Chapter 3

Corporate Governance

3.1 Introduction

Corporate governance has recently become a key discussion item for the reform of state-owned enterprises and the development of a modern enterprise system. The literature reviewed on privatisation in the previous chapter revealed that the countries in transition encounter governance problems in relationship in particular enterprise management and owner-manager relationships. Governance serves as an essential foundation for superior performance. If organisation structure or managerial accountabilities and rewards are inconsistent with value creation, effectiveness will decrease [McTaggart, Kontes and Mankins, 1994].

Governance identifies rights and responsibilities, legitimises actions and determines accountability. It is concerned with the source, use and limitation of power. Corporate governance is concerned with the process by which corporate entities are governed, that is, with the exercise of power over the direction of the enterprise, the supervision of executive actions, the acceptance of a duty to be accountable and the regulation of the corporation within the jurisdiction of the states in which it operates [Tricker, 1994].

The purpose of this chapter is to briefly review corporate governance in order to draw out implications about the relationship between ownership and management of enterprises.

In section 3.2, we describe corporate governance, in section 3.3, we present the theoretical background of ownership and firm value and in section 3.4, we discuss management empowerment and control. In section 3.5, we analyse the corporate governance of the transition economies and finally, in section 3.6, we conclude the chapter.

3.2 Definition

According to Tricker [1994], corporate governance is an umbrella term that includes specific issues from interactions among senior management, shareholders, board of directors, and other corporate stakeholders. In its narrowest sense, the term may describe the formal system of accountability of senior management to the shareholders. At its most expansive the term is stretched to include the entire network of formal and informal relations involving the corporate sector and their consequences for society in general. According to Keasey and Wright [1993], corporate governance is defined to include the structure, process, cultures and systems that engender the successful operation of an organisation. They argue that there is a need to view corporate governance as having two broad dimensions. First, the monitoring of management performance and ensuring accountability of management to shareholders; it emphasises the stewardship and accountability dimension of corporate governance. Second, governance structure and process need to encompass mechanisms for motivating managerial behaviour towards increasing the wealth of the business; that is, to enhance enterprise value.
For the purpose of this study, we will adopt the definition of Keasey and Wright (1993) because we are examining how effective the organisation’s governance in creating value is. We will focus mainly on the relationship between the owner and management of state-owned enterprises because owner-manager relationships influence the managers in making effective decisions to restructure companies and to create value in transition to a market economy.

3.3 Ownership, Agency and Incomplete Contracts

Corporate governance in the Anglo-American corporate context, where the subject and practices are most actively debated and studied, has predominantly been about how to resolve the problem of incentive misalignment in a world of incomplete contracts and imperfect information, and achieve effective monitoring, control and accountability that arise from the separation of corporate ownership and management control [Tam, 1999]. Corporate governance is about ensuring effective decision-making and governance reform should seek ways to create and maintain an efficient decision-making process [Pound, 2000]. In order to understand the current approach to enterprise reform in the transition economies and draw implications for the empirical study of enterprise reform in Eritrea, we present the theories related to the governance of enterprises. These theories are property rights theory, agency theory and incomplete contracts theory.

3.3.1 Property Rights Theory

The debate of property rights is centred on whether the distribution of ownership influences the performance of enterprises and on whether property should be publicly or privately owned. Property is concerned with assets in one form or another. These may be tangible, such as machinery, or intangible, such as patents and goodwill. Ownership connotes the right of use and disposal of property and the owner of property rights should be entitled to the residual benefit. When ownership of property is clearly defined and resides with specific economic agents, the latter benefit from using that property in the most productive manner or personally bear the cost in the form of reduced returns [Walters, 1987]. Due to this, mechanisms must be put in place to ensure that the value of assets is not eroded at the expense of the ultimate owner.

Berle and Means (1932) were the first to raise explicitly the issue of the relationship between corporate ownership and performance. In their book, the Modern Corporation and Private property, they claim that a more diffuse ownership breaks the link between ownership and control, and the maximisation of profits is no longer guaranteed. The fewer shares each shareholder owns the less control he will have over the activities of the management. The latter may then not necessarily pursue value-maximising strategies. They argue that managers (who have control rights) do not bear the consequences of their actions, whereas the shareholders (who have cash flow rights) do.

The influence of the distribution of and changes in ownership on corporate governance and firm performance and valuation has been studied in developed market economies [Shleifer and Vishny, 1997]. A common implication of many models of corporate governance is that firms with more concentrated ownership structures, but otherwise identical, have higher profitability and are valued higher as there is a greater incentive on the part of owners
to monitor the firm and make the necessary changes in management, and other measures. For market economies, this approach has been used by, among others, Demsetz and Lehn [1985], Megginson et al. [1994], and Denis and Denis [1995].

