTRAL AND EASTERN EUROPE: CONVERGENCE TO EUROPEAN CORPORATE GOVERNANCE?

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Countries appear to differ considerably in the basic orientations of their corporate governance structures. In advanced market economies, one observes significant diversity in the ways that alternative corporate governance systems confront the basic problem of corporate governance. The scope of this paper is to analyze the case of Central and Eastern European countries corporate governance system in the spot of today's changes – European integration and globalization. We proposed some possible propositions regarding convergence to European model.

Keywords: corporate governance, convergence, Central and Eastern Europe

1. Introduction

Corporate governance has attracted a great deal of attention since the mid eighties all over the world. The initial impetus was given by Anglo-American codes of good corporate governance, like the Cadbury Code (1992) in UK and the Principles and Recommendations of the American Law Institute (1984) and the Treadway Commission (1987) in the USA. These developments stimulated other countries to look into the necessity of establishing and adapted version of these codes for their own companies. Supra-national authorities like OECD and the World Bank did not remain passive and developed a proper set of standard principles and recommendations. Institutional investors as well as the accounting profession stimulated these recommendations while the controlling authorities at the stock exchanges were instrumental in enforcing these rules for listed companies.

Countries appear to differ considerably in the basic orientations of their corporate governance structures, but in business and in academic circles has started a discussion analyzing whether global financing will lead to one single corporate governance model, and if so, what model will be the reference base. While there are numerous supporters of a global convergence in corporate governance models, a number of opposing opinions continue to flourish. Moreover, the debate is no longer the privilege of some corporate convergence experts as several recent evolutions have enlarged the importance of the issue.

In this paper, we intend to analyze the case of Central and Eastern European countries corporate governance system in the spot of today's changes – European integration and globalization. Which is the trend of these countries? What systems of corporate governance are they adopting?

First of all we have to see if there is a convergence in Europe itself, having in mind the diversity of system laws, development and cultures of European countries. For this reason, the paper proceeds as follows: section 2 presents the European corporate governance; section 3 presents the case of Central and Eastern Europe; section 4 presents some possible propositions and section 5 concludes.

2. European corporate governance

The corporate governance systems in Europe differ markedly. Economists tend to use stylized models and distinguish between the Anglo-American, the German and the Latinist model. In this view, for instance, the Austrian, Dutch, German, and Swiss systems are said to be variations of one model. For lawyers the picture is of course, much more detailed as particular rules may vary even where common principles prevail.

The question "which corporate governance model will reign" is especially relevant for Europe. Despite increasing unification effort, Europe is the territory with the largest diversity in corporate governance models in the world. Whether Europe will opt for a full European convergence of corporate governance models or whether divergence will persist is a matter of great debate. Moreover, Europe is still figuring out to what extent there is a true European model to be developed. Actually, this discussion transcends the mere confrontation between a governance model such as the Rhineland or Alpine model and the Anglo-American system. The issues have not only to do with setting a standard, but also with the degree of harmonization and the way monitoring is to be implemented.

Until the 1970s corporate laws in Europe and the rules relating to corporate governance were the result of individual and separate national developments, corporate law being shaped individually and separately. Each of these systems showed and still shows specific features reflecting institutional differences, national political decision-making and cultural diversity. In principle though, corporate laws and corporate governance systems were developed independently.

Things have changed however. The organs of the EU have the power to harmonize the corporate laws of the member states as far as is necessary to achieve the aims of the Union. The EU has issued several binding directives in this respect and initiated further proposals. European corporate governance systems do not and probably will not converge as a consequence of centralized rule-setting or of competition between national legislators. Convergence or, to be more precise, an approach at least by the German corporate governance system to a more market-oriented, Anglo-American type model, can be observed. But this process is, for the most part, a reaction of the traditional national rule-setting system, based on infra-state discussion and lobbying by various political and interests groups – to internationalization, the globalization of markets and technological change.

