The Relevance of Corporate Governance to Eurasian[1] Transition Economies

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I. Introduction

Corporate governance has recently come to the forefront of policy debates around the world. Essentially, it relates to the mechanisms and framework for corporate decision-making, but it may also include a wide range of other issues, mostly concerned with the incentives that drive firm behaviour. From the perspective of the 1999 OECD Principles on Corporate Governance, corporate governance has a two-fold meaning. On the one hand it encompasses the relationships and ensuing patterns of behaviour between different agents in a limited liability corporation. In other words, corporate governance refers to the way managers and shareholders, but also employees, creditors, key customers and communities, interact with each other to form the strategy of the corporation.

On the other hand, corporate governance also needs the support of public policy, as corporate strategy formation is made within a framework provided by a set of rules. These rules may include private self-regulation, but consist mainly of public laws and regulations such as company law, securities regulation, listing requirements and insolvency legislation. Good corporate governance practices cannot develop without appropriate public policy, without an adequate legal and regulatory framework. This is mainly why governments all around the world pay due attention to corporate governance.

During the last few decades, private sector corporations have vastly increased their role as critical engines of economic development and job creation all over the world. As economic growth depends more and more on the development of a competitive corporate sector, the establishment or improvement of corporate governance is a matter of growing concern for all countries. This is particularly true for transition countries that need to put together their private corporate sector from scratch in the context of a difficult economic transformation.

This brief paper is divided in two sections. In the first one, the focus is on why good corporate governance is important in the economic transition process. Three points will be raised in this section. First, good corporate governance is indispensable for transition economies to build well-functioning institutions for economic growth. Second, good corporate governance leads to efficient allocation of capital and contributes to the development of financial markets. Third, the existence of proper corporate governance is an important prerequisite for transition countries to attract foreign investment. The second section of the paper focuses on the Eurasian region. It will first attempt to describe the key elements of an incentive structure that has produced only

[1] In this paper we use the term Eurasia to refer to all the countries that are involved in the Eurasian Roundtable Process. These are the mainly the countries that have been created as a result of the break-up of the former Soviet Union, with the exception of Russia, the three Baltic states, Belarus, Turkmenistan and Tajikistan. We also include Mongolia in this group, even though Mongolia was not part of the former Soviet Union.

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limited corporate restructuring in the region. It will then review the main corporate governance problems through the scope of the OECD Principles.

II. The importance of corporate governance in the context of transition

A. Institution-building for a market economy

In a market economy, private corporations raise funds from investors and, combining these funds with other inputs—notably labour and land, conduct business. Their objective is simple: to seek profits. The recognition of the vital role and superior performance of private sector corporations in economic growth was a powerful motivator for widespread privatisation in many developed and developing economies in the last couple of decades. In transition countries, a transfer of corporate ownership on an unprecedented scale was undertaken in the context of economic transformation over the last ten years. In order for these countries to develop an efficient and competitive corporate sector, privatisation is rightly considered an indispensable step. It has been undertaken in more or less all of them, but its implementation has been uneven.

Without good corporate governance the corporate institution cannot pursue its fundamental profit-seeking goal with maximum efficiency, both in terms of private and social welfare. It is this important tenet that was often forgotten when transitional privatisation was on the design board. Corporate governance was assumed to appear automatically, as a direct result of ownership transformation. In fact, experience in transition economies shows that the transfer of corporate ownership to private hands is far from sufficient to ensure the development of a robust corporate sector. A key reason why transition countries have not been very successful in corporate restructuring is the lack of proper corporate governance. Companies will not function efficiently without appropriate, enforceable governance rules and institutions to enforce them; and without building private capacity to support and develop a corporate governance culture among managers, shareholder and stakeholders. In transition economies, the development of good corporate governance practices is not only about enhancing the efficiency of equity markets or “fine-tuning” corporate decision making processes; it is more about creating the key institution that will drive successful economic transformation to a market based economy, the private corporation.

