

# 3

## FIRM-LEVEL GOVERNANCE



The quality of corporate governance – the system of rules and practices by which companies are directed and managed – is critical in a well-functioning market economy. Firms that have better governance and management practices are significantly more productive than equivalent firms with weaker governance. The quality of governance varies greatly across companies in the EBRD regions, tending to be higher in foreign-owned firms

and companies that face stronger product market competition. Firm-level practices and the quality of economic and political institutions at national level both need to evolve in order to ensure that company directors and managers maximise firm value. In particular, weak governance at national level will make owners reluctant to delegate the running of their companies to professional managers.



## Introduction

Governance at firm level is all about the rules, practices and processes that determine the relationships between shareholders, the board of directors, senior managers and other employees. A firm constitutes a partnership between outside investors, who contribute financial capital, and the company's management and employees, who operate the firm and contribute human capital.<sup>1</sup> A successful company will require both types of capital and use formal arrangements to combine the two in an efficient manner. Good governance practices can help to align the incentives and interests of companies' owners, management and employees, thereby helping to solve the "agency problem" that arises from the separation of firms' ownership and control.<sup>2</sup>

This chapter looks at how businesses can achieve good governance practices. It begins by presenting findings from the EBRD's Corporate Governance Sector Assessment, which discusses the state of play in the EBRD regions in terms of legislation, regulations and industry practices in the area of corporate governance. It then uses data from the latest wave of Enterprise Surveys, which includes special modules on the quality of management and the use of senior managers' time (see Chapter 1). The results of those surveys are consistent with a plethora of studies across various countries showing that good governance practices raise firm-level productivity, thereby increasing the value of firms. Although this chapter focuses on firms' maximisation of shareholder value, contemporary assessments of corporate governance are also increasingly emphasising the importance of stakeholder value – a concept that encompasses the interests of consumers and society as a whole.

The analysis in this chapter reveals a close relationship between the various aspects of firm-level governance. For instance, data from the latest round of Enterprise Surveys indicate that firms which are located in countries with higher scores in terms of the EBRD's Corporate Governance Sector Assessment tend to have better management practices. Moreover, senior

managers of firms in those countries also tend to use their time more efficiently.

This chapter argues that firm-level differences in performance are, in part, driven by differences in the formal arrangements that determine the ways in which financial capital and human capital are combined. It points to several factors driving variation in management practices and senior managers' use of time.

The first thing to note is that ownership of companies matters. Across the EBRD regions, affiliates of multinational companies consistently outperform domestically owned firms when it comes to the quality of management practices. And among domestically owned firms, listed companies tend to be better managed than firms owned by families or individuals.

Family-owned companies often appoint family members to senior management roles, rather than recruiting managers externally. The analysis in this chapter finds that family members are less efficient than professional managers when it comes to allocating working hours to different parts of the business. At the same time, weaknesses in governance at national level can make owners reluctant to delegate the running of their companies to professional managers.

Competition can also have a transformative effect on firms' governance. Domestically owned firms that engage in international trade tend to have better management practices, as do firms that face strong competition in product markets. Less onerous labour regulations also appear to facilitate the adoption of good management practices.

<sup>1</sup> See Brealey et al. (2014).

<sup>2</sup> See Shleifer and Vishny (1997) for an overview of this issue.

## Governance at firm level

### Firms' shareholder value

Corporate governance is generally defined as the system of rules, practices and processes by which companies are directed and controlled. These formal arrangements determine the manner in which the owners and shareholders of a company interact with its board (which typically includes non-executive and independent directors, in addition to managers), as well as governing interaction between the board and the managers responsible for running the company.

Corporate governance is often regarded as helping suppliers of finance to ensure that companies' managers invest funds responsibly and return profits.<sup>3</sup> The provision of such "shareholder value" is widely considered to be the chief goal of a firm, and this view of corporate governance is written into law in both the United States of America and the United Kingdom.<sup>4</sup>

### A broader take on corporate governance

However, it is often suggested that firms should adopt a more inclusive perspective on governance, looking beyond shareholder value. The concept of "stakeholder value", for instance, takes account of the interests of all stakeholders in a company, including workers, customers and suppliers, as well as environmental issues. Indeed, it is worth noting that shareholders themselves may have objectives other than the maximisation of profits.<sup>5</sup> Where the various objectives embedded in stakeholder value contradict each other (for instance, when it comes to the maximisation of profits and customers' right to privacy), managers may face difficult trade-offs.

### Good corporate governance in practice

When companies reach a certain size and need to raise capital outside their close-knit network of initial shareholders and founders, or when the business becomes more complex, more formal governance arrangements are required. This is especially true of situations where external finance takes the form of equity investment.

In such companies, shareholders often delegate their responsibilities as supervisors and strategic decision-makers to an independent board of directors. The role of the board is to help management – often the firm's founders – to put in place the necessary processes to allow a company to grow, strengthening investors' trust and ensuring that risks are kept under control. For instance, in the case of a family business with multiple owners, investors may insist on the establishment of a board to drive the firm for the benefit of all shareholders and avoid conflicts between family members.

Boards are instrumental in providing strategic guidance to management and ensuring that managers follow that strategy within the agreed budget and risk envelope. An effective board of directors will set measurable performance targets for management and regularly evaluate performance against those targets.

Evidence from a recent survey of non-executive directors who have served on the boards of companies where the EBRD holds an equity stake suggests that local legislation can help in this regard, revealing that directors who feel adequately empowered by local legislation play a stronger role in the company's strategic decision-making.<sup>6</sup>

### Minimising the costs of agency

A firm's corporate governance structure should be designed to minimise the costs that are associated with misalignment between the interests of owners and managers.<sup>7</sup> For instance, senior managers may seek to maximise their own wealth, prioritising short-term objectives (such as next year's profits) at the expense of shareholders, who may take a longer-term view and place greater emphasis on R&D, for instance.

Such agency problems stem from an imperfect flow of information. Companies' boards delegate the authority to implement strategic decisions to management, in part because management teams running firms' day-to-day operations have better access to relevant information. However, the advantage that managers gain from having this information complicates external supervision of the company by the board or the annual general meeting of shareholders.<sup>8</sup> In particular, it may be hard for shareholders to decide whether a dissenting view put forward by a firm's management is rooted in managers' superior access to relevant information or managers' personal interests.

For this reason, a company's shareholders and creditors will insist on a set of governance practices to ensure that managers' behaviour remains aligned with their interests. One such practice is incentive-based pay, whereby shareholders offer managers remuneration packages that tie their pay to the firm's long-term performance.

Another is the establishment of an independent board of directors, which should consist of qualified individuals who are able to challenge management and ensure that they act in the long-term interests of the company (which may sometimes be different from the interests of the controlling shareholder). In this way, independent boards are able to provide a fresh perspective on a company's future that controlling shareholders might not have. They can also help to shield corporate decision-making from any conflicts of interest between shareholders and managers. At the same time, various studies have found strong links between high levels of diversity on boards and good corporate performance.<sup>9</sup> When pursued in isolation, incentive-based pay, independent directors and other corporate governance practices may not succeed in aligning stakeholders' interests. But when they are pursued in combination, they often do.<sup>10</sup>

<sup>3</sup> See Shleifer and Vishny (1997).

<sup>4</sup> See Brealey et al. (2014).

<sup>5</sup> See Hart and Zingales (2017).

<sup>6</sup> See De Haas et al. (2019).

<sup>7</sup> See Jensen and Meckling (1976).

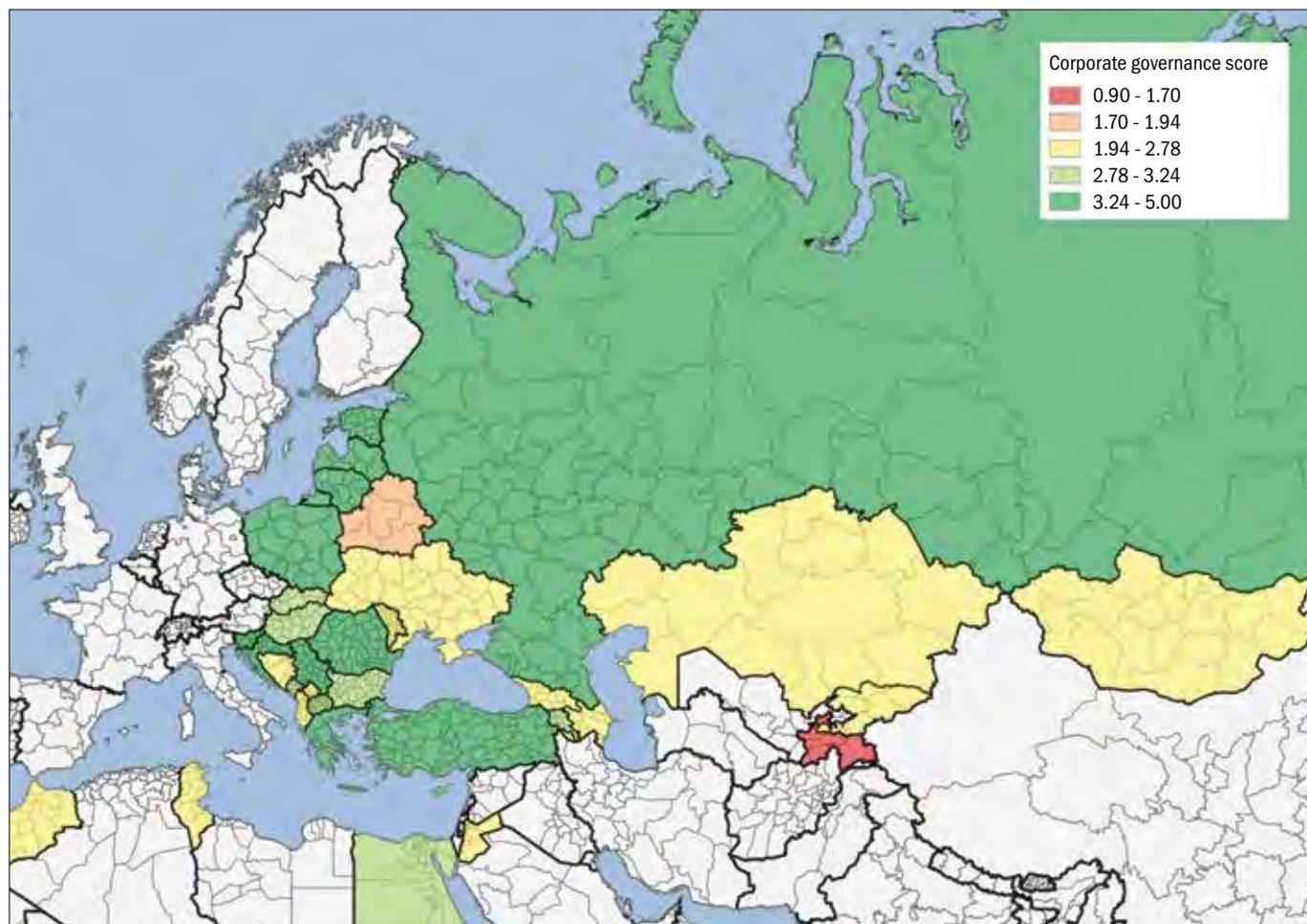
<sup>8</sup> See Tirole (2017).

