

CORPORATE GOVERNANCE ISSUES IN SELECTED ECONOMIES OF SOUTHEASTERN EUROPE

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ABSTRACT

This article aims at introducing the main corporate governance mechanism's influence on governance in South Eastern Europe (Western Balkans) transition economies: Albania, Bosnia and Herzegovina, Croatia, Serbia and Slovenia. The implementation of corporate governance in transition economies, where Albania is one of the countries that have implemented such corporate governance principles, require a suitable legal framework and relevant protection of minority shareholders. In 2008 the new law "On entrepreneurs and commercial companies" was enacted. The latter introduced new practices and concepts, some of them not familiar to the Albanian legal system.

This paper discusses comparative insight on the most pressing issues of corporate governance in selected economies of South-East Europe (Western Balkans). It is widely accepted that both private sector and governments can benefit from identification of the most important determinants and implications of good corporate governance. Corporate governance systems have a common goal – protection of investor's rights and transparency of the system in which transactions take place. However, it is also well recognized that systems of corporate governance in attempt to gain necessary level of harmonization and consistency rely heavily on contextual factors of specific economy. Specifically, the research covers corporate governance in Albania, Bosnia and Herzegovina, Croatia, Serbia and Slovenia.

JEL CLASSIFICATION & KEYWORDS

■ K22 ■ CORPORATE GOVERNANCE ■ PROTECTION ■ LEGAL FRAMEWORK

INTRODUCTION

Corporate governance has become a topic of a worldwide economics debate. A series of events over the last two decades has placed corporate governance issues - including the power and responsibilities of boards of directors, ownership structure, the rules governing takeovers, management compensations schemes - as a top concern for both the international business community and international financial institutions.

The corporate governance problem was first referred to by Berle and Means (1932) as the problem arising out of the separation of ownership and control in large corporations. Given their discretionary power, company managers may use company resources to their own advantage. Investors therefore cannot take their returns of cash flow from the company's projects for granted¹.

Dispersed ownership and liquid capital markets can be found in both the United States and the United Kingdom.

¹ This so-called agency problem represents the heart of the Jensen, Meckling and Coase contractual view of the firm. Hart, Grossman and Moore explain this problem by focusing squarely on the investors' power relative to the insiders. By distinguishing between the contractual and residual control rights that investors have, the authors explain the incapability of the latter to write complete contracts that could determine all the actions and limit the discretion of the managers, also in unpredictable future circumstances.

On the other hand, most European Countries have highly concentrated ownership and relatively illiquid capital markets². La Porta et al. (1997, 1998, 1999) explain these differences by the differences in investors' legal protection.

The corporate governance problem has been gaining importance in transition economies. Economic growth in these countries has turned out to lower than expected. The problems of governance in the transition economies vary with the ownership, which in turn are an outcome of the diverse methods of privatization employed in the region. Privatisation does not seem to have brought about the anticipated improvements in corporate efficiency. The state and 'para-state' institutions such as privatisation funds remain the largest shareholders of companies. Internal owners dominate in many companies, while the external owners do not have enough voting power to control the companies and thereby to ensure themselves appropriate returns. The capital markets are under-developed and do not facilitate the inflow of new capital as intended. Further, market transactions are often based on the abuse of inside information.

The research in this paper is to be focused on examining governance 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. 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.

In a narrow sense, the term corporate governance determines the system that ensures owners, that the top management is set to achieve the objectives of the organization, meet the basic commitment - to create value for owners. The objective of corporate governance has traditionally been conceptualized by agency theory (Williamson, 1975; Jensen and Meckling, 1976:308) as the maximization of profits for shareholders (Friedman, 1970), or as Friedman puts it - business of business is business. Companies aim to sell where marginal costs meet marginal revenue, where they generate the most profit. Exactly that, an over-emphasis on profit maximization and on share price performance, however, has been found as a root cause of the latest governance crises (Zandstra, 2002:16; Currall and Epstein, 2003:193; Omazić, 2007; Posner 2009) as well as the current financial crisis of 2007-2008 (Posner 2009, Stiglitz, 2010, Spitzek, Hansen, 2010).

² Thus, there are different systems of corporate governance. Most authors refer to the so-called outsider (USA, UK) and insider (Germany, Japan, Continental Europe) systems of corporate governance.

Corporate governance systems of transition countries in Central and Eastern Europe share several common characteristics (Pučko, 2005). Firstly, supervisory and executive functions are rarely separated due to the fact that executive managers are often most influential shareholders. Secondly, even in case when managers do not have significant ownership of the company they try to establish significant level of control through concentration of voting rights. Thirdly, there is significant influence of workers in corporate governance structures. And finally, supervisory boards of companies in transition economies are rarely composed of experts.

