

INSTITUTIONAL CHANGES IN THE CORPORATE GOVERNANCE SYSTEM IN TRANSITION

Стаття присвячена дослідженню ефективності функціонування системи корпоративного управління залежно від інституціонального розвитку. Розглянуто інституціональну систему корпоративного сектора, її елементи й фактори її розвитку.

Ключові слова: *інституційні зміни, корпоративне управління, елементи інституційної системи, фактори розвитку інституційної системи.*

Статья посвящена исследованию эффективности функционирования системы корпоративного управления в зависимости от институционального развития. Рассмотрена институциональная система корпоративного сектора, ее элементы и факторы развития.

Ключевые слова: *институциональные изменения, корпоративное управление, элементы институциональной системы, факторы развития институциональной системы.*

The article is devoted to investigation of efficiency of the corporate governance system from institutional development. The institutional system of corporate governance system is considered, its elements, and factors of its development.

Key words: *institutional changes, corporate governance, elements of the institutional system, institutional system development factors.*

Problem setting.

1. Institutional approach for corporate governance.

The «New Economy» studies different forms of coordination and cooperation problems in the company, including the conflict between old and new stakeholders. An absence of significant progress in corporate sector development has been caused not only by negative consequences of the carried out restructuring, but it has been affected by insufficiently deep character and consistency of institutional reforms realization at the initial stage of economic reforms. The institutional transition suggests the transformation of existing command economy institutions to the new kinds of market institutions.

Numerous economic studies consider that the privatization result not only in proprietors' motivation mechanism establishment, but it causes ownership concentration in the shareholders' and managers' hands. The corporate governance triangle represents the relations among management, controlling shareholders, and minority shareholders.

It combines the behavior rules, norms inside the company, and also the institutions providing performance and decisions' observance, optimize shareholders' decisions, and organize an effective control over management. The alternative corporate governance forms application includes hostile takeovers, proxy fights, board activity, and executive compensation scheme mechanisms use. They are directed to control shareholders, extract private benefits, and manage to weaken the insiders' protection.

Management behaves opportunistically towards stakeholders in the company. Shareholder access to created value is determined by the degree to which key corporate «insiders», especially executives and management, can claim a disproportionate share of corporate value (the «insider effect»). The contrary of short-term managerial interests and long-term company' performance causes the conflict among the insiders and outsiders of the company. It results in the destruction of company's balance structure and leads to bankruptcy.

The present stage of corporation development is characterized by joint-stock company shares removing with high real value from a financial circulation and absence of the dividends mechanism for shareholders in the Ukraine. The corporate governance model is exacerbated by the weakness of corporate governance mechanisms in transition. The problem of unqualified managers, the appointees of the managers or government officials' domination in the board of directors cause incentives for internal work organization and create motivation mechanism in the company.

System of mutual relations between management and shareholders, and also set of institutions (organizations) of corporate sector define institutional basis of corporate governance system. The conflicts between management and shareholders are constantly arisen and resolved in the company. The managers' withdrawal of a part of company' resources for own needs is considered one of the typical infringement in corporate sector. It significantly decreases the company value added. The absence of personal managers' motivation suggests a possibility of agency problems emergence. It does not provide maximization of managers' skills for company's management improvement.

The institutional mechanism creation of the corporate governance system concerns to the major problem in transition. The absence of legal mechanism for bank access to company's shareholding, weak stock market development, undeveloped financial infrastructure, the lack of system's transparency, low control level of managers are distinguished features of corporate governance model in the Ukraine. The effective corporate governance institutional system is directed to agency costs minimization of opportunistic management behavior in joint-stock company. The degree of institutional development depends on expected risk property expropriation, contracts performance, a level of legality observance, and a level of corruption in the state.

The implementation of the basic principals of the American and Western European corporate governance models positive features into transitional corporate system would promote institutional system development, reduce the «insider effect», increase the transparency, accountability, property distribution, stimulate value creation, and raise corporate control in the Ukraine.

2. Institutional changes in corporate sector

Heightened interest to a problem of corporate governance forms choice, ways of its modern model formation are caused by low Ukrainian economy efficiency and weak corporate management system. Questions of the old and new competitive advantages preservation and the creation are concerned to a number of national economy priority problems. World state of the market changes at the national governance subject's level, integration processes deepening act as the basic capitalization factors of corporate governance reforming system development in transition.

At the initial stage of economic reforms an absence of significant progress in corporate sector development has been caused not only by negative consequences of carried out restructuring, but it has been also affected by insufficiently deep character and consistency of the institutional reforms' fulfillment in transition. The last includes transformation of existing command economy institutions and new kinds of market economy institutions foundation.