<sup>9</sup> See Bernile et al. (2018).

<sup>10</sup> See Tirole (2017).

**CHART 3.1.**

Corporate Governance Sector Assessment scores in the EBRD regions



Source: EBRD Corporate Governance Sector Assessment.

Note: Corporate governance scores (which are on a scale of 1 to 5) are based on the quality of legislation and the quality of the governance practices of the 10 largest listed companies in each country, both of which are assessed relative to international best practices. Higher scores denote superior corporate governance.

## Corporate governance across the EBRD regions

The EBRD conducts regular assessments of the legal frameworks that shape corporate governance in the economies where it invests. These assessments cover the quality of the legal framework in place (including voluntary codes), as well as the extent to which the country’s institutions (courts and regulators, for example) are able to enforce legislation. In order to test the effectiveness of such frameworks and alignment with best practices, this analysis also includes a review of the corporate governance disclosures of the 10 largest companies in each jurisdiction.

**2.9**  
**OUT OF**  
**5**  
**AVERAGE SCORE IN THE**  
**EBRD’S CORPORATE**  
**GOVERNANCE SECTOR**  
**ASSESSMENT**

The most recent assessment of this kind was carried out in 2016 and 2017 and covered 34 countries across the EBRD regions (see Box 3.1). As part of that assessment, a detailed report was produced for each country and scores were calculated detailing the quality of legislation and practices in five areas of corporate governance: structure and functioning of firms' boards; transparency and disclosure; internal controls; rights of shareholders; and stakeholders and institutions. That assessment found significant variation across the EBRD regions in terms of the quality of corporate governance (see Chart 3.1) and highlighted several key weaknesses in the corporate governance systems in question, which was reflected in an average score of 2.9 (on a scale of 1 to 5) across the EBRD regions.

The first thing to note as regards that assessment was that the quality of listed companies' non-financial disclosures was poor, particularly when it came to their own corporate governance. The information that firms provided regarding the composition of boards and their subcommittees (and the qualifications of the people sitting on them) was often insufficient, as was information on companies' compliance with national corporate governance codes.

Second, in almost all countries there were concerns regarding the responsibilities and composition of firms' boards of directors. There were only a handful of countries where boards were clearly assigned, by means of legislation, responsibilities that could be considered key functions of a board of directors. In most cases, such powers continued to be exercised by the general meeting of shareholders, raising fundamental questions about the reasons for having a board in the first place.

Third, the results showed that little attention had been paid to the issue of board-level diversity. There seemed to be a lack of regulatory measures aimed at recognising and addressing this issue, coupled with an absence of good practices, particularly as regards gender diversity. In 19 of the 34 countries covered by the assessment, women made up less than 10 per cent of the boards of the 10 largest listed companies, compared with 29 per cent in the United Kingdom (on the basis of 2018 data for FTSE 100 companies).

Fourth, the roles and required characteristics of independent directors were not typically well defined. Legal frameworks did not generally establish clear expectations as regards the number of independent directors that should sit on firms' boards and the qualities they should have in order to contribute meaningfully to the functioning of the board. Moreover, in many cases the definition of independence was itself found to be inadequate. It was frequently the case that independent directors needed only to be unaffiliated with the company's executives or owners. However, independent directors also need to be highly engaged and demonstrate objectivity of mind in order to challenge executives. In fact, there was very little in listed companies' disclosures which showed that independent directors, and the issue of their independence, were being taken seriously.

Fifth, the assessment also revealed a need to improve internal control systems in many countries. This will involve clarifying

**IN 19  
OUT OF  
34  
COUNTRIES  
COVERED BY  
THE CORPORATE  
GOVERNANCE SECTOR  
ASSESSMENT, WOMEN  
MADE UP LESS THAN  
10% OF THE BOARDS OF  
THE 10 LARGEST LISTED  
COMPANIES, COMPARED  
WITH 29% IN THE  
UNITED KINGDOM**

the positioning and roles of individual control functions (risk management, compliance and internal audit) and strengthening the role of boards' audit committees. The responsibilities of an audit committee will typically include overseeing the financial reporting process, reviewing audits with management and external auditors, and discussing possible risk exposures and mitigation with management.

## Measuring the quality of management practices

How does good governance at firm level translate into increases in the value of firms on a day-to-day basis? And given the benefits of good governance, why do owners of successful businesses often find it hard to adopt sound corporate governance practices?

In order to gain insight into these questions, the analysis in this chapter uses preliminary data on more than 18,000 firms taken from the latest round of Enterprise Surveys conducted by the World Bank, the EBRD and the EIB (see Chapter 1 for details). As part of that survey round, respondents (all of whom were either senior managers or owners of firms) answered a set of detailed questions about their business planning and strategies, their management practices (for firms with at least 20 employees) and the use of senior managers' time (for firms with at least 50 employees).

The questions on management practices (which cover everything from the number of key performance indicators (KPIs) used by a firm to the links between promotion decisions and business outcomes) can be used to ascertain a firm's core business practices as regards operations, monitoring, targets and incentives.<sup>11</sup> Operational KPIs typically include measures of customers' satisfaction with a company's main product or service, while financial KPIs include net profit margins, returns on assets and returns on equity. The questions about management

<sup>11</sup> See Bloom et al. (2012) and EBRD (2014).

**MORE THAN  
80%  
OF TOTAL VARIATION  
IN THE QUALITY OF  
MANAGEMENT ACROSS  
FIRMS CANNOT  
BE EXPLAINED BY  
DIFFERENCES BETWEEN  
COUNTRIES OR SECTORS**

practices also capture the extent to which companies are well organised in terms of developing a sound business plan and executing it in a way that enables the board or shareholders to monitor progress against that plan. On the basis of firms' answers to these questions, the quality of their management practices can be given a rating. For example, the management score is higher if a firm monitors more KPIs or the remuneration of senior managers is linked to progress against KPIs. Similarly, firms are given a higher score if a large number of managers and workers are aware of production targets.

## Measuring the use of senior managers' time

Senior managers – typically the CEO, although official titles vary across firms – also answered questions on how many meetings they had with suppliers, other senior managers and employees involved in production activities in a typical week, how many people attended those meetings and how long those meetings took. Research shows that CEOs' answers to such questions can be used to ascertain their leadership style – that is to say, whether they are “managers”, who primarily implement specific tasks or monitor their implementation, or “leaders”, who foster organisational alignment and improve communication between various stakeholders.<sup>12</sup>

Various studies have found that CEOs who style themselves as “leaders” tend to contribute more to firms' performance than those who act as “managers”. In this regard, meetings with senior executives and participation in longer meetings with large numbers of participants tend to constitute efficient use of a senior manager's time, as opposed to time spent with suppliers and workers involved in production.

Answers to questions about a specific management practice (such as monitoring) are aggregated to form a single score and normalised such that they have a mean of 0 and a standard deviation of 1. The sum of the scores for the various individual management practices, which are also normalised with a mean of 0 and a standard deviation of 1, represents the final overall “z-score”. A positive value for that z-score denotes performance that is better than the sample average. Scores assessing the use of CEOs' time are constructed in a similar manner.

## Positive correlation between national corporate governance frameworks and the quality of firms' management

The quality of firms' management varies greatly across countries. In countries with stronger legislative guidelines regarding corporate governance and countries where listed firms follow such guidelines, as reflected in the EBRD's Corporate Governance Sector Assessment scores, firms also tend to score more highly in terms of management practices. A similar relationship can be observed for senior managers' use of time. These correlations are stronger for listed companies, which tend to have larger and more complex operations.

Subindicators used in the Corporate Governance Sector Assessment reveal that shareholder protection can explain almost a third of total variation in the average quality of management across countries. Indeed, increasing shareholder rights from the level seen in Hungary to that observed in Greece is associated with an increase in the average management score totalling 80 per cent of a standard deviation. That is a large increase, equivalent to two-and-a-half times the difference between foreign-owned and domestically owned firms in terms of the average quality of management (with foreign-owned firms tending to be better managed, as discussed below). That differential in the quality of management is, in turn, associated with a 1.3 per cent boost to labour productivity, as analysis later in the chapter will show.

Similarly, cross-country differences in the structure and functioning of boards can explain around a quarter of total variation in the average quality of management practices. These cross-country relationships suggest that the scores for management practices and senior managers' use of time that are obtained from Enterprise Surveys are also indirectly indicative of the quality of corporate governance at firm level (which is not observed for individual firms in Enterprise Surveys).

