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I. Governance and Enterprise Restructuring in Southeast Europe – gross domestic product and foreign direct investments

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Abstract:

This paper is to be concerned with the corporate governance mechanisms' influence on governance and enterprise restructuring in **Southeast Europe (Western Balkans)** transition economies: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia.

The institutional changes and corporate governance mechanisms in national governance systems are essentially important for the transition process, thus there are specificities of corporate governance mechanisms in transition economies that indicate the progress towards market based economy. Most notable are: the market-based corporate governance mechanisms, management-structure based corporate governance mechanisms, ownership structure, boards of directors, management compensations schemes, that is, management structures and financial structures. Corporate governance mechanisms are seen through governance and enterprise restructuring indicator which has already established link to gross domestic product and foreign direct investments in the literature.

The data set is of Southeast European economies, and will be examined the interrelationships between governance and enterprise restructuring, set of policies that influence the governance patterns, gross domestic product and foreign direct investments.

JEL Classifications: G30, G32, G38; L33; O11; P31
Keywords: governance, enterprise restructuring, corporate governance, transition, Southeast Europe

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Introduction

The research in this paper is to be focused on examining governance and enterprise restructuring in **Southeast Europe (Western Balkans)** transition economies. International organizations classify the following countries in Southeast Europe (Western Balkans): Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia.

The institutional changes and corporate governance mechanisms in national governance systems are essentially important for the transition process, thus there are specificities of corporate governance mechanisms in transition economies that indicate the progress towards market based economy, the most notably the market-based corporate governance mechanisms, management-structure based corporate governance mechanisms, ownership structure, boards of directors, management compensations schemes i.e. management structures and financial structures.

Using data of South-East European economies, will be examined the interrelationships between governance and enterprise restructuring, set of policies that influence the governance patterns, gross domestic product and foreign direct investments.

Hypothesis: The basic hypothesis to test governance and enterprise restructuring is that it is influenced by gross domestic product and foreign direct investments dynamics.

Corporate governance mechanisms are seen through governance and enterprise restructuring indicator which has already established link to gross domestic product and foreign direct investments in the literature.

Theoretical and literature framework

1. Institutional changes and corporate governance mechanisms in national governance systems

There are many studies conducted on determining the way stakeholders can use corporate governance mechanisms in transition. Most often is used the agency theory to explain the changes in ownership structure in an environment of dominance of government and institutional owners (Chan, Lin, & Zhang, 2007), as well as, the differences of transition economies' ownership structure in comparison to developed countries (Young, 2002).

Noteworthy contributions are the studies on firm performance and governance structure in political and regulatory environments that have a significant impact on corporate governance systems (Firth, Fung, & Rui, 2006). Also, there is significant literature that analyzes corporate governance through the importance of strong in addition to good governance and minority shareholder protection to reduce agency problems (Dharwadkar, George, & Brandes, 2000).

The institutional aspect of the economic transformation towards free market economies is characterized by institutional transition, providing in the literature evidence on the firm behavior in such environmental set (Hoskisson, Eden, Lau, & Wright, 2000). Indeed, business strategies (Peng, 2000) introduced due transition are important for this study. These features of Central and Eastern European economies are extensively analyzed (King, 2001), which gives good foothold for further study of the similar transition aspects in Southeast Europe.

2. Corporate Governance Mechanisms in transition economies

There are number of corporate governance mechanisms which are used to resolve agency problems, thus are classified by the corporate governance literature, and the most prominent are: market-based corporate governance mechanisms, management-structure based corporate governance mechanisms, ownership structures, boards of directors, management compensation schemes, and financial structures (Fama & Jensen, 1983; Jensen, 2000; Prowse, 1995; Shleifer & Vishny, 1997).

a) Market-based corporate governance mechanisms

The market-based corporate governance mechanisms incorporate two basic values i.e. the managerial labor market and the market for corporate control (Jensen, 2000), the managerial labor market as corporate governance mechanism, verifies the managers' human capital hence determining the managers' career development path (Fama, 1980). On the other hand, the market for corporate control functions as corporate governance mechanism by introducing discipline on managers through the threat of takeover (Shleifer & Vishny, 1997). In context of transition economies it is estimated that the market-based corporate governance mechanisms are likely to increase and improve along the progress of the transition (Le, Kroll, & Walters, 2010).

b) Management-structure based corporate governance mechanisms

The role of management-structure based corporate governance mechanisms in the governance of companies takes shape through internal managerial labor markets and constant mutual monitoring between mangers by creating hierarchical controls (Ocasio, 1999), due to the process of firm management (Williamson, 1985).

