

**CORPORATE GOVERNANCE STRUCTURES IN POSTSOCIALIST  
ECONOMIES:  
TOWARD A CENTRAL EASTERN EUROPEAN MODEL OF  
CORPORATE CONTROL?**

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Studies (1997-98)

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TOWARD A CENTRAL EASTERN EUROPEAN MODEL OF CORPORATE CONTROL?**

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Fifteen years after the dawn of postsocialist economic transformation, corporate governance structures are extremely different across Central Eastern European countries (CEECs) and CIS members. The observed differentiation is basically due to the variety of methods that have been used to privatise former state-owned enterprises (SOEs). The growth of the *de novo* private sector and its mushrooming start-ups as well as residual state property also had an unevenly important impact on governance structures from one postsocialist economy in transition (PET) to the other. In the new private start-ups a strong corporate governance structure – I mean entirely under the monitoring of a single or a few owner(s) - tends to prevail while in privatised firms (*i.e.* former SOEs) a managerial corporate control is widespread. A privatised enterprise in CEECs today basically is a managerial firm. In our country sample, corporate governance structures change very slowly since the emerging capital markets are not yet functioning properly and the set of appropriate institutions is not comprehensive and not entirely enforced. One decade after privatisation has begun, the different corporate governance structures in CEECs can be sketched as four stylised facts: foreign capital controlling stake, managerial control (sometimes with the co-operation of banks), an outsider-insider coalition governing the enterprise, and a peculiar ‘employee and start-up’ governance. In the past recent years, some converging tendencies toward an ‘average’ Central Eastern European model of corporate governance have shown up; its two major pillars are a strong foreign investor control over big corporations combined with a strong governance by its single owner over genuine small and medium sized private enterprises (SMEs).

Although our classification of corporate governance structures may fit with the principal-agent model, it is not the agency cost theory, which lies in the background of our presentation. Thus, after a brief critical assessment of this model, we would suggest how, in our view, the economic analysis of

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corporate control over firms in CEECs can progress beyond the main conclusions of a principal-agent approach.

### **1. The impact of privatisation on corporate governance structures**

The corporate governance structure of a Soviet enterprise was rather simple: the state, as the single owner, assigned all management decisions to a single firm's executive director (the *edinonatchalie* principle) who was assisted in his work by some engineers and executive managers. In charge of fulfilling the enterprise plan, the executive director was subject to different checks and controls from his tutelage industrial ministry, from the state bank (*Gosbank* in the USSR) and from the communist party. Due to information asymmetry, all enterprise directors were any time capable of cheating (biasing all information transferred to controlling bodies) during both processes of building-up and achieving the plan. Such a cybernetic weakness was one basic source of inefficiency in the former centrally planned economy (Andreff, 1993).

The economic reforms launched by Gorbachev in the Soviet Union attempted to alleviate the causes of economic inefficiency through increasing the decision-making autonomy given to enterprise directors and managers, that is – in terms of a property rights analysis – through fully transferring the cash flow right (or *usus fructus*) over the enterprise's assets to them. In some other socialist countries, such as Hungary and Poland, an elected employee committee was entitled to supervise the current decisions (or *usus*) made by the director and managers whereas in Yugoslavia self-management was materialising the so-called social ownership (different from state ownership) in granting supervision and cash flow rights to the enterprise personnel (however the control right or *abusus* never got out of state hands). Thus, during the last years of the communist regime, in nearly all CEECs, corporate governance was taken over by insiders, either managers (the director included of course) or employees (or both). The only exception to insider governance was regarding the control right over the enterprise's assets, namely the right to sell them, which was kept by the state administration, although it was partially alleviated by newly introduced schemes of leasing and renting assets.

In the early years of postsocialist transition, privatising SOEs was envisaged as the major tool for changing not only ownership, but also management and governance in order to improve economic efficiency through asset restructuring and labour shedding. However, even before a privatisation law had been passed, a significant development of so-called spontaneous or *nomenklatura* privatisation sprang up in all PETs. It means that the director and managers immediately used their supervision and cash flow rights in such a way as to take over all the enterprise residual revenue, tunnel it into private companies they had just set up on purpose, and strip the most interesting assets from the SOE to their own newly settled private firms. Spontaneous privatisation strengthened the fans of the Washington consensus in their firm belief that the privatisation drive should proceed at the fastest speed, whatever the price to be paid for, so that communist managers and politicians could not transform their former

political power into economic ownership. The long run consequences for corporate governance of such an accelerated, if not forced<sup>2</sup>, privatisation process remained unheeded, at least in the mainstream economic literature, for several years. Nevertheless, some time was required to elaborate on and adopt privatisation laws and, usually, they were not passed early enough to avoid or prevent spontaneous privatisation from occurring.

On the other hand, some economists have advocated since the very beginning a (slower) development of the private sector based on new enterprises created from scratch (Kornai, 1990) or a privatisation drive exclusively implemented by means of asset sales, the only way not to generate serious corporate governance problems (Andreff, 1991 & 1992). Their recommendations were ignored or criticised by the mainstream and rejected by international economic organisations until the late 1990s<sup>3</sup>. In their survey of the literature, Shleifer and Vishny (1997) conclude that an efficient and strong corporate governance structure (that triggers restructuring and turning a loss-making SOE around) requires a 'hard core' of controlling blockholders. The latter can only be the outcome of firm privatisation through direct asset sales to strategic investors or initial public offerings followed with a market acquisition of the newly issued shares by those investors who wish to take over a majority or minority blockholding position. At odds with the previous conclusion, Washington international organisations and their experts privileged criteria such as the speed of privatisation and the number of firms privatised and assumed them to be guaranteeing the political objective of an irreversible change in ownership.

Albeit he demonstrated that initial economic conditions in PETs made it impossible to efficiently privatise SOEs through asset sales, Jeffrey Sachs (1991) nevertheless recommended resorting to non-standard methods of privatisation, supposedly enabling a rapid transfer of SOE ownership to new private proprietors. The so-called non-standard methods are mass privatisation, management and employee buy-out (MEBO) at preferential prices, and restitution (to former owners, before communism, or their heirs). The problem is that MEBO transfers those property rights (*usus* and *usus fructus*) previously acquired by SOE managers ... to the same incumbent managers while adding the *abusus* to their former rights. As to mass privatisation, it generates a widespread capital scattering since vouchers (then redeemed into shares) are allocated for free to the whole population. When the vouchers are redeemed into shares, managers are used to take benefit from their insider information in such a way as to acquire significant blocks of shares. If they succeed in such endeavour, mass

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<sup>2</sup> Often managers and employees first reacted with some resistance to privatisation, since they expected it to reduce overmaning in their SOE, which meant a threat over their jobs.

<sup>3</sup> A strategy of 'organic development' (Kornai) of the private sector and an economically efficient privatisation (through asset sales) was only supported by a minor group of economists in the early 1990s, namely Włodzimierz Brus, David Ellerman, Kasimierz Laski, Ronan Mc Kinnon, Lubomir Ilcoch, Peter Murrell, Gérard Roland, David Stark (non exhaustive list) and, later, Joseph Stiglitz (2000) - ... and of course myself. Their economic analyses and recommendations remained unheeded until a World Bank (2002) report recognised that mass privatisation and employee-management buy-out (nearly for free) revealed as inefficient privatisation methods. Since this report the Bank gives its support to those basic market institutions which facilitate entry by new start-ups and privatisation through direct case-by-case transactions.

privatisation then comes out with the same result as MEBO, that is a transfer of property rights from incumbent managers ... to incumbent managers.

Given the economic importance rapidly reached by the private sector in GDP (Table 1) and the fact that this sector's growth is partly due to privatisation, the variety of current corporate governance structures in PETs is strongly determined by those privatisation methods that have been adopted in each country.

### **Insert Table 1**

In the heat of the privatisation battle, by mid-1990s, the distribution of privatised assets according to privatisation methods in PETS was as follows (Andreff, 1999a): only 13% had been privatised through asset sales, 43% through MEBOs, 24% through mass privatisation and 20% by means of other methods such as restitution, heirs' (financial) compensation and municipalisation of assets. Since then, the distribution has more than slightly evolved toward a higher share of asset sales due, in particular, to an increased participation of foreign investors. However, mass privatisation is still the primary method, which has been used so far in eight PETs and MEBO in thirteen of them. Asset sales, including to foreign investors, has really been privileged only in Hungary and Estonia, even though it has become a significant privatisation method in Bulgaria and Poland in the past recent years; it is also going to outstrip all other methods in the Czech Republic with bank privatisation, very much open to foreign capital since 1999 (Bednarova, 2001). Corporate governance structures have been diversified further in PETs by the skyrocketing growth, though uneven from one country to the other, of start-ups in the *de novo* private sector (Duchêne & Rusin, 2003; Dallago & McIntyre, 2003). On the other hand, some SOEs appear to be so much 'unprivatisable' that the state has kept, willy-nilly, a significant share in their capital stock (residual state property) whereas some other SOEs will remain in a state of ongoing privatisation for a rather long time, and a last group of SOEs is still skip out from the area of privatisation simply because the state has given up the idea of (or does not wish) transferring their assets so far.