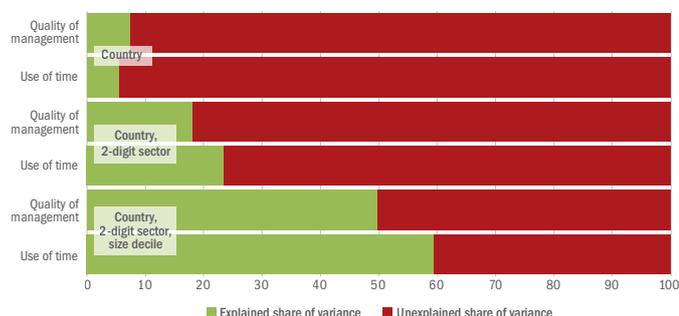
## Quality of management varies significantly within individual economies

The quality of firms' management also varies significantly within each individual country, particularly in emerging markets. Indeed, more than 80 per cent of total variation in the quality of management across firms cannot be explained by differences between countries or sectors (see Chart 3.2; manufacturing firms tend to have better management practices than firms in the services sector). Around half of all intra-country and intra-sector variation in management practices can be explained by firm size, as larger businesses tend to have more formal arrangements governing the setting of targets, their monitoring and the management of operations, as well as having various firm-level characteristics discussed in the next subsection.

<sup>12</sup> See Bandiera et al. (2017).

**CHART 3.2.**

The quality of firms' management and the use of senior managers' time vary greatly within countries



Source: Enterprise Surveys and authors' calculations.

Note: This chart shows the shares of variance in firm-level scores for quality of management and use of senior managers' time that are explained by different combinations of country, sector and firm size fixed effects.

**IN A FIELD EXPERIMENT  
LOOKING AT TEXTILE  
MANUFACTURERS  
IN INDIA, THE  
IMPLEMENTATION  
OF MANAGEMENT  
CONSULTANTS'  
RECOMMENDATIONS  
IMPROVED LABOUR  
PRODUCTIVITY BY  
17%  
IN A YEAR**

## Management as a production technology

Existing studies leave little doubt as to the importance of management for firms' performance. A survey of more than 11,000 firms from 34 countries over 15 years documents a robust positive correlation between management practices and various measures of efficiency, such as labour productivity.<sup>13</sup> Similarly, senior managers and key employees within a firm play a major role in determining the quality of management practices and the firm's level of performance.<sup>14</sup> Moreover, analysis of data on firms from 30 countries in emerging Europe and Central Asia taken from the previous wave of Enterprise Surveys suggests that management practices can be more important than the introduction of new products or the importing of foreign technology when it comes to raising productivity levels in lower-income economies.<sup>15</sup>

Importantly, rather than being a simple correlation, the relationship between the quality of management and firms' performance is likely to be causal. In a field experiment involving textile manufacturers in India, the implementation of management consultants' recommendations resulted in labour productivity increasing by 17 per cent in a year.<sup>16</sup> In another study where access to management consultancy services was granted in a randomised manner, improvements in management had a positive impact on total factor productivity and profitability for SMEs across a range of industries in Mexico.<sup>17</sup>

Recent work suggests that differences in management practices account for nearly a third of overall differences in total factor productivity – the efficiency with which physical capital, human capital and materials are combined to produce final goods.<sup>18</sup> These differences add up at country level: the average quality of management is higher in the United States of America and other advanced economies than it is in emerging markets (including those where the EBRD invests).

**TABLE 3.1.**

Better management practices are associated with higher output per worker

Dependent variable	Sales per worker (log)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Use of time (z-score)	0.110*** (0.034)					0.102*** (0.035)	0.092** (0.036)
Quality of management (z-score)		0.155*** (0.016)			0.143*** (0.018)		0.135*** (0.018)
R&D spending (percentage of total costs)			0.073*** (0.027)		0.058** (0.027)	0.065** (0.026)	0.056** (0.027)
Skilled workers (percentage of total workers)				0.106*** (0.037)	0.096*** (0.037)	0.095*** (0.036)	0.092** (0.037)
Observations	3,274	3,274	3,274	3,274	3,274	3,274	3,274
R <sup>2</sup>	0.704	0.705	0.704	0.704	0.707	0.706	0.708

Source: Enterprise Surveys and authors' calculations.

Note: Estimated using ordinary least squares. Regressions control for the logarithm of firm age, a set of dummy variables (indicating the number of employees by decile of the distribution, whether the firm is a listed company, whether it is foreign-owned and whether it is state-owned), industry fixed effects (at two-digit ISIC level) and country fixed effects. Standard errors are shown in parentheses, and \*, \*\* and \*\*\* denote values that are statistically significant at the 10, 5 and 1 per cent levels respectively.

<sup>13</sup> See Bloom et al. (2016).

<sup>14</sup> See Bertrand and Schoar (2003), Bennedsen et al. (2007), Kaplan et al. (2012), Bandiera et al. (2017) and Bloom et al. (2019a).

<sup>15</sup> See EBRD (2014) and Bartz-Zuccala et al. (2018).

<sup>16</sup> See Bloom et al. (2013).

<sup>17</sup> See Bruhn et al. (2018).

<sup>18</sup> See Bloom et al. (2016).

In this sense, good management and decision-making can be regarded as part of a firm's production technology.<sup>19</sup> In the most recent wave of Enterprise Surveys, higher-quality management and more efficient use of CEOs' time are strongly associated with greater output per worker, even after taking into account the firm's sector, age and size, whether or not it is a listed company and the type of ownership (see Table 3.1). Specifically, a 1 standard deviation improvement in the quality of management can raise output per worker by 16 per cent. A similar improvement in the use of a senior manager's time raises output per worker by 11 per cent. These effects are greater than the estimated impact of conceivable increases in a firm's expenditure on R&D or human capital (measured as the percentage of workers with university degrees).

Many best practices in the area of management (such as the monitoring of KPIs) have been the subject of numerous studies and seem easy to apply. Many also have cost risk profiles superior to those of investment in R&D, innovation, the upgrading of skills and plenty of other measures that are commonly used to enhance productivity. And yet, many firms still choose to refrain from improving their management practices. The next section explores the reasons for such decisions.

## What explains differences in firm-level governance?

### Foreign-owned firms tend to be better managed

Some of the differences that are observed in the quality of management across firms may be related to company ownership. In most countries, affiliates of multinational companies generally have better management than other firms, as parent companies often export their management styles to their foreign subsidiaries. Family-owned domestic firms, on the other hand, tend to have weaker management than other domestically owned private firms (such as listed companies or firms that are owned by private equity funds or institutional investors).<sup>20</sup>

In emerging markets, dynastic family firms tend to play a more important role in the economy than they do in high-income countries. In such firms, ownership and senior management roles pass from one generation to the next within a family, partly owing to weaker legal protection of outside investors in companies.<sup>21</sup> Firms owned by families and individuals account for 74 per cent of all the companies located in the EBRD regions that participated in the most recent round of Enterprise Surveys. They also account for 57 per cent of all employment provided by those companies (see Chart 3.3). Ownership structures vary from economy to economy

**TABLE 3.2.**

#### Determinants of the quality of firms' management practices

Dependent variable	Quality of management (z-score)		Use of time (z-score)			
	(1)	(2)	(3)	(4)	(5)	(6)
Domestic private firm	-0.187*** (0.064)	-0.118* (0.064)	-0.157* (0.092)	-0.127 (0.081)		
Managed by family					-0.152** (0.076)	-0.137* (0.076)
Partially state-owned	-0.108 (0.121)	-0.116 (0.098)		-0.394*** (0.143)		
Strategy		0.216*** (0.047)		0.041 (0.055)		0.059 (0.066)
Board		0.070 (0.052)		0.080** (0.041)		0.059 (0.064)
Experienced senior manager		0.031 (0.039)		0.033 (0.042)		-0.095 (0.064)
Not credit-constrained		-0.032 (0.035)		-0.034 (0.059)		0.070 (0.091)
Exporter		0.104*** (0.037)		0.018 (0.058)		0.120 (0.094)
Importer		0.178*** (0.042)		0.023 (0.072)		-0.079 (0.101)
Part of a group of companies		0.070 (0.049)		0.133*** (0.051)		0.190* (0.109)
Observations	6,170	6,170	3,124	3,124	1,101	1,101
R <sup>2</sup>	0.116	0.143	0.102	0.107	0.144	0.155

Source: Enterprise Surveys and authors' calculations.

Note: Estimated using ordinary least squares. Regressions control for the logarithm of the number of employees, the logarithm of firm age, whether or not the firm is a listed company, industry fixed effects (at two-digit ISIC level) and country fixed effects. The base category is foreign-owned firms. Standard errors are reported in parentheses, and \*, \*\* and \*\*\* denote values that are statistically significant at the 10, 5 and 1 per cent levels respectively.

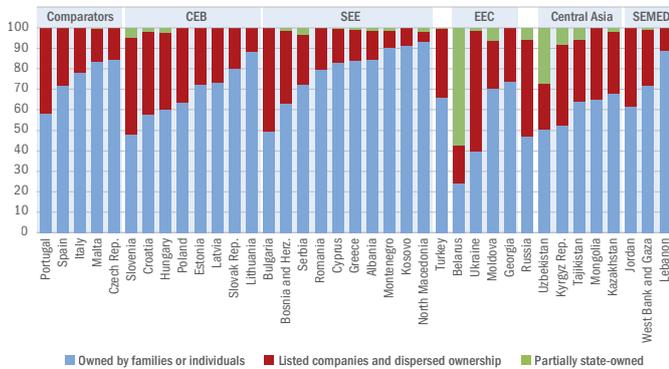
<sup>19</sup> See Bloom et al. (2016).

<sup>20</sup> See Bloom and Van Reenen (2010) and Bloom et al. (2014).

<sup>21</sup> See La Porta et al. (1998) and Aminadav and Papaioannou (2019).

**CHART 3.3.**

Firms owned by families and individuals account for a large percentage of corporate employment in the EBRD regions



Source: Enterprise Surveys and authors' calculations.

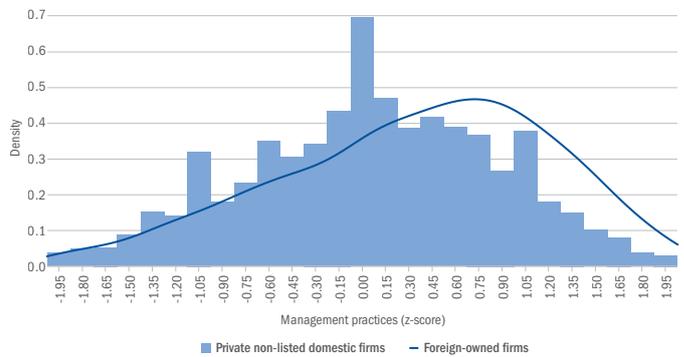
across the EBRD regions. Firms with dispersed ownership and listed companies are more common in central Europe and the Baltic states (CEB), while firms that are partially owned by the state account for a larger percentage of total firms in Belarus and Uzbekistan. (Firms that are owned entirely by the state are excluded from the Enterprise Surveys.) It is worth noting in this regard that many people in the EBRD regions believe that the state should have primary responsibility for providing jobs (see Box 3.2).