These hierarchical-bureaucratic structures used to regulate agency problems and manage the firm are characterized by layers of management bringing high degree of formalization of operating procedures and authority in firms' functioning and effectiveness (Jensen, 2000).

Hence, the effectiveness of the hierarchical-bureaucratic structures in transition economies declines during the restructuring process as market-supporting institutional framework and market based mechanisms take hold (Le et al., 2010).

c) Ownership structure

The ownership structure can function as corporate governance mechanism in the sense where inside ownership reduces agency costs. Thus, managerial ownership is opposed to the divergence of interests between managers and shareholders which leads to maximization of shareholders' wealth in the case of owner-managers' decision making (Fama & Jensen, 1983).

On the other hand, the corporate governance literature points out that large owner-managers are likely to lessen agency problems, making at the same time principal–principal agency problems more severe (Young, 2002).

In the transition process as companies move towards free market functioning, the role of ownership structure is determined mostly by independent outside blockholders and foreign investors (Le et al., 2010).

d) Boards of directors

In corporate governance literature the board of directors is usually defined as to represent the firms' shareholders. Thus, the boards have the authority over the work of the managers to control and monitor their decision making and results (Jensen, 2000).

Due to its characteristics the board of directors has the role of classic corporate governance mechanism i.e. central to the internal control system (Jensen, 1993), even though in practice often these responsibilities are blurry and undetermined.

As far as transition economies are concerned, the literature suggests that at the early stage of privatization the already set, state-appointed board members, are likely to be more effective, however later in the transition process when market mechanisms enter into force, outside board members that hold large stakes in the firm are ought to offer more (Le et al., 2010).

e) Management compensations schemes i.e. management structures

Management compensations schemes and management structures can be used as corporate governance mechanism through aligning the interests of managers to those of shareholders (Bloom, 1998).

On one hand, there can be a scheme where the principal is monitoring the agent's behavior on prearranged compensation i.e. behavior-oriented contract, and on the other, outcome-based contract where the principal measures the agent's marginal output and compensation based on the marginal output (Shleifer & Vishny, 1997). The use of one contract over another would be determined based on industry, legal, and other characteristics important for the firm or the country.

Thus, in transition environments most of the early stage countries have predominantly behavior-based compensation shemes as opposed to those in the latter stage that typify more with of outcome-based compensation structures (Le et al., 2010).

