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Corporate Governance: a South-Eastern European Perspective

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The purpose of the article is to illustrate the main characteristics of the corporate governance challenge facing the countries of South-Eastern Europe (SEE) and to subsequently determine and assess the extensiveness and effectiveness of corporate governance regulation in these countries.

Therefore, we start with an overview on the subject of the key problems of corporate governance in transition. We then address the issue of corporate governance measurement for SEE countries. To this end, we include a review of the methodological framework for determining both the extensiveness and the effectiveness of corporate governance legislation, as defined by the EBRD and a discussion on aspects related to corporate governance development, the quality of corporate governance codes and of the "law on the books". We then focus on the actual analysis of legal institutions effectiveness and provide a measure of corporate governance in Romania and other SEE emerging markets. The paper concludes by emphasizing the relationship between legal change and the development of financial markets in the SEE region.

Key words: corporate governance, South-Eastern Europe, transition, extensiveness, effectiveness

1. Introduction

Corporate governance has been a dominant policy issue in developed market economies for more than a decade. In the transition economies, it took some time for corporate governance to advance the ranking of policy priorities, but since the late 90's it became one of the most intensely debated issues.

At least two set of events are responsible for the heightened interest in corporate governance. During the wave of financial crises in 1998 in Russia, Asia, and Brazil, deficiencies in corporate governance endangered the stability of the global financial system. Just three years later, confidence in the corporate sector was sapped by corporate governance scandals in the United States and Europe, which triggered some of the largest insolvencies in history. The scandals and crises, however, are just manifestations of a number of *structural reasons* why corporate governance has become more important for economic development and a significant policy issue[1], especially for transition economies in South-Eastern Europe (SEE)[2], that do not have the long-established (financial) institutional infrastructure to deal with corporate governance issues.

Privatization has raised corporate governance issues in sectors that were previously in the hands of the state. Firms have turned to markets to seek capital, and mutual enterprises and partnerships have converted themselves into listed corporations.

The private, market-based investment process is now becoming more substantial for most of these economies, being underpinned by better corporate governance. The role of institutional investors is growing in many of these countries, with economies moving away from "pay as you go" retirement systems. This increased delegation of investment has raised the need for corporate governance arrangements.

Also, due to technological progress, liberalization and opening up of financial markets, trade liberalization, and other structural reforms, the allocation within and across countries of capital among competing purposes has become more complex, as has

monitoring of the use of capital. This has made good corporate governance more important, but also more difficult to achieve.
Furthermore, programs of deregulation and reform have reshaped not only the local (SEE) financial landscape but also the European one. Long-standing institutional corporate governance arrangements are being replaced with new ones but, in the meantime, inconsistencies and gaps have emerged.
European financial integration has increased, together with trade and investment flows. This has led to numerous cross-border issues in corporate governance.

All these developments have enhanced the need for formulating corporate governance rules and have led to the adoption all over the world[3] and by most of the SEE countries of corporate governance codes, as a measure of dealing with each country's specific governance problems (besides international organizations' efforts, such as the OECD corporate governance principles). These initiatives have recently resulted in improvements of formal legal rules, as well as in the drafting of soft-law recommendations.

These sets of rules and regulations, whether international, national, or company-specific, are all remarkably similar. As a common denominator they want to shape comprehensive standards of good governance. These are mainly the protection of minority shareholders, the avoidance of conflicts of interests and the request for disclosure and transparency[4], the constitution of the boards (the issue of independent directors and supervisory board members), smaller boards to secure better coordination, the formation of monitoring, compensation and nomination committees, as well as the claim for one-share-one-vote[5].
Yet, corporate governance practices tend to differ quite substantially across countries and companies, especially among developed and transition economies in Europe, with some specific features for SEE economies, which explains the concerns regarding the effectiveness of corporate governance rules, especially in these countries.

The general aim of this paper is to identify the specificities of the institutional environment in SEE countries and to subsequently determine and measure the extensiveness and effectiveness of corporate governance laws and regulations in these countries.