The quality of management tends, on average, to be significantly higher in foreign-owned firms than it is in domestic firms (see Chart 3.4). Indeed, the difference between the average quality of management in foreign-owned firms and private non-listed domestic firms totals 32 per cent of a standard deviation. These differences are more pronounced in the southern and eastern Mediterranean (SEMED), Central Asia and Turkey, reflecting the weaker management practices of domestic firms located in those economies (see Chart 3.5). In central and south-eastern Europe, domestic firms tend to be managed better, although there is still a gap relative to foreign-owned firms (see Chart 3.6). Only a small part of the difference between foreign-owned and domestic firms can be explained by the industries in which firms operate, their size, their age, whether they are listed on a stock exchange and other firm-level characteristics (see Table 3.2).

**FIRMS OWNED BY FAMILIES AND INDIVIDUALS ACCOUNT FOR 74% OF ALL THE COMPANIES LOCATED IN THE EBRD REGIONS THAT PARTICIPATED IN THE MOST RECENT ROUND OF ENTERPRISE SURVEYS**

**CHART 3.4.**

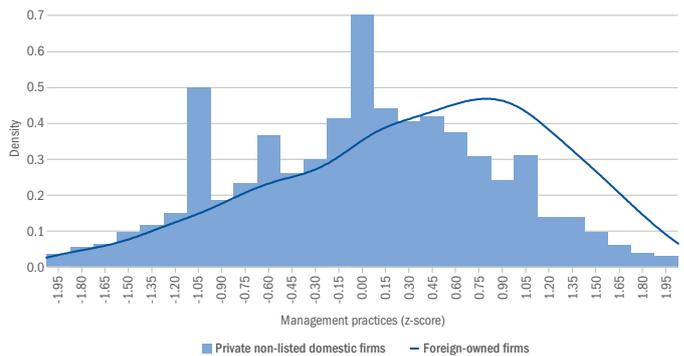
Foreign-owned firms tend to have better management practices



Source: Enterprise Surveys and authors' calculations.

**CHART 3.5.**

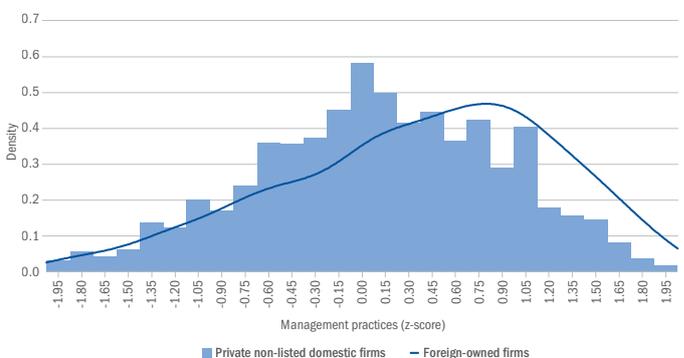
Differences between foreign-owned and domestic firms in terms of the quality of management are more pronounced in the SEMED region, Turkey and Central Asia



Source: Enterprise Surveys and authors' calculations.

**CHART 3.6.**

Differences between foreign-owned and domestic firms are less pronounced in central and south-eastern Europe



Source: Enterprise Surveys and authors' calculations.

## The quality of management practices varies significantly across partially state-owned companies

Firms that are partially owned by the state also tend to score poorly in terms of senior managers' use of time (see Table 3.2). This may be caused by poor practices in terms of the appointment of managers in such companies (see Box 3.3). The quality of management varies significantly across partially state-owned companies covered by the Enterprise Surveys, with some firms scoring highly and others scoring poorly. Easy access to funding, resulting in greater use of debt relative to equivalent private firms, may also blunt incentives to strengthen the quality of management in badly managed partially state-owned companies (see Box 3.4).

## Firms with a clear strategy tend to have better management practices

Firms that have a clear written business strategy also tend to score more highly in terms of management practices (see Chart 3.7). Perhaps unsurprisingly, foreign-owned firms are more likely to have a written strategy: 66 per cent of them do (on the basis of responses to the most recent round of Enterprise Surveys), compared with 41 per cent of domestic firms. Foreign-owned firms are also twice as likely to have a board of directors: 60 per cent of them do, compared with 30 per cent of domestic companies. That being said, companies with a board of directors do not necessarily do better than other firms in terms of the quality of management. This highlights the importance of boards being able to effectively supervise management, as discussed in the previous section.

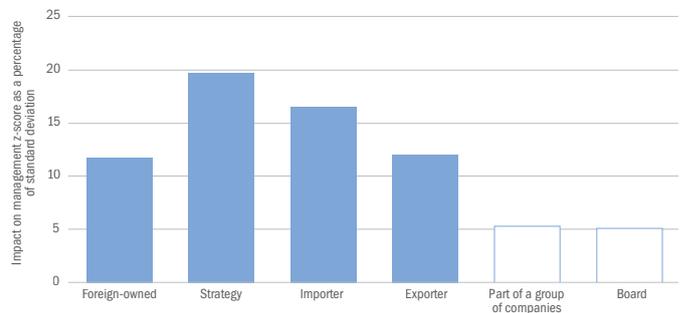
## Competition helps to improve management practices

Analysis of firms participating in the Enterprise Surveys also shows that companies that are involved in international trade (either as exporters or importers) tend to have better management practices. (A total of 63 per cent of foreign-owned firms in the sample export, compared with 26 per cent of domestic firms.) In part, this reflects the higher levels of competition that are faced by firms with cross-border operations.

More broadly, firms that face greater competitive pressures in the markets where they operate tend to have better management practices. With firms reporting the number of competitors that they have as part of the Enterprise Surveys, the level of product market competition can be measured as the percentage of firms in a given subnational region that have at least 10 competitors. (Overall, more than 60 per cent of surveyed firms fall into this category.) This analysis reveals that firms which operate in regions with higher levels of competition tend, on average, to have significantly higher management scores (see Table 3.3).

**CHART 3.7.**

Firms that are engaged in international trade tend to have better management

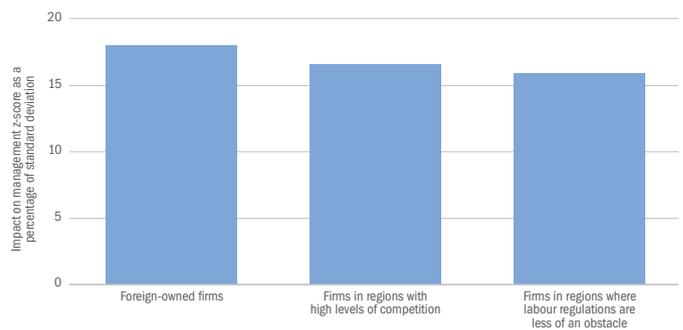


Source: Enterprise Surveys and authors' calculations.

Note: Based on the estimates reported in Table 3.2. Hollow bars denote effects that are not significant at the 5 per cent level.

**CHART 3.8.**

Firms operating in regions with stronger competition and a more favourable business environment tend to be better managed



Source: Enterprise Surveys and authors' calculations.

Note: Estimates are based on regressions similar to those reported in Table 3.3 and are significant at the 5 per cent level. Regions with high levels of competition are those where the percentage of firms that report having at least 10 competitors exceeds the median across all regions. Regions where labour market regulations are less of an obstacle are those where the extent to which labour market regulations are regarded as an obstacle is, on average, less than or equal to the median across all regions.

Competitive product markets reduce the scope for managerial slack and encourage managers to adopt best practices applied by their peers in order to remain profitable. Equally, low levels of competition, coupled with regulations that restrict the application of good management practices, allow bad management to persist.<sup>22</sup> At the same time, competition's ability to discipline managers may be limited where a firm's investment represents a sunk cost and managers use the resulting resources irresponsibly despite competitive pressures.<sup>23</sup>

The degree of product market competition can directly affect firms' ownership structures and governance choices. For instance, firms that operate in more competitive environments tend to have more dispersed ownership.<sup>24</sup> This is because competition increases businesses' need to raise equity capital externally, reducing the benefits of private control of a firm.

## Favourable business environments support good management

Research suggests that business-friendly regulations (such as the right-to-work laws in the United States of America, which regulate agreements between employers and labour unions) may enable firms to adopt better management practices.<sup>25</sup> Regression analysis finds some evidence of such effects in the EBRD regions. Domestic firms located in regions where firms tend, on average, to regard labour regulations as less of a constraint on their operations tend to be better managed (see Table 3.3 and Chart 3.8).

## Professional managers do a better job than family members

Senior managers and key employees have a strong influence on firms' management practices and performance.<sup>26</sup> In global surveys of management practices, family-owned firms that are run by professional CEOs do better than family-owned firms where senior managers come from within the family.<sup>27</sup> CEOs who are family members work 9 per cent fewer hours than professional CEOs at family-owned firms, according to a study of more than 1,000 firms across six countries. This difference in working hours accounts for 18 per cent of the performance gap between family-run and professionally run firms.<sup>28</sup>

Data from the Enterprise Surveys indicate that professional managers of domestic family-owned firms tend to make better use of their time than managers who are members of the family (see Table 3.2), with the difference between the average time use scores of the two groups of managers standing at around 15 per cent of a standard deviation. Consistent with this evidence, family successions (whereby management of a firm is transferred from one family member to another) are estimated to result in a decline of at least 6 percentage points in the profitability of the firm.<sup>29</sup>

And yet, only 17 per cent of family-owned firms in the EBRD regions are run by professional managers. Why are family-owned firms so reluctant to hire professional managers?