The institutional theory analysis acts as a theoretical-methodological basis of evolutionary research of the post Soviet economy at all CIS territory. The category «institution» is used for purposeful – indirect coordination of various interests groups of economic agents. In conditions of behavioral forms' plurality this category allows to determine and coordinate socially – recognized behavioral rules, where the compulsion mechanism is used as a mean of observance norms, rules in a society.

Institutional transformation includes change of norms, rules, traditions and institutions (organizations) of previously dominated system on new institutional system. It is based on the creation of new market economy institutions set on micro and macro levels. Scientists allocate formal rules and informal restrictions. The compulsion mechanism is not considered as a distinction basis for performance of the certain rules, but the form of their fastening plays the key role in a society. Formal rules represent the accepted and fixed rules of economic agents' behavior. Informal restrictions are supplement to formal rules which define a set of accessible alternatives in view of the individual transaction (Lance, North, 1971).

In transition economy there is a problem of rational use of formal and informal rules by economic agents. One could mention an absence of their precise definition in a society. The lack of transparency and transferability results in transaction costs emergence and increase. The conflict by laws and normative legal documents contradictions' form a basis for intrigue appearance for personal goals achievement. Unpredictability and obscurity creates conditions for additional income gain by proprietors.

Economic transformation has been directed on property relations change in East Europe. The unsolved problems existence is explained an urgency of institutional investigation in transition. The most vivid property transformation questions are considered the legal maintenance of the property rights protection, the creditors' and shareholders' rights, the intellectual property objects rights regulations, and risks' minimization of the control loss over the property.

The **paper is aimed** to uncover the tasks that should be solved in order to provide corporate governance system reforming in transition.

Capital accumulation and placement mechanisms investigation, firms' activity motivation as a whole and separate individuals, a degree of market self-

control within the company are concerned to the determining factors used for performance estimation. Modern tendencies study and the corporate sector development analysis testify the joint-stock property concentration in hands of separate financial and industrial groups (FIG) representatives, the banks domination with a prevailing share of the foreign capital in financial sector, and the attraction and the use of large extra corporate sector assets by the state.

In order to provide a variety of ownership patterns application one could study property relations system development, and corporate sector effective mechanism creation in transition. One could apply the institutional approach as a research method in the research paper. It explains the formation process of a new property rights system. The subject of the institutional approach is dealt with the investigation of the essence and the contracts role, the transaction costs, and the significance of modern corporations in the economic development.

An analysis of current research and publication.

The theory of the property rights is applied to research and analyze various property structures. They are depended on firms' distinction. The property rights specification includes the subject definition, having an exclusive right of any thing for individual use; object concerning to which corresponding set of proxies is realized. It examines the mechanism to provide with the rights and its transfer. The property relations reforming is based on an appropriate form change, and economic results improvement. Privatization is directed on a change of a state ownership to private ownership pattern. It includes the subsequent right transfer to the individual proprietor for effective order organization. Privatization methods are an open sale to people, shares sale to separate individuals, rent and the subsequent workers redemption, reorganization or abolition. Nureev and Runov (2002) specify insufficient use of neoinstitutional theories tools in 90-th years in XX-th century. They mark the western economists' contribution who has analyzed privatization from the position of the analysis of a trajectory of path development in the East Europe.

In the economic literature the privatization forms and consequences have been discussed in the ambiguous estimation. The most economists would argue that privatization will only achieve more efficient under private ownership if it is accompanied by increased competition (The Oxford for Business World, 1993). Chechetov (2004), pointing out the influence of a political factor of privatization fulfillment, notes: «The privatization policy would be more effective if there was no political subjectivity, and it was carried out on the basis of deep calculations, long-term forecasts, the system analysis and modeling». The estimation of privatization results demonstrates the variety methods application, organizational – legal forms of managing and development of different ownership patterns. In accordance with Nureev, Runov (2002) opinion, alongside with really market processes of a private property development there is looked

through parallel process of the authority – property modification. The original private bureaucratic property appearance, created by the nomenclature within the framework of former institutional structure, is considered as the form of the authority – property display in the period of the «despotic» state weakening. Negative tendencies were caused by former exchange forms preservation based on the position in authority hierarchy use by individuals for personal enrichment in the privatization period. Special pseudo market mechanism was created for special tasks achievement. «Privatization opportunities have only strengthened tendencies of the state resources use in the private purposes and interests. As a result of that the present shadow relations system, focused on structure and opportunities of a formal framework of the Russian society, became not than other, as the privatized state, acting in a role of universal shadow state. It is quite stacked in semantic borders of concept «shadow economy» (Sirko, 2003). Unsatisfactory results of privatization implementation caused the appearance of views concerning expediency of its results revision. The various deprivatization methods were proposed.