First, in order to have good corporate governance, all related agents, in particular managers and shareholders, need to recognise and perform their roles appropriately. Such a cultural shift takes time and it is not yet evident in most transition economies. Mass privatisation has created a number of private shareholders, who have not yet realised the role, rights and responsibilities they are expected to assume as corporate owners, perhaps because they have got shares almost for free. Most of them are simply waiting for the payment of dividends that are often trivial. Corporate managers do not seem to fully understand their role as the agents for shareholders, either. They run their companies as if they own them, seeking personal benefits at the cost of shareholders, and often of the company as a whole. Change in this context will take time and will require an effective mix of "carrots and sticks". In many cases, it will boil down to recognising that increasing the longer term value of the company is better than diverting its assets to a foreign bank account.

Second, the legal and regulatory framework for corporate governance is still weak in transition countries. Upgrading it, both in terms of coherence and enforceability, is probably the most

urgent task that policy makers are facing in reshaping their micro-economy. Most of these countries have already enacted a company law that is the core of the corporate framework. However, in many cases, the law does not provide a sufficiently clear and complete set of rules and is not well implemented, due to the lack of a proper enforcement mechanism.

A limited liability corporation is in fact a legal creation, established by the provisions of company law. By limiting liability of shareholders to the amounts they invest in the share, the law allows such an institution to raise funds from the wider public, in order to conduct and expand a business. By enabling the corporation to have its own well-defined property, it provides creditors with an assurance that lending is supported by corporate assets. Without adequate legal backing, such a complex institutional arrangement cannot function satisfactorily or develop soundly. Moreover, while company law is a key for the corporate governance framework, it is not enough. Other laws and regulatory rules also have significant influence in shaping corporate behaviour. They include insolvency legislation and securities regulation, which have yet to be developed and implemented in many transition countries.

From another perspective, corporate governance is a procedure to select corporate managers under a market mechanism. In an adequete corporate environment qualified managers can reward capital providers sufficiently and thus attract more investment to develop their business; while unqualified ones should face difficulties in raising funds for their operations and lose their businesses. This market-based selection of corporate managers is a central feature of a healthy institutional set-up. By ensuring managerial competence, it fuels the development of a robust corporate sector and hence, of the economy as a whole. This aspect of corporate governance is still largely missing in transition economies.

Finally, it should be pointed out that the improvement of corporate governance should have an important spillover effect on society as a whole. Unaccountable and opaque corporations are more than likely to undermine the rule of law and the effectiveness of government, creating and sustaining a vicious circle of corruption, bribery and mismanagement not only in the private sector but also in the public sector. The development of good corporate governance can be seen as key public institution-building ingredient for a transparent and accountable society.

B. Efficient allocation of capital

Corporate governance is closely related to corporate finance and investment. Under communism, corporations depended entirely on the government for their investment needs. In contrast, in a market economy, they have to raise funds from the public directly or indirectly through financial institutions; and/or generate enough earnings to fund their own development. The public and the financial institutions provide their money to corporations not as a gift but in expectation of sufficient financial returns. In seeking maximum returns, fund providers try to discipline corporate managers to work for their interests.

Good corporate governance is key for the development of equity markets in developing and transition countries, as it is for all other economies. First of all, if shares do not generate sufficient financial returns, nobody wants to invest in them. Secondly, if the value of shares cannot be evaluated appropriately due to unaccountable and opaque management of a corporation, it is also difficult to expect active trading of shares of such a corporation. In other words, if there are enough companies that provide reasonable returns by an accountable management, the whole market will grow and the corporate sector in its entirety will benefit from a lower cost of capital. In the opposite scenario, an overall market impression of “bad

governance" will impose higher costs on the few good corporations and will drive them out of the market in search of other (usually foreign) listings. This is the so-called "adverse selection" effect.

Good corporate governance is also important for the sound development of the banking sector. Banks channel public savings to the corporate sector. If banks cannot assess the viability and risk of the companies to which they provide credit, as a matter of course, a number of important systemic risks arise. Banks will see their balance sheets submerge with rising bad loans and will thus be forced to direct or indirect renationalisation. Another common "disease" of the banking sector in unstable transition environments is banking capture by corporations. This capture often occurs with the help of the government, pointing to the importance of another aspect of governance, the governance of banks. One cannot overestimate the importance of good governance practices in the banking sector for the health of the financial sector.

The establishment of proper corporate governance is especially important to transition economies in two ways. First, in these economies, domestic savings are scarce. They should be used most efficiently for the development of the economy. This means that the financial resources need to be allocated to the most profitable companies with the highest growth potential. This cannot be achieved if the fund providers cannot get adequate information and cannot ensure adequate monitoring through corporate governance mechanisms. Hence, corporate governance directly impacts on the efficient allocation of scarce savings.