**TABLE 3.3.**

### Institutional determinants of the quality of firms' management

Dependent variable	Quality of management (z-score)			Use of time (z-score)			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Domestic private firm	-0.187*** (0.064)	-0.180*** (0.065)		-0.157* (0.092)	-0.153* (0.091)		
Partially state-owned	-0.108 (0.121)	-0.089 (0.108)		-0.385*** (0.148)	-0.385** (0.151)		
Managed by family			0.049 (0.043)			-0.152** (0.076)	-0.158** (0.074)
Competition (regional average)		0.093*** (0.033)	0.114* (0.064)		0.014 (0.039)		-0.042 (0.095)
Favourable labour regulations (regional average)		0.082 (0.098)	0.205*** (0.067)		-0.086 (0.060)		-0.021 (0.123)
Observations	6,170	6,170	2,448	3,124	3,124	1,101	1,101
R <sup>2</sup>	0.116	0.122	0.115	0.099	0.103	0.144	0.145

Source: Enterprise Surveys and authors' calculations.

Note: Estimated using ordinary least squares. Regressions control for the logarithm of the number of employees, the logarithm of firm age, whether or not the firm is a listed company, industry fixed effects (at two-digit ISIC level) and country fixed effects. Competition is measured as the average percentage of firms operating in the same subnational region that report having at least 10 competitors. Standard errors are reported in parentheses, and \*, \*\* and \*\*\* denote values that are statistically significant at the 10, 5 and 1 per cent levels respectively.

<sup>22</sup> See Bloom and Van Reenen (2010) and Bloom et al. (2016).

<sup>23</sup> See Shleifer and Vishny (1997).

<sup>24</sup> See Bena and Xu (2017).

<sup>25</sup> See Bloom et al. (2019a).

<sup>26</sup> See Bertrand and Schoar (2003), Bennedsen et al. (2007), Kaplan et al. (2012) and Bandiera et al. (2017).

<sup>27</sup> See Bloom et al. (2010) and Lemos and Scur (2019).

<sup>28</sup> See Bandiera et al. (2018).

<sup>29</sup> See Bennedsen et al. (2007).

**TABLE 3.4.**

Family-owned companies are more likely to hire professional managers in regions with high levels of trust

Dependent variable	Professional manager		Time use score	
	(1)	(2)	(3)	(4)
High trust (region with above-median trust)	0.029** (0.013)			
High trust * delegation-intensive industry		0.031** (0.015)		
High trust * non-delegation-intensive industry		0.026 (0.023)		
Professional manager			0.278*** (0.103)	
Professional manager * low trust				0.022 (0.174)
Professional manager * high trust				0.393*** (0.076)
Number of observations	1,873	1,873	563	563
R <sup>2</sup>	0.090	0.090	0.209	0.214

Source: Enterprise Surveys and authors' calculations.

Note: Estimated using ordinary least squares. Regressions control for the logarithm of the number of employees, the logarithm of firm age, industry fixed effects (at two-digit ISIC level) and country fixed effects. Subnational regions are divided into high-trust and low-trust regions on the basis of the percentage of respondents in Gallup World Polls who believe that others can be trusted. The list of delegation-intensive industries that has been used for this analysis is taken from Bloom et al. (2012). Standard errors are reported in parentheses, and \*, \*\* and \*\*\* denote values that are statistically significant at the 10, 5 and 1 per cent levels respectively.

## Weaknesses in country-level governance impede delegation to professional managers

One reason why firms' owners may potentially forgo the services of professional managers is low levels of trust, combined with weaknesses in the rule of law. This is because when the rule of law is weak, owners may have little recourse against rogue managers who steal from their firms or otherwise expropriate value.

The analysis below examines the determinants of decisions to delegate the running of family-owned firms to professional managers. For each subnational region, an average is constructed indicating the extent to which respondents in Gallup World Polls (a household survey; see Chapter 1 for details) believe that others in society can be trusted. On the basis of that measure, which is also strongly correlated with measures of confidence in government, regions are divided into high-trust regions (where the percentage of respondents who think that others can be trusted is above the median) and low-trust regions (all other regions).

Family-owned firms operating in high-trust regions are 2.9 percentage points more likely to hire a professional manager than equivalent firms operating in low-trust regions (see Table 3.4). This is a fairly sizeable effect, given that 17 per cent of all firms delegate to professionals. What is more, that figure rises to 3.1 percentage points for firms operating in industries where production technologies require greater delegation of tasks to middle managers (such as the manufacturing of electrical motors, where specialist expert knowledge is required).<sup>30</sup>

Furthermore, professional managers in regions with higher levels of trust appear to make better use of their time than peers in regions with lower levels of trust – presumably because they are, in turn, more able to delegate management tasks to others (see Table 3.4).

In addition to delegation within the firm, the quality of economic institutions will also affect a firm's sourcing decisions, altering the boundaries of the firm by encouraging or discouraging vertical integration of supply chains. In practice, this means that firms may, in a weak legal environment, deviate from the choice of supplier that would have been optimal had institutions been stronger (see Box 3.5).

A lack of access to finance may amplify inefficiencies arising from weak institutions.<sup>31</sup> Where owners prefer to keep management within the firm, regardless of other managerial talent available, talented managers can still take over family firms if they have the vision and skills needed to improve the running of those businesses – provided that they also have access to the funding that is required for a change of ownership. At the same time, a combination of weak institutions and large numbers of family-run firms may also affect the composition of investment at country level (see Box 3.6).

<sup>30</sup> The measure of the intensity of delegation that is used in this analysis has been taken from Bloom et al. (2012).

<sup>31</sup> See Caselli and Gennaioli (2013).

## Learning about good governance and management practices

### Learning from other parts of the firm

The analysis of the quality of management that is reported in Table 3.2 suggests that managers who work for a firm that forms part of a wider group of companies tend to make better use of their time. This suggests that managers can learn about good practices from each other.

Indeed, firms may be run badly because their executives are unaware of good management practices. A study a few years ago looking at firms employing fewer than 1,000 workers in India found that many were unaware of KPIs and other basic management practices.<sup>32</sup> As part of that study, a randomly selected plant within a firm was given advice provided by management consultants, while other plants within the same firm did not receive such advice. A follow-up study conducted several years later revealed that many of the consultants' recommendations had subsequently been implemented at other plants within the firm.<sup>33</sup>

### Movement of managers facilitates dissemination of management practices

Firms can also learn from each other through repeated business interactions with suppliers and customers and as a result of managers moving from one firm to another. Importantly, managers often move across industries. For instance, US data suggest that it is fairly common for managers to move from the production of machinery and equipment to the production of fabricated metal products, supporting the dissemination of good management practices across industries.

Accordingly, firms participating in the Enterprise Surveys that are located in cities which host well managed foreign-owned firms also tend, on average, to be better managed. (Admittedly, the data do not allow the effect of interaction between firms to be separated from the effect of, say, superior local governance, with well-managed firms tending to be located in cities with better governance.)

The dissemination of good management practices that is brought about by the movement of managers works both ways: management expertise may be lost when managers depart, unless companies make specific efforts to ensure that knowledge of good management practices is shared within the firm. The study of management practices in India that was described earlier found that some of the management practices that were introduced with the help of management consultants were subsequently dropped, particularly in instances where the plant manager changed, the CEO and the CFO were busier and the practice in question was not commonly used in other firms.<sup>34</sup>

**17%**  
OF FAMILY-OWNED  
FIRMS IN THE EBRD  
REGIONS ARE RUN  
BY PROFESSIONAL  
MANAGERS

FAMILY-OWNED FIRMS  
OPERATING IN HIGH-  
TRUST REGIONS ARE  
**2.9**  
PERCENTAGE  
POINTS  
MORE LIKELY TO HIRE  
A PROFESSIONAL  
MANAGER THAN  
EQUIVALENT FIRMS  
IN LOW-TRUST REGIONS

<sup>32</sup> See Bloom et al. (2013).

<sup>33</sup> See Bloom et al. (2019b).

<sup>34</sup> See Bloom et al. (2019b).

## Conclusion

This chapter has discussed the importance of corporate governance and examined the ways in which shareholders, companies' boards and managers can work together to maximise the value of firms. The discussion has drawn on the novel Corporate Governance Sector Assessment conducted by the EBRD, as well as a wealth of firm-level data on management practices and the use of senior managers' time that has been collected as part of the latest wave of Enterprise Surveys.

Improvements in governance can be regarded as a relatively low-cost and low-risk way of improving companies' performance by increasing the efficiency with which physical capital, human capital and material inputs are combined to produce goods and services. The EBRD's Corporate Governance Sector Assessment points to several priority areas in terms of boosting the quality of corporate governance in the EBRD regions.

For instance, companies need to be organised in a way that enables boards to effectively supervise decisions taken by management. Having an engaged board of directors and establishing an audit committee comprising independent non-executive directors can go a long way towards ensuring proper disclosure of information and overcoming any frictions that may arise as a result of an imperfect flow of information from managers to directors to shareholders. Moreover, in many countries the enforcement of legislation relating to corporate governance has been found to be relatively weak.

In countries that score more highly in terms of the EBRD's Corporate Governance Sector Assessment, firms tend to have better management practices and firms' CEOs tend to make better use of their time. Foreign-owned firms tend to set the standard in the EBRD regions when it comes to the quality of management. Firms that are exposed to greater competition in product markets (including firms that operate internationally) also tend to have superior governance, as do firms that operate in regions with more business-friendly labour regulations.

It is important to emphasise that there is no one ideal corporate governance system that suits all countries. Successful market economies such as the United States of America, Germany and Japan have very different corporate governance procedures. What they do have in common, however, is significant legal protection for investors, which allows the development of external financing mechanisms. In contrast, weak governance at national level will make owners reluctant to delegate the running of their companies to professional managers.

Recent thinking in the area of corporate governance emphasises that companies should look beyond shareholders and consider the broader interests of stakeholders such as employees and customers. This new approach to corporate governance, which aims to maximise stakeholder value, rather than just shareholder value, should help to create more sustainable and inclusive economies. This could, for instance, involve the monitoring of non-financial outcomes, such as greenhouse gas emissions (see the discussion in Chapter 4), and the establishment of links between those outcomes and managers' remuneration.