Continental stock markets have been thin and illiquid. For some political theorist, this was actually a virtue of European corporate governance because it protected corporate management from the tyranny of a fickle stock market, preoccupied only with the short term, and instead permitted long term business planning by corporations in conjunctions with their principal banks. Now, the US is no longer the ultimate example of market-oriented country. Although the absolute size of the stock market is the highest in US, in relative terms (total market capitalization in comparison to GDP) the US only ranked first until the mid 1980s. During the last decade, the UK and especially Switzerland played the leading role. In the 1990s a number of projects were launched which significantly changed the existing stock market landscape in Europe. In several countries new stock exchanges were created particularly for small growth companies. Although companies across Europe increasingly rely on external finance as a common trend, national stock exchanges initiatives still differ from each other within the European Union. However, some important consolidations of stock markets appeared, important mergers taking place[209]. One consequence of the integration of European currencies into the euro has been the growth of a unified European corporate bond market which ended the dependence of European acquirers on bank financing.

3. Corporate Governance in Central and Eastern Europe (CEE)

The countries in Central and Eastern Europe begun their transition from different points and then pursued remarkable different policies. Their economies also followed different trajectories of economic and financial development, sometimes with repeated financial crises. Yet, today their economic systems are rapidly converging, combining features of Continental Europe capitalism with large controlling shareholders and elements of entrepreneurial or founder capitalism most associated with the United States. Essentially, this is the pattern of emerging capitalism around the world, and the core corporate governance challenge is the same: how to balance the incentive of controlling owners to exercise governance against the protection of minority investors.

An unintended outcome of transition is the emergence of new forms of governance. All countries in the region have transferred ownership to private individuals and entities, yet the transfer of ownership alone does not suffice to create appropriate incentives for managers. Managers may use their insider position to serve their own personal interests rather than those of the corporation. Hence, a system of corporate governance is required.

A massive amount of laws and regulation have been adopted over a short time period. Some countries could rely in part on earlier legal traditions and even legal texts, but to a considerable extent the new laws have been imposed from the outside, as part of the EU accession process or copied from the UK or US. Ensuring the implementation and sustained enforcement of these laws is another challenge facing the Central and East European countries.

The pattern of corporate governance that is emerging in transition economies is, at least in the short term, path dependent, reflecting the means used to privatize state-owned enterprises, the law that have been enacted or revived, and the institutions that have emerged to facilitate corporate governance.

Corporate governance mechanism	Relative importance in Central and Eastern Europe	Scope for policy intervention
Large blockholders	Likely to be the most important governance mechanism; leads to concentrated ownership	Strengthen rules protecting minority investors while retaining incentives to hold controlling blocks
Market for corporate control	Unlikely to be important when ownership is strongly concentrated	Remove some managerial defenses; disclosure of ownership and control; develop banking system
Proxy fights	Unlikely to be effective when ownership is strongly concentrated	Technology improvements for communicating with and among shareholders; disclosure of ownership and control
Board activity	Unlikely to be influential when controlling owner can hire and fire board members	Introduce elements of independence of directors; training of directors; disclosure of voting; use cumulative voting
Executive compensation	Less important when controlling owner can hire and fire and has private benefits	Disclosure of compensation schemes, conflicts of interest rules
Bank monitoring	Important, but depends on health of banking system and the regulatory environment	Strengthen banking regulation and institutions; develop credit bureaus and other information intermediaries
Shareholder activism	Potentially important, particularly in large firms with dispersed shareholders	Encourage interaction among shareholders. Strengthen minority protection. Activate institutional investors
Employee monitoring	Potentially very important, particularly in smaller companies with mobile high - skilled human capital	Disclosure of information to employees; possibly require board representation; assure flexible labor markets
Litigation	Depends critically on quality of general enforcement environment, but can sometimes work	Facilitate communication among shareholders; encourage class-action suits (safeguards against excessive litigation)
Media and social control	Potentially important, but depends on competition among and independence of media	Encourage competition in and diverse control of media; active public campaigns can empower public
Reputation and selfenforcement	Important when general enforcement is weak, but more powerful when environment is stronger	Depend on growth opportunities and scope for rentseeking. Encourage competition in factor markets
Bilateral private enforcement mechanisms	Important, as they can be more specific, but do not benefit outsiders and can have downsides	Relies on well functioning civil and commercial courts; institution- building in this area helps
Arbitration, auditors, other multilateral mechanisms	Potentially important, often the origin of public law; but the enforcement problem often remains; audits sometimes abused; watch conflicts of interest	Facilitate the formation of private third party mechanisms (sometimes avoid forming public alternatives); deal with conflicts of interest; ensure competition

The Corporate Governance Mechanisms in Central and Eastern Europe

Source: Berglof (2005)

Some critics raised against the method of corporate governance in transition economies must be tempered by the realization that no system of governance can be optimal. Yet, because the mechanism employed in developed market economies are the same ones being introduced in transition economies, it is important not to judge them against standards of perfection that are attainable neither in practice nor in theory but rather to judge them against the standards of performance that can be derived from the observation of Western practice.