Second, a rules-based corporate governance mechanism is crucial for transition economies, because direct capital and product market disciplines are not expected to work effectively, due to important market imperfections and failures. These disciplines will thus not be sufficient to police corporate managers. In advanced market economies, when shareholders are not satisfied with the performance of a company, they may shift their investments by selling shares in the market, which leads to decrease in the share price. The company would subsequently have difficulties in raising funds either by issuing new shares or corporate bonds due to the eventual downgrading of its rating. Banks would, in principle, be less willing to provide loans to such a company. The managers could also encounter the real threat of take-over as the share price goes down. In developing and transition countries, this mechanism of market discipline hardly works because of the lack of securities markets and of an efficient banking sector. Take-over may be possible but is still hard to carry out when no organised markets exist and no reliable corporate information is available. Therefore, in order to ensure efficient management of corporations in those countries, direct rules that create a governance mechanism through which shareholders and sometimes also creditors can discipline corporate managers are required.

Overall, the policy makers' effort in this area should be to promote the emergence of a virtuous cycle. Good corporate governance is an important factor in the establishment of a well-functioning financial market which leads to the efficient allocation of financial resources, and is key for economic growth. In its turn, an efficient financial market should promote better practices in corporate governance by increasing market discipline on corporate management

C. Promotion of foreign investment

Because of the relative scarcity of domestic savings, development and transition economies need to raise funds from foreign countries. The establishment of proper corporate governance has become increasingly important in this context, as foreign investors tend to put greater importance in selecting their investments.

In the last few decades, international financial markets have dramatically changed. One of the prominent changes is their globalisation. Vast amounts of capital are now transferred from one country to another on a daily basis. Numerous investment funds and other money management vehicles have been established and have considerably helped the expansion of securities markets. Most importantly, pension reform in some major OECD economies has created enormous pools of funds that are invested in various markets around the world.

The globalisation of capital markets benefits transition countries. Although the recent financial crises in emerging economies have highlighted the risks involved in such transactions, it is still true that foreign investment played a key role in the remarkable economic growth in these economies before the crisis. Moreover, the evidence suggests that equity investors, either portfolio or FDI, were not the ones to rush for the exit. It was mostly short-term bank lending that created the sharp reversal in capital flows.

The growing foreign investment trend is largely irreversible, because excessive savings in advanced market countries seek investment opportunities in developing countries that lack sufficient domestic savings. Sizeable assets accumulated in pension and investment pools need to be diversified. They are partly allocated into high- risk but high- return investments in developing economies. Large-scale institutional investors also tend to pay attention to corporate governance, as many of them, especially pension funds and life insurance companies, have a long-term investment perspective to match the long maturities of their liabilities. Instead of selling- out quickly whenever returns do not match expectations, these investors have been trying to make sure good corporate governance, in particular transparency and proper protection of minority shareholders, is in place to ensure sufficient long-term value growth. In order to attract these long-term foreign investors, it is of urgent necessity for transition economies to establish good corporate governance. Empirical analysis suggests that economies with poorer corporate governance have been more severely damaged in Asia, as a result of foreign investment outflows.

Foreign portfolio investment comes, most would argue, second to foreign direct investment as a facilitator of rapid transition. Foreign direct investment has been shown to address most effectively the problems faced by corporate sectors in transition. It does not only consist of a transfer of funds but also of skills, market access, technology and know- how. Thus, economies that have attracted more direct investment among transition countries have consistently outperformed the rest in terms of the speed and sustainability of their transformation over the last ten years.

Is corporate governance relevant to FDI? After all, a direct investor assumes control so that she can function without external constraints. In practice, however, direct investors worry very much about the corporate governance framework. As most of them function under transparency and accountability standards set globally, they might find themselves severely disadvantaged in an environment where local companies can externalise these costs through corruption, hidden subsidies and opacity. Direct investors need a sound company law framework as much as portfolio investors as they will often have to deal with minority shareholders and creditors in environments lacking in rule of law. In transition economies, one is not surprised to find direct investors having the state, local government or voucher recipients in the capital of the companies they control. If the corporate governance rules are not clear, these situations can create (and have in the past created) a lot of problems.