The overall result is – insofar as various privatisation methods have been experimented - a variety in the forms of ownership and in the distribution of property rights (Aukutsionek *et al.*, 1998), and a diversity in corporate governance structures, both in each PET and across all PETs.

## **2. Diversified corporate governance structures**

Corporate governance structures are now complex and diversified in all PETs. An overview of these structures is exhibited in Table 2 in which they are classified from the strongest as assessed by the principal-agent model (those structures where shareholders are assumed to have the strongest monitoring power) to the weakest (where the shareholders' supervising power is the most alleviated, diluted and ineffective).

## Insert Table 2

The economic analysis of corporate governance in PETs is in the limbo so far because there is no device that compares neither to the 20-F form in the USA which encompasses one section about control (governance) to be filled by the informant nor the European Directive 88/627/EEC on big holdings (Becht & Mayer, 2002). Therefore, a precise quantitative or qualitative analysis is out of reach now. In the future, such a study will become feasible for the eight PETs which have been admitted to join the European Union (EU) in May 2004, since they will have to implement the aforementioned European Directive. A better information about shareholders' votes, and their possible concentration, then will be available even though information regarding the concentration of stock ownership may remain partly undisclosed (and which is especially impenetrable in PETs so far). Meanwhile, studying the outcome of privatisation can provide an insight into the whole spectrum of governance structures that do exist in postsocialist firms.

The first configuration is one in which a private owner, often the only owner or a few associated owners, hold the entire enterprise stock (capital) and exerts all the prerogatives of a (owning) boss, that is as chief executive officer (*usus*), as residual claimant (*usus fructus*) and as possible seller of his/her enterprise (*abusus*). It is so in *private enterprises* created from scratch (start-ups) whether they are individual enterprises or small corporations (SMEs). It is a strong governance structure, which very well foreshadows the emergence in PETs of a governance structure similar to the one of SMEs in Western market economies. Where do the assets come from in such small enterprises? Their origin can be legal or not, the assets provided to the start-up can result from a primary accumulation of capital by the new entrepreneur, usually exploiting his/her rent seeking situation in PET newly emerging markets, or from asset stripping and tunnelling from a SOE in which he/she was previously (or still is) employed. The major problem with these new private SMEs is that their access to banking and other finance is hindered by their tiny or non existing collateral for loans. Nevertheless, the creation of start-ups has been of tremendous magnitude, mainly in Poland (Rusin, 2002) and then the Czech Republic (Vincensini, 2003), as well as Hungary, Slovenia, Bulgaria, Romania and Slovakia.

A variant of small private enterprises is the one owned by a single or a few associated owners coming out from the process of *small privatisation*. The latter refers to the state releasing retail shops, hotels, restaurants, cars, lorries, buses, and small craft production through public auction sales. Small privatisation also encompasses the state selling the physical assets of beforehand-dismantled SOEs such as various machine tools, equipment goods, buildings or workshops that can be of interest for some private purchaser.

Small privatisation have brought about millions of mushrooming SMEs in all PETs taken together. If one has to speak of a major success story in postsocialist privatisation, including in terms of corporate governance, small privatisation shows up in the foreground. The only dark side of the story is that private SMEs are facing high mortality rates, due to their lack of finance and/or expertise, that is not every time compensated by their high birth rates (Rusin, 2002).

Strong corporate governance, with a strict shareholder monitoring of managers, is rarer in *privatised firms*. When it comes to restitution to a former owner or his/her heirs, the outcome is open-ended. In a number of cases, the former owner or heir has flown away from the communist regime long ago and stays abroad; he/she may only be interested in closing down the factory and making all workers redundant. He/she may intend to restructure or change the nature of the business. He/she may simply resale the assets he has got in the restitution process. Whatever his/her decision, it exhibits that, when benefiting from restitution, the owner enjoys non-alleviated property rights despite a possible resistance on the side of managers and employees. The problem lies elsewhere. In case of restitution, the owner's decision is not necessarily beneficial to the home country (factory close down, labour shedding) so that few PETs, except the Czech Republic, engaged into ambitious restitution programmes. Elsewhere, like in Hungary for instance, those entitled to restitution did not receive physical assets but were compensated with privatisation vouchers enabling them to participate in the privatisation of SOEs that were for sale (with voucher redemption into shares) at the moment. Then, they entered the stockholding of privatised corporations, most often as minority shareholders excluded from corporate governance.

Privatisation based on *initial public offering* eventually was rather rare in PETs since, when the privatisation drive was launched, the stock exchange was not yet existing (except in Hungary). Afterwards, the newly emerging stock market was tiny in terms of (not even daily) transactions. All the more so since, at the very beginning, institutional investors were few, apart from state banks, state insurance companies and state financial institutions. Gathering a hard core of monitoring blockholders remained, in most cases, an unresolved issue because this hard core could not rally non-state shareholders and foreign investors (whose acquisitions were restricted or forbidden in most privatisation programmes, except in Hungary and Estonia). Moreover, domestic or local capitalist tycoons, capable to buy a substantial block of shares, were very few or non-existing in the first hours of transition. The most efficient corporate governance structure coming out from privatisation has revealed to be the acquisition or take-over<sup>4</sup> by foreign investors. The take-over has nearly always resulted from a direct asset sale negotiated by the state with a foreign firm and practically never from the latter's raid by means of swiftly buying shares of the targeted domestic firm at the stock exchange. In this event, the monitoring blockholder is a foreign transnational corporation, which is capable of supervision and used to efficiently supervising its foreign subsidiaries' managers, including in those subsidiaries recently acquired in PETs.

A number of assets have been directly sold by the state to domestic or local investors, *i.e.* to domestic outsiders. However, at the dawn of the privatisation process, sales to domestic outsiders were rather

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<sup>4</sup> Under certain conditions, monitoring over managers and a prevailing decision power over other shareholders can be reached with a minority share (see Andreff, 1996). A 'blocking minority', usually defined in each corporate law (for instance, it is fixed at 25% of total stock – votes – in Hungary), can sometimes be enough for a foreign investor to prevail in managerial and financial decisions, but it can also carry out a conflict of interest with domestic shareholders or with the state when it keeps some share (as it has been witnessed in Hungary and other PETs).

few and undesirable because they boiled down to transferring assets to incumbent *nomenklatura* leaders and managers or, even worse, to those who had previously been capable to illegally enrich themselves and to accumulate enough wealth in the second (underground) economy or in the *Mafia* to be able to invest it in a substantial share of a privatised corporation. In some PETs, the law or the programme of privatisation was forbidding the sale of SOEs' assets to incumbent communist leaders and rulers. After some time, since the mid-1990s, the circumstances have changed and privatised corporations have been acquired or taken over by domestic outsiders. The number of 'new riches' has substantially increased thanks to legal, illegal or borderline transactions in formal or informal emerging markets; their capacity of investing in the property of privatised corporations has improved. After the initial MEBO and mass privatisation programmes, share resale transactions expanded, sometimes in the stock market, more often off the market <sup>5</sup>. Share re-sales have opened up an opportunity for domestic outsiders such as new riches, but also for insiders using their own private 'screen companies' and oligarchs heading the new financial-industrial groups (FIGs), to acquire substantial – often controlling – blocks of shares in privatised enterprises. All these share purchasers were looking for a sizeable blockholding which, with some alliances, can enable them to take over all strategic decisions in the targeted privatised enterprise – *i.e.* to exert a strong corporate governance – in spite of the wishes, hopes and intents of both incumbent managers and minority shareholders. Although all share re-sales did not end up with a corporate governance dominated by a hard core of monitoring blockholders, they increased the proportion of corporations under outsider and FIG control, as in Russia for example (Table 3).