The paper is structured as follows. Section 2 identifies the key problems of corporate governance in transition. To do so, it describes some current features of the institutional environment in the South-Eastern European countries and subsequently identifies and analyzes the common and specific characteristics of the corporate governance issues facing these countries.
Section 3 addresses the issue of corporate governance measurement for SEE countries, with an emphasis on Romania. To this end, its first part includes a review of the methodological framework for determining both the extensiveness and the effectiveness of corporate governance legislation, as defined by the European Bank for Reconstruction and Development (EBRD). It also comprises a short overview on the subject of corporate governance development, the quality of corporate governance codes and of the "law on the books". The second part focuses on the actual results of the assessment exercise, by supplementing the investigation so far with an analysis into the effectiveness of legal institutions as opposed to the law on the books and attempts to provide a measure of corporate governance in Romania and other SEE emerging markets.

Section 4 concludes, by emphasizing the relationship between legal change and the development of financial markets in the SEE region and identifies research issues that require further study.

2. Specific corporate governance issues in the transition economies of SEE

a. Key facts

Although transition countries in SEE vary considerably in history and current institutional setup, they share certain important features. They all had and some still have quite a large sector of former state-owned enterprises, in the process of restructuring. In addition, these economies inherited a dysfunctional legal system, and in many cases they had to construct basic institutions from zero.

Consequently, a useful prerequisite for the analysis of corporate governance in transition economies is a short review of corporate control issues under central planning.

Enterprise structures in central planning were characterized by two distinctive features that have persistent influence until the present day[6]. First, budget constraints for socialist enterprises were soft: passive finance was provided under the central plan, so they did not have to worry about external financing. Hence, the concepts of financial discipline and accountability were essentially absent. Second, the state as the owner of most assets had a pervasive monitoring problem in trying to ensure that managers of socialist enterprises acted according to the targets set out by the central plan[7].

The two problems were closely inter-related. Absent the sanction of enforcing financial discipline by cutting off supplies and ultimately forcing an enterprise to close down, the problem of corporate control could never be resolved.

When central planning was abolished, the lack of external financing became a serious constraint on enterprises. The problem of substituting government finance with new sources of external finance is thus very much at the heart of the problem of corporate governance and restructuring in transition.

Parallel to the reduction of state financing, economic reforms in transition countries also fundamentally altered the structure of ownership rights through privatization.

Starting in the mid 1990s, the corporate governance debate within transition economies revolved around specific privatization issues and initial efforts in the move toward responsible corporate governance included legislative, judicial and corporate initiatives to provide investors with more disclosure and transparent information[8].

However, in this endeavor governments were constrained by the power of incumbent managers, who had accumulated implicit control rights as a result of weak state monitoring under central planning. In many SEE economies, privatization simply led to the explicit recognition of these control rights through the allocation of ownership titles to insiders. Further, new outside owners were often dispersed and weak (particularly where voucher privatization prevailed). As a result, transition has in some instances created an extreme version of the two classical problems of corporate governance: on one hand the control of managers by dispersed outside owners and, on the other hand, the protection of minority shareholders against strong block-holder interests[9].

Against this background, external investors have been cautious in providing new capital, and restructuring efforts have been disappointing. Indeed, unchecked by owners and with little access to new funds to finance risky restructuring, managers faced incentives that were skewed towards asset stripping and expropriating minority shareholders[10].

b. Major findings

At the risk of simplification, the problem of corporate governance in the transition economies of SEE may thus be summarized as follows:

- the persistence of the issue of soft budget constraints, coupled with difficulty in obtaining external financing[11];
- the remaining influence of the state over corporate decision-making through a nexus of subsidies, regulatory favors and tax arrears provided in exchange for residual control rights;
- poor investor protection (especially minority), with an entrenched position of incumbent enterprise managers, who retain effective control rights even where privatization has shifted ownership to outsiders;
- concentration of ownership that also undermines the liquidity of equity markets. Ownership and control are relatively closely held by identifiable and cohesive groups of "insiders" who have longer-term stable relationships with the company (i.e. families, banks, and workers). Furthermore, there is a strong dependency on banks, high debt/equity ratios and less developed capital markets.