III. The Eurasian corporate reform context

In Eurasia as in other transition economies, economic reforms were widely expected to lead to substantial reallocation of resources, rectifying the distortions inherited from central planning. While causing temporary economic and social upheaval, this allocation would then underpin the subsequent recovery. However, even though market reforms have been going on for almost a decade in the region, there is still little restructuring and a persistent lack of investment in the corporate sector. Corporate reform results after nearly ten years of ongoing reforms show that the transition process is longer and more complex than initially envisaged.

A. The incentive environment for corporate reform

a. Weak and ineffective privatisation

A decade ago, with the break-up of the Soviet Union and the market-oriented reforms in many former socialist economies, privatising inefficient state-owned companies became the symbol of change from central planning to capitalism. Privatisation seemed to promise an end to the inefficiencies of central planning--the key to freeing the resources and talents and lifting living standards. An unprecedented transformation has doubtless occurred as most Eurasian countries have changed from an almost 100% state-owned economy to one that is now primarily privately owned. However, real change and modernisation at corporate level has been slow to emerge, mainly due to a pervasive set of negative incentives driving corporate behavior.

To begin with, privatisation has produced much more limited results as a driver of restructuring as initially expected. While small and medium size enterprises have almost all been privatised, a high proportion of economic activity still remains in state hands, in most Eurasian countries. The state owns or effectively controls major utilities, and many of the largest firms. This contrasts quite sharply with the three Baltic states as well as in Russia. In Kazakhstan, the 330 largest enterprises producing more than 1/3 of the GDP are still under state control. The situation of large state-owned corporations in Eurasia does not seem to suggest that prolonged state ownership might lead to better outcomes for the companies or for society as a whole.

Eurasian countries have adopted a wide variety of privatisation methods. Ukraine has mainly used voucher privatisation and transfers to insiders; only very recently it has been trying to attract foreign investors to some of its biggest enterprises. Other countries have already introduced tender privatisation and have, as a result benefited from more substantial foreign investment, as has energy-rich Kazakhstan. Corporate ownership is still dispersed in the Ukraine, with over 19 millions shareholders. It is more concentrated in countries where the privatisation method of trade sale led to significant ownership by strategic investors. Ukraine and most other countries in the region are also using the management-employee buy-out approach to privatisation, by which shares of an enterprise are sold or given to managers and employees. Within the new privatisation programme, the Ukrainian parliament has for example approved, in July of this year, a law on the preferential sale of 50% plus one share of one of the largest metal producers in Ukraine, Mariupol Ilicha, to the company's management and employees, united in a closed joint stock company. The powerful position of managers, in Ukraine as in Russia, gives this approach the twin advantages of feasibility and political popularity. Nevertheless, experience shows that a large scale sell-off to insiders creates important obstacles to corporate restructuring down the line, as insiders are unwilling to meet the conditions for attracting badly needed external finance, especially better corporate governance.

Voucher privatisation has been the main privatisation method in Georgia, Armenia and the Kyrgyz Republic. Its simplicity and distributional fairness make it politically and administratively quite attractive. Its main downside is that a dispersed ownership structure will result in weak corporate governance pressure from shareholders and will thus delay restructuring, leaving unchecked control to incumbent company managers. These problems have been partly addressed by pooling vouchers in investment or mutual funds. These investment funds were established during the mass privatisation process in order to collect privatisation certificates from citizens. In Kyrgyzstan for example the mass privatisation programme created around 400,000 shareholders, a quarter of which are shareholders of investment funds. In Kazakhstan, citizens were required to invest their vouchers through these funds. In practice, voucher funds have not lived up to their assigned role as corporate governance principals. They were often captured by managers or other politically well connected parties. In some cases, they co-operated with insiders to strip assets off companies and then disappear with the proceeds.

The initial hopes that mass privatisation would create the foundation for improved governance and transform firm-level incentives have not been realised. Voucher programmes have brought few tangible benefits to enterprises. With hindsight, institutional weakness was severely underestimated at the beginning of the process. The expectation that corporate governance institutions and practices would develop overnight to the benefit of the firms and society as a whole has proved irrealistic. Both the corporate sector and the newborn financial intermediaries suffered from the same ailments: weak monitoring by their beneficial owners and a complete lack of a “fiduciary culture”.