Comparative analysis of corporate governance systems in Albania, Croatia, Slovenia, Bosnia and Herzegovina and Serbia

Following the big changes in Central and Eastern Europe, economic literature is often dealing with different transformation and development models of the area countries.

Transition countries have or they have had big number of corporations in state ownership which needed to go through process of restructuring. Besides that, it is important to introduce changes in dysfunctional legal system as well as to build fundamental institutions from the beginning (Berglöf, von Thadden, 1999).

Albania

Albania is obviously one of the most unique cases in Eastern Europe not only for its size and location but also for its legacy in the economic development and many other peculiarities as well. Without denying similarities with other excommunist countries, Albania has pursued its way of economic transformation toward a market economy. During the 45 years of communist rule Albania had become a very rigorously centralized economy. Central planning had virtually replaced all forms of market mechanisms.

Albania unlike other eastern European countries came from a deep isolation and centrally planned economy. Albania compared to other countries was presented with a lot of problems and had its own difficulties in transition process. The public enterprise reform which earnestly started in the early 1990s. Privatization of enterprises, economic reforms, development and implementation of the legal framework for privatization and reforms were accompanied by a large number of difficulties.

The improvement of the business climate that should influence indirectly on creating market instrument to encourage the implementation and enforcement seems to be a real priority for the Albanian authorities, which is being combined with the implementation of a number of legal and institutional reforms.

On the other side the business community is increasing its role in the process of reform. As a result it is going to be more active in the process of improving the regulatory framework and in advocating for avoiding administrative barriers and bureaucratic behaviour of any kind.

Albania is market with small own business more than 80%. More development is the family business. The family member are present in director board, or supervisory board. Important is to say that are company that has implement the corporate governance, but this company are specially banks and some big company that has take the result of corporate governance.

Albania actually has the corporate governance code. Switzerland has supported the introduction and improvement of Corporate Governance (CG) of private

companies and banks in the Western Balkans (WB) region since 2006. Phase 1 of the CG project, implemented by IFC, focused on 4 areas: (i) assist companies and banks to implement good CG practices; (ii) develop an effective CG framework in support of open and transparent markets which is able to attract investment; (iii) increase the training capacity of educational institutions; (iv) increase public awareness on CG issues.

Corporate Governance is understood as the system by which companies are directed and controlled. As empiric research shows, companies abiding to good corporate governance usually will perform better than their counterparts that do not. One reason is that through improved mechanisms of direction and control, competencies are better allocated and the entire decision process is better driven. The second is that companies with good corporate governance inspire more confidence, hence attracting more investors. Both of these elements, help companies with good corporate governance outperform companies with poor or non existing standards in this field.

Actually by the Ministry of Economy Trade and Privatisation is approved Corporate Governance Principles for All Unlisted Joint-Stock Companies. This principles help companies in their business in the time when the stock market is inexistent, because there are no company listed in this institutions from 1996, when were the first time that in Albanian officially started the stock market.

Owners of companies should establish an appropriate constitutional and governance framework for the company. Every company should strive to establish effective board which is collectively responsible for the long-term success of the company, including the definition of the corporate strategy. However, an interim step on the road to an effective (and independent) board may be the creation of an advisory board. The board should meet sufficiently regularly to discharge its duties, and be supplied in a timely manner with appropriate information.

• Corporate Governance

The corporate governance framework in Albania is essentially regulated by Law no. 9901 approved by the Albanian Parliament on 14 April 2008 on "Entrepreneurs and Commercial Companies", which entered into force on 21 May 2008 and replaced the previous legislation on business organisations in Albania (Laws no. 7632/1992 and no. 7638/1992). The new law regulates individual entrepreneurs and commercial companies. In contrast to the previous company law, the 2008 law also includes the definition of branches and representative offices of foreign companies and details provisions on groups of companies. Companies incorporated under the old regime have a three-year transition period in which to align their organisational structure with the new law. Joint stock companies can be organised under a one- or two-tier system. Under the two-tier system, the General Shareholders Meeting appoints the Supervisory Board. The Managing Board can then be appointed by either the General Shareholders Meeting or the Supervisory Board, as regulated by the company by-laws.

Corporate governance in Croatia

Development of corporate governance in Croatia is set parallel with the processes of privatization and market economy institution building (Tipurić et al, 2004: 255-292). As a result of privatization in Croatia appears a large number of small shareholders, both at the beginning of the 90-ies, and in the coupon privatization in 1996. The causes of fast

selling of stocks and reactive actions of shareholders are the slow development of capital markets and the relatively disadvantaged position of small shareholders.

