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Between Capital and the Organization – Corporate Governance Problems in Central and Eastern European Countries

This 21st volume of the EBS Review is dedicated to the issue of corporate governance and contains ten articles addressing the subject. The problems of corporate governance, which have so far attracted relatively little attention from researchers compared to the other business and management issues, have recently started to win well-deserved popularity. This has partly been caused by setbacks (corporate scandals) in the practice of corporate governance, including in developed countries by the increasing realisation that a deeper and broader concept of corporate governance will enable economists, sociologists, organisational and management researchers and others to better understand the functioning of organisations and the economy as a whole.

It should be emphasised that little attention has been hitherto paid to the subject of corporate governance in Estonia. EBS views its mission as contributing to the development of research in this field; accordingly, this volume of the EBS Review addresses the corporate governance issue. Since this subject has not been extensively discussed, this volume serves, at least to some extent, as an introduction to the field and therefore some general theoretical articles have been included in this volume.

The models of corporate governance and culture are only just developing in Central and Eastern European countries –– a gradual rearrangement and concentration of ownership is in progress after the completion of privatisation, the roles of owners and managers are being more clearly defined and the financial markets are developing. However, the internationalisation of economies in the region continues, and from the corporate governance viewpoint, this is resulting in the emergence of issues such as cooperation between foreign capital and domestic managers and the problems related to the coordination of different organisational and business cultures. Therefore, the rapidly developing and changing countries of Central and Eastern Europe serve as highly promising “test labs” in the study of corporate governance and the results gained there may provide generalisations for corporate governance theory as a whole.

The Estonian Business School views corporate governance as one of its central fields of research. It launched a corresponding study program in Estonia in 2004, which involves researchers from other Estonian universities and institutes. A collection of articles in this volume reflects the outcomes of the first stage of this research program, covering a number of aspects.

This collection contains practical analyses of corporate governance in Estonia and abroad as well as articles addressing theoretical issues.

The opening article by **Külliki Tafel** and **Erik Terk** from Estonian Institute for Futures Studies and **Alari Purju** from Estonian Business School provides an overview of the dilemmas in corporate governance theory and the development of corporate governance in the countries emerging from state socialism. The article also presents the main emphases of the previously mentioned study program launched at the initiative of EBS; it further includes a description of the methodology used in the first stage of the program –– the outcomes described in this and other articles concerning the results of the program, were achieved using that methodology.

The results of the first stage of the study program are reflected in a total of three articles, which also sum up the three central issues of the study –– the connection between governance and management, more precisely owner-manager relations, the connection that governance and management has with the rest of the organisation or the problems within owner-manager-employee relations and the relations of an enterprise (owners and manager) with its external business and social environment. The results presented in these articles are based on in-depth interviews carried out with Estonian owners and managers and reflect the opinions of the latter on the current situation in Estonia and changes over the past decade.

Owner-manager relations and the regulation of these are addressed in an article by **Ivo Vaks** (Tallinn University of Technology). The author addresses the problems of contracts regulating owner-manager relations, the significance of the roles of the owner and the manager, including the owner's interference with routine management, as well as the owner's dictate of the manager via the establishment of various desired indicators.

Külliki Tafel from Estonian Institute for Futures Studies and **Ruth Alas** from Estonian Business School concentrate in their article on the extent and form of the effect that the owner's actions have on the manager and (through the manager) relations throughout the organisation. The authors express the view that the introduction of the owner level significantly expands the treatment of the manager's role.

Mari Kooskora (Estonian Business School, University of Jyvaskyla) approaches corporate governance from the viewpoint of the stakeholder concept. The article analyses the owners' and the managers' idea of social responsibility, the role of the enterprise in that respect and the possible contradiction of the owners' and managers' views in that respect; the author also studies, which stakeholders the managers and the owners reckon with, and how they do it.

Helena Hannula from Tartu University concentrates in her article on the differences in economic behaviour between domestically and foreign-owned enterprises. The article analyses the effect of changes in ownership on enterprise restructuring by using the example of Estonian industrial enterprises. The ownership database, collected by the Statistical Office of Estonia in 2004 using a questionnaire survey, and a new panel-database comprising balance sheet and income statement data about manufacturing enterprises in the period 1996-2002 are used as the empirical basis for the paper.

Mike Wahl's (Tallinn University of Technology) article addresses the study of ownership structures with an emphasis on the classification of owners. He discusses various ways of classifying owners, and based on these, proposes a possible typology of owners for further studies.

Articles contributed by foreign authors primarily concentrate on corporate governance practices in different countries, including post-socialist countries, and the related problems.

Milan Maly (Prague University of Economics, Czech Republic) writes about the problems of adapting models from the economies of developed Western countries to post-socialist countries using the Czech Republic as an example. The development of board structure and competencies has become one of the central problems in the Czech development of corporate governance due to attempts to introduce the German and American models at the same time.

Rudi Rozman from University of Ljubljana, Slovenia discusses the problems within the Slovenian corporate governance system and possible future developments. The author concentrates on those issues within the present model of corporate governance that evoke most attention: the role of the supervisory board and the role of labour within the supervisory board.

Thomas Steger's (Chemnitz University of Technology, Germany) article addresses co-determination in the context of the German corporate governance debate. Making use of a broad analysis of the German print media, the article demonstrates how societal discourses may develop over time, how the importance of certain aspects change and how the debate can be influenced by the particular strategies of different actors.

Martin Hilb from the University of St. Gallen, Switzerland, presents in his article, which is published in the discussion section, a vision of a new and more progressive corporate governance. The article introduces the concept of New Corporate Governance, which is based on four guiding principles: keep it situational, keep it strategic, keep it integrated and keep it controlled.

To sum up, as in most quality scientific journals, it has become our requirement that all articles go through a time consuming process of review and evaluation, and the authors often have to rewrite and submit their papers several times before our distinguished editors are satisfied with the results. We consider the topics covered to be of utmost importance and hope that the reader can also find something interesting to discover. We would also like to show our gratitude to the authors, editors and partners, indeed to everybody who has helped us prepare this issue for our readers. We wish you all a pleasant and stimulating read.

The editors of EBS Review special volume on corporate governance,

Külliki Tafel and **Erik Terk**

Corporate governance in post-socialist countries - Theoretical dilemmas, peculiarities, research opportunities

Külliki Tafel, *Estonian Institute for Futures Studies*
Erik Terk, *Estonian Institute for Futures Studies, Estonian Business School*
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Introduction

Corporate governance (CG) belongs to the type of objects of research, which are defined in different ways and are characterised by a number of different variable approaches. The discussion of the issue of CG has become significantly more frequent in the theoretical works on the subject within the last decade than previously and in various countries.

Within this article, the authors focus on the development of the theory of corporate governance as well as on different shortcomings of its theoretical treatments. The principal approach used in this article may be called "contextualising". As a specific CG context, whose main features are discussed in detail by the authors and the knowledge of whose peculiarities they emphasise, this article uses the CEE countries,' (previous) transition countries', context.

The article initially discusses the issue from the theoretical aspect: why should the application of approach to any corporate governance consider the peculiarities of corresponding context. It continues on a more detailed level: why have the traditional and most widespread CG treatments turned out problematic in case of the CEE countries; what makes the transition country context special and what should be kept in mind when applying some treatment of corporate governance transition in this transition context? The final part of the article will present the main features of the CG study programme drafted in 2004 and realized in 2005. This article also provides references to the ties to this programme of several other articles in this volume, which present its results.

The authors claim that CEE-countries represent a very good testing ground for CG related research as the changes in the economic environment and in the related institutional and social environment occur here faster than in the other groups of the countries, in countries with a developed economy and in the developing countries. Therefore the experience of considering the context in CG studies could be of broader interest regarding the methods of studying CG as a whole.

1. Corporate Governance: Development Of Theory And Criticism Of Theory

The discussion of the issue of CG has become significantly more frequent in the theoretical works on the subject within the last decade than previously, including in relation to countries in different development situations and located in various geographic regions. The theory of corporate governance has been growing out from US authors and, as is noted on many occasions, still displays a relatively strong US, or, more broadly, Anglo-American dominant.

Klijnsmit (2001, p. 25-26) claims that the issues in corporate governance have been in the centre of attention in primarily Anglo-Saxon countries. Yet it can be claimed, at least regarding the past dozen years, that CG has become an important subject in other countries all over the world.

Despite the varied and frequent treatment of corporate governance (CG), the topic is far from being exhausted. One of the reasons for CG being still topical and apparently remaining so in the future is the multiplicity of its various aspects. The subjects which can be discussed within the CG approach vary broadly; moreover: there are several different basic concepts enabling to raise the CG-related subjects in different ways and thus continuously keep CG a "hot" topic.

Due to the opportunity to combine various aspects of approach in the study of CG (to study only mechanisms and links directly related to market regulation or others; whether „outside" or „inside" problems predominate from the organisation's viewpoint; the formal or informal aide of activity) we deal with at least three separate, but mutually connected, sets of subjects on which researchers concentrate. The first and so far the most discussed subject is linked to CG as an institutional mechanism, by which the reliable regulation of capital markets is ensured. Markets do not work, especially in developed economy, "on their own" as a sum of simple, individually executed sale and purchase transactions. In order to ensure the involvement of capital in the firms the owners of capital require additional guarantees, clearly defined rules of game, a guaranteeing mechanism, working agreements in the broad sense. All that should ensure the capital owner's certainty that his capital is used for earning him profit, that he can control the process and adequately react to undesirable developments. This is especially topical regarding small shareholders. Hence the high topicality of issues like stock exchange rules, public access to information (dissemination), auditing etc., the pressure for establishing CG good conduct codes. The second set of problems is related to the owners' opportunities and means for exerting influence on the operations of the firm beyond the sale or acquisition of shares and changing the manager. This issue is not topical regarding small shareholders but in case of strategic owners (core owners, block owners). As a rule, this activity also takes place within market regulations with an aim of maximising profits, but is administrative/managerial as to its nature, implemented via participation on the firm's board, the setting of managers' performance indicators and terms for incentives, as well as interfering with the firm's course of action by controlling and influencing it. Compared to the previous set of problems this is more "internal" and more active. It no longer reacts to changes in the markets and the operations of the firm, but attempts (together with managers or by "pushing them to the right path") to foresee and make use of opportunities and changes. Besides standard, universal indicators and control measures, specific information available to owners is being used and the activities are typical of an entrepreneur.

The set of problems described above is "evergreen" for CG, yet it is theoretically clearly less addressed than the former one nor can it boast of offering particularly clear and practical recommendations.

The third, recently quite widely developed direction of CG treatment, exceeds to tome extent the framework of operational market regulation problems and proceeds from the idea that a firm operates not only in the markets but in a socio-economical system, where its activities influence various social groups (from employees and local residents to environmentalists), while on the other hand it is significantly influenced by them. Mutual effect between such related groups may have long-term strategic nature, but need not be, at least fully, evaluated by measuring financial income or expenses (or at least not via short-term expenditures and profits). The above set of problems has so far been discussed by disciplines like the enterprise's external environment links (see D.P. Baron, Business and its Environment, Prentice-Hall, O Simon& Schuster Company, 1996), corporate ethics, as well as corporate strategy, but this method of treatment is increasingly invading the CG theory as well.

Institutional regulations or 'rules of the game' in general can be divided into formal and informal. In case of CG we cannot also underestimate the informal side of the regulations: the norms, routines, traditions, 'best practices', etc. It touches upon all the three theoretical perspectives mentioned above.

A number of authors, e.g. Letza & Sun (2002, p. 43) claim that the current debate on CG has been 'polarized' between, on the one hand, the shareholding paradigm and, on the other hand, the stakeholding paradigm. The shareholding paradigm approaches

CG via owner-manager relations. According to this, CG is, to cite a much-quoted definition 'the system by which companies are directed and controlled' (Report of …, 1992). The stakeholding paradigm takes a broader approach to CG. According to Demb & Neubauer's (1992, p. 9) definition, CG can be described as 'the process by which corporations are made responsive to the rights and whishes of stakeholders'. N. Mygind (1999, p. 2) has also provided a relatively similar CG definition: '… coordination mechanisms of different stakeholders to produce and distribute the output of the enterprise'1.

The difference between the above two approaches largely depends on the definition of the firm as such. This naturally leads to differences in the treatment of roles concerning top management, the employees and outside relations, as well as the issues of corporate ethics. Referring to Turnbull (1997, p. 184) one group of authors, mainly financial economists, view firm as an organization which is servicing mainly their owners (and obtaining resources from its employees and suppliers). On the other hand, the stakeholder view is different: it considers that investors, employees, suppliers, customers and stakeholders generally both contribute and receive benefits from a firm.

We shall further discuss some aspects which have provoked the most debates and criticism regarding the approach to CG theory.

From multi-aspect approach to blurring of theoretical core

Corporate governance is treated within various disciplines of research like theory of economics, corporate finance, law, the theory of organisation and management, sociology etc. As Turnbull (1997, p. 180) argues, each may view corporate governance in a different way. Every discipline is characterised by its various approaches and treatments and this in turn contributes to the highly varied ways of addressing CG. On the other hand it could be claimed that variety as such is characteristic of CG due to its inner logic, as there are, referring to Turnbull (1997, p. 180), diversity of agents involved in influencing, controlling, regulating and managing firms, productive networks, associations, etc.; i.e. CG concerns many different subjects. And last, but not least, the variety of CG is complicated by the fact that within nearly every discipline or treatment a different key problem can be found for the CG subject, dependent on the aspect of approach and the emphasis (on some aspect, situation, environment etc.). Briefly, we have to admit that this situation has led to certain "diffusion" or "blurring" of the theoretical concept of CG, compared to other theoretical concepts. This is also one of the reasons why it is difficult to talk about the treatment of corporate governance as a whole.

Historically, certain CG problems have been considered market related or as 'right' economic scientific problems and other problems (e.g. coordinating the relations between other parties besides shareholders or how the strategic owners influence the firm's process of development via supervisory board and how the roles are divided with management in this question) and are belonging to the sphere of sociologists, political scientists and specialists in organizational theory rather than economists. However, this attitude has become obsolete with the development of modern institutional economics. As is pointed out by O. Williamson (1996), it is important to consider that there exist both simple transactions and complicated ones in economic activities. The former, which are preponderantly of an autonomous kind (and these have been traditionally the subject of economics) are better carried out by the markets. The latter require cooperation and are better to be performed in hierarchic structures or hybrid forms of markets and hierarchies (Williamson, 1996). Economics need to address all these forms rather than only those displaying the undisputed advantages of pure market regulation. The above is directly related to corporate governance, since this is located by its nature on the border between the different types of regulations, on the one hand regulation via market (market for corporate control in its various forms) and on the other hand regulations similar to intra-organisational management (e.g. administrative control via supervisory board or incentive schemes established for managers by owners). At the same time we feel that economists, especially financial economists have a tendency to somewhat overestimate the influence and effect of markets compared to other regulative measures used by private capital.

The focus is on different key problems

In case of CG theory we can notice focussing on various individual problems (such as the principal-agent problem, considering different stakeholders, the problem areas of capital markets, etc.), rather than linking of different problems and combining them within a certain whole. According to the authors' opinion, compared to the emphasis on individual aspects, more attention should be paid in CG theory to the ties between the individual subjects – the ways of linking the different issues. It can be concluded that the ties between the individual approaches have not found very much attention. The problem is further complicated by the practice of frequently comparing the different approaches (incl. supporting some and opposing the others) without noticing that the approaches need not be comparable at all.

Ideal system approaches

Most of the theoretical basis of CG presented in books consists of ideal or model situations – situations constructed on the basis of certain simplified theoretical premises, which need not be adequate reflections of the functioning of actual economies and societies.

The authors of this article believe that operating merely with such constructed ideal systems significantly restricts the efficiency of the CG concepts. We here refer to Williamson (1996, p. 167): "the ideal capitalist firm is relentlessly engaged in profit maximisation …/and/ "…control and all rights to residual claims are concentrated on the suppliers of equity of finance". As admitted by Williamson (1996), this hypothesis could be useful (at a certain stage of construction of theory), but certainly would not be eventually realistic. De facto control is actually performed by those "who are knowledgeable, strategically situated, and disposed to be active" (Williamson, 1996, p.167). In order for a theory to be usable in the change of reality, it must address not only ideal constructions but also, e.g., actual behaviour of firms and working mechanisms of control in reality.

Anglo-American-centrism

A number of authors have stressed that the CG theoretical treatment has not been actually developed on the basis of a certain type of ideal construction, but this paradigm has been shaped according to ideas predominant in certain countries. As Turnbull (1997, p. 185) argues most research into the theory and practice of corporate governance has been heavily focused on English speaking countries and the US in particular. The central moment is the firms theory developed in the USA and characteristic of it, whose positions were reinforced by the economic success of the US and the triumph of capitalism over communism in ideological struggle. Hence the idea that other countries should learn from the USA as a "citadel of capitalism" and a widely recognised role model for other countries seeking to better themselves about how to manage and govern firms, rather than attempt to develop their own ways or copy the experience of third countries. At least during certain periods hardly anyone disagreed with the assumption that the more traditional and, therefore, backward economies like Japan, Germany, or Europe as a whole would have to adopt American patterns of industrial organization. Turnbull (1997, p. 186) points to Gilson (1994) who notes that the American system seemed to represent the evolutionary pinnacle of corporate governance, so other systems were either less far along the Darwinist path, or evolutionary deadends; neither laggards nor neanderthals made interesting objects of study.

Thus the US-centrism in this case does not mean only the consideration of the peculiarities of that country's business environment in the development of CG theory, but actually the predominant orientation of other countries to the US CG practice, its treatment as a benchmark of this field. This practice disregarded several setbacks in the USA: Enron-type cases, the behaviour of the stock markets after the bursting of the so-called IT-bubble.

As Kuznetsov and Kuznetsova (1998) point out, the American or more broadly t Anglo-Saxon tradition places in the centre of the paradigm an efficient market. As Williamson (1975, p. 20) put it, "in the beginning there were markets". By Kuznetsov and Kuznetsova (*Ibid.*) : two important assumptions characterise the Anglo-Saxon system of corporate governance in its classical form. First, the disciplining action by equity owners relies on options offered by an efficient equity market, mainly the right of free exit for shareholders and the threat of a hostile take-over. (The above mechanisms presume for efficient operation, on the one hand, corresponding ownership structure, listed companies based on dispersed stock ownership and, on the other hand, the correspondingly developed institutional mechanisms). Secondly, the structure of corporate governance is built around a specific criterion of efficiency, which insures the unequivocal maximisation of shareholders' wealth.

Without starting a debate on whether the implementation of the Anglo-American model would be unequivocally desirable, e.g., in the CEE or some other region's countries; this model certainly possess clear advantages as well as drawbacks like, according to many authors, excessive orientation on short-term financial results; we should instead pose the question of whether it is actually possible in the foreseeable future. Many principal supporters of this model, who have studied the premises of potential recipient countries for adopting the Anglo-American model, would here take the negative position and this attitude has strengthened rather than weakened in the latest period. The premises of this model can be considered quite specific and they are absent in a number of regions. For example, E. Berglöf and A. Pajuste (2003) point out: "Most of the world never went through the dispersion of shareholdings ...CEE countries are unlikely go through it any time soon" (p. 20). The dominating capital structure is one of the factors, which determines the terms of efficient use of CG models and it can be concluded from this fact that other than Anglo-American CG versions will be more topical in the CE countries at least in the near future.

One model, several models, many models?

The last, but not least problematic which the authors wish to draw attention to is that in theoretical literature, when the authors refer to different models of governance, they mainly concentrate on the limited number of already existing models – mainly two (or three): the Anglo-American model and the model of Continental Europe (as well as the Japanese model). At the same time, it has been admitted that governance models vary greatly between different countries – „there is no single ideal model of governance" (Mygind 1998). Based on the fact that there are a variety of different governance structures around and that for developing a model operating well in a certain country it is logical to consider both various environmental contexts and the specific characteristics of business enterprise, we could start fearing that the reduction of the CG "menus" to a couple of basic models would be excessively restrictive. One may even set the hypothesis that each country will develop a specific system of governance.

It is argued in social systems theory that a system is capable of reacting to change only in accordance with its own logic, rationality and history (Luhmann, 1984, p. 15ff). The attempt to making it take over some external institutional system, although effectively functioning in other contexts, should be considered as hardly implementable. The new solution may not suit with historical reflexes of the system neither with the tasks which should be resolved during this certain period. Therefore the system may not function or it is modified during the process.

It is probably practical to take a step backward here and define which different contents would be possible or practical to fit in the term "CG model". In our opinion, at least four different levels of problems could be singled out here. First, the level approaching CG from the financial system aspect. We would hereby certainly agree with E. Berglöf and A. Pajuste (2003, p. 2) that "the structures of financial systems are (internationally) rapidly converging" and that this process doubtlessly involves the CEE countries as well. It would probably be difficult to differentiate between the various models at this level soon. The second level concerns the capital structures in different countries and we can point out the structures typical of certain countries and classify them here; to group, like e.g. Berglöf and Pajuste, the Estonian capital structure as to its peculiarity with the Netherlands, while Poland and the Czech Republic with Austria, Belgium and Sweden. Neither are there any logical grounds for presuming that these differences in structures would rapidly decrease. The third level is related to administrative structures and procedures foreseen for CG by a country's legislation, e.g., one- or two-tier board structure, board members, the allocation of responsibility, etc. Some leveling has taken place in the EU regarding these problems due to the harmonization of legislation, but a limited number of various basic models have survived. The fourth level is related to the organisation cultural aspects of the CG functioning and here, as well as in case of the intra-firm organisational culture, a number of different version can be discussed dependent on history, the predominant traditions of implementation of power, communication patterns, peculiarities of national culture etc. Some harmonisation can be presumed at that level due to the internationalisation of economy and generally closer relations, but it would not be very rapid. It is important to consider, however, that all above-mentioned four levels would not function in isolation, but would influence each other.

2. Need For Contextualising. Why Corporate Governance Theoretical Treatment Lacks For Contextualising?

As was mentioned above, the previous criticisms targeting the CG theoretical approach can be, to a smaller or larger degree, combined under an umbrella problem: there has been little consideration of the context to which the theory or its sub-problems are applied. The authors thus claim that in many cases the failure to consider the context has been the central reason for the emergence of criticism. Raising the significance of the context dimension could be one of the keys for explaining in many cases the accusations of "failure" of various CG treatments or discussion of problems with their application. Briefly: based on the above the problem can be worded as follows: the issue is not as much the intrinsically problematic nature of the CG concepts, but the failure to consider the context in the interpretation and application of these treatments.

The problem of interpretation and failure to consider the context is topical in a large number of various fields. This is a more universal and rather complicated problem, which pertains to the domain of semiotics. As it is, considering the context has not been obvious for interpretation as such. There were initial attempts in the semiotics theory as well to disregard context and to interpret within a closed system. Thus in the interpretation of words (signs) only a closed linguistic system was considered, disregarding the fact that the outside environment – context – determines to a significant degree how we understand a sign (e.g. word) and further on a concept or a treatment.[2] To draw a parallel to the criticism of theoretical approaches to CG we can say that the criticism emerged in this case due to insufficient attention to the context in which a theoretical approach works, in which context it is meant to work.
CG, primarily one of its approaches and also the central one – the agency theory – has also been quite directly criticised for the failure to consider context. Gedajlovic & Shapiro (2002, p. 565) point to Hamilton & Biggart (1988) who argue that agency theory has been criticized in the sociology literature for its proponents' failure to pay sufficient attention to the contexts in which exchange and principal-agent relations are embedded.

The agency theory criticism for disregarding context could be explained from an even broader aspect: by observing the basis from which the agency theory has emerged. This also enables to point out that the introduction of signs, by approaching them from the communication angle, is not merely a digression but is rather directly linked to the development of the CG concept. The set of problems the authors point out is the approach to information, which holds a central place in the agency theory and refers to incomplete or asymmetrical information, where one of the parties possesses an informational advantage towards the other: in the particular CG context the top management possesses a certain advantage in information towards the owners about the events in the organisation. According to Turnbull (1997, p. 195), the comprehension of information treated in the agency theory is based on cybernetics – cybernetics is based on the mathematics of information theory. From the communication theory viewpoint this means proceeding from the linear communication theory, which approaches the information primarily from the technical side. Neither the meaning, interpretation nor consequently the context is the subject within this theoretical approach. It has been claimed that the notions peculiar to the treatment of closed systems derived from cybernetics have exerted a broader influence on the agency theory via the comprehension of the communication process as such (rather than only the issues of the related information). On the other hand, the impact of communication cannot be underestimated either – if it can be termed that way in our case; we are actually discussing only a part of it: information – and to claim that it is merely one component among many others. In the organisation context communication is understood as on of the main foundations, as something binding the organisation together. In addition, referring to Turnbull (1997, p. 195), cybernetics not only provided a bases for the treatment of information, but also for understanding organizational relations, solving problems, designing teams, structuring boards, etc.

Therefore the authors claim that since this theoretical approach to CG (at that one of the most central approaches) rests on a base, where the interpretation and consideration of context had never been built in to begin with, it can be considered one of the reasons why the CG theoretical approaches in general have been unable to attribute significance to context as such. In other words: we cannot think, let alone speak, of something we lack words to describe. When describing the unknown we can move at best a step or two away from the existing knowledge and vocabulary, but not more, as Maran (2000, p. 148-149) points out. Let alone placing the "unknown" in any context. The out-of-context quality itself can make that something unknown. Thus it does not seem in the transition countries (incl. Estonia) quite convenient to discuss stock markets as one of the central issues of corporate governance or the so-called typical agency problem, since the dispersed stock ownership as a context is either absent or marginal.

Yet not all CG theoretical approaches can be blamed for disregarding context. According to Dopfer (1991, p. 539, 541) institutional economists have recognized that institutions must be stated as an „on-going process", they have emphasized the time scope and introduced into economic analysis the all-important historical dimension. One of the realisations of this ideas was the path dependence theory[3] which, according to Babic (2003) can also be seen as one possible perspective in defining corporate governance. Babic (*Ibid.*) continues that central to the idea of path dependence is that initial historical conditions matter in determining the corporate governance structures that are prevalent today. Gedajlovic & Shapiro (2002, p. 566) add that a national system of corporate governance evolves from a country's history and legal, political, and social traditions. Babic (*Ibid.*) argues that in order to understand the problem of corporate governance it is most important to stress that it is, first of all, dependent on the political system of any country and the country's historical and cultural characteristics.

3. Corporate Governance In Post-Socialist Economies

3.1 Situation Of Transition Countries: The Hard Road To The Development Of A Working System

The corporate governance problems as known in market economy arose in the CEE countries in connection with the privatisation of large enterprises at the beginning of the 1990s, to a large degree even afterwards. Before the so-called large-scale privatisation there were, on the one hand, the state-owned large enterprises, traditionally managed via the political hierarchy and directly ministries, which formed the core of economy (the employees' self-management schemes used in former Yugoslavia and to a limited extent in some other countries were a special case), in whose case the principles of market economy corporate governance did not apply, and, on the other hand, small enterprises which existed in the best case in the periphery of economy or in the so-called semi-state forms (formally cooperative or even state-owned, but practically private). In the latter case there existed some similarity with small enterprises of market economic countries, but since ownership and management are combined as a rule in small enterprises, the key problem of corporate governance, the agency problem, never emerged there. A separate category was the joint ventures established with Western capital, but their number was small and they were rather viewed as special cases operating under specific regulation.

Corporate governance reviews reflecting the initial period of the large enterprises' privatisation in the various CEE countries are rather general as a rule. They state that the new organisational forms emerging after privatisation tend to be insider-centred[4] (both management and employees, the so-called employeeism), most of the authors consider this negative, while others (Nuti, 1997; Mygind, 2002) recommend to take it calmly and argue that employee ownership has some advantages of its own. Another widespread aspect pointed out by analysts and linked to attempts to create foreign owners by introducing institutional actors like funds and banks to ownership are the various types of cross-ownership cases, which are hard to define. In a number of cases it is difficult to determine who is insider or outsider and in which connection (Lavigne, 1999). A much-cited problem in the works of that period is the threat that the socialism-period elite (nomenclature) could gain privileged access to ownership and financial infrastructure, carry out a 'recombination of ownership' (Stark, 1991; 1993 *via* Tatur, Bukowski 2004, p. 59), and that there is the possibility of emerging 'political capitalism', 'oligarchies' or so-called 'managerial capitalism', based on former state-owned firms' directors and considered undesirable for a variety of economic and non-economic reasons capitalism" (Staniszkis, 1998 *via* Tatur, Bukowski 2004, p. 59-60). There were attempts to counter these threats by developing politically more acceptable privatisation technologies. At the same time, it was admitted quite quickly that the development of ownership structures desirable as to economic efficiency (e.g. attempts to create "hard core" owners with certain set parameters) or the somewhat opposite attempts to create under any privatization scheme a large-scale class at small capitalist-minded and highly-motivated shareowners, could not be practically realised (Lavigne, 1999). The first option is simply not possible in the initially hyperactive political process, since the governments cannot defend their vision of an ideal ownership structure ("Why prefer these and not others".), while the second option dissolved rapidly in all countries, which tried it as the "newly emerged small capitalists" took advantage of the first legal opportunity to sell their shares or vouchers for cash.

Through debates, the idea began to gain prevalence that it is most important to launch rapid massive privatisation as soon as possible (may countries considered the privatisation model involving vouchers distributed among the population free of charge as the magic key), that the distribution of ownership immediately after privatisation does not matter and that a new more suitable ownership structure and corporate governance would develop independently, at least in case "good institutional solutions" have been imported from the West.

Based on the theories imported from the West, it was considered necessary to emphasise the great significance of establishing strong independent financial intermediaries (Frydman *et al*, 1996, p. 9). In reality, it was tough going at first. As shown by (Revoltella, 1998, p. 44) based on the generalisation of developments of several Visegrad countries in the first half of the 1990s, the legislation on credit and capital markets remained rather weak for a long time and could not protect the financiers adequately. There were problems with collateral and bankruptcy laws. The percentage of bad loans granted by commercial banks increased. The culture of work was low in the new commercial banks (their number was initially high, but they were small). For a variety of reasons the banks could not buy shares or bonds either (Revoltella, 1998). The recently opened stock exchanges were initially symbolic "shrines of capitalism" rather than played an actual role in economy. The systems of privatisation vouchers were quite unwieldy and unstable in a number of countries; the secondary market did not take off properly or yielded unreliable results. Only FDI as an important source of funds, which ensured a satisfactory solution to information assymetries and agency problem, worked relatively well in that situation (Revoltella, 1998, p. 35). But FDI concerned only a small number of firms and thus could not replace the companies' conventional way of finance.

Even in cases en enterprise received outside owners, these owners often encountered problems with establishing their control over insiders, the managers or sometimes a coalition of managers and employees. In particular, the role of various funds as outside owner was often proven inefficient. Especially in Russia, but in some other countries, the term "corporate wars" came into being regarding the corporate governance conflicts. As the authors of OECD-published material (Oman *et al*., 2003) pointed out, the transition countries, similarly to the developing countries face firstly the expropriation problem (as a rule linked not to the threat of nationalisation as is typical of the developing countries, but to takeover by other private owners, either illegal or exploiting legal loopholes) and secondly the vested-interest groups' negative sum game behaviour[5].

M. Nuti (1997) has note that dependent on which country's legislation a post-socialist country was oriented on and on which privatisation schemes it used, the development of different types of corporate governance could be observed in various countries, e.g. in Poland the German type and in Russia the Anglo-American type. It turned out, however, that the chosen legislative solution had less real effect than it was initially expected. Russia's corporate governance system, for example, developed more similar to the South Korean chaebol system than the Anglo-American one.

As is noted by (Lavigne, 1999), the studies of enterprises' financial behaviour carried out in the first years after large-scale privatisation yielded quite contradictory results. Some showed the privatised enterprises' better financial-economic progress compared to the state-owned firms, while others did not.[6] It seemed that the only more or less clear exception was the behaviour of firms receiving FDI, i.e. actually foreign-owned enterprises, which was, according to practically all studies, better than other groups of ownership or at least had significantly improved from the initial state. Surveys containing comparisons of various groups of owners also yielded contradictory results in the beginning, some showing better financial results of enterprises owned by outsiders compared to insider-owned firms (managers and employees), but some did not.

A significant change on the spectrum of problems under discussion could be noted staring from the second half of the 1990s. Privatisation of so-called regular enterprises had been completed in most of the CEE countries and the financial indicators of the privatised enterprises began to improve after initial restructuring. The issue was no longer whether privatisation as such had been vindicated, but which type of privatisation, according to which pattern, had worked better. In other words, how efficient CG structures had been established by one or another form of privatisation. Staring from that moment the CG problems actually emerged from the shadow of the privatisation issue. At the same tile a paradoxical situation had developed: the emerged pattern of CG was quite difficult to interpret according to the traditional Western models and varied greatly in different countries. It can be noticed that established juridical systems functioned differently from how it was expected. Theoretical recommendations concerning future moves remained rather cautious and hesitant.

3.2 CG In Transition Countries: Peculiar Context?

While there used to be a great scarcity of theoretical generalisations on the transition economies' CG, some have emerged in recent years. As Babic (2003) points out, in developed market economies a system of corporate governance has been built gradually through centuries and today it can be defined as a complex mosaic consisting of laws, regulations, politics, public institutions, professional associations and ethics codes. However, in transition economy countries a lot of details of the mosaic are still missing. Trying to develop a system of good corporate governance in these countries is made difficult by problems such as complex corporate ownership structures, vague and confusing relationships between the state and financial sectors, weak legal and judicial systems, absent or underdeveloped institutions and scarce human resource capabilities.

As pointed previously CG is usually treated in advanced or in the so called ideal market economy or even within the paradigm of the ideal economy of the United States. The central issues there might prove to be quite dissimilar as in transition countries (or also in other countries). As Kuznetsov and Kuznetsova (2003, p. 244, 245) claim the Anglo-American theory of corporate governance, which concentrates mostly on the problems of stock ownership, is not exactly adequate in a situation, where the ownership structure is in a rapid transition and where ownership concentration as well as increase in foreign ownership is in progress. As far as particular context or rather its scale is concerned, the US capital market for example cannot be compared to those of a small European country.

According to Babic (2003) there are two basic dilemmas connected with the corporate governance problems in transition economies. Both refer hereby to the same issue of disregarding context, which the authors have repeatedly emphasised.

The first dilemma, according to Babic (*Ibid.*) is the following: "is it possible to have the identical framework that has evolved over centuries in developed market economies for the emerging markets, or is it better to adapt the system of corporate governance to the specific circumstances of transition economy". Babic hereby raises two problems at once: whether the CG system working in developed economies could be adapted to transition countries at all and whether it would be a good solution.

The second dilemma pointed out by Babic, details the first one. Babic (*Ibid.*) points to the question of the appropriateness of the mechanism used for corporate governance. Namely, the existing corporate governance literature is almost exclusively concerned with external mechanisms – accounting transparency, regulatory pursuit of fraud, the role of the shareholders' general meeting, "disciplinary" takeovers, and so on (Monks & Minow 2001). Babic (*Ibid.*) argues that in these external mechanisms the crucial role belongs to the well-developed stock market or to the monitoring role of the banks; but in transition economies these mechanisms of market discipline hardly work, at least in the initial stage of transition process. Briefly: here we approach the same problem already mentioned: the literature that deals with corporate governance discusses mechanisms of advanced countries and may, therefore, not be applicable in transition economies.

There are a number of differences between advanced economies and those in the transition stage. In the present article the authors pay attention to those differences, which especially bring out the contextual differences. In principle this is a more detailed discussion of the two central dilemmas the authors mentioned. The authors consider important to treat the following aspects in more detail.

Firstly: **altering ownership structures**. On the one hand this is related to the issue of how to structure. The ownership structures in transition economies have been changing quite fast not only in relation to privatization, but also due to emerging new entrepreneurship (Berglof & Thadden 1999, p. 24) and this restructuring continues also in the post-privatization period (Jones & Mygind 2004, p. 3). To point out the characteristics of ownership structures in transition economies (in addition to many advanced European economies), the authors also stress the following aspect. As Berglöf & Thadden (1999, p.3) state „the CG literature comes from a worldview where the main corporate governance problem is an entrenched and weak, dispersed shareholders ... [but this] worldview is highly unrepresentative when taken beyond United States and United Kingdom; ... different studies[7] demonstrate clearly that widely held firm is a rare phenomenon in most countries … in the economies in transition the USA and UK type of minor shareholders practice is extremely rare“. However, the problem constitutes itself in the relationship between core ownership and internal minor ownership, especially during the initial period of the transition.

E. Berglöf and A. Pajuste (2003) advance the interesting argument, admittedly without detailed empirical proof, that serious agency problem conflicts would not occur in the CEE countries, since the firms in general are not governed under dispersed stock ownership and therefore the managers operate under much closer owner control than according to the Anglo-American CG model. They argue that the problems concern instead the inadequate protection of small owners against majority stockholders and to some degree the excessive interference of block-owners with the firms' operations. While we generally agree with this position, we nevertheless find that it should be detailed at least in two aspects. Firstly, the owners' stronger position in itself would not ensure the prevention of agency conflicts. Such conflicts can break out for a large variety of reasons if the owners' or their representatives' and the managers' perception of role should differ. The context of post-socialist economy with its rapid changes, considering the newness and immaturity of owners and professional managers as social categories should provide sufficient ground for such conflicts. Secondly, significant inter-owner conflicts need not be reduced merely to the majority and small shareholder conflicts. The latter are typical at the present development stage, admittedly to an increasing degree, of publicly traded stock companies, but their number in the CEE countries is still relatively small and it would require specific proof that a rapidf increase of such firms' share would pertain to the most urgent moves in the development of these countries' CG systems.

The studies of CEE countries clearly display the strong positive impact of core owners on disciplining and efficiency of the firm's management. Theoretical concepts of this aspect can here vary in this point, should this situation be considered as temporary deviation (although not short-term) from the mainstream (more based on market regulation) of CG practice and consider it nothing more than 'second-best solution' (Berglöf & Pajuste, 2003); or leave the amount of solutions open, and consider the development of CG in CEE countries in different directions also as one possibility.

Secondly: the institutions are in the development stage. The framework of corporate governance depends greatly on the legal and regulatory environment. As was already mentioned, weak legal and judicial systems are common to transition countries (Babic 2003). Taking a broader look and continuing with Babic (2003) the missing element in the context of corporate governance development in transition economies is the lack of institutions associated with successful market economies where there is a standard set of institutions that have been successful as the tools used to control corporations.

The third aspect which is related to the first (and which could be viewed as a subdivision of the first aspect), is the effort to **attract external investment and especially foreign direct investment.** Drawing on Berglöf & Thadden (1999, p. 25), „the overwhelming finding from transition economies, at least in Central and Eastern Europe, is that outside, preferably foreign, investors are crucial in bringing about active and deep restructuring“.

Fourthly: **the role of an underestablished supervisory board (or the one in the phase of being established).** As we mentioned above, the fact that the state stays still as shareowner in privatised companies (to certain extent) is characteristic to the practice of CG in the initial period of transition, blurs the whole picture essentially and also raises the problem of politicising the boards. At present time the extent of this problematic is declined, still there is a question about qualification and (working) culture of the boards. It can be claimed that in most post-socialist countries the training of the members of the boards is insufficient and the companies have not been able to develop the proper working culture.

Fifthly: the limited number of competent top managers. It has sometimes been emphasized that the managers of former state-owned enterprises are the so called "an archaic cadre" (Babic, 2003), with scant ability for such things as "strategic thinking, vision creation, team work, risk taking and change management" (*Ibid*.). The authors argue that this may probably be said about the managers active in the initial stage of the transition period. And even so, this statement is too extreme. Whether a manager with a Western education and competencies would succeed in this period, is a different question. Skills are acquired through active participation in the conditions of market economy. The authors consider that Babic's (*Ibid*.) statement: "…the non-existence of a market for management talent and the difficulty of evaluating managers in an impartial manner" is of a much greater importance.

To summarise: in case of transition countries various institutions, environment as a whole do not work or at least do not work fully (this definitely applies to the initial period of transition and in comparison to developed countries). Accordingly a transition country is characterised by a constant search for ways of making the systems work. The simplest (it obviously depends on the viewpoint) but certainly the most traditional method is taking over from the other, working and established systems – developed countries. It is quite frequent in adopting foreign experience to disregard the fact that a system successfully working elsewhere need not work in the adopting country. In other words: it is forgotten to find out whether the contexts – those of the country with the working system and the adopting country – are similar enough to enable a successful adoption. In that sense as Babic (2003) points out, although there are considerable differences between the Anglo-American, German, Japanese corporate governance systems, they all share the luxury of defining the subject of corporate governance within the context of functioning market systems and highly developed legal institutions [and at the same time] many developing and emerging economies lack or are in the process of developing the most basic market institutions. Therefore the "solution" need not work if the most similar system is adopted from the developed countries, since the basic context is principally different. Or it can be even dangerous as referring to Berglöf *et al* (2003, p. 8) who argue that the attempt to „transplant" a specific rule from one system to another can be associated with huge risks.

Yet another aspect is important. Considering that in a transition country there is no working system (in out case a CG system), the analysis of such irregular system is often accompanied by a temptation to find any similar features with a working (larger) system. In other words: a transition country is being equated to another existing system, classified according to an already available system, claiming that transition country X is moving towards a system Y. Such striving towards identification by itself is hardly unusual. It can be argued that the tendency to classify everything is a quite typical quality of the human mind. By interpreting Shepard (1995, p. 135), this is supported by the existing linguistic constructs, by using which the man learns quite early to pigeonhole everything around him. A problem emerges if the classification is done hastily and by making excessive generalisations. In the context of CG theoretical approaches: by failing to consider the general context, a transition country's developing CG system is forcibly shaped according to a developed country's CG system. Alternatively it may be concluded that some CG system element in a transition country is underdeveloped in comparison with the Anglo-American CG system, where it is a central subject and predicted that this subject would definitely become topical in near or more distant future. The authors would like to emphasise here that since the contexts are significantly different, such comparison need not be adequate at all and the particular subject, which occupies the central position in the Anglo-American system, could remain dormant in a transition country and never become urgent. Or as Nuti (1997, p. 133) argues, it would seem that in all transition economies, neither the German-Japanese nor the Anglo-Saxon mechanisms of corporate governance are yet fully at work. This statement is hypothetical; however, it cannot be simply ignored.

From a broader viewpoint, the authors emphasise that one should be careful in identifying a transition country's CG system with another country's working CG system. A transition country's context is changing constantly: apparent similarity to some country's system could in short time be replaced by similarity that of quite another country. Moreover: it is equally important to consider the possibility that a transition country's CG system could in time become quite unique – i.e. different from all existing systems. It is important to add that the list of potential forms the system could adopt is long rather than short. It would apparently be suitable to compare a transition country's situation with a state known in synergetics – the bifurcation point, where there are many potential future states and where exists a possibility of moving to a qualitatively new state; and what is the most important in this case – it is quite unknown, which of the options could be in fact realised. It can not be excluded that in certain moment in the forthcoming period, the CG systems in CEE countries may reach once again the so-called bifurcation point where changes may lead to large-scale qualitative changes.

The emphasis on identification or an attempt to adapt a transition country to an existing system could complicate understanding of the new system actually developing. Yet, although several authors admit that „cross-cultural transplantation of economic institutions" is a difficult and even questionable undertaking, they tend to adopt the position that a "portfolio" of solutions suitable for post-socialist countries already exists in the capitalist countries and only the choice would matter (Frydman *et al* 1996). Otherwise the post-socialists could get diverted from the "right way" and start seeking for the so-called third way between socialism and capitalism. As time passes and the European integration advances, such excessive fears can be expected to diminish.

4. From Theory To Empirical Research

4.1 Some Starting Positions For Drafting Empirical Research Programme

The preceding review of the heterogeneous nature of the CG theory positions and the differences of practical solutions and problems in various countries/groups of countries provides no ground for an opinion that it would be productive (for some concrete country, and especially for CEE countries with their CG practice which is still forming) to attempt to define one 'correct' CG theory, so as to use it as a base for "setting right" the CG practice. The CG theory positions, the contexts of various positions as well as the urgent problems differ, despite the CG theory's development during the past twenty-odd years and certain convergence of practical solutions caused by the globalisation of economy and the EU integration, too much to allow a uniformity-oriented approach to be successful. It would most probably only result in the implementation of ideas and certain theoretical constructions prevalent in certain groups of countries in situations where they need not work. Firstly, the CG practices of post-socialist countries are still in formation phase. Despite the legislation of CG in these countries is adopted years ago, it is still not functioning properly. Several solutions are questioned and principal changes are quite probable (see also M. Maly's and R. Rozman's article in this volume). Secondly, it is not clear, whether the present CG theory mainstream will prevail in the future in general. Several authors predict here paradigmatic shifts in corporate governance in general (e.g. related to the shifting of authority from capital owners to knowledge owners). Accordingly, we believe that empirical studies of various countries' and groups of countries' CG practice and its development are highly topical, so as to use information gained from these studies and its generalisation for the detailing of the CG theory or for choosing between the various alternative positions of this theory. It is important in that respect that the approach focus of these empirical studies were broad enough, not restricted to the testing in practice of the approach of a single field or a normative individual theory, but attempting to provide a comprehensive answer to the question of how CG works and evolves in a country or some (economic) development stage. In the opposite case the situation would persist, where even articles based on materials of many empirical studies either fail to open the authors' premises on the CG context, its changing factors and the central problems of CG of the country (or development stage) CG or display them without adequate explanation. Classical examples are the discussion of the problems of public trading stock companies as central issues of transition economies' CG (in a situation, where the significance of such companies is generally rather marginal in these economies) or the uncritical transfer of the vision of the US agency problems to the CEE countries (despite the fact that the owners and managers level of separation, the development of the professional managerial contingent and the working of capital as a whole in these countries differ greatly from the US situation). There is reason to believe that in such cases the results of empirical studies, although numerically possibly correct, would be difficult to interpret and that practical recommendations based on them could turn out quite incorrect.

When drafting the programme of such broadly focused empirical study it is initially necessary to define some theoretical and methodological positions of the compilers of the programme, so as to explain why and from which aspect the programme would study certain phenomena. The following section of the article tries to explain that.

Let us begin with the first dilemma, the contradiction between the shareholder- and stakeholder-centred approaches. In the former case CG is treated as a mechanism for the realisation of the shareholders' interests, in the latter case as a mechanism for achieving a balance of interests of a broader circle of subjects, while at least some authors tend to blur the line between the shareholders and the other stakeholders, they are treated as in principle equal interested parties. (The article by Mari Kooskora in this volume discusses this issue in greater detail). This approach essentially deals with two ideologically opposing concepts. If the former should prevail, it would mean higher priority of the shareholders' interests or an idea that, within the existing legislation, the managers operating in the owners' interests should not consider (at least not significantly) any other interests besides the maximising of profit, since they have been empowered to operate as agents of the capital owners. The prevailing of the latter concept would mean a greater consideration of competing interested parties (e.g. the employees, environmentalists and champions for community affairs etc.), even in cases where the legislation would not directly require it (for simplicity's sake we ignore the issue of strategic time horizon, within which such decisions with potentially competing criteria are made; a decision not maximising profits in the nearest perspective could do so long-term), in extreme cases including these groups' representatives in the company board (This volume addresses the problems of including the employees on the board in the articles by T. Steger and M. Maly). Yet this direction could have besides positive effect (e.g. the increase of social harmony and stability in ideal situation) negative influence as well: decline of economic efficiency, the fall of capital allocators' under uncontrolled influence of different interest groups, decrease of saving (since the public would find investment in shares less profitable). When creating the concept of the empirical study, it is therefore reasonable to distance ourselves from the ideological/normative background of this issue, rather than attempting to answer the question whether and to what degree the priority and opportunity of realisation of interests of other stakeholders should be increased in comparison with shareholders. Firstly, it is reasonable to get descriptive 'picture' of this situation. For instance: how closely and how would the firm's managers and capital owners cooperate with various (especially outside) stakeholders, how would it take place, what is the perceived significance (for profit earning as well as other, incl. broader social motives) of various stakeholders, what is the owners' and managers' sharing of work in performing this liaison function. It is clear that in case of such approach the traditional shareholder-centred concept would provide too narrow a view, since it would not enable to address one of the most central issues of corporate strategy and general running of an enterprise: the consideration and balancing of external groups linked to the enterprise, which would not be reduced to direct purchase and sale transactions. In case of shareholder-centred CG theory these problems have been excluded or in other words, exiled to manager-centred strategy theory. Yet it is clear that the problems of an enterprise's long-term strategic development and the related liaison concern both managers and capital owners.