### BOX 3.1.

#### EBRD CORPORATE GOVERNANCE SECTOR ASSESSMENT

The EBRD's Legal Transition Team carries out regular Corporate Governance Sector Assessments. These assessments are designed to measure the quality of corporate governance legislation and the effectiveness of its implementation as evidenced by companies' disclosures. They also take account of the ability of a country's institutions (such as courts and regulators) to sustain high-quality corporate governance. The analytical grid that has been developed for the assessment of governance frameworks is based on internationally recognised best practice benchmarks (including the OECD's Principles of Corporate Governance and governance methodologies applied by development finance institutions such as the International Finance Corporation and the World Bank).

For the purposes of this assessment, corporate governance practices are divided into five key areas: (i) structure and functioning of the board; (ii) transparency and disclosure of company information; (iii) internal controls; (iv) rights of shareholders; and (v) stakeholders and institutions. Each of these key areas is, in turn, divided into a number of sections and subsections.

The assessment begins with the sending of a questionnaire to law firms, audit firms, national regulators, stock exchanges and the 10 largest listed companies in terms of capitalisation in each country. Questions differ across the various types of respondent. Respondents are asked to provide information about the legislation that is in force and give details of how that legislation is implemented in practice.

Responses are validated by the EBRD's corporate governance specialists, who look at the applicable frameworks, relevant reports by international financial institutions and the disclosures made by the 10 largest listed companies in each country (on the assumption that those companies will be the ones making the best disclosures in each country). Conclusions are then formulated for each subsection in the form of a score ranging from 1 (very weak) to 5 (strong) reflecting the level of adherence to international governance standards. In addition, a number of adjustments are made to the average scores for the various sections on the basis of a qualitative assessment.

**BOX 3.2.****COUNTING ON THE STATE TO PROVIDE JOBS?**

This box explores people's expectations regarding the role played by the state in terms of the provision of jobs, using data from the 2018 OeNB Euro Survey conducted by Austria's central bank. The sample for that survey comprised 1,000 individuals in each of the following 10 economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Hungary, North Macedonia, Poland, Romania and Serbia.

In line with evidence from Gallup World Polls (see discussion in Chapter 1), respondents have fairly limited confidence in economic and political institutions. For instance, nearly 70 per cent of people surveyed believe that most politicians primarily serve the interests of particular groups, while 45 per cent report a lack of trust in the government.

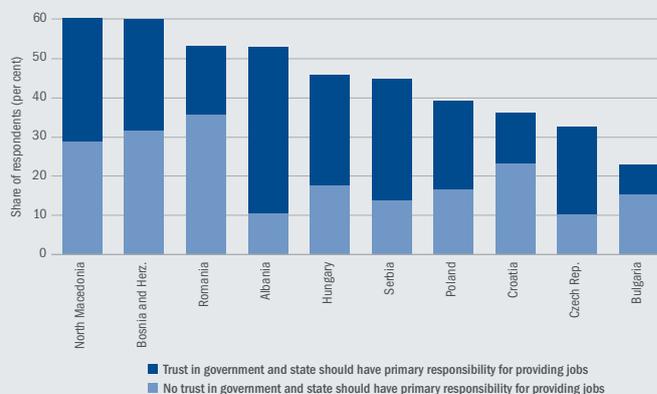
And yet, despite those concerns, about 45 per cent of respondents argue that the state should have primary responsibility for providing jobs (see Chart 3.2.1). Regression analysis reveals that respondents are more likely to expect the state to provide people with jobs if they have lower incomes, lower levels of assets or fewer years of education, have previously worked in the public sector, are reliant on welfare payments or live outside the capital city.

Some of those who expect the state to be the primary provider of jobs have confidence in state institutions, while others do not. When institutions are weak, private firms may find it easier to abuse their market power or political connections. This may result in demand for greater state ownership and regulation, even though people have little confidence in economic institutions.<sup>35</sup> Indeed, around 20 per cent of respondents report a lack of trust in government but still agree that the state should have primary responsibility for providing jobs.

In conclusion, these survey results suggest that support for state intervention in the economy remains relatively strong. Improving the quality of economic institutions and building effective social safety nets can go a long way towards strengthening support for the idea that the private sector should play a greater role in the economy.

**CHART 3.2.1.**

**Many people believe that the state should have primary responsibility for providing jobs**



Source: OeNB Euro Survey and authors' calculations.

Note: Survey respondents were asked who should be responsible for supplying people with work and were given five options: "primarily the state"; "primarily the private sector"; "shared responsibility between the state and the private sector"; "it does not matter, as long as the task is performed to a satisfactory standard"; and "don't know". Respondents who replied "don't know" or declined to answer have been excluded when calculating percentages.

<sup>35</sup> See Aghion et al. (2010).

**BOX 3.3.****CORPORATE GOVERNANCE IN STATE-OWNED ENTERPRISES: BEST PRACTICES AND REALITY**

The quality of corporate governance is of great importance for state-owned firms, which have a significant impact on the rest of the economy through their activities. For example, a recent report found that poor management at EPS, a state-owned electricity company in Serbia, was the cause of a strong decline in its production levels, significantly impairing the economic growth of the entire country.<sup>36</sup> Indeed, the efficiency of state-owned utility companies can have a major impact on the quality and cost of infrastructure used by other firms.

Economic research suggests that superior governance (in the form of independent and well functioning boards and the recruitment of professional managers, for example) will improve operational efficiency at state-owned firms, increasing returns on equity and assets.<sup>37</sup>

In addition, state ownership often involves an inherent conflict of interest, whereby the owner of a company may also be the sector's regulator and have a policy-making role. Against that background, the OECD published Guidelines on Corporate Governance of State-Owned Enterprises in 2005 (and updated them in 2015) with the aim of (i) professionalising the state as an owner, (ii) making state-owned enterprises operate with the kind of efficiency, transparency and accountability that well-functioning private firms exhibit, and (iii) ensuring a level playing field for state-owned and private firms.<sup>38</sup> Those guidelines cover: the rationale for state ownership (clear definition of the state's objectives for state ownership in a public ownership policy document); the state's role as an owner (informed and active ownership with proper governance); the issue of a level

playing field and fair competition with private competitors; equitable treatment of non-state shareholders; stakeholder relations and responsible business; disclosure and transparency (allowing for proper monitoring of state-owned enterprises' activities by the public); and the responsibilities of the boards of state-owned firms (professional management and proper managerial oversight).

As a recent survey by the OECD shows, full compliance with these principles has yet to be achieved in OECD countries. For example, financing is often provided to state-owned firms on non-market terms, while the remuneration of such firms' boards is frequently below market rates.<sup>39</sup>

More significant deviation from those principles can be observed in non-OECD countries in the EBRD regions. Ownership policies are often lacking, allowing ad-hoc political interference in the operations of state-owned firms. Managerial and board appointments are often politicised, with board members lacking appropriate qualifications. For instance, 12 of the 20 largest state-owned enterprises in Serbia have had "acting" managers for periods of up to six years, and those managers have often appeared to have conflicts of interest as members of parliament.<sup>40</sup> Management objectives can be unclear, in some cases prioritising a desire to appeal to governing parties' voter bases over the desire to meet key financial performance targets. Proper disclosure may also be lacking, with annual reports published late and omitting essential information. Regulatory and ownership functions may not be clearly separated, with "independent" regulators biased in favour of state-owned firms. Accordingly, uneven playing fields are common, with state-owned enterprises receiving direct or indirect subsidies and substandard service being tolerated.

<sup>36</sup> See Fiscal Council (2017).

<sup>37</sup> See, for example, Jurkonis and Petrusauskaitė (2014) and Curi et al. (2016) on Lithuania, Miring'u and Muoria (2011) on Kenya, Fan et al. (2014) on China, Menozzi et al. (2012) on Italy, Andrés et al. (2013) on Latin America and the Caribbean, and Heo (2018) on South Korea.

<sup>38</sup> See OECD (2015).

<sup>39</sup> See OECD (2018).

<sup>40</sup> See Richmond et al. (2019).

**BOX 3.4.****STATE OWNERSHIP AND FIRM LEVERAGE**

In countries with good general governance and strong protection for creditors, creditworthy firms will find it relatively easy to attract bank funding. Indeed, there is a large body of literature showing that stronger legal systems with better legal protection for creditors and minority shareholders will have a positive causal impact on the size of a country's financial system.<sup>41</sup> Firms can then use debt to supplement their internal financial resources where those resources are not sufficient to fund all investment projects with a positive net present value.

In such a scenario, firms' leverage – the ratio of debt to equity financing – depends on the intrinsic trade-offs in the area of debt finance. On the one hand, interest expenses are typically tax deductible, whereas dividends are not, favouring debt financing. In addition, if the firm raises external finance via equity, the original shareholders' stakes are diluted, weakening their incentives to maximise value.

On the other hand, though, an excessively high leverage ratio may make the firm more exposed to financial distress. High levels of debt entail large interest payments and, everything else being equal, greater vulnerability to external shocks.

In countries with underdeveloped financial systems, many firms may be credit-rationed or face particularly high interest rates. Governments may then be tempted to take ownership of such firms in order to

ease those credit constraints and use the firms to further a variety of economic or political goals.

There is an extensive body of literature showing that such active government involvement in private companies typically results in significant inefficiencies.<sup>42</sup> This is especially true where state ownership is used to support “national champions” as part of an active industrial policy, help politically connected individuals, or create employment with a view to maximising political support (see Box 3.2 for a discussion of voters' expectations regarding the provision of jobs by the state).

One important effect of state ownership is that it can dramatically change the trade-off between the benefits and risks of taking on more debt. The implicit or explicit bailout guarantees that accompany state ownership can reduce the cost of debt, as banks and other lenders will worry less about firms defaulting on their obligations.

This debt bias may be even stronger if a large percentage of the domestic banking system is also in state hands.<sup>43</sup> Indeed, there are widespread concerns about the ballooning debt of state-owned companies in China and other emerging markets where state banks play an important role in the financial sector.<sup>44</sup>

This box analyses the impact that state ownership has on firm leverage using an extensive dataset detailing ownership of listed firms across 127 countries.<sup>45</sup> State ownership is defined as a situation where the state holds more than 20 per cent of a company's voting rights, but the results below are robust to changes in this threshold.