Having said all this, a process of asset recombination is indeed occurring in most of the region, mostly in grey markets. The shifting of assets to new, more closely held firms is quite widespread, as managers with small minority ownership stakes in newly privatised firms (or with the power to shift assets in still state- owned firms) try to gain greater control over company assets. In this regard, the nascent markets of the region are not used to raise funds but much more to swap shares and redefine corporate ownership in opaque and often illegal ways. This exacerbates adverse selection and creates enormous problems in their development.

Slow and ineffective privatisation has been the main cause for a lack of restructuring. “Red” directors of state owned or newly privatised companies, especially in one-company towns, refuse to go ahead with inevitable downsizing and change of economic activity of their companies. State enterprises have traditionally provided many social services to employees, which diverted them from their core activities, raised their costs and kept them from being competitive. Dealing with social assets is a major problem in post- privatisation restructuring as companies are often the only providers of key social services and the state institutions that could succeed them are not up and running. Divestiture of social assets is sometimes postponed or blocked by the same managerial elites that have benefited form the first wave of reforms. Power to determine social welfare is often a key currency for capturing policy by these powerful vested interests.

Slow and ineffective privatisation can also be largely blamed for a lack of investment. Domestic investments have fallen and foreign investments have remained limited in many countries in the region. In contrast, countries that have taken a more proactive attitude towards foreign sales have seen more restructuring and rising investment levels. Kazakhstan has allowed important investment both in its energy and utilities sectors and has seen some growth in these sectors. A small country like Moldova managed to attract over $48 million of direct investment in the first quarter of 2000 as compared with $6.99 million in the same period of the previous year as the cash privatisation programme moved ahead.

b. The rule of law and judicial enforcement

The absence of rule of law constitutes a major shortcoming for the development of corporations in all countries of the region. Proper protection of property rights requires first, an adequate legal framework, and second, its effective enforcement. In Eurasian countries, however, both requirements are often not satisfied. In contrast to Central and Eastern Europe, the Baltics or even Russia, the long period of central planning and a very recent statehood for the majority of these countries signify a lack of a legislative or regulatory tradition. While some countries rushed to adopt laws suggested by foreign consultants, they have often found that they bear little relevance to realities in the country. In Moldova and Georgia major legal instruments underpinning the corporate ownership environment have been adopted. Ukraine and Armenia have yet to consolidate their legal framework. In Ukraine, key laws have long been pending in parliament (i.e. new civil code, tax code, land ownership code, etc.).

Throughout the region, courts are often described as corrupt and slow; but judges will often argue that their work is particularly difficult since there are still many loopholes and contradictions in existing laws. Changes are often ill considered and are themselves subject to further change with little regard for the overall coherence of the legal system. The reform of the judiciary and its upgrading is a priority throughout the region.

Without strong institutions that can uphold the rule of law, companies whether domestic or foreign have trouble with enforcing contracts, collecting debts, and resolving disputes. In state-owned or newly privatised enterprises, incumbent managers find expropriation easy, as rules that would stop them from doing so are either non-existent or not being enforced. They also find it rational, as the weak protection for investment makes diversion of assets to foreign bank accounts more appealing: the government or a competitor may confiscate holdings or change the rules on the firms at any time. In an environment where expropriation is rampant, there is no way to ensure that money flows to its intended purpose. In a system that lives on bribery, businesses are forced to pay more money to more and more people, as the people in positions of power change. Georgian companies reportedly pay an average bribe tax of 8 percent of their annual revenue, while over 50 percent of companies in Azerbaijan admit to frequently bribing officials The economy and society as a whole are the ultimate victims of these practices.

c. Macroeconomic and structural weaknesses

Weak corporate restructuring is also a result of the failure of policy to provide for a longer-term perspective of growth based on macroeconomic stability. Although most transition countries of the region (except Moldova) will be recording positive growth in output this year, a decade of macroeconomic instability, high inflation, and inconsistent fiscal and monetary policies have undermined confidence in the economy. The difficulties of operating in an uncertain environment shorten business horizons and negatively affect the private sector. Exchange rate depreciation and volatility also add uncertainty. Recent backtracking in trade liberalisation in Central Asia has changed again the economic prospects for many enterprises in Kazakhstan, Uzbekistan and Kyrghyzstan. Because of unpredictable economic developments, local managers, although they often control and own large blocks of company shares, often perceive their positions as uncertain and temporary. With short time horizons, their expected gain from increasing company value are less than what they can obtain by stripping assets. Faced with the choice of maximising company value or diverting cash flows for immediate personal gain, controlling managers have frequently taken the second option, and not only because of the lack of

a “rule-of-law stick”. In an environment of prolonged instability, the absence of any “carrot” makes the situation even more difficult.