Demsetz and Lehn [1985] focussed on investor decisions to hold concentrated or dispersed shares. They challenged the position of Berle and Means [1932]. For Demsetz and Lehn the decision of how to hold the shares is a rational one based on a profit maximising calculation. Ownership structure and performance are related only in so far as firms choosing a sub-optimal structure will not perform as well as those firms with the optimal structure. For these authors, the size of the firm and the stability of the producer’s market influence investor’s decision. They expect ownership concentration to increase with the increase in market instability and to decrease with the increase in firm size. Demsetz and Lehn [1985] conclude that highly diffused shareholdings do not necessarily perform worse than those with highly concentrated shareholdings. In dealing with the effects of property rights, reference is often made to Coase’s theorem [1960]- that the optimality of the outcome is independent of the initial distribution of property rights provided certain assumptions (such as the absence of transaction costs) are made.

Public (state) and private ownership differ in the objectives of the owners of the firm and in the system of monitoring company management. Privatisation policy is followed on the assumption that a private owner will restructure companies better due to the alignment of control rights and of residual income rights. However, Frydman et al. [1997] argue that under certain conditions, the state-owned firms can be as efficient as private firms. According to Frydman et al., if a state firm operates in an area in which entry is costly, and technological change is slow and relatively predictable, and if the firm has a well established product and market, competent management should permit it to preserve its position and profitability, allowing it to perform at levels not so manifestly inferior to private firms as to create serious legitimisation problems. Even then, state firms usually deteriorate over time due to primarily political depredation and special interest demands that state bureaucrats find very difficult to resist. Absent such political pressure, however, state enterprises in some areas may hold their own and withstand a certain amount of competition.

The property rights literature suggests that transfer of ownership, here understood as entitlement to the residual profit from operating an enterprise from public to private sector, changes the relationship between managers and owners and thus entails changes in both managerial behaviour and company performance. Since the Eritrean government has opted for privatising state-owned enterprises, we will, however, not dwell on the debate of public versus private ownership issues. We will focus on how the (change in) governance structure of the state-owned enterprises influences performance. The property rights theory is used in our research to highlight the governance issues in designing our conceptual framework and as a background theory in understanding the influence of state-ownership on value performance of enterprises in the empirical study.
3.3.2 Agency Theory

Agency theory explores how contracts can be written and incentives provided to motivate individuals to achieve goal congruence. It attempts to describe the major factors that should be considered in designing incentive contracts. Agency theorists attempt to state these relationships in mathematical models. This section describes the general ideas of agency theory without actual models in order to draw implications for understanding management behaviour during transition.

Agency theory is predicated on the belief that individual economic agents choose actions that maximise their personal utility. Within the modern corporation, there often exists a separation between the individuals making corporate decisions (managers) and the individuals bearing the wealth consequences of those decisions (shareholders). This raises the possibility of conflicts of interest between managers and shareholders [Jensen and Meckling, 1976]. Jensen and Meckling [1976] state that a firm’s value increases along with ownership concentration as long as the change in ownership results in a better alignment of manager and shareholder interests. In other words, if costs incurred by increasing ownership concentration are smaller than the benefits derived from reducing agency costs, it will be in the interest of some individuals to acquire a concentrated holding in the firm. Jensen and Meckling [1976] define agency costs as the sum of the monitoring expenses by the principal, the bonding expenditures by the agent and the residual loss. Contracts, according to Jensen and Meckling [1976] are thought to be efficient if they minimise the sum of the following agency costs:

1) Monitoring costs borne by the principal to reduce agent actions that would harm the interest of the principal (for instance, auditing financial statements).
2) Bonding costs born by the agent to guarantee that agent will not take actions to harm the interest of the principal.
3) A residual loss incurred because monitoring and bonding may not fully align agent behaviour and principal interest.

Agency theory proposes that a utility-maximising economic agent may take actions that are inconsistent with the interest of the principal. In some situations, managers may prefer to undertake actions that run counter to the preferences of shareholders. Examples of such actions include the payment of excessive salaries to managers, resistance to value-increasing take-over bids, and outright shirking [Denis, Denis and Sarin, 1999]. This is because the agent is not perfectly monitored, either because the actions are not observable or because the principal does not have the incentive to monitor. The separation between ownership and control and ensuring conflicts results in agency costs that reduce the value of the firm [Amihud and Lev, 1999].