The second nodal problem, which was briefly touched above and has been treated in highly varied fashion in literature, is the so-called agency problem. One can find highly varied treatments of how strong commitment to the owners' interests could be expected from the manager, what it would depend on, which possible deviations can occur (e.g. the so-called myopia effect in the manager's activities) and how they could be prevented. As Andresoo, Elenurm and Terk emphasise (2005/2006), the answer to these questions is further complicated by the fact that a manager is usually expected not only to implement fairly the owner's will, but also to display entrepreneurship. The role of the entrepreneur is actually divided between two levels: that of the owner and that of the top manager. Whether and how the manager can act as an entrepreneur is largely dependent on the type of ownership structure and owners and on whether the owner has ambitions of acting like an entrepreneur or will he limit his role to the investment of capital and risk allocation. (This problem is addressed in this volume by M. Wahl, who develops the typology of owners). Post-socialist context predetermines here that the ownership structure is at least in current phase highly dynamic and formation of more stabile dominant variety of division of roles will take time.

It can be presumed for most of CEE countries that: a) a social stratum of professional managers has either already developed or in the process of developing; b) that the gradual movement of entrepreneurs previously occupying the roles of both manager and owner towards a more clearly defined owner role would continue; c) that this process probably involves a large variety of owner-top manager role allocation; d) that the existence of various role conflicts between owners and managers is likely, incl. ones caused by the failure of the owner-entrepreneur, previously acting as top manager, to distance sufficiently from the earlier role; e) that the role allocation of the owner (or his agent) and the manager can differ greatly in enterprises based on domestic and foreign ownership; f) that the allocation of roles and the working of CG as a whole would be significantly influenced as context by the development of business environment, especially banking on the one hand and changes in the markets, both the saturation level of the domestic market and shifts in the international markets, on the other hand.

4.2 The Structure And Main Features Of Methodology Of The Research Programme On Estonia's Corporate Governance

We attempt in this section of the article to move from the level of CEE countries to the level of one concrete CEE country, namely Estonia, and to determine the main features characterising the CG research programme carried out in cooperation of Estonian Business School and Estonian Institute for Futures Studies in 2004 and at the beginning of 2005. Additionally, we characterise shortly what has taken place in Estonian economy, the important aspects of the formation of CG system, the main emphases of the research programme and its methodology.

Estonia belongs to the Central and Eastern European transition countries, where the shifting of economy to private economic tracks and the development of corresponding institutional systems have been largely completed. As far as the current decade is concerned, we can discuss Estonia as a country acceding to the EU and a catching-up country rather than a transition economy. Yet in Estonia's case any "complete" economy or working type of CG cannot be mentioned. The basic amount of privatisation was completed in 1994-1996 (Terk, 2000) and the business code, which sets the basic framework of the CG system is in force since 1996, yet significant developments and changes can be observed in economy (greater stabilisation of economy, albeit at high economic growth; concentration; dividing of markets; increasing significance of foreign ownership) as well as in CG practice (clearer differentiation between the roles of owners and managers; the emergence of a cadre of professional top managers competent in market economic operations and a corresponding labour market; somewhat stricter procedures; the development of CG routine and culture).

In comparison with other transition economies, both common and specific features can be noticed in Estonia's ownership relations and CG. The common features are the variety and dynamism of the initial ownership structure, typical of the market economy's initial period weakly formalised and sometimes conflicting relations between owners-managers and different owners, the small significance of listed enterprises. As specific to Estonia the following features can be listed:

- Somewhat faster emergence of core owners compared to several other post-socialist countries, largely due to the organisation of the privatisation process;
- Higher significance of foreign owners s compared to most post-socialist countries;
- Rapid development of commercial banks and their important role in the privatisation via bank guarantees and loans and thus in the development of the owner structure;
- Somewhat larger significance of domestic outside owners compared to the inside (managers and employees) ownership. Lack of incentives for insiders to become owners during the privatisation period;
- Small significance of privatisation funds in the development of initial CG structure;

- Legislative orientation at preferably clear differentiation of the owner and manager roles and the increase of responsibility of the management board;
- The domination of the German model as the bases of general legislation, but without particular orientation at the use of the German CG special solutions (regarding the roles of the banks and employees). As for Estonian banks one can observe concentration on their main business, extending loans, rather than performing the owner's role via participation.

Considering previous discussion, the following emphases were made into the research programme:

- Orientation at finding out the **dynamics** of characteristics of CG system. Regarding all more important issues the research programme attempted to determine not only the situation in the current period, but also its difference from the previous (pre-2000) period;
- As an important part of context, the attempt to determine the capital-level phenomena (business groupings, type of capital, relations between various owners etc.);
- Attempt to compare the practices of foreign capital and domestic capital CG;
- Refusal to be limited to the agency theory-based „owner-manager" relation as the main axis, but study of managers' and owners' relations with other stakeholders within the firm and outside (see Figure 1). One of its sub-theme was the study of relations between enterprises and banks in a way differentiating between the roles of owners and managers (owners' personal role in dealing with banks, the significance of the owner's image in securing credit etc.).

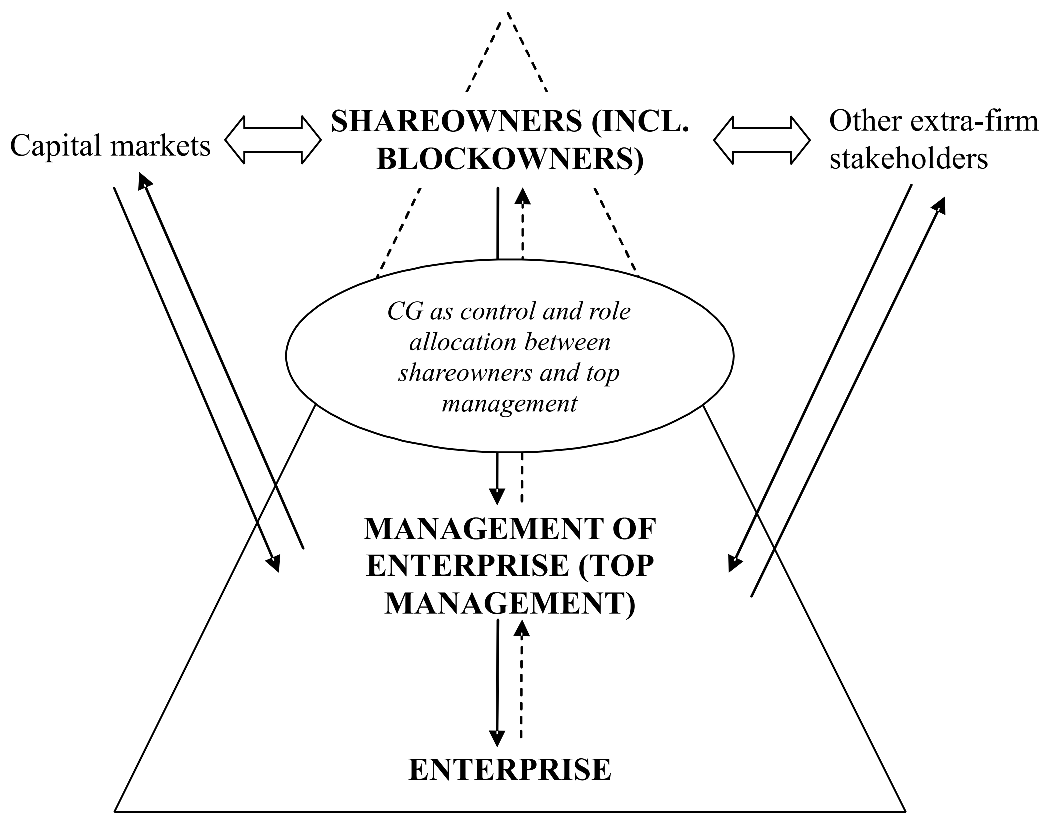

Figure 1 Internal and external relations of corporate governance

It was proceeded from the understanding that it would not be sufficient to study the relation between owners, especially strategic owners, and top managers as merely control-based, but as significantly more complicated interaction system and roles allocation. Their relations which were studied include the following elements:

- criteria for selection and change of managers;
- orientations and goals of developing business;
- setting operations result indicators for managers;
- managers' incentives system;
- independence of managers in organising the firm's operations;
- role allocation (between owners and managers) in developing the firm's strategy;
- role allocation in outside relations (incl. relations with banks);
- communication between owners and managers;
- formal control mechanism over the activities of managers.

The research programme was not oriented so much at the legal framework of CG and the formal aspects of its functioning (e.g. the membership of supervisory board or the frequency of meetings), but at the study of CG as real cooperation practice, incl. the practice of solving or preventing conflicts. Particular attention was paid to the role allocation of owners and managers in the determining of the firm's strategy and in making strategic decisions.

In the research programme it was issued form the understanding that shareholders, managers and their directly related groups operate in a economic, social, institutional etc. context, where the elements of the context are in the process of change and development. The main elements of context which became topical in this study are presented in Figure 2.

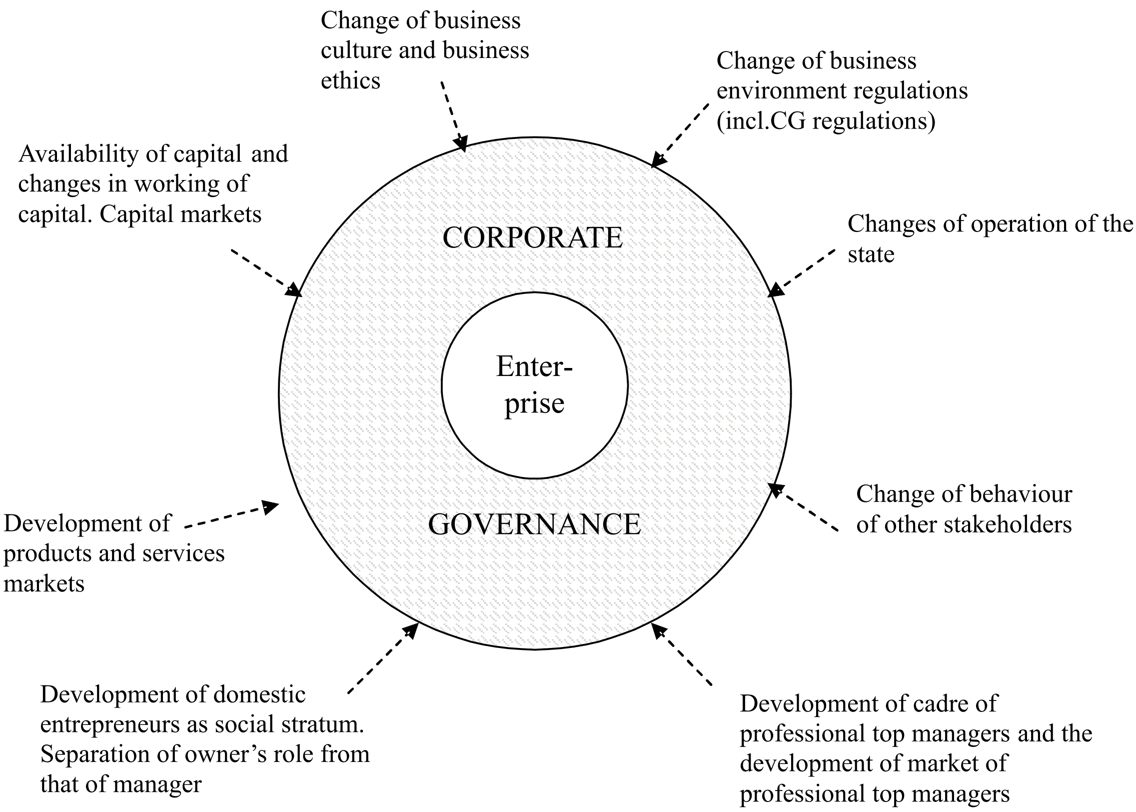

Figure 2 The changing context of corporate governance

The main method of the first stage of the research programme was interview

These in-depth interviews with owners and top managers were rather extensive, relatively unstandardized, but nevertheless structured interviews, lasting two or three hours. The interview questions were divided between four sub-topics: **(1) study block of operation of capital** concentrated on the issue of whether and how the type of capital (foreign vs. domestic, large vs. small, active vs. passive) influences CG, how the duration of investment of capital has changed in the various periods of time and its effect on CG; this level also facilitated the study of problems to do with the owners' groupings and their ties; **(2) The corporate level block** meant primarily the study of the success models of corporations and top managers in connection with the CG subject. The study of this block was concentrated on the change of the models over time, which top managers or agents are valued (by the principals) and how the agents can operate at the corporate level; **(3) The block about ties between capital and corporation** concentrated on the problems of the so-called principal-agent relations. Emphasis was laid on the relationships between the owners and managers, the managers' freedom of action and regulation, as well as conflicts between the owners and the managers; **(4) The environment level block** focuses on the relationship between the corporations and the main elements of its environment. The topics of study of this block were corporate social responsibility, the consideration of various stakeholders by the corporation or its absence, as well as how and whether the general environment, including the legislative one, influences the activities of the corporation.

The closer treatment of the problems of capital functioning was necessary because as it enables to cover such issues as co-operation models with banks, decisions concerning diversification made on business group level and redirecting capital inside business group, etc. These issues determine in quite large extent the relations between top managers (management) and supervisory board.

The interview questionnaire consisted of a total of 60 questions. Interviews were recorded.

In nearly all questions, two aspects were addressed – on the one hand, the difference between the periods 1995-99 and 2000-04, and on the other hand, between enterprises based on foreign and domestic capital. By the beginning of the former period (1995), the privatisation period in Estonia was predominantly over and the first legislative framework concerning the operation of corporations in the Western sense had started to develop. The second turning point is represented by the year 2000, when the "purge" following the Asian and Russian crises presented new demands upon economic activities and change of paradigm in economic thinking.

A total of 25 individuals were interviewed. The criterion for inclusion in the sample was having had broad experience in business and the resulting ability to generalize. Therefore a 'traditional' division – dividing the respondents by sphere of activity, by size and type of company – could not be used this time since the key criterion was having had broad experience in different areas and in different positions. Although, it can be said that the background of the respondents was diverse; nevertheless, they were more representative of larger enterprises (in the Estonian sense); at the same time experience from industrial and service companies were almost equally represented.

The respondents were asked to generalize according to several years of experience, and not to give answers based on the enterprise they were concerned with at the moment. The selection of interviewees observed the principle of more or less equal representation of owners and managers, as well as a separate group of owner-top managers – individuals, who had had experience of both roles.

4.3 Results of the Research Programme

The main part of this research programme – the interviews with top managers and owners – has been executed and the results of the interviews have been summarized. Several articles have been published based on the results of the interviews and due to the comprehensiveness of the topic and the results, preparing the articles can and will be continued. There is also plan for carrying simultaneously through supplementary interviews for specifying certain positions of the results.

In this volume the following articles have been based on the results of this first stage of the research programme:

- Vaks, I. Separation Of Functions And Profession Related Arrangements Between Owners And Managers In Estonia; discussing the owner-manager relations and the regulation of these relations;
- Tafel, K., Alas, R. Between "Internal" And "External" Worlds – The Influence of the Owner On Intra-Organizational Relations And On Managerial Activities In Particular; discusses the impact of the owner's activities on managers and (through it) relations within the organisation;
- Kooskora, M. Looking at Corporate Governance through Stakeholder Theory, Estonian Owners' and Managers' Perceptions of Relations with Stakeholders; which discusses corporate governance from the stakeholder concept viewpoint.

Additionally it is important to point out the following articles based on the results of the interviews, but published in other journals:

- Kooskora, M. 2006. Perceptions of Business Purpose and Responsibility in the Context of Radical Political and Economic Development – The Case of Estonia Business Ethics – European Review (BEER) Blackwell Publishing (refereed) Business Ethics: A European Review, Vol. 15, pp. 183-199, April 2006.
- Elenurm, T., Terk, E., Andresoo, J. 2005/2006 Owners and managers in the strategic management process: challenges in a rapidly changing economy. *In process*.
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Endnotes

[1] Mygind (1999) hereby defines the term 'enterprise governance'.

[2] Compare the views of representatives of two different schools (F. de Saussure *versus* Ch. S. Peirce) on a sign's ties/absence of ties with external environment. Also see e.g. Emmeche & Hoffmeyer, 1991.

[3] It should be added that the path-dependence theory has its critics as well. Dopfer (1991, p 540) describes path-dependency approach as a determinate relationship between past and present actions which suggests that the probability that individual agents adopt an idea, such as an invention, transaction, or other behavioral pattern, will increase as the idea is adopted. Dopfer (*Ibid.*) argues that the ideas are timeless and spaceless – they are [rather] path-independent.

[4] The Czech Republic is an exception in this respect.

[5] A separate and much-discussed issue in corporate governance-related literature of the first stage of large-scale privatisation were the problems of corporativisation/commercialisation of former state-owned enterprises, i.e. their transfer to market economic organisational forms (e.g. becoming stock companies) in a situation where they had to be initially, usually until privatisation, kept in state ownership and managed by the state as shareholder, as well as the issues of the state-owned blocks of shares and the related rights after other blochs of shares had been sold. Since these issues are not related to the main subject of the article, we would not discuss them here in detail.

[6] As claimed by Blaszczyk *et al.* (2003) the reason could be that especially in case of cross-ownership the firmns' profits were „transferred" to other structures controlled by the same owners.

[7] See for instance: LaPorta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 1998, "Legal Determinants of External Finance," *Journal of Finance* 52: 1131-1150.

Corporate Governance from the Perspective of Stakeholder Theory and in Light of Perceptions among Estonian Owners and Managers of Relations with Stakeholders

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Abstract

Corporate governance has become one of the major international issues that have succeeded in attracting a good deal of public interest in recent years, especially since the recent spate of 'world famous' scandalous corporate failures (Enron, Arthur Andersen, World-Com, Barings Bank, Royal Ahold and others).

Today, it is considered that corporate governance plays an important role in the economic health of corporations and society in general. However, one may claim that the concept of corporate governance is poorly defined because it potentially covers a large number of distinct economic phenomena. As a result different people have come up with different definitions that basically reflect their special interest in the field.

Corporate governance is most often viewed as both the structure and the relationships that determine corporate direction and performance. The supervisory board is typically central to corporate governance, its relationship to the other primary participants, typically shareholders and management, is critical. Additional participants include employees, customers, suppliers, and creditors. The corporate governance framework also depends on the legal, regulatory, institutional and ethical environment of the community.

The issue of corporate governance has often centred on shareholder versus stakeholder and, which of the two models is better for corporations. Central to the issue is the need to highlight the intertwined nature of governance, responsibility and the quality of social and economic choices. Corporate governance addresses the key issues of our times and provides a synergistic connection between corporate social responsibility and economic viability. Corporate governance arrangements are considered especially relevant to the private sector as they form one of the key determinants of an organization's relationship with the world.

This article arises from the area of corporate governance that looks at a corporation's relationships with its various stakeholders (including shareholders) and explores the concept of corporate governance from the perspective of stakeholder theory.

The empirical part of the article is based on the results of in-depth interviews with 26 top Estonian managers and owners, often known as generalists. The article discusses the results of qualitative research conducted among these business leaders, owners and top-managers in Estonian organisations, exploring how corporate relations with different stakeholders are perceived and how these perceptions have changed in Estonia during the last decade.

Key words: corporation, Estonia, governance, relations, responsibilities, stakeholders

Introduction

There are increasing concerns about corporate governance around the world arising from organizational failures and the negative social consequences that appear to be systematic in nature. The majority of the research conducted and articles written has been about Anglo-American corporations. We can argue that the dominance of short-term decision-making and subsequent lack of growth is also a concern to most European societies. From the OECD report (2004) one can read that: 'The dramatic collapse of major companies over the past few years has focused the minds of governments, regulators, companies, investors and the general public on weaknesses in corporate governance systems and the associated threat posed to the integrity of financial markets' (2004, 3).

We may say that there is no single definition of corporate governance that can be applied to all situations and jurisdictions. The various definitions that exist today largely depend on the institution or author, as well as the national and legal background. However, stakeholder theory is coming into play more as companies increasingly become aware that they cannot operate in isolation but, as well as considering their immediate stakeholders, they also need to have regard for a wider stakeholder constituency.

In the mainstream, or neoclassical, approach, the term corporate governance is typically defined rather narrowly as, the processes of supervision and control 'intended to ensure that the company's management acts in accordance with the interests of the shareholders' (Cadbury 1992, 15; Mathiesen 2002). Lazonick and O'Sullivan (2000) have explicitly focused on the implications of innovation and economic performance as the social process that shape 'who makes investment decisions in corporations, what types of investments they make, and how returns from investments are distributed'. This view has attracted lot of criticism and other authors have contributed broader perspectives (Freeman 1995; Carroll 1979, 1991; Brenner 1995).

Sir Adrian Cadbury stated at the Global Corporate Governance Forum that corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society (World Bank 2001).

There is still ongoing debate about the purpose of corporations. Different authors argue whether the primary purpose of corporations is to make profit for the shareholders, supporting the ideas expressed by Adam Smith and Milton Friedman (1970 in Beauchamp and Bowie 1997, 56-61; Crook 2005), or whether the interests of various stakeholders, those groups affected by the firm, are more important (Carroll 1991, 1995; Freeman 1984; Donaldson and Preston 1995; Harrison and Freeman 1999; Clarkson 1995; Wood 1991; Goodpaster 1991).

Today, few doubt the need for profits to keep companies viable, but when management sees profit as their product rather than a by-product of good business choices, long-term (unwanted) consequences result for companies and society. It has become evident that in order to survive and thrive, the modern corporation must be more than a profit machine. In 1971, Ahlstedt-Jahnukainen stated that the firm is not a closed system lacking any relationship to the outside world, but it is open and connected to several external systems in a number of ways as well as through its stakeholders (Näsi 1995, 104). A growing body of evidence indicates that corporate relations with various stakeholders, corporate citizenship, responsibility, and accountability are becoming as vital to the bottom line as an effective business model (Freeman 1995, 35; Paine 2002).

Organisations and their various attendant groups of stakeholders all involve people in a web of relations with the environment and society, and within this resulting network social issues emerge and choices must be made by the organisations' leaders. Wider social concerns primarily impact business decisions through government regulations, consumer choices, managerial good will and stewardship (often supported through hopes of economic gain or diminished regulation). Today, many argue strongly that organisations and their leaders must consider the impact of their decisions and actions on the environment and society as a whole and that they must assume responsibility for their activities. It is said (Sims 2003) that organisations should take steps to protect and improve the welfare of the environment and society.

The transition from the former centrally-planned economies in Central and Eastern European Countries (CEECs) to market economies has been cited as one of the most interesting and most important issues in contemporary economics and in the development of the world economy (Vensel 1996). Estonia is one of the best examples, and therefore, much research has been done and numerous articles written about transition in Estonia, trying to define why the process has been so successful (Sölvell and Porter 2004). Much has been written about macro-economic policies, ownership structures and privatisation, internationalism and foreign investments, innovations and fiscal determinants, but only a limited number of studies have focused on management and corporations (see Kooskora 2006). Practically nothing has been written in the area of corporate governance and corporate relations with stakeholders in Estonia.

As there has not yet been any significant research conducted in the field of corporate governance and relations in Estonia, a group of Estonian researchers, including myself, have prepared an interdisciplinary study program, where topics such as corporate governance, relations, ownership, corporate responsibility and stakeholders are being studied.

Among other issues the study will look at corporate relations, corporate consideration for or lack of consideration for stakeholders, perceived responsibilities, as well as how and whether the general environment, including the legislative environment, has influenced the activities of the corporation. This article will discuss the results of the study so far particularly in connection with these issues.

The Concept of Corporate Governance and its Theoretical Background

Corporate Governance as we know it today is a relatively new area and its development has been affected by theories from a number of disciplines including finance, economics, accounting, law, management, and organisational behaviour. The term *corporate governance* relates to how corporations, firms and organizations are owned, managed and controlled.

Paul Lawrence and Jay Lorsch (1986) have analysed the connection between a company's external influences and the pattern of organisation and administration that has led to its successful economic performance. They were looking to identify the relationships between organisational states and processes and the external environmental demands, and found it useful to view an organisation as an open system in which the behaviours of its members are themselves interrelated and, in the context of the formal organisation, also interdependent.

The notion of corporate governance relates directly to the issue of management structure at the top of corporations. According to the OECD's (1999) definition, 'the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance'. Narrowly it can be defined as the relationship a company has with its shareholders or, more broadly, as its relationship with society.

A major reason for increasingly adopting the stakeholder concept when setting business objectives, is the recognition that businesses are affected by the 'environment' and society in which they operate. Businesses come into regular contact with customers, suppliers, government agencies, families of employees and special interest groups. Decisions made by a business are likely to affect one or more of these 'stakeholder groups'.

The main theory which has affected the development of the concept of corporate governance and which provides a theoretical framework within which it seems to rest most naturally, is agency theory. This mainstream or neoclassical approach has been restricted to the issue of how to ensure that managers follow the interests of the shareholders. Agency theory identifies relationships where one party, the principal, delegates work to another party, the agent. It is argued that delegating authority to an agent, however, carries risks as the agency relationship can have a number of disadvantages relating to the opportunism or self-interest of the agent (Mallin 2004, 10).

Williamson (1983, 1991), the best-known author supporting the transaction-cost approach, proposes that firms may be the chosen institutional form in circumstances where normal market transactions would be more costly, considering bounded rationality, asset specificity and opportunism. Simon (1991, 34) finds that 'The attempts of the new institutional economics to explain organizational behaviour solely in terms of agency, asymmetric information, transaction costs, opportunism, and other concepts drawn from neoclassical economics ignore key organizational mechanisms like authority, identification, and coordination, and hence are seriously incomplete'.

In examining the answers that economic theories provide for the basic questions of corporate governance (objectives, interests, mechanisms), Paterson (2001, 21) has argued that these theories either consciously or unconsciously fail to account for or consider that the problems that economists themselves are increasingly aware of may require answers from outside that discipline. In this regard, stakeholder theories, with their explicit openness to a broader range of interests, and their criticism of the narrowness of economic approaches, appear to offer a potentially fruitful source that may provide a more complete view of the firm.

Stakeholder Theory

From a stakeholder perspective, the company and its activities are defined according to concepts and propositions arising from those that hold some kind of stake in its existence. The idea is that 'holders' who have 'stakes' interact with the firm and thus make its operation possible (Näsi 1995, 19).

The basic ideas behind the stakeholder approach are not based on recent discoveries, even though the explicit formulation of the theory is rather new. The Oxford dictionary definition of stake-holding records the first use of the term in 1708 as a bet or deposit, 'to have a stake in (an event, a concern, etc.): to have something to gain or lose by the turn of events, to have an interest in; especially to have a stake in the country (said of those who hold landed property)'.

A stakeholder theory of the firm has existed in various forms based on different economic principles since the origins of industrialism. The philosophical antecedents of stakeholder theory reach back into the 19th century, to the conceptions of the co-operative movement and mutuality. Periodically such theories have become marginalised and forgotten, only to be reclaimed later in response to changing economic circumstances. Because of its fragmented development and marginal status, it has never been elaborated and explained as fully and coherently as in the stakeholder theory in respect to the firm.

The term stakeholder theory was first used in 1963 at the Stanford Research Institute, where stakeholder analysis was used in a corporate planning process by Igor Ansoff and Robert Stewart (Freeman and Reed 1983, 89). The authors discussed the stakeholder concept in terms of corporate governance. Using their reasoning, socially responsible investors proclaiming (and seeking to enforce) values contrary to those espoused by managers attempted to participate in the governance of the organization.

In Scandinavia, stakeholder theory was known and discussed in the early 1960s and it remained a prominent view in academia and also in practice till the 1980s. In 1964, Rhenman presented his concept of the stakeholder as follows (Näsi 1995, 102): 'Stakeholders in an organisation are those individuals and groups who are depending on the firm in order to achieve their personal goals and on whom the firm is depending for its existence.' Since that time the systems view – the idea of seeing the entirety in the form of a system – has been more or less consciously the basic methodological framework within stakeholder theory (Näsi 1995, 27).

In America and round the world, stakeholder theory rose to popularity through R. Edward Freeman's work (1984), when his seminal book *Strategic Management – A Stakeholders Approach* was published. The book demonstrated in a comprehensive fashion that the strategic management of private sector firms could become much more effective and efficient if managerial efforts regard various stakeholders' concerns. Or, in other words, the shareholders benefit in the long-term if other legitimate interests in the firm do not fall by the wayside. Freeman's book and stakeholder theory initiated an ongoing academic discussion, which still finds prominent proponents on both sides.

Stakeholder theory has been advanced and justified in management literature on the basis of its descriptive accuracy, instrumental power and normative validity (Donaldson and Preston 1995). Acceptance of the idea that corporations have stakeholders has now become commonplace in management literature. An increasing number of books and scholarly articles have been written about stakeholder theory

(Clarkson 1988; Goodpaster 1991; Hill and Jones 1992; Wood 1991; Logsdon and Wood 2000).

Since its introduction, the stakeholder approach has become a consistent dimension in organisational life and is therefore difficult to discount in any organisational model (Andriof and Waddock 2002). It was not until Freeman (1984) integrated stakeholder concepts into a coherent construct however, that stakeholder thinking moved to the forefront of academic attention. A number of scholars have since developed and enhanced Freeman's work. Carroll (1979) was one of the first to use the stakeholder approach explicitly as a framework for organising business in societal topics. Brenner and Cochran (1991) and Hill and Jones (1992), meanwhile, offered stakeholder models as alternative approaches to Wood's (1991) corporate social performance framework.

In recent years, many professional associations, special interest groups and government organizations, including national governments and the OECD, have endorsed the theory in favour of all stakeholders. Even traditionally pro-business publications such as the *Financial Times* have supported the stakeholder-oriented model of corporate governance.

Edward Freeman (1995, 35) is convinced that paying attention to stakeholders is the only way to sustain the creation of value over time. According to Donaldson and Preston (1995) the stakeholder theory is intended both to explain and to guide the structure and operation of an established corporation. Toward that end, the corporation is viewed as an organizational entity through which numerous and diverse participants accomplish multiple, though not always entirely congruent, purposes.

Logdson and Wood (2000) argue that a major purpose of stakeholder theory is to help corporate managers understand their stakeholder environments and manage more effectively within the nexus of relationships that exists for their companies. However, a larger purpose of stakeholder theory is to help corporate managers improve the value of the outcome of their actions, and minimize the harm to stakeholders. The whole point of stakeholder theory, in fact, lies in what happens when corporations and stakeholders act out their relationships.

Stakeholder theory claims that whatever the ultimate aim of the corporation or other form of business activity, managers and entrepreneurs must take into account the legitimate interests of those groups and individuals who can affect (or be affected by) their activities (Donaldson and Preston 1995; Freeman 1994). Stakeholder theory attempts to describe, prescribe, and derive alternatives for corporate governance that include and balance a multitude of interests.

By the end of the 1980s, recognition had dawned that, in a post-modern world where the very existence of value-neutrality is questionable, conceptualisation about ethics needed to be more closely linked to thinking about the business–society relationship, whether through the stakeholder or corporate 'social' performance (Wood 1991) lens. Etizioni (1988) believed that the inclusion of the moral dimension in organisational decision-making would lead to better results for both firms and for society.

Stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business (Freeman and Evan 1990). It asks managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. It also pushes managers to be clear about how they want to do business, and specifically what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose.

The theory provides the underpinnings for a mode of corporate governance, which takes into account ethical and public concerns, and not just profit making. The moral environment of shareholder theory is tightly constrained, and focuses only on the duties of management toward the shareholders to maximize the profits of the corporation. Stakeholder theory, on the other hand, opened the door to bringing fundamental moral principles to bear on corporate activity. For, under that theory, the obligation of business is not to seek profit for its shareholders but to coordinate stakeholder interests.

Defining Stakeholders

Stakeholder theory focuses on the various stakeholder groups to which the corporation has a responsibility, and the main starting point is the claim that corporations are not simply managed in the interests of their shareholders alone, but a whole range of groups, or *stakeholders*, also have a legitimate interest in the corporation (Crane and Matten 2004).

Every company, to a greater or lesser degree and in different ways, influences and is influenced by its various stakeholders. According to Carroll (1991), the stakeholder approach puts 'names and faces' on the members of society who are the most critical for the business, and to whom the company must respond. The range of stakeholders differs from company to company; however, generally there are five major stakeholder groups recognized by most firms – owners (shareholders), employees, customers, local communities and the society at large.

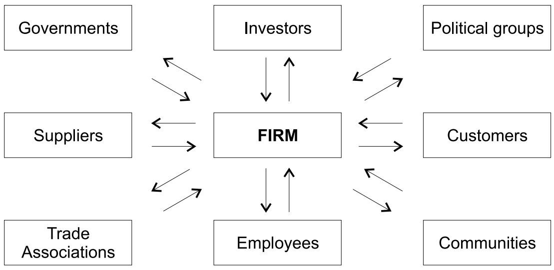

Figure 1. The Stakeholder Model (Donaldson and Preston 1995, 5)

One main difficulty with the stakeholder theory is that there is no unified concept defining the stakeholder. The notion of a stakeholder is deceptively simple, but definitions range from the highly specific and legal to the general and social. In his book, Freeman (1984) defined stakeholders as follows: 'A stakeholder in an organization is … any group or individual who can affect, or is affected by, the achievement of the organization's objectives' (see also Freeman and Reed, 1983). In the context of natural resource management, however, Röling and Wagemakers (1998) offer a more appropriate definition: 'Stakeholders are … natural resource users and managers.'

Much of the literature about stakeholder management has categorised stakeholders based on their attributes. Harrison and St. John (1996) sorted stakeholders according to Freeman's original classification: a stake in the organization and an influence on behaviour. Stakes are then divided into three types: those stakeholders who have ownership in the organization, those stakeholders who are economically dependent on the organization and those stakeholders who are not linked directly to the organization, but who are interested in seeing the organization act in a socially responsible manner. They also suggested classifying stakeholders by the extent to which an organization is dependent on them for survival and prosperity.

Clarkson (1995) argued that identification should be based on whether stakeholders bear risk as a result of an organization's activities. Of course, these notions include virtually everyone and still leave us with the question of identification. Following a comprehensive review of stakeholder management literature, Mitchell et al. (1997) were more specific, proposing a model that bases the salience of stakeholders on their *power* as well as on the *legitimacy* and *urgency* of their claims. They referred to power as the ability to influence the actions of organizations, legitimacy as the perceived appropriateness of claims, and urgency as an indicator of whether these claims call for immediate attention. In an attempt to empirically test the model, Agle et al (1999) found strong evidence that power, legitimacy and urgency act as attributes that increase stakeholder salience.

Carroll (1979 and 1991) has defined stakeholders by placing them in their respective environments – economic, technological, social and political environments. Like Clarkson (1993), he talks about primary stakeholders – those who have formal, official or contractual relationships with the firm, and secondary stakeholders – other interrelated groups. Näsi (1979) has grouped stakeholders into internal and external coalitions, where internal stakeholders have an ownership or other fixed or permanent relationship with the firm.

Jonathan Charkham suggests a distinction between *contractual* stakeholders who have some legal relationship with the company, and *community* stakeholders whose relationship with the business is more diffuse, but nonetheless real in its impact (see Table 1, Clarke, 2005, 15).

Table 1. Contractual and Community Stakeholders

CONTRACTUAL	COMMUNITY
Shareholders	Consumers
Employees	Regulators
Customers	Government
Distributors	Pressure Groups
Lenders	Local Community
Suppliers	Media

Adapted from Clarke, 2005, p.15.

The challenge in stakeholder management is to ensure that the firm's primary stakeholders achieve their objective while other stakeholders are also satisfied and not completely forgotten. According to Freeman (1984), if corporations want to be effective, they have to pay attention to all and only those relationships that can affect or be affected by the achievement of the organization's purposes. In order to maximize shareholder value over an uncertain time frame, managers ought to pay attention to key stakeholder relationships.

Freeman (1995) argues that stakeholder theory gives managers more resources and a greater capability to deal with this challenge because they can offer not only financial reward, but language and action to show that they value relationships with other groups and work to advance their interests over time. In an era when firms rely on committed value-chain partners (e.g., employees and a whole range of suppliers in the supply chain) to create outstanding performance and customer service, stakeholder theory seems to provide managers with more resources for success.

There can be a wide variety of goals for a business: the traditional profit maximisation, earnings per share, total sales, numbers employed, measures of employee welfare, manager satisfaction, environmental protection and many others. One major reason for embracing the stakeholder concept when setting business objectives is the recognition that businesses are affected by various groups and vice versa.

Stakeholder governance, with appropriate collaborative communication practices, can generate more creativity impacting on new product development, greater efficiency and effectiveness in personal and organizational goal accomplishment, higher levels of mutual commitment, and greater product and service customization. Interaction modelled on collaboration that is grounded upon embracing difference has great potential.

The Study of Estonian Business Leaders in Summer 2004

During the last 20 years, Estonia has experienced a number of different business eras and practices. We have witnessed the erosion of socialism followed by typical cowboy capitalism or shark capitalism (often called rough entrepreneurial capitalism) and economic boom. Today, still profiting from this rapid development, we have reached a period of increased economic and political (and social) stability, and now the first phase of convergence with the EU is commencing (see Kooskora 2006).
According to the common understanding today, although the situation is visibly improving, most businessmen prefer financial success over considering the interests of different stakeholders, and for them considering stakeholders and corporate responsibilities in corporate governance seems irrelevant and unimportant. Even when these businessmen are aware of the concepts and believe they are important, they lack the know-how for implementing them in their own company.
A study, in the form of in-depth-interviews, was conducted in summer 2004 by a group of Estonian researchers (including the author of this article) to explore ties between the sources of capital, corporate levels and the environment (Research Report 2005). The purpose of the study was to investigate corporate management, business practices and business responsibility over the last 10 years by interviewing top Estonian managers and owners, often referred to as generalists. The aim was to obtain a broader overview of how corporate governance and related issues have been perceived by Estonian leaders/decision-makers and how these views have changed during last 10 years. The business leaders were asked questions that addressed two aspects: on the one hand, the difference between the periods 1995 – 99 and 2000 – 04, and on the other, between enterprises based on foreign and domestic capital (about methodology of this empirical research see article by Tafel, Terk and Purju in this volume).
Part of the study addressed issues of corporate relations, consideration for or lack of consideration for various stakeholders, perceived responsibilities, as well as how and whether the general environment, including the legislative environment, influenced the activities of the corporation. Below I will discuss the results, paying particular attention to these issues by adding descriptions and interpretations of the contextual factors influencing the views and perceptions of business leaders.

The Process of the Analysis

Stemming from our understanding of business in society and the environment (the paradigm shift described by O'Malley in 2003), I argue that in order to understand corporate activities and their relationships it is important to consider the wider societal and environmental context and also the changes taking place in society and the environment in which organisations operate. My analysis is conducted in the constructivist-interpretive paradigm, and by examining the perceptions of business leaders, owners and managers my task is to find out how different views on organisations, management and organisational relationships, and consideration of stakeholders are described and understood and how contextual influences on the Estonian business community have defined these different perceptions.

The idea of social constructivism, as developed by Berger and Luckmann (1966), focuses on the ways people make sense of the world especially through sharing their experiences with others via the medium of language. People do not construct their realities independently of other people. Instead, groups of people socially construct their models of reality and this is done through social interaction (Vaara 1995, 216). Easterby-Smith et al (2003, 42) have named the ability to look at how change –– the processes of understanding people's meanings over time, to adjust to new issues and ideas as they emerge and to contribute to the evolution of new theories as the strengths of the approach. The main weaknesses that have been suggested include consuming time and resources, difficulties with analysis and interpretation and the dependence on the researcher's intuition and knowledge.

It has also been said that qualitative studies often feel very untidy because it is harder to control their pace, progress and end points. In order to increase the validity and reliability of my analysis I have been using the qualitative research software NVivo. Coffey and Atkinson (1996, 26) have written that the segmenting and coding of data are often considered as taken for granted elements of a qualitative research process. The term coding encompasses a variety of approaches to and ways of organising the data, besides simplification and reduction of data, it may also mean expanding the conceptual frameworks and dimensions, thinking creatively with the data, asking questions and generating theories and frameworks (Hiillos 2004, 101). With the help of the NVivo 7 software, I conducted coding and re-coding of the data, and realised that the role of coding in reaching an understanding of data rich in different concepts, factors and constructs was paramount.

During the analysis process the clean interview transcripts were first imported into NVivo 7, where they were coded into nodes representing the different themes of interest that either existed prior to the coding or were created along the way. Respondents were classified — attributes named according to whether they belonged to managers, owners and owner-managers groups, and whether they represented local or foreign capital, and finally personal characteristics were added as attribute values. In terms of coding, I reviewed data documents line by line, developing or applying codes to represent themes, patterns or categories. The codes were saved within the NVivo database as 'nodes' that could then be re-ordered, duplicated, merged or removed to help visualise and locate analytical items or categories.

These secondary processes helped to highlight areas that were unclear, and encouraged a return to the data and further coding, refinement and review, and hopefully, resulted in an improvement in the quality of the analysis. The 'modeller' and 'search tool' options were especially useful in creating, labelling and layering connections made between ideas and concepts and enabled a variety of searches using the data, the coding and supporting material. Memos, containing my own thoughts and views on the issues, and also the theoretical and conceptual understandings of well-known researchers, academics and practitioners were linked to the categorised data in the nodes, enabling me to locate relationships between respondents' views and understandings previously noted.

I found the software helpful as it suited this type of analysis, allowing both data-driven and concept-driven coding. Although it is important to note that software does not analyse qualitative data, it only aids in the analysis, helps with data storage, coding, retrieval, and comparing and linking the data to the different concepts and constructs.

Analysis of Research Results and Discussion

The Estonian Context, 1995 – 2004

Since the re-establishment of independence in 1991, and a subsequent economic slowdown, Estonia has experienced positive growth since 1995 (Purju 1996), real economic boom in 1997, some downturn in 1999, and since then, steady growth of GDP and modest inflation (Enterprise Estonia, Statistical Office Estonia).

Our research focused on the last 10 years. At the beginning of the period, 1995, the economic and political situation had stabilised, so it was possible to start out in business in more 'normal' ways. People had plenty of initiative and they wanted to accomplish something – to do things that mattered and position themselves as powerful individuals in society. Various ratings show that, compared to other Central and Eastern European countries, Estonia has performed very well and as far as regulatory quality is concerned, Estonia scores close to some of the largest EU-countries (Bennett et al 2003; Terk and Varblane 2001; EBRD 2001; World Bank).

As the economic environment has become more stable and opened up, the growth of the economy has seemed automatic. Overall, Estonia has enjoyed positive development. Drawing on the experiences of Finland, Ireland and the Asian Tigers, the main pillars for raising the competitiveness of the Estonian economy were: 1) a purposeful effort to attract knowledge and technology intensive foreign direct investments; and 2) focusing on sectors that are perceived to induce the highest rate of growth (IT, bio- and nanotechnology), using these technologies to raise the productivity of traditional industries, and significantly raising the effectiveness of the education system, investments into education, skill conversion and retraining at all levels (Tiits et al 2003: 7; Kurik et al 2002). At that time, it was not so easy to find new markets; therefore, customers, especially loyal customers, became important.

Training people increased knowledge levels and the awareness of newer business and leadership trends, at the end of the period it became increasingly apparent that managers and owners started to understand the importance of treating employees as important stakeholders who also have a 'stake' in the organisations' activities. The organisational climate, working atmosphere and relations between people gained importance (Alt et al 2003). Besides turning their faces towards their employees, the general environment, society and various other interest groups also became more important (Kooskora 2006).

In the last decade, we have witnessed economic growth based on technology transfer spurred by foreign direct investments that increased the efficiency of the economy (Tiits et al 2003:6). Foreign companies active within Estonia have praised the stability of the country and its labour productivity (Tiusanen 2003). Particular strengths included the country's openness to international trade and investment and the good basic level of education among the workforce; the weaknesses remained the quality of the infrastructure, and advanced education and research.

The Management and Managers of Organisations, 1995 – 2004

According to responses from interviewees, during the first period of 1995-1999 and earlier, (business) activities basically focused on short-term interests – earning a profit and attaining success – thinking no more than 1-3 years ahead. But in 2000-2004, attention turned to long-term investments, planning periods became a minimum of 5 years and perspectives of 10 or even more years were common. Those business leaders who participated in the study indicated that between 1995 and 1999, the main activities among business leaders can be divided between those involving the restructuring and redesigning of old soviet style enterprises, a task that required tough, rough managers, who had to make unpopular decisions; and secondly, founders and new entrepreneurs, who started from a zero point and who had sufficient initiative and readiness to work hard.
The lack of experience or knowledge of business and management in the early years of independence meant that entrepreneurial spirit, innovativeness, motivation and the ability to find loopholes in legislation were most valued (Kalmi 2003; Kooskora 2005; Kooskora 2004; Virovere et al 2002). Business leaders were young, powerful, even rude people who had connections; they were self-starters with a good business instinct (Kooskora 2006). Companies were founded in the following way: people had been used to working in summer camps during their university years –– those who had found they got along well came together and started to do business. They were ready to work 24 hours a day seven days a week and all that was normal and common practice. Many of these businesses have since failed, and issues such as trust, honesty, and differing values and ideas often played a significant role in these failures.

In the period 1995-1999 and earlier, business activities were typified by a rough, entrepreneurial capitalism with considerable risks, but even greater opportunities – practically nobody cared about what impact their business activities had on others or on society or the environment – these aspects were considered irrelevant (Aaltio et al 2002; Kooskora 2004). Those business leaders who were clever enough to know how to get around the laws and regulations were admired and considered good businessmen (Kalmi et al 1999). By 2000-2004 a more stable environment had emerged and the risks were lessened, but there were already fewer opportunities and the hard work became less attractive and less interesting. Since 2001, companies started to implement new management techniques and styles, pay more attention to democratic values in organisations and put more emphasis on strategy (Alt et al 2003; Barnowe et al 2003; Kooskora 2005a). Management became more aggressive in its decision-making and western benchmarks started to gain importance among top managers.

By 1995, the private sector had achieved a dominant role in the economy partly thanks to privatisation and partly thanks to the emergence of a number of new private firms. At that time the legal system was only starting to develop and the young government imposed very few restrictions on business activities, so CEOs had considerable power to 'hire and fire' and they concentrated on short-term profitability indicators, preferring radical change with strong strategic, preferably foreign owners (Kalmi 2003; Kalmi et al 1999). During the transition period, Estonian managers stressed that enterprises should find the means for survival by themselves – the state and government institutions were not expected to be of much help (Liuhto 1996: 13).

Since the beginning of the period, Estonian leaders focused strongly on forging Western European partnerships, such as their membership of the European Union and NATO for political, economic and security reasons (Liuhto 1996, 16; Liuhto 1999; Liuhto 2001). The pursuit of EU membership also required major institutional reforms (Jones et al 2003; Postma and Hermes 2002, 8-9). Such changes in the environment and increased awareness and demands highlighted the need to ensure sustainability and the ability to adapt to change.