Privatization has created the preconditions for restructuring and consolidation of corporate ownership stakes in them. However, its course was marked by slow and a significant dose of inconsistencies and arbitrary decisions, and establishing legal and institutional framework for corporate governance has also been slow and not sufficiently effective (Račić, Cvijanović, 2005:45). The result of such relations was the prevalence of unregulated takeover and dominance of concentrated ownership structures that are part of the case management and supervised employees, a part of the larger external shareholders (Tipurić et al., 2004:262-263). All this has had a major impact on the spread and establishment of good corporate governance practice in the Republic of Croatia, which are further influenced by the lack of knowledge, as well as partial recognition of the importance of the concept of corporate governance by the business community and experts.

Such practice has negatively affected the transparency of business enterprises, protection of shareholder rights, and thus the interest of investors and capital market development. Also, when it comes to long-term financing, Croatian companies have maintained a traditional reliance on bank loans, with significantly less reliance on financing through the issuance of securities. Most of the newly established companies generally maintained a concentrated ownership structure, and were outside the scope of capital markets-except through the entry of strategic partners in the ownership structure (Račić, Cvijanović, 2005:3).

Minority shareholders and protection of their interests are one of the major problems of corporate governance in Croatia (Hruška, 2005). High ownership concentrations in most cases prevent opportune behavior of management in the use of controls for their personal benefit. So we can safely conclude that the Croatian huge task, which is the regulatory and research problem, is to find an institutional solution to the issue of protecting the interests of small shareholders in relation to the dominant owners.

Even today, 20 years from beginning of privatization, there are many issues in Croatian corporate governance. Those are foremost: lack of knowledge about corporate governance, lack of activity of educational and professional institutions and associations that bring together members of the supervisory board and management and the problem of defining and promoting good corporate governance practice.

Corporate governance in Slovenia

As in other countries of Central and Eastern Europe, corporate governance in Slovenia was heavily influenced by the privatization process that took place in 90-ies. During the privatization of 40% shares of the company were distributed through a free transfer to quasi-public and public funds such as pension funds and development. The other 60% of shares were privatized by the insider's (internal privatization) or outsider-a (foreign privatization). Wealthy corporations have been privatized through internal privatization, while less-standing corporations have completed the state-owned investment funds.

Privatization in Slovenia sets the context for forming systems of corporate governance in Slovenia. About 90% of companies in Slovenia have chosen internal distribution and internal purchase as privatization model. Furthermore, privatization in Slovenia resulted in the introduction of

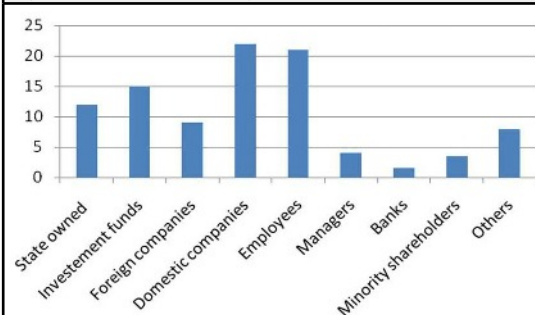
two-tier system of corporate governance. Most of the privatized company then decided to form a joint stock company, and introduced the Board as the supervisory authority.

The main features of corporate governance in Slovenia after the privatization process are: (1) a relatively low concentration of ownership (majority shareholder controls 35% equity stake), (2) increasing the equity shares in the hands of domestic non-financial companies and managers, (3) Reduction of employee ownership; (4) Gradually falling sales of proprietary control package by state funds, (5) Low level of involvement of foreign non-financial companies (Gregorič, 2003; Knežević Cvelbar, 2006).

In several studies conducted by Gregorič, Pahor (2003), and Prašnikar (2002), confirmed the correlation between ownership structure and performance of companies in Slovenia.

Knežević and Čvelbar (2007:37) showed in their investigation of how companies are mostly owned by the state are less effective than other corporation in Slovenia. To summarize, these authors dealing with corporate governance in Slovenia, have come concluded that the government is usually weak and passive shareholder, while domestic and foreign companies, as well as insiders (employees and managers) are more active and effective owners. Shareholder identity of Slovenian companies is also quite dispersed as showed in figure 1.

Figure 1: Shareholder identity of Slovenian companies (%)



Source : Cvelbar, Lj. and Mihalič, T. (2007).