### **Insert Table 3**

The trickiest issue with corporate governance in privatised firms has surged after MEBO and mass privatisation. In PETS with a self-management tradition (former Yugoslavia, Poland), MEBO was the tool for transferring most firms to their personnel. Then, those who govern the enterprise are easily identified – *i.e.* employees and managers –, but with MEBO we should say that enterprise assets are 'socialised' rather than genuinely privatised. Of course, employees become private owners of their enterprise but their main objectives are different from those of a capitalist owner. In acquiring ownership, and corresponding property rights, employees look for maintaining jobs, securing current wage rates, and safeguarding working conditions. Assessed from the viewpoint of the principal-agent model, such a corporate governance structure is weak or inefficient, not likely to pave the way for high firm profitability. Most studies realised on enterprise samples in PETs show that employee-owned firms on average underperform other enterprises, even SOEs, as regards to productivity and profitability, except a few noticeable exceptions in Poland (see a survey of these sample studies in Djankov & Murrell, 2002; Megginson & Netter, 2001). On the other hand, employee ownership has triggered an interesting effect: it has markedly reduced, in particular in Poland, asset stripping by

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<sup>5</sup> About 90% of share resale in the Czech Republic and Russia occurred off the market after mass privatisation.

incumbent managers before, during and after privatisation (Nellis, 2002a). In their quality of owners, employees have submitted managers to a strict supervision in such a way as to prevent their attempts to loot the firm's assets. However, the managerial discipline obtained by employees primarily did not aim at profit or shareholder value maximisation – as it uses to be with capitalist shareholders.

Anyway, a more frequent way out of MEBO is managerial governance over privatised enterprises in all PETs. In the most frequent scheme, former communist enterprise managers have transformed their political power into economic capital<sup>6</sup>. Either altogether the managers hold a significant share in the privatised firm's stock or they acquire it in purchasing shares to employees, after the stock has been scattered across all the employees (by MEBO). Often, managers have simply utilised their authority over employees to take over all governing decisions or acquire employees' shares at low prices (managers are used to threatening of redundancy those employees who intend to sell their shares to outsiders, promising to keep jobs for those who will sell them their shares, etc.). In some countries, such as the Czech Republic, employees were excluded from MBOs (management buy-outs); managers were the only ones allowed purchasing assets. Sample studies have exhibited that manager-controlled (owned) firms on average outperform employee-owned enterprises and SOEs as far as productivity and profitability are concerned, although they underperform outsider-owned firms and do markedly worse than enterprises taken over by foreign investors (Andreff, 2003). *Managerial firm* is the predominant corporate governance structure coming out from privatisation so far. This is confirmed when looking at mass privatisation.

In all those PETs which have privileged *mass privatisation*, today the results are disappointing, standing very far from what has been expected ten or fifteen years ago. The objective was to offer for free, or nearly for free, to the whole population privatisation, vouchers redeemable into shares that would materialise the right for anyone<sup>7</sup> to participate into the acquisition of state-owned assets. An initial and egalitarian distribution of property rights was supposed to evolve, in accordance with the Coase theorem<sup>8</sup>, through share re-sales in the stock market, in such a way as to favour the emergence of blockholders. The latter were assumed to be willing to invest in privatised enterprises and purchase the shares of those citizens not interested or unfitted for business. Contrary to these expectations, in all PETs, mass privatisation has paved the way, directly or not, for corporate governance dominated by managers in privatised firms.

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<sup>6</sup> According to a large EBRD survey, hardly one third of former managers have been replaced in privatised firms, in all PETs. Among the new executive managers, 40% come from outside the firm while 60% have been promoted within the same enterprise (EBRD, 1999).

<sup>7</sup> We can also see in this privatisation scheme a sort of 'egalitarianism', either a strong whiff of socialism and communism or the effect of the theory of property rights regarding the whole population as the true owner of SOEs. In some circumstances, free distribution of vouchers was thought of as a tool for overcoming popular resistance against the privatisation programme (Boycko *et al.*, 1995) or as a means, for political parties in power, to « purchase » their success in the next democratic elections (ex. : in the Czech Republic).

<sup>8</sup> We elaborate elsewhere (Andreff, 2004a) on a critical analysis of Coase theorem on the grounds of both some inconsistencies between the so-called theorem and the Coasian theory of the firm (Coase, 1937) and the full inaccuracy of the assumptions underlying the Coase theorem vis-à-vis the economic situation in post-Soviet economies (extremely high transaction costs, an absent stock market, etc.).

For instance, in Russia, three options were open in the framework of mass privatisation. According to option 1, 40% of corporate stock was offered to the personnel at a preferential price. In option 2, employees could immediately get 51% of the stock at a higher (than the book value) price, and option 3 preserved 30% of the stock to a managerial group committing itself to turn the enterprise around and avoid its bankruptcy. In each case, the remaining part of the stock was to be sold against privatisation vouchers until June 1994 and for money 'cash' privatisation afterwards. Option 2 was chosen by over 73% of the roughly 15,000 enterprises involved in the mass privatisation programme while option 1 was adopted by 25% of privatised firms, leaving only less than 2% in option 3 (Blasi *et al.*, 1997). In nearly all circumstances, managers have kept a firm hand over corporate governance since the remaining stock was so much scattered. Moreover, they have proceeded to a capital concentration into their hands by acquiring the shares held by the personnel (under threat, see above). Thus, strong managerial entrenchment was the key result of mass privatisation (Filatochev *et al.* 1999; Labaronne, 1998). It was strengthened by the opportunistic and strategic behaviour of managers. In Russian privatised firms, managers exert strict supervision over who buys their enterprise shares; most enterprises do not use independent shareholder registers; and most managers say they oppose financial disclosure and majority ownership by an outside investor with enough capital to turn the firm around. Inadequate legal and regulatory framework and poor protection of minority shareholders' rights may increase managerial benefit to be gained from holding a controlling stakes. When legal rules fail to constrain the actions of controlling managers, the latter are used to engage in self-serving activity such as the transfer of assets at arbitrary prices to manager-owned private firms. This, in turn, dilutes minority claims further. Incumbent managers have also circumvented the law: we have listed (Andreff *et al.*, 1996; see also the list provided in Blasi *et al.*, 1997) more than twenty varieties of violations of the corporate law in Russian privatised enterprises, from not convening the shareholder meeting to votes by show of hands<sup>9</sup>. The weakness and unpredictability of the Russian court system was not able to put a brake on these violations. When a firm is locked in managerial control, managers tend to consider shareholding as a management variable and substitute the firm to the court<sup>10</sup>.

In other PETs, corporate governance was taken over by managers as an indirect result of mass privatisation. In the Czech Republic, about three-quarters of all privatisation vouchers have been purchased to the citizens by Privatisation Investment Funds (PIFs) which thereafter have redeemed them into shares. At first sight, becoming major shareholders, these newly created institutional

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<sup>9</sup> Note that remedies for illegal self-dealing by managers or board members include criminal sanctions in some OECD countries.

<sup>10</sup> Williamson (2002, p. 178) states: "courts will refuse to hear disputes that arise within firms – with respect, for example, to transfer pricing, overhead, accounting, the costs to be ascribed to intra-firm delays, failures of quality and the like. In effect, the contract law of internal organisation is that of forbearance, according to which a firm becomes its own court of ultimate appeal". As long as market institutions are not fixed and laws are not enforced, the boundary of the firm remains blurred between the nexus of internal contracts (mentioned by Williamson) and outside contracts (including share ownership). Then,

investors (*i.e.* the PIFs) seemed to have taken over most privatised firms. Therefore, PIF's managers were in position to monitor the decisions made by the managers running the firms belonging to the PIF's portfolio but, as Stiglitz (2000) stressed it, the problem then became 'who monitors the monitors?' (*i.e.* who monitors the PIFs' managers?). In the context of the Czech Republic, the response was quite clear since most PIFs had a major (often only one) shareholder, which was a state bank or a state insurance company. Thus, a Czech Minister for the Economy (Mertlik, 1996) once said that mass privatisation is the fastest track to transfer state property ... to the state. As regards to corporate governance, it was transferred from former (now privatised) SOEs' managers to PIFs' managers and eventually to state banks' managers, in other words from incumbent *nomenklatura* to *nomenklatura*.

In the Polish variant of mass privatisation, the state set up fifteen National Investment Funds across which the assets of would-be privatised firms have been allocated. Polish citizens could not acquire shares in the privatised firms' stock but they were entitled to become shareholders of the Funds. Attempting to circumvent the issue of monitoring the monitors, each Fund is managed by a management consortium gathering foreign and Polish banks and audit agencies. The resulting governance structure *a priori* seemed stronger than the one with the Czech PIFs, since each management consortium was given the explicit objective of increasing the value of asset portfolio held by its Fund. However, all the Funds behaved in such a way as to disinvest from the least profitable firms in their portfolio and to invest in the most profitable ones instead of, as expected, restructuring and modernising the most obsolete firms. In fact, they adopted the behaviour of an institutional investor (such as, say, an American pension fund) and did not step in the corporate governance of those firms they were supposed to monitor; as a result, restructuring is lagging behind in Polish mass privatised firms.