All these problems are closely intertwined. Enterprises will be unable to tap external sources of funds as long as they remain subject to extensive state intervention and/or insider control. Conversely, insider control will remain pervasive as long as potential investors are doubtful about the possible returns on their investments and refrain from acquiring substantial amounts of shares. And as long as enterprises are unable to survive on their own, the state will feel it is necessary to ensure the survival at least of key enterprises.

With external funds accessible at reasonable costs, the need for state support would be reduced, which would lead to a change in the ownership structure of firms. New emissions would over time crowd out insiders who may also find it attractive to part with their current holdings, provided that outsiders are willing to offer a reasonable price.

Table 1 gives an indication of where the SEE transition economies position themselves with respect to such a scenario. It shows the ratio of stock market capitalization to GDP, of stock trading volume as percentage of market capitalization and the private sector credit to GDP and respectively in 2005, in relation to a number of EU member countries (Central and Eastern European countries).

Table 1. Development of capital markets, end 2004

Country	No of listed companies	Mk. cap., mln. USD	Stock mk. cap. as % of GDP	Stock trading volume, mln. USD	Stock trading volume as % of mk. cap.	Private sector credits as % of GDP
Czech Republic	120	26 891	25	20 167	75	27
Estonia	13	6 292	54	896	14	43
Hungary	49	28 300	28	13 005	46	46
Latvia	39	2 568	19	119	5	50
Lithuania	43	6 423	29	424	7	25
Poland	230	71 547	30	16 269	23	23
Slovak Republic	302	3 919	10	750	19	26
Slovenia	140	9 677	30	1 479	15	48
Bulgaria	332	2 801	12	572	20	23
Romania	4058	11 938	16	747	6	10
Croatia	241	10 952	32	439	4	52
Macedonia	146	413	8	86	21	18
Albania	0	0	0	0	0	6

Bosnia and Herzegovina	1132	3 691	45	174	5	19
Montenegro	211	313	13	21	7	-
Serbia	406	3 281	15	435	13	-

Source: World federation of Exchanges, EBRD Transition Report 2005, home pages of national exchanges

Other specific corporate governance problems of the transition economies in SEE involve weaker legal systems and corruption. Of course, there are differences in the degree of these problems depending on the state of transition.
Court delays, as a measure of contract enforceability are higher in Civil Law countries than in Common Law countries[12]. Most of the SEE transition countries have adopted a Civil Law system. According to the World Bank (2006), SEE economies are generally belonging to the group with very high court delays (especially Serbia, Bosnia and Herzegovina and Montenegro). Such delays therefore increase the costs of using courts for conflict resolution and deter foreign as well as domestic investors (highest costs for Macedonia, Albania and Bosnia and Herzegovina).
Furthermore, the transition economies of SEE have to deal with the problem of corruption. The "corruption perception index (CPI)" compiled at the University of Passau[13] relates to perceptions of the degree of corruption as seen by business people, academics and risk analysts. It ranges between 10 (highly clean) and 0 (highly corrupt). The 15 Member States before the enlargement were ranked within the top 25 of this survey (with 109 countries). Portugal, with a CPI score of 6.6 was ranked 25th. With scores ranging from 2.4 to 3.4, the SEE states are significantly more corrupt (or at least seen as more corrupt by market participants) than their European partners (see table 2).