In terms of ownership structure, the majority of Slovenian companies do not have a shareholder which consolidates more than 50% of total shares. Partly this is a consequence of the Slovenian model of ownership transformation, according to which Slovenian companies have got the same large-scale owners with compatible power, as long as individuals have no power of decision making and corporate governance. Among the largest outside shareholders of Slovenian companies on the stock market today, in addition to domestic and foreign financial companies, are even the authorized investment companies, stemming from the Slovenian ownership transformation.

In Slovenia, the area of corporate governance is regulated by the Law on Business Companies Act, the Takeover Act and the shareholder participation in governance, while the decisions are detailed in the statutes, rules and regulations of individual companies in Slovenia. 18th March 2004. Slovenia has adopted the Code of the management of public companies, which have shaped the Ljubljana Stock Exchange, Association of Supervisory Board members and association managers, who are also signatories to the Code and are responsible for the regular control of the effectiveness and application of the Code.

In formulating the Code to take account of legislation, ethical principles, and business culture, which are made in accordance with internationally accepted standards. In addition to the Code there are other recommendations and criteria, which guide the area of corporate governance in Slovenia. Association members of the supervisory board is so even brought their "Recommendations for the appointment and dismissal of board members" and "criteria for membership, performance and compensation of the supervisory board" and on the ground that "recommendations for the compensation of members of supervisory boards.

Corporate governance in Bosnia and Herzegovina

For Bosnia and Herzegovina, we can say that it is among the last countries in the region of Southeast Europe to be included in the transition process. Only a late entry into the privatization process is not necessarily a negative sign. Question Choice of system of corporate governance is currently in transition countries, as well as in Bosnia and Herzegovina, where the legislative and institutional framework of corporate governance to create one of the priority tasks of post privatization.

Bosnia and Herzegovina has found itself facing the same challenge, with negligible experience in the functioning of companies and the need to quickly develop a system of corporate governance, whereby the Companies Act contains general rules of importance to its development and functioning (Omerbegović, 2008: 201).

As it emphasized by Omerbegović (2008:200), unlike most countries, the structure of corporate governance in Bosnia and Herzegovina is not the same for all companies. Specifically, the bank has retained two-level system of corporate governance, under which, with the General Assembly, work management and supervisory board, with the characteristics of the audit committee, while the bank is managed by the Director-General. Two-level structure of corporate governance raises the question of responsibility for establishing and implementing best practice standards and to harmonize the needs of the structure of corporate governance (Omerbegović 2008:202).

Bosnia and Herzegovina is a country with a closed system of corporate governance, which is characterized by concentrated ownership, where owners often chairman of the supervisory board. What is important to emphasize is the fact that Bosnia and Herzegovina is a country with two institutionally-differentiated legal entities that characterize the different models of corporate governance, companies operating in the Federation following the American model of corporate governance, while in the Republic of Serbian companies follow the German model of corporate management.

Institutional and legal framework of corporate governance is being established since 1998 and is in constant process of upgrading (Šunje, 2007).

Ownership concentration is the dominant factor in corporate governance in Bosnia and Herzegovina. Ownership in most corporations in Bosnia and Herzegovina is concentrated in the hands of a few major shareholders.

According to Suljkanović the key to success to establish a healthy business environment with a strong framework of corporate governance in Bosnia and Herzegovina includes the following few basic steps (Suljkanović, 2007: 26).

Firstly it is necessary to develop a regulatory framework for an acceptable level of Bosnia and Herzegovina. The capital market in Bosnia and Herzegovina is still underdeveloped

and illiquid to attract interest in investments. While on the other hand, the fragmented regulatory framework increases the cost of its operations in the capital market. Development of regulatory frameworks on the state level and will increase liquidity, encourage mergers and acquisitions, and make them more interesting for investment.

Furthermore, it is necessary to promote the development of capital markets. It is necessary to resolve the issues concerning equity in the newly privatized companies. It is also important to encourage the state to deprive its stake in privatized companies by selling their shares on stock exchanges. On the capital market in Bosnia and Herzegovina issuance of shares is limited, while other securities do not exist. This is a serious obstacle to the development of institutional investors (insurance companies and pension funds).

In addition to appear among, the development of corporate governance in BiH is necessary to increase financial transparency. The first step towards increasing the financial transparency is the adoption of IFRS - International Financial Reporting Standards", and international auditing standards - International Standards on Auditing.