Finally, Russia has experimented the wrong, most disavowed and criticised privatisation method, that is the so-called 'loans for shares' scheme, even though it ended up with a strong corporate governance structure. Such a scheme was suggested in 1995 to President Eltsin by Vladimir Potanin, the Uneximbank CEO, and consisted in that the Russian State would deposit in Russian banks significant blocks of shares from the stocks of the most valuable Russian SOEs (oil companies, other energy and raw materials producers). Banks would consider the stock they held as collateral for the loans that they offered to provide in order to bail out a serious fiscal deficit. For each company involved in this device, an auction was opened and the winning bank got a block of shares, remitted the price as a loan to the state, and was holding the shares until September 1996. If, on this date, the state had not reimbursed the loan, the bank would be allowed to sell or definitively keep the shares (and the ownership in an oil trust, etc.). Since the state obviously was not capable to repay its debt, banks gained through this scheme the ownership of the 'crown jewels' of the Russian industry, for a nominal

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its inability to be perceived as an identifiable entity by other economic agents creates important transaction costs for the

sum <sup>11</sup>, insofar as auctions were rigged and not exempt of collusion. All the winning banks were owned by a small group of financial oligarchs well acquainted with the President of the Russian Federation (Nellis, 2002b). Some of these transactions were so much fraudulent that the Moscow arbitrage court invalidated them. Nevertheless, a small group of oligarchs, including Roman Abramovitch, Evgueny Ananiev, Boris Berezovski, Mikhaïl Fridman, Vladimir Goussinski, Mikhaïl Khodorkovski, Igor Malatchenko, Vladimir Potanin, Alexander Smolenski, etc., appropriated the finest jewels of the Russian industry. The ‘loans for shares’ scheme definitely discredited the Russian privatisation drive which was both disapproved by the World Bank and overtly criticised by the great bulk of Russian population, and became infamous outside Russia <sup>12</sup>. Absolutely questionable from a moral or business ethics point of view, the discussed scheme has brought about the integration of valuable firms into oligarchic FIGs with a strong corporate governance structure (privatised enterprises are then monitored by the core bank of the FIG or by an oligarch – major shareholder – himself). It has contributed to increasing the outsiders’ share in the overall control over Russian enterprises (Table 3) and to the emergence of a new economic and financial ‘elite’, although it is with the help of the most dubious, rigged and amoral device, at the extreme opposite of the Coase theorem! (Andreff, 2004b).

Until now, a number of enterprises remain in *mixed ownership* in PETs, with both private owners and the state sharing their stock. First, there are those firms whose privatisation have been launched and is still going on, but some part of the stock is still at state hands. Second, there is state residual property. In several privatised enterprises, the state has kept a share in the stock ownership for one or another reason: the state may be willing to avoid an undesirable take-over of the enterprise by foreign stakes and then it keeps a golden share or a minority blockholding; the state has not been able so far to find enough purchasers to sell them the whole stockholding; some of those entitled to benefit from MEBOs or from redeeming their vouchers into shares have not acquired the shares they have right to, and their shares remain at state hands. Therefore, we find some state representatives seating in the board of directors of such firms, in proportion with the stockholding share still in state ownership. A serious issue of corporate governance derives from this situation. Either incumbent managers govern the firm or state representatives in the board of directors do adopt a strategic behaviour which dissuades private owners to invest further in this firm (or even incites them to sell their shares). Since the state representatives in the board usually are civil servants, academics from state universities, and state experts appointed by a ministry, they have not necessarily all the required financial, juridical, accounting and managerial skills to act as efficient enterprise executives. Moreover, as soon as

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economy as a whole.

<sup>11</sup> Since the auctions were rigged the shares were sold at down rock (extremely cheap) prices. For instance, Mikhail Khodorkovski is suspected to have paid \$300 million for obtaining the ownership of assets now valued at about \$10 billion.

<sup>12</sup> Keeping M. Khodorkovski in jail and circulating rumours about M. Abramovich and other oligarchs might give the feeling that President Putin’s administration is now willing to put the most fraudulent acquisitions of Russian enterprises into question. An alternative assumption is that we are witnessing a harsh struggle for redistributing assets between a part of this administration (the ‘security’ services) and oligarchs.

appointed, they make up a group of stakeholders with its own interests in the board of directors. This group's interests often conflict with the ones of private owners, since the former are leaned to put a halt on the privatisation process of the firm (of course a comprehensive privatisation of the stock would entail the phasing out of their participation to the board of directors, and a loss of influence and directors' fees). Besides, the sustained relationships between these state representatives seating in the boards and the state administration they are coming from may harm independent corporate governance in partially privatised firms. It also happens that state residual property paves the way for an unspecified corporate governance structure due to lack of consensus or missing alliances between conflicting interests of managers, private shareholders and state representatives in the board.

The last subset of firms in PETs encompasses *public enterprises*; they still represent about 20% of GDP in Hungary and up to over 80% in Belarus and Turkmenistan. Their survival traces back to various stories. First, in successor states of former Yugoslavia, self-managed enterprises were in 'social ownership' so that the first step before privatisation was to nationalise them in order, for the state, to have full ownership at its disposal and then corporatise the newly state-owned enterprises. However, since privatisation has taken some time, meanwhile the board of directors comprised only of state representatives in charge of running the corporation according to state command. On the other hand, in all PETs, primarily in Belarus, Turkmenistan and Uzbekistan, a number of SOEs have not even been corporatised. In this case, state-appointed managers as before, dominate corporate governance. From the standpoint of the property rights theory and the principal-agent model, such a governance structure is assumed to be weak and inefficient, since managers are not monitored, and cannot be monitored, by too many shareholders (here the assumption is that the whole population owns each SOE). An alternative view is to regard SOEs as having a single unique shareowner – the state – which is then in a strong position to lay down governance guidelines on to the managers, *i.e.* a strong governance structure. For instance, in China (Djankov & Murrell, 2002), the state is used to provide SOEs' managers with very strong incentives to behave in such a way as to maintain the enterprise in the black while threatening them of heavy disciplinary and financial penalties if it is in the red; sanctions can go as far as death penalty in case of abuse of power! *A contrario*, sanctions are less stringent and often deferred, sometimes non existent, *vis-à-vis* SOEs' managers in Central and Eastern Europe and CIS countries.

In the same vein, we have recommended to privatise the management in public enterprises (Andreff, 1992 & 1995) when the privatisation of assets is not immediately feasible or is not desirable. What does it mean? Privatisation of management consists in managing a public enterprise in such a way as to put a full stop to current deficit, and then make profit in order to invest it into restructuring the assets and eventually into foreign subsidiaries abroad; in other words, it means managing public enterprises according to exactly the same criteria as a private firm. Privatisation of management is only feasible if the state, as the single shareholder, adopts an efficient corporate governance structure by providing appropriate incentives to SOEs' managers, that is those incentives which drive them to

‘manage as in the private sector’, and firing them overnight otherwise. Once profitable and efficiently managed, due to a strong corporate governance exerted by a unique shareholder, privatisation of SOEs’ assets happens to become only a question of political opportunity (depending on the colour of the political party in office) and no longer one of economic efficiency, since the latter has been restored meanwhile. A recent World Bank report (World Bank, 2002) acknowledges that, often, it would have been preferable to leave assets in state hands – instead of swiftly launching mass privatisation and MEBOs – long enough to identify reliable strategic investors and, only then, to sell SOEs to them. Unfortunately, the World Bank was not open to accept such an advice when it was suggested ten years ago (see among others Andreff, 1991 & 1992).

### **3. Slow concentration of ownership and the momentum of corporate governance**

The overall picture of corporate governance in PETs that we have screened above is put in somewhat static terms and only describes governance structures during the first decade of transition. Of course, corporate governance structures are dynamic and usually evolve over a period of time. In emerging market economies, such as PETs, the initial absence of appropriate rules and institutions that regulate changes in corporate governance and, above all, their absent enforcement, have put limitations on the dynamic of corporate governance structures.

The first lack of institutions resides in a missing developed and tightly regulated capital market in all PETs, more than one decade after the early days of transition (Table 4). A tiny stock market not only delivers a distorted – disequilibrium - price for each quoted share (contrary to what is assumed when a great variety of shares are traded among very numerous traders), but it is often plagued by connected trading and speculative bubbles (from Warsaw to Prague, from Sofia to Moscow, raging crises have burst out after financial bubbles), and circumvented by vast off the market transactions. A prerequisite for peaceful take-overs as well as swift raids in the stock exchange is that shareholders can remain anonymous in the market, a precondition which is not often satisfied in tiny PETs’ capital markets. Regulating bodies of the stock exchange, when they are existent, have no long experience and are not capable to secure that any transaction is fair or simply legal. This explains why, after privatisation properly speaking, share re-sales basically developed off the market and facilitated a reinforced monitoring of incumbent monitors (primarily incumbent managers) instead of the expected concentration of stockholding in outsiders’ hands. When the latter occurred, it was often to the benefit of newly enriched oligarchs or newly emerging banks and FIGs.