Table 2. Democracy, economic development and legal reform, 2005

	GDP per capita, USD	Population, mln.	Voice and accountability	Rule of law	Freedom House Classif.	CPI
Czech Republic	19 311	10.2	1.03	0.69	Free	4.3
Estonia	13 740	1.4	1.13	0.91	Free	6.4
Hungary	16 596	10.1	1.16	0.85	Free	5
Latvia	11 962	2.3	0.96	0.48	Free	4.2
Lithuania	12 994	3.4	0.97	0.60	Free	4.8
Poland	12 786	38.2	1.13	0.51	Free	3.4
Slovak Republic	14 549	5.4	1.10	0.49	Free	4.3
Slovenia	20 853	2.0	1.12	0.93	Free	6.1
Bulgaria	8 026	7.8	0.58	0.05	Free	4
Romania	8 413	21.7	0.36	-0.18	Free	3
Croatia	12 336	4.4	0.46	0.07	Free	3.4
Macedonia	6 767	2.0	-0.02	-0.44	Partly	2.7
Albania	4 929	3.2	0.03	-0.80	Partly	2.4
Bosnia and Herzegovina	7 168	3.8	-0.14	-0.76	Partly	2.9
Montenegro	3 800	0.6	0.12	-0.72	Free	2.8
Serbia	4 400	8.3	0.12	-0.72	Free	2.8

Legend: *Voice and accountability index* is a measure of political, civil and human rights – higher scores indicate higher democracy; *Rule of law index* is a measure of the quality of contract enforcement, the police, courts and the likelihood of crime and violence
Source: EBRD Transition Report 2005, Freedom House, Transparency International

Consequently, the predominant corporate governance problem in the transition economies of SEE could be summarized as "*frequent insider control, difficult outside finance*". While hardened budgetary constraints and improved investor protection could

have an effect on investment decisions, the prevailing issue in most of these countries seems to be enforcement or the effectiveness of corporate governance regulations.

3. Measuring corporate governance in the SEE countries

3.1. Conceptual issues – the research method

Corporate governance codes are in general not mandatory regulations and therefore it is optional for companies to adhere to them. The situation changes if codes are becoming listing requirements at stock markets or formal legal rules by the legislators, which we can observe in many European countries (such as the UK or Germany).

Most SEE transition economies (with the exception of Romania, where a corporate governance code has been issued by the stock exchange in 2003) have adopted a corporate governance code. Whereas we can find differences within the scope of the codes, they have in common that they abide closely by the OECD Principles.

Given the characteristics of the corporate governance systems' institutional surrounding in SEE transition economies and the specific corporate governance problems in these countries, formal legal rules which may arise from such codes cannot rely only on a basis of broad minimum standards[14], as it is often the case in the developed economies, but on binding legislation (mainly directives[15] adopted in the harmonization process), that can at least partially reduce the existent shortcomings.

The level of compliance of specific legislation with international standards and best practices is defined by the EBRD as "*extensiveness*" ("law on the books") and is estimated in respect of corporate governance regulations proclaimed into law.

In order to analyze the corporate governance related legislation of each country, the EBRD created a questionnaire based upon the OECD *Principles of Corporate Governance*: (1) rights of shareholders; (2) equitable treatment of shareholders; (3) role of stakeholders in corporate governance; (4) disclosure and transparency; and (5) responsibilities of the board. Based upon the assessment results of individual countries, a rating system has been developed to show how countries have progressed in the corporate governance area.

"Effectiveness" ("law in action"), on the other hand, looks at how the legal regimes work in practice, as opposed to the quality of the law on the books.

Changes in the legislation say little about the effectiveness of the new laws; this depends on the voluntary compliance rate on the one hand, and on the effectiveness of legal institutions that are charged with enforcing the law, on the other. Both are mutually reinforcing.

We use an index of the *effectiveness* of corporate, banking and capital market law in transition economies, constructed by the EBRD, to measure the actual enforcement of regulations in SEE economies.

The *effectiveness* index is taken from the EBRD *Transition Reports*, which use survey data to rank countries according to the effectiveness of legal reforms (speed, simplicity, enforceability and the institutional environment have been used as measures for the effectiveness of disclosure and redress mechanisms).