A second approach to the agency problem, presented by Holmstrom [1979] and others is to focus on unobservable managerial efforts and the moral hazard problems arising from it. When shareholders do not know how hard managers work, managers may slack off. Moral hazard exists due to a lack of efforts (shirking) on the part of the agent. Stated differently, the principal cannot adequately verify the agent’s effort. Adverse selection exists when the agent misrepresents his or her ability or, more generally does not behave in the manner as assumed and preferred by the principal [Eisenhardt, 1989b]. Agency costs are incurred in order to reduce or eliminate the effects of moral hazard and adverse selection.
Managers are expected to comply with the interests of the external owners of the private enterprises; however, *given information asymmetries*, it is difficult for owners to ensure that managers do so. The principal has inadequate information about the performance of the agent; therefore, the principal can never be certain how the agent’s effort contributed to actual firm results. Without monitoring, only the agent knows whether he or she is working in the principal’s best interest. Moreover, the agent may know more about the task than the principal. The added information that the agents have about the task is referred to as *private information*. Ideally, managers and equity investors would enter into a binding contract [Shleifer and Vishny, 1997], but it is difficult to specify contracts *ex-ante* that accommodate all possible future contingencies. Therefore, should unforeseen circumstances arise, managers assume contingent control rights that provide them with the potential to operate against investors’ best interests. Asymmetric information between managers and external investors serves to increase the costs of monitoring and, therefore, enables managers to pursue their own goals rather than those of the equity investor. The potential for large total monitoring costs is particularly pertinent if there is a large number of dispersed external investors, creating a free-rider problem. This problem can be minimised if ownership is concentrated in the hands of large block-holders who will be more likely to utilise their voting power to influence managerial behaviour. However, as Shleifer and Vishny [1997] note, this will require a robust legal system in order to protect voting rights.

Fama and Jensen (1983) argue that if the concentration of ownership rises such that it allows entrenchment of management, that is, makes it harder to allocate resources via take-overs, then the value of the firm falls. There is no agency problem if the decision-maker in the firm hold all the residual claims. However, in this case the residual claimants forgo optimal diversification of their present portfolio.

The agency cost premises of shirking and misalignment of incentive in the outsider-based model (where shareholders have less involvement in company governance) are directly challenged by Donaldson and Davis [1994] in their stewardship theory. According to them, managers are good stewards of the corporation and diligently work to attain high levels of corporate profit and shareholder returns. Managers are motivated primarily by achievement and responsibility needs. Thus, empowering managers to exercise unencumbered authority and responsibility will facilitate the maximisation of organisational performance and shareholders wealth.

Privatisation can be viewed as changing the nature of the agent-principal relationship to reduce agency problems and therefore facilitate the introduction of more effective systems that bind agents to the principals’ goals in state-owned enterprises [Rees, 1985]. Moreover, due to the privatisation process new agency problems may arise, for instance, in Eritrea a privatisation agency (NASPPE) is established to oversee the privatisation of state-owned enterprises. The agency literature provides insights for studying whether managers are maximising enterprise value during the transition and also whether the privatisation agency (NASPPE) is controlling the managers effectively.
3.3.3 Incomplete Contracts Theory

According to Hart [1995], firms arise in situations where people cannot write good contracts and where the allocation of power or control is therefore important. He argues that contractual incompleteness and power could be used to understand a number of economic institutions and arrangements. Contract theorists argue that firm participants agree to cooperate with each other within organisations (that is, through contracts), rather than simply dealing with each other through the market, to minimise the costs of search, co-ordination, insecurity and others. The firm can thus be seen as a “nexus of contracts” [Jensen and Meckling, 1976] between itself and its stakeholders.

How can the owner of a company constrain the behaviour of management when there is a separation between ownership and control? One possibility according to Hart [1995] is to put managers on an incentive scheme. Hart argues that the manager’s empire-building tendencies are such that he always wants to invest if he can. That is, just as the manager wants to avoid liquidation at all cost, so he wants to invest at all cost. The only thing that can stop him is an inability to raise the capital.

Drawing on the incomplete contracts literature, Hart, Shleifer, and Vishny [1997] conclude that private ownership must be preferred to public ownership whenever the incentive to innovate and/or to contain costs is strong. If complete and enforceable contracts could be written, public versus private provision of goods and services would usually yield similar efficiency results. If only incomplete contracts can be written then it becomes very difficult to motivate an agent to control costs or to invest in non-contractible “quality” improvement. The authors find that government managers (agents) have very poor incentives to either cut costs or improve quality, and that private ownership is therefore preferable in almost every realistic industrial setting. Public ownership is preferred only when [Hart, Shleifer and Vishny, 1997] cost reduction opportunities lead to non-contractible quality reductions that are significant, innovation is relatively unimportant, competition is weak and consumer choice is ineffective and finally, reputation mechanisms are weak. Even here, the non-profit organisational form will generally be preferable to public ownership.