#### **Insert Table 4**

Until the end of the 1990s, take-overs, mergers and acquisitions achieved between firms based in the same PET or in different PETs (transborder mergers) remained a few exceptions while an important wave of (including transborder) mergers and acquisitions was flooding the global economy and world capital markets from 1994 to 2000. Since the end of the 1990s, concentration through take-overs and

acquisitions started to develop in PETs and, as a consequence, corporate governance has evolved in acquired or merged firms, switching from managers to outsiders and FIGs. For instance, in the Czech Republic, the number of take-overs and acquisitions raised from 67 in 1997 to 196 in 1999, 221 in 2000 and 158 in 2001. In Russia, as soon as 1996-1997, the state supported some take-overs and the setting-up of big holdings in key industries such as electricity, hydrocarbons and telecommunications (Nestor, 2002). In most PETs, the strategies that enable to disconnect one's shares in the stockholding from one's votes at the shareholder assembly meeting have not yet (or seldom) emerged. Through such strategies some group of interests can maintain its corporate control over a firm whatever the exact share of the stock it owns. These strategies rely on proxy fights, limiting voting rights associated to some shares, privileged options to buy shares, exchanging shares against investment certificates, preferential share issuance's to incumbent shareholders, anti-raid measures, including some famous poison pills. In PETs, a change in corporate governance has nearly no chance to occur by means of any of the aforementioned (often non existing) instruments.

On the other hand, underground alliances between different groups of interests still exhibit the inertia of former networks between communist leaders, managers and bureaucrats. These alliances gather either insiders (primarily managers) or outsiders (primarily bankers and oligarchs), or only outsiders. There is practically no study that systematically identifies who exactly is those involved in such alliances so far. However, in a work by Baltowski & Mickiewicz (2000), three types of alliances appear to be widespread across Polish privatised firms: 1/ alliances between a group of outsiders and representatives of the State Treasury (which holds the shares corresponding to residual state property), often opposed to the firms' personnel; 2/ alliances between managers and employees against the representatives of the State Treasury; 3/ alliances of employees and the representatives of the State Treasury against either an outsider or the managerial team. Further studies of monitoring blockholders and interlocking directorates remain to be conducted when all information about them will be disclosed (for a first and partial attempt, see Mesnard, 1999).

#### **4. Interpretation from the principal-agent model standpoint**

Since Coase (1937), the mainstream literature about the 'master-servant' relationship has evolved, due to the separation of ownership and control (Berle & Means, 1932) in a number of joint stock corporations in which important decision agents (managers) do not bear a substantial share of the wealth effects of their decisions. Then, starting from a view of the firm as a nexus of written and unwritten contracts (Jensen & Meckling, 1976), the mainstream analysis came up with the principal-agent model (Fama & Jensen, 1983). In a corporation, agency problems arise because contracts are not written and enforced without cost. Agency costs include the costs of structuring monitoring and bonding a set of contracts among agents with conflicting interests.

Expanding shareholders' supervision over agents (managers) derives from the view that shareholders are the genuine owners of corporations. Bearing the residual risk, they are those who contract for the rights to net cash flows. The assumption is that, as residual claimants of the firm's net revenue, shareholders stand last in line for the distribution of gains or losses deriving from the firm's performance and, thus, have the appropriate incentives to make accurate discretionary strategic decisions (Easterbrook & Fischel, 1991). In particular, their ability to monitor managers (and through them other employees) is crucial, and is effective only if their property rights are not alleviated by managerial rent-seeking behaviour. When shareholders are capable of disciplining managers, the profit is higher than otherwise. Under this assumption, the more dispersed the distribution of corporate capital, the higher the cost for shareholders to gather information and monitor the managers. Efficient management and enterprise restructuring thus require appropriate managerial incentives. These incentives are less likely when corporate capital is less concentrated. Such is the principal-agent problem in which the principal is in possession of less information than the agent (moral hazard) and must design a suitable procedure for inciting managers (agents) to act according to his/her interest (maximising profit and shareholder value). Quite logically, in their survey of the literature, Shleifer & Vishny (1997) argue in favour of establishing controlling block shareholdings. However, obsessed by the privatisation speed, PET reformers have often supported and implemented those (non-sale) methods of privatisation that exactly do not guarantee the emergence of hard cores of monitoring shareholders.

In the perspective of the principal-agent model, all corporate governance structures can be ranked on a scale at the lower step of which we find SOEs. Then come insider privatised firms and finally outsider privatised firms with a variety of possible outside controllers: banks, institutional investors, domestic shareholders, foreign investors, and individuals. Individual control usually emerges in start-ups and small privatisation with no corporate governance concern about it. In a small firm, a single owner is the boss who disciplines at a low cost a handful of managers, and supervises him/herself all the labour force. In big firms, asset sale privatisation is supposed to provide a strong corporate governance structure with either a single majority owner or a hard core of monitoring shareholders. Controlling owners could own only a minority stake (block of shares) as well, but bigger than the one of any other co-ordinated group of shareholders (Andreff, 1996).

The real pattern of corporate governance that is emerging in PETs is path dependent, reflecting the means used to privatise SOEs, the laws that have been enacted or revived, and the institutions that have emerged – or not - to facilitate corporate governance (Brada & Singh, 1999). This explains why, due to national specificities, various empirical surveys produce a very scattered picture of restructuring in PETs. An increasing number of studies have published non-converging results after 1995. At least for CEECs, a number of surveys based on firm samples have reached the same sort of findings: microeconomic profitability has improved after privatisation, and privatised firms have outperformed existing SOEs. However, in most surveys, the result is subject to a selection bias. Was it privatisation

that fostered better enterprise performance or was it better performance that led enterprise to be selected for privatisation? Privatised firms were not randomly selected. The choice of a standard privatisation method often reflects the fact that the firm is viable and potentially or really profitable under market conditions. Several enterprises sampled as privatised may well be still under state control (residual state property), so that differences in performance between genuinely privatised and state-run firms may be partly levelled off. This occurs namely when some major adjustment efforts in state firms have been achieved, including redundancies and wage control in loss-making firms, under the pressure of the final cut in open-ended subsidies.

Profitability and productivity are supposed to reflect the scope and depth of restructuring, and thus the quality of corporate governance. Hypothesis follows, often tested in enterprise surveys, that privatised firms must perform better than SOEs, and outsider-controlled must outperform insider-controlled firms, in terms of profitability and productivity. The most robust finding in various surveys so far is that foreign owners outperform former SOEs and all privatised firms in strategic restructuring (Bornstein, 2001) by bringing in expertise, technology and capital. On average, privatised firms are more profitable than SOEs, in line with the principal-agent model. Across privatised firms, more surveys exhibit insider-controlled firms engaged in survival-oriented adjustment than the other way round. Outsider-owned firms enjoy an advantage over SOEs. Firms with investment funds as the largest owners perform rather well, but firms owned by domestic non-financial companies often exhibit a weaker performance. Insider-controlled firms shed labour at significantly lower rates than either SOEs or other privatised companies, and do even worse on costs and revenues. Employee-owned firms even underperform SOEs in terms of labour shedding. This backs a strong mainstream case against the efficiency of employee buy-out privatisation. Paradoxically, worker councils in Polish enterprises ultimately have proved to be a positive force, namely in keeping an eye on managers and hindering them, if not totally preventing them, from asset stripping and spontaneous privatisation (Nellis, 2002a) that has pervaded privatisation in most PETs. Worker control in this country eventually seems qualitatively more efficient than managerial control, at odds with the mainstream. Contradicting the mainstream hypotheses as well, some surveys have found strategic restructuring in all ownership types, including SOEs and insider-controlled firms. Managers, under the pressure of new market conditions, unexpectedly initiated restructuring, at least defensive restructuring in not yet privatised SOEs (Pinto & van Wijnbergen, 1995).

