EC330-3-SP – Lecture 11

Corporate Governance

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Plan of talk

- **Introduction**
1. Governance: *theoretical* preliminaries
2. Governance and *enterprise* reform during transition
3. Governance and *bank* reform during transition
4. *Empirical* literature on governance during transition
- **Wrap-up**

Aim and learning outcomes

- **aim**: analyse the problems of governance during transition from *theoretical*, *policy* and *empirical* perspectives
- **learning outcomes**
  - discuss the ratchet effect and the soft budget constraint
  - see why privatisation to insiders facilitates asset stripping
  - comment the typology of problems to be solved through restructuring
  - understand how enterprises and banks were reformed
  - summarise the empirical literature on privatisation and governance during transition

Governance: state and corporate

- **state** governance: relates to *intervention* via regulation, taxation, inflation, policy (in)stability, infrastructure, law and order
- **corporate** governance: relates to the *principal-agent problem* and the ways to solve it
  - this problem originates in the *separation of power* between
    - the principal, i.e. shareholders who *own* the firm
    - and the agent, i.e. the management who *controls* the firm
  - and the ensuing *asymmetry* in terms of:
    - objectives
      - shareholders care for firm's value maximisation
      - managers care for their own utility maximisation, determined by level of income and its growth, perquisites, effort, job security
    - attitude to risk: risk-neutral (diversified portfolio) vs risk-averse (stake in the firm)
    - information: indirect vs immediate
    - time horizon: long-term vs short-term

Governance and transition

- **government-firm** relationship: the *key* micro-economic link affected by post-socialist transition, by
  - radical reformulation of the role of the public sector
  - deep restructuring of all enterprises expected to be viable
- **two views** are usually contrasted
  - *difference in objectives*: politicians are pursuing goals different from economic efficiency and intervene in firms in order to achieve these objectives, introducing inefficiencies: e.g. ratchet effect, Berliner (1952)
  - *lack of government commitment* in its relation to firms is seen as the source of inefficiencies: e.g. soft budget constraint, Kornai (1980)
  - should not be seen as contradictory but rather as *complementary*
    - both of them are general incentive problems and apply beyond socialism
    - these problems are related: the temptation to extract resources from good firms (ratchet effect) is much higher when there are bad firms to bail out (soft budget constraint)

Transition, insiders and asset stripping

- a common case of failed reform, in the sense of unchanged behaviour of corporate governance, is **privatisation to insiders**
- **Debande and Friebel (1995/1999) model**: approach and conclusions
  - analyse the privatisation decision of a government whose objectives are to preserve jobs and to stabilise its budget
    - a firm which needs restructuring gets funds from the government
    - the manager then has to exert effort to reorganise the firm
    - if the productivity of the manager is unknown to the government, privatisation involves a trade-off b/n better managerial incentives and a loss of control:
      - productive managers restructure since they receive the profits of the firm
      - unproductive managers shirk and deviate the funds to unproductive uses
  - under insider privatisation, the probability of a rent-seeking manager governing the firm is higher than under competitive bids by outsiders
  - privatisation increases managerial incentives but may also increase the soft budget constraint problem through **asset stripping ("looting", "tunnelling")**
- <u>Figure 10.1, p. 241 in Roland (2000)</u>: a **typology of** heterogeneous **problems** to be solved through **restructuring** by heterogeneous responses

Enterprise reform during transition (I)

- **not all** of the former SOEs were privatised
- most countries did not have any particular **strategy** in this domain
- only *Romania* defined the scope of the **state sector** in a French-type fashion:
  – energy distribution, mines, railways and the postal service were not intended for privatisation but considered as *régies autonomes*
  – a change in initial plans was, however, introduced by new legislation in 1997: in effect, these sectors were partly privatised
- most privatised firms remained under **national** control

  only in *Hungary* companies under foreign control accounted for a significant share in industrial output

Enterprise reform during transition (II)

- except 100% foreign-owned companies, all other forms of ownership and control have tended to evolve toward the *same* kind of **corporate governance**
  - no "ownership frontier" as far as performance is concerned
  - successful firms were those which quickly adjusted
  - complex cross-ownership, and hence cross-control, structure resulted from privatisation involving the major microeconomic agents: banks, investment funds, other enterprises, state agencies, local governments
  - the actual managers, however, those who exercised control over the firm, were most often the former (i.e. pre-privatisation) ones: there were no competent and willing individuals willing to take up the job
  - the blurred boundaries of ownership have ultimately led to a dominance of **spontaneous privatisation**, with *corporate control by insiders* no matter the complicated cross-ownership link