Transformations to corporate sector of economy are connected with deep property relations changes which include redistribution of the rights within the framework of the same kind of ownership, transition from one form of ownership to another. The structure of the company capital represents a combination of corporation securities. Sources of its financing include shares, which unite ordinary voting shares, and debts to which all types of bank credits, bonds and all hybrid papers concern. A. Sirko (2003) defines theoretical blanks in the nature and functional specificity of the corporate form judgment in the enterprise. He considered that it was the reason of fact underestimation between the capital – property and the capital – function differentiation; which was typical for the corporate property. Within the framework of the statutory fund there is a formal division into the real capital submitted by the enterprise property, and the fictitious capital which unites shares in the corporation. The peculiarities analysis of the property economic forms development should be based on consideration of the joint-stock property as organic unity of the real and fictitious capital. The created value added and its continuous increment acts as the functioning form of the real capital increment in the corporation. Chechetov, Zadan (2004) define property relations by means of the rights and duties provided to the proprietor in the firm. They specify the positive social and economic effect achievement in the property process transformation. It could be achieved in a case when simultaneous observance of property rights transfer; duties to the new proprietor or their preservation behind the state are reached as a result of privatization in Ukraine. The mechanical ownership transferring of a corporate pattern has taken place in the unmarked environment in the

country. The application of non-standard types of joint stock enterprises behavior was applied. They distinguished from the private companies, using the stimulus creation strategy, and proprietors' interest's motivation due to an effective management.

The State Statistics data confirm, that the state enterprises' share in the total volume of objects makes up 0,1 % to 20 % in the various fields of business activity in the Ukraine. It makes up about 45,4 % at the government's sphere. Moreover the share of the collective property objects achieves 57,5 %, and a private property – 29,6 % (Ukraine in Figures in 2003, 2004). In 2001 the Ukrainian budget received only on 37,3 % from privatization plan fulfillment, in 2002 – on 10, and 3 %. «Ukrtelecom» company, 12 energy distributed stock companies were related to unrealized privatization objects. The absence of precisely certain privatization strategy made impossible its results use for the national economy as investment instrument. This process is continued to have an unpredictable and changeable character.

Existing formal institutional restrictions of command economy were eliminated at starting period of reforms. The new institutional forms and enforcement mechanisms of the former state enterprises were absent. The directorship and representatives of the nomenclature have monopolized the right to use the state property for personal enrichment. Informal relations have got special form, having filled in emptiness of absent institutional relations. The time mismatch between old «routines» and newly developing analogues of new system can take place during institutional transformation carrying out. A high level of the taxation and economic relations bureaucratization are related to the factors complicating economic subject's inclusion in official activity. They promote the informal relations distribution within economy. «At the same time the performance control over contract obligations is weakened by economic subjects, – N. Sedova points out, – the real guarantees level of their rights and duties has decreased. As a result economic agents prefer not to go whenever possible on superfluous charges, and to function outside of formal frameworks, the introduction in which causes the overestimated costs. Besides addressing to the help of informal «guarantors» of the rights is more considerable effective, rather than appeals to corresponding structures».

Institutional changes have contradictory, unsystematic, inconsistent character in the Ukrainian economy. As a consequence, a backwardness, and at the same time a substitution of market processes by changes in the structure of the authority – property distribution have not resulted in the property relations specification, and have accompanied by washing out of shareholders property rights. The state represents itself as the institute consolidating different interests of various social groups. It carries out the regulation function of multilevel relations system between functionally specialized elements.

Scientists mark, that the state reserves corporate rights in more than 50 % of open joint stock companies, and provides a control shareholding in every fifth of them. It has practically withdrawn, from management of the corporate rights, indulging the activity to squandering of corporate assets. Specifying the major role of the market as institute, C. Gutnik notes: «The market is a special institute, and it is simultaneously a set of institutional forms. The market is as institute, on the one hand, a cover consisting from certain rules of law, norms, observing which sellers and buyers make transactions, and on another hand, it is a network of privately created organizational structures». Market relations institutionalization includes a private property creation, a competition, the market institutions, including financial establishments, the financial markets, the market infrastructure and etc».