Despite the number of studies on the relationship between ownership and corporate governance, and performance in transition, the results have been weak and rather mixed so far. The most annoying problem is the increasing number of conflicting observations that accompanies the increasing number of surveys. So many different and contradictory results eventually mean that something went wrong with their theoretical background, *i.e.* the principal-agent model. It is all the more so since the qualitative picture of corporate governance is less bright than the quantitative one. The theoretical relationship postulated by the principal-agent model between corporate governance and restructuring

is probably too restrictive. In the real world of current business, this relationship is not stable due to frequent changes in the shareholding of each single corporation (share sales, take-overs, acquisitions). The same agent may unpredictably modify his/her economic behaviour depending on macro- and micro-circumstances, including the threat of a take-over, the redistribution of shareholding, the appointment of new enterprise boards, the result of a proxy fight, the emergence of a FIG, the loopholes in corporation law, the opportunities of corruption, and the claims of non residual claimants (all factors unheeded in the mainstream model). More or less regular bonuses, premiums, perks and bribes can link insiders to outsiders (Blasi *et al.*, 1997), in a not yet fully-fledged market-oriented enterprise, in a way unpredictable by the principal-agent model, so that profitability is often a meaningless variable, not to speak of profit distortions in a still imperfect competition. Lower profit may reflect the existence of a coalition between outsiders and insiders involved into a profit hiding strategy, that is a widespread strategy for tax evasion purpose in PETs.

## **5. Beyond the principal-agent model**

One of the shortcomings with the principal-agent model is that institutional environment is practically neglected. For instance, an effective regulation of the securities market is one of the most crucial institutions to permit effective owner monitoring over managers of privatised enterprises. Capital market failures certainly were an important element in the failure to improve company performance after privatisation (Estrin, 2000). Privatisation cannot itself generate financial markets that are critical to selling shares to those who look for control. However, capital markets are needed to provide legitimate mechanisms for asset transactions. Privatisation and private ownership without an institutionalised capital market have been disastrous for corporate governance. A desired outcome of privatisation should have been that entrepreneurs could purchase assets, but there was no institutional mechanism by which shares could be purchased in efficient markets. The distribution of shares to millions of shareholders who could not transact in absent or tiny capital markets is a basic shortcomings of mass privatisation; it gave to entrepreneurs a strong incentive for striving to acquire these assets by extra-legal means. Closed subscriptions of shares still doubled in 2000 in Russia, compared with 1999. The Federal Securities Commission has been unable to address the issue effectively.

Financial markets work well when institutional mechanisms strengthen property rights, provide verifiable information on prices and enforce institutional trust. These mechanisms include the registries that record ownership claims to shares, the depositories that permit the clearance and settlements of shares, the broker-dealer licensing that restricts entry to individuals who meet certain financial and fiduciary standards, and the stock market regulation that establishes criteria for the creation of such markets as well as for the requirements to list a company's shares. The development of such institutionalised market mechanisms is a precondition to the success of privatisation, not the other way

round. For example, in Russia, up to 2,000 unlicensed financial companies have been operating on the emerging financial markets. They were mushrooming because of a number of opportunities for speculation, arbitrage and trade existed. The lack of regulatory oversight allowed financial agents to participate in the market virtually at will. For example, the MMM scandal has shown both the misdoing of an emerging capital market and the limits of institutional trust. Both Russian and the Czech examples (Kogut & Spicer, 2002) indicate that a principal concern of the post-privatisation era has not only been corporate governance, but the legal transfer of assets from uninformed shareholders through tiny and weakly legitimate financial markets.

Most restructuring in Russia was confined to shedding labour and rehabilitating firms' existing production capacity (Aukutsionek *et al.*, 1998), since strategic restructuring calls for important investment that exceeds the finance available to firms. The capacity of many enterprises to upgrade or expand their capital stock was severely constrained by lack of finance from internal or external sources. In particular, banks were reluctant to lend money to unstructured insider-controlled firms, fearing that credit would be allocated to wage increases or managerial appropriation. On the other hand, such credit should have been the first step towards strategic restructuring. Therefore, most enterprises have to rely on self-financing – hence on short-term profitability - to invest in the modernisation of their production capacity. A strong limitation is that insider-controlled firms are less or non-profitable. Those firms involved in FIGs, and benefiting from a privileged access to credit of a 'pocket bank' belonging to the group, did not engage in strategic restructuring either (Perotti & Gelfer, 1999). Thus, except when foreign investors stepped in, privatisation had not triggered much strategic restructuring. As a result, firm boundaries have not much changed, by lack of both in-house restructuring and intensive take-over deals.

In the background of slow restructuring, we find top managers that have really taken over enterprises and own many of them, including firms where employees apparently hold more shares than managers. In PET circumstances, managers and employees have actually colluded to save insider control over privatised enterprises. Managers have purchased employee shares; some top managers have bought up stock without the employee's knowledge and have used 'pocket companies' to buy shares quietly. The shares had not been traded anonymously (Aghion & Blanchard, 1998) and, at the end of the day, managers were among the main buyers. Therefore, managerial entrenchment is a widespread result of privatisation in all PETs. Entrenchment seems to be a common attitude of most managers, although some managerial turnover has been observed in privatised firms. Pre-tax profits, rate of return on capital, export sales and other economic indicators do not produce statistically significant effects on managers' intentions to buy shares from employees while entrenchment proxies proved to be very significant determinants of a managerial strategy aimed at preserving their control over companies (Filatochev *et al.*, 1999). Increased managerial ownership can cause increased entrenchment detrimental to strategic restructuring.

When facing managerial entrenchment in a joint stock company in a Western market economy, shareholders may handle several levers to get rid of incumbent managers since there is a competitive market for managerial talents, an efficient capital market and a possible threat for the enterprise to be taken over if unsatisfied shareholders sell their shares. In the face of these potential or real threats, managers are used to achieve idiosyncratic investments in the corporation that raise the opportunity cost of firing them (Shleifer & Vishny, 1989). Then, idiosyncratic transactions encompass higher costs for outsiders. In privatised firms in PETs, not only incumbent managers do achieve this kind of investment, but they also unscrupulously utilise more activist, legal, illegal or borderline means for guaranteeing the firm survival and their own entrenchment in corporate governance (Labaronne, 1998). Loopholes in the new legislation on joint stock companies were used by incumbent managers to avoid disclosure (Klipper, 1998) and, thus, alleviate small shareholders' property rights. Managers have even hidden relevant information or have circulated it after introducing some bias in order to increase the governance costs of a shareholder monitoring. They have not been disciplined by the threat of bankruptcy since the law is not often enforced.

Thus, a number of rather simplistic assumptions underlying the principal-agent model have become increasingly hard to maintain. The overall outcome of PET privatisation has damaged the model. However, alternative theoretical explanations of corporate governance were existing before 1989. First, there was a theory of corporate control that prevailed since the work by Berle and Means (1932), in a less-developed stage of Western market capitalism, and before the emergence of the agency cost analysis. Second, one can also dwell upon the literature on coalitions within economic organisations. In the quite peculiar ownership structures of PET firms, what matters is not only the concentration of ownership, but also the identity of owners. Who personally are the new owners and in how many different corporate boards are they involved? Do they behave as shameless tycoons? How many shares do they personally own? What are their alliances or interest groups, and their legal or illegal manoeuvres? All this matters as well.

The theory of corporate control distinguished insider (usually managerial) and outsider control, the latter being in the hands of a hard core of strategic shareholders, the tycoon's family, banks, or institutional investors. The whole issue was not only depending on the concentration or dispersion of shares, but was also based on distinguishing majority and minority control of shares (and on pointing at the blocking percentage of shares). The basic hypothesis was that corporate governance structures are not static or fixed forever. They are moving due to mergers, acquisitions, take-over bids and, in the most sophisticated versions, to proxy fights for appointing the firm's boards (Andreff, 1996). Though moving, the financial capital structure is interlocking a number of industrial firms and banks, through cross-ownership, into FIGs. This should be a valuable analysis for PETs today, as well as the analysis of interlocking directorates.

A part of the theory of economic organisations focuses on coalitions (Mintzberg, 1983). Among the participants in a firm, some subsets or groups can coalesce around a mutual target of satisfying results

under the hypothesis of a bounded rationality of economic agents. At any moment, some coalition dominates the enterprise but can be removed by another in the making. The ruling coalition should adopt a management providing the highest return on assets if one wants a formally privatised firm to be transformed into a private firm maximising its profit. The type of coalition in power and contingencies of economic environment determine the kind of target, which must reach a satisfying level in the firm: efficiency, survival, autonomy, growth, asset value or another one. The emergence of a new dominating coalition within the enterprise can obviously change the prevailing target. Although survival usually characterises insider coalitions and profit-making outsider coalitions, the real picture in a corporation is often blurred when managers are shareholders, when employees own shares, when there is discord within the management team or the corporate board, or when alliances tie some managers to core shareholders. Once all these factors are taken into account, the objective functions of insiders and outsiders might well overlap. A deeper analysis of the ruling coalitions in various privatised firms would help to detect a revealed (probably multi-variable) objective function for each type of coalitions. A first step in this direction is the above-mentioned survey of Polish privatisation by Baltowski and Mickiewicz (2000). We are far beyond the simplistic distinction between the profit-seeking behaviour of residual claimants and managerial rent seeking. Though old-fashioned, the analysis of intra-firm coalitions is of interest in nascent market capitalism.