Research conducted by the World Bank's 2005th year, which has conducted an assessment of corporate governance in Bosnia and Herzegovina in relation to the OECD Principles and found numerous weaknesses of corporate governance. The weaknesses are reflected in the ill-defined and vague duties and responsibilities of board members, while the rights of minority shareholders to sue management company limited and rarely used, due to lack of specialized justice system. Also, lacking education board members that would enhance the possibility of making independent decisions by the independent members of management and supervisory boards. The World Bank has also pointed to a lack of financial reporting in accordance with international practice, where there are a handful of companies that report in accordance with international practice. Also, the survey noted that minority shareholders were not always able to sell their shares, where in any part of the law does not say that minority shareholders are bound to sell, or controlling shareholders buy shares from them, when it reached the ownership threshold of 90%. According to some predictions of privatization investment funds in Bosnia and Herzegovina will be the main drivers of corporate governance.

The most successful Bosnian company will modernize and grow with the help of such funds and strategic investors will own the largest stakes.

The report, Doing Business 2010 Bosnia and Herzegovina is ranked 116th on the list, which measures the ease of doing business in 183 economies worldwide. Place of Bosnia and Herzegovina for the first time since improved in 2006. The Doing Business began to publish the overall ranking of countries. Although a slight improvement over the previous year (3 seats, with now is the 119th to the 116th), it nevertheless represents an important break the trend of deterioration.

Corporate governance in Serbia

Corporate governance has been a key part of the reform process in Serbia (Mihajlov-Denčić, 2006:169). State of corporate governance has never been on a high level, indeed the very low level, as well as the Serbian economy, which lags behind the other, particularly developed countries.

For purposes of this research project "Corporate Governance: five years later, the state of Serbia", carried out by the Centre for Liberal Democratic Studies, 2008,

made a survey on corporate governance in Serbia, where the sample consisted of 214 companies.

According to a survey conducted by the "Center for Liberal-Democratic Studies", in July 2008 there are many causes of bad corporate governance practice in Serbia. Those problems mostly origin in small number of, so far, privatized enterprises. State-owned enterprises are in their functioning still dominated by the old socialist-self-governing mechanisms of governance, based on strong political interference.

Privatization in Serbia was not adequate to liberate the country from the problems facing in corporate governance. Although privatization brings the improvement of governance, which can be seen in last few years, some burning issues are still opened. There is primarily the problem of insufficiently well-reformed economic regulation. So it happened that the legal framework in which the functioning of the company sometimes sends the wrong incentives. Law on Enterprises which was passed on 2004 have put forward framework governing corporate governance in Serbia, but there is lot of space for further improvement. Inefficiency and weakness of institutions in Serbia in the exercise of their jurisdiction is major structural problem in practice in corporate governance in that country. Furthermore, research has shown that at least 52% of companies in Serbia there is an owner who owns more than two thirds of the shares. In addition, 19% are owners of companies with 25 to 50% of the shares, which leads to the conclusion that in Serbia there is no significant concentration of ownership (Mijatović, Begović, Paunović, Živković, Bisić, Jolović, 2009:4).

In recent years there has been an increase on concentration of ownership in Serbian corporations. The reasons for such marked concentration are (1) poor protection of property rights in Serbia, (2) frequent expropriation of minority shareholders by the management, (3) the natural process of moving stock from the hands of employees to investors, (4) the majority shareholders attempt to close ownership structure, ie to convert a joint stock company limited liability company, which is easier to manage (Mijatović, Begović, Paunović, Živković, Bisić, Jolović, 2009:4-5).

The basic problem of corporate governance in Serbia is the principal and agent relationship between the dispersion of ownership, because the Serbian limited liability companies is no clear majority owner to easily set up and controlled by management. The bigger problem is the relationship between majority and minority shareholders where majority shareholders have the opportunity to go out minority shareholders. The major factor of corporate governance in Serbia's governing board, not management, because the majority owner realizes the control over the enterprise across the board which sets easily, while the director of the company only figure who implement the decisions.

Conclusion

Framework for analysis is in this paper described from perspective of transition economy where corporate control mechanism are more unstable and fragile that they are in countries with longer tradition of market for corporate control. In this paper we argue how corporate governance systems in transition countries of south east Europe share some common characteristics.

Corporate governance systems in transitional countries are influenced by the process of privatization which had major economical and social influences in all countries around the world. The way this process was handled in observed countries determined development of all mechanism of

corporate governance and it mostly influenced ownership concentration. This paper suggests that in observed countries major contemporary issue of transition corporate governance is not conflict between large number of dispersed shareholders at one side and professional management at another side as it is in countries of Anglo-Saxon business circle. Concentrated ownership in the hands of several or even one blockholder insures significant level of control to directly influence on nomination and efficiency control of managerial team while role of supervisory board is prevalently formal.

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