Important incentive distortions have their origins in the tax system. In this respect some Eurasian countries such as Kazakhstan, Kyrgyzstan and Armenia have outpaced Russia in introducing a new comprehensive tax code, although enforcement is still sometimes arbitrary. In contrast, Ukraine still has a tax code that results in punitive effective tax rates for enterprises. In its turn, this makes managers adopt double book keeping and encourages the diversion of assets from companies.

Weak competitive pressures have caused companies to remain inflexible to developments in output markets. The pervasive presence of the state in the economy continues in many countries through extensive direct and indirect subsidies. Extensive licensing requirements hamper the development of competition; in Kyrghyzstan some companies are reportedly required to obtain up to 100 licenses to carry out their activities. In Uzbekistan state enterprises are being changed into shareholding companies and private enterprise account for 45 percent of all registered firms but business decisions to set prices, output, and investment are often not market-based, nor within the purview of business. In the absence of any discipline, managers are left free to pursue their own (or their political patrons’) objectives with little regard for the firm’s overall profitability.

Although exposure to bank lending is almost completely absent in Eurasian corporations, most enterprises are known to run up wage arrears and inter-enterprise indebtedness remains substantial in all Eurasian countries. This is partly a heritage from the Communist period, when payments to other enterprises or tax authorities were made only on a book basis and were not accompanied by a real cash transfer. Continuing arrears make the imposition of discipline in external payments more complicated, with illiquidity contaminating the whole corporate sector. At the same time it renders the latter more opaque: the real situation of individual enterprises becomes more difficult to fathom in a general environment of arrears and barter payments

Insolvency systems have not been effective in Eurasia, neither as a disciplinary mechanism, nor as a mechanism to re-allocate resources. In the case of Ukraine, for example, the current bankruptcy law, which does not apply to state companies, provides for liquidation of a bankrupt company but does not clearly specify the procedure for financial restructuring during bankruptcy and is vague in many other respects. Thus, in 1998, 9075 cases reached the court, 3500 proceedings were initiated, but as of today less than 40 cases have had concrete results for the debtor company. Other countries such as Georgia or Kyrghyzstan have been dotted with relatively advanced insolvency legislation, which has, however, remained largely non-enforced.

d. The legacy of the Soviet management culture

Critical to the understanding of issues surrounding the emergence of corporate governance in the Eurasian economies is the fact that many of the shortcomings of the former system were due to massive and pervasive failures in the governance structure that existed under central planning and social ownership of capital.

Radical shifts in corporate ownership and control structures in the region have ushered in significant changes in the way companies and their management view their shareholders and set their objectives and prospects for the future. However, a lot of the old patterns have stubbornly persisted. State authorities and firms continue to be tied together in a web of incestuous interaction, where the boundaries between regulator and regulee are often lost. Corporate behaviour is still pray to the persistence of soft budget constraints. The state provides a wide

range of direct and indirect subsidies to firms, while firms provide public officials with a certain amount of control over company decision-making and cash flows. Hence, the management's behaviour continues to be motivated largely by the search for new direct or indirect subsidies, not by meeting existing or potential investor concerns. For some of the older managers, a lifelong education in opportunism when it comes to using company assets for one's own welfare—in the absence of formal material rewards for success—has found new uses in the unpredictable transition context. As some commentators have pointed out, while the Soviet manager's experience in making input and output decisions for firms was largely non-existent, improving one's own welfare by diverting state resources was a high art.