3.2. Research results

a. The extensiveness of corporate governance legislation in SEE – law on the books

Table 3. Corporate governance development in SEE countries

Country	Set of rules that serve as a national code of CG	Proponent of the National code of CG	Extent of compliance with OECD principles	Existing code - mandatory or voluntary
Albania	Company Law (1992).	Government	It is not in line with OECD principles	It is fully mandatory
Bosnia & Herzegovina	Law on Banks and Law on Business Companies	Government	Law on Business Companies and Law on Banks are based on the OECD principles.	Law on Business Companies and Law on Banks are mandatory.
Bulgaria	Law for Public Offering of Securities	The national code is developed by the Government and is adopted by the National Assembly.	The existing law is based on the OECD Principles.	The existing code is mandatory.
Croatia	Croatian Company Law	Enacted by the Parliament and proposed by the Government	Croatian Company Law closely resembles the German Law model on CG and EU directives	There are provisions in the Croatian Company Law which are mandatory. However, certain matters may be regulated by the company articles of association
Macedonia	Company Code and the Rules of the Stock Exchange	Mainly by the Government.	OECD principles are highly respected	The corporate governance rules are to a great extent mandatory.
Serbia & Montenegro	Law on Enterprises and Law on Securities and other financial instruments market	By the Government.	The future code will be in accordance with OECD principles	Both laws are mandatory
Romania	Such a national code does not exist. Corporate governance is observed according to provisions in the Companies Law, the Securities Law and NSC's and BSE's regulations and procedures	The private sector promotes and develops principles related to corporate governance, but such principles are not promoted on a government level	The existing Code of Corporate Governance issued by the BSE is, to a certain extent, inspired by the OECD principles	The Corporate Governance Code issued by the BSE is mandatory only for the companies listed as members of the "plus tier" of the BSE.

Source: own compilation, based on EBRD legal sector assessment, 2004

Two comments can be made in relation to recent CG developments as described in Table 3.

First, while EU accession countries might be performing better in terms of economic transition, they do not always have better "laws on the books" than other non-accession countries. This observation is supported by the 2005 country ratings calculated by EBRD[16] (high compliance – Macedonia; medium compliance – Albania, Bulgaria, Croatia, Serbia and Montenegro; low compliance - Bosnia and Herzegovina, Romania).

One possible explanation is that the EU accession process itself focuses on the harmonization of national laws with the EU *acquis* and accordingly better corporate governance regimes can be considered as a side effect of harmonization (but not as a goal for EU accession purposes). The fact that the European Commission has recently decided to take a more direct and organized approach in tackling corporate governance issues within the EU further supports this explanation and has a more direct consequence on the new acceding countries' legislative framework.

The second comment is related to the evolving EU legislation and, consequently, permanent harmonization process for the EU accession. Over the years, a dilemma constantly facing accession countries was that while they were endeavoring to establish a "EU compatible" regulatory framework at the national level, the relevant EU norms themselves were not standing still and the global economic environment in which countries were trying to thrive was also changing very fast. If we take Romania as an

example, throughout the accession process it was not uncommon to see a piece of legislation adopted only in the previous year being amended to include new relevant EU regulations (company law in December 2006 and securities law in July 2004, for example). Therefore, for the countries which joined the EU in 2007, the high level of harmonization anxiety resulted in more recent efforts put into the legislative process in order to comply with the provisions of the EU Action Plan on corporate governance[17].

With respect to the five dimensions of CG that, according to the EBRD, define its extensiveness, the table below confirms the empirical findings outlined above, meaning that major problems of the SEE countries are evidenced in the "disclosure and transparency" sector and in the "rights of shareholders" sector, with specific reference to control arrangements and control disclosure.

In Romania's case, the major failings in the observance of the OECD corporate governance principles were identified in the areas of the responsibilities of the board and disclosure and transparency.