Bos [1996] also evaluates the privatisation and restructuring of enterprises in a transition economy using an incomplete contracts approach. He argues that since an enterprise, which is to be privatised, has to be restructured under uncertainty, and the restructuring investments are sunk when the final decision on the sale price is taken, there is an imminent danger that restructuring is not efficient, and there is underinvestment. He further elaborated, based on the experience of the Treuhand, that since the government wants to privatise quickly the contract between privatisation agency and investors is signed before the net value of the firm is known. The firm value, moreover, depends decisively on how much has been invested in restructuring investments. These costs are, however, not verifiable before a court, hence only an incomplete contract can be written at the ex-ante stage. Hold-up problems arise because the division of net surplus from the sale of the firm cannot be fixed ex-ante and the contracting parties cannot be prevented from renegotiating the initial contract terms when the value of the firm finally has become known. At the moment of renegotiations, the restructuring costs are sunk; hence they do not influence the division of the net surplus for privatisation. The parties anticipate that their restructuring efforts will not be rewarded at the
renegotiations stage and underinvest. Bos [1996] concludes that when the privatisation agency engages in some restructuring before contracting with the buyer, it increases the probability of increasing the value of the firm for sale.

In our study, we used the incomplete contracts theory to understand the relevance of governance issues in creating value such as the difficulty of writing complete contracts between owners and managers and how this affects the monitoring of managers. In addition, the need for incentives to motivate managers to improve value and the need for minimising hold up problems that might arise during a transition are relevant issues. Due to this, we included governance in designing the conceptual framework of our study.

The literature on property rights, agency and incomplete contracts theories was described in order to help us understand the governance of state-owned enterprises during transition. The theories are used in highlighting governance issues and problems in enterprise management. Table A3-1 in the appendices summarises the theories reviewed. The property rights, agency and incomplete contracts literatures underscore the relevance of owner-manager relationships in building a value creating company, but detailed contracts explicitly outlining partner interactions are costly to design. The property rights theory indicates that ownership distribution matters. The agency theory also shows that owner-manager relationships and alignment of their interests are essential in creating value. The incomplete contracts theory highlights the problem of incomplete contracts and evidences that power and control are important for understanding corporate governance.

Property rights, agency and incomplete contracts theories provide a theoretical background for privatisation and they show the relevance of ownership and owner-manager relationships for creating value. Based on these theories reviewed, we included governance in our conceptual framework. Moreover, they also help in explaining the management and owner’s (the state) actions and their influence on performance in the empirical part of this study.

3.4 Management Empowerment and Ownership Control

Parker [1999, p. 33] argues that “There is a need of assessing the impact of privatisation in terms of power and control. However, the privatisation literature tends to be dominated by concerns with economic efficiency. Issues to do with power and control either become secondary issues or are ignored altogether.” Potential influence, the extent to which the state actually intervenes in management decision-making, thus determines the outcome of privatisation and according to Parker [1999], the implication of continuing state shareholdings for an interpretation of ‘control’ issues in an era of privatisation is worthy of detailed research.

Empowerment has become the term of choice to identify any group which currently suffers a lack of power to influence the course of events to its own advantage or to move some group or organisation towards some new level of power. In analysing power in either private or public hands, the following questions are essential: How much power? In whose hands? Power for what purposes? What assurances are there that the power will be used fairly
and justly? Is there a mechanism by which the power and the method of its exercise can be made responsive to the needs of society?

Most current definitions of power derive, at least in part, from the early Weberian idea that power is “the probability that one actor within a social relationship would be in a position to carry out his own will despite resistance [Weber, 1947, as quoted in Mitchel, Agle and Wood, 1998, p.289].” Pfeffer [1981, p.3] defines power as “a relationship among social actors in which one social actor, A, can get another social actor, B, to do something that B would not otherwise have done.” Mitchel, Agle and Wood, [1989] define power as the ability of those who possess power to bring about the outcomes they desire.

Etzioni [1964, p.59] suggests “A logic for the more precise categorisation of power in the organisational setting, based on the type of resources used to exercise power: Coercive power based on physical resources of force, violence or restraint; Utilitarian power based on material or financial resources; and Normative power, based on symbolic resources.” This categorisation reveals that owners of businesses have at least utilitarian power that originates from their financial investments in companies.