B. The main corporate governance problems

Since their adoption in 1999 by the 29 OECD member countries worldwide, the OECD Principles of Corporate Governance have become the main point of reference for corporate governance reform from a policy perspective. In March 2000, they were included in the Compendium of 12 global standards for financial stability, compiled by the Financial Stability Forum. As such, they are expected to be used increasingly for country assessments by international financial institutions, namely the World Bank. It seems therefore appropriate to look into some key problems areas in Eurasian corporate governance using the taxonomy of these Principles, i.e. following their five chapters.

a. The rights of shareholders

What is perceived as the region's unfavourable investment climate is, to a considerable extent, due to the lack of credible investor protection. Corporate laws do not establish sufficient legal rights for shareholders, and even when they do, enforcement mechanisms and remedies against violations of shareholder rights are inadequate or non-existent. The protection of the rights of shareholders is a pillar of any effective corporate governance system. The first important right in this respect is an effective system for the registration of ownership. In Eurasia, share registration has often been the victim of fraudulent practices in the past.

The ability to participate in basic decisions concerning the company, chiefly by participation in general shareholder meetings is set forth as an important right. Most typical shareholder violations in Eurasia include the refusal to provide information on a company's activity in view of the shareholder's meeting, the creation of important obstacles towards participating in the general meeting and the introduction of changes to company charters without a general meeting's decision. In 1999, the Ukrainian Securities Commission received 9,345 complaints from citizens and professional securities market participants on the violation of their rights and lawful interests; this is 33.5% more than in 1998. Share dilution by controlling owners has also been reportedly widespread and the ensuing transfers of control, mainly to incumbent management, have been quite opaque. These are ongoing failures of the system in Ukraine, Moldova and Georgia. They most often affect small voucher-holders-turned-shareholders and employees.

b. Equitable treatment of shareholders

The OECD Principles stipulate that the corporate governance framework should ensure the equitable treatment of all shareholders. To begin with, this includes the right to judicial protection. As we mentioned above, this right is severely limited under weak rule of law conditions prevailing in Eurasia. In Georgia, although the minority shareholder rights provided in the Law on Entrepreneurs are deemed adequate, the basic problem is that minority shareholders

are not fully aware of their rights, and management – who may or may not be aware of these rights themselves – are not motivated to make minority shareholders aware of their rights. Meanwhile, the few institutional investors that could have spearheaded the effort for better corporate governance have not been present. In Kazakhstan, it is hoped that the newly formed pension funds will fulfil some of these roles and increase the potential of local securities market.

As described above, self-dealing by managers and controlling shareholders is the scourge of most Eurasian countries. Throughout the region, corporate governance is part of a vicious circle of entrenched insider control and low outside investment. Company managers, who are often also shareholders, use the company's assets for personal gain to the detriment of minorities. As a result, outside investors have little confidence that they will be able to weigh on the company's decision making process and stay away.

Self-dealing—or related party transactions as it is known in company law—may take a number of forms. It can be done through transfer pricing, i.e. selling at very low prices to companies set up by insiders or buying at very high prices from such companies. It can take the form of outright asset stripping through asset sales to insider-controlled companies. Self-dealing cannot be reversed unless very strong legal sanctions are attached to it. These should arguably include penal sanctions, as is the cases in some OECD countries, such as France. There should also be a strong and enforceable requirement on managers, to disclose any direct or indirect interest they have in a transaction with the company. Securities Commissions should be given enough power to implement such requirements. In most Eurasian economies, there are no rules on disclosure of related party transactions.

c. The role of stakeholders

The OECD Principles point out that it is in the long-term self-interest of firms to encourage stakeholder active participation in the governance process. Legal rights of stakeholders (i.e. employees, creditors, long- term suppliers and customers among others) should be effectively respected. Factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can have an impact on that company's reputation and long-term success; but these are not yet on the agenda of local Eurasian managers or investors.

Most importantly, the legislative framework that primarily ensures the protection of stakeholders' interests from abusive corporate behaviour is not in place. Consumer and environmental protection laws, environmental protection and an adequate, market–oriented labour law are still in their infancy in most of the region.

In Eurasia, stakeholders-- especially employees-- receive little information and have little voice in corporate governance, despite the fact that they are also shareholders of their company. Employee presence could potentially be a powerful force for monitoring the fiduciary functions of managers and limiting self-dealing. However, at present, employee stakes are often manipulated through threats and strategic behaviour to consolidate the power of management and create a bigger divergence between control and cash flow rights.

d. Disclosure and transparency

Good corporate governance calls for a strong disclosure regime, acknowledging transparency as a key element of an effective market economy. They call for timely and accurate information to be disclosed on matters such as the company's financial and operating results. Most countries in the region have taken the initiative to improve transparency and reporting practices by either adopting International Accounting Standards, as in the Kyrghyzstan, or by using International Accounting Standards as the basis for national accounting systems, as in Ukraine and Moldova. Indeed, in some respects Eurasia is much more advanced than Russia in adopting market-based accounting practices and breaking with the old Soviet tax-based accounting prescribed by the Ministry of Finance. However, in practice many companies continue to have a double bookkeeping policy, especially to avoid paying heavy taxes.