As with previous research, our study showed that the corporate owners have had and still have a significant influence over the qualities that are necessary and required in top management. Between 1995 and 1999, top managers were predominantly viewed as developers, and between 2000 and 2004 as maintainers (Terk 1999; Terk et al 2004). We can characterise developers as being well-connected, 'launcher-types' with a strong business sense, tough and even ruthless, decisive and risk-taking, and round-the-clock-managers. Maintainers are those who care about sustainability, developing and maintaining relationships and are capable of working with others.

One can mention that older Estonian managers have experience, education and erudition and an ability to operate within the limits set by the rules. Foreign owners, who have predominantly established their presence in Estonia in recent years, brought about a change in the type of top managers preferred. The preference among Estonian managers to be more independent, developer-type managers, taking more risks and operating without set limits, could be considered as one of the reasons why there have been quite a number of dismissals of top managers in foreign companies in Estonia in recent years.

The Organisation as Part of the Environment and Society

O'Malley (2003) talks about today's business leaders not yet having understood that the true sustainability that they are chasing after is based on an entirely different worldview to the prevailing paradigm, and that it will have profound effects for all aspects of business. In order to be successful and sustainable in the long-term, organisations have to be well-behaved actors in society and the environment. Behaviour and the quality of activities and relationships play a central role in successful and sustainable operations and development.

The old paradigm or worldview regards business, society and the environment as if they are separate spheres, even though they overlap. In this sense the sustainability of a business is approached more from the financial perspective or in other words as a way of making a profit. Businesses can only justify their involvement in the social and environmental spheres in financial terms, since the paradigm sees the purpose of business primarily as the creation of financial value. According to O'Malley, the new paradigm on the other hand sees business as a subset of society, as a mechanism for social value creation – private value creation is secondary, since all private value exists only in the social context. The new paradigm realizes that society itself is a subset of the environment, and can only flourish in the long term to the extent that the environment flourishes. Although the planet can survive without us, we cannot survive without the planet.

These somewhat obvious views were not considered relevant among business leaders in Estonia during the period of transition to a market economy and initial rapid economic growth. The results of our research showed clearly that especially during the years 1995 – 1999 and even earlier, practically nobody paid attention to the environment, society or the considerations of stakeholders other than owners, and supervisory boards were not very widely utilised. At that time, earning a profit was seen (and is still seen by many) as the main goal among organisational leaders. One of the respondents clearly stated that:

> *'Money is the most important thing, and whether there are differences between the managers and owners depends on how well the tasks have been explained to the managers. I think absolutely that the purpose for the owner is always only earning profit.' (top-manager, 8)*

Another manager said that Estonian business leaders think it is sufficient to pay taxes and have an enterprise, and even when some more socially sensitive Estonian entrepreneurs do something for society and their employees, they are ashamed to talk about it due to the prevalent attitudes in the business community. The respondent said:

> 'The Estonian entrepreneur says: I pay my taxes and now I want to be left alone. I have fulfilled my tasks in front of society. The foreign organisations have come into a very favourable environment as it is in their own country and they invest in the working environment. Because of the overall attitudes, Estonian entrepreneurs with more sensitive social nerve are ashamed to talk about the things they do for society or their employees. It is more popular to splurge with flagrancy.' (top-manager, 9)

Similar views were seen among all groups of respondents. It came out very clearly that organisations are the ones who produce wealth, who create employment and who can influence processes, when they find it useful and or beneficial to them. One respondent (owner, 21) said: *'the state becomes weaker and corporations stronger, the hope for the human nation lies with the corporations '*.

Still it was clear that views about organisations and their environment have changed. One female top manager as a representative of foreign capital said that in 1995 – 1999 the priority was definitely profit, but in 2000 – 2004 the importance of softer values has increased. She also added that foreigners have always valued the soft issues more than local business leaders.

Considering Different Stakeholders

Corporate governance is a system of relationships, defined by structures and processes. These relationships may involve parties with different and sometimes contrasting interests. The governance framework should acknowledge that the interests of the corporation are served by recognizing the interests of stakeholders and their contribution to the long-term success of the corporation.

The firm is a social and technical system where different stakeholders play a part. These different stakeholders, such as owners, customers, employees, suppliers and lenders, even the state and municipality all make contributions to the activity in the firm. However, at the same time, these stakeholders set demands for their rewards. These rewards refer equally to the mode in which activities should be organised and arranged and to the way the entire 'result' of the activity should be divided (Näsi 1995, 99). Only if these demands are satisfied through rewards from the company, will the stakeholders be willing to continue their interaction with the company.

In a fully developed stakeholder model, the function of the management would need to become the coordination of the conflicting interests of stakeholders rather than the managing or controlling of them. The logic is not one of containing stakeholder interests, but trying to accomplish them through corporate activity. In a fully developed model, management would be hired by all stakeholders and work to optimally coordinate the meeting of all interests as if they were the interests of the corporation, thus seeking the most creative co-determination for the benefit of all stakeholders (Deetz 2005).

According to the author's view of the firm, the performance of executives should definitely include social performance. 'Corporate social performance can be analyzed and evaluated more effectively by using a framework based on the management of a corporation's relationships with its stakeholders than by using models and methodologies based on concepts concerning corporate social responsibilities and responsiveness' (Clarkson 1995, 92).

Stakeholder inclusion is not aimed at balancing power and advancing self interests, but is essential for the processes of creativity that can advance both social and economic interests rather than trade them off against each other. Such a juxtaposition of goals is a critical feature of any attempt to move towards creativity and innovation. Such a model begins with the determination of who has legitimate stakeholder interests, some determination of what those interests are, and how interest diversity advances responsiveness and creativity. Concerns with the representation of social values and economic success are rarely necessarily contradictory and are most often mutually supportive especially in the long term.

From our study, it became clear that stakeholder thinking and stakeholder concepts have just recently became recognised and understood among our business leaders. It can be seen from the responses, that the representatives of the Estonian business community operating on the basis of Estonian capital have a more personalised and the representatives of foreign companies a more institutional approach to their companies. Estonian owners use organisation as a means not for institutional ends. Foreign owners consider 'corporate citizenship' clearly in the institutional context. The consideration of the interests of owners and the needs of managerial boards were seen as the most significant factors having an impact on the organisation's activities especially in the beginning of the period being studied. Today, one can say that other stakeholder groups have also gained importance, but when the important decisions are being made, consideration and inclusion of the interests and needs of different stakeholder groups are still rarely taken into account.

Perceptions of the Relationships with Society and the Environment

When talking about relationships with society and the environment, the majority of respondents in our research referred to the concept of corporate social responsibility (CSR), finding that some changes have definitely taken place in this area, but taking responsibility for society and the environment is still seen more as the task of the state and not of the organisations. Our findings about the understanding of CSR among Estonian businesses indicated that CSR was mostly linked with being a good employer and providing employment, and also with staying within the law and giving money away to charity or sponsoring different activities. Business leaders still saw economic and legal responsibilities as the most important part of CSR. Therefore, being a successful business and providing sufficiently good working conditions already seemed to be enough for most business people.

One respondent (top-manager, 5) found that; *'... today compared to 1995, social responsibility has significantly increased. There are organisations that do something for society'.* Another top-manager (no 13) stated that: *'... wider contributions and fulfilling social functions has become more important due to development and stabilisation'*, this respondent did not notice any differences between the views of managers and owners on this point.

When talking about the environment and society it was not considered important that companies should take care of the environment or help society or the local community, instead respondents started offering examples of sponsorship and charity activities and they believed that business leaders were only doing something in these fields when they saw some benefits for themselves or their companies. These benefits could be in the form of money, reputation, marketing or PR. One top-manager-owner (no 20) said that:

> *'... quite a lot of top-managers have understood that this is an area where one can gain personal reputation more quickly and easily and retain it than through business results alone. The question is not only about organisational reputation; more often top-managers seek opportunities where they can be seen as respected citizens. But as it is quite expensive to do this using one's own finances, it is much better to spend the company's resources.*'

Interesting observations can be drawn from some responses about how sponsorship and other socially oriented projects are chosen. We discovered that quite often the sponsorship of sports teams have been chosen because the manager's or owner's close relative or friend is a member of that team. It was also mentioned that the owners in local companies often think of these activities as their personal acts of charity hoping to improve their reputation as a 'good' person – one respondent stated that '… *in Estonian organisations, even when money has been given by the company, the owners are still highlighted in the background as individuals'.* Of course we cannot generalise about this, but there were a number of such examples and stories related by the respondents during their interviews.

The study has show that views about corporate relations in regard to the environment and society have changed over time. It seems that at the moment some people are starting to think more about the manner in which profit is achieved, and there are some enterprises who want to transform their business methods and make them softer, but in general such changes are still seen as a means for marketing or PR.

Many of the responses from the owners indicated that while they supported social responsibility, in many cases they still felt that the main purpose of business is to make a profit. The interviews tended to indicate that if the company exists then it has already given something to society: companies are the principal employers, they pay taxes, they are involved in infrastructures, and by using them they are sponsoring their development. The things that encourage the adoption of socially responsible activities the most are things like gaining a partner's trust and the interests of the company's management. Many company leaders strongly agreed that CSR activities have a positive affect on the company's image and customer expectations, but better relationships with different NGO's and the local community are rather under valued.

In general, several respondents stated that the Estonian system is simultaneously intricate, permissive of various different solutions and clearly owner-centred. This intricacy refers to the multiple levels of Estonian organisational structure, sometimes producing a feeling of '*superior-subordinate'* relations between otherwise equally positioned individuals. This became apparent when the respondents answered questions about decision-making and choosing from among projects. In reference to the idea of Estonia being owner-centred, the respondents stressed the management's total liability *versus* the owner's liability, which is limited by the potential of losing money.

Participation in Business and Professional Associations

Our research looked at how business leaders perceived the value of business and professional associations and how actively business people participate in the activities of such unions.

Most of the respondents found that the significance of business and professional associations and unions is definitely important and has recently become more important. Also, these associations and unions have only become more active in recent years. While respondents from the groups of managers and owner-managers strongly supported this view, there were also two respondents from the owners who did not see these as important at all.

One top-manager (no 14) said that the role of business associations has clearly increased.

> *'...they have become more active, their roles as negotiation partners (with the state) has increased. Earlier many of the large companies did not want to deal with things through these associations, finding that a direct approach is more efficient. 'Talking to the prime minister myself' is now an exception, although many try to continue dealing directly...'*

Another top-manager (no 15) saw clear and positive dynamics. Stating that: *'... the fact that the owner and the managerial board are not looking at this in the same way is again Estonia's tragedy and a children's disease'.* Adding that in the beginning these associations were often '*formed by some groupings'* and some members of the sector viewed these negatively because those who were leading them were competitors, but when external factors (in the form of the state authorities) started to impact more strongly, then '*the common enemy unites'* and the need to have joint representation was clear.

One of the respondents, an owner-top-manager (no 20), highlighted the different motives of local and foreign organisations seeing the importance of belonging to associations and being actively involved in these activities, and referring to the need to develop networks and also because it just goes along with the business.

> The respondent explained that *'... the companies have like an understanding and habit that one needs to be near these things when wants to operate. One just needs to be there, and the need is definitely bigger among foreign companies, and on the other side they also need networking, especially the relationships side... Estonian companies have this anyway; everybody knows each other (anyway)... But when you take the real role of these associations in influencing laws and regulations, then this is the need which is recognised more by the Estonian enterprises.'*

Two of the owners believed that the role and impact of these associations is still small and insufficient. Two of the main associations that were mentioned among all respondent groups were the Estonian Chamber of Commerce and Industry and the Estonian Employer's Confederation. One of the respondents believed that these two main associations could be united in order to become more powerful and influential.

Attitudes towards the State

There were two extremes among the perceptions of the state, and these didn't depend on the status of the respondent. The first group was made up of those who thought that the government had improved: in the first period, the state was seen as the tax collector and this was seen as a barrier in every way. Now it is acceptable to pay tax. It is seen as something important that has to be done. This group of respondents thought that the state had established its regulatory role very well and that the environment was rather friendly for entrepreneurs.

The second group was negative about the state. Typical comments included: '…*the state is a villain*'; '…*there is no one less trustworthy than the Estonian state*'; '…*anonymous, no feelings of respect'; '... everything that has something to do with the state you have to treat with enormous care'; '... because whatever one institution says or promises today, the other one will do the opposite tomorrow'.* They also pointed out that there was a lot of hostility towards entrepreneurs –– there were lots of precedents in Estonian law that are not found anywhere else in the world (e.g. the company's shareholder is responsible for the company's actions).

In general, the respondents believed that the state's role had increased, and as one of the them pointed out, this was mainly thanks to joining the EU *'...because corporations didn't know what kinds of regulations and laws there would be after joining, so businesses became dramatically more interested in the state's actions after the negotiations with the EU started and this hasn't stopped yet. Obviously, thanks to the EU, the state's role as a customer has improved, mostly because of EU money...'* (top-manager 4, Estonian, male) It should also be pointed out that corporations on the whole did not really accept the state (constructively) as such in terms of how it could be helpful, but some larger companies have started to.

The situation in regard to legality has improved in recent years, as some respondents also remarked: '…*we need laws, but to help society to develop, the companies need some freedom of action*' (owner / top manager, Estonian, male). The laws are in place, and it is no longer considered very wise to avoid taxes. Paying taxes is considered important and necessary, but paying cash in hand is still quite common, especially in heavy industry and construction companies.

Considering Trade Unions

Opinions about trade unions differed greatly, some of the respondents said that unions had become more professional: their role in negotiations (with the government) had increased because they had more information and this is useful because it is necessary to have one united representative. The common standpoint among these respondents was that companies are working with trade unions and that in the given period this exhibited itself as an increasing trend.

Still there were plenty of responses indicating that trade unions '… *do not have any power and do not deserve any real attention'; '... trade unions are disagreeable'; '... trade unions are totally pointless' and '... these just do not exist'.*

One of the top-managers (no 13) believed the trade unions to be '*more like political parties, often without the required education and knowledge, being just one organisation, representing the interests of one particular group of people, still being quite weak, sometimes helping to get things done'.*

One top-manager – owner (no 20) said that it would be better if trade unions were stronger, as it would facilitate activities in some aspects. Still the majority of responses showed either neutral or negative attitudes towards trade unions. Some of the respondents said that even when trade unions are weak, there is constant conflict between the trade unions and the entrepreneurs and in some organisations these unions are even forbidden.

Most of the respondents believed that trade unions will probably become stronger in the future and will also have some impact upon the activities of organisations, but it was also stated that decision-making power cannot be given to employees.

Changes in the Consideration of Stakeholders

In our research we had included 10 main stakeholder groups –– employees, customers, suppliers, banks, local authorities / municipalities, high public officials, Estonian political elite, public pressure groups, media and others who might have their own interest in the activities of companies. We asked the respondents to name four stakeholder groups that were most important to them and show whether consideration of the interests of these groups has increased or decreased.

Table 2 presents an overview of how much the respondents consider the needs and interests of different stakeholder groups, and whether this consideration has increased or decreased.

Table 2.
Overview of how perceptions of the main stakeholder groups among Estonian business leaders between 1995 – 2004 have changed

Respondent groups / Dynamics – increase or decrease / Stakeholders	Top-Managers ↑	Top-Managers ↓	Owners ↑	Owners ↓	Owners - TM ↑	Owners - TM ↓	Total	Total ↑
Employees	4	1	7	0	2	0	14	1
Customers	4	0	3	0	4	0	11	0
Suppliers	2	1	3	0	1	2	9	3
Banks	1	1	0	4	0	2	8	7
Local authorities	1	0	3	0	2	0	6	0
Public officials	1	0	-	-	1	0	2	0
Political elite	2	0	-	-	-	-	2	0
Public pressure groups	2	0	1	0	-	-	3	0
Media	4	1	1	0	4	1	11	2
Others	0	2	0	1	-	-	0	2

In general, most of the respondents paid attention to public opinion and the media, owners considered customers important, and top managers said that it would be important to start considering employees more in the future. These three groups were named more often than the others by all respondent groups. Among the interviewees there were individuals who are well known and closely observed by the media, and they considered public opinion very important. There was one common line in the responses saying that: '…*you cannot look at making a profit as a very primitive action. It's a far-reaching process and it reflects how you have looked after one stakeholder group or another. It's a logical circle where you cannot just take one component out*'. All stakeholder groups were mentioned as important, but the answers varied greatly.

It is also interesting to note that although only one top-manager considered public officials as important stakeholders, it was said that these are the most important stakeholders considered by that top-manager. The same result can also be highlighted about the political elite, although only two respondents found this group important, it turned out that they are of 2nd importance among all stakeholder groups.

Below are some example responses:

- '…*you can actively motivate your employees and direct them and inform them about future changes, so when they do come they are prepared for them*' (owner / top manager, Estonian, male).
- '… *politicians –– you can pay for some party's advertising'* (owner 4, Estonian, male)
- '… *the overall plan, the consideration, doesn't necessarily mean donating money, but to communicate with the stakeholders'* (top manager, foreign capital, male).
- '… *you should try to achieve long-term relationships with your clients, which is more important than just selling something quickly to them'* (owner 7, Estonian, male).

When analysing the changes in these perceptions between the two periods, it was clear that there was one particular group that had lost importance –– the banks. While eight respondents named banks as important stakeholders, seven stated that their significance had decreased. But there was also considerable variance in the responses in this area:

- *'...you can't deprive yourself of a relationship with the banks, they are highly important,* *even though they are not the same as 5 or 10 years ago. If it used to be the way that the bank greeted you, had a discussion and then asked if there were any papers to see, then now the first thing they ask for is papers'.*

- *'... basically the fact that your uncle works in the bank and backs you doesn't mean that everything will be fine. The banks are much more conservative and the only requirement is that if you are a correct, honest client, then you are a potential client for the bank'.*

In general, banks are not seen as being so important any more – it was said that it is not difficult to find money when you have a good idea and a good business plan.

The results of these questions about the consideration of different stakeholders and the changes that have taken place in these perceptions were not surprising. One interesting aspect, which also arose without being the topic of any particular question, but was mentioned by several top-managers, was that managers do not treat owners as the main stakeholders any more. Their importance has decreased significantly, especially in the case of foreign owners *'... who are far away and do not care much about the local activities'* as explained by one top-manager.

Considering the Interests of Different Stakeholders

If we look at how business leaders took into account the interests and needs of the various stakeholder groups we can see clear patterns. Top-managers found it relevant to keep the stakeholders informed about what is going on in the organisation, and be open to different issues. It was also mentioned that companies try to please local authorities/municipalities in order to get things through. Political parties are supported and their campaigns paid for, and the organisations then expect more favourable conditions from the political elite.

One of the respondents from the owner-top-manager group (no 12) argued, that *'... all things are related to each other, when I'm able to achieve a shift in one place, then I hope that in the end it will also be expressed positively in the financial results and vice versa.*'

Another owner-top-manager (no 20) said that one has to pay attention to the employees, especially during change management and stated that '... *in general it has been understood that there is a need to talk to people. Although we still have a long way to go, talking to people has become more common.'*

Owners highlighted the need to include major suppliers and clients when working out the company's long-term plans and communicating with all main stakeholder groups (such as customers, suppliers, media and employees) relevant for the company's well-being.

One of the owners (no 2) explained that from among all stakeholder groups, '... *those four (customers, suppliers, media and employees) are the ones the company depends on for its long-term success'.* The respondent thought that '... *organisational leaders may discuss long-term plans with some of the customers and suppliers'.* The same respondent found that no-one can negotiate with all employees, '*.... at best, one can somehow give extra motivation to the employees, guide them that... for example some changes may come, so that they will be able to survive these coming days better'.*

Main Findings

There are clear differences between the views of owners and top-managers about stakeholders and a company's relations with society and the environment; the origin of the capital involved also has a clear impact on these issues. Representatives of the Estonian business community operating on the basis of Estonian capital had a personalised rather than institutional approach to organisations, while the representatives of foreign companies saw organisations more as institutions. It was not considered important that companies should take care of the environment or help society or the local community.

The most important stakeholder groups included: the media and public opinion, employees (except managers) and customers — the importance of these three groups has increased. Suppliers and banks were seen as being almost equally important, but it must be pointed out that the importance of banks has decreased. Local authorities, which have also increased in importance, were next in the list. Perceptions of the state showed two extremes, one supporting the view that perceptions of the government have improved, while the other group harboured more negative perceptions of the Estonian authorities. These two opposing views did not appear to have any relation to the status of the respondent.

The owners definitely considered earning a profit more important than other things. They suggested that the existence of a company already entailed a responsible contribution to society and the environment. Not all owners shared this view since some

donations have originated from purely social and humanitarian intentions.
The group of top managers and owner/top managers considered activities directed towards enhancing societal and environmental issues a growing area. Profit earning was still the primary goal of all enterprises, but owners /top managers were especially able to see the wider picture and consider different interests when making decisions. Managers positioned themselves in regard to their team, because it was more profitable for them and they felt they had to consider employees more, otherwise the organisations would not be successful.

While analysing the results, it became evident that although there are changes taking place, Estonian businesses are still more concerned with those interests that reflect their public image to their clients and partners, and not those that reflect the internal qualities of the company to their employees. Therefore it is possible to say that Estonian companies are more concerned with the way they are seen outside the company and not with what is seen inside the company and by their employees. External communication seems to be more important than internal communication.

When referring back to the distinction between *contractual* stakeholders who have some legal relationship with the company, and *community* stakeholders whose relationship with the business is more diffuse but nonetheless real in its impact, it can be seen that stakeholders from both groups were equally mentioned as the most important. Contractual stakeholders such as customers and suppliers were even considered as relevant negotiation partners when discussing the company's long-term plans. Media and the political elite were also named as important and relevant stakeholders, who can visibly influence the company's activities.

From the results we may conclude that although there is plenty of room for improvement, at least those Estonian business leaders who took part in our research are becoming increasingly aware of the idea of stakeholder thinking, and are starting to pay more attention to different stakeholder groups and relations with those groups. Although the results can not be generalised for the entire Estonian business community, the views of these business leaders, owners and managers are relevant in order to better understand this particular context and the impact of the changes taken place here in the last decade. These changes can be considered positive progress, and an increasing number of business leaders acknowledge that businesses are only a subset of wider environments –– society and the environment –– and in order to be successful and sustainable in one's activities, it is essential to consider the interests and needs of various stakeholder groups.

Conclusion

Corporate governance can be defined as a set of relations between a company's board, its shareholders and other stakeholders, providing the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Corporate governance is seen as an essential mechanism to help the company attain its corporate objectives, and this includes the corporation's responsibilities towards its different stakeholders. It looks at the institutional and policy framework for corporations –– from their very beginnings as entrepreneurship, through their governance structures, company law, privatisation, all the way to market exit and insolvency. The integrity of corporations, financial institutions and markets is particularly central to the health of our economies and their stability.

Corporate governance has implications for company behaviour towards employees, shareholders, customers and banks. Good corporate governance plays a vital role in underpinning the integrity and efficiency of financial markets. Poor corporate governance weakens a company's potential and at worst can pave the way for financial difficulties and even fraud. If companies are well governed, they will usually outperform other companies and will be able to attract investors whose support can help to finance further growth.
Meeting social and economic goals requires a transformation of organizational governance and decision-making processes to include more decisional voices representing social and economic values and generating the explicit contest of values as part of the business decision process. Such representation and contest can enhance creativity, productivity, economic performance and the greater fulfilment of social good. Accomplishing this requires new models of corporate governance focusing on stakeholders rather than shareholders and new models of communication enabling more productive discussions and decision processes.

Business creates value not only for itself but also for society, but society and the businesses in it cannot develop without the well-being and development of the entire environment. The environment in the broadest sense refers to our planet, and in a narrower sense our local community.
In today's business environment, management cannot deny its obligations to its stakeholders. One cannot operate without the other. The stakeholder concept suggests that the managers of businesses should take into account their responsibilities to different groups when making decisions and by doing so, businesses can benefit significantly from cooperating with stakeholder groups, and incorporating their needs in the decision-making process. Stakeholder theory is considered to be something of an alternative to government regulation and it is suggested that through stakeholder pressure, corporations will implement concerns related to product safety, truth in advertising, workplace safety and environmental problems. Therefore, in theory, a business should take into consideration all the different stakeholders it influences and set up a two-way communication with them. However, as in practice it is often difficult if not impossible to give the same amount of attention to all stakeholder groups.

This paper shows how corporate relations, stakeholders and the consideration of stakeholders' interests and needs are perceived in a rapidly developing former post-socialist and now EU member state, Estonia. The results show that the situation in Estonia is clearly different from the US and Western Europe, as capitalism has existed here only briefly and people aren't really yet used to running their own businesses, and are even less prepared to share their profits with others. The 'modern' business environment in Estonia is very young, only about 15 years old, and companies are still learning new methods and new approaches. Recent rapid development has also been one reason why issues like stakeholder interests and corporate relations and responsibilities in business have seemed less important. The overall perception is that the company's main goal is to earn profit; it can do something for the society and environment as well, but only when it is really necessary and when it is profitable. Although the situation has improved, being cut off from the Western world without self-determination, partially explains why our people still want to get rich quickly without considering the means, and this has an impact on all business activities.

It can be said however, that such attitudes among business leaders have changed in recent times, and they have changed due to changes in the environment leading to businesses and business leaders having different needs. As we have passed through different developmental stages from the period of socialist erosion to rough entrepreneurial capitalism, from the boom period to the current more stable business climate, the views of corporate managers and requirements of top managers have changed. However, it is obvious that economic concerns are still considered most important, and to many business representatives economic and legal responsibilities are the only ones companies have to care about.

I would like to conclude on a positive note. Improvements and positive developments have emerged, and the number of business leaders who see their companies as part of the wider society and environment, and who recognise that in order to be successful and sustainable they must consider the interests and needs of different stakeholders will probably continue to increase substantially in the coming years.

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APPENDICE

IV Environmental Level
Considering the interests of society, corporate social responsibility and stakeholders.

1. How do the owners/managers understand their responsibilities in society – Is their "business" to make a profit and increase the company's value, or should they also contribute to the development of society? Have there been any changes in the period 1995-2004 and are local and internationally owned companies different?

2. Do the corporations participate in Trade Unions (entrepreneurs and professions)? i.e. have they an idea of their interests in a wider plan? Are there any differences between local and foreign companies in the period of 1995-2004?

3. Can you see changes in the attitude towards the State? The state as a) regulator (law) b) developer/helper (i.e. supportive export and innovation politics) c) subscriber/customer

4. What is the attitude towards Trade Unions? Does the management board have to have members from unions?

5. How much do corporations actually take part in charitable/patron projects?

6. How much do corporations use sponsorship?

7. Are there actual budgets for charity and sponsorship? At which level are decisions made – management board/council?

8. How do you decide what projects to take part in?

Stakeholders

9. From the following list pick out the 4 stakeholders groups that you consider the most important and point out if consideration of them has increased or decreased
    - employees (except the managers)
    - clients
    - suppliers
    - banks
    - local authorities (town/county)
    - top politicians (state)
    - Estonian political elite
    - social pressure groups (Greens etc)
    - media, public opinion
    - other persons with some contact with the company (personal acquaintances, friends) you want to favour

10. Can you see a difference between the people that are more important for the owners and for the managers? Are there differences between local and foreign companies?

11. How are the stakeholder groups considered? What are corporations doing in addition to what they do to make a profit?

Relationships with banks

12. How important are the relationships with banks nowadays – is it that if you have a good relationship you'll get a loan even if your balance sheet and profit loss account isn't that acceptable?

Separation of Functions and Profession Related Arrangements between Owners and Managers in Estonia

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Introduction

Corporate governance is the relationship between various participants which determines the direction and performance of corporations. The primary participants are the shareholders, the management, the supervisory board, and other corporate stakeholders. The two questions that form the core of corporate governance issues are: (1) who benefits from corporate decisions/senior management actions, and (2) who should benefit from corporate decisions/senior management actions? When an inconsistency arises between "what is" and "what ought to be," then a corporate governance issue exists. In this article the author presents some conclusions that could be drawn from an empirical study conducted in relation to these issues.

Generally corporate governance is a vague term with many definitions. For some people, corporate governance is about "the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated" (Blair, 1995, p.95). In the current article, the author narrows the focus of governance to "the relationship between various participants [chief executive officer, management, shareholders, and employees] in determining the direction and performance of corporations" (Monks and Minow, 1995), specifically the relationship between owners and managers.

The subject of corporate governance has attracted increasing attention on both sides of the Atlantic during the last decade, for good reasons. Every country wants the firms that operate within its borders to flourish and grow in such a way as to provide employment, wealth and satisfaction, in order not only to improve material standards of living, but also to enhance social cohesion. These aspirations cannot be met unless those firms are competitive internationally in a sustainable way, and it is this medium- and long-term perspective that makes good corporate governance so vital.

A system that is flexible and responsive is also a system that is subject to abuses. The first and most important line of defence against abuses must be effective and responsible boards of directors or supervisory boards. Each firm is engaged in a unique and complex balancing act trying to encourage and reward innovation and wealth creation, to satisfy the providers of capital, and to discourage waste and empire building. Only management and directors who understand the business intimately, who are willing to devote the time and energy necessary, and who are properly motivated can be expected to accomplish this balancing act.

According to a study conducted by Gerndorf, Elenurm and Terk in 1999, the daily practice of corporate governance in Estonia was often influenced by conflicts between shareholders, the supervisory board and management. There have been situations where management have engaged in illegal activities, and by doing so caused serious damage to their corporations and in extreme cases even forced their company into bankruptcy. A trend of conflicts between large and small shareholders has also been identified (Gerndorf, Elenurm and Terk, 1999, p.11).

Thus far, however, not enough relationships between shareholders, supervisory boards and managers in Estonia have been investigated, and therefore we cannot conclude how these relationships are with any real certainty. If we know these relationships we can find solutions to certain practical problems which may occur on a day to day basis in corporate governance issues.

With all this in mind, the author here presents a short overview of the relationships between shareholders and management in Estonia. My study is partly based on my personal master's study on methodology elaboration for corporate governance research in Estonia (Vaks, 2002), where I did research into different questions regarding the corporate governance issues which often arise, including management accountability practices and the experience of different countries. With these results I could form different questions in order to address and research the subject, using international research findings, especially those regarding accountability issues and the interaction between different boards, management and supervisory. I also used an empirical study conducted together by the Estonian Institute of Futures Studies, Tallinn University of Technology and Estonian Business School in autumn 2004. The author took part in this preliminary study in which 26 people were interviewed, who had a view and experience of the issues in hand. The goal of that study was to get an overview and an understanding of the issues that influence corporate governance in Estonia. It also aimed to establish which problems or issues dominate, which are semi-present, which are periphery, and which are absent, when compared to both previously conducted and foreign theoretical studies.

Theoretical Principles

The theoretical approach to ownership and control emerges from the modern corporation, a term coined by Berle and Means which refers to a limited liability company where management is separated from ownership and corporate control falls into the hands of the managers. This separation of ownership and management, and the loss of direct owner control and involvement in the firm, posed a major political problem for the country as it moved from an economy dominated by agriculture and small locally- and family-owned businesses, to an industrially based economy with very large firms, and an increasing concentration of wealth in the hands of a few. They presented their findings in the book "The Modern Corporation and Private Property" (Tricker 1994, p.11).

The problem was that managers and insider control groups could serve their own personal interests in the corporation without benefiting the public shareholders and society. Managers, instead of managing the firm in the best interests of society, might manage the firm in their own interests, or in the interests of an oligarchy. By the beginning of the 20th Century the professional manager as such emerged, and the stock exchange was created. This period is also referred to as the start of financial capitalism (Chew 1997, p.281).
Consequently, what Berle and Means sought were ways to subordinate managerial private interests to the public good. Two approaches emerged, a trustee structure and a contracting structure.

Controlling Managers

The trustee solution defined managers as legal trustees for the shareholders' property. Under this structure, managers would be held legally accountable in the courts for the waste and misappropriation of the owners' property. However, who was to say that the courts had the technical competence to monitor managers, or that those judicial officials would be any less self-seeking than the managers themselves? And why should the managers of the corporation be anointed as the trustees? Why not the workers or members of the wider community? The contracting solution, rather than relying on the courts as did the trustee solution, relied on market mechanisms and the counterbalancing self-interest of the firm's stakeholders. In this structure, corporate managers negotiated and administered contracts with the corporation's customers, suppliers, employees, creditors, and the shareholders. The shareholders would receive what remained after all the other stakeholders had received their due; hence, the characterisation of the shareholders as residual risk bearers and residual claimants. The self-seeking and opportunistic behaviour of all but the residual risk bearers would be held in check by managers, who were responsible for carrying out their contract written with the residual risk bearers (the owners) as well as with the other stakeholders. Managers would be motivated to write the best contracts they could with the workers, suppliers, customers, and other managers because it was in the managers' self-interest. If they didn't, they would be replaced by the owners who sought to maximise the present value of the residual cash flows coming to them. The present value of these residual cash flows is another (technical) name for the stock price of the company.

Financial Agency Theory

Ultimately, this contractual approach evolved into modern day financial agency theory, the framework we use for exploring the implications of corporate governance for managers. The key to understanding financial agency theory is to view the firm as a nexus of contracts among individuals where the explicit and implicit contracts control everyone's self-interest. In particular, financial agency theory is primarily concerned with the contracts that suppliers of capital write with each other and with managers; hence, the focus of financial agency theory is on managerial performance contracts, security indentures, financial reporting, and governance rules for electing and controlling boards of directors.

More generally, financial agency theory describes a governance system where the firm is prevented from growing beyond an economically efficient size by the shareholders. The role of the shareholders is to monitor the performance of management to ensure managers are acting in the shareholders' best interests, interests that are equated with economic efficiency at the societal level. Ultimately, the shareholders evaluate managerial performance by looking at the present value of the residual claims on the firm – otherwise known as the market value of the firm's common stock, or stock price for short.

Management Accountability to Shareholders

Corporate governance means accountability, and good corporate governance helps to ensure that top management uses the capital they have control over effectively. An effective governance regime also helps to establish boundaries, such that corporations should consider stakeholders interests and their supervisory boards and management boards be accountable to society and shareholders. Such an approach and a state of mind offers both local and foreign investors assurance, and attracts more patient and long-term capital (OECD, 1999). In Estonia there is still a lack of the required respect and awareness towards society. Currently it is considered good practice if even only shareholder interests are taken seriously.

Corporate activity involves different parties interacting on a day to day basis, employees and stakeholders, and the relationships between them. Internal questions involve who controls what information and how between the different counterparts; who makes what kind of decisions and who has what level of responsibility for the enterprise's sales and assets. These questions influence not only the wealth distribution generated from daily activities, but also the material interests that all parties have in the enterprise in terms of making decisions about how to invest and again boost the wealth creation processes. Rules and regulations implemented to regulate these questions are a directly issue and purpose of corporate governance. Most importantly, the concern is that the power and resources needed to conduct the activities that help to create value and additional wealth be at the disposal of those people who best have the ability and material interests to use them in a wealth-creating manner. Regulations must assure that agents who use, and have the opportunity to use, resources be accountable towards other parties who have stakes of interests in that use (Ward, 1997, p.208).

The corporate governance framework is dependent on the legal, regulatory and institutional environment. In Estonia corporate governance issues are dealt with by Corporate Law (*Äriseadustik*), which lays out certain conditions and rights for shareholders, the supervisory board and management. In Corporate Law the governance structure and certain responsibilities are identified (for example, management must arrange company's book-keeping). At the same time quite a lot of space is left so that certain functions and their executors can be written into statutes or regulated with other legal documents. Therefore there can be quite significant differences in corporate governance practices. The author believes that a more general and united practice could be applied through use of the guidelines issued by the Organisation of Economic Co-operation and Development (OECD) on corporate governance good practice.

In Estonian Corporate Law there is also a particular corporate governance structure, which is generally called the two-tier board. We have two separate boards, the supervisory board and the management board. Members of the supervisory board cannot serve at the same time on the management board, and vice versa.

Effective accountability is important due to the separation of ownership and control. Shareholders own only shares and the rights stemming from these. Thus the shareholder has the exclusive control of the stock itself. But as a condition of the shareholder's limited liability, the shareholder gives up the right to control the use by others of the corporation's property. That right is delegated to the management of the corporation. Indeed, it is one of the benefits of the corporate organisation to the investor; he can entrust his money to people who have expertise and time that he does not. It is however also one of the drawbacks. Thus, it is this separation between ownership and control that has been the focus of the struggles over corporate governance (Monks and Minow, 1996, p.93).

The owners are not a homogeneous group. They include fragmented public shareholders, large private block holders, private and public institutional investors, company employees and managers, and other firms. If there are a lot of shareholders with different opinions and agendas, then the actual control and use of corporate resources and infrastructure lies in the hands of paid management. They have the actual power in the company. The problem briefly described here is also called the Berle and Means hypothesis.

Research Methodology

The following research results and analysis are based on the empirical corporate governance research program conducted by group of Estonian researchers (including the author of the article) in 2004/2005. Interviews were the preferred research methodology for gathering empirical data.

For the interviews, a standardised questionnaire was prepared by the research group. The questionnaire was divided into four parts. These were named capital, corporate, interaction between capital and corporation, and environmental. About the methodology of the research see the article by K. Tafel, E. Terk and A. Purju in the current volume. The research and findings of the current paper are based on the first three of these; the fourth, environmental, dealt with relationships and accountability between different stakeholders and their role in the company's overall development.

The people chosen to be interviewed were individuals who have experienced and have been actively engaged in business, and who have been involved or should have been involved in issues of corporate governance. People who have observed the issues from different perspectives and who have an ability to generalise were also chosen. The ideal person to interview would have been a shareholder or owner who has also been a manager. It was also necessary to keep in mind the balance between the experiences of local and foreign companies, and between people with experience of large and small enterprises. Altogether 26 people were interviewed.

Interconnections between Owners and Managers

The theme of the empirical study of the relationship between owners and managers was narrowed to establish what is expected from managers. Focus was also drawn to the questions which relate to issues such as what owners regulate and directly influence and what they do not; what guidelines owners "give" to managers and what managers are accountable for. The empirical study, and more specifically the question "What kind of measurable ratios and rules of engagement are set and where, and in what kind of document, if at all, they are set? Were there any changes during the periods 1995 to 2000 and 2000 to 2004 and are there any differences between local and foreign companies?" show that relationships between owners and management, and issues of management accountability to owners in terms of content (what kind of financial targets are set or what rules of business are implemented) depend on the following:

- Shareholder strategy – what are their expectations towards the company? Are growth, diversification or similar expected? From this, different tasks, targets and valuation terms or bars emerge. According to the study, valuation terms are mainly implemented by relying on the previous fiscal year's performance (income statement and balance sheet);

- Shareholder type – are they actively involved in the company's day-to-day activities, are they long- or short-term shareholders. If the shareholders are actively involved, management gets clearer targets and evaluation indicators. If we have short-term shareholders then the targets and evaluation indicators are also oriented to short-term gain, but with long term investors the targets and indicators set are those which can be measured in a longer perspective.

Additionally, research revealed that in a clear majority of cases, agreed daily rules for engagements are set within various limits, such as how large an amount transferred can be without additional approval, what the maximum value of a contract that can be signed is etc. In other words, the independence of the manager is related to the limits granted to him or her.

According to a majority of participants in the research, the specific tactical steps or activities to be taken in order to achieve the targets set by the shareholders are generally not specified; in that respect management has a free hand in its daily activities. There may be exceptions, and there usually are when we deal with a foreign company's subsidiary. Then it is important to keep in mind corporate policies while choosing the tactics with which to achieve the right results. The framework for activity is based on general business ethics principles, which make it rather subjective. Therefore it is dependent on management members "upbringing" and assumptions of the values which they respect. On the other hand, based on the research again, it is fair to assume that these aspects have been considered during nominations to the management.

There is a separate issue related to the separation of the functions of managers and owners (or their representatives), which is related to long term strategy deployment. According to Elenurm, Terk and Andersoo (2006), a clear majority of the managers and owners interviewed would want to have co-operation in this matter regulated in some way. We can, however, distinguish some differences in opinions as to how strong and influential the two parties' activities in this procedure should be, and how to arrange this co-operation. Whereas, the majority of top managers feel that corporate strategy as such, or a particular strategic solution, should come from the management team, i.e. a strategy draft from them not the owner, a majority of the owners interviewed stressed that the distinctions between these roles depended on the situation in hand. Distinction between roles may vary according to shareholder type or according the stage of the project (beginning or normal functioning) etc. Equally, it can be that strategy comes from the owner, and management or the manager is only responsible for fine tuning it and implementing it.

According to the study by Kevin Hendry and Geoffrey C. Kiel there is little consensus on the behavioural dynamics of boards and on how they impact on the development and execution of company strategy.

Indicators for Performance Evaluation

There is no one rule as to what and how many indicators are set or rules engaged and agreed. In some cases those interviewed stated that the fewer indicators and rules are set, the better. Moreover, discussions should be related to guidelines, paths and visions. From another perspective though, the research reveals quite a lot of precise indicators which are set to measure management's performance and used as the basis on which accountability issues are discussed and addressed.

Quite heavy reliance is placed on financial results and ratios, and as a trend this reliance has increased during the period being observed. The following indicators were identified by those interviewed: net profit, profit growth, profit before taxes, profit ratio to investments, net profitability, cash flow, turnover, net profit to sales etc. Depending on the company there were also industry or company specific ratios.

The study also revealed that indicators have become more numeric than before (during the period 1995 to 2000). In a couple of interviews concern was shown that this has decreased the "human touch" and efforts should be made to turn this around somewhat. The timeframe for evaluation and achievement of these indicators was usually between one and three years.

Among these specific indicators, accountability was measured as follows: number of clients; market share – for example, after two years we need to have market share of 25-30%l; growth rates compared to the previous year; employee expenses. Additionally, some indicators that relate to staff development and succession plans.

There were differences between the indicators but the most common were profit, market share and investments. For companies with foreign capital it was mostly ROI and EBITA, for local companies it was mainly just better results and profit than in the previous year. From the manager's side it was argued that the number of such indicators should not be very large. There were cases where there was too many indicators to follow but also some cases with the opposite problem. In some cases a need was identified for a fixed line for where a manager can decide how to act and use funds.

It was interesting to note from this research that generally these indicators are not written into employment contracts. One variant was to mention them on certain scorecards.

According to one owner interviewed: "All kinds of arrays of numbers that managers report, have significantly increased and therefore meetings between the supervisory board and management have become more constructive. Small talk has been decreasing and maybe some of the human aspect has suffered because of that. In meetings there are a great many graphics, and numbers and business issues get very detailed attention, and then when it is asked if there are any questions, then no one has any, because everything has already been dealt with."

Also it turned out, according to a minority of managers, that there are contradictory and impossible-to-reach targets. In some cases this means that reaching one target makes it impossible to reach another. In such cases managers have also addressed these issues to the shareholders to discuss and have asked them to try to agree on priorities or make a choice.

There were differences between local and foreign companies as well. In one sense it turns out that local capital is more flexible, as managers are left with more authority. At the same time, the shareholder has also left himself a larger right to influence and get involved in the daily business. In companies with foreign capital, top management's ability to make decisions is more limited and regulated by different corporate policies; then again, the space which is left to them is totally under their control. Regardless of the origin of capital (local or foreign), research shows that in both cases the movement is towards more regulation of activities.

A need was identified for clear differentiation between "what to achieve" and "how to achieve". According to the empirical results and the managers' opinions, the latter should be left to them to decide.

As pointed out before, according to research, certain easily measurable targets or numbers or ratios etc. are not written into employment contracts. Despite this serious discussions are still held about targets and the form of reporting. These may be fixed in a separate written document. Rights, obligations and rules are written very briefly and generally (how and what is expected) in management boards' contract terms. There is an argument that with top management you cannot be detailed. According to the study of shareholders, top managers differ from second level managers as to how detailed the job descriptions are, if they even exist at all. For top managers it is their duty to work out how they should achieve the results and what activities they should engage in. As one interviewed owner put it: "It is the top manager's task to run the company in the best possible way. What is the best way is his responsibility to figure out, and if he can't, then what happens next to him is quite clear". Middle management can still rely on specific detailed rules and guidance. There is one further exception, in that it depends whether the top manager is chairman of the management board or chief operating officer. For chief operating officers job descriptions with fairly detailed duties can exist.

Contracts with Managers

As for management contracts, there is a clear tendency for them to tend to get more detailed and longer over time. Contracts with foreign companies were especially detailed. The comments related to contracts varied widely. To sum up this general tendency, one manager said: "In 1988, a contract that was 10 sentences was considered the real thing. Today the simplest contracts are at least twenty pages or so without annexes; if you add these you get another twenty".

The question asked was how detailed the contract signed with the manager is. How specifically are duties, tasks and sanctions for non-fulfilment of tasks described as opposed to a gentlemen's contract of good faith?

According to a majority of those interviewed during the research, how detailed a manager's employment contract is depends on the person's personality. The level of detail in a contract was directly dependent on the relationship between the shareholder(s) and the manager, and the trust between them. In cases where there is not sufficient trust, or it is felt that there is not sufficient, then managers tend to request a very detailed contract. Shareholders then tend not to agree on details at all. The research also showed that another disadvantage of not having a detailed agreement from the manager's point of view, is the lack of sufficient data for judging the manager if things have turned out well or according to expectations. The level of detail also depends on the size and age of the company. The bigger or older the company the more detailed and more traditional the contract is. And foreign companies tend to sign more detailed contracts than local ones. This seems very logical according to the findings of this research.

Looking at the findings of the research, we can see two main reasons why detailed contracts are appreciated by managers. First it fixes possible bonuses in writing. Most of those interviewed would argue that their experience suggests that gentlemen's agreements tend not to hold when results turn out to be considerably better than expected. It was considered the owner's natural reaction that firstly, it is a shame to pay, and secondly there is a general understanding that "we can get along and get good results anyway, without paying heavy bonuses".

The second reason why a detailed contract is appreciated by managers is related to the termination clauses of the employment relationship. It turned out from research that specific written terms of termination are not believed, which does not mean that it makes no sense to write them down. In principle it is possible to terminate a contract with only one day of notice (although it is another question how often this really takes place); this is also related to the contract's principles. If there is either significant mistrust between shareholders and management or a different approach and understanding of business and strategy, generally managers can protect themselves somewhat with a contract, although eventually it is managers who leave, not shareholders. The general feeling from the managers interviewed was that you cannot save yourself with any contract. The risk of the management's contract being terminated very fast and easily is balanced by compensations – this was the main point with which managers could trade themselves a decent contract. The general understanding among managers was that it was better not to take a position offered than to gamble with an unsuitable or insufficient contract.

The study also revealed that we cannot draw any particular conclusion about the manager's confidence about termination of employment or fear of it. Confidence was mainly directly influenced by personal practice in this matter.

Theoretical principles about contracts with managers are often an issue in corporate governance. The problem is how to minimise so-called opportunism in manager's activity, the possible tendency to prefer, for example, low risk and therefore achievable results – which support his continuing in his position in future – rather than choosing a strategy that would maximise shareholders profit. Some authors consider a contract which protects managers from situational interference and the termination of employment during execution of what is, in their minds, a correct and successful approach and strategy in business as essential to solving this problem. The assumption behind it is that security of employment should increase a manager's interest in long-term positive cash flow (Jing Zhao). The compensation system should also support it. On the other hand there is the understanding that such contracts might easily cause entrenchment. Managers might secure themselves in such a way that it is very difficult to terminate their contract even if there is clear reasoning behind it. Therefore it should be possible to redo contracts, but there is no clear answers as to how this should happen etc.. Therefore issues with contracts definitely need further empirical investigation; what they look like, what is expected, how it is evaluated etc.

To conclude, most of those interviewed had no fixed opinion about contracts with managers. At the end of the day what matters most is still the relationships between managers and owners, not a formal agreement.

Owners Interference in Daily Activities

In terms of issues of daily influence, the question in the survey was how and by what means the supervisory board intervenes in company management and daily activities.