Hart [1995, p. 7] argues that “Firm boundaries are chosen to allocate power optimally among the various parties to a transaction. Power is a scarce resource that should never be wasted. One implication of the theory is that a merger between firms with highly complementary assets is value enhancing, and a merger between firms with independent assets is value reducing.” In merging independent assets, the acquirer gains little useful power while the seller loses useful power and thus, reduces value. Hart [1995] indicated that ownership is a source of power when contracts are incomplete. According to the property rights approach, it is the owner of the asset in question who has this right. That is, the owner of an asset has residual control rights over that asset: the right to decide all usage of the asset in any way not inconsistent with a prior contract, custom or law. A party is more likely to own an asset if it is necessary to make an important investment decision (where the investment decision might represent figuring out how to make the asset more productive or looking after the asset).

Empowerment, according to Kinlaw [1995, p. 2], connotes: “pushing authority for decision as far down the organisation as possible, letting the people closest to a problem solve the problem, giving people a job and staying out their way so that they can do it, increasing the sense of ownership that people have for their work and their organisation, letting teams manage themselves and trusting people to do the right thing.” Kinlaw defined empowerment as the process of achieving continuous improvement in organisation’s performance by developing and extending the competent influence of individuals and teams over the areas and functions which affect their performance and that of the total organisation. Being competent describes the potential that people must possess for exercising influence that improves performance. Influence describes competence in action. It describes the action of moving people and events in a direction that improves performance. Being empowered means exerting competent influence over every aspect of what one does and what one does with others so that the total performance of the organisation is continuously improved.
Kinlaw argues that there is a need to move beyond a meaning of empowerment which concentrates on distributing influence, that is, power. There is a need for an organisational strategy of empowerment, which concentrates on distributing competent influence. He argued that the best way to understand empowerment is as the process, that is, developing and distributing competent influence to achieve sustained superior performance. The idea of competent influence is usually implicit in what many people mean by empowerment.

In this research, we will define empowerment as the ability of managers to influence activities to enhance the creation of value in enterprises. Empowering helps in focussing measures and incentives on collaborative value creation and identifying and encouraging performance that enhances value. The fundamental problem in corporate governance stems not only from a power imbalance, but also from failures in the corporate decisions that are not challenged in an efficient and effective manner. Corporate failures occur because of failures in the decision making process- in how boards and managers make decisions and monitor corporate progress [McClelland, 1995].

Effective owners empower their managers because they believe in the innate potential of people to innovate and add value. Empowerment does not mean having more personal discretion. It means having an increased ability to create value. A key element of empowerment is the belief that effective value creation depends on interdependence and collaboration, with corresponding limits of personal discretion. Maintaining a balance between empowerment and control is a fundamental challenge to organisations intent on developing and extending empowerment. Keeping a proper balance between empowerment and control is, however, a difficult task [see for example Simon, 1995].

In our research, we used the concepts of management empowerment and ownership control in designing the conceptual framework of this study. Moreover, in designing the questionnaires we asked managers whether the management team is empowered to influence the restructuring activities identified from the literature to create value.

3.5 Corporate Governance in Transition Economies

The development of appropriate corporate governance mechanisms in transition economies is distinguished from the economies of the West by the initial complete absence of the necessary prerequisites of an appropriate legal infrastructure and financial institutions in an environment where incumbent management and employees have entrenched rights within enterprises. Legislation has to be enacted which for the first time introduces Western-style property rights, financial reporting requirements, and bankruptcy laws [Wright, Filatotchev and Buck, 1997].

The discussion of corporate governance in transition economies mainly considers the role of the state as a main shareholder of enterprises and banks and the banks’ involvement in enterprise restructuring [Dilova-Kirkowa, 1999]. Corporate governance issues in transition economies have arisen out of the privatisation process because the pace of privatisation has a decisive impact on the continuing role of the state in corporate governance and because the
Chapter 3

The method used to privatise firms has determined the type of owners who have emerged [Brada, Hess and Singh, 1996].

The emergence of separate identities of the state as credit provider and as owner of state-owned enterprises requires the development of effective governance. The state property, particularly the assets of the state-owned enterprises, had been leaked and depleted through neglect and wilful depredation [Tam, 1999]. This problem has often been attributed to the lack of progress in clarifying property rights or the inevitable agency costs arising from a divorce of control and ownership. The state, in the name of the people is supposed to be the owner of all state property including state-owned enterprises of all sizes. The executive council of the state is usually held to be the ultimate state organ holding state property. The decentralisation of administration over the years has, however, given provincial governments in the Central and Eastern European countries the ultimate authority to exercise major property rights over the state-owned enterprises assigned to them. This decentralised state-ownership is further complicated by the fact that at each level of government, the ministries or departments administer and own the state-owned enterprises in their field.