State-owned companies tend, on average, to have a leverage ratio (defined as total liabilities over total assets) that is about 5 percentage points higher than that of private firms in the same country, sector and year (see column 1 of Table 3.4.1). This is a substantial difference relative to the average leverage ratio of 49 per cent across all firms in the sample. Controlling for firm size, profitability and other characteristics that are known to be correlated with leverage reduces the impact that state ownership has on firm leverage to 2 percentage points (see column 2).

Perhaps the most convincing way of showing the impact that state ownership has on leverage is to look at changes in ownership – that is to say, nationalisations (moves from private to state ownership) and privatisations (moves from state to private ownership). The inclusion of fixed effects in column 3 leaves only firms that experienced such a change in ownership in the period 2004–12. Regression analysis shows that, for that subsample, privatisation is associated with a 2 percentage point reduction in leverage, with nationalisation associated with a 2 percentage point increase, while the average leverage ratio for that subsample is 53 per cent.

Column 4 shows that this effect is driven exclusively by privatisations: when a firm moves from state to private hands, its leverage ratio tends, on average, to drop by about 6 percentage points. This is a substantial difference and shows that when firms cease to be owned by the state and become exposed to market discipline, they reduce their leverage ratios substantially.

**TABLE 3.4.1.**

State-controlled firms have higher leverage ratios

Dependent variable	Leverage (current and non-current liabilities over total assets)			
	All firms		Nationalised/ privatised firms	
	(1)	(2)	(3)	(4)
State control	0.047*** (0.007)	0.015** (0.007)	0.023* (0.013)	
State control (after nationalisation)				-0.007 (0.019)
State control (before privatisation)				0.060*** (0.023)
Firm characteristics	No	Yes	Yes	Yes
Firm fixed effects	No	No	Yes	Yes
Country * sector * year fixed effects	Yes	Yes	No	No
Country * year fixed effects	No	No	Yes	Yes
Sector * year fixed effects	No	No	Yes	Yes
R <sup>2</sup>	0.210	0.252	0.075	0.098
Adjusted R <sup>2</sup>	0.163	0.206	0.069	0.088
Number of observations	155,237	142,299	1,659	1,659
Number of firms	30,416	28,224	225	225

Source: Aminadav and Papaioannou (2019) and authors' calculations.

Note: Estimated using ordinary least squares. Standard errors are clustered at firm level, and \*, \*\* and \*\*\* denote values that are statistically significant at the 10, 5 and 1 per cent levels respectively. Specifications 2 to 4 also control for firm tangibility, profitability, non-debt tax shields and total assets. "Within R<sup>2</sup>" is reported for specifications 3 and 4.

<sup>41</sup> See, for example, La Porta et al. (1997, 1998).

<sup>42</sup> See, for example, Megginson (2017).

<sup>43</sup> See Kornai (1980) and Berglöf and Roland (1998) for a discussion of soft budget constraints.

<sup>44</sup> See Molnar and Lu (2019).

<sup>45</sup> See Aminadav and Papaioannou (2019).

**BOX 3.5.**

**SOURCING OF INPUTS AND CONTRACT ENFORCEMENT**

The quality of legal institutions not only affects firms’ internal organisation; it also affects firms’ boundaries and sourcing decisions. When firms cannot enforce contracts with suppliers because enforcement costs are prohibitively high or judges make poor decisions, sourcing inputs becomes costlier.

This is particularly true of relationship-specific inputs – goods that are tailored to a particular buyer – because the lack of enforceability gives rise to opportunistic behaviour.<sup>46</sup> Indeed, countries with strong legal institutions have been shown to have a comparative advantage in sectors that rely heavily on contracting.<sup>47</sup> Researchers have also used detailed data on plants’ input and output mixes in India to show that weak enforcement of contracts with suppliers causes firms to carry out more production steps within the same plant, switch to alternative (sometimes inferior) suppliers or switch from relationship-specific to generic inputs.<sup>48</sup>

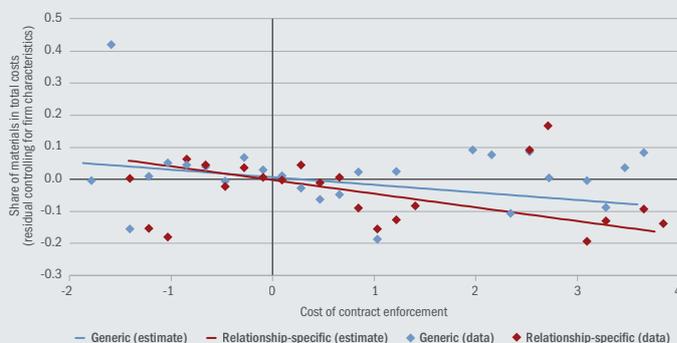
Distortions in individual firms add up to distortions at regional level. Researchers looking at the situation in India estimate that improving the quality of courts from the median level to the level observed in the best-performing Indian state would raise aggregate productivity by several percentage points.

The problem of weak enforcement of contracts is also pervasive in the EBRD regions.<sup>49</sup> Indeed, 17 per cent of all firms taking part in the Enterprise Surveys report that courts are a “major” or “very severe” obstacle to their operations. And in Kyiv, nearly half of all firms fall into that category.

As in the case of India, data from the Enterprise Surveys reveal correlations between the quality of courts and the cost shares of the various factors of production. In regions where courts are of poor quality according to the World Bank’s subnational *Doing Business* indicators, material inputs account for a smaller share of firms’ total costs (see Chart 3.5.1). This correlation is stronger in industries that rely heavily on relationship-specific materials and are therefore more prone to hold-up problems (where a party to a contract fails to comply with the terms of that contract after production has started).<sup>50</sup> This evidence is consistent with firms adjusting their organisational structures and the mix of factors of production on the basis of the quality of judicial institutions.<sup>51</sup>

**CHART 3.5.1.**

Where contract enforcement is costly, firms’ use of material inputs is lower



Source: World Bank *Doing Business* reports, Enterprise Surveys and authors’ calculations.  
 Note: The share of material inputs in total costs on the vertical axis represents residuals after taking account of firms’ size and sector and other observable characteristics in the regression analysis. The cost of enforcing contracts is derived from the World Bank’s *Doing Business* reports.

**49%**  
**PERCENTAGE OF FIRMS IN KYIV WHICH REPORT THAT COURTS ARE A MAJOR OR VERY SEVERE OBSTACLE TO THEIR OPERATIONS**

<sup>46</sup> See Klein et al. (1978).

<sup>47</sup> See Nunn (2007), Levchenko (2007) and Ciccone and Papaioannou (2009).

<sup>48</sup> See Boehm and Oberfield (2018).

<sup>49</sup> See Johnson et al. (2002).

<sup>50</sup> See Nunn (2007).

<sup>51</sup> See Boehm (2018).

**BOX 3.6.****GOVERNANCE AND FOREIGN INVESTMENT**

Cross-border asset holdings such as portfolio equity investment and foreign direct investment can help to diversify investment risks, channel finance towards opportunities with higher expected returns and contribute to the diffusion of technology and skills. However, levels of cross-border asset holdings are lower than the international capital asset pricing model and other economic models would suggest. This well-documented fact is known as “equity home bias”.

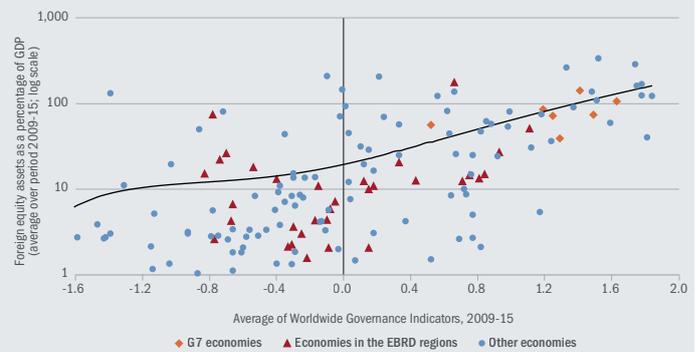
The quality of institutions appears to be an important factor explaining that equity home bias. Economies with higher levels of institutional quality (as captured by the average of their Worldwide Governance Indicators) tend, on average, to receive more foreign investment (as discussed in Chapter 2). They also hold more foreign assets (see Chart 3.6.1). These relationships hold when alternative measures of institutional quality or cross-border investment are used. In the EBRD regions, outward equity investment levels tend to be even lower than the modest quality of those regions’ institutions would suggest. This reflects, in part, the relatively low levels of savings in the EBRD regions, as discussed in the *Transition Report 2015-16*.<sup>52</sup>

This pattern whereby residents of economies with weaker institutions exhibit a stronger home bias may appear counterintuitive at first. Recent research<sup>53</sup> highlights the importance of two factors in this regard. First of all, when levels of institutional quality are low, influential individuals and families tend to retain large controlling stakes in companies. In part, this is because when protection of minority shareholders is weak, insiders can only sell small stakes at a significant discount, reflecting the low levels of protection associated with such stakes. This means that existing large shareholders are unwilling to sell their stakes in the first place, reinforcing the home bias. And that home bias, in turn, locks funds in the domestic economy, reducing the supply of funding for outward investment.

The second – more surprising – insight from that recent literature is that the *optimal* investment portfolio of an individual in a country with weaker institutions may also be strongly dominated by domestic assets. Imagine that a country with weaker investor protection is experiencing strong productivity growth. Such a boom tends to increase both investment by controlling shareholders and wages in the economy. As controlling shareholders increase investment, they reduce dividend payouts. This results in a negative correlation between labour income and income from dividends. Individuals who want to hedge their labour income may, in turn, find this negative relationship convenient, reinforcing the home bias. In contrast, where economic institutions are stronger, minority shareholders tend to have a greater say in dividend and investment decisions.

**CHART 3.6.1.**

**Levels of outward equity investment are higher in economies with higher-quality institutions**



Source: Lane and Milesi-Ferretti (2017) and authors' calculations.

<sup>52</sup> See EBRD (2015).