Supervisory boards' – as representatives of owners or, in most local companies cases, the owners themselves – influence on daily activities showed as follows: when comparing local and foreign companies there was a general consensus between those interviewed that in local companies the supervisory board interacts with or influences daily management more often than in foreign companies. The main reason for this for the majority of foreign companies' boards is very obvious and simple – foreign companies' supervisory boards are geographically more distant. The supervisory board holds their meetings once in each calendar quarter, reviews the numbers etc. and does not interact in daily business activities. Furthermore, foreign shareholders are used to a different kind of business culture, and their roles have been determined over time. There are still some cases of foreign activity in daily business and in management affairs, but this is done differently from how it is in firms with local capital. Mainly it is done by sending the foreign company's own consultants to do some share of the work or project. An overview is then gained from this consultant who acts partly as an agent. To illustrate this with practical experience from one local manager: "The foreign owner does not want to influence local activity in building a mill, but he says how this is done in his own country. And then he says that he knows one engineer whose name is Mr.X and he now arrives with a daily allowance for this and that and he knows very well how to build a mill".

It was pointed out that generally during the timeframe researched the job of the supervisory board has developed a lot in a positive direction, in respect of both meetings culture and set-up (it used to be too fragmented and it was not always clear what was decided). In particular, reporting culture has improved significantly. It is now continuously clear what issues are being addressed and reported, so owners now have a much better overview of daily business.

It is also important to note that in most cases with foreign companies' supervisory boards there were no owners but only the paid managers of the foreign parent company – the legal owner of local subsidiary. So the interaction was held in the vast majority of cases with another manager.

For the supervisory board of a company with local capital, the temptation to check up on management activities is bigger due to the geographical closeness. One interesting thing was that local shareholders were more willing to get actively involved in daily business if they were the type of shareholder who had got their wealth relatively recently. One answer from a person interviewed was that shareholders who have experienced a couple of years of success in business consider that these businesses have been successful just because: a) it was they who got them up and running; b) they still continue to be actively involved in these businesses daily activities.

Generally the vast majority of those interviewed consider active influence on and interaction in daily business by the supervisory board is a negative thing. The reasoning behind this lies in the belief that a combined parallel or double management is bad and is not in the interests of a company's ability to perform. It raises questions as to who should have the final say in what situations. This may lead to insufficient flexibility to react to market trends.

The general tendency in terms of active involvement is hard to establish by research timeframes, but the general tendency is still towards less involvement by the supervisory board in day-to-day management. Still, I would like to point out that for foreign companies there is a tendency to implement more formal rules than before.

As a separate issue, it turned out from the research that members of the supervisory board sometimes influence company's daily activities by lobbying. And this is in a positive sense. Members of the supervisory board use their contacts for the interests of company. If this activity is part of real value creation then it is beneficial. If it is more or less related to different kinds of corruption, then it certainly shall not help the company in the long-term. In the experience of the companies involved in the research, this influence can be quite significant.

According to agency theory there are agency costs involved; these are the costs shareholders need to bear in order to monitor and control management activity. In addition to these alternative costs should be considered which arise from fact that very thorough monitoring and controlling of management activity may be more expensive than the result gained from it. To summarise this part of the study in respect of this paper we can quote one interviewed shareholder's comment on this problem: "if we have hired a capable top manager and are paying him a decent salary, then why the hell should I jump in there all the time".

Conclusion

The Western-European understanding is that the goal of good corporate governance should be to maximise a company's ability, as a whole, to create value. This is more than just a shareholder's standpoint on value maximisation (Demb and Neubauer, 1992, p.21). To reach that goal it is important that stakeholders understand their role in governance and strive for that goal via co-operation. The base of this co-operation can be clearly agreed rules of engagement which are closely monitored while the daily practice of corporate governance is developing.

A legal framework for corporate governance, allegedly meeting the international requirements, has been developed in Estonia during the years since the restoration of independence. Due to the liberal economic policy and openness, the current legislation with its low level of regulation frequently gives advantages to majority shareholders. In order to avoid machinations and manipulations, the legislation needs to be improved, especially where it concerns the protection of small shareholders and the governance groups.

In Estonia corporate the governance problem and related issues are not as evolved as in Western-Europe, as our companies are rather young and they do not have so many different shareholders. And if they do, there is still some controlling shareholder or shareholder group.

There are number of problems with ethics and business culture in the area of implementation of the laws. This concerns not only the Estonian owners and managers, but also a significant share of the foreign investors. Certain problems are also connected to the training of the owners and managers. Board members do not have any special education in order to do their job. Looking at other studies it is clear that the world recognises this problem too. There are ideas around on the certification of board members. A professional member should have a very good academic background and long experience, and there are also many more aspects that form the professional board member.

To conclude a partial overview of the study, it is fair to say that management's accountability to shareholders in Estonia is mostly agreed in both content and form. Both shareholders and managers consider this normal; and leaving aside some exceptions, they also act according to this agreement and worldwide corporate governance practice. Still, it is important to outline that this was a qualitative study with a limited number of participants, and therefore we cannot present final quantitative conclusions about these issues. The main findings regarding Estonian practice in the empirical study were concerned how organisational culture looks from the corporate governance point of view.

We can also conclude that, within the timeframe used to describe the tendencies that occur in the relationships and interactions between owners and managers, there is now a trend in Estonia too towards professional managers and less daily influence from owners. Owners are withdrawing from daily activities and giving day-to-day operations over to paid managers who they trust to know better than them how to develop a business. A study conducted in the first quarter of the twentieth century by Berle and Means, which shows the same trend in America, leads us to the assumption that in this process we are behind by around seventy years. In that respect their findings are similar to ours. This may very well play out in our favour – if we are intelligent enough to use the experience gained from this period, and we manage to use best practice.

Following that assumption we have relatively young owners who withdraw themselves from daily business activity. For further research it would be interesting to find out whether we face the issue of burn-out, and whether we are able to capture the experience of the western world and use it wisely; can we really make use of that knowledge, or are our managers and owners too busy to have time to investigate best practices? Or will they act differently from their counterparts in the western world years before – mainly because of their age difference and the practical experience gained by that age?

It would be fair to assume that managers would not have enough time to study different practices. What may help Estonian managers and owners would be, for example, to make a very brief summary of one or two pages of this study with the main findings and declarations. Perhaps with keywords – this is current practice, best practice according to the study's findings on performance or success, and remarks on the world's experience or practice or exemptions on same issue. This leaflet could then serve as a tool for using or avoiding best or worst practices in dealings and interactions between managers and owners (or owner's representatives).

Using the information gathered in this study, the author would like to address the issues of greatest interest and concern in Estonia, and to author and prepare a questionnaire that could be used over time to get comparable information; and by getting that information make assumptions and proposals in order to determine best corporate governance practice for Estonia in the value creation process.

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Between "Internal" and "External" Worlds –– The Influence of the Owner on Intra - Organizational Relations and on Managerial Activities in Particular

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Introduction

The role of top managers and their relations with their staff are spheres attracting a lot of interest and are discussed in numerous articles. Despite varied and frequent treatment of this theme, the authors find that some aspects still do not attract sufficient attention. The authors argue that the management and organizational literature mainly stays within the internal context of the organization. In this article, the authors wish to point out that treatment of managers and their role within the framework of the internal context of the organization still neglects one level – the governance level. Although the governance level does not directly belong to the organization, it does have (quite a significant) effect on the events within the organization. Resulting from the latter point, the authors attribute considerable significance to the influence of the individuals at that level – the owners – on developments in the organization.

This article takes the novel approach of introducing the owner as a new significant actor into the analysis of intra-organizational relations. That is, the article does not limit itself merely to observations of "manager-subordinate" and "manager-intra-organizational relations", but expands the system under observation by introducing the owner as an important actor. This article accordingly concentrates primarily on aspects that demonstrate that top manager-employee relations are not determined solely by these two parties, but that there is another significant party that has a more or less direct effect on manager-employee relations and also defines the repertoire of the top manager's role. This article uses the theoretical treatment of corporate governance as a framework, and via various sub-treatments, analyses how and on which bases owner-manager relations operate and how the role of the top manager accordingly develops and may further develop.

The significant aspect here is that, with the introduction of the owner level, the analysis of top managers (their position, role, etc.) does not begin from the top managers themselves (the analysis of relations between top managers and subordinates in the hierarchy), but top managers become an intermediate link between the owners and the employees. In other words: besides the top manager as a decision-maker as treated by the majority of works on management and organization, the owners play an important role as decision-makers, and their decisions and actions have an influence on the top manager and the kinds of decisions the manager can make.

In this article, the authors use the results from an empirical study undertaken by Estonian Business School and the Estonian Institute for Futures Studies in 2004 to analyse the development of owner-top manager relations in the opinion of top managers and owners in Estonia. While using the example of Estonia in this analysis of the potential influence of owners on top managers and their role, several factors support the use of Estonia as an example. On the one hand it is significant to point out that Estonia is predominantly characterised by core owners and the absence of the classical small shareholder. On the other, in Estonia's context we can predominantly discuss small and medium-size enterprises, with specific emphasis concerning small enterprises. Both factors point out that in such cases the owners play quite a significant role in the enterprise.

Intra-Organizational Role of Top Managers: Theoretical Background and Problems

On the Treatment of Top Managers

The study of the manager's job has shown that there are a large number of different (and emerging from various bases) roles (Mintzberg, 1973; Mintzberg, 1989). Some of them are related to intra-organizational activities, some mostly to the external environment, while some straddle the border between these two areas. The manager's task to profitably employ labour is not possible in the environment of a developed economy without leadership, the motivation of the staff, the development of organizational culture and intra-organizational relations (including informal ones). These are the issues that the behavioural treatment of management – organizational behaviour – concentrates on.

The efforts of behavioural scientists initially displayed an attempt to develop, if not completely universal (best) models of activity, then at least those considering the peculiarities of the human contingent working in an organisation. The domination of the so-called contingency approach (see e.g. Lorsch, Morse, 1974) in organisational and management theories heralded the recognition that an organisation's internal characteristics should meet the employees' premises as well as outward conditions. The question of which type an organisation should be so as to succeed in various economic and market conditions became paramount (Lawrence, Lorsch, 1967).

Adjusting the organisation to the requirements of a constantly changing environment was seen as the task of the firm's management – above all that of the manager. The owner was and is viewed as an actor distanced from the organisation and its evolution. Authors like Warner and Witzel (1997), who invite us to rethink relationships between the general manager, the functional managers and the workers and also between the firm and its owner/s, are a clear minority.

Expanding the Scope of the Approach – Top Manager as Intermediary Link

The authors hold the view that the literature on organizations and management continues to concentrate predominantly on relations concerning top managers and employees; the chain of relations upward from the top manager – more precisely the chain of relations between the managers and the owners – has been paid too little attention. The concentration on the manager (and ignoring the owners) is vividly described by Mizruchi (1983, p. 426), who argues that it is generally believed within organizational theory and business management literature that although boards have formal power over management, management [in case of the system of US] in fact dominates the board. Citing Leonard (1969, p. 5): "*The answer to the question "Who's in Charge?" is unmistakable. It is "management"*.

The position of the authors of this article is, however, that the opportunities of the top manager and management to shape intra-organizational relations, to conform them to the dynamics of the outward environment, are limited. We raise a hypothesis that this influence could be significant and its "transfer mechanisms" could vary. The traditional paradigm of organisational and management theory is not sufficient for the study of these influences. A broader framework is required and such a framework is provided by corporate governance theory.

The issue of corporate governance, especially within the last decade, has continuously been attracting more attention. This has brought an 'additional' group of actors, which are concerned with the organization – the owners – into focus.

Hendry & Kiel (2004, p. 500) argue that recent media attention highlights more than ever that boards of directors are being held accountable for the organizations they govern.

Issuing from the context of corporate governance, it is possible to treat the organizational issues in a wider framework. This means that the level of governance, which influences the organization, but exists outside the organization's internal environment, is also included (See figure 1).

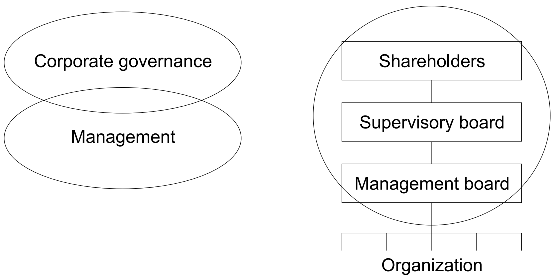

Figure 1. The Content and Overlap of the Terms of Corporate Governance and Management
Source: Gerndorf, K. (1998) 'Corporate Governance', manuscript, Tallinn: Tallinn University of Technology

As can be seen in Figure 2, corporate governance leaves the narrow framework of management and organization and brings a new level as well as new parties, which do not directly belong to the organization, but nevertheless (and quite significantly) influence the activities of the organization.

The inclusion of the CG concept will provide an opportunity to extend the treatment of the top manager's role. The theoretical framework for the current study is formulated as follows (see Figure 2):

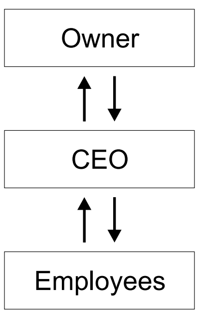

Figure 2. The Theoretical Framework for the Study

In this article the authors argue that owners play a very significant role in the development of internal relations within an organization. To quote, in addition to Leonard (see p. 3), Freeman (1984, p. 9), who refers to an important change that occurred as early as the 1960s: "the Wall Street Rule, 'If you don't like the management, sell the stock,' was turned to 'If you don't like the management, buy enough stock to throw the bums out'".

As a result of corporate governance theory we can treat the top manager within a significantly broader framework (compared to the theoretical treatment of the organization and the management). The top manager cannot be viewed as the initial or central subject; the top manager is viewed as a connecting link between the owners and the employees. Accordingly, a separate role for the top manager is construed: the top manager as an intermediary or buffer, or a balancer and harmoniser of interests.

The Owner as a Source of Influence on Intraorganizational Relations: the Extent and Mechanisms of Influence

Regarding the influence of the owner on intraorganizational relations, it is important to observe the strength and extent of the influence as well as the various mechanisms via which it can be manifested. The authors of this article have focused on the owner-top manager relationship in their analysis of the owner's influence. The authors proceed from the fact that intra-organizational relations are largely dependent on owner-employee relations including top manager-employee relations, which are predominantly discussed, as the authors have already pointed out, from the top manager's viewpoint without considering the owner level.

Conceptualisation of the Influence of the Owner

In order to discuss the owner's influence and the extent of this influence, the authors will identify on the one hand those factors deriving from the general context and/or system and on the other hand the various theoretical approaches, which in one way or another conceptualise the owner's influence on relationships within the organisation.

First, under **general contextual and systemic factors**, we can talk about how the influence of the owner is dependant upon the types of corporate governance used in different countries – each system results in different ranges of owner influence. There is also scope for mentioning other aspects of the corporate governance system (e.g. the roles of the Anglo-American system's predominantly dispersed owner and the Continental European core owner need not be directly comparable). Secondly, the owner's influence is further differentiated by the types of enterprises themselves. On the one hand, this depends on whether we are dealing with a large, medium-size or small enterprise. Obviously, in the case of a medium-size or small enterprise (and especially a small enterprise) the owner's impact on the organization's activities can be and is significantly greater than in a large enterprise. In the case of a small enterprise it should be especially pointed out that the owner can also play the role of top manager and frequently does so. Considering Estonia's context, it is important to point out here that in the case of large enterprises operating in Estonia, which are predominantly foreign-owned, one has to recognise active owners and significant owner-side influence on the enterprise: very often the foreign mother company exacts quite detailed control of their daughter companies by recruiting new managers, imposing quite detailed instructions and daily routines for the organization, etc. Thirdly, a significant difference in the owner's potential influence can be noticed when observing the enterprises via the organization's stage of development. In the initial stage, the owner's influence tends to be greater in emerging enterprises than in enterprises that have reached the mature stage. Fourthly, depending on whether we are dealing with a passive or active owner, or a strategic or financial investor there is considerable difference regarding their range of influence.

On the other hand, there are **various theoretical approaches** for conceptualising the influence of the owner. It can be argued that the various approaches to analysing the influence of the owner level differ as to their extent, or more precisely, as to which and how many various parties are involved in the approach. Thus, the authors differentiate between:

1) treatments where the owner is viewed as one party among a number of parties
2) treatments concentrating on the owner's relations with some other party – these are predominantly treatments concentrating on owner-manager relations.

Thus it can be argued that these two treatments differ as to whether they narrowly concentrate on the owner-manager relation or whether they take the so-called multi-party approach, which addresses the owner, the manager, the employees and several other parties. It is also important to point out that these two different methods, view the extent of the owner-level influence differently. The treatments of bilateral relations – owner-manager – largely emphasise the issue of which side performs or can perform the active or even dominant role: either the owner or the manager is viewed as the active or central party. The treatments based on multilateral relations do not emphasise the identification of a central party; at least they certainly do not place it at the centre of their approaches.

In most cases, **treatments concentrating narrowly on owner-manager relations** start from the role of the owner, or his institutionalised embodiment – the supervisory board – performed in relation to the top manager (top management). Here two principally different approaches can be determined. Interpreting Hendry & Kiel (2004, p. 502), two broad schools of thought on board involvement can be distinguished, often referred to in the literature as "active" and "passive". **The passive school** views boards as rubber stamps or as tools of top management whose only contribution is to satisfy the requirements of company law. This line of thinking argues that board decisions are largely subject to management control, particularly to that of a powerful chief executive officer. On the other hand, **the active school** sees boards as independent thinkers who shape the strategic direction of their organizations. The passive school is underpinned by managerial hegemony theory, while the active school relies on stewardship, agency and resource dependence theories. Under the active school one can also refer to the contra-managerial hegemony theory (Dallas, 1996, p. 4).

Referring to Hendry & Kiel (2004, p. 502) **managerial hegemony theory** argues that boards are a legal fiction dominated by management and they play a passive role in directing the corporation. According to Hendry & Kiel (*Ibid.*) this managerialist perspective relies on different mechanisms for management control. The first was initially expressed by Berle and Means (1932), who argued that the separation of ownership and control in corporations, together with growth in their share capital, leads to a diffuse ownership situation in which the power of large shareholders is diluted. A second factor is the information asymmetry between non-executive directors and top management: by the very nature of their internal position, management develop an intimate knowledge of the business, putting the board, and particularly the non-executive directors, at a disadvantage. Thirdly, according to Mizruchi (1983, p. 427), the managers in profitable organizations can reduce their dependence on shareholders for capital and hence enhance their control by using retained earnings to finance investment decisions.

Contra-managerial hegemony theory on the other hand, according to Dallas (1996, p. 4), is based on the belief that the management should not have substantial influence over the board. Dallas (*Ibid.*) continues: "according to this theory, the board's most important function is to ensure the management acts in the best interests of the shareholders". As in many cases the board has informational dependence on the management, this theory focuses on diminishing the board's informational dependence (*Ibid*. p. 4, 5).

The basis of **agency theory** is the separation of ownership and control (see e.g. Fama & Jensen, 1983), depicting a situation where an owner, who has capital, but lacks the human capital necessary for making it earn, delegates the work to a manager, who owns the corresponding human capital, but does not have sufficient financial capital, which could be invested (Schleifer & Vishny, 1997, p. 740). The problem that rises from such a contractual relationship –– the so-called agency problem — concerns "the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattractive projects" (*Ibid*., p. 741). Hendry and Kiel (2004, p. 503) refer to Eisenhardt (1989) according to whom agency theory argues that the major role of the board is to reduce the potential divergence of interest between shareholders and management, minimising agency costs and protecting shareholder investments. What is important in the context of this article, as Hendry and Kiel (*Ibid.*) put it by referring to Eisenhardt (1989), is that agency theory has very clear implications for the monitoring and controlling role of the board.

Stewardship theory argues against the opportunistic self-interest assumption of agency theory, stating according to Davis *et al* (1997, p. 24) that the managers as stewards are motivated to act in the best interests of their principals; the steward is collective, because the steward seeks to attain the objectives of the organization. Davis (*Ibid*. p. 25) continues: "... a steward's behaviour can be considered organizationally centred … they make decisions that they perceive are in the best interests of the group … [and] a steward who successfully improves the performance of the organization generally satisfies most groups …". Donaldson (1990, p. 375) adds that the managers are motivated by "a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby gain recognition from peers and bosses". Hendry & Kiel (2004, p. 503) pointing to Stiles (2001) and Hung (1998) argue that this perspective recognises a range of non-financial motives for managerial behaviour and it supports the active school, arguing that the strategic role of the board contributes to its overall stewardship of the company.

The most central of the approaches that discuss many different parties, is the stakeholder perspective[1]. The other similar treatments can be considered derived from these to a greater or smaller degree.

The **stakeholder approach**, compared to the previous treatments, is special by the fact that it discards the definite owner-centred approach. As stated by Freeman & Reed (1983, p. 89): "there are other groups to whom the corporation is responsible in addition to stockholders: those groups who have a stake in the actions of the corporation". It is especially important to point out in the context of this article that the stakeholder approach "immediately" covers different parties, including the employees, which means that we can no longer only discuss the impact of the owner and owner-manager relations on employees, but that the employee has also become an active and significant party. As Freeman (1984, p. 196) states: "at the absolute minimum … the board of directors must be aware of the impact of their decisions on key stakeholder groups".

Considering the **resource dependence theory,** Hendry & Kiel (2004, p. 503) refer to Zahra and Pearce (1989), who state that this theory focuses on the role of interlocking directorates in linking firms to both competitors and other stakeholders. Hendry and Kiel (*Ibid.*) continue by referring to different authors, that according to this theory, boards are a "cooptative" mechanism for a firm to form links with its external environment, to access important resources and to buffer the firm against adverse environmental change. Tremblay *et al* (2003, p. 1659) state that resource dependence theory suggests that some jobs within organizations control resources (e.g. financial resources, information, scarce employee skills, etc.) vital to the survival of the organization; and some groups of employees may hold these critical resources and are therefore able to derive power from the control of important resources.

Power coalition theory is by its essence similar to the previously discussed resource dependence theory. This approach describes the board's roles in terms of the corporation's relationships with various corporate stakeholders (including shareholders) and the corporation's social environment. According to Dallas (1996, p. 10) the board is used as a "bridging strategy" through which the corporation is able to mediate its relationships with various stakeholders and others comprising its environment. One has to admit that this theory places the owner in a rather central position, through whom, according to Dallas (*Ibid*.), "the corporation gains access to needed resources (information, advice, contacts)" and the owner in turn has the obligation to strengthen and create various relations with different parties so as to reinforce the organisation's position. It is important to add that board membership is seen as a measure for the protection of the owner's interests – taking a person into a group as a member, which could be realised in different ways (contracting, cooptation, coalescing, i.e. merger) (*Ibid*. p. 11).

To sum up the various theoretical approaches, on the one hand it can be concluded that the influence of the owner and its extent depend on the number of parties involved in the approach. That is, it can be presumed that multi-actor approaches (e.g. stakeholder perspective) could mean the dispersal of the owner's influence between the other parties, since the central issue is not just the owner's interest, but the interests of various actors and the combination of these interests hold the central position. On the other hand, viewing the narrower treatments of owner-manager relations, we can conclude that the owner's influence depends, on the one hand, on how active a role he wants to perform, and on the other hand, on how active the managers would like to be. It is important to point out that in either case one party is generally intruding in the other's "playground": either the owners want to assume a decisive role, which also means exerting significant influence on the top manager (e.g. as can be interpreted from the agency theory, which concentrates on the owners' control and supervision of the top manager) or vice versa – the top management has assumed the active position, granting the owners the mere role of passive coordinator, the "rubber stamp" as described in the managerial hegemony theory.

By comparing these different approaches it can be said that the stewardship theory also "exits" from the narrow treatment of emphasising only the central role of owner-top manager relations; its main issue is not who controls whom, but the idea that the fulfilment of an organization's goals is based on the mutual support of the parties (owner, employee, top manager).

Mechanisms of Owner-side Influence

Besides the discussions of the extent of owner influence, including who – the owner or the top manager – has greater say over the developments in the organization or has greater influence on the organization, it is important to pay special attention to some themes or mechanisms determining relations between the owners and the top managers.

One of the most central functions of the owners is their **control function** over the management. Dallas (1996, p. 2) refers to Eisenberg (1975) who states that boards[2] are uniquely suited to perform monitoring functions[3]. As is expressed in one of the most widespread definitions of corporate governance, according to who holds the central position, "how do the suppliers of finance [the owners] get managers to return some of the profits to them … how do they make sure that managers do not steal the capital they supply or invest it in bad projects? [All in all:] how do the suppliers of finance control managers?" (Shleifer and Vishny 1997, p. 737)

Another important mechanism for expressing the owner's influence is **the owners' personnel policy** – the selection of a CEO suitable for the organization. Mizruchi (1983, p. 429) argues that because the board is responsible for selecting, evaluating, and, if necessary, removing the management, the board is in a position to set the premises, or the boundaries, within which managerial decision making will occur. Shortly, the board has ultimate control over the management through their capacity to hire or fire the CEO (*Ibid*.). The personnel policy mechanism is related to the top manager's motivation – the remuneration system used, etc.

Thirdly, a decisive role is also played by who controls **the development of strategy**. If we view the development of the owners' and top management's role in strategy-making over time, there has been a change towards the increasing activity of the owners – this has taken place in parallel with the generally increasing importance of the owners' role in the organization.

According to Hunger and Wheelen (1997), one can distinguish different degrees of involvement by the board of directors[4] in the strategic management process (Figure 3).

The lowest board involvement is Phantom, where the board does not know anything and is not interested and not involved at all. A Rubber Stamp board votes as instructed by the director-managers. Minimal review means formal review of selected issues that the director-managers bring to the board's attention. Nominal participation means review of selected key decisions. Active participation also includes the approval of decisions and making final decisions on mission, strategy and policies. They perform fiscal and management audits. Highly involved boards act as Catalysts; they take the leading role in establishing and modifying the mission, objectives, strategy and policies. They take very seriously the tasks of monitoring, initiating and determining, and keeping management alert[5].

In the generalised view, Figure 3 shows that owner activity increases from left to right – towards significant interference with the top manager's activities; there is also a contrary logic: the top manager's activity can increase in the opposite direction: from right to left, in which case the top manager gradually begins to perform the role(s) generally attributed to the owner.

Generally, the following conceptual framework can be developed for the owner-CEO-employee chain of relations (see Figure 4).

Figure 4 shows that the owner-CEO-employee chain of relations is on the one hand influenced by various contextual factors and also theoretical approaches, and, accordingly, the method used to define their relations. The extent of the treatment or involvement of the subjects differs according to the theoretical approaches: the chain of relations is either viewed in its entirety or simply as the owner-CEO relation. That which influences the third party – the employees – is focused upon. One of the issues having the greatest determining effect on the owner-CEO relation is that of control – who controls whom – the owner controls the CEO or the CEO controls the owner; and how – does the owner view the CEO's role as realising the owner's desires and visions, is the CEO granted significant freedom of action or does the CEO want to be highly active and view the owners as passive investors. The latter in turn is linked to the general behaviour patterns in the organization, including the idea of the clarity of roles and the significance attributed to it. The influence of behaviour patterns is certainly expressed more broadly. It also reflects the idea, vitally important for the organization, of the principal approach to handling the affairs of the organization; including whether the activities (the owner's actions) are aimed at long-term prospects or whether they meet the needs of the moment. This also raises the importance attributed to relations (individuals) in the organization. The latter in turn influences the following important subject in the development of the CEO-owner relationship: the hiring and firing of the CEO, which is an expression of the immediate power of the owner regarding the CEO and grants the owner power over the

Phantom	Rubber Stamp	Minimal review	Nominal participation	Active participation	Catalyst
←	Degree of involvement in (strategic) management				→
Low, passive					High, active

Figure 3. The Degree of Involvement of the Board of Directors in the Strategic Management Process
Source: Adapted from Hunger and Wheelen (1997) p. 21.

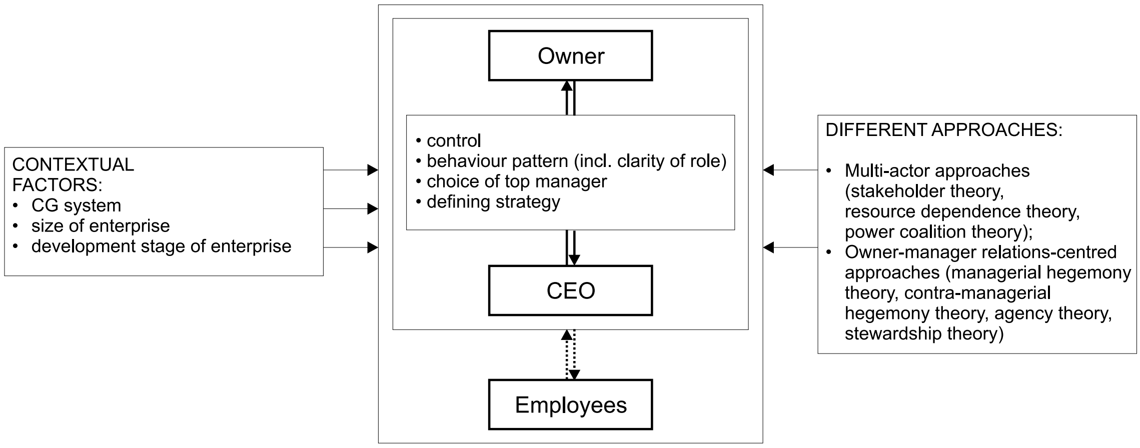

Figure 4. Framework for Treatment of the Owner-CEO-Employee Chain of Relations

CEO. Strategy is of equal significance as the process of determining the direction of the organization's progress: the key question is, who determines it and to what extent is it a common issue for the owners and the CEO. At the same time, strategies can be essentially different: there is a great difference between a firm only having a business strategy or also having a corporate strategy, the latter should in general contain definite positions on the organization's personnel policy.

In summary, one can conclude that the key issue in the development of the owners' and CEOs' relation is the coinciding of their ideas about the roles of the parties involved.

It is further important to mention that Figure 3 also depicts how the role of the CEO – what the limits of his activities and his opportunities will be – are influenced by a number of various factors. Figuratively speaking, the CEO is one "box" among many others – setting the CEO as the starting point for the analysis is equal to failing to consider a number of circumstances.

Estonian CEOs as Connecting Links Between Owners and Employees – a Complication?

Estonia's Situation and the Owner's Influence: the Most Significant Contextual Factors

The legal framework for CG in Estonia was created with the enactment of the Commercial Code in 1995, within which a two-tier system was legally stipulated, and this system has not changed in its main features since then. By establishing a two-tier system, the aim was to bring clarity to the legal landscape in Estonia. The beginning of the 1990s was quite a confusing period in Estonia, in addition the number of state enterprises was relatively large at this time. Compared to the one-tier system, the roles (incl. the roles of managers and owners) are more clearly separated in the two-tier system and that played a decisive role in selecting between these two systems[6].

The Estonian business community is predominantly characterised by a core owner; compared to large companies in developed economies, the use of small shareholder's in Estonia is significantly less developed. Furthermore, in Estonia we can predominantly discuss small and medium-size enterprises, with specific emphasis on small enterprises. Besides, in Estonia's case the time period should be emphasised separately – the most recent period, of approximately 15 years, is when the Estonian business environment developed. All these factors point out that in such cases the owners play quite a significant role in enterprises.

For a more detailed analysis of Estonia's actual situation, the authors use the results of generalist interviews (see the methodology of the research program in the article by K. Tafel, E. Terk and A. Purju in this current volume). These interviews enable further analysis of the influence of the owner and the extent of this influence on owner-CEO relations in Estonia. The analysis of the interviews presents the opinion of selected owners and top managers. The interviews were extensive and in-depth, and so the following questions were selected for analysis from among those asked, and are considered the focus of this article:

- How in general has the division of labour in the drafting of strategy been organised between the owners and the top managers?
- Which qualities do the owners value in their top managers and how have these indicators changed during the period 1995-2004?
- Can the top manager lead his own independent personnel policy?
- Can the top manager plan his career for a longer time period?
- How long a career in an enterprise does a top manager usually plan? Or is the top manager hired for a certain period – e.g. for a period of bringing the enterprise out of difficulties?
- Do a large percentage of the top managers want to become owners?
- What is the attitude of the rest of the owners about a trustee of another owner being the top manager? Do the other "loser-owners" receive any compensation and what is it?
- To what extent do the owners (board) interfere with the enterprise's management and daily issues?

Owner and manager relations can also certainly be characterised by several other issues, but this article concentrates upon the analysis of relations that can be treated within the limits of behavioural science, ignoring the more formal issues (e.g. contracts). The latter are analysed by Ivo Vaks in his article in this same journal.

The authors will initially attempt to provide a general estimate of which type of owner influence could exist in Estonia after considering the various theoretical approaches previously mentioned. They will subsequently analyse the influence of Estonian owners via the different mechanisms of its manifestation (strategic development, owner-side personnel policy, etc.).

The Domination of the Owner or Top Manager – Interview Results in the Light of the Theoretical Approaches

In the light of the above-listed theoretical approaches, which have conceptualised the owner's influence, the authors will subsequently attempt to define the theoretical concept for the description of the owner's influence and owner-top manager relations in Estonia. Since the interview responses are the opinions of selected top managers and owners, some preliminary conclusions can be made.

The interview results enable us to claim quite confidently that the owner's influence is expressed via direct interference from the owner and not merely within the limits of the owner's role, but also by transcending them. It can be claimed that the owner's influence on the relations within the organization need not appear in the "natural-logical" way – that is, via the owner-top manager-employee chain of relations, but also in a manner that breaks this chain of relations. According to the interview results, this situation can be primarily explained through the following two sets of problems. On the one hand, it concerns the owners' interference with (daily) operational management – a role, which should be (predominantly) performed by the top manager. The other aspect concerns the owners' desire to deal with the organization's personnel problems.

The interviewees' answers enable us to conclude that the situation where the owners' interfere with the daily problems of the enterprise, something that is (more) clearly within the top manager's competence, is not infrequent. Accordingly, the interviews contained a separate question about **the extent of the board's (owners') interference with the management of the firm in its daily problems.** The answers enable us to generalise that the domestic owner (at least in the initial period – 1995-99) tends to interfere with operations quite actively. The interviewees remarked that the owners could grant the top manager "superficial" freedom of action, by failing to determine the activities/roles in detail, which means in reality that Estonian owners reserve greater freedom for themselves to interfere in the activities of the top managers.

Quoting the respondents:

> *"... the owners cannot really draw the line between being owner and actively managing the firm ... the owner comes up very frequently and interferes with some details he considers important .... Yet he cannot understand whether or not his interference will earn him more money. Very often it does not earn any and results in a great confusion... "* (top manager 8)

„The owners tend to interfere with the management all the time. If the owner is an engineer and knows his pipes, he wants to run the pipe business; if he is a timber man and can set up a sawmill, he wants to carry on with that. ... If people have one, two or three favourite businesses, which were successful, such owners find that their businesses were successful because: a) they set it up once; and b) they keep interfering with their activities. Such people, who understand that what they did in the early 1990s need not be valid any more in 2004 and thus it would be better not to interfere, such people are practically nonexistent." (top manager 15)

To quote an owner:

Probably there are not many such passive owners in Estonia ... and the development has not progressed so far that you could just give some capital to a great idea, like take the money and do it. Yes, people want to interfere ..." (owner 17)

The owners' restrictions on top managers are also expressed in a different way. Estonian owners, although in a somewhat different manner, are seconded by an increasing number of foreign owners active in Estonia. Foreign owners, especially strategic foreign owners, impose many more instructions on top managers and much greater restrictions on the top manager's freedom of action. As one of the interviewees described: *"the foreign owner has all kinds of procedural rules: regarding this matter see Article 3 §29 prim etc. – it has been written down and has to be done that way"* (top manager 15).

Another important issue revealed by the interviews and characterising the problems of owner-manager relations is the interference of the owners in (not only) the everyday management problems, but directly in personnel issues. It can be concluded from the interviewees' responses that cases of managers interfering (bypassing the manager) with the organization's personnel issues are not at all infrequent.

When asked whether **the top manager can administer an independent personnel policy (to create his own team),** the respondents tended to believe that the top managers are rather independent in personnel issues (and should be). Predominantly The owner interviewees predominantly tended to view the situation in a more positive light. The top managers provided more varied answers. To quote one top manager:

"It can be this way and that way. It can be 100% this way and 100% otherwise. If your personnel policy is dictated to you 100%, it is a clear sign that you should start packing real soon. The realisation of the personnel policy is/should be the top manager's elementary right and the content of his work. If the owners start to tell that you should dismiss this man and hire that one, this means that the top manager must make some rapid conclusions and leave." (top manager 13)

The top managers also provided some quite unequivocal answers about owner interference: *"In Estonian firms the supervisory board forces you to hire their acquaintances"* (top manager 4); or in an even more negative light:

"[Estonian owners] *have the problem of "planting" their favourites in the firm. ... This is a very widespread problem in Estonia ... This is a very disturbing factor from the top manager's position, since generally their qualification does not warrant their post."* (top manager 15)

The managers clearly consider such owner-side interference in personnel issues deplorable and obstructive.

To sum up, the authors argue that the results of the interviews point to the owner having a rather central role and significant influence in the organisation. The authors consider it especially important that the owner's influence is expressed as a disturbance to the owner-top manager-employee chain of relations and that they bypass it altogether – which in turn provides proof of how significant the influence of the Estonian owner is. Thus, in light of theory, owner-top manager relations in Estonia can be described primarily within the limits of the active school. The owner wants to make decisions himself, to do himself and to monitor the "heartbeat" of the organisation. Yet it cannot be ignored that the owner's considerable influence is identified more by the top managers than the owners themselves. The mechanisms of owner-side influence, which will subsequently be observed, should enable us to provide a more detailed assessment of the situation.

Owner Influence on Internal Relations within the Organization: Strategy Formulation and Selection of the Top Manager as the Primary Mechanisms for Exerting Influence

The issues of the drafting of strategy and the selection of top manager, raised in the theory, also turned out to be central questions in the interviews.

The issue of the extent to which **strategy-making** is the domain of the owners or the top managers turned out to be one of the questions that provoked the most emotions. Obviously, strategy-making is an area where top managers and owners meet and the result determines the direction of the organization's activities, exerting significant influence on the top manager's activities, their scope (or lack of scope) and potential, as well as influencing top manager-employee relations. Besides the so-called natural influence through strategy development, exerted by owners on the organization and its subjects, the interview results clearly reveal the fact that strategy-making plays one of the key roles in the development of owner-top manager relations. Above all, this is reduced to the alignment/nonalignment of visions regarding who should make the strategy. The responses from interviewees enable us to define three approaches to dividing up responsibility for the strategy: firstly, where the strategy is predominantly within the competence of the top manager (and his team); secondly, where a clear owners' strategy is adopted; and thirdly, where the strategy is formulated via informal close cooperation between the owners and the top manager (see Elenurm *et al* 2005). Referring back to the theory, the type of owner in Estonia varies in principle throughout the whole scale (see Figure 3): in the first case we can see rubber stamp (or phantom or minimal review) owners, in the second case owners as catalysts or who participate actively, and in the third case we have an intermediate case, where both owners and managers have space for action.

The interviews show that the most problematic situation is (admittedly, primarily seen from the top managers' perspective) where the owners reserve strategy-making for their exclusive competence (since, despite various approaches, the setting of strategy predominantly pertains to the owners' competence), or when we are dealing with so-called catalyst or the active participant type of owner. The problem emerges in situations where the top managers notice that merely performing the role of carrying out strategy that has been permitted by the owners obstructs the performance of the top manager's role.

It can be concluded that the responses predominantly reflect a situation where strategy is determined in cooperation between the top manager and the owner. Nevertheless, there were several responses where the owner's influence was considered greater than necessary. Some top managers remarked:

> *"... especially the owners, who began early and have been successful, remain of the opinion that they are the best strategists. And they would not let anyone else close to it."* (top manager 15[7])

> *"More frequently than otherwise it happens that the owner wants to decide the strategy. He would decide anyway, but he is not too good at it ... And the owner always has the right to come in three months and say that we shall now do it another way."* (owner-top manager 20)

Besides strategy, the interviews revealed that the **owners' personnel policy and selection of top manager** was the second most important owner-side channel of influence. In other words, via the choice of the top manager the owner sets the direction of management in the organization and the results expected of the management. This also serves as the first step in the development of the top manager-employee relations. The answers given by the interviewees clearly emphasise the significance of time as a contextual factor in choosing a top manager (incl. the previously stressed importance of the organization's stage of development). The owner's influence is expressed in ensuring that the top manager meets the enterprise's needs at a certain moment – the top manager's motivation and, further, his ability to motivate the employees will depend on that. To quote one of the owner interviewees:

> „*... businesses have different stages.* [Let us presume] *that we have been growing full throttle for five years, we have had a really hot top manager* [but] *now we – the owners cannot see opportunities for continuing this growth trend.* [In this situation] *the man* [the top manager] *who has been* [acting vigorously] *all the time will become bored. It seems to be all right, but there is no big leap*

> *ahead. The owners will then become worried about him* [the top manager] ... *getting relaxed, this is not good. This is not good for the employees, they will also relax. ...* [To sum up:] *different strategies require different top managers – it is very rare that one person can handle them. (owner 2)*

The significance of the issue of owner-side selection of the top manager as well as the related time factor becomes even more prominent when we analyse the **owners'** positions regarding the **preferred profile of the top manager**. The basic types of top managers emerging from the interviews show quite clearly the decisive influence of the owner's choice of top manager on relations within the organization. The interview results primarily presented two different types of top manager. On the one hand, the interviewees mentioned the active developer-type of top manager, and on the other hand, the maintainer-type of top manager[8]. Regarding the developer-type[9] of top manager, the owners presumed ruthless managers, capable of making many unpopular decisions (e.g. the enterprise's streamlining, restructuring, including (massive) dismissals of staff, etc), or on the other hand, the establishment of entirely new businesses, which again called for a strong, resourceful, decisive and risk-taking round-the-clock manager. Top managers who were valued possessed the following qualities according to the interview results: they were well-connected individuals, "launcher-types" with a strong business sense, tough and possibly even ruthless. The interviews also quite clearly revealed the fact that in the case of the developer-type of top manager, a strong social dimension would not have been favoured. As for the maintainer-type of top managers, the owners see predominantly those who can maintain existing successes, managers who can retain and/or improve an established system and who can deal with the better satisfaction of the needs of existing customers. It is important in the case of this type of top manager to have values (incl. the so-called soft values), education and erudition, an ability to operate within the limits of certain set rules, good administrative skills, strong verbal skills, etc.

Regarding the preferred profile of the top manager, we cannot ignore the following situation described by several respondents, which again serves as a clear example of the owner's influence. The respondents cited a problematic situation, where there are several owners and the so-called stronger group of owners sets "**their man**" to the post of **top manager**. This is a complicated situation not only for the top manager, but also for the "weaker" group of owners. To quote the interviewee:

> *This is a very nasty situation, and as a rule it is not well tolerated. ... One owner's "personal" top manager can be easily caught in the works because of his ties. They would say "nothing personal", but you are, for example the "*[group's X] *man" and we cannot accept that (e.g. regarding promotion).* (top manager 14)

A profile-related choice of CEO is in turn linked to the issue of the length and stability of his or her career. The questions in the interview regarding the **potential for the top manager to indulge in (long-term) career planning** and **the potential of being fired overnight** reflected several owners' quite rigid attitude towards the top manager, and this allows us to interpret this as the owner's rather significant role in shaping the top manager's career. One comment by an owner was as follows:

> *„The latest examples show that* [top managers'] *resignations are sudden. ...* [The top manager] *can make plans, but he must always consider the possibility that his plans may have to change overnight. ... it seems to me that owners dismiss managers more often than the managers resign on their own."* (owner 2)

The owners' personnel policy specifically concerning the **inclusion of the top manager in the circle of owners** has an even more immediate impact on top manager-employee relations. This issue is predominantly discussed in the context of the various systems of remuneration and motivation for top managers. The authors noted the fact that this issue is also significant when analysing the owner's influence on the development of top manager-employee relations.

In this regard, the interviewees raised the issue of the top manager's equality/inequality with the other employees. That is, if the top manager is a hired specialist like the other employees, the latter view him as occupying the same level with them, but they do not if the top manager also belongs to the circle of owners. Quoting a top manager:

> *"I think that it is still quite good if the enterprise has a manager, who is not in the owner's role. I believe that in this case it would*

be easier to manage the organization and to communicate with it ... to be equal in the sense of all being hired workers... This will certainly result in a more open organization." (top manager 7)

Thus, in the light of the development of CEO-employee relations, one could claim that the CEO, being another hired hand, can create better relations with the employees, since the situation places him more on the same level as the employees so he can understand them better[10]. The respondents admitted that the task of the top manager is to *"... cultivate that feeling of "us"… to position themselves via the team ... this is their pardon and protection mechanism at the same time..." (top manager 15)* and it could be argued that a hired top manager would find it easier to perform that task.

To summarise, one could conclude quite directly that the owner-side "personnel policy" – the selection of the top manager, deciding the length of his career, the involvement/non-involvement of the top manager in the circle of owners – has a significant effect on the top manager's role. In other words: the role performed by the top manager or at least its limits are not determined by the manager exclusively – the owner's influence is directly noticeable.

Conclusion and Discussion

The analysis of top manager-employee relations within the framework of the organization and management theory need not explain why certain processes take place in an organization. Theoretical approaches proceeding from the corporate governance framework describe the various bases for owner-top manager relations with the common feature being that the owner's influence on events in the organization exists and can sometimes be very much apparent.

Estonia is well-suited to such a study of the owner's influence for several aspects. The contextual factors typical of Estonia and emphasised by the authors, such as the domination of small enterprises, "core owners", as well as time related factors and Estonia's presence in the general launching or "settling-down" stage are all in favour of significant owner-side influence. The interviews carried out with Estonian top managers and owners, while allowing us to make some preliminary conclusions based on the limited number of respondents, also point to a rather clear owner-level influence, compared to corresponding theoretical approaches. It can definitely be stated that the study of owner-level influence contains a large amount of important information, which enables us to view intra-organizational relations in a new or different light.

When observing the significance of the owner and relations between Estonian owners and top managers in light of the previously discussed theoretical positions, the authors claim that, proceeding from the fact that the owners were characterised in quite a number of cases as assuming an active position, the influence of Estonian owners can be described primarily within the limits of such approaches that stress the centeredness of the owner. The authors hold that the impact of Estonian owners can be predominantly described via the active school and above all within the framework of agency theory and contra-managerial hegemony theory, where the owner's controlling role, as well as the extent of his influence on the organization, are relatively strong and clearly apparent. Interestingly, one can conclude from the interview results that the top managers' vision or their idea of a desirable situation is closer to the position in managerial hegemony theory, where the owners have a relatively passive role. In several cases the top managers expressed the idea that they would rather see the owner in the so-called 'rubber stamp' role and criticised active and 'catalyst-type' owners. It is difficult to identify the idea typical of the stewardship theory, where top managers are motivated to operate in the owners' interests and view that as the best way of achieving the goals of the organization. However, the idea of the stewardship theory that the top manager realises himself through his employees is clearly apparent.

One of the most significant aspects, which can be concluded from the interviews on the basis of various theoretical approaches, is the fact that the owners' and the top managers' ideas and visions of their respective roles, or in the broader sense their general behaviour patterns, do not interconnect or at least quite significant dissimilarities in their positions could be found.

Regarding the various mechanisms through which the owner's influence could be expressed, the results of the interviews enable us to conclude in a generalising manner that the owners' main areas of influence in Estonia's case are in the making of strategy and the owners' personnel policy in selecting the top manager. Above all, the selection of the top manager plays one of the most important roles: the grounds for this choice can be seen in the setting of further limits upon the top manager's activities via the latter's career planning and motivation systems, etc. In addition, the time factor was clearly reflected – the enterprise having different needs at different times and being at different developmental stages played a decisive role in the choice of top manager (the owners previously preferred developer-type top managers, while today they increasingly favour the maintainer-type).