The OECD [1998] shows that the weaknesses of governance in state-owned enterprises stem from insufficient market incentives and disciplines. There is no market for corporate control, for instance, no threat of take-over and replacement of incumbent management, shareholder exit is not possible and monitoring of performance by the state-equity holder is weak mainly due to the lack of economic motivation. Chains of agents without identifiable principals exercise corporate governance and there is no credible threat of bankruptcy as state-owned enterprises are frequently bailed out.

The present confusion over how state assets are to be administered and the still widespread belief that the state will not permit large enterprises to cease operating has created some serious moral hazard problems for the de facto owner of state-owned enterprises. Thus, official ministries of various levels of government have on the whole taken a territorial approach and would rather prolong bad utilisation of certain state assets (which produce negative returns and may require subsidies) than to lose state property. This notion of losing state property is a narrow one that does not take into account the negative impact on aggregate net income flows resulting from maintaining those bad assets in their current form.

Privatisation has been crucial in reducing the direct influence of the state in the economy. Two important outstanding problems in the transfer of ownership are the disposal of those remaining state shareholdings and the operation of corporate governance in the firms themselves. According to Brada, Hess and Singh [1996], three significant pressures are evident in terms of managing these state shareholdings: the need for budget revenues, the reluctance of insiders to have their own position weakened through increased outside shareholdings and the tendency to look for new forms of conglomerate structure to overcome problems of finance and organisations. If the remaining state shareholdings cannot be disposed of quickly because of the desire to raise revenue from their sale, then they could be placed in an independent trust, provided that it has an explicit mandate with strict provision for it to act where possible to maximise the share price of the enterprises it holds, and to wind itself up over a specific-time period.
One common element of the privatisation process has been that of *corporatisation*; whereby state-owned enterprises were converted into corporations whose shares were held by the state until privatisation took place. Although seemingly only symbolic, corporatisation had important effects on corporate governance and managerial power and behaviour. Corporate governance changed through corporatisation because the state appointed outsiders to the corporate bodies that represented shareholders in the corporate governance process. In Poland this marked a significant shift in power away from the Workers Council, which had been the main locus of power within the state-owned enterprises, in Hungary and the Czech Republic, the shift was more subtle, but in all cases, the power of managers was strengthened. This reallocation of power to managers and the impending privatisation that corporatisation signalled led to the first effort at restructuring and to a strategic response by firms being privatised [Brada, Hess and Singh, 1996]. However, the establishment of a privatisation agency has added another layer of government organisation as a stakeholder and the old paternalistic relationship with the previous supervision departments remained largely unbroken after state-owned enterprises had been corporatised. The pursuit of diverse sectional and personal interests is seen as another hindrance to the restructuring and transformation of state-owned enterprises.

The reason for establishing *state holding companies* usually includes rationalising governmental control of its assets, increasing managerial autonomy from political interference, and creating opportunities for greater exposure to market forces. This triad illustrates that the organisational innovation is expected to readjust the relationship between owners and managers in state-owned firms so that they approximate those found in private companies, with subsequent benefits in productive and financial efficiencies [Pistor and Turkewitz, 1996].

After unification of Germany, the Treuhand (THA) actively appointed western experts to the enterprises’ boards to oversee the transition process. But in what might have been an attempt to increase its control over passive restructuring, the Treuhand also dissolved boards and transformed companies to limited liability companies. In cases where the limited liability companies remained large enough to require a supervisory board, these boards have by law, less control. Specifically, they do not appoint managers [Kettler, 1997]. The Treuhand officially finished its operations at the end of 1994. However, according to Bos and Kayser, [1997], effective January 1st 1995, the Treuhand was renamed the Federal Agency for Special Problems Arising from Unification. This agency is responsible for the management of the privatisation contracts, and for the remaining re-privatisation and liquidations. In spite of the highly acclaimed completion of privatisation of these key-sector firms, the Treuhand in fact had not privatised some firms, but shifted them to a special public enterprise namely the Participation Management Company Berlin, which is preparing these firms for restructuring and privatisation [Bos and Kayser, 1997].