Within a firm, shareholders and other stakeholders may collude. In fact, the latter can compare, to some extent, to shareholders, if one considers that a firm needs both finance capital and human capital to function, and thus both are residual claimants, and must be rewarded as such out of the firm's revenue. This is the core argument of an attempt to renew the analysis of corporate governance (Blair, 1995). According to Blair, most Western modern corporations do not fit the mainstream model of corporate governance and the underlying analysis of the principal-agent, because in practice shareholders are rarely the only residual claimants. If assets such as finance capital and human capital are dependent on each other, co-specialised, by definition neither has much value without the other. Neither has a more legitimate claim for residual revenue. Then the mainstream model becomes irrelevant. The firm (*i.e.* capital shareholders) must share with employees some of the economic rents or quasi-rents from their common enterprise. Therefore, the mainstream model wrongly overemphasises the potential conflict between shareholders and managers. This is the stakeholder management nexus that is important, whoever the stakeholders (managers, employees, and shareholders) are.

## **6. Towards a Central Eastern European model of corporate governance?**

Systemic change in PETs cannot reduce itself to the issue of ownership transformation, although the latter is crucial. The privatisation outcome has left a sort of overall 'neither social, nor private' ownership regime. If so, PETs are mixed economies, in the sense of having a mixed - private and

public - ownership, with often some employee ownership. The widespread managerial control over privatised firms gives to these countries a flavour of managerial capitalism but, in PETs, managers are not gaining control through acquiring a sizeable stake of property, but are acquiring a sizeable property in order to keep and strengthen the control they exercise. Now the question is to know whether a typical Central Eastern European model is emerging after systemic change.

Since the dawn of transition, the debate in PETs was about the system of corporate governance and the model of capitalism that should emerge from privatisation. Most reformers in touch with Washington international organisations were supporting rather the Anglo-American model of governance while some political leaders were openly revealing a preference for the German ('Rhine') model. In the former, corporate shareholding is scattered; the role of capital markets is very much significant; corporate governance is more geared towards short term profitability and serves first outsider interests, in particular pension funds, insurance companies and other financial institutions (although all these institutional investors are passive minority shareholders); legal protection of (minority) shareholders is better than everywhere else; the frequency of raids, take-overs and even proxy fights is higher than in other models so that managers are on average more disciplined<sup>13</sup>. Here, just one single objective is assigned to managers, which is to increase the shareholder value. As to the German model, it is characterised by more cross-ownership relationships between firms (and banks), forming FIGs, a higher capital concentration and a passive behaviour of institutional investors; it better takes into account wage earners' and stakeholders' interests by means of decision sharing between them and controlling blockholders; the very existence of these blockholdings and hard cores of monitoring shareholders reduces the opportunity of hostile raids in the stock exchange and, by the same token, the financial market discipline (compared to the Anglo-American model) ; on the other hand, it maintains long-term oriented relationships among all the participants to the enterprise ; these characteristics make insiders and managers more influential and increase their entrenchment capacity despite the participation of institutional investors to the stockholding. Thus, the shareholder value is not the only one objective of corporate governance.

However, opposing an outsider system of external monitoring to an insider system of inner control is too sharp when it comes to analyse the heterogeneous corporate governance structures that we have observed in PETs as well as those witnessed in EU countries (Pollin, 2003). Sometimes, governing coalitions in a firm gather both outsiders and insiders in PET privatised firms so that the delineation between outsider and insider control is blurred, just like it appears to be now in Western capitalism (Becht & Mayer, 2002). The borderline between an outsider-dominated and an insider-controlled corporate governance structure is disrupted by the power positions acquired together by blockholders and managers (Boutillier *et al.*, 2002) or, in PETs, by alliances between oligarchs and incumbent

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<sup>13</sup> This was admitted at least until such dirty cases as Enron, World Com, Vivendi Universal, and so on (Aglietta & Reberieux, 2004).

managers. From this point of view, some similarities emerge between the prevailing corporate governance structure in Western and Eastern Europe. Crowding out minority shareholders from decision making is another common feature. However, this is not enough to conclude that all corporate governance structures are converging towards a single European model, since such a conclusion is not even valid across Western European countries (Boutillier *et al.*, 2003; Plihon *et al.*, 2001) where there are several hybridizations of the aforementioned Anglo-American and German models. The driving force of a new hybrid model is the rising power of institutional investors (Geoffron, 1999; Jeffers & Plihon, 2001), imposing a (15%) return norm on the shareholder value. PET firms do not converge toward this new hybrid model given the low level of development of local institutional investors and the very modest investment of foreign institutional investors in local companies so far. Regarding institutional investors as « potential agents of a (retired) employee shareholding » that determines « a socialised property of corporate companies » (Aglietta, 1997), they appear as a sort of Western counterpart of MEBOs which have *directly* transferred the company's shares to employees in PETs.

Could we at least assume that there is some sort of convergence towards a Central Eastern European model of corporate governance? During the last decade, corporate governance structures have markedly differentiated in PETs. If we except those countries where privatisation is lagging behind (Belarus, Turkmenistan, Uzbekistan), as well as the issue of residual state property, it seems that the privatisation drive has generated, in a context of tiny financial markets, four corporate governance models corresponding to the following stylised facts:

A/ A model of *foreign corporate control* (FCC) – or the ‘Hungarian’ model: about 150 out of the biggest 200 corporations in Hungary exhibit an influential foreign participation into their stockholding (and a majority blockholding in 50 out of the biggest 100 corporations). Today, foreigners own 46.7% of the overall stock of all corporations based in Hungary. Besides, foreign owners wholly own 61% of those firms showing a foreign participation to their stock (100% of the stock). Still in Hungary, foreigners (62% in Estonia) hold 72% of the overall stock exchange capitalisation value as against 34% in Poland and even less in all other PETs. Hungary and Estonia are the two PETs where shareholders have the strongest supervision of managers (Vagliasindi, 2003) and where monitoring shareholders are mainly foreign. The precondition for building up the FCC model is the important magnitude of inward foreign direct investment (FDI) compared with GDP or per capita; its emergence is facilitated when there is no regulation that prevents foreign firms from buying assets in local firms in the process of privatisation (as in Hungary and Estonia from the very beginning, and contrary to all other PETs). Therefore, the great bulk of Hungarian and Estonian firms are governed by mighty foreign outsiders which are famous transnational corporations and banks, and not by institutional investors. Such a corporate governance structure is typically strong and capitalist and stands as the closest scheme to the above mentioned hybrid model of corporate governance, fully immersed in current economic globalisation.

#### **Insert Table 5**

B/ A model of *banking and managerial control* (BMC) – or the ‘Czech’ model: privatised firms are monitored by their managers who are supervised by the privatisation funds’ (now holdings) managers, these holdings being a proxy or a substitute to non-existing genuine institutional investors. The managers of those banks, which have set up the former privatisation funds, supervise holdings’ managers, in turn. Since most of these state banks have been privatised since the late 1990s through take-overs and acquisitions by foreign banks, BMC model partly overlaps in the long run with the previous FCC model (see, for instance, the significance of inward FDI in the Czech Republic, in Table 5). On the other hand, private ownership by individual owners is not widespread, but managers in privatised firms do resist to the supervision by the funds (holdings) in utilising their privileged insider information and knowledge. Collusion between firm’s’ managers and banks’ managers is all but exception. Holdings re-concentrate a property that has been scattered by mass privatisation and organise it into FIGs. Cross-ownership, off the market trade of shares, managerial entrenchment and a corporate governance that takes care of stakeholders’ interests (for years, the Czech Republic was distinguished by showing the lowest unemployment rate in PETs) make the BMC model not that far from the German model of corporate governance.

C/ A model of *control by an outsider-insider coalition* (COIC) or the ‘oligarchic-managerial’ model detrimental to (small) minority shareholders is typical in Russia and several CIS countries: a great number of firms are under the inner control of insiders (primarily managers) while others are integrated in one or two hundred FIGs and holdings governed by new tycoons, financial oligarchs and bankers. Numerous insiders are at the same time outsiders in other companies in which they have invested their new wealth (or companies that they have started up on purpose) whereas interlocking directorates and outsider-insider alliances (between oligarchs, bankers, CEOs and managers) strengthen a network structure of governance. The issuance of shares off the market to the exclusive benefit of blockholders and managers (Kogut & Spicer, 2002) is a tool for such a networking. The resulting networks are the more long lasting the more they are connected to political power. Then, they put a brake on FDI inflows into the stockholdings of big Russian industrial and financial trusts and hinder the emergence of new private start-ups. Generally speaking, FIGs, managerial networks and oligarchic power are not supposed to facilitate a blossoming competitive market economy. A major potential driving force which may push forward this model into significant changes might well be the globalisation of Russian firms and FIGs by means of their outward FDI (Andreff, 2003d).