Basic part of the paper. At the present stage the market relations development the state has no attributes of the special economic subject, and acts as the formal proprietor. It does not express interests of all groups of the population. At the same time the state is really realized the proprietor competences for the most part of the property by means of tariffs regulation for energy and fuel, differentiated use of the bankruptcy procedure in relation to the working and unprofitable enterprises and etc. Separate economic agents are used the state rent regulation opportunities in private interests, in particular, for any certain kind of activity implementation by means of direct interdiction establishment or ambiguously treated licensing conditions of the specified kind of business. In the making the democratic state one could suggest that priority development of market institutions maintenance is considered to be expedient. It is necessary to mention the target reorientation role of indirect distribution of credit-and-monetary, financial and tax-budgetary institutions for the economic growth. The objective need of institutional relations reproduction concerns to a number of priority market institutions development problems. Modern institutional transition type system is based on continuity of a lot of former institutional norms, rules, stereotypes behavior use, institutions which are not having analogues in newly created system. They include observance of moral norms in a society, the responsibility, and patriotism.

In a broad sense Keasey (1999) determines the corporate governance system as set of the interconnected elements including shareholders, board of directors, managers, the market of the corporate control, structure of the property, the financial structure, rationally working investors, the competitive market. The institutional system corresponds to corporate governance structure described by means of the internal company organization, a labor market, and the financial market institutions. Complementary and interaction functions are set by different kinds of institutional forms that are formed hierarchical structure.

Under corporate sector institutional system one could consider a set of norms, rules, institutions (organizations) providing protection of shareholders, managers corporate rights by effective mechanisms use of joint-stock property realization. It is considered as a subsystem of institutional state system. The examined corporate sector system is defined by a degree of formal and informal relations development inside the company (Figure 1).

Martin (2005) argues that international economic interactions occur within a framework of norms, rules and organizations, and appreciation of this institutionalization is essential for understanding the functioning of the new global economy. International and national organizations activity is based on an effective management mechanisms introduction, an application of the international accounting and control standards, a professional culture formation in corporate governance system.

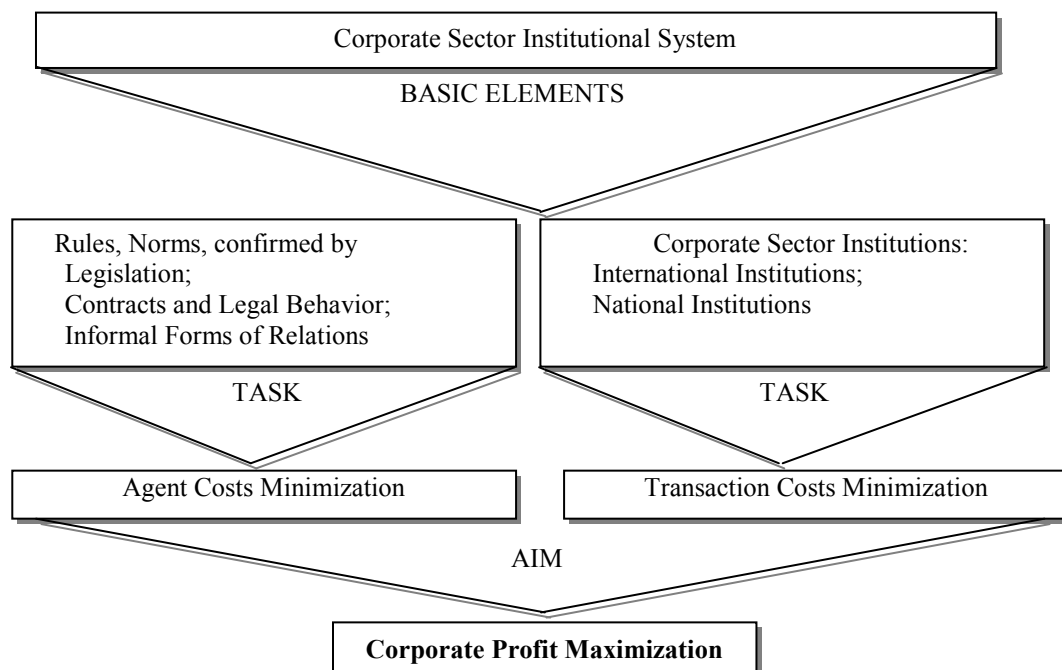


Figure 1. Structure of corporate sector institutional system

The determined aim achievement is directed on the transaction costs minimization which connected with the irrational use of limited institutional resources. The international organizations carry out coordination and concordance functions for mutual relations of international subjects in the corporate sector. They include the European Committee of Regulators of Securities, the International Council of Accounting Standards and etc. The Securities and Exchange Commission, the National Association of the State Boards of Accountancy, Financial Accounting Standards Board, and Special Investigation Committee are considered to the national institutions.