The introduction of the Company Law in 1988 in Hungary resulted in a wave of manager-initiated organisational restructuring of enterprises’ assets. Seeking to increase the independence of state firms without changing the underlying ownership structure, Hungarian officials in the late 1980s gave increasing power to enterprise managers. The final move was to give managers the right to reorganise all or part of their enterprise into a limited liability company or a joint stock company. Managers cashed in on the opportunity to separate out the
best of the enterprise assets in commercial companies and proceeded to distribute shares in these companies. While the Hungarian government was the owner of a large portion of those assets, state officials had almost completely lost control of the process and were unable to keep track of the ownership structures put in place by their managers [Pistor and Turkewitz, 1996]. Early experience of “spontaneous” privatisation in Hungary emphasised the need for some form of regulation to deal with abuses arising from incumbent management obtaining state-owned assets on highly advantageous terms. The advent of the State Property Agency (SPA) stopped this chaotic period of company creation and share reshuffling, but the government has not been able to roll back ownership structures or disentangle the bundle of property relations [Pistor and Turkewitz, 1996]. A highly regulated approach was then introduced where although investors, managers or the State Property Agency (SPA) could initiate a sale, approval was strictly controlled by the SPA. The problem with this approach was that there was still scope for managers to dissipate state assets. As a result in September 1991 a further measure was adopted based on self-privatisation and “automatic” clearance by the SPA provided the transaction was prepared by independent advisors from an approved list. Remaining enterprises in state ownership were required to transform themselves into corporations, and could submit a privatisation proposal for approval by the SPA [Filatotchev et al., 1996].

According to Mlcoch [1998], privatisation in post-communist countries is inevitably a long lasting process, lasting perhaps a few decades. In this case, the government should have a clear policy of corporate governance and management of state enterprises. It means that the government should not meddle in a company’s microeconomic choices, but only discipline managers by managerial contracts and stimulate them to enhance the future market value of managed enterprises. Mlcoch argues that the private sector should grow by gradual evolution “from below” as well as by “step by step” restructuring and privatisation of portions of state enterprises “from above” in the traditional way.

The state has remained the owner of many firms not slated for privatisation in the Central and Eastern European countries. Some of these firms are perceived to be integral to the functioning of the state or to its security, and thus, their privatisation or ownership is subject to additional scrutiny and regulation. In the case of Poland, because of opposition to privatisation legislation, the state has retained control over many companies regardless of whether they were slated for privatisation or not. Other firms remain under state control either for a transitional period or because they are not attractive to investors. In many such cases, the company has been transformed legally from a state-owned enterprise to a private entity with a corporate structure, but the state holds the share capital. When the state owns a firm, the founding ministry or the state property fund or agency appoints members to both the Board of Directors and the Supervisory Board [Brada, Hess and Singh, 1996].

State-owned enterprises like their private sector counterparts generally face the same problems in ensuring that companies operate in the most efficient manner. Conflicting interests of a company’s board and management vis-à-vis the shareholders, create a motive for opportunistic behaviour by these agents with respect to the shareholders. Monitoring difficulties for shareholders-stemming from the separation of ownership and control under the company model- may create scope for boards and management to act opportunistically to advance their own interests, rather than the best interests of the company and its shareholders.
The detrimental effect on efficiency can be more severe in the case of government-owned business, as the government faces some additional problems in ensuring that its commercial businesses operate efficiently. Those problems include [Brumby, 1998, p. 39]: “weak external pressures from capital markets (for example, no threat of take-over), and often from product markets; and the political reasoning that produced public ownership often conflicts with economic efficiency.”

In socialist economies, as emphasised by Kornai [1990], the relationship between the managers of firms and their superiors, whether the director of a trust or a branch minister, differ little from the relationship between managers and foremen or production supervisors under their direction. A principal task of transition is, therefore, the reorganisation of the productive units of the enterprise sector in the formerly socialist economies through vertical and horizontal integration and disintegration to form an industrial structure in which the boundaries of the firms ensure that costs (manufacturing and administrative) are at a minimum.

The issue of establishing sound management is also essential to successful privatisation efforts, but this, according to Ozakaya and Askari [1999], has not received due attention in the literature. They argue that privatised firms that addressed management issues directly performed much better than those that neglected managerial reforms.