Bank reform during transition (I)

- during socialism: a **monobank system**
    - issuing the national *currency*
    - acting as the *Treasury* of the state
    - being the sole source of *credit* for the economy
- in the late 1980s: reform to a **two-tier banking system**
    - a *central* bank was separated
    - regional branches of the former monobank were given independence and were endowed with the functions of *commercial* banks
    - *new* banks were allowed to be created
    - *foreign* competition in the banking industry was also let in
- the reformed banking system was intended to serve several roles
    - manage the monetary side of the stabilisation programme
    - substitute inter-enterprise indebtedness with bank credit
    - but not necessarily control the privatised enterprises
        - the ***Anglo-Saxon (US-UK) model*** of financial structure was thus *preferred*
        - and not the ***German-Japanese model***, where banks have close equity links with enterprises

Bank reform during transition (II)

- numerous **financial scandals**
  - *MMM* scandal in Russia (1994): a finance house that collapsed after having issued bogus shares whose value had risen 8 times in 3 months
  - *Caritas* pyramid scheme in Romania (1994): attracted, in 22 months, deposits from 4 million Romanians for a total amount of 1 billion USD
  - collapse of financial pyramids in Albania (1997) => political and economic crisis
- usually occurred **due to**
  - naïve behaviour of the population
  - lack of experience of the operators
  - the control established by the new mafias on these activities

Bank reform during transition (III)

- **banking crises** in mid-1990s: bank runs, withdrawal of deposits from the banking system and numerous bank failures: e.g. Latvia (1995), Lithuania (1995), Czech Republic (1996-1997), Bulgaria (1996-1997), Romania (1996-1997), Russia (1996-1998)
  - typically **emerged as a combination of**
    - a legacy of non-performing loans (short-term) to state-owned enterprises
    - too quick financial liberalisation allowing too many new banks
    - unfavourable macroeconomic policies: high interest rates to pay on the liability side given bad loans on the asset side
    - inexperience of bank management, insufficient prudential regulation, large opportunities and incentives for fraud
- **bank privatisation** that followed was seen as an instrument to
  - recapitalisation and restructuring of banks
  - forcing banks to comply with prudential rules
- steps toward building **financial markets** were undertaken

Empirical literature: corporate governance during transition

- **initial studies** on corporate governance
  - existing enterprises (SOEs and privatised)
  - *de novo* enterprises
  - new firms display better performance in terms of productivity growth, controlling for factors such as enterprise size and capital intensity
- however, the **subsequent literature** pointed out to
  - potential *selection bias*: the new companies are those that survived an early competitive process, which tends to overstate their performance
  - *endogeneity*: Gupta, Ham and Svejnar (1999/2001) questioned causality and provided evidence that more profitable firms get privatised first

Empirical literature: effects of state governance during transition

- **state governance**, in relation to *corporate governance*
  - business surveys initiated by the EBRD in the late 1990s have indicated a negative correlation b/n the degree of state capture and governance
    - degree of ***capture of the state by powerful business interests***: approximated by the *perception* of the effect of the sale of parliamentary votes or presidential decrees to private interests on a firm's own business
    - in "high-capture" countries like Russia, Ukraine, Moldova, and Azerbaijan more than 40% of the firms felt a significant impact of the sale of legislation
    - in "low-capture" states like Uzbekistan and Slovenia, fewer than 10% of the firms reported a significant impact
- **overall evidence** so far on transition countries
  - does *not* confirm prior analyses about the economic effects of privatisation: namely, that privatisation can enhance enterprise performance *provided* that sound corporate governance is in place
  - *not* true that *any* form of privatisation is better than state ownership

Concluding wrap-up

- **What have we learnt?**
  - what the basic theoretical *concepts* underlying governance are
  - what the main *policies* of restructuring enterprises and banks in transition economies were
  - what the *empirical literature* on transition privatisations has to say about governance
- **Where we go next**: to the tasks and forms of *industrial policy* during post-socialist transition