Effective corporate governance is particularly important during times of crisis when major corporate restructuring is to be initiated and implemented, as in the early years of transition. The management has to decide upon a strategy for the enterprise in the market environment, including major changes in product mix and organizational structures.

A number of recent papers have studied differences in firm-level corporate governance mechanisms (Shleifer and Vishny (1997), Maher and Andersson (2000) for comprehensive surveys). Klapper, Laeven, Love (2005) suggest that the decision to adopt corporate governance provisions is influenced by large, minority shareholders in their battle for representation on the board and in managerial decisions. They also find that foreign owners do not behave differently from domestic owners with a controlling stake. They do not find any significant effect of foreign ownership on the adoption of these provisions, regardless of whether the foreign owners come form countries with or without these provisions in their "home country" legal codes. This suggests that foreigners are not likely to export better corporate governance standards to their host countries. The problems of governance in the transition economies vary with the ownership. The privatization processes led to a variety of ownership patterns within each country of the region (Earle and Estrin (1997)). The protection of minority shareholders is becoming an increasingly important issue in Eastern European countries, since as these countries transition to market economies, firm-level ownership and control remain very concentrated. As a result, the main agency conflicts arise between controlling shareholders and minority shareholders rather than between shareholders and managers, as is the case in most western countries (Berglof and Pajuste (2003)).

4. Convergence to European model - some possible propositions

Convergence in corporate governance may occur when shareholders based in countries with good corporate governance standards impose good corporate governance on the companies they control. On the other hand, the foreign corporate governance standards must be inefficient for or incompatible with the business environment of that developing country. To make progress on this issue empirically there is a need to identify the origin of top shareholders of firms in developing countries. Based on this statement, for Central and Eastern Europe, we can propose the next proposition.

Proposition 1: At least in the short run, the foreign shareholders will follows the rules of the host country (from Central and Eastern Europe). Their influence will not be significant.

It is important to see whether each company's securities are traded in the European market. A common reason for listing in the foreign developed market is to expand the shareholder base by making it easier for investors to buy shares. The business press has cited numerous examples of companies listing in the U.S./Europe to find additional capital to fund their growth. The academic literature has also pointed to this motivation. The Central and East European companies that are listed on developed markets are subject to reporting, disclosure, and corporate governance requirements mandated by those markets regulations. These are examples of capital market pressure.

Proposition 2: The Central and East European companies that are listed on the European market will adopt faster and deeply the European model of corporate governance.

A great role in the adoption of European model of corporate governance will have the CEOs and other level managers with European nationalities. Although we do not know the percentage of all employees that are foreign, we can estimate this figure for senior management and directors, as it is this class of employees which should have the strongest relationship with corporate governance.

Proposition 3: The Central and East European companies that are managed by managers with European nationalities will adopt faster and deeply the European model of corporate governance.

For testing the convergence to European model we can take into account and the industry factor. We can measure the extent to which industries are exposed to European competition and examine whether these are correlated with the governance scores of firms in those industries.

Proposition 4: Those industries which are more subject to pressures from European capital, product, and labor markets show greater convergence to European model.

5. Conclusions

The transition economies have developed corporate governance systems that differ from those in mature market economies, even taking into account the variation between for instance the US and Continental

Europe. The emerging diversity of governance mechanisms and competition patterns is likely to be a continuing feature of the region for years to come.

The unusual circumstances of economic transition led to unusual patterns of ownership, and thus unusual governance structures. These governance systems may not be conducive to radical change due to complex coordination challenges, as too many stakeholders may inhibit change. However, the convergence to West European or Anglo-Saxon systems of governance is slow. The identity of multiple stakeholders may change, but stakeholder influence will be around for quite some time.

The conclusion goes beyond corporate governance and corporate and capital market law. The traditional idea that each sovereign state is free to choose which law should reign in the land is no longer true in a world of international competition and of globalization. As far as we can see, the market forces will have their way across borders and legal systems. It remains a task for transnational political and legal cooperation to see that the necessary rule of law is not lost. Globalization may have induced the adoption of some common corporate governance standards but that there is little evidence in the literature that these standards have been implemented.

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