f) Financial structures

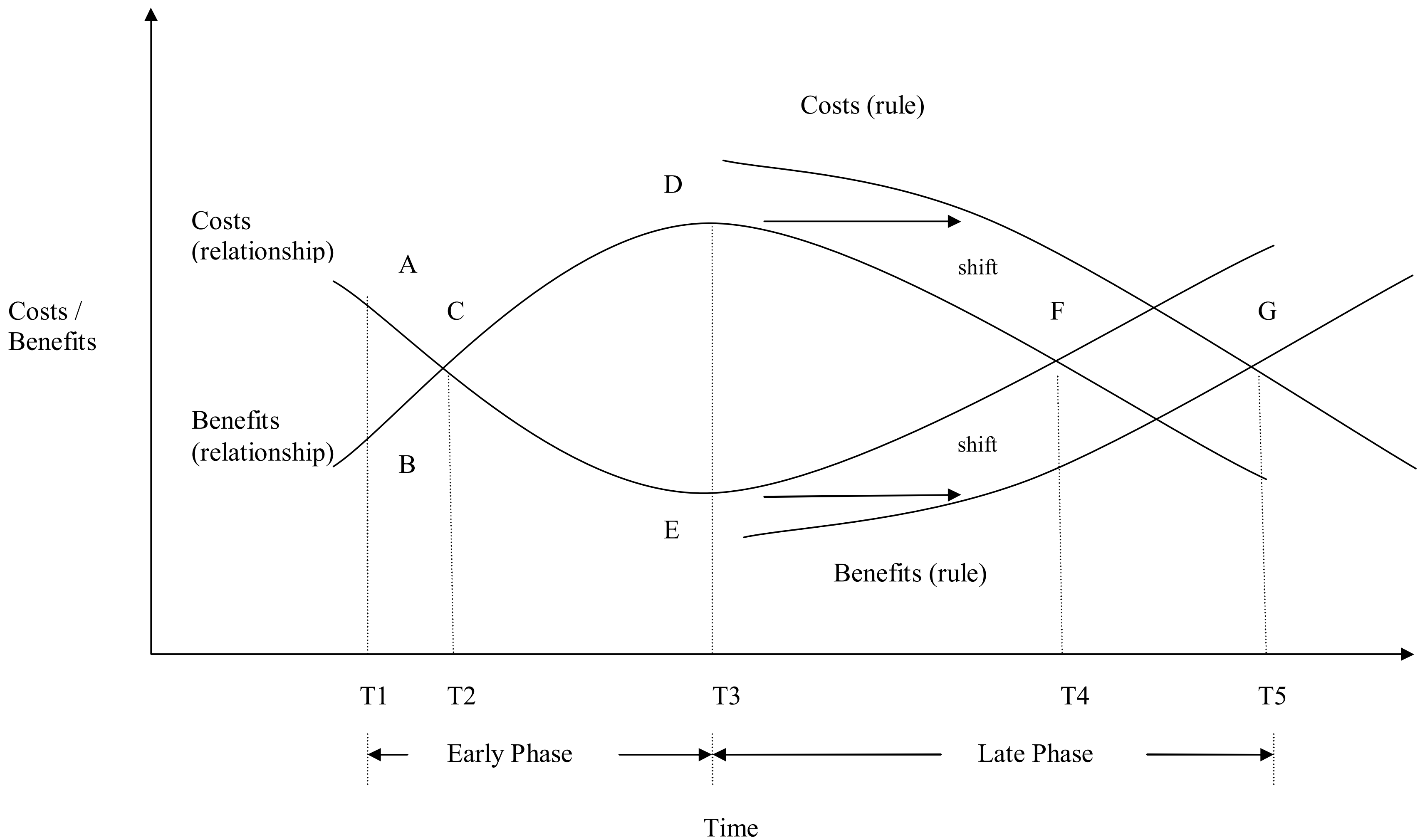
There is a positive relationship between free cash flow and incentives managers to peruse their goals and self-interests i.e. peruse investments that increase their personal compensation and influence (Shleifer & Vishny, 1997), clearly increasing agency costs.

Further, debt financing is important to a firm and thus essential are the ties to banks and other financial institutions that allow access to financial resources (Porta, Lopez-De-Silanes, & Shleifer, 1999). In this case the corporate governance mechanism is in place through the notion that banks and other financial lenders and instruments monitor their borrowers helping to restrain managers' self-serving behaviors (Berglöf, 1995).

The debt as corporate governance mechanism in transition economies is operationalzed through state owned banks at the beginning of the process; however this role further in the transition is taken by foreign creditors.

According to Peng the 'Two-Phase Model of Institutional Transitions' is the following (Peng, 2003):

Figure I.1Two-Phase Model of Institutional Transitions



Analytical Framework

1. Sample selection and Data

The estimation is based on data provided by the data bases of the European Bank for Reconstruction and Development (EBRD) Transition report series (EBRD, 1994-2009), the World Bank Database (WB)[1] and the National Banks' databases of the countries in Southeastern Europe (BA; CBBH; CBM; CNB; NBRM; NBS) [2]. The indicator of GDP is measuring growth in real GDP (in per cent) for the time period of 1989 to 2009 (with exceptions for the years where data was not available, which is minor) and the indicator of FDI's is measuring foreign direct investment as net inflows recorded in the balance of payments.