Table 4. Level of compliance with OECD principles on CG

	Rights of shareholders	Equitable treatment of shareholders	Role of Stakeholders	Disclosure & Transparency	Responsibilities of the board
Central Europe and the Baltics	70	83	79	62	70
South Eastern Europe	72	78	**63**	**52**	72

Source: own compilation, based on EBRD legal sector assessment, 2004

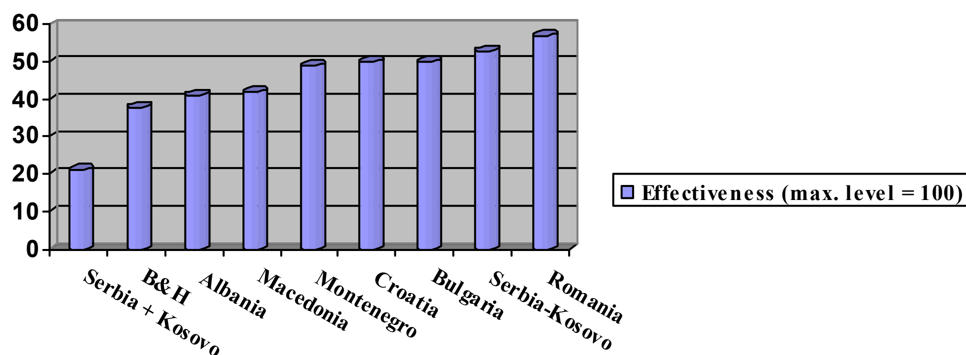
b. The effectiveness of corporate governance legislation in SEE – law in action

The results of the legal indicator survey conducted by the EBRD in 2005 (aimed at measuring the effectiveness of disclosure and redress mechanisms[18] - see figure 1) indicate that:

- as far as disclosure is concerned, South-Eastern Europe is generally characterized by the persistence of a complex legal framework, limited competence and experience of institutions and limited availability and use of case law (with an especially weak institutional environment in Albania, but relatively sound in Bulgaria, Croatia and more recently Romania) and with difficult enforcement of judicial decisions (the average time needed to obtain a court order varies from a few months in Bulgaria and Romania to three or more years in Bosnia and Herzegovina. A relatively effective framework for disclosure was reported in Bulgaria, Romania and Serbia and Montenegro;
- with respect to redress mechanisms, Romania and Serbia and Montenegro have the most effective legislation in the SEE region. Major weaknesses consist in long periods of time needed for obtaining an executable judgment (the average time needed varies from 18 months in Romania, to two years in Bulgaria and more than five years in Serbia and Montenegro), complex legal proceedings and a weak institutional environment (Bulgaria offers only one course of legal redress, while in Romania and Serbia and Montenegro, minority shareholders can choose between several different procedures which are generally deemed clear and enforceable)

A clearer picture on Romania's situation is presented in table 5.

Figure 1. Effectiveness of CG legislation in SEE



Source: own compilation, based on EBRD legal indicator survey, 2005

Table 5. Effectiveness of CG legislation in Romania (58%)

Disclosure	refers to a minority shareholder's ability to obtain information about their company.	**68.25%**
Speed		61%
Simplicity		78%
Enforceability		72%
Institutional environment	refers to the capacity of a country's legal framework to effectively implement and enforce CG legislation	62%
Redress	refers to the remedies available to a minority shareholder whose rights have been breached.	**47.8%**
Speed		38%
Simplicity		48%
Enforceability		77%
Institutional environment		37%
Costs	refer to estimated expenses a minority shareholder must pay to take legal action	39%

Source: own compilation, based on EBRD legal indicator survey, 2005

4. Concluding remarks

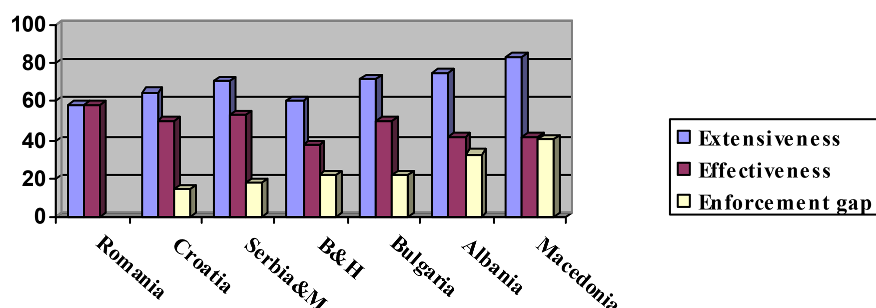
Taken together, the two assessments (of the extensiveness and the effectiveness) provide a multi-dimensional view of the quality of corporate governance legislation and the functioning of legal regimes in the SEE countries. The conclusive results, under the form of the enforcement gap, are illustrated below (see figure 2).