In the Ukraine, there are no clearly specified mechanisms or restrictions on the appointment and withdrawal of external auditors. Even though independent auditors are required, the company management usually appoints and dismisses them with little outside scrutiny. Most strategic investors are familiar with lax accounting and audit practices and try to impose international independent audits before acquiring company stakes. But management is still in a position to raise important obstacles to a meaningful due diligence. An important task that lies ahead is the creation of adequate professional bodies in the region that can impose a credible quality and ethics control on their membership and become the driving force for transparency. During the last couple of years there have been quite a few positive developments in this respect in the region

It is much more difficult to obtain disclosure of non-financial information such as the company's objectives, major share ownership and voting rights, remuneration of key executives, personal material interests of the board and management in matters affecting the corporation, and material foreseeable risk factors. In most Eurasian countries there are few requirements for non-financial disclosure. Under these circumstances, control structures are non-transparent and consequently self-dealing goes largely undetected. Reportedly in Kazakhstan there are five big corporate groups in the country but due to complex arrangements between companies, it is practically impossible to identify the real owners of these companies.

Developing Eurasian infant stock exchanges might depend on the availability of financial and non-financial information. Stock exchanges should therefore take the lead in introducing international standards and practices, both in terms of regulation and enforcement.

e. The responsibilities of the board

The board of directors should be the main mechanism for the effective monitoring of management and for providing strategic guidance to the corporation. It is the duty of the board to act fairly with respect to all groups of shareholders and with stakeholders, and to assure compliance with applicable laws. Board members should be able to exercise objective judgement on corporate affairs, independent of management. Good corporate governance hinges upon the competence and integrity of directors and the board as a whole.

Boards of directors are legally mandated in most of the region's countries. In Ukraine, since January 1998, joint stock companies with more than 50 shareholders have to elect a board of directors, which represents the interests of shareholders. But, in practice, management is often unwilling to recognise the body, which supervises its activities. As it stands, many established joint stock companies don't have operating boards of directors.

As the presence of the state as a shareholder is still quite important in the region, it could be used to improve board structures. The government and its asset management institutions (i.e. State Property Funds) could adopt property management policies force companies to have independent boards that take their monitoring roles seriously. Directors could be trained to this effect. Important positive spillovers could be generated for private companies and the market as a whole, if the government were to become a corporate governance pioneer. In many OECD countries the state is taking a similar stance of an activist owner: Sweden and Italy have both used their ownership stakes to improve board structures and enhance corporate governance.

IV. Concluding Remarks

The Eurasian transition experience shows that reformers have underestimated the importance of institutions. The lack of properly functioning private institutions, i.e. corporations, impacts directly on growth by limiting the availability of debt and equity investment. It also impacts on the distribution of income within a society: with more transparency and accountability major shareholders or controlling directors will have less of an opportunity to strip assets at the expense of all the other stakeholders--and the society as a whole. But the proper functioning of companies also depends on the existence of adequate public institutions, such as courts, bailiffs, securities commissions etc. that are ready to enforce property rights and governance rules.

While good corporate governance cannot exist without an adequate level of public governance, public governance will never taker off unless the private sphere of the economy and its main players, the companies become transparent, law- abiding corporate citizens. Awareness of this mutual interdependence should be at the centre of any reform effort.

Over the last few years, decision-makers have become more aware of weak corporate governance practices and their effect on the economy as a whole and are taking steps to strengthen their corporate governance framework. In July 1997, the Kyrgyz government was the first in the region to adopt by decree a handbook on corporate governance, which emphasises the importance of good corporate governance and provides a model company charter.

But government initiatives are not enough. Private sector action is essential if good governance is to take hold. For private sector action to take place, managers and other key decision-makers need to be persuaded that good corporate governance is good for business. In this respect, outside investors and, in the case of Eurasia, international financial institutions such as the EBRD and the IFC could take a much more activist stance and give corporate governance more weight in their investment policies.