2. Model and Econometrics

The econometric model (Freedman, 2005), that is used in this study is a regression model where we have estimated the fallowing equation:

$$\gamma i = \beta_o + \beta_1 x_{1i} + \ldots + \beta_p x_{pi} + \varepsilon_i \quad \textbf{(1)}$$

$$i = 1, \ldots n \quad \textbf{(2)}$$

Thus, applied to our research this model has the fallowing shape:

$$GOV_{i,t} = \beta_o + \beta_1 GDP_{i,t} + \beta_2 FDI_{i,t} + \varepsilon_{i,t} \; \textbf{(4)}$$

- where the ***dependent variable***, $GOV_{i,t}$. shows governance and enterprise restructuring;
- the ***independent variables***, are as follows :

[1] World Bank Database, Available at: http://data.worldbank.org/

[2] National Banks' databases of the countries in Southeastern Europe: Bank of Albania [http://www.bankofalbania.org/]; Central Bank of Bosnia and Herzegovina [http://www.cbbh.ba/]; Croatian National Bank [http://www.hnb.hr/]; National Bank of the Republic of Macedonia [http://www.nbrm.gov.mk/]; Central Bank of Montenegro [http://www.cb-mn.org/] and National Bank of Serbia [http://www.nbs.rs/]

1. $GDP_{i,t}$ gross domestic product;
2. $FDI_{i,t}$ foreign direct investments;

- β is a p-dimensional ***parameter vector*** ;

ε is the ***error term*** or *noise.*

Results and Effects

1. Results on the assumption

The hypothesis is that the variable governance and enterprise restructuring is encouraged by movements in gross domestic product and foreign direct investments. The results of the OLS regression explaining the link between GOV and GDP, FDI are given in the Figure 2, whereas Figure 3 descriptively shows the relationships and movements between these variables.

The GDP results are significant only with Croatia and Macedonia ($p < 0.01$). On the other hand, the FDI variable results occur significant in Albania and Bosnia and Herzegovina ($p < 0.05$), as well as, Croatia, Macedonia and Serbia ($p < 0.01$).

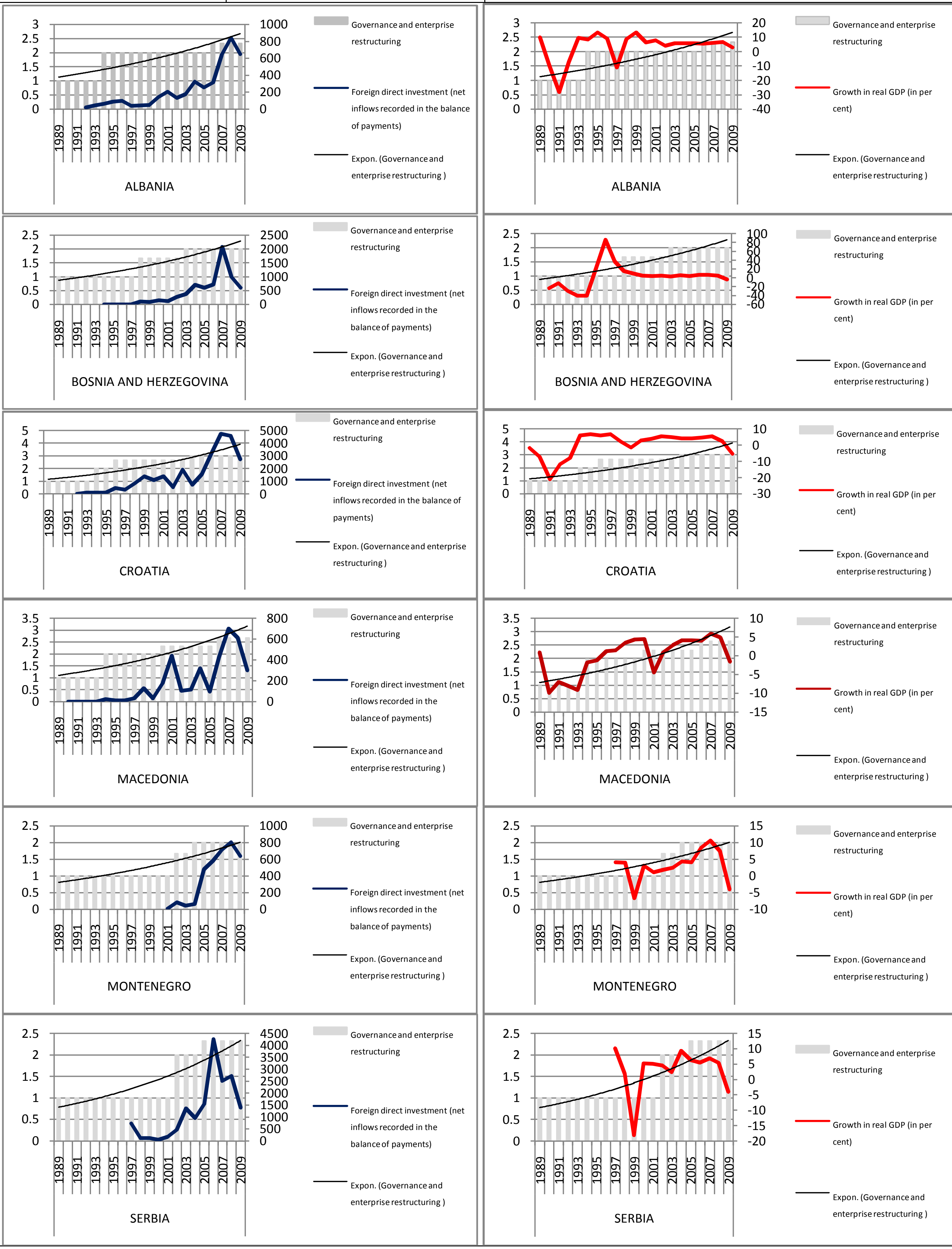
It is clear from Figure 2 and Figure 3 that governance and enterprise restructuring is positively influenced by gross domestic product and especially foreign direct investments dynamics.