Several general conclusions can be drawn from this assessment:

- first, the quality of the legal framework on corporate governance is improving in all countries, but its implementation is lagging behind. Countries that have developed a solid institutional environment can generally offer an effective legal framework (Romania, Croatia). Nevertheless, good laws on the books are not enough to guarantee the effectiveness of a system. The sound environment needs to be coupled with a corporate governance framework in line with international standards and with an effective civil and/or administrative procedural framework;
- second, recent EU member states (Bulgaria, Romania) and candidate countries (Croatia, Macedonia), while displaying a better institutional environment, do not systematically outperform other transition countries with regard to the effectiveness of disclosure or redress mechanisms;
- third, the existence of implementation gaps undermines the usefulness of legal provisions and diminishes the confidence of foreign investors in the legal system as a whole. Consequently, most SEE countries, while still needing to upgrade their corporate, banking and stock market legislation, should also focus on implementing and

understanding the utility of this legislation in practice, in order to provide an explicit signal for investors that are essential for the development of their financial markets.

Figure 2. Enforcement gap



Source: own compilation based on EBRD Transition Report 2005

The most important conclusion of this paper is that a key aspect of weak corporate governance in SEE countries – namely the difficulty in attracting external finance – cannot be solved only by improvements, however radical, in the CG legal framework The extent of legal reform in these areas of the law has been impressive by any standard. In fact, many of the SEE countries, which received foreign legal technical assistance, can today boast higher levels of investor rights protection on the books than some of the most developed market economies[19]. Yet, the development of the law has not been matched so far by the development of financial markets. An important constraint on financial market development is the absence of effective legal institutions, or what we have termed "effectiveness". Improving the law on the books in such an environment is at best a partial solution, but will not be rewarded unless a commitment to rule-based governance of markets is made credible.

In their analysis of law and finance around the world, LLSV (1998)[20] show that effective law enforcement is not a substitute for poor laws on the books. The situation of SEE economies indicates that the reverse can also be considered as valid: the existence of laws cannot substitute for weak institutions.

Recent studies on transition economies have emphasized the relevance of law, judicial efficiency, corporate governance and the regulatory framework. Empirical evidence suggests that better legal protection of outside shareholders is associated with higher valuation of listed firms[21]. Consequently, a further area of investigation might be to test the correlation between the enforcement of financial regulations (e.g. security market supervision) and the stock markets performance.

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[13] Transparency International, 2005
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[15] Directives are legal commands which differentiate legal from illegal behavior in a simple and clear way
[16] EBRD Legal Indicator Survey 2005
[17] The Romanian framework was improved in 2004, 2005 and 2006 with the enactment of new provisions aimed at harmonizing national law with EU legislation. According to the last assessment (that considered the 2004 improvements), the ranking of Romania improved to "medium compliance" – 62%. For the 2005 and 2006 amendments to the legislation, it is too early to evaluate whether these provisions have addressed the failings identified in the assessment.
[18] Disclosure refers to a minority shareholder's ability to obtain information about their company. Redress refers to the remedies available to a minority shareholder whose rights have been breached. Institutional environment refers to the capacity of a country's legal framework to effectively implement and enforce corporate governance legislation. Costs refer to the estimated expenses a minority shareholder must pay to take legal action.
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[21] see La Porta, Rafael, Florencio Lopez -de Silanes, Andrei Shleifer & Robert Vishny, LLSV (2002) *Investor Protection and Corporate Valuation,* Journal of Finance 57, 1147-1170