Referring to the above, the authors finally argue that owners in Estonia whose behaviour exerts significant influence on the manager as well as intra-organizational relations in general are rather active. This position is in turn supported by the fact that the owner's influence is also expressed via interference beyond the limits of his role – the owner quite clearly interferes with the top manager's sphere of competence. In such cases we can talk about owner domination of the organization. It is important to add that owner-side domination is also dependent on time factors. In general, it can be claimed that in Estonia the owner's vision of being a "hands-on" owner is declining rather than increasing.

The owner's influence analysed via the corporate governance framework – the effect of the governance level on the organization – enables us to determine how „tied" (or alternatively free) the top manager is in his activities. The top manager's success or failure in his role is often in the "hands" of the owners, hidden in a behaviour pattern created by them consciously or unconsciously – a framework according to which the business is run.

To summarize, it is important to pay attention to the fact that not only do owners' exert influence, but the owner's will should also be considered. Therefore, the governance level not only exerts influence, but the subjects of that level can and frequently do have an active will to "run the business" and depending on their position they have the opportunity to realise this, and sometimes this can mean exceeding the limits of their (traditional) role.

The interviews carried out with Estonian owners and top managers enable us to conclude that such direct owner-side interventions take place (e.g. direct interference with the recruitment of employees), yet they cannot be considered a typical phenomenon. The conclusion, clearly arrived at on the basis of the interviews, about the existence of indirect owner-side influence (their desire to interfere), which also has a significant influence on manager-employee relations is of much greater importance. More detailed definition of these chains of influence would require further studies; such studies would also be significant from the viewpoint of the development of theoretical literature in this field.

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Endnotes

1 It is possible via the stakeholder perspective to discuss, besides the owner as source of influence, many other actors (banks, other investors besides owners, the public sector etc.), which exert more or less direct influence on the organisation and its internal relations, but this remains beyond the scope of this article (for further information see e.g. Mygind, N (1999) *Enterprise governance in Transition – a Stakeholder Perspective*).

2 Eisenberg talks about „board of directors". This term refers to the Anglo-American model of corporate governance. According to this the *board of directors* cannot be fully identified as the supervisory board, but a body, which merges the functions of supervisory and management boards (in some cases also representatives of the trade unions and other stakeholders); CEO – *chief executive officer* – is the executive director and *management* – in our terms equal to executive management.

3 Of course, the board does perform various other roles (see for example Dallas (1996).

4 Here too we are dealing with a term from the Anglo-American corporate governance model. See also the previous endnote.

5 Study indicated the following proportions (Dobrzynski, 1992): 30% of boards were active or catalysts, 30% had minimal or nominal participation and 40% phantom or rubber stamp.

6 As a matter of fact there have been (also lately) discussions about that the two-tier system being too complicated for Estonia as there are mainly small and medium size enterprises here.

7 Hereinafter the figure indicates the code of the respondent.

8 It is important to add here that the owners' preferred top managers are largely sensitive to the time period. The periods 1995-99 and 2000-04 observed in the interviews presume, according also to the interviewees, different types of top managers due purely to objective requirements: in the 1995-99 period we can view the top manager as the developer and in the 2000-04 period as the maintainer.

[9] It is important to remark that the developer-type of top manager means in turn two different types: on the one hand the creator of the organization, a team, launcher of initiatives, creator of spirit; but on the other hand a reorganiser, a performer of changes (incl. negative).

[10] The situation can certainly be viewed from another angle as well: the interviewees remarked several times that including the top managers among the owners is one way of creating a sense of greater stability and certainty in him (at the same time they admitted that „*this approach of ensuring one's future by becoming an owner is relatively naïve (top manager 13)*).

Identifying Patterns in Ownership Changes and Their Implications for Enterprise Restructuring in the Estonian Manufacturing Sector

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Introduction

The issue of ownership has always been fundamental to the activity of a free market economy. Since Adam Smith wrote his book '*The Wealth of Nations'* (1776), political economists have argued that the workings of a free market with private property would keep businesses, and the individuals who control them, from abusing their power and would promote the most efficient use of the productive resources they control (Blair, 1995, p. 18). At that time it was common that those who owned property also managed it and had a control over it according to the size of their personal wealth. The situation had changed dramatically by the beginning of the 20th Century, and a revolutionary work by two scholars, Adolf Berle and Gardiner Means (1944 (1932)), shed light on some remarkable changes in the functioning of American corporations. They noted that the dispersion of the ownership of large corporations was so broad that only 11 per cent of the 200 largest industrial corporations had an identifiable individual or compact group of individuals holding the majority of the equity. This was the start of a new research agenda, later labelled corporate governance, that also studies among other issues the changes in ownership structure and their influence on enterprise value.

The term corporate governance and its daily use in the financial press is a new phenomenon that has only emerged in the last fifteen years. The majority of corporate governance studies have concentrated on British and American corporations, leaving the emerging corporate governance systems in transition countries poorly understood. The most recent development that brought corporate governance issues to the forefront was the breakdown of the socialist economies of Eastern Europe and the former Soviet Union. This created an urgent need for advisors from Western countries, who could help create new corporate governance systems from scratch to manage and control the newly privatised industries. Nowadays, we may say that the experience of the former socialist countries shows that the ability of enterprises to generate wealth in a sustainable way depends crucially on who has what ownership and control rights over corporate resources, how decisions are made, and what pressures, terms and conditions come into play. In transition countries, the development of corporate governance systems has been largely influenced by political decisions and economic reforms undertaken at the beginning of the 1990s. Whilst each country chose its own path, it is impossible to assume that the experience of these transition countries in introducing new corporate governance systems was similar. For example, Estonia is a unique case with its rapid and radical economic reforms at the beginning of transition and its current open and fast-growing economic development. This also evidently had an impact on the development of ownership structures, which differed from transition countries such as Poland or the Czech Republic, who both applied rapid economic reforms, but differing privatisation policies at the beginning of the transition.

The aim of this paper is to identify changes in ownership structures in Estonian manufacturing enterprises and the impact of these changes on enterprise restructuring. The main research topics presented in the paper are based on literature in corporate governance and enterprise restructuring research that focuses on the determinants of ownership changes and the impact of ownership changes on enterprise performance. The overview of literature about the determinants of ownership changes concentrates heavily on the works published by Derek Jones and Niels Mygind. Their work is based on a very unique database allowing the study of the determinants of ownership and ownership changes in the post-privatisation period. There are no studies that use a methodology similar to theirs because of the difficulties in obtaining such data. Therefore, the results of their studies are of primary interest in the current study, which uses a similar database. The empirical analysis of the paper is based on an ownership database compiled by the Statistical Office of Estonia using a questionnaire survey in 2004, and a new panel-database comprising balance sheet and income statement data from manufacturing enterprises in the period 1996-2002. This new rich panel-database enables the study of the relationship between ownership changes and restructuring outcomes.

This paper is structured as follows: the first section deals with the theoretical framework, including an overview of the determinants of ownership changes and the impact of ownership changes on enterprise restructuring. In the second section, a brief introduction to the Estonian privatisation process is given and the methodology used in the empirical analysis is described. This is followed in the third section by an empirical analysis of the changes in ownership structures illustrating the ownership change matrices for Estonian manufacturing companies. Then, in the fourth section, a comparison of selected restructuring indicators between different ownership groups is presented for testing differences in performance. Finally, conclusions will be drawn.

Theoretical Background

The Determinants of Ownership Changes and Ownership Dynamics

According to Filatotchev *et al* (1996) there are several reasons why ownership changes take place. For example, it can happen when an owner is interested in selling his shares because of a high share price or moving to another market (taking out the equity capital). The latter behaviour is common to investors who invested in a business at the growth stage and leave when the business has reached the mature stage with the highest share price. Financial requirements are also thought to play a crucial role in triggering ownership changes; in particular when the current owners, who are predominantly insiders, recognise that new financial capital is required. Without the ability to borrow from banks, liquidity constrained insiders may have no recourse but to issue new shares to outsiders, thus producing a change in majority ownership. There might also be reasons for risk diversification.

Jones and Mygind (2004) have pointed out that the ownership structure is determined by many factors, both at enterprise and country level. At enterprise level, ownership is determined by the size of the enterprise, its need for capital, the specificity of the different inputs, transactional costs for the outside investor and economic performance. At the country level, changes in ownership are influenced by the economic, institutional and cultural environment.

Demsetz and Lehn (1985) have also stressed the importance of the size of the enterprise as a determinant of ownership. According to Hansmann (1996) the larger the group of employees combined with a higher heterogeneity, the higher cost of collective decision-making. Thus, it can be hypothesized that the larger the enterprise, the less the share of employee ownership, and the greater the share of managerial or outsider ownership. The need for capital as another important determinant of ownership is connected to capital intensity, the size of the enterprise and the specificity of capital (Jones and Mygind, 2004). This means it is difficult for wealth-constrained insiders to take-over the enterprise, and if they own the enterprise it will mean a high concentration of risk. Transaction costs for the outside investor as a determinant of ownership changes is connected to the specificity of the assets of the enterprise, information asymmetries and of the institutional framework. Jones and Mygind (2004) argue that the economic performance of the firm may influence a shift in ownership combined with, for example, an economic crisis. An economic crisis may induce a defensive take-over by the employees to introduce more flexible wages and to save their jobs and their specific human capital.

Jones *et al*. (2003) have said that so far as the movement from insider to outsider ownership is concerned, a key focus in the literature is the role of strong economic performance. Especially successful employee-owned firms are often more likely to convert into conventional ownership structures. In turn, outsider owners are more likely to be interested in firms with a proven performance. On the other hand, poorly performing firms may have to turn to investors out of necessity. The effect of performance on ownership is thus ambiguous. Economic performance is also crucial in triggering ownership changes from outsider to insider ownership. In that case the employee buy-outs are more related to underperformance (saving failing firms by making downward wage adjustments), and management buy-outs to undervaluation of shares (share prices are lower than management's subjective valuation of the firm). However it should also be noted that the block holder argument presented by Shleifer and Vishny (1986) applies to both types of ownership change. That is, the more shares a minority owner holds in a given firm, the less costly it is for that minority owner to take over the enterprise.

Jones and Mygind (1999) have stated if an enterprise's economic performance is found to influence the type of ownership, then macroeconomic cycles can also be expected to have an impact on the governance structure. The institutional setting in relation to legislation may present specific barriers to or offer advantages of different forms of ownership. The degree of protection for minority owners through legislation and the liquidity and development of the stock markets can be a determining factor in the diversification of ownership. Informal social relations and culture, defined as the historical traditions, cultural values, norms and preferences of the stakeholders, can also explain important differences in the governance structure between countries. For example, the governance structures of Anglo-American countries are widely diffused between many shareholders who can operate successfully in a relatively stable environment with developed capital and financial markets. In contrast, the governance structures in transition countries are often the result of privatisation policies and do not conform to an environment characterised by insufficient institutional development. This makes its necessary to study these corporate governance systems separately.

The empirical literature on ownership changes or dynamics in the post-privatisation period is still rather poor. However, there are several studies that capture this research field. Jones and Mygind (1998) analyzed the ownership changes in Baltic countries and found that in Estonia and Latvia, ownership has changed quite fast. Firstly, there was a strong change away from employee dominated ownership. Secondly, there was a tendency, most pronounced in Estonia, for a change away from employee ownership in large enterprises. Jones *et al*. (2003) studied Estonian enterprises and found that the changes from outsider to insider ownership outnumber the changes from insider to outsider ownership (although the difference is not great), mainly due to the prevalence of managerial take-overs. In general, their results were consistent with the view that efficiency considerations drive ownership changes, but they also recognize that there are other important influences as well. Consequently, the studies imply that most ownership changes would be expected to be towards foreign ownership and to a somewhat lesser extent in the direction of managerial ownership.

An interesting explanation for ownership dynamics is given by Jones and Mygind (2004), who explain the development of a typical ownership structure in relation to the typical life-cycle of the firm. Most companies start out as small entities with few employees, low capital and low knowledge about the economic potential of the firm. Some then continue at a stage of early growth, with demands for higher inputs of capital, knowledge, networks and employees. The need for extra capital may be spread over several growth stages eventually leading to some diversification of ownership. However, a specific shock in the environment may also lead the enterprise into a stage of crisis, which makes some kind of new input necessary. This will often be a new input of capital, which can only be facilitated through an ownership change. During these stages, the change in ownership can be related to the determinants of the ownership structure. Changing conditions both from inside and outside the enterprise generate changes in ownership and hence in the development of the governance cycle.

The Relationship between Ownership and Enterprise Restructuring

The literature from transition countries encompasses many studies about the impact of ownership on enterprise restructuring (e.g., Wright and Suhomlinova, 2003; Djankov and Murrell, 2002). Looking at the development of studies of restructuring, early studies mainly deal with the effects of privatisation on performance, comparing the performance of private and state-owned enterprises (see, e.g. Carlin *et al*., 2000; Frydman *et al*., 1999). Later the focus shifted towards issues of ownership concentration, dispersed versus concentrated ownership (see, e.g. Claessens *et al*., 1996; Claessens and Djankov, 1999). The next studies look more deeply at the differences between outsider and insider ownership and its impact on performance (see, e.g. Smith *et al*., 1997; Linz and Krueger, 1998; Filatotchev *et al*., 1999). Thereafter, the particular groups of ownership have been studied, comparing the impact of employee, managerial, foreign ownership, domestic investors, and to a lesser extent institutional investors, on the restructuring of firms (see Claessens and Djankov 1999, Djankov 1999a, Smith *et al*., 1997, Frydman *et al*., 1999, Jones and Mygind, 2002, etc.). Recently, the issue of the ownership life cycle and its relationship to corporate governance and restructuring have become increasingly important (see Jones and Mygind, 2004; Mygind *et al*., 2004).

According to several studies (e.g. Lieberman, 1994; Bonin, 1998) one can distinguish between three different types of restructuring: financial, organisational and technological restructuring. Organisational and technological restructuring are also treated under the term operational restructuring. In this case, two different types of enterprise behaviour are distinguished between, viz. 'reactive' and 'strategic' restructuring. Restructuring, which is undertaken to improve competitiveness of cost without major investments in plant and equipment, and includes labour shedding, wage cutting, product decreases, changes in assortment and selling of assets and old inventory, is called reactive restructuring. In this case, changes in the organization and its scope are minimal. Strategic restructuring involves a forward-looking strategic orientation –– the creation of a new product mix, changes in the organisation, accounting and control systems, quality improvement, radical reorganisation of product lines and processes, investment in new technology, and research and development work. (Lieberman, 1994; Grosfeld and Roland, 1996; Carlin and Landesmann, 1997; Bonin, 1998; Ericson, 1998).

Several authors have argued that reactive restructuring is proper for all enterprises at the beginning of transition (e.g., Carlin and Landesmann, 1997). Others claim that this holds true only for domestic owned enterprises, as they do not have the necessary resources for strategic restructuring. In a similar way, it has been suggested that since strategic restructuring is very capital consuming, equity by foreign investors is needed. Thus, foreign owned firms are usually more actively engaged in strategic restructuring. (Meyer, 1998; Schusselbauer, 1999).

According to the studies that compare the effects of insider (employees and managers) and outsider ownership (domestic outsiders and foreign investors) on performance, outsider ownership is considered to be the most efficient. Aghion and Blanchard (1998) argue that restructuring requires ownership by outsiders for reasons that include better access to raising new capital and a better ability to pay for necessary expenditures. When insiders dominate, it is argued that the most efficient form of insider ownership is managerial (rather than worker) ownership. This is based in part on the argument that the interests of enterprise workers are likely to conflict in important respects with the long-run interests of their enterprise, leading to underinvestment in capital equipment.

Earle *et al.* (1996) also note that insider privatization is expected to be superior to state ownership, but worse than majority outsider control. They compare the forms of insider ownership and argue that employee ownership is hypothesized to have deficiencies in long term restructuring, especially when rearranging the boundaries of the firm, and short term restructuring when employment levels are at issue. But perhaps employee ownership is superior in terms of depolitisization and the evolution of governance structure. Jones and Mygind (1999) believe that the closer the alignment of the goals of different economic agents within insider-owned firms, the better workers are motivated to join in restructuring efforts and the better they use their accumulated experience and firm-specific knowledge. In such cases, the interests of the firm are more aligned with the interests of its employees. In the context of transition economies, Earle and Estrin (1996) also argue that the effects of employee ownership may be dependent on a host of factors such as market conditions. Jones and Mygind (2000) stress that in particular cases, some forms of employee ownership may be a feasible solution to the choice of ownership structure.

Different owners will have different objectives, and it is highly likely that the identity of owners will matter when it comes to restructuring efforts. Usually, the impact of ownership on enterprise restructuring is measured by different performance indicators. The most common indicators are productivity (Smith *et al.* 1997; Lee, 1999) or profit (Claessens and Djankov, 1999; Estrin and Rosevear, 1999), but sales or revenue have also been used extensively (e.g., Frydman *et al.* (1999) and Jones (1998)) under the premise that the ability to hold onto customers or to find new ones is an indicator of successful change within the enterprise, especially when accomplished in the face of steep recessions (Frydman *et al.*, 1999). In some studies, the measurement of restructuring focuses directly on enterprise decisions, for example, changes in the structure of corporate governance and management (Estrin and Rosevear, 1999) or renovations of factories (Djankov, 1999b), or investment rates (Grosfeld and Nivet, 1999). In addition to these indicators the following financial indicators, such as average wage, the level of employment (Carlin and Aghion, 1996), the share of export in revenues, total factor productivity, profitability, and capital intensity (Pohl *et al.* 1996) are also used.

There seems to be no consensus in the literature concerning which variables are the best measures of restructuring, apart from a greater preference for measures of performance than for indexes of internal decisions. The prevailing sentiment in the literature is that the quantitative variables are to be trusted more (even with the misreporting and accounting difficulties that are rife in transition countries) (Djankov and Murrel, 2002). They directly measure the prime output of enterprise restructuring, economic performance. On the other hand, the view exists that quantitative performance might not be the most appropriate one when an enterprise is investing in large-scale reorganization and that the results of this process might be observed sooner in qualitative variables.

The empirical literature provides very controversial results on the effects of different ownership types on performance. In general, outsider ownership has been more effective than insider ownership (for an overview see Djankov and Murrell, 2002). At the same time, Frydman *et al* (1999) showed that outsider-owned firms had significantly higher revenue growth than state or insider owned firms, but they did not find a significant difference between outsider and insider ownership in terms of cost performance. Filatotchev *et al* (1999) detected no effect of outside ownership on profits and return on capital. While Smith *et al* (1997) and Linz and Krueger (1998) reported that insider ownership positively affected, respectively, value added and labour productivity. Frydman *et al* (1999) found no difference between state-owned enterprises and insider-owned firms in terms of revenue and costs. Also, Jones and Mygind (2000) found quite mixed evidence on the effects of particular ownership configurations when studying the Baltic countries. However, they found some support for the mainstream hypothesis that outside ownership is preferred to insider ownership in Estonia. Moreover, they argue that in some instances majority ownership by employees is found to deliver better business performance than majority ownership by managers. Jones *et al* (2003) have pointed out that employee ownership is most durable in less volatile firms. Managerially owned firms are associated with a significantly higher volatility of performance than employee-owned firms, suggesting that managerial control becomes especially valuable in risky firms.

Important Facts about Privatisation in Estonia and a Description of the Research Methodology

Privatisation in Estonia

The privatization of state-owned manufacturing enterprises in Estonia started as early as 1991 with the so-called pilot privatization on a case-by-case basis. However, privatization of manufacturing enterprises on a much broader scale was launched only after the monetary reform in June 1992. This was followed, between 1993 and 1996, by the very intensive programme of privatization of medium and large enterprises. After preliminary attempts to use the voucher system, which very much concentrated on insiders (former employees and managers), the Estonian Privatisation Agency decided to use the sales method and ask for support from the German Privatization Agency, Treuhand. Privatisation was launched in the form of international tenders giving equal access to all bidders, including foreign investors. This means that enterprises were sold to either Estonian or foreign buyers on the condition that the buyers would be able to guarantee a certain amount of investments during a fixed period of time and to maintain a certain number of jobs.

In comparison with other transition economies, the Estonian approach to privatization seems to be similar to that of Hungary. Both have benefited from the conditions of privatization open to investors from abroad and have altogether been more successful in attracting foreign investors than other transition countries. As a result of the privatization program, a rather large share of foreign direct investment also moved into the industrial sector, facilitating the co-operation of Estonian firms with several European industrial countries. The wholesale and retail trade, and transportation and communication sectors have also been notable recipients of investments. Estonia's approach to privatization by selling to strategic outside investors was a very natural way to integrate the Estonian economy with its European neighbours.

The privatisation of Estonian state-owned enterprises has been completed and again was rather successful compared with other central and eastern European countries. Hence, the pilot privatisation favoured insiders; in the later stages privatisation was opened to everybody. Therefore, ownership structure in Estonian firms involves both insider and outsider owners. After privatisation the ownership structures in Estonian firms have become more concentrated, which makes it possible to assume that the separation of ownership and control is not a very broad issue in Estonian firms. The ownership structures of Estonian enterprises are very concentrated, whilst at the time of privatisation a market for shares did not exist and enterprises or individuals could not buy the shares of enterprises as they could in Western countries. This makes the Estonian case different from the so-called Anglo-American system, where ownership is more diffused, and also from the so-called German system, where the role of banks is very high, as the participation of institutional investors (banks and other financial institutions, including pension funds) in share trading has also been very low. It is more similar to the Italian model, as many enterprises are family-owned, but the concentration of domestic outsiders and foreign investors is also high. However, it is obvious that ownership plays an important role in the performance and restructuring of Estonian firms as in most enterprises the owners also have the control over the enterprise.

Sample Description and Analysis Method

The empirical analysis of this paper is based on data provided by the Estonian Statistical Office. Firstly, the ownership database, collected through a questionnaire survey by the Estonian Statistical Office in 2004, will be used. This database enables analysis of the ownership structure of manufacturing enterprises at the time of privatisation, for the years 2000 and 2004. Secondly, a new unique panel-database, where a merged ownership database and financial database comprising balance sheet and income statement data from manufacturing enterprises in the period 1996-2002, will be used. This database enables measurement of the process of and progress in restructuring manufacturing enterprises in Estonia and also the relationship between ownership changes and restructuring outcomes.

The size of the sample from the ownership database is 436 enterprises. The size of the sample from the new panel-database is smaller as we had to omit enterprises that were not also included in the financial data. In 1996, the sample from the new panel-database included 251 enterprises, and in 2002, 261 enterprises. Comparing this sample with the Estonian Statistical Office manufacturing enterprises sample, the sample is quite well balanced. Only the food, beverages and tobacco sector is a little overrepresented and the machinery and machinery parts and publishing sectors underrepresented. In total, the number of enterprises in the sample form 5.9 per cent of the total number of Estonian manufacturing enterprises. The extent to which this is representative is apparently not very high, but if we look at the average number of employees, sales and export indicators then the sample is representative. The sample forms 41.5 per cent of all employees in the Estonian manufacturing sector, 41.2 per cent of sales and 45.2 per cent of exports from the Estonian manufacturing sector. This is because the sample involves mainly enterprises with 20 or more employees. Thus, the sample might be biased towards large enterprises.

In the current paper, the ownership types are specified according to the dominant owner. This is because the ownership structure in Estonian enterprises is rather concentrated, i.e. enterprises usually have two/three owners from whom the largest shareholder also holds the most control. In this particular case there is no need to also specify majority ownership, which would provide more precise results for the control of enterprises. In the paper the ownership types are grouped as follows: state, foreign, domestic outsider, manager and employee. This is the frequently used method for distributing ownership in earlier empirical studies. Also, such a division enables the comparison of this study's results with the earlier studies. The types of ownership have been identified according to the distribution of nominal capital reported by manufacturing enterprises[1]. The ownership change groups (groups of enterprises where ownership has changed during the analyzed period) are determined according to the ownership at the time of privatisation and also in 2004. Because of the peculiarity of the data collection, we are not able to identify the exact time that ownership in different enterprise groups changed. However, we can identify the changes of ownership in enterprises between the time of privatisation and 2004 and assume that this is similar to ownership changes occurring between the time of privatisation and 2002.

The empirical analysis of this paper is divided into two stages. In the first stage, to analyse the ownership changes, two transition matrices are formed. These matrices enable the changes in ownership between the time of privatisation and 2000, and 2000 and 2004 to be studied. In the second stage, a descriptive analysis is used to analyze the impact of ownership changes on the restructuring of manufacturing enterprises. Changes among different ownership categories according to selected restructuring indicator's means will be measured. The enterprise restructuring indicators to be analysed are as follows: average number of employees, labour productivity (measured as net sales per employee), capital intensity (equity per employee), average wage (wage per employee), export orientation (export share in net sales), export productivity (export per employee), fixed assets per employee and profitability (share of net profit in sales). These are among the most commonly used indicators for measuring the restructuring of enterprises (see theoretical background) and make it possible to analyse the main changes in an enterprise's performance during the analysis period, such as their size, need for capital, quality, export orientation, investment level and the general management of the enterprise.

Emerging Ownership Patterns in the Estonian Manufacturing Sector in the Post-Privatisation Period

Firstly, we will look at the composition of manufacturing enterprise ownership structure at the time of privatisation and for 2000 and 2004[2]. From Table 1, approximately 38 per cent of Estonian manufacturing enterprises were owned by domestic outsiders in 2004. One third of enterprises are owned by foreign investors and the same ratio of enterprises by managers. The share of enterprises with employee ownership in the manufacturing sector is extremely low. This might be explained by the fact that manufacturing enterprises are usually large enterprises that need a lot of capital to function. It is more difficult for enterprises with employee ownership to gather the amount of investment needed for restructuring a manufacturing enterprise. This is why the employee ownership is more common in small enterprises. Also, it is seen that practically all manufacturing enterprises are privately owned, the share of state ownership in the manufacturing sector is marginal.

Since privatisation, the ownership structure of the manufacturing sector has remained practically unchanged. However, some interesting changes have occurred. For example, the share of foreign investors has increased and also to some extent the share of manager ownership. However, there are opposing changes in terms of the share of employee ownership. By 2000, this had decreased by four percentage points. These enterprises have been bought out, probably by foreign investors

[1] In the questionnaire by the Estonian Statistical Office enterprises were asked to distribute their nominal capital according to the following owners: state, municipal enterprises, enterprises employees (of which management and other employees), Estonian persons not employed by the enterprise, Estonian private enterprises, foreign persons and enterprises and owners in public distribution. In this paper state ownership refers to state and municipal enterprise ownership. Domestic outsider ownership refers to Estonian private enterprises and Estonian persons not employed by the enterprise's ownership. Owners in public distribution are left out of this sample because of the small number of observations.

[2] The choice of these time periods comes from the methodology of collecting the ownership data, where enterprises asked to specify the amount of their nominal capital at the time of privatisation, year 2000 and 2004.

and managers. Also, the share of domestic outsiders has decreased, but not by such a large extent. It is more likely that these enterprises have been bought out by foreign investors. For a more precise overview of how changes in enterprise ownership have occurred (who has bought out whom), we can explore the transition matrices, which are illustrated in the following two tables, Table 2 and 3.

	Year		
Ownership type	**Time of privatisation**	**2000**	**2004**
Domestic outsider	39.0	36.9	37.8
Foreign	26.8	31.4	30.0
Manager	25.0	28.0	27.6
Employee	7.1	3.0	3.0
State	0.9	0.2	0.2
No answer	1.1	0.5	1.4
Total	**100.00**	**100.00**	**100**

Table 1. Estonian manufacturing enterprise ownership structure at the time of privatisation, 2000 and 2004 (%)
Source: Estonian Statistical Office, 'Ownership Database, 2004'; author's calculations

Firstly, we will look at the ownership of manufacturing enterprises at the time of privatisation and 2000. As pointed out, the number of enterprises with foreign ownership and enterprises with manager ownership has increased. Foreign investors have primarily taken over or bought out enterprises with domestic outsider capital, but also enterprises with manager ownership. Although, at the time of privatisation there were four enterprises in state hands, by 2000, three of them had been bought out by foreign investors. This shows foreign investor interest in Estonian post-privatisation state-owned enterprises. These enterprises were strategically more important. Enterprises with manager ownership have also bought out enterprises with domestic outsider capital. More importantly, they have been the main buyers of enterprises with employee ownership.

The number of enterprises with domestic outsider capital has decreased, and as we already know they have been taken over by foreign investors or the enterprise's managers. Still, during this period some enterprises with domestic outsider capital have bought out many enterprises with manager ownership. In addition, they have taken over some enterprises with employee ownership and enterprises with foreign ownership. Regarding those enterprises that were governed by employees at the time of privatisation, we can see that employee-ownership has been the most unstable ownership type. During the analysis period, 35 per cent of 31 enterprises have remained employee-owned and in approximately 40 per cent of cases the managers have bought the enterprise.

From Table 2 it can be seen that ownership at the time of privatisation is the initial ownership and that it changes in the post-privatisation period. From the moment of privatisation until 2000 the dynamics of ownership took the following cycle:

employee => manager => domestic outsider => foreign investor

This means that the most unstable ownership type has been employee ownership, as many enterprises

	Ownership in 2000							
Ownership at the time of privatisation	**State**	**Foreign**	**Domestic outsider**	**Manager**	**Employee**	**No answer**	**Total**	**Difference***
State	0	3	1	0	0	0	4	-3
Foreign	0	112	5	0	0	0	117	20
Domestic outsider	1	14	138	16	0	1	170	-9
Manager	0	5	10	92	2	0	109	13
Employee	0	2	6	12	11	0	31	-18
No answer	0	1	1	2	0	1	5	-3
Total	1	137	161	122	13	2	436	

*Difference in number of enterprises at the time of privatisation and 2000 (2000-time of privatisation)

Table 2. Ownership of manufacturing enterprises at the time of privatisation and 2000 (no. of enterprises)
Source: Estonian Statistical Office, 'Ownership Database, 2004'; author's calculations

with employee ownership have been taken over by the managers of the enterprise. Manager ownership and domestic outsider ownership, where more than 80 per cent of the enterprises remained under the same ownership, were more stable. Still, the main buyers of enterprises with manager ownership were domestic outsiders and the main buyers of enterprises with domestic outsider ownership were foreign investors. The most stable ownership type was foreign ownership as 96 per cent of such enterprises have remained under foreign ownership since the time of privatisation. Only four percent of enterprises with foreign ownership have found new ownership status during this period (i.e. in 2000 they were already governed by domestic outsiders).

Secondly, Table 3 allows us to see the changes in ownership in manufacturing enterprises between 2000 and 2004. It is interesting to see that during this period, changes in ownership were rather marginal compared with the period before 2000. This might mean that adjustments to initial ownership structures in the post-privatisation period have tended to take place before 2000. After 2000, only minor changes in manufacturing sector ownership structures occurred. For example, the number of enterprises with foreign ownership decreased during this period in opposition to the period before 2000. At the same time, the number of enterprises with domestic outsider ownership has increased, though not remarkably. More interestingly, six enterprises with domestic outsider, two enterprises with manager-ownership and one enterprise with employee-ownership were taken over by foreign-owned enterprises. This might be considered the start of a new stage in ownership changes in the post-privatisation period, where ownership starts to move back from foreign ownership to domestic outsiders and insiders.

From the analysis of ownership changes, it is possible to conclude that the share of outsider ownership in the Estonian manufacturing sector is very high. During privatisation many manufacturing enterprises were sold to domestic outsiders and foreign investors, but also to the managers of former state-owned enterprises. In the post-privatisation period the share of foreign involvement in the manufacturing sector has even increased. Foreign ownership has been the most stable ownership form in the manufacturing sector. At the same time the share of employee-ownership in the manufacturing sector has diminished remarkably. There might be many reasons why employee-ownership has not survived in the manufacturing sector. As was pointed out in the theoretical section, employee ownership is more viable in small enterprises, where demand for capital is not too high. Also, when the employees are the owners of the enterprises there is always a greater risk that they may postpone decisions important for the enterprise's further development – for example, if laying-off of some employees is necessary to improve productivity.

As can be seen from the analysis above it is possible to identify the specific cycle of ownership during the post-privatisation period and to talk about two different stages of ownership change since the time of privatisation up to 2004 (according to this sample). The main characteristics of the first stage of ownership change are a high and increasing share of foreign ownership and a remarkable downsizing of employee-ownership. The second stage of ownership change is characterised by stability

	Ownership in 2004							
Ownership in year 2000	**State**	**Foreign**	**Domestic outsider**	**Manager**	**Employee**	**No answer**	**Total**	**Difference***
State	1	0	0	0	0	0	1	0
Foreign	0	124	6	2	1	3	136	-6
Domestic outsider	0	6	144	10	0	1	161	3
Manager	0	0	12	107	2	0	121	-1
Employee	0	0	2	1	10	0	13	0
No answer	0	0	0	0	0	2	2	4
Total	1	130	164	120	13	6	434	

*Difference in number of enterprise at the time of privatisation and 2000 (2000-time of privatisation)

Table 3. Ownership of manufacturing enterprises in 2000 and 2004 (no. of enterprises)
Source: Estonian Statistical Office, 'Ownership Database, 2004'; author's calculations

and reverse changes whereby enterprises with foreign ownership have started to move back into the hands of domestic outsider owners or insiders. The latter movement is definitely also supported by the strong economic growth which has been experienced during this period (from 2000 until 2004)[3] in the Estonian economy.

Implications of Ownership Changes for Manufacturing Enterprise Restructuring

The following analysis will be divided into two subsections. In the first subsection, the enterprises with stable ownership structures will be analysed – that is, enterprises where the ownership has not changed between the time of privatisation and 2004. More precisely, we will compare selected restructuring indicators (for an overview of these indicators see subsection 2.2) for foreign, domestic outsiders, manager and employee ownership. The second subsection will be dedicated to the analysis of enterprises where ownership has changed in the post-privatisation period. Here, we will concentrate on looking at differences, for example, between enterprises whose ownership has changed from employee to manager and enterprises whose ownership has changed from employee to foreign ownership or vice versa. The purpose of this section is to identify the implications of ownership changes for enterprise performance. We are particularly interested in finding out: 1) whether it matters who takes over or buys out enterprises, i.e. whether ownership matters; and 2) whether the impact of ownership change on enterprise performance is dependent on the initial ownership?

In the sample, three-quarters of the enterprises did not change ownership in the post-privatisation period, whilst one-quarter did.

Enterprises with Stable Ownership in the Post-Privatisation Period

In this subsection, we will analyse the differences between enterprises with foreign, domestic outsider, manager and employee ownership using selected restructuring indicators, where ownership has been stable during the entire analysis period. Differences between enterprises will be identified according to their size (number of employees), level of labour productivity (net sales per employee), capital intensity (equity capital per employee), level of wages (wage per employee), export orientation (share of export in net sales), export productivity (export per employee), amount of fixed assets (fixed assets per employee) and profitability (share of net profit in net sales).

From Table 4 we can see that on the basis of number of employees, enterprises with foreign ownership are the largest group. Their number of employees has approximately doubled during the analysis period. Enterprises with domestic outsider ownership are two times smaller than enterprises with foreign ownership and the size of enterprises with manager or employee ownership are two and half times smaller than enterprises with foreign ownership. As we know from earlier studies, the size of an enterprise is an important determinant of ownership. This analysis supports the findings from earlier studies that enterprises with outsider ownership (foreign and domestic outsider ownership) are larger than enterprises with insider ownership (enterprises with manager and employee ownership).

The need for capital in enterprises is measured by their capital intensity indicator. It can be seen from Table 4 that capital intensity is highest in enterprises with foreign ownership. It is explicit that larger enterprises also have a greater need for capital. At the same time, it can be seen that the level of capital intensity has increased in enterprises with manager and employee ownership by approximately three to four times over seven years. This means that the need for capital might not always be connected with the size of the enterprise because the number of employees has decreased in enterprises with employee ownership, despite increased capital intensity. This might be explained by the need for deeper internal restructuring within enterprises with employee ownership because they have been over-staffed.

When comparing levels of labour productivity, it is clear that the productivity level of enterprises with foreign ownership is many times higher than enterprises with other ownership types. Low labour productivity levels are characteristic of enterprises with employee ownership. Still, the level of labour productivity has increased in all enterprises. Especially high levels of growth have occurred in

[3] GDP growth in Estonia since 2000 has been remarkably high: 2000- 7.9% ; 2001- 6.5% ; 2002- 7.2%; 2003- 6.7%; 2004- 7.8% and 2005- 9.8%. (Main Social and Economic Indicators of Estonia, Estonian Statisitcal Office, 2006)

enterprises with domestic outsiders and employee ownership. It can be seen that the growth of labour productivity in enterprises with domestic outsider ownership has been achieved by increasing sales figures, while in enterprises with employee ownership this has also been supported by reducing the number of employees.

By looking at wage differences it can be seen that enterprises with foreign ownership are better employers – they can afford workers with better skills because they can pay them better salaries and the motivation level of their workers is obviously higher as well. This might also explain

their high level of labour productivity. The largest wage difference occurs between enterprises with foreign ownership and manager ownership, where the wage difference amounts to 38 thousand EEK per year in favour of enterprises with foreign ownership. Wages in enterprises with domestic outsider ownership are 25 per cent lower than in enterprises with foreign ownership. The wage level in enterprises with employee ownership is rather similar to enterprises with domestic outsider ownership. This is surprising considering their level of productivity and the number of employees. At the same time it supports the argument that if the employees are owners of enterprises they might make decisions that are good for the short-term development of the enterprise but hinder the long-term growth. Proof of this can easily be found by observing the differences between the growth of productivity and wages. Over seven years, wage growth in enterprises with employee ownership was faster than productivity growth, which is usually considered a threat in view of long-term developments. The same also applies to enterprises with manager ownership. The most sustainable enterprises are enterprises with domestic outsider ownership, where productivity growth is faster than wage growth.

Another important indicator for measuring changes in production quality is the share of exports in sales; this shows the extent of the enterprise's export orientation. From Table 4 it can be seen that export orientation is very different between the different ownership groups. The production of enterprises with foreign ownership is very export-orientated. Their exports form approximately 70 per cent of their sales. Enterprises with domestic outsider ownership are more orientated to the domestic market, where only 38 per cent of their sales are

Ownership group	No. of firms (2002)	Average no. of employees		Capital intensity		Labour productivity		Wage per employee		Export share in net sales		Export per employee		Fixed assets per employee		Profitability	
		Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change (%) 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100 (%)
Ownership unchanged																	
Foreign	66	301.7(634)	1.86	335.5 (476)	2.20	957.3 (994)	1.75	95.8 (44)	1.78	70.1 (34)	3.71	562.8 (684)	1.79	277.3 (304)	1.18	4.2 (9)	6.64
Domestic outsider	72	156.2(157)	1.13	187.9 (226)	1.60	632.0 (634)	2.09	76.7 (35)	1.97	38.1 (35)	0.12	230.4 (397)	2.10	256.5 (340)	1.70	3.9 (9)	3.55
Managers	46	118.0 (84)	1.40	110.5 (124)	3.76	342.4 (203)	1.76	57.5 (21)	1.91	55.3 (32)	9.72	173.6 (163)	2.28	110.5 (152)	3.02	4.1 (8)	0.59
Employees	10	119.5 (41)	0.58	112.2 (113)	3.39	305.8 (110)	2.09	72.6 (21)	2.21	21.4 (27)	-6.29	52.1 (72)	2.37	103.5 (89)	3.45	6.4 (7)	1.43
Total	194																

Table 4. Differences between enterprises with stable ownership according to selected restructuring indicators, 1996-2002 (thousand EEK) *Source*: Estonian Statistical Office, 'Estonian manufacturing enterprises panel-database, 1996-2002'; author's calculations.

exports. This has practically not changed at all over the seven-year period. The share of exports in enterprises with manager ownership is relatively large; exports form over 55 per cent of their sales. This increased nearly 10 per cent over seven years. However, enterprises with employee ownership are mainly orientated to the local market and there is no sign that the share of exports will increase.

Export productivity is extremely high in enterprises with foreign ownership compared with other enterprises, but has doubled in all enterprises over the seven years. The difference in export productivity between enterprises with foreign ownership and enterprises with employee ownership is ten-fold. Export productivity is very low in enterprises with employee ownership, which shows that their production is not very competitive in foreign markets and their access to export channels is also low.

The level of fixed assets is rather high in enterprises with foreign and domestic outsider ownership compared with enterprises with manager and employee ownership. At the same time the level of fixed assets in enterprises with manager and employee ownership has increased more than three times over the seven years. This shows that enterprises with manager and employee ownership are also dealing with production process quality improvement, making more and more investments in upgrading technology.

Finally, the comparison of profitability figures shows us that the level of profitability is higher in enterprises with employee ownership than in all other enterprises. This is to some extent an unexpected result. Of course, the level of profitability in enterprises with foreign and domestic outsider ownership is not very much lower, but has always been above the level of enterprises with employee ownership. Based on this analysis alone, it is difficult to explain the causes for this, but one explanation might be that enterprises with foreign and domestic outsider ownership have reinvested their earnings, resulting in a smaller profit.

In conclusion, enterprises with different ownership types show different results using performance indicators. In general, enterprises with foreign ownership perform better compared with the other ownership types. Enterprises with foreign ownership are larger, more productive and more capital intensive and they are very export-oriented. The level of fixed assets in those enterprises exceeds the others many times. Wage levels is also a good indicator, showing that wages are higher than in other enterprises. Enterprises with domestic outsider ownership are also rather productive and capital intensive and have a similar technological level, but are slightly smaller in size and primarily focus on serving the domestic market. As expected, enterprises with manager and employee ownership are much smaller and more unproductive than enterprises with foreign and domestic outsider ownership. Still, they show rather good growth indicators, which means they are catching up with the other enterprises.

The lower level of the performance indicators in enterprises with manager and employee ownership might mean that the enterprises they bought out at the time of privatisation were not so good compared with the enterprises that were bought out by foreign investors and domestic outsiders. However, we found some support for the argument that the cost of decision-making might be higher in enterprises with employee ownership because according to their productivity level and movements in their export activities, growth in wage levels in these enterprises has been too fast, exceeding growth in productivity. Accordingly, we can argue that ownership does matter for the performance of the enterprise.

Enterprises that Have Changed Ownership in the Post-Privatisation Period

While the analysis above concentrated on identifying the differences in enterprise performance between different ownership types, the focus of the following analysis will be on how changes in ownership might affect enterprise performance in the post-privatisation period. Here, our interest lies in both directions – the influence of the new owner and also the former owner.

Firstly, we will try to identify changes in performance in different enterprise groups where the initial ownership remained the same. From Table 5 it can be seen that there are two groups of enterprises with state ownership at the time of privatisation, two groups where the initial owners were foreign investors, two groups where the initial owners were domestic outsiders, three groups where the initial owners were managers and two groups where the initial owners were employees.

By comparing the changes in the number of employees it can be seen that in all cases where foreign investors have taken over the enterprises, the number of employees has increased independently of the previous ownership. The largest change was seen in the group where the previous owner was a manager. At the same time, in all cases where the enterprises were bought out by managers or employees, the number of employees was reduced. In other words, when ownership changes from outsider to insider, then the number of employees will decrease. By contrast, it is important to make a distinction between foreign ownership and domestic outsider ownership, as in the first case the number of employees increases and in the latter case it decreases.

Capital intensity has increased in all groups of enterprises. There is a difference when a state enterprise has been taken over by a foreign investor or manager. It can be seen from Table 5 that when state enterprises were taken over by foreign investors, then the capital intensity has increased two and half times during the analysis period. At the same time, in the case of a manager take-over, the capital intensity has increased one and half times. Also, there is a difference in the growth of capital intensity when the initial owner was a foreign investor and the enterprise was taken over by a domestic outsider or employee. It is obvious that domestic outsiders have more capital than employees. There is not such a great change in the capital intensity when the initial owner was a domestic outsider and the enterprise has moved over to foreign ownership or manager ownership. In both cases, the capital intensity has increased markedly. Thus, the change from outsider to insider ownership does not have to slowdown growth of capital intensity when the insider is a manager. Still, when the initial owner was a manager and the enterprise is taken over by a foreigner or domestic outsider, then the growth of capital intensity has been faster in the case of foreign ownership.

Changes in labour productivity have been somewhat different to changes in capital intensity. For example, productivity growth was slower in cases where a state enterprise was taken over by a foreign investor compared with when state enterprises were taken over by a manager. This is because of an extremely high productivity level in the enterprise group where the ownership has changed from state to foreign, which might be one reason for the slower growth rate. In the case of foreign ownership there is a clear difference in the productivity changes when the enterprise was taken over by a domestic outsider or employee. In the latter case, the productivity level has started to decrease. As with capital intensity, growth in productivity was faster in those enterprises with domestic outsider ownership that were taken over by a foreign investor compared with manager owners. There is also a clear difference in productivity growth between enterprises with employee ownership taken over by domestic outsiders compared to enterprises taken over by employees. In the latter case the growth of productivity slowed down.

Changes in wage levels were very similar to changes in productivity between different enterprise groups. In most cases the growth of productivity is faster than wage growth. Still, there are four enterprise groups where wages have grown faster compared to productivity: domestic outsider – foreign, domestic outsider – manager, manager – domestic outsider, and employee – manager. It is more interesting to compare the differences in wage levels between enterprise groups. In enterprises where the ownership has changed to foreign or domestic outsider ownership the wages are the highest. These enterprise groups are followed by enterprises where the ownership has changed to manager ownership, and the lowest wage is paid in enterprises where ownership has changed to employee ownership. However, it is important to mention that the differences in wages are much smaller than the differences in labour productivity or capital intensity.

It is quite difficult to determine any general changes to the share of exports in net sales between different enterprise groups. For example, there are enterprises for which the export share in net sales has increased while the ownership has moved from foreign to domestic outsider, and decreased while ownership has moved from manager or employee to domestic outsider ownership. It can be seen that when the ownership changes from insider to domestic outsider ownership, then the export orientation decreases, and when the ownership changes from foreign to domestic outsider it increases. However, by comparing the share of exports in net sales, it can be said that export orientation is higher in those enterprises where the ownership was taken over by foreign investors. This is followed by enterprises taken over by managers and domestic outsiders.

		Average no. of employees		Capital intensity		Labour productivity		Wage per employee		Export share in net sales		Export per employee		Fixed assets per employee		Profitability	
	No. of firms (2002)	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change (%) 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100	Mean (2002) (sd)	Change 1996=100 (%)
Ownership changed																	
State-foreign	2	165.0 (42)	1.10	963.3 (185)	2.47	1243.1 (232)	1.52	116.7 (8)	1.37	82.9 (16)	-3.89	1012.5 (11)	1.47	838.4 (301)	1.46	13.3 (9)	3.39
State-manager	1	422.0	0.88	93.4	1.49	316.6	2.66	63.5	2.38	68.8	4.11	217.9	5.07	99.5	1.49	0.9	29.40
Foreign-domestic outsider	7	120.4 (42)	1.02	236.2 (196)	1.90	773.9 (594)	2.37	78.0 (27)	2.20	37.6 (39)	10.04	225.5 (306)	2.27	212.3 (144)	1.95	4.9 (7)	5.82
Foreign-employee	1	74.0	0.67	63.1	1.18	308.9	0.91	40.2	0.80	8.1	4.69	25.0	2.56	175.3	1.82	0.1	-2.05
Domestic outsider-foreign	9	233.8 (224)	1.10	189.6 (99)	2.30	824.7 (501)	1.76	79.9 (12)	2.00	63.2 (38)	-2.32	412.6 (309)	1.68	239.7 (147)	1.92	3.4 (4)	8.14
Domestic outsider-manager	14	133.6 (88)	0.88	147.9 (165)	3.05	315.9 (232)	1.45	65.1 (29)	1.69	48.6 (36)	-0.85	143.2 (129)	2.64	156.1 (172)	2.37	2.2 (22)	-0.77
Manager-foreign	3	298.0 (246)	2.04	42.9 (27)	3.32	284.1 (39)	4.80	76.1 (11)	2.66	87.6 (13)	13.03	250.1 (61)	9.54	83.7 (25)	3.23	2.3 (6)	-8.28
Manager-domestic outsider	8	282.9 (375)	0.79	178.5 (190)	3.17	409.4 (321)	1.40	74.5 (29)	1.78	29.4 (36)	-9.34	165.0 (318)	1.37	200.9 (183)	2.36	3.1 (5)	0.97
Manager-employee	1	61.0	0.88	62.4	15.32	145.3	3.79	61.4	2.91	94.8	35.24	137.7	5.31	38.6	3.02	12.4	18.40
Employee-domestic outsider	7	137.3 (140)	0.97	68.9 (50)	6.20	261.3 (223)	3.20	65.3 (25)	2.16	59.3 (29)	-5.01	145.6 (112)	3.61	52.7 (40)	2.52	1.3 (4)	-0.37
Employee - manager	8	140.1 (70)	0.91	129.6 (84)	2.04	305.4 (177)	1.24	61.6 (14)	1.43	22.1 (32)	-0.68	98.4 (196)	1.20	111.3 (67)	1.66	6.1 (4)	-0.17
Total	61																

Table 5. Differences between enterprises with changed ownership according to selected restructuring indicators, 1996-2002 (thousand EEK)
Source: Estonian Statistical Office, 'Estonian manufacturing enterprises panel-database, 1996-2002'; author's calculations.