D/ A mixed model based on an ‘*employee and start up*’ control (ESUC) – or the ‘Polish’ model: changeovers of political power between parties, followed by a stop and go economic policy (Andreff, 1999b) and a postponed mass privatisation programme until 1996 have created a vacuum which has soon been filled by small privatisation and MEBOs in the form of ‘capital privatisation’<sup>14</sup> and

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<sup>14</sup> A SOE is first corporatised and then sold through a public offering, most often to its personnel, since ‘capital privatisation’ has a prerequisite which is a preliminary agreement of its employees ; the latter can acquire 20% of the stock half price and appoint one third of the board members.

‘liquidation privatisation’<sup>15</sup>; both capital and liquidation privatisation have enabled creating new start ups and an inner supervision of the firm by its employees (and not only managers as in Russia). The outcome is a widespread dispersion of ownership among employees who are both shareholders and stakeholders. They attempt, often successfully, at locking in the existing stockholding and corporate governance and they participate to current management; their success is evidenced by few social conflicts registered at the level of enterprises in Poland. On the other hand, a rather efficient institutional framework (the 1934 commercial and bankruptcy laws has come into force again, an anti-trust law has been passed in 1990) facilitates starting up *de novo* private enterprises. New SMEs have mushroomed, mainly from 1990 to 1993 (Rusin, 2002); in 1993, all these start-ups were concentrating 18.4% of overall employment in Poland. Afterwards, the momentum of the new private sector relied on both the emergence of new start ups and the increasing size of those which survived to the harshness of competition; in 1996, the SME sector reached 31.7% of overall employment (three times more employment than in privatised firms). In 1997, the number of Polish SMEs was 1.398 million. The ESUC model paradoxically combines the supposedly weakest governance structure (employee self-supervision) and the supposedly strongest, *i.e.* the SME monitored by its own boss(es).

#### **Insert Table 6**

Now, we can conclude that the managerial enterprise (exclusively monitored by its managers) is so much widespread in all PETs, except in the FCC model, that it cannot determine, alone, a specific model of corporate governance. By the same token, it is a component of all the four suggested models, in particular of BMC and COIC models.

A sort of inertia affects corporate governance structures in PETs which is due to absent or weak institutions that would facilitate or trigger their change and improvement (**3** *supra*) so that a convergence toward a single model is slowed down. However, in the past recent years, some omens of a possible convergence of FCC, BMC and ESUC <sup>16</sup> models towards a prevailing corporate governance structure have emerged in Central Eastern Europe. The latter would combine a strong foreign stake in the biggest corporations with a big number of SMEs monitored by their bosses (and fewer and fewer former privatised SOEs). In other words, it would be a hybrid of the ‘Hungarian’ and ‘Polish’ models (referring to the latter’s start-ups component).

Indeed, we observe (Table 6) that Poland and the Czech Republic host more FDI than Hungary in the recent years. Both countries, with some delay compared to Hungary, have launched wide programmes of bank privatisation (after ‘cleaning’ bank assets from bad debts) through selling their assets to transnational banks <sup>17</sup> (Bednarova, 2001; Dudzinski & Szymkiewicz, 2003). Since 1998, the Czech

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<sup>15</sup> Liquidation privatisation means a sale or a lease, at a preferential rate, of a SOE’s assets in view of starting up a new enterprise whose owners most often are the SOE’s employees, since a preliminary agreement of its worker council is required.

<sup>16</sup> In Russia and CIS countries, the relative significance of inward FDI is markedly smaller and those institutions that favour the legal start up of new private enterprises are less stabilised (and more circumvented) than in Central Europe.

<sup>17</sup> For example, in the Czech Republic, Nomura has purchased 36% of Investicni a Postovni Banka’s stock (1998), the Belgian bank KBC has acquired a 65.7% stake in Ceskoslovenska Obchodni Banka (1999), Erste Bank a 52% stake in Ceska

Republic also favoured the sale of strategic enterprises to foreign investors so that FDI share in privatisation has grown from 1% in 1997 to 23% in 1999 and 28% in 2001. At the same time, the share of privatisation funds (then holdings) has dramatically reduced in the ownership structure of Czech enterprises in which they now hold a great number of small participation and behave as sleeping partners – and thus increasingly resembles West European institutional investors (Vincensini, 2003). In 1997, Polish authorities have decided to give more momentum to privatisation and sell strategic enterprises, henceforth without any restriction against foreign investors. As a consequence, foreign-owned firms have grown from 1.8% of overall employment in Poland in 1996 to 3.6% in 1999. Besides increasing inward FDI, the convergence towards a common Central Eastern European model of corporate governance is influenced by spreading globalisation of governance standards and, in the last few years, by outward FDI of new transnational corporations from PETs (Andreff, 2002). Adopting global strategies, PET enterprises do converge, in some sense, toward the above-mentioned hybrid model prevailing in Western economies (Plihon *et al.*, 2001).

A second heavy tendency is embedded in the development of new start-ups, both individual enterprises and SMEs. Such small firms are characterising the ‘Polish’ model (ESUC) of governance, but they are widespread and growing in Hungary, the Czech Republic, Bulgaria, Romania and Slovakia as well (Table 6). In 1995, 1 million Czech individual enterprises were employing 11.2% of overall working population; in 2000, 1.471 million individual enterprises were employing 13.2% of overall working population. The same year, in Hungary, 9% of overall working population was employed in 381,000 individual enterprises (51% in all SMEs and individual enterprises) as against 5.6% in 1992 (43% in all SMEs and individual enterprises in 1994).

Therefore, FCC, BMC and ESUC models exhibit, in the past recent years, a convergence towards a Central Eastern European model of corporate governance that is characterised by both an important foreign stake in the ownership of - and foreign control over - big businesses and by single bosses monitoring their own SMEs. If such a converging tendency will prevail in the future, then FCC, BMC and ESUC models have to be regarded as *transitory* governance structures emerging from privatisation; strict managerial control, employee supervision, banks’ monitoring and other *ad hoc* forms (privatisation investment funds, state run holdings, mixed enterprises) will pass away after some time. In the wake of convergence, the increasing significance of foreign ownership is likely to adjust the governance structure to international standards of governance, *i.e.* the ones associated with the aforementioned hybrid model. For instance, after privatisation, investment funds have eventually transformed into genuine institutional investors therefrom setting up a building block of the hybrid model. It remains to be seen whether it would be enough to solve all the unresolved issues of corporate governance that have accumulated during the first fifteen years of transition.

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Sporitelna (2000) and Société Générale 60% of Komerční Banka (2001). In Poland, 48 out of 71 active banks in 2001 were

## **Conclusion**

Since the Enron suit, corporate governance has really become an issue in Western economies. All the more so in PETs where governance issues are intertwined with corruption, embezzlements, asset stripping and tunnelling, illegal appropriation and money laundering. Since the struggle against corruption and money laundering is a priority in PETs, namely in the new EU members, improving the corporate governance structure appears to be an immense and long-term task. Its achievement probably could not avoid some waves of nasty prosecutions. Beyond the latter, one of the major concerns today is to secure shareholder – in particular minority shareholder - protection against misuses of power from blockholders, oligarchs and managers. There is practically no organisation whose cause is the defence of minority shareholder interests in PETs so far. New laws and regulations about disclosure of corporate information to shareholders must be passed and enforced in order to make corporate governance more transparent than when it is monopolised by managers or oligarchs. Boards of directors do not work properly (namely in terms of auditing and directors' fees) and this should be improved by appointing independent directors. Clear accounting rules, independent audits and the disclosure of financial data must become the normal course of events. Sanctions must be imposed (on managers and oligarchs) for circulating biased or fake information about their companies. Better functioning of (capital and goods) markets should reduce the discretionary power of insiders and blockholders. In this respect, the new EU members will move on faster than other PETs. As long as corporate governance will not be transparent and accountable in a number of PET firms, the latter will not be able to find enough finance and attract institutional investors in their stock. The EU enlargement is a step forward to better corporate governance, but not for those PETs (CIS) which cannot expect EU accession.

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under the monitoring of foreign owners.

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