Enterprise management in Russia emerged from the Gorbachev era with a great deal of economic and political power. Managers gained a very high degree of control over firms, including most production, employment and sales decisions. Although managers gained a lot of control over enterprises, cash flow remained publicly owned. The only way in which managers could capitalise on their power was by stripping firms’ assets through spontaneous privatisation which they proceeded to do. If managers were to be interested in restructuring, they had to become owners of equity. Moreover, equity ownership was viewed as a potentially important device for stopping asset stripping. However, the Russian privatisers also feared that excessively high management ownership could lead to full entrenchment of incompetent managers, and as a result slow down restructuring. In transition economies, top managers got their jobs because they excelled at lobbying the government for credits, influencing suppliers into delivering the inputs and so on. These managers did not have to care about selling the products, cutting costs and other issues central to restructuring. As a result, managers of privatising firms were in many cases incapable of overseeing a restructuring program and hence the need for management turnover was much greater there than in market economies [Shleifer and Vasiliev, 1996].

Brada, Hess and Singh [1996] argue that the concern about increased managerial autonomy in transition economies seems to be somewhat misplaced in view of the fact that, historically, the problem of managers in these economies has been the lack of autonomy. In the period of central planning, industrial ministers controlled managers. In the case of Poland, this was replaced by the power of the Workers’ Councils, which controlled both managerial appointments and tenure and involved themselves in the setting of business strategy [Estrin et al., 1995]. Thus, increased managerial autonomy brought about by privatisation may more likely lead to an environment that provides greater scope (and more incentives) for managers to formulate and implement appropriate business strategies.
In the socialist system, the concept of marketing and markets were associated with capitalism and thus, were stigmatised as social evils. Due to this enterprises did not give attention to marketing. Whatever produced was given to distribution agencies and thus whether it is sold or not did not matter as far as the factories were concerned. There were no marketing departments in the factories. The Central and Eastern European countries were also trading with each other and they had a network called Council for Mutual Economic Assistance (CMEA). In the post socialist system, the collapse of the CMEA brought a great challenge to the state-owned enterprises of the transition economies [UNCTAD, 1993]. Factories were obliged to market their products themselves and the lack of marketing departments and trained sales staff at the factories created a crisis.

Breda Hess and Sing [1996] studied problems of corporate governance as a cause for managerial leeway in formulating policy and owners’ ability to dislodge incumbent managers who underperform. They studied the governance of various forms of ownership (foreign, state, banks and investment funds, management and employees) of 18 cases of industrial enterprises in the Czech Republic (N=6), Hungary (N=5), and Poland (N=7). We have summarised the findings of the seven state-owned enterprises included in their study in appendix A3-2.

The findings are heterogeneous in terms of corporate governance experiences and circumstances of the firms. Breda, Hess and Singh [1996, p. 608] generalised the following: “First, it is quite evident from the Polish examples that workers’ de facto ownership overshadowed the de jure ownership role of the state. At the same time, because workers’ ownership rights were tenuous and unclear, workers tended to pursue short-sighted and narrowly self-interested policies. Second, the passivity of owners is generally correlated with good managerial performance. When the owners have confidence in the general manager or director, then owner passivity is, in effect, tacit support. Third, the cases suggest that owner passivity does not extend to those situations where management problems are evident. At the same time there are several examples of owner interference with management (or neglect of management’s efforts to assure the future of the firm) that illustrate the problems that shareholder activism (or its absence) can create. There is clear evidence that managers, once they have the autonomy to do so, have undertaken much the same restructuring measures that were evident in the cases of firms governed by foreign outsiders.”

The managers in the cases studied tried to restructure their companies by focussing on core-competencies of the firm, eliminate unprofitable activities, strengthen the marketing function, implement technological upgrading, and emphasise quality. In those cases where owners exercised greater control over management, the consequences were mixed.
3.6 Conclusion

The theory reviewed and the experiences of the transition economies evidence that managers and owner-manager relationships and behaviour are essential for restructuring enterprises into value creating private enterprises. Competent managers will be able to restructure their companies and enhance the value of their enterprises. Effective owners empower their managers because they believe in the innate potential of managers to innovate and create value. However, effective monitoring of management is essential. The initial experiences of Hungary and Russia revealed that managers were powerful and engaged in asset stripping due to a lack of control. In Poland also workers assumed strong power and restricted management in reducing labour and restructuring of enterprises. Due to this, some researchers advocated for managerial retrenchment [Shleifer and Vasiliev, 1996; Bim, 1996]. However, others also showed that after the establishment of state privatisation agencies, effective governance helps in restructuring enterprises. The cases of enterprises studied by Breda, Hess and Singh [1996] evidenced that managers, once they have autonomy to do so, have undertaken much the same restructuring measures that were evident in the cases of firms governed by foreigners. This suggests that management contracts with established meaningful rewards and penalties could help in restructuring enterprises. Balancing the power of managers and ownership control is essential for restructuring state-owned enterprises into value creating, privatisable firms. In the following chapter, we will discuss corporate restructuring and value creation.