In contrast to the share of exports in net sales, export productivity levels have increased in all enterprise groups during the analysis period. The largest change in export productivity has been in the enterprise group where the ownership has changed from manager to foreign ownership. A quite remarkable change has also occurred in enterprises where ownership has changed from manager to employee ownership. Inside this group of enterprises the change of export productivity has been slowest in enterprises where the ownership has changed from manager to domestic outsiders. Again, the level of export productivity is highest in enterprises where the ownership has been taken over by foreign investors. This explains the very large growth of export productivity in the enterprise group where the initial owners were managers, as their export productivity is usually much lower than in enterprises with foreign ownership.

By considering changes in investment levels (measured as fixed assets per employee), it can be seen that growth has been faster in those enterprise groups where the level of investments is lower – – that is, in enterprises where the ownership has changed from manager to foreign and employee to domestic outsider ownership. This shows that when the ownership changes from insider to outsider it will be accompanied by growth in investments. By comparing the investment levels between different enterprise groups, the picture is similar to earlier indicators, where the level of investment is higher in enterprises where the ownership was taken over by a foreign investor, followed by domestic outsider and manager owners.

Finally, let us look at the profitability of enterprises. The profitability of enterprises was highly volatile in practically all enterprise groups during the analysis period. This might be influenced by the economic crisis that took place in 1999, which forced many enterprises to make radical changes to their general management system.

Next, we will try to identify changes in performance by comparing the enterprise groups where the secondary ownership remained the same. From Table 5 it can be seen that there are three groups of enterprises where the ownership was taken over during the post-privatisation period by foreign investors, three groups where the secondary owners are managers, three groups where the secondary owners are domestic outsiders and two groups where the secondary owners are employees.

Looking at the first group of enterprises where the secondary owners are foreign investors, it is possible to identify clear differences between those enterprises that have been in the hands of state or domestic outsiders and those who belonged to managers. In enterprises where the initial owner was a manager, they are less productive, less capital intensive and their investment level is low. At the same time, these indicators have increased much faster compared with other enterprise groups, showing the positive influence of foreign investors. In this case, we could argue that the performance indicators for enterprises with the same ownership type are different if the owners of these enterprises were different at the time of privatisation.

In the second group of enterprises, where the secondary owners are managers, the enterprises whose initial owners were employees have a lower level of labour and export productivity than those enterprises where the initial owner was a domestic outsider. Also, they are less capital intensive, their export orientation is low and their level of investment is small. Still, they are more profitable. However, this case supports the argument mentioned above that the differences in performance indicators between enterprises with the same ownership types can be explained by their earlier ownership type.

In the third group, where the secondary owners are domestic outsiders, the picture is quite similar to the first group. The level of all measured performance indicators, apart from the share of exports in sales, are lower in enterprises whose initial owners were employees compared to enterprises whose initial owners were managers or foreign investors. At the same time, the growth of measured performance indicators has been fastest in this enterprise group during the analysis period. However, it is surprising that the share of exports in net sales is the highest in this enterprise group. Nevertheless, the share of exports in net sales has decreased in this enterprise group during the analysis period. As we know from the analysis above, the enterprises with domestic outsider ownership are more local market orientated. This might explain the change of export policy in these enterprise groups.

Finally, there are two enterprises where the secondary owners are employees. The comparison of performance indicators shows quite opposing results. They are both small enterprises because their capital intensity level is low. The level of labour productivity is much higher in enterprises whose initial owner was a foreign investor than in enterprises whose initial owner was a manager. Also, the level of investment is higher in this enterprise. At the same time, the share of exports in sales is very high in enterprises whose initial owner was a manager and extremely low in the enterprise where the initial owner was a foreign investor. This has also determined the differences in export productivity. This shows that their market orientation is totally different. Still, looking at the change indicators, the development of the enterprise whose initial owner was a manager has been much faster than in other enterprises. Hence, it is difficult to make any generalisation based on these two cases.

Conclusions

This analysis leads us to conclude that the ownership structure at the time of privatisation is not persistent and changes over time. In the case of the Estonian manufacturing sector it is possible to identify a specific cycle of ownership during the post-privatisation period and to talk about two different stages of ownership change from the time of privatisation to 2004. The main characteristics of the first stage of ownership change (before 2000) are a high and increasing share of foreign ownership and a remarkable reduction of employee ownership. The second stage of ownership change (after 2000) is important for its stability and reverse movements, where the enterprises with foreign ownership started to move back into the hands of domestic outsider owners or insiders.

In order to summarize the results from the analysis of the effects of ownership changes on enterprise performance, it is first important to point out that enterprises with different ownership types are different in their performance indicators. In general, enterprises with foreign ownership perform better compared with other ownership types. Enterprises with foreign ownership are larger, more productive and capital intensive and they are highly export-oriented. The level of fixed assets exceeds the others many times. A good indicator is also their level of wages, which is higher than in other enterprises. Enterprises with domestic outsider ownership are also rather productive and capital intensive and exhibit a similar technological level, but are slightly smaller and primarily focused on serving the domestic market. As expected, enterprises with manager and employee ownership are much smaller and more unproductive than enterprises with foreign and domestic outsider ownership. Still, they show rather good growth indicators which means they are catching up with the other enterprises.

Altogether, the level of restructuring in manufacturing enterprises depends on the owners of the enterprises. Usually, enterprises that were taken over by foreign investors (but sometimes also by domestic outsiders) were the most productive and faster in improving their performance level. For example, when the initial owner was a manager and the enterprise was taken over by a foreigner or domestic outsider, then the growth of capital intensity was faster in the case of foreign ownership. At the same time, when the ownership changes from insider to outsider it is accompanied by growth in investments. Analysis of performance in enterprise groups where the secondary ownership was similar and which showed differences in the performance indicators between enterprises with the same ownership types can be attributed to their previous ownership. When the secondary ownership was foreign it was possible to identify clear differences in enterprise restructuring between enterprises that had belonged to the state or domestic outsiders compared with enterprises that had belonged to managers. Exactly the same results were achieved when the secondary ownership was a manager.

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The Ownership Structure of Corporations: Owners Classification & Typology

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Ownership Research and Corporate Governance

The importance of the above topic is evident in the fact that corporate governance and the ownership structure of companies is currently characterised by change processes as the economies of the world become more and more globally integrated. Ownership structures are also of major importance in corporate governance because they affect the incentives of managers, and thereby the efficiency of firms. The ownership structure is defined by the distribution of equity with regard to votes and capital, but also by the identity of the equity owners. A classic reference is Jensen and Meckling (1976), who discussed the nature of agency costs associated with outside claims on the firm - both debt and equity. Their purpose was to integrate concepts into the beginnings of a theory of corporate ownership structure.

The increased volatility of corporate ownership portfolios observed in recent years has led to renewed interest in ownership structures, especially with respect to multinational enterprises. As the economies of the world become more and more globally integrated, such issues will become more prominent and will affect our understanding of the interweaving systems of corporate relations, through which formal and invisible networks of power are established (Heubischl, 2006). Cross-shareholdings play a particular role in markets. They can be understood as a potential source for inter-corporate power and coordination leading to corporate control. One example of such power structures is the bank hegemony in Germany. Moreover, ownership structure is an important means for governance. Likewise, for interlocking directorships, share ownership may provide influence and control over a third party.

Generally, one can assume that a higher ownership stake comes with more influence on the management of the respective entity. It follows that the more dispersed share ownership one company has, the more independently the management may govern the organisation (Heubischl, 2006). The ownership structure of companies has attracted much attention in the wake of scandals involving corporate governance. Recently there has been considerable interest in the corporate governance practices of modern corporations, particularly since the high-profile collapse of several firms. Because of concerns about money laundering and terrorist financing, it is appropriate to introduce more specific and detailed provisions that verify the identity of any owner (Directive 2005/60/EC).

The identification of share owners[1] - be they families, bans, institutions investors[2], governments, or other companies - has important implications for a company's corporate strategy and performance. For example, compared to other owner identities, financial investor ownership is found to be associated with higher shareholder value and profitability, but lower sales growth. The effect of ownership

[1] Owner or holder is the person responsible for an asset and therefore for defining the objectives and policy for its security (Law of Property Act).
[2] Entity with large amounts to invest, such as investment companies, mutual funds, brokerages, insurance companies, pension funds, investment banks.

concentration is also found to depend on owner identity (Thomsen et al., 2000). The identity of the ultimate owner of a corporation could have a direct influence on its dividend policy. The wealth of an individual or a family as a large block holder is directly affected by the chosen dividend pay-out policy. Things become more complicated if the state or a financial firm are ultimate owners, since these are also agents, and the notion of cash flow rights becomes blurred (Gugler et al., 2003). Owners are an important source of capital for entrepreneurial ventures, yet their considerable potential seems to go unrealised in the capital market.

There are considerable differences between the different profile, style or types of owners. This means that the various owner categories perceive the capital market differently. Accordingly, different owner classes will probably respond differently to private and public efforts introduced to stimulate the capital market. It would be especially interesting, for example, to learn more about owners as they are accumulating wealth and experience. An owner's profile or style can be defined by their preference in money decisions, such as: deciding between short term trading or long term holding; whether they are averse or tolerant to risk; whether they hold all classes of assets or just one type (stocks for example); whether they prefer a stock's value or its growth potential, big cap or small cap stocks, and their choice between defensive or cyclical stocks; their use or avoidance of derivatives; their diversification between home turf or international investments; and whether they are hands-on or prefer investment funds. In the case of state ownership, politicians are likely to have interests in addition to maximizing enterprise restructuring, such as their preserving jobs.

There is general evidence that state owned firms are less efficient than privately owned firms (Djakov, 1999). La Porta, Lopez-de-Silanes and Shleifer (1999) studied the ownership structures of large corporations in 27 wealthy economies to identify the ultimate controlling shareholders of these firms. They found that, except in economies with very good shareholder protection, relatively few of these firms were widely held, a finding that contrasts with Berle and Means's image of the ownership of the modern corporation. Rather, families or states typically control these firms. It is far less common for financial institutions to control equity. The controlling shareholders typically have power over firms, significantly over their cash flow rights, primarily through the use of pyramids and participation in management. Private individual investors and institutional investors are not equal. Individuals have to unite to take effective action (Charkham, 1995). Large outside owners have opportunities to expropriate value, particularly when the minority shareholders are not well protected.

When financial institutions are large owners, there is a potential for conflicts of interest to arise that adversely affect minority shareholders. Commercial banks could face conflicts when they are large creditors of the firms in which they hold equity stakes. There can be a direct dilution of other equity holders for the benefit of the bank, for example, through higher lending spreads. Financial institutions related to banks may also have the interests of the bank as a creditor in mind when deciding which company to invest in and how to value a firm.

However, financial institutions with an equity stake in a company can also better monitor a firm and its management, offsetting the negative effects of its involvement in the company, such as the potential for conflicts of interest to arise. The net effect of financial institutions' ownership on the valuation of a firm and its profitability is therefore unclear (Djakov, 1999). Some corporate outside investors, for example, may more competently evaluate firms, based on their access to better information. Other corporate investors may be better owners as they may have access to technology or know-how not available to the firm (e.g., foreign investors) or they may have special monitoring skills (e.g., trade creditors who are owners), which may raise the valuation or profitability of the firm (Djakov, 1999).

The empirical work on the association between managerial ownership and corporate restructuring dates back more than sixty years to Berle and Means (1932). They contended that widespread ownership yields significant power in the hands of managers whose interests do not coincide with the interest of shareholders. As a result, corporate resources are not used for the maximization of shareholders' value (Djakov, 1999). Employee ownership has not been extensively studied. It has been argued that unionized employees more likely seek control of a firm, but the actual monitoring role of employee owners has not been well documented (Djakov, 1999). The privatisation processes in Estonia created ownership structures that were very different from those observed in developed Western economies. The widespread application of employee ownership in privatisation is a particularly fascinating case. The expectation of many observers was that employee ownership would prove to be temporary and a rapid convergence to more familiar ownership structures would take place. Subsequent evidence has partly confirmed the transience hypothesis, since the number of employee owned enterprises was found to decline rapidly (Kalmi, 2003).

It seems that all research on corporate governance is actually research on ownership. Ownership is the exclusive possession or control of some thing, which may be an object or some kind of property. Some consider the term to be closely associated with the idea of private or public wealth. It is also claimed by some that the exclusivity of ownership underlies much social injustice, and facilitates tyranny and oppression on an individual and societal scale. Ownership research needs delicate and sensitive information. Sensitive information is knowledge that might give an advantage if revealed to persons not entitled to know it. Sensitive information is broadly described as information which could adversely affect the privacy of certain individuals if it were to be lost, misused, modified or wrongfully accessed.

The social sciences are sometimes criticized as being "less scientific" than the natural sciences, which raises the question: are the social sciences really sciences at all? Social sciences do not have a paradigm (Chalmers, 1998; Kuhn, 1970). This claim is most commonly made when comparing social sciences to fields such as physics, chemistry or biology in which direct experimentation and falsification of results is generally carried out in a more direct fashion. Part of the reason is that there is no agreement on just what constitutes science as a subject. The social sciences investigate the actions of individuals, groups, social structures and institutional structures. The beginnings of the social sciences in the eighteenth century are reflected in Diderot's grand encyclopaedia, with articles from Rousseau and other pioneers. The theoretical base of ownership research and corporate governance, clarified by an overview of literature, is found in the new institutional economics. It is a school of heterodox economics, which builds on "old" institutional economic arguments about economic activity being embedded in social and legal institutions, using Ronald Coase's (1976) fundamental insight about the critical role that transaction costs play in determining economic structures and performance. Some of the key theories of new institutional economics are: the transaction cost theory (Coase, 1937); property rights analysis (Demsetz, 1992); and agency, relational and incomplete contract theory (Jensen and Meckling, 1976).

Corporate governance has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. The term 'corporate governance' has come to mean many things. It may describe the processes by which companies are directed and controlled. It can also refer to: the encouragement of companies' compliance with codes (as in corporate governance guidelines); investment techniques which are based on active ownership (as in corporate governance funds); and a field of economics, which studies the many issues arising from the separation of ownership and control. However, the concept of corporate governance is poorly defined because it potentially covers a large number of distinct economic phenomena. The best way to define the concept is to list a few of the different definitions rather than mentioning just one.

- Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of receiving a return on their investment (Shleifer and Vishny (1997).
- Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance (OECD, 1999).
- Corporate governance is a field in economics that investigates how to motivate and maintain efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving financial performance, for example, how the corporate owners can motivate corporate

managers to deliver a competitive rate of return (Mathiesen, 2002).
- Corporate governance is a system which owners use to control corporations and assure themselves of getting a competitive rate of return on their investment (Gerndorf, 2003).

Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many players involved and the goals for which the corporation is governed. The principal players are the owners and management. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.

Owner Classification

There are only a handful of studies that actually focus on developing a classification system for ownership. Many authors and institutions have come up with different classification features that basically reflect their special interest in the field. Jensen et al. (1976) differentiated between owners with inside equity, outside equity, and debt. Charkham (1995) classified owners as foreign, miscellaneous, privately held corporations, legal persons in public law, private persons, insurance companies, banks, pension funds, and mutual funds. Gerndof (1998) observed many of the same classifications, but also differentiated between majority owners, minority owners, long term owners, 'wildcat' investors, foreign investors, domestic investors, risk spreaders, actives owners, passive owners, known owners, absent owners, and strategic owners.

Djakov (1999) also differentiated ownership between management, employees, the state, and local outsiders. La Porta et al. (1999) further categorized owners between that which is widely held, family owned, state owned, and that which is controlled by corporations. These and other similar classifications have also been adopted by authors such as Thomsen et al (2000), Mathiesen (2002), Kalmi (2003), Vitols (2003), Heubischl (2006). Ownership categories can also be seen through a national perspective, such as Estonian insiders and Estonian outsiders (Generalistide intervjuude kokkuvõte, 2004), or Estonian corporate, foreign corporate, Estonian individual and foreign individual (Estonian CSD, 2006).

Each author's ownership classification system is a theoretical framework, and the first step to develop an ownership typology that could be used in various ownership studies.

Owners' Legal Status

The classification of "legal status" is divided in two classes:
- Natural persons
- Legal persons

In actuality, the end owners of all private held corporations are natural persons, with only one known exception, that being the state as an owner. Families or private persons might own a holding company.

The class "natural persons" includes a variety of different features, for example, the age of the owner, their gender, education, nationality, and religion.

The class "legal persons" is divided in two sub-categories:
- Privately held corporations
- Legal persons in public law

Privately held corporations as owners are all publicly limited companies, privately limited companies, commercial association general partnerships, and limited partnerships. The term is used in this sense as a much broader reference to any company that is not owned by the state. All kinds of institutional investors, like banks, insurance companies, and mutual funds are included in this description. Legal persons in public law or public ownership (also called government ownership or state ownership) is government ownership of any asset, industry, or corporation at any level, national, regional or local (municipal). A government owned corporation may resemble a not-for-profit corporation as it may not be required to generate a profit.

Owners' Economic Goal

The classification of an "economic goal" is divided in two classes:
- Current benefit, dividends
- Increasing capital, increasing stock price

The interests of shareholders in listed companies – those which are owned by stockholders who are members of the general public and trade shares publicly, often through a listing on a stock exchange - are usually dividend payoffs and an increasing stock price. In other companies the interests of the owners might be very sophisticated. In studying the concept of an owner's "economic goal", the owners' capital disintermediation strategy is investigated.

Owners' Role in Governance and Management

The concept of an "owners' role" is divided in two classes:
- Active owners
- Passive owners

Owners do not have duties or responsibilities by law, they have only rights. The owner's fundamental right, actives duty is to arrange corporate governance. The fly high owners' role in governance & management is more active less passive. An active owner is interested in their property. They might have some emotional connection to it, or might hold a glimmering goal for their company. Owners are invited to show their activity by voting as shareholders, managing or supervising the company. However owners as managers are not a good choice, because the interest of all owners should be equally satisfied. Even if a private person has knowledge and interest in their company, it can be expensive for them to become active in it.

Owners' Contribution to the Realisation of a Business Idea

There are two types of owners covered by this category:
- Strategic owners
- Financial owners

These two types of owners contribute to the realisation of a business idea in very different ways. A strategic owner is interested in his companies, their main economic activity, and their sustainable development. Financial owners are interested only in the earnings of a company, and their contribution to the realisation of a business idea is purely through financing. A strategic owner acts on his knowledge of economic activity, has long term goals, and is involved in management and corporate governance. Dividend pay-offs and increasing the stock price are not overriding concerns. Strategic owners have some business idea, and are involved in managing and governance. Their involvement can be understood by the formula 'Money>Goods>Money'. Financial owners are interested only in earnings: their business formula is 'Money>Money'.

Owners' Investment Horizon

Here we can differentiate between two classes of ownership:
- Long range
- Short range

'Buy and hold' is a long term investment strategy which is based on the understanding that in the long run, financial markets give a good rate of return despite periods of volatility or decline. This viewpoint also holds that market timing does not work, especially for small investors, so it is better to simply buy and hold. The antithesis of 'buy and hold' is the concept of day trading, in which money can be made in the short term if an individual tries to sell during the peaks and buy during the troughs, with greater profit coming through greater volatility. A long range investment is an investment held for over one year, while investments held for less than one year are classified as short range.

Owners' Participatory Rate

The participatory rate is divided into two classes:
- Majority
- Minority

The participatory rate shows the power an owner has within a company. Majority owners, those with over 50% of votes, have unlimited power, while those with less than 50% of votes are classified as minority, and have limited power.

Owners' Attitude to Risk

Here again, we can divide owners into two categories:
- Risk spreaders
- Risk takers

Owners may be risk spreaders or risk takers, depending on their personal taste. Risk is the potential harm that may arise in the present or future. Financial risk is often defined as the unexpected variability or volatility of returns. An owner can reduce the risk level of their portfolio by holding stock in a wide variety of companies in various industries that are not perfectly correlated. Diversification can lead to lower risk, but can also lead to lower portfolio return. Risk takers, however, do not disperse their investments, but have only one investment, usually in a high risk project. If the project proves successful, the return can be far greater, but so too is the potential for failure.

Owners' Country of Residence

There are two types of owners:
- Residents
- Non residents

Estonian residents are, for example, specified by the Income Tax Act as follows: "A natural person is a resident if his or her place of residence is in Estonia or if he or she stays in Estonia for at least 183 days over the course of a period of 12 consecutive calendar months. A person shall be deemed to be a resident as of the date of his or her arrival in Estonia. Estonian state public servants who are in Foreign Service are also residents". A non-resident is a natural or legal person not specified as previously described.

Owners' Involvement

The two types of owners in this category are:
- Insiders
- Outsiders

Insiders are defined as persons who are working inside the company or used to work in the company they own. Outsiders not involved in the company, but work outside it.
In summary, the various authors have created nine classification systems that cover all the features of corporate owners: legal status, economic goal, role in governance and management, contribution to the realisation of a business idea, investment horizon, participatory rate, attitude to risk, country of residence, and involvement. But classification systems are distinct from typologies.

Typology as a Theoretical Framework

In social science, typologies are a well-known form of theory building. Typologies should be properly developed, so they can be subjected to rigorous empirical testing. Organisational typologies have proved to be a popular approach when considering organizational structures and strategies. Authors developing typologies have been criticized for developing simplistic classification systems instead of theories, and typologies are believed to be far short of being theories. Typologies are differentiated from classification systems because they meet several of the important criteria of theories, and are shown to contain multiple levels of theory (Doty et al., 1994).

If typologies are to be considered theories, they must meet some of the minimal definitions of a theory. Although there are no concise, unanimously accepted definitions of a theory, theory-building experts seem to agree that there are at least three primary criteria that theories must meet. Firstly, a theory's constructs must be identified. Secondly, relationships among these constructs must be specified. And thirdly, these relationships must be falsifiable (Doty et al., 1994; Vihalemm, 1979).

Typologies contain two distinct kinds of constructs. The first is the ideal type. Social, economic and historical research can never be fully inductive or descriptive as one must always approach it with a conceptual apparatus. Weber (1922) identified this apparatus as the "ideal type". Weber conceded that employing "ideal types" was abstract, but claimed that it was nonetheless essential if one were to understand any particular social phenomena, because unlike physical phenomena, they involve human behaviour which must be interpreted by ideal types. Weber formulated a three-component theory of stratification, with social class, based on one's economically determined relationship to the market (owner, renter, or employee), and social status, based on non economic qualities such as honour, prestige, religion and party, as conceptually distinct elements.

All three dimensions have consequences for what Weber referred to as one's "life chances" (1922). Ideal types are complex constructs that can be used to represent holistic configurations of multiple unidimensional constructs. They are intended to "provide an abstract model, so that deviation from the extreme or ideal type can be noted and explained". An ideal type is not "a hypothesis but it offers guidance to the construction of hypotheses" (Weber, 1922). These ideal types are theoretical abstractions thought to result in a specified level of a dependent variable. Typologies also include the uni-dimensional constructs that are the building blocks of traditional theoretical statements. These "first order" constructs are the dimensions used to describe each ideal type in the theory (Doty et al., 1994).

A second criterion is that a theory must hypothesize relationships among the constructs incorporated in the theory. Unlike more traditional theories, typological theories do not highlight the hypothesized relationships between the uni-dimensional first-order constructs and the dependent variables. Instead, typological theories highlight the internal consistency among the first-order constructs within an ideal type, and they explain why this internally consistent pattern results in the specified level of the dependent variables. Thus, typologies hypothesize relationships between the similarity of an actual organisation to an ideal type and the dependent variables (Doty et al., 1994).

The final criterion for considering typologies as theories is falsifiability, which implies that the predictions associated with a typology must be testable and subject to disconfirmation. The predictions that must be testable to classify typologies as theories are the hypothesized relationships between similarity to the ideal types of organizations and the dependent variable. These predictions can be falsified by measuring the deviation between real organizations and an ideal type, and then using this deviation to predict the dependent variable (Doty et al., 1994; Chalmers, 1998).

To empirically falsify any theory, the verbal model presented by the initial theorist must be translated into a quantitative model. Any statistical test is based on one or more equations that model key assertions of the theory. This quantitative model must be an accurate translation of the verbal theory, or the empirical test will not be valid (Doty et al., 1994). Precise definitions of the ideal types described in a typology are a prerequisite for modelling the ideal types.

Guidelines for Developing Typologies:

1. Theorists working with typologies should make explicit their grand theoretical assertions.
2. Typologies must define completely the set of ideal types.
3. Typologies must provide complete descriptions of each ideal type using the same set of dimensions.
4. Typological theories should explicitly state the assumptions about the theoretical importance of each construct used to describe the ideal types.
5. Typological theories must be tested with conceptual and analytical models that are consistent with the theory.

Typologies are based on a unique form of theory building that is intuitively appealing and holds considerable promise for helping researchers to understand complex, holistic phenomenon if they follow these guidelines (Doty et al., 1994). Typologies should be differentiated from classification systems.

Hypothetical Ownership Typology

This author is further developing a hypothetical typology that distinguishes between two dimensions - power and return. These are two principal interests for owners, based on corporate governance definitions found in this author's literature overview. Sociologists usually define power as the ability to impose one's will on others, even if those others resist in some way.

Returns are the distributions or payments awarded to the various suppliers of the factors of production. Returns, in economics, are the distributions or payments awarded to the various suppliers of the factors of production. In classical economics the factors of production are labour, land, and capital. Interest is the return to the owner from capital. Unlike labour, capital can be owned in shares and interest need not be individualised. What is called "dividends" in later day financial parlance is, in fact, interest in the economic sense of the term. And in financial parlance much of what is called "interest" is actually economic rent. Return, in financial terms, refers to the benefit derived from an investment. Return, in economic terms, is the benefit distributed to the owner of a factor of production. For example, the goodwill of social groups can be seen as social capital, which replaces the need for financial capital or the control of other capital assets, and can simply be considered goodwill on a much larger scale.

The ideal type never corresponds to concrete reality but is a description to which we can compare reality. Using this author's classification system and theoretical power-and-return matrix, we can see the connection of ideal types and the classification classes. This author distinguished four main types of ownership (see figure 1):

- Authority
- Renter
- Generalist
- Specialist

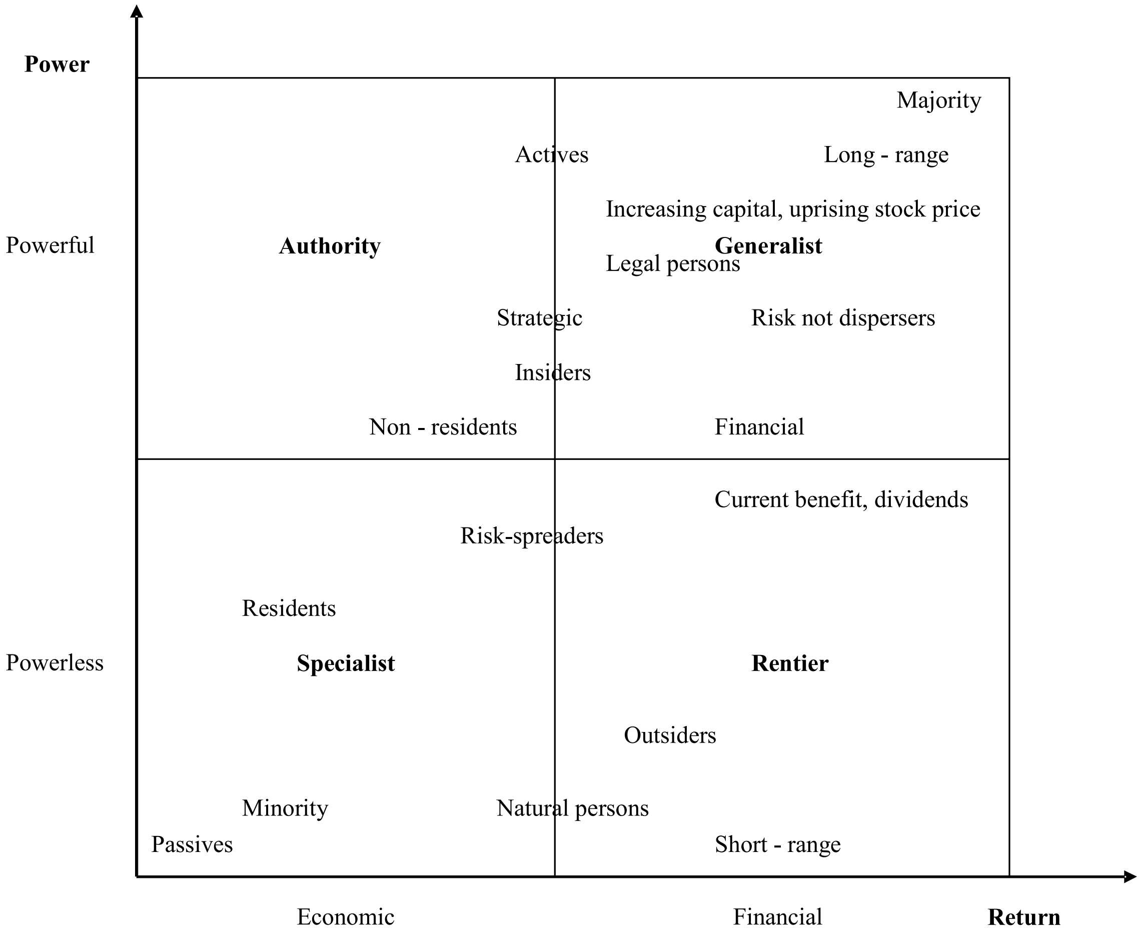

Figure 1. The Main Types of Ownership

In Weberian sociology, authority comprises a particular type of power. The dominant usage comes from functionalism, defining authority as power, which is recognised, as legitimate and justified by both the powerful and the powerless. Authority is maximising power and minimising the economic return. Authority can be a referent authority, which refers to the ability to influence others through charisma, personality, and charm. Coercive authority refers to motivating managers and owners by punishment and is predicated on the fear of losing status, positions, bonuses or jobs. Reward authority refers to positive reinforcement and the ability to award something of value. Expert authority is earned if the team respects one‘s skills as an expert on a subject matter. A rentier is an owner who lives on the income from property, bond interest, or other investment and is not personally involved in its operation. A rentier is maximising return and minimising power. A generalist is one whose skills, interests, or habits are varied or unspecialised, and a specialist is one who specialises in a particular occupation, practice, or branch of learning. Generalists are also dealing with the merging and acquiring of different companies as well as other assets. A specialist minimises power and return. On the contrary, generalists are maximising power and return.

A primary motive for developing a hypothetical typology was to encourage future researchers to more deeply investigate the ownership structures of corporations. It is clear that properly developed and fully specified typologies are complex theories that can be subjected to rigorous empirical testing. The next question is how to progress from the theoretical typology to the fully specified ownership typology. Researchers have many possibilities. A good research possibility is to work with qualitative methods such as interviews and case studies, or use quantitative research methods. This author's suggestion is the use of triangulation. In the social sciences, triangulation refers to the use of multiple cross-checked sources and methodologies. Triangulation heightens qualitative methods to their deserved prominence while quantitative methods can be used in a complementary fashion.

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Some Organizational Corporate Governance Issues in Slovenian Enterprises

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Abstract

In the following article the author will briefly cover the genesis of the Slovenian corporate governance system. Firstly, the author will describe the preceding self-governance system, which only influenced the present system in some respects, and the eventual abandonment of this system. After that the author will analyse the present model of corporate governance in Slovenian enterprises. This is a two-tier model, which follows the characteristics of the German model. The author will primarily discuss the two issues within this model of corporate governance that most draw the attention of Slovenian authors: the role of the supervisory board and the role of labor representatives within the supervisory board.

On the basis of the rich history of governance in Slovenian enterprises, the author will discuss some broader issues relevant for understanding the phenomenon. He will also briefly speculate about the possible future of corporate governance on the basis of current developments and Slovenian experience.

Keywords: corporate governance, self-governance, two-tier model

Introduction

Although I believe that today's systems of governance will change radically due to the revolutionary development of both the economy and society as a whole, including the rather dramatic change in traditional ownership, in this article I will primarily concentrate on the situation and problems associated with existing corporate governance in Slovenian enterprises. The discussion of current issues of governance might not be as important and noble as discussions and predictions about long-term changes and future governance, but it is nevertheless necessary. It is important to analyze the present systems of governance and top management to understand their characteristics and development potential. On the basis of experience and lessons learnt we could improve the current approach and create a system of corporate governance for the future.

An analysis of governance in Slovenian enterprises could well be of particular value. While an increased interest in corporate governance in Western countries has immerged in the last two decades, in both Yugoslav and Slovenian theory and practice, governance and especially one particular model of governance — self-governance –– was much discussed and practiced throughout the second half of the 20th century. According to Cadbury (1999, p. 12), the emergence of global markets and pressure for board accountability and performance are the main issues driving the worldwide interest in governance today. Although I agree with this statement, I believe the main reason for such interest in governance is the recognition of the decreasing role of owners in influencing the conduct of their enterprises. The question of whether to restore power to the owners or to admit that today's and certainly tomorrow's concept of ownership calls for new approaches to governance can and should be raised and thoroughly discussed.

Three main topics are covered in my writing. Firstly, I will briefly show the development of corporate governance in Slovenian enterprises in the period characterized by self-governance. The experiment of self-governance, although unsuccessful, might be interesting. But the fact that it 'might be interesting' is far from being the main reason for presenting it. Perhaps we can learn more from such a failure than from a success. By discussing the self-governance model, its dependence on a certain socioeconomic system can be seen more clearly, and some rather topical issues such as the role of stakeholders and especially employees within governance, social responsibility, networks, etc. can also be explored.

In 1993, Slovenian enterprises adopted the German model of corporate governance. Some of the problems within the corporate governance of Slovenian enterprises exist also in other countries that have applied the two-tier model. My second goal is to discuss two very commonly tackled problems in more detail: the distinction between the roles of the supervisory and the management board, and the role of labor in corporate governance. The discussion of both these issues in the literature is both extensive and intensive. I will approach my discussion of both these issues by analyzing decision-making about the over-all business.

Thirdly, based on the experience of both systems of governance in Slovenia, I will distinguish the organizational, decisional and socioeconomic aspects of corporate governance and speculate about possible development. This discussion could contribute to the development of the theory and practice of governance (and management), and consequently result in improved effectiveness for corporations.

The self-governance period in Slovenia and its abandonment

A Brief Historical Overview of the Development of Self-Governance

In Slovenia, as in other former Yugoslavian republics, and following the example of the Soviet Union, enterprises were nationalized and became state property from 1945 – 1948. Immediately after the war, a centrally planned socialist economy was established in Yugoslavia. Firms were more or less dependent units following a centralized state plan. The state through its representatives governed (and managed) firms.

After the split with the Soviet Union in 1948, a new socioeconomic system had to be "invented", but neither a capitalist nor a communist one. In 1950, a transformation of ownership took place with the introduction of a self-governance (which was incorrectly translated into English as self-management) system based on social property. Those who officially made the most important decisions regarding assets and their sources were employees in individual enterprises, which were rather autonomous business units.

Each socioeconomic system is determined by the ownership of production assets, by their control or governance and by their socio-economic goal. All three elements should be in harmony. Let us determine the three elements in the self-governance system. Social ownership means that there was no specific person or institution to which these funds belonged. Property was owned by society and given to worker's collectives to be governed in the best interests of society. This interest was measured as income (close to the net value added) per employee as opposed to profit per capital. However, each socioeconomic system changes in time and its development heavily depends on the development of the means of production. The Yugoslav self-governance model was not in accordance with the socioeconomic state and its development, and as such could be seen as a utopian model.

From 1953 to 1962, the Yugoslav planned-market economy went through an impressive increase in the national income. Later, from 1962 to 1977, the average annual increase in the national income was lower than in the previous decade. It became obvious that the self-governance system was deficient in the creation of new capital. The economic reform in 1965, which introduced many elements of a market economy, gave more freedom to employees as collective governors in allocating economic added value. The propensity to use profits in order to increase personal incomes became dominant. Some Slovenian authors insisted that the enterprises ought first to take care of development by paying a contribution to society for the right to govern the social capital. To prevent the growth of increased personal income, measures were imposed by law and by social contracts between the government, the chamber of commerce and the labor union, and also by self-governance agreements between enterprises.

With the same aim, a scheme to encourage savings and investments was offered. Governance rights were also given to employees on the basis of their savings, known as "past labor". Although the idea was supported by the Constitution (1974) and the Associated Labor Act (1976), it was never introduced on a large scale. Both acts however, brought many changes to the self-governance model. Already starting from 1970, the socioeconomic situation changed. Instead of focusing on the (socialist) market economy as having the leading role, the government and politicians started to emphasize trust and agreements among enterprises. Some features of the system resembled today's networks. The role of employees in governing enterprises increased. From 1976 onwards, when the Law on associated labor was adopted, we began to talk about the associated labor period, which lasted until the early nineties.

Minor changes appeared and were introduced also within governance, and these paved the way for the introduction of a capitalist economy, enabled by the Yugoslav Constitution adopted in November 1988. It may be that more changes have been introduced within the economic system and policy and less in the area of self-governance.

Self-governance Structure

The governance structure of a company consisted of an assembly of workers, a council of workers and a governing board. Although at first glance such a structure of governance resembles that in the West (a shareholders' meeting, a workers council as the board of directors, and a governing board as the executive committee), one difference was in their membership. To prevent managers influencing the employees they were not allowed to become members of governing bodies. Despite this fact, the real power of managers was quite high (Mihelcic, 1995, p. 13), either directly or through self-governing bodies, which had the right to accept their proposals. The influence of the State and the Communist party was – at least in practice – strong. Accordingly, the responsibility of the managers was more political than economic. The function of business planning was highly emphasized; organizing, leadership and controlling were less important. It was believed (theoretically) that the employees – being the "owners" – were highly motivated and very little pressure and control over them was needed.

According to the law on associated labor, it was the employees themselves that governed the companies owned by society in a socially responsible way. The basic goal of companies was not profit but income. Income could be seen as the quantitative expression of the social responsibility of enterprises. The income included "profit", as the result of social capital and as the motivation for appropriate governance, all the contributions (social care, medical care and similar) and taxes to society, salaries, wages and other contributions to employees. Part of the income should have been used primarily for the development of social property. The allocation of income between different stakeholders was supposed to be achieved using the contractual approach, which has been discussed by sociologists (e.g. Martin, 2001, pp.728-729) as one viable and ethical way of deciding between the conflicting interests of stakeholders. The salaries of the employees, including managers, depended to a certain degree on their performance and results achieved.

To enable employees to more easily make the governing decisions, the basic economic units were small. They were called basic organizations of associated labor (BOAL) to emphasize that they were governed on the basis of labor and not capital. In reality, they were small, but nevertheless varying in size –– a small workshop or a larger factory (Hocevar, Jaklic, Zaman, 1999, p. 202). They were mainly functionally organized, and being income centers they could be compared to profit centers.

BOALs integrated with other related units into working organizations (WO). In a similar way BOALs and WOs could integrate into composed organizations (COAL). The entire integration was conducted by self-governance agreements among the BOALs. Interestingly, they were regarded as "owners" of WOs and COALs. The organizational structure of COALs and also of WOs was mainly multi-divisional (more about the characteristics of the organizational structure within COALs was discussed in the paper prepared for the CEMP conference on Common Managerial Practices: Rozman, Rudi: Multi-divisional Structure in Slovenian Enterprises, Molde, Norway, 2001, 19 pages).

The governing-managerial structure of BOALs consisted of assemblies of workers, councils of workers, governing or executive boards and the general manager. The general manager was independent in managing the business and considering the statute, self-management agreements and other acts set by the governing bodies. The governance within WOs and COALs was organized in a similar way. Members of their workers' councils and executive boards were delegated by BOALs. They were supposed to find common interests within the integrated units.

Despite the interesting and complex organization of governance and management, and despite the many changes in the socioeconomic system and policy, the economic results were not according to expectations. The reasons for a collapse, which coincided with other changes in Yugoslav republics, were many. The theory, law and practice of the self-governance system were quite separate things. The theories about the role and connection between BOALs, WOs and COALs all differed. The system had not considered the level of technological and economic development. The Communist Party, the trade unions and the government were all highly involved. Management was still more political and obedient than innovative and independent. There existed little professional managerial education until 1990.

The Abandonment of the Self-governance System

In 1991, Slovenia was the first Yugoslav republic to gain independence and start privatization, "marketization", liberalization and so on. A law on privatization was passed at the end of 1992. The result of this privatization was ownership that was highly dispersed and largely consisted of internal owners (Hocevar, Jaklic, 1997, p. 7). This was due to the fact that employees obtained certificates of ownership for "their" enterprises. A number of state mechanisms regulated both the privatization and some financial institutions to mediate between the dispersed structure of the distributed certificates and the enterprises' capital – equity was established (Korze, Simonetti, 1992). However, the major share of the enterprises' equity was given to two para-state funds.

A new law on companies was passed in 1993, introducing similar formats for the legal existence of companies as in Western countries. The option was given to Slovenian enterprises to either introduce a one-tier or two-tier model of governance. For larger enterprises, the two-tier model was obligatory. However, there are some minor differences compared to the German model –– for example, in Slovenian enterprises the management/governing body was less collegial, labor representatives were selected by workers councils and others. The role of banks within the governance of enterprises can be seen as unimportant compared to their dominant role in Germany. Many authors working in the area of law (e.g. Kocbek, Ivanjko, Bratina, 1998) and others (e.g. Gregoric, Setinc Tekavc, 2000) discussed the legal issues of corporate governance.

The characteristics of the changes at the beginning of the transition (dispersion of ownership, participation of workers in governance and so on), briefly mentioned above, clearly indicate a connection with the previous system of governance.

When the German two-tier model was introduced, its shortcomings were also noted. By following the two-tier model, some practical experience has been gained and certain minor changes introduced. Nowadays, as already mentioned, two problems within the organizational area of corporate governance require wide-ranging discussion.

Today's Governance Problems in Slovenian Corporations

One key problem, which is quite often discussed in newspapers and professional journals, is the role of the supervisory board in relation to the management board. At least the members of the supervisory boards and almost everyone else, except the managers themselves, claim that there is too much power held by the management board, which, by the way, as the author claims, should be known as the governing and managerial board, because, according to its function it governs as well as manages. This causes much misunderstanding and confusion, not only because of semantics. The semantic problems are more a consequence of a misunderstanding of the essence of governance and management. Some authors for example compare the board of directors in the Anglo-Saxon model with the management and not the supervisory board in the German model. Some again see the supervisory board as the only "governing" board, which might be the reason for the increasing involvement (discussed later) of supervisory boards in the direction of enterprises.

The basic reason for this discussion in Slovenia and elsewhere is the existing lack of power, or rather, the malfunctioning of supervisory boards. Long ago, Drucker (1974, p. 728) pointed out that…"its members are always the last group to hear of trouble in the great business catastrophes". There is also the feeling that supervisory board members have very little influence over company affairs. They lament their dependence on (the information provided by) the managers. It is very likely that the same or similar problems also appear in other countries practicing the two-tier system of governance.

Perhaps in the Slovenian case an important problem, which is probably common to all transitional countries, is the behavior of many of the managers. Through privatization they tried to become the owners of previously state or socially owned assets (which, basically is appropriate if made in line with stock exchange rules and not based on inside information). According to Gregoric and Simonetti (2004, pp. 60-63), the ownership of companies by managers has increased from 3.86% at the beginning of privatization to 9.03% in 1999. The increase was rather small among the corporations listed on the stock exchange. Managers themselves thought that their share should increase further. The people watching them becoming richer called for tighter controls to prevent vast privatization. At the same time, the ownership of employees has remained the same and the motivation for employee ownership is low (Gregoric, Debeljak, 2005, pp.16-21). The other reason for these demands for tighter control is connected to the relatively high income (compared to that of employees) among managers (who often themselves propose the income criteria, as shown in a discussion in the Slovenian journal *Manager*, in June 2005, pp. 30-32), which sometimes has no relationship to company performance.

Authors also discuss other factors, such as the inappropriate selection of supervisory board members (sometimes even on a political basis), their low level of devotion to company problems, (Kostrevc (2005, pp. 38-39) argues, in connection with the system for compensating managers, that supervisory boards quite often do not check on results as the basis for compensating managers), limited knowledge of business affairs (these issues are discussed and confirmed in Cajnko Javornik and Hafner, 2005, pp. 26-29), and the unclear distinction between the tasks of the supervisory and the management board –– both in law and practice.

Different suggestions have been made for improving corporate governance in Slovenian corporations (let us mention Gregoric, Zajc, 2006, pp. 261-274). They are quite similar to suggestions made by foreign authors (e.g. Schreib, 1996, pp. 285-291), such as the careful selection of supervisory board members, their increased involvement in company affairs, more committees to support the supervisory board, a proper and independent information reporting system, more intense cooperation between auditors and supervisory boards, etc. While these suggestions are important, they do not change the basic relationship between the supervisory and management board and they can all be implemented within the existing legal system.

Very often the suggestion is made that more power should be given to supervisory boards. This is somehow not in line with the information in newspapers about Slovenian supervisory boards confirming strategies, annual plans and other decisions prepared by the management/governing board. These decisions are part of the direction given to the company, and the question arises whether this orientation in giving more power to supervisory boards is not in contrast to the basic principle accepted in the two-tier model of governance that the supervisory board should not be allowed to interfere with management in business matters. In addition, even commentators on the Slovenian Company law (Kocbek et al., 1998) are not in favor of supervisory board involvement in the directing of corporations.

The question addressed is: should more power be given to supervisory boards; does this mean they should be involved in setting direction and what would then happen to them and the responsibility of their members. Should they better exercise their supervisory role? Should these changes be incorporated into Slovenian Company law?

The second question discussed concerns the role of employee representatives on supervisory boards. Quite often managers and other supervisory board members believe their role is overemphasized and hinders the development of the company and should therefore be reduced, while labor representatives see their role as undervalued and subordinate.

Should More Power be Given to Supervisory Boards?

Types of Decisions within the Firm

To answer the above question let us first look at the intended role of supervisory boards. According to Potthof (1996, pp. 257-258), banks and landlords played an important role in the German economy at the beginning of the 19th century. They looked for good investments, but were not much interested in managing enterprises. Further, they simply tried to transform short-run assets into long-run assets and to supervise the business results, without any special intention to direct and manage enterprises.

Everybody agrees that the role of supervisory boards is supposed to be supervision. What is rarely – if ever – discussed and not clearly and explicitly stated is whether that means the supervision or control of business (results) or the supervision of governing decisions made or proposed by the management board.