System of mutual relations between management and shareholders, and a set of corporate sector institutions (organizations) define institutional basis of corporate governance system. The corporate governance triangle represents a set of behavior rules, norms inside the company, and also the institutions providing performance and decisions' observance, optimizing shareholders' decisions at the effective control organization over management. Stakeholders are considered to be the subjects of the company alongside with shareholders. They unite consumers of production, suppliers, workers and the company's competitors. Stakeholders include physical and legal persons without help of whom the company could not function.

The property rights theory studies mutual relations between proprietors, managers of the company. It investigates questions of agency costs reduction. The agent is understood as the person or the company, authorized to represent interests of the interested person. «We determine mutual relations between the principal and the agent as the contract according to which the principal employs other person (agent) for performance of services, delegating him the certain rights for decision-making. If each of subjects achieves maximization of utility it allows to make an assumption that the behavior of the agent is not always directed on the fullest satisfaction of principal's interests. In order to restrict agent behavior deviations from satisfaction of the principal interests the last is compelled to carry the monitoring costs, directed on reduction of the specified kinds of irrational agent behavior» (JENSEN, MECKLING, 1976). Agency costs include the principal charges directed on monitoring, charges of the agent under bonds and residual losses. The principal supervises the agent behavior by an establishment of budgetary restrictions, carrying out compensatory policy and definitions of operational rules stereotypes.

Shareholder interests are served when management is highly motivated to strive for higher productivity and better performance. In the result the

value of the firm is raised. Conflicts between management and shareholders are arisen and resolved constantly in the company. The managers' withdrawal of a part of company's resources for own needs is considered one of the most important conflicts. It decreases significantly wealth of the company. Rydyk (2004) emphasizes, that «activity of corporation is the catalyst of agency conflicts. For example, as soon as in structure of the capital of corporation there is a debt loading then there is an agency conflict between shareholders and bond's holders». The managers' activity contains an opportunity of agency problems emergence. They are connected to a possibility of lot of situations appearance. Managers make smaller efforts for management of the company that explains their desire to reduce up to a minimum probability of adverse consequences possible emergence owing to market conditions change. They are guided by a choice of smaller investment horizon of the company's development. It is connected to restriction of the definition of the long-term company strategy development, and directed on probability decrease of some inefficient decisions acceptance and realization. Management activity is directed on reduction of probability occurrence of possible risks as which reasons act political, investment, financial, and also random factors: uncertainty and unpredictability in the world financial markets. Managers are not interested in an effective utilization of the company's assets. An absence of personal motivation of managers' activity forms a favorable basis for agency problems emergence. In connection with that the big efforts application for company governance by managers, a strategic choice of a long-term way of its development, an effective utilization of the company's assets, minimization of probable risks occurrence are not directly connected to increase of their own well-being, therefore the management activity does not aspire to achieve utility maximization at decision-making. Jensen, Mecling (1976) specify real character of agency costs, and point

out their dependence on a law in force, procedure of the contracts' conclusion and inheritance transfer.

The alternative corporate governance forms application includes hostile takeovers, proxy fights, board activity, and executive compensation scheme mechanisms use. They are directed to control shareholders, extract private benefits, and manage to weaken the insiders' protection.

Legal definition, legality observance is considered to form a guarantee basis for the property rights protection, a financial transparency maintenance, stability, and economic development predictability in a society.

Conclusion. In order to provide corporate governance system reforming in transition the following tasks should be solved.

1. To improve institutional environment on condition that property rights guarantees and contracts' discharge. To promote the stock market and financial institutions development, to organize regular information interchange between the companies and financial institutions for favorable investment climate creation in the countries.
2. To increase the control over legality of transactions that will be directed on protection of the shareholders rights and legitimate interests, will promote the prevention of abusing and swindle in corporate sector.

Efficiency of corporate governance system functioning depends on institutional conditions conformity to a level of modern technologies development. Carrying out institutional system changes includes not only corresponding norms and behavior forms use, corporate culture formation, ethics development of behavior inside the company. It is also effect an expansion of institutional functions of institutions of stock market, insurance market, and infrastructure development. In transition economy institutional changes should have constant and irreversible character. Institutional performance changes stimulate economic development of corporate sector, and promote economic growth.

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