Figure I.2 OLS on GOV for GDP and FDI - SEE

OLS	Dependent Variable Governance and enterprise restructuring					
Independent Variable	**Albania**	**Bosnia and Herzegovina**	**Croatia**	**Macedonia**	**Montenegro**	**Serbia**
GDP	0.0123485	-0.0040617	0.0652003	0.0741883	0.0077875	0.0029588
	[0.0128073]	[0.0033471]	[0.0180422]***	[0.0140246]***	[0.0252081]	[0.0184404]
FDI	0.0008832	0.0004519	0.0002227	0.0010187	0.0006387	0.0003701
	[0.0003161]**	[0.0001546]**	[0.0000655]***	[0.0003291]***	[0.0003446]	[0.0001059]***
Constant	1.68905	1.498044	2.057019	1.859174	1.540364	1.26501
	[0.1252254]***	[0.1140025]***	[0.1346605]***	[0.0845265]***	[0.1623643]***	[0.1800817]***
Observations	60	57	62	63	43	47
R-squared	0.3738	0.4743	0.6528	0.8039	0.4427	0.5747
Adjusted R-squared	0.2903	0.3934	0.6065	0.7808	0.2569	0.4896
Time period	1989-2009					
Standard errors are in parentheses.						
Significance Level:	*** p < 0.01	** p < 0.05	* p < 0.1			

Figure I.3 FDI & GDP in GOV

FDI dynamics within GOV indicators | **GDP** dynamics within GOV indicators



Discussion

The results on the hypothesis show that the governance and enterprise restructuring is positively influenced by gross domestic product and foreign direct investments dynamics. Indeed, positive results in almost all counties are found for foreign direct investments, but still mild evidence to its connection to gross domestic product.

The relation of institutional changes and corporate governance mechanisms in national governance systems to overall economic movements, and especially foreign direct investments has good evidence in the literature and the empirical analyses. Thus, it is apparent that the new way of functioning of the systems creates an endogenous competitive characteristics for the home companies due time, through the process of learning and cooperation with foreign companies or their capital.

Furthermore, it is apparent that governance and enterprise restructuring advance through time due to imposed policies, as well as, overall progress of the economies' gross domestic product and especially the influx of foreign direct investments.

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