It is also commonly accepted that the supervisory board should not interfere with management when conducting business affairs. It is more or less certain that the supervisory board should not be involved in operative and tactical decisions. Still the question remains: should it be involved in accepting strategic decisions or perhaps only discussing them; again only in checking the results or also in controlling the decisions.

Let us make a brief analysis of one small but important group of business decisions. Due to the fact that shareholders own the company as a whole, it is obvious that governing decisions will only be made on the overall business (profitability criterion). Decisions on overall business are either within the plan or control. Within the plan (direction) and control (supervision) overall business decisions can be strategic (long-term) and tactical (short-run). Strategic decisions within the planning are decisions on investments, acquisitions, disinvestments and so on. Tactical decisions are mainly about product and market mix. Strategic control is the control of strategies implemented whereas tactical control is the control of tactical decisions. Both are mainly executed on an annual basis and appear in the form of business reports including financial statements, such as the balance sheet and the profit and loss statement.

Decisions about overall business are a potential area for governing decisions. Due to the high number of owners and the increasing complexity of decisions, owners delegate them to their representatives: governing bodies. The governance function has to be structured, in our case of two-tier governance, to the shareholders, the supervisory board (Aufsichtsrat) and the management/governing board (Vorstand).

Demarcation between Governance and Management and within Governance between the Two Boards

The process of decision-making in regard to the entire business –– the governance-management process –– is a united process and separation on the basis of content into a governance and management part could be complicated. The whole process, which consists of many individual subprocesses, starts (in the author's opinion) with governance and continues within the management. The demarcation between governance and management is determined rather by law and/or by the owners themselves, and not by content. The author sees it as an integrated process that can be defined as follows: the governance-management process is an organizational process of setting goals, policies and strategies, which develops into the sub-processes of planning, execution and control.

The law and/or the owners play an arbitrary role in separating the governing function from the managerial function. Broadly speaking, we can say that setting major goals, policy and strategies and overall control of business execution are reasonable aspects of governance. In the Anglo-Saxon model, the board of directors attends to governance in its entirety (one-tier). It includes both direction and control decisions. In the German model, governance is assigned to two bodies: the supervisory board and the management/governing board. The latter is responsible for direction and the former for control of over-all business.

Direction requires a good knowledge of both business and its environment and planning processes. Due to the increasing complexity of these decisions and the increasing number of shareholders in corporations, they have been delegated to managers. Managers can reasonably set the direction because they can devote all their time, efforts and knowledge to running the business. The management/governing board has to direct and manage the corporation. The task of the management/governing board is very complex. The supervisory board only makes control decisions and its governing role is less important. However, its power arises from the fact that it controls the management/governing board and can hire and fire it. The question that still remains is the following: what do we understand by the control that is left to the supervisory board?

It is very likely that the management can prepare a better direction than the supervisory board. However, there is a danger that they will prepare a decision in their own interest. The question is whether the supervisory board should possess the power to approve or reject the decision? It is reasonable to assume that the person or body that accepts the decision should be held responsible for the consequences. If it is the supervisory board that accepts the decision, then it should also be held responsible for any consequences. The other possibility is that the management makes the decision and is held responsible for the consequences. In this case the supervisory board controls only the consequences of the decision or the business results. The disadvantage of only controlling the consequences is that it might be too late to react properly.

In the Slovenian case, the discussion about expanding the role of the supervisory board runs more in the direction of involving supervisory boards in strategic decisions and less in the tighter control of business results. In practice (the actual situation differs from enterprise to enterprise (Kocbek, 2005, pp. 34-35)), supervisory boards have started in many cases to approve and accept (not only ask questions and consult) annual and strategic plans and other strategic decisions. There is, as yet, no discussion of increasing their accountability. Managers are not opposed to this development. They still make or prepare decisions as before and probably see the shared responsibility as an advantage.

Supervisory Board: Tighter Control, no Direction

Still, I would argue in favor of the supervisory board only performing a supervisory role. Responsibility in this case very clearly lies with the management/governing board, which also continues its decision-making in regard to operations resulting in actual performance. The control of the consequences of business decisions should become better and as concurrent as possible.

The reason for many supervisory boards in Slovenia favoring more power also lies in their mistaken belief that the control of business results is simple and undemanding. I believe that supervisory board members often do not conduct their present work of controlling results well enough, and at the same time, they are asking for more power. Many members do not fully understand financial results and statements, such as the balance sheet, income statement, different ratios showing the quality of business, etc. They are also unaware that they have to compare the results with the competition, consider investments, the environment, etc. In this case, the control function will be very demanding and the decision to identify the responsibility of management quite difficult.

The abovementioned interest in giving more power to supervisory boards is also due to the fact that the members of supervisory boards are often former managers. At least at the beginning they can make planning decisions themselves. However, this can more often result in conflict between the present and the former manager.

I am also in favor of the solution mentioned due to the fact that the members of supervisory boards do not live within the company and they do not devote much time to business affairs. The good selection and development of the members of supervisory boards as well as other measures can improve this situation. But they have to improve the control function, whereas it would be difficult for them to set the direction for the company. By asking different questions, by showing interest, by devoting more time and by asking for appropriate information, they can improve. It is imprudent to try to decrease the (rather high level of) power enjoyed by Slovenian managers by taking over part of their job, so that they end up hiding themselves behind the approved decisions of the supervisory boards. Tight control of decisions without being held responsible is also unfair. Both, increased control and trust will lead to decisions in favor of the owners.

On the basis of this analysis, I am convinced that improving and strengthening the control of results by the supervisory board and leaving the direction to the management will yield the best results. The answer to the question of whether to give more power to the supervisory board (for direction) is: negative. Instead the supervisory board should use their existing powers to check and control business results more effectively and more often be prepared to fire poor managers.

Worker Participation in Corporate Governance

Most members of supervisory boards representing owners, as well as most managers would agree that representatives of the workers do not act in favor of the shareholders. They will even argue that employee representatives often start and maintain conflicts as they give priority to their interests. According to the company law (1993), representative members of employees have to take care of the interests of the employees. These interests are not explicitly determined, but they could be salaries, working conditions and so on. These interests are often opposed to those of the shareholders. Many authors agree about the involvement of employees in governance and the protection of their interests. Stiles (1993, p. 123) quotes the opinion of the Cadbury committee that "the German system with its representation of diverse stakeholders may be seen as a better model of corporate governance, which can actually increase national competitive advantage".

It is not quite clear whether workers' representatives discuss and vote only in their own interests. It is clear that according to company law, the supervisory board as a whole does not represent the interests of employees but of the company. Labor representatives join as decision-makers for all the decisions of the supervisory board. They might oppose other members because of different interests, and this could be the main reason why there are voices asking for a reduction of their role within the supervisory boards.

The argument that workers' representatives more often oppose the interests of the owners by following their own interests is not strong enough to justify a reduction of their present role. It is very unlikely that the interests of the owners would be jeopardized because they have not been taken into consideration. Capital representatives always retain the majority. Even in larger enterprises, where they represent half of all the members, the representatives of the owners have decisive power. The chairman of the supervisory board, according to Slovenian company law, is always a representative of capital.

According to stakeholder theory – and employees are rather important stakeholders exerting considerable influence on the business and its results –– the role of employees should be increased. No such requirement exists in Slovenia so far. Still, within the existing situation, employees can increase their role. Workers' representatives often only discuss matters connected to their work within the corporation; they should look at the company from a broader view and especially determine and protect the interests of the employees. Labor representatives thus have to devote more time to knowing the company better and learning more about business. In addition their selection should be better and cooperation with workers' councils should be tighter.

Officially, according to company law, only owners and labor representatives have the right to govern. The other stakeholders can also influence governance. Representatives of banks, suppliers, customers and the state are often members of the supervisory boards. They cannot be involved in the management/governing boards. In Slovenian practice there is little talk about governance by other different stakeholders, and when we talk about stakeholder governance we usually think of the shareholders and workers as the main stakeholders.

It is quite obvious that the requirements to decrease the role of employees would be against the expectations of stakeholder theory. Meanwhile, while writing this article, a proposal considering these two issues was presented, and after passing certain bodies, was accepted by the Slovenian Parliament. The discussion concluded with the decision to give the right to all corporations to select either the Anglo-Saxon model or stay with the German one. This change would represent a decrease in the role of the owners, an increase in the role of managers and a decrease in the role of the employees (Rajgelj, 2005, p. 9). Slovenia is joining some other European countries where both structures are present as shown in Mallin (2004).

Slovenian firms have been asked whether they will move to the Anglo-Saxon model. Only a few have answered –– most corporations will first study the consequences (Markovic, Korazija, 2005, p. 19). I am afraid that most of them (not only those with block ownership) will accept the one-tier model. A new discussion has already started on how to introduce the interests of the employees within the boards of directors.

Some Theoretical Key Issues

Corporate governance can be defined as an organizational function and process. It is determined by the socio-economic system, is the source of authority in the enterprise and develops dynamically within the process of determining goals, policy and other important decisions. Therefore, it functions to represent, preserve and develop the interests of the owners (Lipovec, 1987, p. 52). In this definition there are three aspects of corporate governance: socioeconomic, organizational and decisional.

In the first of these, which we have already mentioned, governance is determined by the socioeconomic system to represent, preserve and develop the interests of the owners. But at the same time governance must follow the criteria set by the socioeconomic system and thus maintains the system. Governance represents a link between social economy and the enterprise.

As the socioeconomic system has changed so also is governance changing. If we look at the past there were different forms of ownership and governance. Earlier, authors (e.g. Koontz and O'Donnell, 1959, p. 48) emphasized that the shareholders governed the company on the basis of private property as defined by the constitution, laws and economic and political institutions. McFarland (1962, p. 277) defined governance as the final authority within an enterprise, deriving from the rights of individuals to possess private property. Due to the over-all development of the economy and enterprises, owners first disappeared from the production function and then from management and direct governance of their property. Ownership and governance became separated. At the same time the managerial function and its importance began to increase.

With the increasing number of owners/shareholders, and the increasing complexity in decision-making, the role of managers became crucial. The relationship between governance and management became increasingly important and a matter of continuous discussion. If the owners allow the managers sufficient autonomy, the managers will be able to use their knowledge and experience and make good decisions. But there is the danger that they will act in their own interests. On the other hand, if the owners control the management more rigidly, the managers will act in the owners' interests, but their decisions might be worse. In addition to those researchers and authors investigating the organization, economists are also studying this relationship under the heading of the principal-agency relationship, and they suggest solutions for overcoming these problems by either controlling and/or rewarding managers.

Many authors dealing with organizational issues are discussing the diminishing influence of owners. As they believe that the socioeconomic system is not changing (yet), they see the decreasing role of the owners as a problem within the present system and not that the existing system is itself the problem. They discuss the option of returning the power to the owners and propose many improvements (Rozman, 1998, pp. 28-45).

However, in the recent past some other modes of governance have developed that are not rooted in private or state capital. After capital as the basis of governance we could also imagine labor. Dow (2003, p. 3) shows a simple division of firms according to criteria of ownership (private, public) and control (capital, labor) into capitalist (private, capital), socialist (public-state, capital), laborist (private, labor) and self-managed (public-society, labor) firms.

There exist many arguments for and against worker direction and control. Dow (2003, pp. 23-44) discusses arguments in favor of worker involvement, such as equality, democracy, property, dignity and community. Still the number of worker owned and governed enterprises, like Mondragon cooperatives, is small. Structures of governance in labor-governed firms vary considerably. Despite the small percentage of worker governed firms, like cooperatives, some authors (e. g. Barker, 1997, pp. 109-117) believe that they represent the organizations of the 21st century.

Deriving from the socio-economic understanding of governance we arrive at the conclusion that governance is the ultimate authority in the firm and also the source of all authority for everyone else. With more shareholders and more complex governance-management relationships, the governance function starts to structurally evolve. Shareholders establish different bodies of governance and design relationships among them. They delegate their authority to other governing and managing bodies or individuals.

The organizational structure of governance is defined as a network of relationships (relationships between owners and governing bodies; relationships between governing bodies) between people (members of boards) and bodies at the level of governance, which ensures that the governing function will remain the source of authority and take care, protect and develop the interests of the owners (Lipovec, 1987, p. 197).

In practice a variety of structures have evolved. The two most known and discussed are the Anglo-American or Anglo-Saxon and the German. Both models are appropriate and logical –– a different historical development and different culture led to different yet consistent solutions.

The governance-management process is the process of setting enterprise goals, business policy and other important decisions within the process of planning, executing and controlling. The decision-making process is a cognitive-methodological process in which we learn about the subject of the decision and its goal, try to develop alternative solutions and choose from among them the best alternative to meet a criterion (which is usually the goal). Within this process it is primarily the decisions made by the supervisory and management board that are discussed.

A Possible Future Trend

In theory, quite a number of authors seem to be in favor of a stakeholder governance model. Employees, the general public and governments are questioning whether the practice of maximizing value for the shareholder is really at the expense of the other stakeholders in the corporation (Lawler, Finegold, Conger, 1998, p. 23). In practice, they also recognize the importance of stakeholders, but do not agree that they should be involved in governance. This is quite in line with the view held by Lorca and Garcia-Diez (2004, pp. 93-99). They emphasize the increasing role of stakeholders, but look at stakeholder theory as a model of management. Goodijk (2003, pp. 225-244) also emphasizes the importance of stakeholders and talks about a stakeholder management (not governance) model. He assigns a specific role to employees, who, in his opinion, really can become partners in decision-making at the corporate level. Post et al. (2002, pp. 6-28) see the long-term survival and success of the company as being determined by its ability to establish and maintain relationships within its entire network of stakeholders. It remains open whether these connections are a sufficient reason to give stakeholders the right of governance.

Many are opposed to the notion of stakeholders being involved in governance because they are paid according to their endeavors (salaries, interests, products, payments, etc). As Easterbrook and Fischel (1991, pp.195-200) argue, only owners have the right to govern as they are the only risk-taking party. Arguments from the organizational perspective against stakeholders being involved in governance are discussed by Argenti (1997, pp. 442-445). He maintains that a group of shareholders is homogeneous. It is quite obvious what they expect from investments. The decision-making process is clear and follows the profitability principle. The managers can only follow the requirements of one stakeholder. Stovall and others (2004, p. 221) claim that the dominant contemporary model of corporate governance maintains that the shareholder is the primary constituent of the firm and maximization of the shareholder's wealth is the goal of the corporation.

I have intentionally not made a distinction between employees and other stakeholders. As we can see from various articles, most authors discuss the direct involvement of employees and much less or not at all of other stakeholders in governance. Blair (1998, pp. 195-200) comes to the conclusion that due to socioeconomic development, shareholders are no longer the only investors in corporations. The employees are a kind of investor, too. The value added for the enterprise is the sum of both investments. Blair does not see any need to make a distinction.

If we look at the present changes in the socioeconomic system, we find evidence of a (quite broadly) shared opinion and agreement that rather than the traditional notion of capital, ownership of the means of production, the ownership of knowledge, human capital, is of utmost importance. This is becoming a scarce resource. We like to say that we are entering a new era, an era of knowledge –– the information era. Grant has said: "if knowledge is the pre-eminent productive resource and most knowledge is created and stored within individuals, then employees are the primary stakeholders" (1997, pp. 450-454). Handy and others argue that definitions of ownership are not appropriate any more. They are…"an affront to natural justice because it gives inadequate recognition to the people who work in the corporation, and who are, increasingly, its principle assets" (1997, pp. 26-28).

If employees are the owners of the most precious resource then the concept of ownership has to change. Two elements of the socioeconomic system – ownership and direction and control – need to change. But does this mean that the goal of the enterprise must change, too? Duncan and others (1988, pp.16-21) offer us the answer by saying that nowadays, in the postindustrial society, if it is to be different from the industrial one, corporations are supposed to follow a new measure of effectiveness, not profitability. The critical production factor is becoming knowledge. People are the only bearers of creativity and innovation; nowadays they are both important for success. If profit attracts capital, what attracts knowledge?

As already mentioned, many authors discuss social responsibility, which has to be considered in addition to profitability or will even replace it. Social responsibility goes beyond legal and economic requirements and is tightly connected with ethics. Each developed model of governance requires more relationships between people. Each higher form of governance demands increased consciousness and fairness among all members involved. Without any doubt managers have more power than ever before and the control of their endeavors is difficult. Most of the employees depend on them. Even more, the dependency of people on the behavior and decisions made by others has increased tremendously. People become increasingly sensitive to unethical deeds. Socially responsible and ethical behavior could become a necessity for survival and the well-being of people, and replace the egoistic search for profitability.

The abovementioned leads us to the conclusion that we are entering a new era and a new socioeconomic system is developing. If we agree that we are entering a new era then a new model of governance (such a model is discussed in more detail in Rozman, 2003), in accordance with the ownership and basic goal of enterprises, will have to develop. If we assume that the aim of enterprises will become social responsibility and ethics, the other two elements of the socioeconomic system will be ownership and governance. Private (employees included) and state ownership do not correspond to social responsibility. Social ownership does. Who will govern enterprises and other organizations? Society will through different stakeholders and/or collectives in their name, which will bring different interests into line through agreements (and the mission statement). However, social responsibility is difficult to measure. Can income or value added become a joint quantitative measure of social responsibility, and the contract approach, the way of dealing with the conflicting interests of stakeholders?

Conclusion

The dispute about whether to assign more power to the supervisory board is going on in Slovenia. Through our analysis we have come to the conclusion that giving more executive power to the supervisory board might reduce the quality of direction and cause the issue of who is responsible for business results to become less clear. Despite the greater likelihood of managers exhibiting opportunistic behavior, we see the role of the supervisory board as being just that, supervisory — checking and controlling the work of the management. At the same time, the members of the supervisory board should use their existing powers more effectively, and this also depends on the level of their involvement and understanding of the firm.

Regarding worker participation in supervisory boards, it is my opinion that this should be strengthened by increasing the extent to which the interests of workers are upheld. More involvement from workers' representatives is in line with increasing the power of the stakeholders.

Governance should be seen and studied from all three aspects: socioeconomic, organizational and decisional. The first deals with changes in the socioeconomic system and its impact on the evolutionary and revolutionary changes within corporate governance. The second deals with the organizational structure of corporate governance while the third is concerned with the process and the demarcation within the governance-management process.

Some speculation about the possible development of corporate governance based on the Slovenian experience, considering fragments of the stakeholder and self-governance model, has been made, showing that social responsibility to stakeholders (society) expressed as added value per employee, social ownership and governance by collectives in the name of the stakeholders could be one of the models of the future.

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Board Structure and Competencies after Mass Privatization – The Case of the Czech Republic

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Abstract

The development of corporate governance in the Czech Republic attempted to follow the example of European market economy countries, sometimes without fully understanding the logic of the whole system. The topic of this article is the development of board structure and competencies after mass privatization as an example of such a misunderstanding. The organizational architecture of boards in the Czech Republic was based on a two-tier structure. The influence of mass privatization and the decisive role of investment funds resulting from voucher privatization substantially influenced the original two-tier structure. Two variants of the two-tier model have been developed: the "German model," following the classical competencies of management and supervisory boards, and the "Czech version of American model" (CVAM), attempting to restructure the design and competencies of the boards. The reasons for the implementation of the CVAM can be divided into objective ones, such as stronger supervision of managers by the shareholders in the classical principal-agent approach and rather subjective ones, i.e. increasing the personal incomes of board members who are also often representatives of investment funds. It is expected that in the near future, the system will follow the classical two-tier structure.

Key words: corporate governance, transition economy, voucher privatization, board architecture, German model, and Czech version of American model.

Preface

Corporate governance has emerged as one of many topics that central command planning was not familiar with. This article attempts to contribute to the efforts to gain a better understanding of one of the typical issues of corporate governance, i.e. the development of board structure after mass privatization in the Czech Republic. This development was very public. It was also very specific and it did not follow a fully classical two-tier board structure.

Mass privatization and implementation of new managerial principles, including corporate governance, substantially changed the position of companies in the economic system as well as their structure. The former autocratic managerial style and one-man principle of command were replaced by a system with democratic principles. Instead of the managing director or CEO managing the company with full competency, there was suddenly a management team represented by a board. Members of the board were democratically elected by the owners, and shareholders following the one share – one vote rule. The representatives of the owners also had the right to remove each member of the board. General shareholders' meetings were the place and opportunity to freely discuss, with democratic principles, both the substantial as well as the detailed issues that the owners were interested in. The new system closely resembled the principles of parliamentary democracy implemented into the political system at the same time.

This was of course quite a new experience for local managers. They tried to acquire and apply these new ideas as well as continually look for new ones; they used a variety of sundry sources, from the informal scanning of management and business magazines to formal attendance at business seminars and reading foreign textbooks (Clark – Soulsby, 1999).

The detailed view of the managerial aspects reveals that the process of the rise of real corporate governance is slow and gradual, where the main characteristics of the former managerial and governance system are changing (Brada, Singh, 1999). The former system adopted the characteristics of the former political command system. The management was appointed by a higher hierarchical level and approved by the corresponding level of the leading political party, applying the "nomenklatura" system (Clark – Soulsby, 1999, Lavigne, 1995). The companies were state owned and mostly in a monopoly position. Previously, the companies were legal entities but they were economically dependent on a higher level of the hierarchical system. Bankruptcy law did not exist because the companies with a loss were subsidized by higher levels using redistribution of financial means. Two lines of supervision and control were implemented. The first one was done by the economic hierarchical system from the company's bottom level through the company's associations and ministries to the higher level of the governmental body called the Central Planning Commission. This body was responsible for the strategic planning of the whole national economy; its directives were obligatory and functioned as planned quotas for lower levels. Detailed plans for lower levels created the unique conditions where competition, marketing, financial management and other attributes of the free market were absent. In the whole system, priority is given to political goals and all economic bodies reported to the Central Committee of the Communist Party.

Transition to a market economy fostered the initial conditions for real corporate governance. The fundamental task was changing the ownership form and starting the process of privatization. Different methods of privatization were implemented. These methods can be divided into two groups, standard and non-standard. Among standard methods we can include: direct selling, auction, public competition and joint ventures.
Mass privatization and restitution can be considered non-standard methods. Restitution means returning nationalized property to the former owners. The most important method of Czech privatization was mass privatization in the form of "voucher" privatization. The main aim of voucher privatization was to divide and distribute the national property among the citizens free of charge. The government established investment funds to assist people in the process of voucher privatization. Institutional investors became the most powerful element in privatization; consequently, they have substantially influenced the board structure in corporate governance.

This process created new social classes and shareholders, both institutional and individual. Thanks to mass privatization, for example in the Czech Republic, the ratio of shareholders in the population at the end of voucher privatization amounted to almost 60 percent. Companies were divided into smaller units, their size on average was decreased and they lost the advantage of a monopoly position. This development, together with the end of the national economy's authority and the entrance of foreign companies, has substantially increased competition. Supervision and control of the companies have shifted to the new owners and the companies have become fully economically independent as well. The environmental changes for corporate governance are depicted in Exhibit 1.

Centrally planned	Free market
State (Governmental) ownership	Private ownership
Monopolized position of companies	Competitive market
Hierarchical and political supervision	Ownership supervision
Economic dependency on a higher level	Full economic independence
Primary social goals	Primary economic goals
No entrepreneurs or shareholders (with few exceptions in foreign trade)	Entrepreneurs, shareholders
Trade unions' main task: fulfill the target	Trade unions' main task: protect the employees interests

Exhibit 1. Changes in the CG Environment during Transition
Source: Compiled by the author

The lack of experience sometimes caused some misinterpretation of foreign principles and concepts into one's own observable practices. Managers tried to implement new corporate governance practices, but sometimes because of the difference between the acquisition of knowledge and the operationalizing of those ideas, as Clark and Soulsby state (1999), their results were not fully in harmony with Western business practices. One such example is the practice of building and designing boards in Czech joint-stock companies.

Methods

Analysis is based mostly on empirical data from a KPMG survey (KPMG, 2005) as well as from students' seminar and diploma projects at the University of Economics, Prague (UEP). KPMG is a corporate partner of UEP; as such, KPMG closely collaborates with the university's teachers and students. KPMG representatives often function as visiting lecturers in corporate governance seminars, where the subject's methodological issues are discussed. The author of the article was the main initiator of this cooperation. Five hundred large Czech companies were approached and responses were provided by 242 board members. The whole analysis was conducted by KPMG (KPMG, 2005) and its empirical results were the most important basis for the research conclusions. The statistical sample was composed of all companies from the national economy, comprising mostly large joint-stock companies with a board structure. The composition of the sample is depicted in Exhibit 2. Additional sources included: official statistical data, annual reports of selected companies, literature sources and conference proceedings.

Board Architecture in the Czech Republic

The Czech government had two choices in its decision regarding which system of corporate governance board structure to adopt for the whole Czech economy. It could have chosen either a one-tier (unitary) system (Exhibit 3) or a two-tier (dual) system (Exhibit 4).

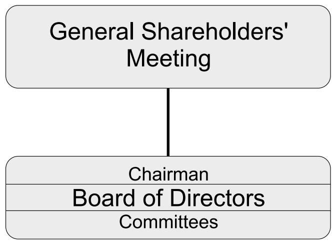


Exhibit 3. Organizational Architecture of the Structure in a One-tier (unitary) System

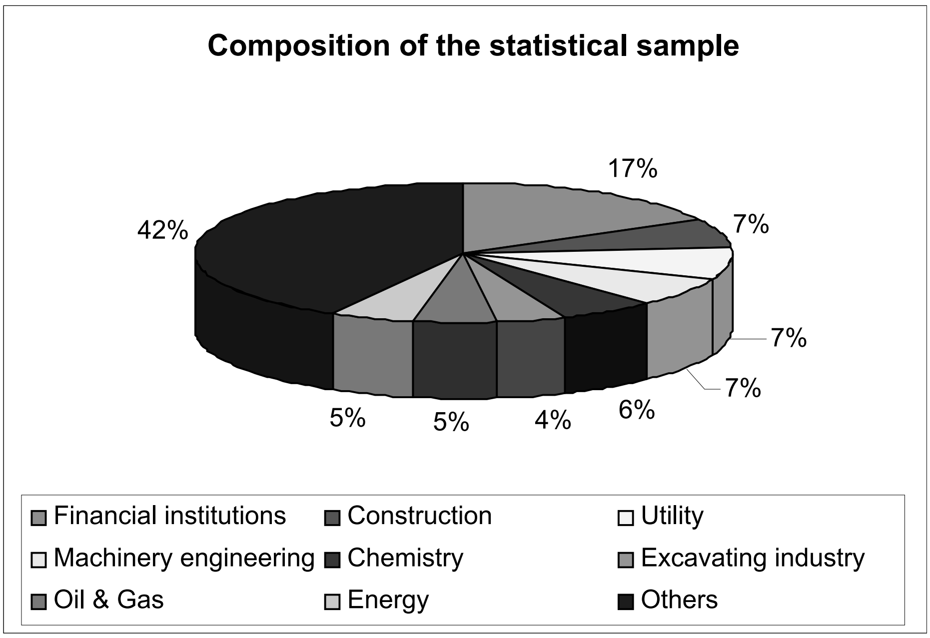


Exhibit 2. Composition of the Statistical Sample
Note: The share of others is 42 per cent and consists of consumer services, transportation, information, communication and entertainment. *Source*: KPMG (2005)

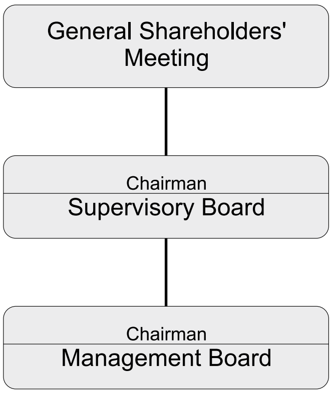


Exhibit 4. Organizational Architecture of the Board Structure in a Two-tier (dual) System

Czech companies adopted, in harmony with the new Czech Business Act, a two-tier structure of board architecture. This means that a company's governance is composed of a general shareholders' meeting as the supreme body with the highest approval authority. This body approves board decisions regarding mergers, acquisitions, selling parts of the company, issuing new shares, terminating the company's activities, electing new board members and removing the existing ones as well as other issues.

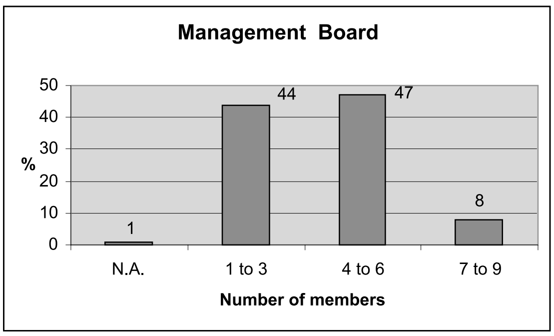
Contrary to common continental practices where the competencies of management and supervisory boards are clearly and logically divided, Czech practices are not yet unified and thus use two different approaches regarding board structure and their competencies in a two-tier structure.

German Variant of a Two-tier Structure

In the first variant, called the "German model," the solution is identical with the widespread application implemented in a lot of European countries (e.g. Germany, Austria, Belgium, Poland, and Russia). The management board (sometimes called the managing board) elaborates the top management, strategy, mission and vision in this model. The composition of the management board is specified by company statutes, usually consists of three to five members, and is formed by the company's top management executives. They are nominated and elected by the supervisory board. The chairman of the management board is the managing director or CEO of the company. One of the important tasks of the management board is nomination and removal of the top managers of the company.

The supervisory board is composed of representatives of the different stakeholders; one third of the seats of the supervisory board are taken by the representatives of employees, who are elected solely by employees. The other seats are taken by the representatives of shareholders, suppliers, important customers and independent members, experts on different areas.

The main objectives of the supervisory board are the supervision of a management board's activities, review of the mission and vision as well as all strategic plans of the company; this involves financial, human resource, technological and all other areas including the prerequisites for reaching the strategic goals. The important task is the election and removal of the members of the management board.



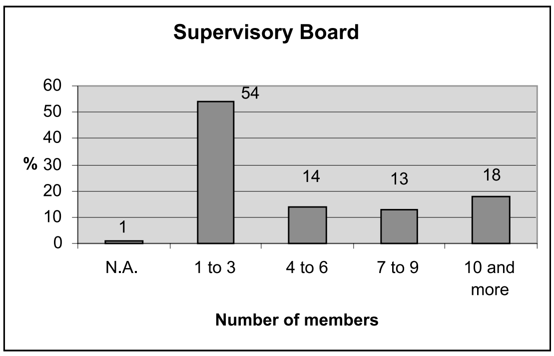


Exhibit 5. Number of Board Members
Source: KPMG (2005)

This authority substantially increases the competencies and importance of this body.

The average number of supervisory board members is usually a little higher compared to the management board. The KPMG analysis (KPMG, 2005) came to the conclusion that the average number of the management board in Czech companies was 4.1; the number of supervisory board members was 5.5. For a detailed division of board members, see Exhibit 5.

As a rule, the chairman is a non-executive member, usually the representative of a majority shareholder, and sometimes an independent member.

Czech version of American Model of a Two-tier Structure

The second variant of the two-tier structure is called the "Czech version of American model" (CVAM) and is taken as an exception compared to the practices of other European countries. It is necessary to point out that the CVMA in this context does not mean a classical one-tier system with a board of directors. Here it indicates only one of the variants of a two-tier model, each having supervisory as well as management boards. The structure is the same in both models; the differences are in the board competencies as well as in which body elects the board members. Differences also exist in the board composition itself. In the "German model," the members are executives; in the CVAM, membership usually includes both executives and non executives.

The role and approval authority of the general shareholders' meeting in CVAM are almost identical with "German model" with one important exception. This body elects and removes not only the members of the supervisory boards but also the management boards. As a result of the Czech method of mass privatization, the typical members are representatives of the majority owners, and investment funds. As was mentioned above, the main role of investment funds was to assist ordinary Czech citizens to invest their voucher coupon points through the investment funds.

The existence of investment funds and the efforts to take part in company management are the main reasons that contributed to the rise of the CVAM of the Czech board structure. The most powerful investment funds, owning a majority of the stock in a company, elected their representatives to the management board as non executive members and tried to manage and control the company through them. It is not of course a logical system, because these representatives spend so little time at the company and they are not fully informed about the company's issues. They are not competent to make important strategic decisions and this negatively influences the quality of the management board's decision-making.

In the "German model," privatization occurred via direct selling / foreign direct investment; examples of companies privatized in this way include: Skoda car maker, Linde Technoplyn, Siemens, etc. Contrary to this method, companies privatized by voucher privatization and that have mostly adopted the CVAM have lower economic results. Details are shown in Exhibit 6.

Indicator	Form of privatization		
	Standard method	Foreign investors	Voucher privatization
Return on costs	5,49	6,25	1,84
Return on equity	25,05	24,67	3,93
Value added per employee (thousand CZK)	343,9	743,2	321,5

Exhibit 6. Economic Indicators from 1998 after Voucher Privatization
Source: MF Daily News (2004)

The other reason for the decrease of the quality of the management board's decision-making is the fact that too many representatives of investment funds are members of multiple boards rather than only one. There are no official statistics regarding the multiplicities of functions in the whole economy, but the results of students' seminar projects mention the membership of five to, in some extreme cases, even 15 company boards where the same person is a representative of the investment fund. The result is not only the necessary conflicts of interest in decision-making, and the danger of insider trading, but total loss of orientation regarding the real problems of each company. In the KPMG analysis sample, the percentage of the management board members that are in more than one board is 39 per cent; the percentage of the supervisory board members is 38% (KPMG, 2005).

The role of the supervisory board is substantially decreased in such a model because the representatives of the most influential shareholders are members of the management board and the seats of the supervisory board are occupied by less influential stakeholders. Moreover, in this model the supervisory board has no authority to elect and remove the members of the management board. This is within the authority of a general shareholders' meeting as was mentioned earlier. By and large, the prestige of the supervisory board was reduced to the level of an accounting or internal auditing department without any substantial influence on the top management or corporate governance activities.
We are also witnesses of the situation that nomination as a member of the supervisory as well as management board is a certain form of reward for the politicians, "old boys" or friends for different kinds of assistance. Qualification of the board members is still unsatisfactory. Exhibit 7 shows board members' qualifications.

	Management Board	Supervisory Board
Education in related business	22%	8%
Managerial education	19%	11%
Personal qualities	57%	34%

Exhibit 7. Percentage of Board Members Fulfilling the Requested Qualification Criteria
Source: KPMG (2005)

The "German model" and the CVAM of the two-tier system are depicted in Exhibits 8 and 9.

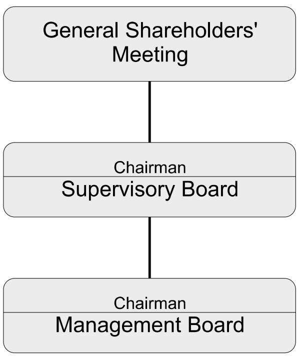


Exhibit 8. Organizational Architecture of the Board Structure of the "German model" in a Two-tier System

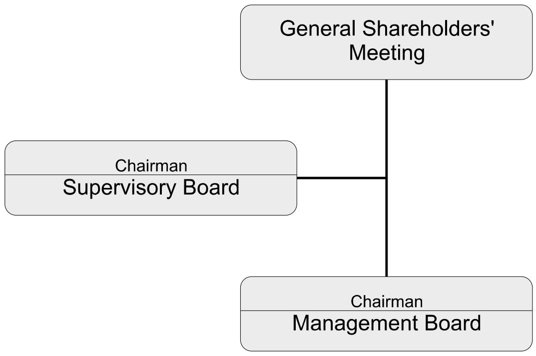


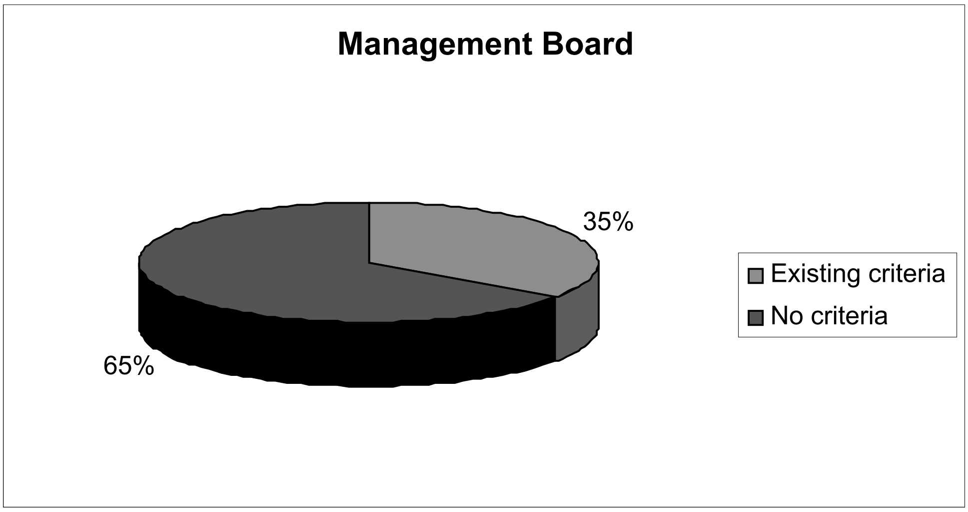
Exhibit 9. Organizational Architecture of the Board Structure of the CVAM in a Two-tier System

The academic community, as well as the practical business world in the Czech Republic, is aware of the situation. The business community admits the CVAM is not systematic and logical and it agrees with the idea to abandon it but still there are some reasons to continue in this practice. Most representatives of investment funds declare the necessity to supervise and control the company managers directly as members of the management board team because they do not fully believe they will completely follow the aim of increasing the wealth of the owners in harmony with the agency theory (Hillman, Keim, 2001, Berndt, 2002).

The negative experiences from the transition -- such as tunneling, assets stripping and looting – provide evidence that the situation is not yet under the full control of the owners. The other reasons were not openly disclosed because they are not willing to discuss the very comfortable additional revenues that board members receive for these memberships, e.g. the representatives of investment funds being members of ten, sometimes fifteen boards. In a majority of the cases in the sample analyzed, this compensation is not based on fulfillment of any clearly defined performance criteria (Exhibit 10).

The KPMG analysis shows that the logical and acceptable "German model" is implemented in only nine percent of the analyzed sample (Exhibit 11).

Analysis of the composition of the management board and the participation of top management in this board also show the prevailing practices of the CVAM (Exhibit 12).



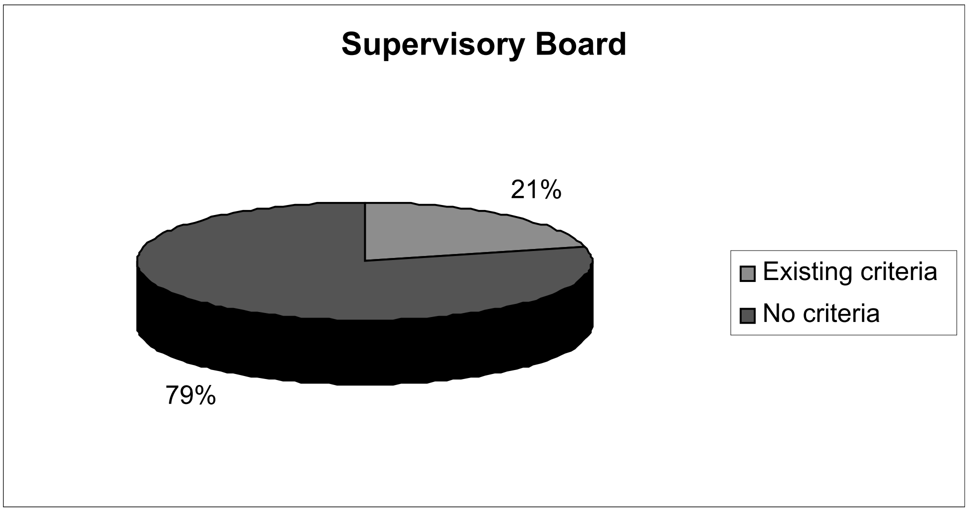


Exhibit 10. Ratio of Board Compensation based on Criteria
Source: KPMG (2005)

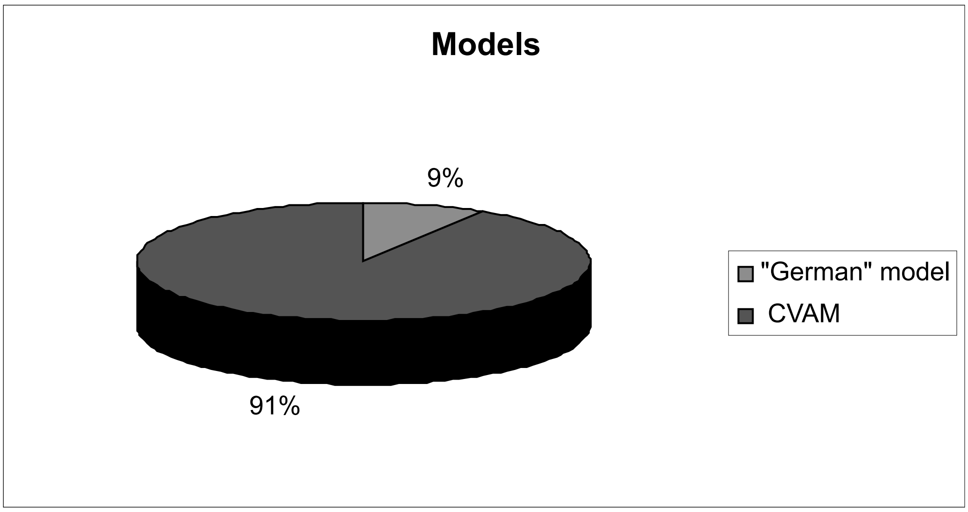


Exhibit 11. Ratio of the "German model" vs. the CVAM in Czech Companies
Source: KPMG (2005)

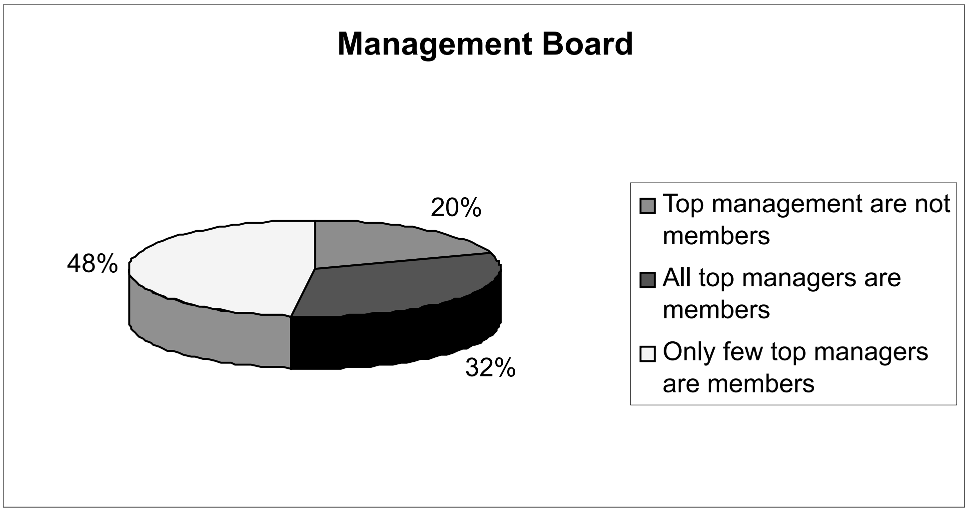


Exhibit 12. Management Board Composition
Source: KPMG (2005)

Conclusion

The results of our empirical study of the development of the Czech board structure and competencies shows that the logic of a classical one-tier or two-tier system was not fully comprehensible for those managers with a legacy of state socialist institutional logic from the former command economy. The low level of experience among transition managers and the unique conditions after the mass privatization led to a unique solution for which it is hard to find a logical explanation.

The CVAM of board architecture in a two-tier system is an illogical attempt to follow the general aim of corporate governance to manage and control the company in an unknown environment with former managers who lacked experience in a market economy and had practically no knowledge of corporate governance (Cadbury, 2002). This logically leads to a vague division of competencies among board members, the duties and discretions of the supervisory and management board starting to overlap and the borders of responsibility between these two becoming unclear.

The main aim of the academic community now is to explain the necessity of the changes and persuade the owners, together with their agents-managers that it is necessary to find a logical way to choose viable two-tier or one-tier approaches as they work in traditional market economy countries. The existing illogical hybrid cannot survive.

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Swansong or Renaissance? - The Topic of Co-determination in the Context of the German Corporate Governance Debate

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Ronald Hartz, *University of Siegen*

Against a background of several cases of company failure and managerial misconduct, a major debate about corporate governance has developed in Germany in recent years. Co-determination plays a limited but nevertheless highly interesting role in this. Based on a broad discourse analysis of the German print media, this paper draws a picture of the difficulties faced by co-determination in recent years. With the help of five hypotheses, several aspects of the debate are highlighted. Moreover, the (problematic) strategies of the supporters of co-determination and the future prospects for German co-determination are critically discussed.

Introduction

In the context of the hype and failure of the New Economy, corporate governance as "the system by which companies are directed and controlled" (Cadbury, 2002, p. 1) has become a highly fashionable topic for academics, practitioners and – with the help of the media – the wider public (Kochan, 2002). This is as true for the situation in Germany as it is for most other highly developed countries.

If we consider the German debate about corporate governance in recent years, it becomes obvious that there has not been a continuous development, and that the debate itself has undergone a profound change (Hartz and Steger, 2006): until autumn 2000 a neo-classical, short-term oriented perspective was dominant, propagating free entrepreneurship and common welfare. Under this, the winners of the New Economy were especially praised, while the classic German structures (e.g. co-determination, state intervention) and virtues (e.g. prudence, solidity) were criticised as being outdated. With the end of the hype, however, the debate has changed markedly. Since summer 2001 the old virtues (e.g. hard work, long-term orientation) have at last been re-introduced. The „honourable merchant" has become the new ideal, and to control companies' behaviour has more and more become considered important and necessary.
This situation marks the starting point of our paper. It focuses on the debate about corporate governance in Germany, with particular regard to the topic of co-determination. The fact that Germany is one of the leading economies in Europe and that it has a fairly individual economic system justifies closer consideration (Jackson and Moerke, 2005). Moreover, co-determination has a long tradition within the German economic and political system and, therefore, corporate governance in Germany can hardly be understood without recognition of this topic. We shall illustrate this, with the help of a relatively alternative perspective.

Four questions stand in the centre of the analysis:
1) What role does co-determination play (and what has it played) in the German corporate governance debate?

2) Which aspects of co-determination have been highlighted in different phases and which have not?
3) Which actors have particularly promoted the concept of co-determination over the years and which others have not occurred?
4) What kind of prospects and consequences may be derived from this debate for the future of co-determination in Germany?

The paper starts with a short introduction to the methods of discourse analysis according to Greimas (1971), as it forms the methodological basis of this paper. Section three then provides an overview of the German system of corporate governance. In the fourth section the empirical basis of our analysis will be described. The German corporate governance debate during the last few years will be outlined in section five. In section six, the main findings of this analysis are described, discussed and highlighted by five theses. Finally a short outlook is given about further steps for research and practice.

Discourse Analysis

Given the importance of storytelling and narratives in the mass media (Fairclough 1995) it seems worth analysing those processes more closely through the lenses of discourse analysis. By this, we understand discourse as social practice, both influenced by and influencing other social practices, events and actions (Fairclough and Wodak, 1997). In addition, we share three further methodological assumptions: *Firstly*, every discourse is structured and regulated. There exist borders, modes of production and transformation of meaning and truth, and mechanisms for the ex- and inclusion of problems, themes or actors (Foucault 1972, 1974). *Secondly*, discourses are part of the social construction of reality (Berger and Luckmann, 1966). According to this, a discourse is not only a collection of texts or documents but something that makes the world meaningful and gives sense to our actions. *Thirdly*, discourses do influence other social practices and are, at the same time, influenced by other social practices.

This notion of discourse raises the question of how to explore the structure of a discourse. In our analysis we will use elements of the semiotic approach of the Paris School of Semiotics (Greimas 1971, 1970; Ricoeur and Greimas, 1991) as a powerful tool to analyse discursive structures and change. Following Greimas (1971), we analyse the discourse on two different levels and through two linked types of discursive structure: The *discursive level* is the surface level, on which there exist a number of semantic fields, which play a dominant role in the totality of the texts. The *narrative level* is the deep level of the discourse that underpins all discourses and constitutes the "organising principle of every discourse" (Greimas and Courtés, 1979, p. 348). Uncovering this structure is necessary for an understanding of the (re-)production and the transformation of a specific discourse.

To explore the narrative structure of the discourse, we can apply the actantial narrative scheme first developed by Propp (1958) in his analysis of Russian folk-tales. In the model of Greimas, every narration consists of a maximum set of six actants, each playing a fixed role in the narration. These actants represent the six key narrative functions setting in relation all the possible relationships of a story (Figure 1).

The hero or subject of the narration goes in quest of an object. The object of the quest could be a concrete person or an abstract thing. In its quest, the hero is supported by the helper(s) and can be hindered by the opponent(s). The sender transmits the motivation or desire to the receiver to act as a hero. The receiver can be transformed into a subject to go in quest of an object, or can receive the object from the hero. For example, Greimas interprets classical Marxism as an actantial structure: Hero = Communist Party, Object = society without classes; Sender = history; Receiver = mankind; Opponent = Bourgeoisie; Helper = working class (Greimas, 1971, p. 166).

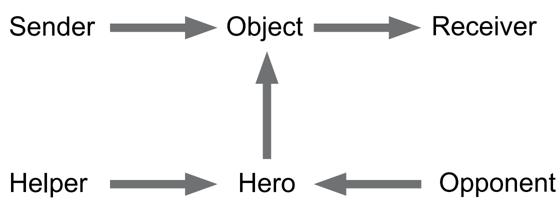

Figure 1. The Actantial Structure (according to Greimas, 1971, p. 165)

The sense produced by a narration is not fixed. Stories and narrations can lose their status, normally taken for granted, as providers of a specific world-view. For example, it is possible that in the eyes of the storyteller, reader or listener, the narration no longer "fits" with the events and facts which really occur (Blumenberg, 1979). In other words, there can be a growing "misfit" between the narrative and the other social practices which the narrative explains and is linked to.

The German Corporate Governance System

General overview

In order to better understand the following analysis, it seems worth giving a short overview of the German corporate governance system. It is both deeply rooted in German history since 1945, and incorporated in German company and capital market law (Bernhardt, 2002), and it has four main characteristics:

At first, *the two-tier board organisation* comprises a management board (Vorstand) with the primary function of directing the company, and a supervisory board (Aufsichtsrat) assigned to appoint and control the management board (Schilling, 2001). While the members of the management board are usually hired full-time managers, the supervisory board members often have some other functions, such as senior manager of another company, lawyer, state official etc. Consequently, the supervisory board usually meets only three to five times per year. Cross-memberships between the two bodies are prohibited by law (BDI/PwC, 2002); however the chairman of the supervisory board is often a former CEO of the same company. This is currently the case in large corporations such as Bayer, ThyssenKrupp, Volkswagen, Siemens or Allianz.

Secondly, among a lot of the largest German corporations, some notable shares of stocks are held by other corporations (Schilling, 2001). Additionally, these corporations are often strongly connected with each other on a personal level and through interlinking directorships. This traditional network is commonly (in an ironic way) referred to as "*Deutschland AG*". It is also worth noting that this system of cross-ownerships worked as a highly effective defence against unfriendly takeovers, especially from other countries, in the past. Although some commentators have argued that "Deutschland AG" was slowly shrinking, recent studies underline its persisting economic and political power (Heinze, 2004).

Thirdly, the large German banks are usually *universal banks* engaged in both investment banking and commercial banking. They hold a key position in the German system. This condition is based on their blocks of shares, the proxy votes which they command, and their traditional role as lenders. Furthermore, the numerous seats top bankers hold on the supervisory boards of large German corporations are a source and manifestation of their power (Hackethal et al., 2005). It is not surprising, therefore, that the large German banks (e.g. Deutsche Bank, Commerzbank) can also be found in the centre of "Deutschland AG" and that they are usually considered by the public to be the most influential networkers inside the German economic system.

Fourthly, the mandatory *co-determination,* created in the early 1950s and enacted in its current form in 1976, provides distinct power to employees at different levels of the company. Given this situation as well as the target of our paper, it seems worth saying a few more words here about the particular role of co-determination in the German corporate governance system.

The role of co-determination in the German corporate governance system

Co-determination strongly influences corporate governance in Germany at two distinct levels in a company. Firstly, employees have the right to set up a works council in each firm with more than five employees, irrespective of whether it is an independent company or a dependent subsidiary (Müller-Jentsch, 2003). Works councils are provided with high levels of information, and have consultation, veto and co-determination rights. Consequently, employees have a strong "voice" (Jackson, 2005) and they are even able to exercise considerable blocking power against far-reaching management decisions. It is not surprising, therefore, that a growing number of companies, particularly investors from Anglo-Saxon countries, aim to limit employees' rights, by preventing works council elections or by reducing the number of workers with union membership. Particularly in regions with high unemployment (e.g. East Germany) this has resulted in precarious labour relations (Schmidt et al., 2003).

Secondly, German law reserves a third of the seats on the supervisory board (in joint-stock companies with less than 2000 employees) or half of the seats (in larger companies) for worker's delegates.

Among these are usually also some external union leaders. To avoid impasses, the chairman of the supervisory board, who is elected by the shareholders, is granted a double vote (Müller-Jentsch, 2003). Nevertheless, major strategic decisions in German companies can hardly be taken or put through without the support (or at least the tolerance) of the employees.

It would be wrong, however, to perceive co-determination as just a hindrance to efficient corporate governance structures. In most German companies, the nature of the interaction between management, shareholders' representatives and employees' representatives is highly constructive and consensus-oriented. This has resulted in a high level of political stability and social peace, and in a limited number of strikes (Frege, 2002). At the company level, empirical evidence has been found for an increase in productivity and profitability (Dilger, 2003). Several authors also reported that, thanks to co-determination, company restructuring and even massive employment reductions have been realised much more smoothly than would otherwise have been possible (Lang and Steger, 1999; Müller-Jentsch, 2003). Last but not least, it has to be noted that unions and works councils have also supported corporate governance reforms concerning greater information disclosure or the involvement of the supervisory board (Jackson, 2005).

Data Basis

To explore the topic of co-determination within the context of the German corporate governance debate, we collected a total of 441 articles published in the most important German newspapers between 1998 and 2003 (Table 1).

95 of the articles related to the corporate governance debate were considered relevant to the topic of co-determination as well. However, not all of them focussed directly on co-determination; some just referred to it incidentally, while some other articles that might have been expected to discuss the topic managed to avoid it. Moreover, the articles dealt with different aspects of co-determination; some of them focussed on co-determination at the supervisory board level and others on co-determination at the company level, while others took a general look at the topic (Table 2).

Newspaper	Corporate Governance-Debate	Co-determination Topic
Bild	40	1
Die Welt	96	17
Die Zeit	38	6
Frankfurter Allgemeine Zeitung	55	18
Frankfurter Rundschau	7	2
Financial Times Deutschland	51	9
Handelsblatt	37	10
Manager Magazin	26	9
Spiegel	15	1
Süddeutsche Zeitung	22	6
Tagesspiegel	30	9
Welt am Sonntag	13	4
Wirtschaftswoche	11	3
TOTAL	**441**	**95**

Table 1. Articles Collected for the Analysis

	1998	1999	2000	2001	2002	2003	TOTAL
Weight of the topic							
- Main topic	1	1	3	9	12	4	**30**
- Marginal topic	--	4	10	6	8	7	**35**
- Avoided topic	--	2	8	10	8	2	**30**
Focus of the article							
- Supervisory board	1	7	14	18	22	11	**73**
- Company level	--	--	1	5	3	--	**9**
- General view	--	--	6	2	3	2	**13**
TOTAL	**1**	**7**	**21**	**25**	**28**	**13**	**95**

Table 2. Articles Collected in Terms of Weight of the Topic and Focus

In order to enrich and deepen our analysis, we used two other sets of data, namely

1) a collection of 2 33 press articles dealing with co-determination (but not with corporate governance) from between 1998 and 2003, and
2) 31 qualitative interviews held with corporate governance experts from various (German) institutions between March 2003 and April 2004.

The German Corporate Governance Debate

From 1998 until 2000 the public debate about "good" corporate governance was dominated by the search for a transformation of the German system of Corporate Governance. Diverse features of the German system such as co-determination or the two-tier system were criticised for no longer meeting the requirements of the international capital markets. At the same time, a certain "Americanisation" of the concepts postulated (e.g. unitary boards, strict shareholder orientation) could be identified. Hence, the Old Economy was put in sharp opposition to the New Economy which became a symbol and model for the renewal of corporate governance.

"If there is a symbol for the often cited decline of Rhine Capitalism, then it is the New Market." (Die Welt, 9th March, 2000)

Moreover, in this context a new "hero" emerged, i.e. the new type of brave manager, who represented entrepreneurial spirit, innovation and imagination.

"It seems that this land is awakening like Sleeping Beauty from a long deep sleep, as if someone has smashed with a sword the network under which the entrepreneurial spirit of the Germans had slumbered." (Süddeutsche Zeitung, 3rd May, 2000)

The actantial structure of this debate can be concluded as follows (Figure 2): The entrepreneur of the New Economy (=hero) is on a quest for growth and public welfare (=object). In this, he/she is supported by the capital market boom as well as by the growing stock culture (=helper) and hindered by old structures of the German corporate governance system (=opponent). The market economy's invisible hand (=sender), which (re-)connects personal interests with public welfare, transmits the motivation to the managers and the wider society (=receiver) to act as the new entrepreneurs do.

With the end of the hype of share prices, the numerous profit warnings and the multiple dramatic company failures during 2000, the dominant characteristics of the public debate changed as well. Although a few commentators tried to keep watching the "great trend", a turnaround became more and more visible.

"Of course, not everything is great just because it is decorated with the name 'New Economy'. But this does not change the overall trend." (Die Welt, 30th December, 2000)

Until spring 2001, the new debate was dominated by harsh critics of the "bad" behaviour of managers, analysts, banks and start-up companies, culminating in a veritable crisis of confidence.

"The former heroes have become the bad guys." (Tagesspiegel, 24th June, 2002)

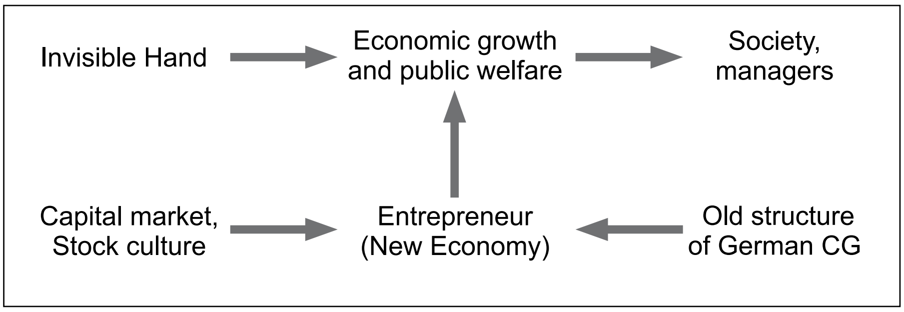

Figure 2. The Actantial Structure of the Old Narration

Moreover, the weaknesses of the Anglo-Saxon model were highlighted in the debate. Consequently, a renaissance of traditional values such as modesty, trustworthiness and hard work – outlined in the concept of the "honourable merchant" – took place.

"There are basic rules, which are valid for an 'honourable merchant' – and precisely these rules have to be re-established." (Handelsblatt, 21st July, 2002)

The actantial structure of this renewed debate is displayed in Figure 3: The classic honourable merchant (=hero) bothers to re-establish public trust in the market economy (=object). He/she is supported by some traditional (German) virtues as well as by the commission in charge of developing and maintaining the German Code of Corporate Governance (=helper). The still remaining public greed and the promoters of short-termism try to hinder this engagement (=opponent). The moral needs of the economy (=sender), representing the new nexus between individual action and public welfare, transmit the motivation to managers and to politicians (=receiver) to act as the honourable merchants do.

Co-determination as a Topic in the Corporate Governance Debate

The findings of our analysis answering the initial four questions will be concluded and discussed in five theses.

<u>*Thesis 1:*</u> *Although the topic of co-determination occurs in the corporate governance debate as well as in the co-determination debate, there is a clear difference between the two debates in terms of the perception and discussion of the topic of co-determination.*

As already mentioned, the debates about corporate governance and about co-determination cannot be strictly separated from each other. However, most articles either deal with co-determination on the supervisory board (and therefore are to be included in the corporate governance debate), or focus on co-determination at the company level (and therefore often do not belong to the corporate governance debate).

Although this separation is somewhat subjective, the two debates also differ with respect to the involvement of employee representatives. While

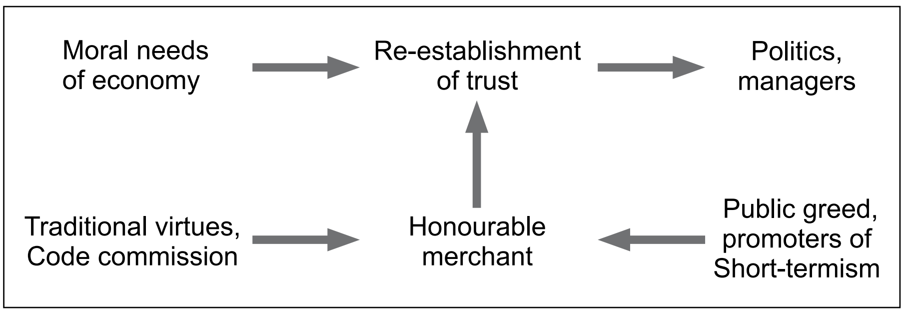

Figure 3. The Actantial Structure of the New Narration

this point is relatively active in the co-determination debate, it remains rather passive in the public discussion about corporate governance. This situation is even noted by the corporate governance experts of the German unions.

„... in spite of all the conflicts between government and unions, it is taken for granted that we are to be involved. But, indeed, there are only very few among us who deal exclusively with this topic. (...) Actually we are two and a half persons doing this.“ (Interview 9, union representative, 15th July 2003)

„The whole topic is relatively new. We do not, indeed, really have much experience of that...” (Interview 16, union representative, 19th August 2003)

Moreover, it becomes obvious that the role of co-determination is discussed much more positively in the separate co-determination debate or in other public discussions (e.g. about democracy, political stability) than it is in the corporate governance debate.

<u>Thesis 2:</u> *While the dominant corporate governance discourse has undergone a considerable change, the role of co-determination has remained fairly stable. Co-determination is still considered a major obstacle to the development of "good" corporate governance in Germany.*

As was pointed out in the previous section, the dominant corporate governance discourse in Germany has changed considerably during recent years. This becomes obvious on the one hand from the renaissance of several classic German virtues (incorporated in the myth of the "honourable merchant") and on the other hand from the paradigmatic shift of the role of the former hero. To repeat the quote above:

"The former heroes have become the bad guys." (Tagesspiegel, 24th June, 2002)

However, this fundamental change has not affected the topic of co-determination. Co-determination has remained in its oppositional role, i.e. it is considered negative and is criticised by the majority of authors and in most articles. At the same time they demand complete reform of German co-determination or even its abandonment. This is also reflected by the nature of the criticisms, which have remained fairly stable over the years. It is usually argued that co-determination has been responsible for the limited efficiency of German supervisory boards; that it provokes some problematic arrangements within company boards, such as coalitions of management and workers against shareholders' interests; that the employee representatives are not able to execute high-quality corporate governance; and that there is only limited diversity (only Germans) among the employee representatives on the supervisory board.

„The co-determination act is simply obsolete. A company such as BMW earns more than half of its money abroad, but at the same time all employee representatives are Bavarians. This has nothing to do with globalisation." (Die Welt, 13th February 1999)

„... we also need to re-consider the co-determination of the employees. It is no longer adequate in the face of global competition and it constitutes a real disadvantage of location." (Rolf-Ernst Breuer, CEO of Deutsche Bank, Frankfurter Allgemeine Zeitung, 26th April 2002)

Any arguments that differed from the dominant discourse were of only limited duration. The propagation of employee share-ownership as an alternative to co-determination in spring 2000 (during the period when share prices reached their absolute peaks) can be considered a good example of this. It was obviously driven by the idea of making a fortune overnight and, consequently, quickly disappeared when share prices started to fall.

„People become rich when shareholders become rich. That's absolutely okay for me." (Ulrich Schuhmacher, CEO of Infineon, Spiegel, 13th March 2000)

If we consider the arguments in favour of co-determination, their proponents refer most often to its long tradition (and, therefore, the impossibility of abandoning it). Moreover, it is argued that employees might be less opposed to company restructuring processes because of co-determination. However, these arguments are fairly rare and are mentioned without enthusiasm.

„When we talk about co-determination on the supervisory board, this is a fact and, therefore, part of German corporate governance.“ (Wolfgang

Bernhardt, University of Leipzig, Handelsblatt, 20th November 2000)

Thesis 3: The negative role of co-determination in the context of the corporate governance debate is closely connected with the relative reluctance with which employee representatives participate in this debate.

The employee representatives form a clear minority among the participants in the German corporate governance debate. The people most often cited – namely Rolf-Ernst Breuer and Hilmar Kopper (CEO and Chairman of Deutsche Bank), Christian Strenger (board member of DWS funds), Theodor Baums (University of Frankfurt, head of governmental expert commission) and Gerhard Cromme (Chairman of ThyssenKrupp, Head of the code commission) – are all fairly critical of co-determination. Personalities from the employees' side most often come up in connection with the negative cases they are personally involved in (e.g. Klaus Zwickel and the Mannesmann trial, Frank Bsirske and the strike at Lufthansa). Consequently, they take a fairly passive role from the beginning.

„... after all, strikes do also promote consensus. And it is in the interest of the companies to create consensus." (Frank Bsirske, Head of ver.di, Welt am Sonntag, 19th January 2003)

One may assume that the newspapers selected for this analysis often have a right-wing standpoint and therefore tend to neglect the employees' position. However, this argument can be rejected: if we analyse the articles dealing exclusively with co-determination (independently of the corporate governance debate), the employee representatives come up much more often here. This may be explained by the different weight of certain key topics in the two debates. While the corporate governance debate focuses most often on co-determination on the supervisory board (cf. Table 2), the co-determination debate most often deals with co-determination at the company level. The latter topic may be considered more important by German unions than the former.

Nevertheless the limited presence of employee representatives engaged in favour of co-determination in the context of the German corporate governance debate remains astonishing. Even in the international academic corporate governance debate there is a considerable number of scholars who actively defend co-determination (e.g. Höpner, 2004; Streeck, 2004), even including some US scholars (e.g. Thelen and Turner, 1998; Kochan, 2002).

„Another necessary reform is to grant loyal employees who invest and put at risk their human capital a right to sit on the boards of their corporations..." (Thomas A. Kochan, MIT, Academy of Management Executive, Aug. 2002)

Thesis 4: The actors taking a position in favour of co-determination obviously follow a passive strategy of "tacit patience" rather than an active strategy of "critical opposition". This passive strategy, however, has been fairly successful until now.

That positive voices in favour of co-determination are relatively limited in the German corporate governance debate, as mentioned above, is not just due to a lack of engagement or to the limited resources of those actors. It became more and more obvious in our analysis that these people in fact follow a distinct strategy. In contrast to those US unions that try to influence the debate by means of some classic corporate governance instruments (e.g. active involvement in the powerful pension funds), the German supporters of co-determination take a more traditional, corporatist way: on the one hand, many prominent unionists (e.g. the heads of IG Metall, Jürgen Peters, and ver.di, Frank Bsirske) clearly concentrate on the topic of co-determination outside the corporate governance debate, while on the other hand, the unions have succeeded in excluding co-determination from the discussions in the governmental expert commission (headed by Theodor Baums) as well as from the code development process in the code commission (headed by Gerhard Cromme). Moreover, they were even able to make some particular political arrangements in the code commission.

„... the company lawyers said: It can't be allowed that each shareholder can come along and make a claim. Thus we said: Of course, we can talk about this (...) but if so, you have to agree about some supervisory board affairs that need the employees' approval. It must be included in the law that each supervisory board must have a list of such affairs." (Interview 9, union representative, 15th July 2003)

This situation is also reflected by several articles in the corporate governance debate that obviously prefer not to touch upon the topic of co-determination (cf. Table 2). This was found in articles about the development of the German corporate governance code as well as in press accounts about the deficits of supervisory board work. Moreover, even among those who are critical of co-determination, we find some affirmative or resigned voices that explicitly make this point.

„We should not get involved in battles we can never win.“ (Hilmar Kopper, Chairman of Deutsche Bank, Frankfurter Allgemeine Zeitung, 23th June 2000)

„If there were a common will to reform co-determination at the supervisory board level, then we would have a different discussion. But all agree that nobody really wants this, and so we have to accept it and try to make the best of it." (Rolf-Ernst Breuer, CEO of Deutsche Bank, Manager Magazin, 14th November 2002)

<u>Thesis 5:</u> *In the medium and long term the passive strategy of those who are in favour of (current) co-determination will produce some negative consequences for co-determination at the supervisory board level. A necessary pre-condition, though, is a re-enforcement of both the general political reform debate and the particular corporate governance debate in Germany.*

In spite of some resigned voices about the fact that co-determination has been excluded from the current reform efforts of the code commission and the federal government, the passive strategy of the supporters of co-determination may turn out to become counter-productive in the medium and long term. In several more recent articles some rather aggressive voices could be heard, which supports the assumption that the battle is not over yet…

„I don't know any US subsidiary that freely accepts co-determination. They rather try to find some legal forms free of co-determination.“ (Joachim Thalacker, CEO Dow Germany, Frankfurter Allgemeine Zeitung, 20th September 2003)

„If we assume we had some very low tax rates and all other great framework conditions, which we unfortunately do not have, then co-determination would not play such an important role. But since we do not have these advantageous conditions in Germany at the moment, this is a very decisive location factor. That's why we need to do something." (Interview 15, industry association representative, 19th August 2003)

Judging from the focus of the supporters of co-determination on the company level, as outlined above, one can assume co-determination on the supervisory board to be endangered in the first place. There is no question but that some considerable cuts at this level would dramatically change the power balance of German corporate governance.

However, "automatic" processes in this context should not be expected. Two important preconditions have to be mentioned; firstly, the public reform debate in Germany (e.g. about the federal structure of the state, about de-regulation in the public administration, about the national tax system) that has slowly developed in recent years needs to be considerably reinforced in order to provide a general climate for greater reform projects. It is rather improbable that the current German federal government, the grand coalition of Christian Democrats and Social Democrats, will dare to take any steps to significantly change the co-determination system in the near future; secondly, the reform activities of the code commission still have to be considered as rather moderate. Here too, a reinforcement is needed to put some "hot topics" on the agenda. This could also include several topics besides co-determination that have been kept out of the discussion by the employers' representatives (e.g. CEOs appointed as chairman of the supervisory board immediately after their resignation).

Conclusions

The analysis of the German corporate governance debate given in this paper has pointed out how societal discourses may develop over time, how the importance of certain aspects change and how the debate can be influenced by different participants' particular strategies. This underlines the explanatory power of the discourse analysis and the diverse interesting opportunities for analysing and for deepening our understanding of social and economic processes. Moreover, the discourse analysis has also helped us to recognise the loud tones of the debate (e.g. situations in which the discourse provokes or promotes some specific actions) as well as the quiet ones (e.g. aspects that are not explicitly mentioned or are even intentionally excluded from the discussion). It seems promising to use this methodological approach more often in the future.

In terms of content, the problematic situation of co-determination in Germany was highlighted. It is still considered *"the greatest hindrance to efficient corporate governance" (Handelsblatt, 20th November 2000)* in the public debate (Thesis 2) and, consequently, it is liable to suffer considerable cuts in the future, especially at the supervisory board level (Thesis 5). In this context, some of the considerable problems of the German unions, as the most important supporters of co-determination, in aggressively defending its positions became obvious (Thesis 4).

Moreover, there remains the question as to the future of the German corporate governance debate; maybe corporate governance is just a fashionable topic in the end, which was promoted through the stockmarket crisis and which will disappear with the recovery of share prices? Or is it really a topic that touches fundamental social questions and, hence, is able to significantly influence the general political and economic debates? If one considers this from a discourse analytical standpoint, the answer will most probably depend on the complex interplay between the interested public, the trend-setting social elites, the media and, last but not least, the surrounding political climate.

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Discussion

New Corporate Governance

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Introduction

In recent years, the topic of corporate governance has gained prominence as a result of the large number of attention-grabbing corporate scandals at the board level. What was formerly a topic of interest to academics has become a burning issue worldwide for researchers and practitioners alike.

In practice, there seem to be four reasons that account for the public crisis of confidence about the economy in general and about chairpersons and CEOs in particular (Taylor, 2003, p.1).

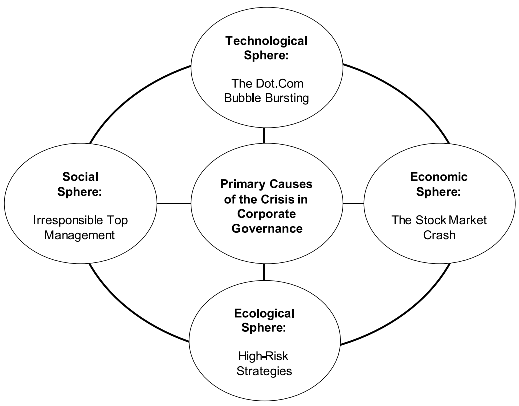


Figure 1. Primary Causes of Crisis in Corporate Governance

In the technological sphere, the main driver of the corporate governance crisis was the bursting of the dot.com bubble. The speculation on stock markets in high-tech companies throughout the world, according to Alan Greenspan, led to "irrational exuberance." Although the Internet undoubtedly resulted in a technological breakthrough, it was assumed that the Internet invented a new business model, "which it didn't. It is a tool that companies can use to build their business, if they can combine it with distinctive products (and or services), but nothing more than that" (Taylor, 2003, p. 3).

In the economic sphere, the many corporate governance scandals in the United States, for example Enron, Worldcom, Global Crossing and Arthur Anderson, led to the greatest stock market collapse in US history. According to a Gallup survey, the public level of confidence in the US economy and its key officials, reached its lowest level since 1981 (Business Week, 2002, p. 14). The positions of board members in the United States could be described as follows: "Highly important corporate positions with ultimate legal responsibility for the company, high liability and reputational risk, meagre pay, too little time, support, or information to do the job,… and the job doesn't even earn much respect nowadays" (Ward, 2003, p. 224).

In the risk management and ecological spheres, numerous corporate collapses (such as Swissair) or strategic mistakes (such as Vivendi-Universal or AOL Time Warner) have shown that boards approved strategies that were too risky. There was a blatant lack of professional risk management at the board level, as demonstrated by the audits of numerous boards of companies in different sectors. There also appears to have been an increasing separation of the economy and society, and an increasingly short-term financial-performance orientation (Gladwin et al., 1995).

In the social sphere, there has been a striking lack of integrity exhibited by those responsible for directing and controlling corporations. In a doctoral seminar in the summer of 2003 conducted by the author, doctoral students from eighteen different countries presented cases of board mismanagement from their home countries. At the end of the presentations, it was asked what all those case studies had in common. The answer was unanimous: lack of integrity, whether at the board, CEO, auditor or CFO level. The irresponsible and one-sided use of stock options was one particular feature of the board mismanagement cases presented. Indeed, Henry Mintzberg described this use of stock options as "legitimised corruption" in certain large, listed companies in North America and Europe.

According to Sir David Tweedie, Chairman of the International Accounting Standards Board: "Executive boards failed, non-executives were kept in the dark, audit committees failed, auditors fell asleep at the wheel, or let problems go, credit rating agents did none too well, analysts missed it, the SEC failed to regulate, and the investment banks and lawyers (and consultants) were part of the problem, helping companies with their questionable deals…. It wasn't just one little piece gone wrong. The whole system was collapsing" (Newing, 2003, p. 6).

In research, the abovementioned "mis-developments" made it increasingly clear that underlying theories were used in an undifferentiated and one-dimensional way. For example, the much-applied *agency theory* (Berle and Means (1932); Jensen and Meckling (1976); Eisenhardt (1989) and Aguilera and Jackson (2003, p. 448ff) have the following failings in corporate governance research:

– "Much of agency theory ... unrealistically assumes that earnings and stock prices cannot be manipulated" (Implying that some of the incentive systems in common use do not generate the alignment between principals and agents for which they were supposedly designed (Brecht et al, 2002, p. 47).
– "Traditional agency theory builds primarily or exclusively on extrinsic motivation" (Frey, 2003, p. 4).
– Only the needs of top executives and shareholders (and in the worst case only the needs of top executives) were taken into account, but not the justifiable needs of employees, customers or the environment (the public realm, the natural environment or the heritage of future generations).
– Finally, agency theory could not "... account for key differences across countries" (Aquilera and Jackson, 2003, p. 448).

It has become evident that the role of the board should be handled in a more differentiated and holistic way. Corporate governance research should take into account the diverse roles that boards play (Hung, 1998, p. 105). For example:

Resource dependency theory suggests that board members can play valuable roles in coaching and in making resources available to the CEO. Thus, the art of board leadership could be "to build and maintain trust in [directors'] relationships with executives, but also to maintain some distance so that effective monitoring can be achieved" (Daily and Canella, 2003, p. 376).

Stewardship theory (Davis and Schoorman, 1997) suggests that top managers can act in the best interests of the company even when financial incentives and monitoring systems are not in place to ensure that this is the case. Under such circumstances, the role of the board shifts from monitoring to support for the formulation and implementation of strategy at a high level.

Finally, *institutional theory* (Aoki, 2001) attempts to understand corporate governance in the context of social and cultural constraints imposed on organisations.

In the past, most research has addressed corporate governance from a single perspective. In the future it will be increasingly important to approach corporate governance from an integrated and "multi-theoretic" point of view. In this regard, Hung presents a valuable research-typology (1998, p. 105), one that can serve as a compass to orient users of the model presented in this book (refer to figure 7).

In theory and teaching, one limitation of corporate governance can be described as follows (these limitations apply equally to human resource management HRM): "One shortcoming has been the tendency of textbooks in the area to make prescriptions about the "best practice" … without providing a credible analytical framework for the students or the practitioners" (Boxall, 1992, p. 60). There is a severe deficit of integrative corporate governance concepts. An analysis of the development stage of teaching shows that, as with HRM, "the future academic strength of corporate governance will depend on how effectively present scholars dedicate themselves to building credible analytical frameworks – focused at the level of the firm, but with the capability of providing an adequate disciplinary basis for comparative corporate governance" (Boxall, 1992, p. 75).

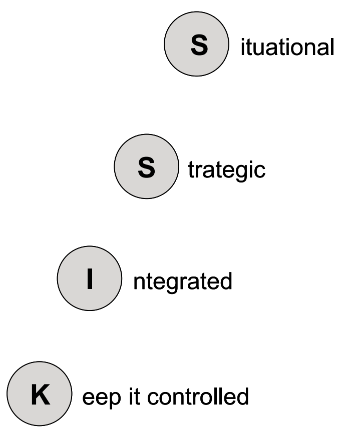
New Corporate Governance

This section will define what is meant by "New Corporate Governance".

Cadbury defines corporate governance as a system, "by which companies are directed and controlled" (Cadbury, 1992, p. 1). Demb and Neubauer define corporate governance as "the process by which corporations are made responsive to the rights and wishes of stakeholders" (1992, p. 187).

By contrast, Shleifer and Vishny suggest that corporate governance deals with "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (1997, p. 737).

"New Corporate Governance" as discussed in this paper supports the view that the board of directors should both direct and control the firm. It can be defined as a system "by which companies are strategically directed, integratively managed and holistically controlled in an entrepreneurial and ethical way and in a manner appropriate to each particular context." "New Corporate Governance" is based on a reversed "KISS" principle:



This holistic framework for the direction and control of enterprises integrates formerly isolated elements of corporate governance in research, teaching and practice. "Framework" here means "an abstraction that preserves in economical forms most of the points that have been developed" (Weick, 1979, p. 95). The proposed framework is articulated into four parts (based on the KISS principle):

Keep it situational	**(Context)**
Keep it strategic	**(Strategic direction)**
Keep it integrated	**(Board management)**
Keep it controlled	**(Strategic control)**

"New Corporate Governance" and "traditional" corporate governance can be differentiated on the basis of four KISS dimensions, as described in the following table:

Dimension	Traditional corporate governance	New corporate governance
Situational Implementation	No difference between national, industry and corporate culture	Implementation appropriate to the specific context of each firm (Keep it situational)
Strategic Direction	Strategic development is not a function of the supervisory board	Strategic development is a central function of the supervisory board (Keep it situational)
Integrated Board Management	Only isolated nomination and remuneration committees in publicly listed companies	Integrated and targeted selection, appraisal, compensation and development of the supervisory and managing boards (Keep it situational)
Holistic Monitoring	Controlling the financial dimension only	Holistic monitoring of results from the perspectives of shareholders, clients, employees and the public (Keep it situational)

Table 1. Differences between Traditional and "New Corporate Governance"

The following sections describe the four elements of "New Corporate Governance" according to the reversed KISS principle in more detail.

Keep it Situational

As a result of the many corporate scandals that have taken place around the world, best-practice corporate governance guidelines have been developed in most countries. Internationally, the biggest influence on these guidelines has come from the

Institute of Directors (IoD) in London, through the advice they provide to other nations. Many countries that do not actually contract with the IoD for advice nonetheless incorporate aspects of IoD thinking in their best-practice guidelines.

This is a positive development, although the following issues should be noted:

- The Anglo-American model of governance is being promoted as the global standard;
- Soft law does not necessarily address the soft dimensions of a firm (in other words, laying down a new soft law does not replace the need for integrity in board relationships and processes); and
- Best-practice guidelines are typically designed for large, publicly listed firms.

In adopting corporate governance guidelines developed elsewhere, companies should be aware of the fact that best-practice guidelines for:

Listed companies	≠	Non-listed companies
Large companies	≠	Small companies
Public companies	≠	Family-owned companies
Bank governance	≠	Hospital governance
US companies	≠	British companies

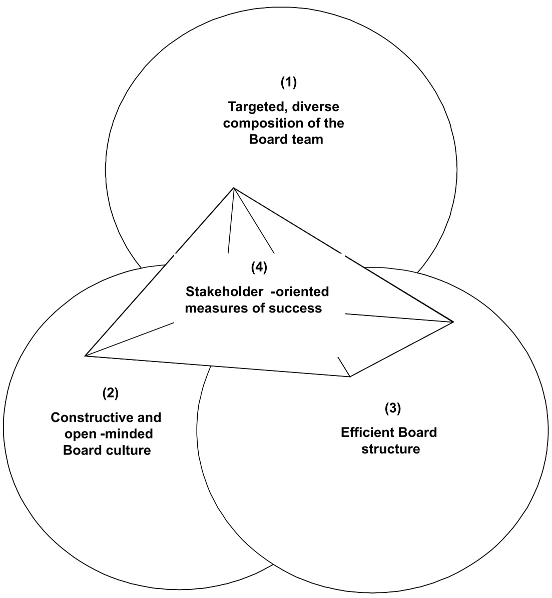


Figure 2. Preconditions for Successful Integrated Board Management

Keep it Strategic

For integrated board management, four main preconditions for success in developing, implementing and controlling corporate strategy are proposed (refer to figure 2.):

1. Diversity: strategically targeted composition of the board team
2. Trust: constructive and open-minded board culture
3. Network: efficient board structure
4. Vision: stakeholder oriented board measures of success

These four components have to be integrated in a process as shown in figure 3. At each of the different levels, success measures are established relating to the important stakeholder groups, and then the responses of members of those stakeholder groups are measured periodically to assess the performance of the company leadership.

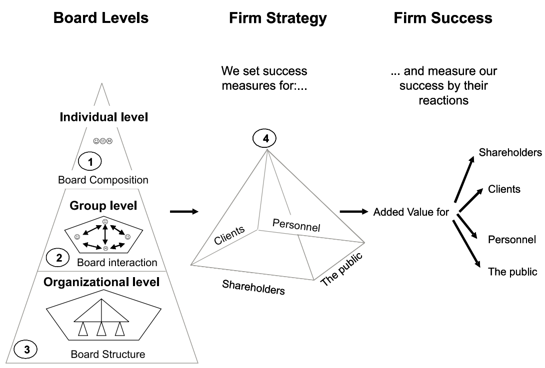


Figure 3. Relationship between Board, Strategy and Success

Anglo-Saxon researchers have been studying the relationship between corporate governance and firm success. A new study conducted at the University of Basle in Switzerland confirms that higher share price and lower cost of capital are directly linked to good corporate governance (Beiner, Schmid and Zimmerman, in Noetzli, 2004, p. 24).

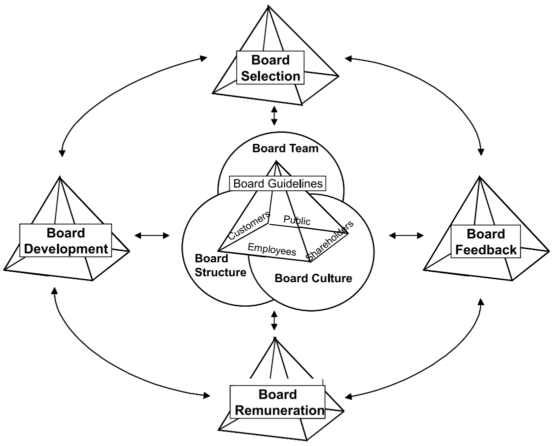
Keep it Integrated

Based on analyses of board practices carried out by doctoral students, the following weaknesses have been found in the majority of companies assessed:

- Insufficient board attention given to strategic direction

- A lack of professionalism in selection, feedback, remuneration and development of board members and top management
- Limited or irregular review of the performance of the board, coupled with insufficient strategic control and risk management by the board

In order to address these weaknesses, an integrated board management concept is proposed (illustrated in figure 4).



igure 4. Integrated Board Management

This concept comprises three dimensions:

1. The strategic elements that are the focus of attention remain:
   - Best possible board team
   - Constructive, open board culture
   - Effective board structure
   - Stakeholder-oriented board success standards

2. The main processes of the integrated cycle concept including:
   - Selection and composition
   - Review and feedback
   - Remuneration
   - Development

3. Use of an evaluation methodology to regularly monitor the success of the board's work.

The most important board management instruments need to be aligned with the firm's objectives in a holistic way, and they need to involve all relevant share- and stakeholder groups in development, implementation and evaluation. This concept ensures that the processes of selection, performance management, reward and development of board members and top managers offer added value for all stakeholder groups.

Keep it Controlled

In the integrated approach, the monitoring dimension of the board encompasses the following:

- The auditing function
- The risk management function
- The communication function
- The evaluation function

The Auditing Function of the Board

During the last few years, more and more "creative auditing" cases, such as Enron and Tyco, have become known. These cases brought the auditing function into disrepute. Considering all this, a professional cooperation between the board and the external and internal auditing functions is becoming increasingly important.

The controlling function of the board has to be clearly differentiated from specific monitoring functions (as illustrated in figure 5.)

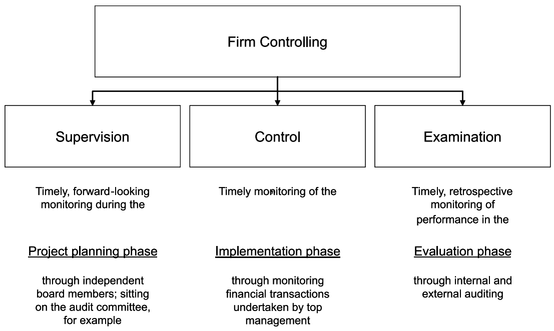


Figure 5. Firm-monitoring Function (Schneider, 2000)

The Risk Management Function of the Board

It is the task of the board and top management to define an integrated, future-oriented risk management concept; one which is integrated with the existing planning and leadership processes, and is equally directed to the realization of opportunities and does not constrain entrepreneurial freedom. Such a risk management concept should guarantee that management copes with daily risk (Ernst &

Young, 2002, p. 7) and it keeps the responsibility for directing and controlling within the board.

As in the case of corporate strategy, the board is responsible for the determination of the strategic risk objectives and for guaranteeing focused, operational risk management practices at managerial levels. “The Turnbull Report of 2000 (in the UK) made the first breakthrough…. by suggesting that boards must report annually to their owners their risk assessment and decision making processes (not content)” (Garratt, 2003, p. XXII).

The Communication Function of the Board

In the context of board communication policies, the old Laswell question is relevant: “Who informs whom, about what and how, using what means and with what success?” The following simple model of internal communication between board and management represents the communication flow in an organisation.

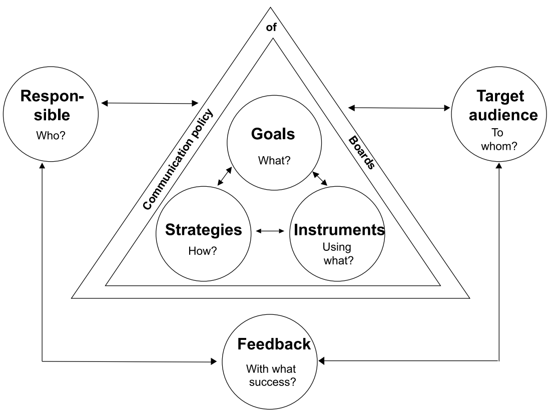


Figure 6. Board Communication Policies

The board and top management are interchangeably responsible for the roles of champion and target audience, and the exchange of information is of critical importance in this regard. The extent and quality of the information delivered by the CEO to the board sets the boundaries of the contribution that the board can make to good governance (Macus in Noetzli, 2004, p. 51).

The Evaluation Function of the Board

With the self and external evaluation of boards, two goals (that belong together) are pursued:

- The periodic, objective, systematic and functional diagnosis of strengths and areas for development and of the corporate governance policies and practices in a company in general; and
- The joint development, implementation and re-evaluation of interventions for the improvement of the corporate governance policies and practices, and the board and management teams, based on the results of the diagnosis.

Implications of New Corporate Governance

The “New Corporate Governance” framework presented here integrates the interests of the shareholders, customers, employees and public.

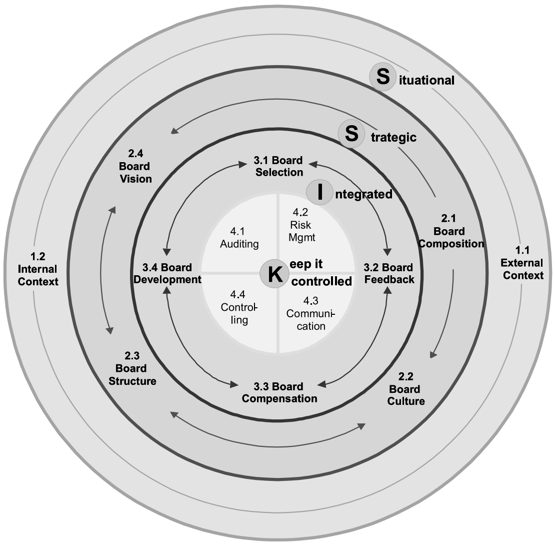


Figure 7. Model of “New Corporate Governance”

The danger of simplifying a complex system, as the “New Corporate Governance” framework is attempting to do, should not be underestimated: as soon as parts of a system are isolated, the understanding of the system is altered (Maleztke, 1972, p. 1515). Only when we are aware of the limitations of any model and of the dangers of isolating sub-components in that model, can we call our approach scientific (Koenig, 1967, p. 7).

There are two main limitations of this framework:

- The visual representation in this article lends itself to the usual critique of the social sciences, which is to “pay lip service to interdependence, and then to investigate the elements of the model in isolation from one another" (McQuail, 1973, p. 83); and

- While the breakdown of corporate governance into single, central components has analytical relevance for our study, in practice these components are not always clearly delimited. There are a number of overlaps and interdependencies between the factors.

In spite of these caveats, "New Corporate Governance" meets the criteria proposed by Brown for the assessment of a [good] model: simplicity, clarity and the logic of a formal structure, closeness to reality and, therefore, adequacy for relevant prediction.

Implications for Practice

The dot.com hype, the crash of financial markets, high-risk corporate strategies, the top executive value mindset and the momentous and numerous corporate crises led to a switch from first-to-worst for many companies within a short period of time. The experience in many countries showed that awards such as board member or executive of the year are no guarantee of future success, nor can they prevent sudden corporate failure.

The current danger consists of some sort of overregulation in the development of laws and guidelines, as most countries have done following the recent crises. The author has conducted self- and external reviews of boards for some years. One such example was of a medium-sized, publicly listed company that fulfilled all best-practice recommendations and was highly rated according to a university study (Meyer, 2003). In reality however, this company had a clear culture of mistrust within the board and, although it had excellent individual board members, the board as a whole demonstrated a low collective IQ.

Another listed company was a leader in its industry and had excellent board evaluations according to the 360º feedback process followed by the board. However, its management and main investors were among the "black sheep" in terms of corporate governance transparency guidelines on business report quality (Meyer, 2003).

What does this mean? Soft laws neglect the decisive soft dimension of companies ("The governance debate is too much about ticking boxes. What really counts are skills and behaviours inside the boardroom", Carter and Lorsch, 2004, p. 220). Successful companies have at the top of their boards and their management, human entrepreneurs (with cool heads, warm hearts and working hands) who succeed in building small boards, committees and management-teams with diverse know-how and team members playing different roles and displaying competence, commitment and integrity (Brabeck, 2004, p. 20f). These human entrepreneurs strive to be role models for shareholders, customers, employees, and the public and belong to the most important "contributors to wealth and employment in virtually every country" (Neubauer and Lank, 1998, p. 11).

Implications for Teaching and Research

There exists an excess of courses and literature on corporate governance based on a "one-size-fits-all" board approach. It is important to resist this misconception. Different corporate governance approaches have to be applied based on the size, sector, culture, ownership structure, legal form, stock-exchange requirements and development stage of the company. Targeted board programs should be offered, such as:

- Corporate governance for chairpersons of small- and medium-sized companies
- Educational governance for school board chairpersons
- Bank governance for bank boards
- Hospital governance for hospital boards
- Public governance for boards of public companies
- Cooperative governance for boards of cooperatives

As the latest literature and current conferences on the subject of corporate governance reveals, many special issues are well researched, but the research is usually completed in isolation of other issues. There is a lack of integrated corporate governance concepts.

Several current corporate governance research and consulting activities have revealed that the success of companies depends on the targeted selection of the board members, on the composition of the board team, and on the competence, availability, commitment and integrity of the board members. The optimal functioning of boards from the point of view of shareholders, customers, employees and the public is only possible if boards are guided by principles that are both legal and legitimate. There are two dimensions along which board actions can display integrity:

- The strategic direction function
- The strategic controlling function

A "both-and" approach is recommended to overcome the "either-or" thinking that currently dominates corporate governance theory and practice, based on the principle espoused by F. Scott Fitzgerald that:

"The test of first-rate (board) intelligence is the ability to hold two opposing ideas in mind at the same time, and still retain the ability to function."

Successful boards strive to deliver simultaneously:

Both	And
Shareholder value	…value for clients, employees and the public
Entrepreneurial action	…checks and balances
Legality	…legitimacy
Short-term results	… long-term sustainability
A culture of trust	… controls
Global integration	…local relevance
Comprehensive transparency	… necessary confidentiality
Performance orientation	… cooperation
Strategic direction	… monitoring
Keeping its nose in	…its hands out of operations

It remains to be seen if boards have the will and resources to transform themselves into true directing and controlling teams – changing their orientations from corporate governance to corporate *control-preneurship*. The result of this challenge will determine whether companies will be among the winners or the losers in the face of global change.

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