<sup>53</sup> See Mukherjee (2015).



## References

- Aghion, Y. Algan, P. Cahuc and A. Shleifer (2010)**  
“Regulation and Distrust”, *The Quarterly Journal of Economics*, Vol. 125, pp. 1015-1049.
- G. Aminadav and E. Papaioannou (2019)**  
“Corporate control across the world”, *The Journal of Finance*, forthcoming.
- L. Andrés, J. Schwartz and J. Guasch (2013)**  
“Corporate Governance of State-Owned Enterprises”, Chapter 5 of *Uncovering the Drivers of Utility Performance: Lessons from Latin America and the Caribbean on the Role of the Private Sector, Regulation, and Governance in the Power, Water, and Telecommunication Sectors*, World Bank, Washington, DC.
- O. Bandiera, S. Hansen, A. Prat and R. Sadun (2017)**  
“CEO behavior and firm performance”, NBER Working Paper No. 23248.
- O. Bandiera, R. Lemos, A. Prat and R. Sadun (2018)**  
“Managing the family firm: evidence from CEOs at work”, *The Review of Financial Studies*, Vol. 31, pp. 1605-1653.
- W. Bartz-Zuccala, P. Mohnen and H. Schweiger (2018)**  
“The role of innovation and management practices in determining firm productivity”, *Comparative Economic Studies*, Vol. 60, pp. 502-530.
- J. Bena and T. Xu (2017)**  
“Competition and ownership structure of closely held firms”, *The Review of Financial Studies*, Vol. 30, pp. 1583-1626.
- M. Bennedsen, K. Meisner Nielsen, F. Pérez-González and D. Wolfenzon (2007)**  
“Inside the family firm: The role of families in succession decisions and performance”, *The Quarterly Journal of Economics*, Vol. 122, pp. 647-691.
- E. Berglöf and G. Roland (1998)**  
“Soft budget constraints and banking in transition economies”, *Journal of Comparative Economics*, Vol. 26, pp. 18-40.
- G. Bernile, V. Bhagwat and S. Yonker (2018)**  
“Board diversity, firm risk, and corporate policies”, *Journal of Financial Economics*, Vol. 127, pp. 588-612.
- M. Bertrand and A. Schoar (2003)**  
“Managing with style: The effect of managers on firm policies”, *The Quarterly Journal of Economics*, Vol. 118, pp. 1169-1208.
- N. Bloom, E. Brynjolfsson, L. Foster, R. Jarmin, M. Patnaik, I. Saporta-Eksten and J. Van Reenen (2019a)**  
“What drives differences in management practices?”, *American Economic Review*, Vol. 109, No. 5, pp. 1648-1683.
- N. Bloom, B. Eifert, A. Mahajan, D. McKenzie and J. Roberts (2013)**  
“Does management matter? Evidence from India”, *The Quarterly Journal of Economics*, Vol. 128, pp. 1-51.
- N. Bloom, R. Lemos, R. Sadun, D. Scur and J. Van Reenen (2014)**  
“JEEA-FBBVA Lecture 2013: The new empirical economics of management”, *Journal of the European Economic Association*, Vol. 12, pp. 835-876.
- N. Bloom, A. Mahajan, D. McKenzie and J. Roberts (2019b)**  
“Do management interventions last? Evidence from India”, *American Economic Journal: Applied Economics*, forthcoming.
- N. Bloom, R. Sadun and J. Van Reenen (2016)**  
“Management as a Technology?”, NBER Working Paper No. 22327.
- N. Bloom, H. Schweiger and J. Van Reenen (2012)**  
“The land that lean manufacturing forgot? Management practices in transition countries”, *Economics of Transition*, Vol. 20, pp. 593-635.
- N. Bloom and J. Van Reenen (2010)**  
“Why do management practices differ across firms and countries?”, *Journal of Economic Perspectives*, Vol. 24, No. 1, pp. 203-224.
- J. Boehm (2018)**  
“The Impact of Contract Enforcement Costs on Outsourcing and Aggregate Productivity”, Sciences Po working paper.
- J. Boehm and E. Oberfeld (2018)**  
“Misallocation in the Market for Inputs: Enforcement and the Organization of Production”, NBER Working Paper No. 24937.
- R. Brealey, S. Myers and F. Allen (2014)**  
*Principles of Corporate Finance*, McGraw-Hill Education.
- M. Bruhn, D. Karlan and A. Schoar (2018)**  
“The impact of consulting services on small and medium enterprises: Evidence from a randomized trial in Mexico”, *Journal of Political Economy*, Vol. 126, pp. 635-687.
- F. Caselli and N. Gennaioli (2013)**  
“Dynastic management”, *Economic Inquiry*, Vol. 51, pp. 971-996.
- A. Ciccone and E. Papaioannou (2009)**  
“Human capital, the structure of production, and growth”, *The Review of Economics and Statistics*, Vol. 91, pp. 66-82.

- C. Curi, J. Gedvilas and A. Lozano-Vivas (2016)**  
“Corporate Governance of SOEs and Performance in Transition Countries. Evidence from Lithuania”, *Modern Economy*, Vol. 7, No. 12, pp. 1339-1360.
- R. De Haas, D. Ferreira and T. Kirchmaier (2019)**  
“The inner working of the board: evidence from emerging markets”, *Emerging Markets Review*, forthcoming.
- EBRD (2014)**  
*Transition Report 2014 – Innovation in Transition*, London.
- EBRD (2015)**  
*Transition Report 2015-16: Rebalancing Finance*, London.
- J. Fan, T. Wong and T. Zhang (2014)**  
“Politically Connected CEOs, Corporate Governance, and the Post-IPO Performance of China’s Partially Privatized Firms”, *Journal of Applied Corporate Finance*, Vol. 26, No. 3, pp. 85-95.
- Fiscal Council (2017)**  
Fiscal Trends in 2017 and Recommendations for 2018, Belgrade.  
<http://fiskalnissavet.rs/doc/eng/Summary%202017.pdf>  
(last accessed on 30 September 2019)
- O. Hart and L. Zingales (2017)**  
“Companies Should Maximize Shareholder Welfare Not Market Value”, *Journal of Law, Finance, and Accounting*, Vol. 2, No. 2, pp. 247-275.
- K. Heo (2018)**  
“Effects of Corporate Governance on the Performance of State-Owned Enterprises”, World Bank Policy Research Working Paper No. 8555.
- M. Jensen and W. Meckling (1976)**  
“Theory of the firm: Managerial behavior, agency costs and ownership structure”, *Journal of Financial Economics*, Vol. 3, pp. 305-360.
- S. Johnson, J. McMillan and C. Woodruff (2002)**  
“Courts and relational contracts”, *The Journal of Law, Economics, & Organization*, Vol. 18, pp. 221-277.
- L. Jurkonis and D. Petrusauskaitė (2014)**  
“Effects of Corporate Governance on Management Efficiency of Lithuanian State-Owned Enterprises”, *Ekonomika*, Vol. 93, No. 2, pp. 77-97.
- S. Kaplan, M. Klebanov and M. Sorensen (2012)**  
“Which CEO Characteristics and Abilities Matter?”, *The Journal of Finance*, Vol. 67, pp. 973-1007.
- B. Klein, R. Crawford and A. Alchian (1978)**  
“Vertical integration, appropriate rents, and the competitive contracting process”, *The Journal of Law and Economics*, Vol. 21, pp. 297-326.
- J. Kornai (1980)**  
“‘Hard’ and ‘Soft’ Budget Constraint”, *Acta Oeconomica*, Vol. 25, No. 3-4, pp. 231-245.
- P. Lane and G. Milesi-Ferretti (2017)**  
“International Financial Integration in the Aftermath of the Global Financial Crisis”, IMF Working Paper No. 17/115.
- R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1997)**  
“Legal determinants of external finance”, *The Journal of Finance*, Vol. 52, pp. 1131-1150.
- R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1998)**  
“Law and finance”, *Journal of Political Economy*, Vol. 106, pp. 1113-1155.
- R. Lemos and D. Scur (2019)**  
“The ties that bind: implicit contracts and management practices in family-run firms”, mimeo.
- A. Levchenko (2007)**  
“Institutional quality and international trade”, *The Review of Economic Studies*, Vol. 74, pp. 791-819.
- W. Megginson (2017)**  
“Privatization, state capitalism, and state ownership of business in the 21st century”, *Foundations and Trends in Finance*, Vol. 11, No. 1-2, pp. 1-153.
- A. Menozzi, M. Gutiérrez Urriaga and D. Vannoni (2012)**  
“Board composition, political connections, and performance in state-owned enterprises”, *Industrial and Corporate Change*, Vol. 21, pp. 671-698.
- A. Miring’u and E. Muoria (2011)**  
“An Analysis of the Effect of Corporate Governance on Performance of Commercial State Corporations in Kenya”, *International Journal of Business and Public Management*, Vol. 1, No. 1, pp. 36-41.
- M. Molnar and J. Lu (2019)**  
“State-owned firms behind China’s corporate debt”, OECD Economics Department Working Paper No. 1536.
- R. Mukherjee (2015)**  
“Institutions, corporate governance and capital flows”, *Journal of International Economics*, Vol. 96, pp. 338-359.
- N. Nunn (2007)**  
“Relationship-specificity, incomplete contracts, and the pattern of trade”, *The Quarterly Journal of Economics*, Vol. 122, pp. 569-600.
- OECD (2015)**  
*OECD Guidelines on Corporate Governance of State-Owned Enterprises*, Paris.
- OECD (2018)**  
*Ownership and Governance of State-Owned Enterprises: A Compendium of National Practices*, Paris.
- C. Richmond, D. Benedek, E. Cabezón, B. Cegar, P. Dohlman, M. Hassine, B. Jajko, P. Kopyrski, M. Markevych, J. Miniane, F. Parodi, G. Pula, J. Roaf, M. Kyu Song, M. Sviderskaya, R. Turk and S. Weber (2019)**  
“Reassessing the Role of State-Owned Enterprises in Central, Eastern and Southeastern Europe”, Departmental Paper No. 19/11, IMF.
- A. Shleifer and R. Vishny (1997)**  
“A survey of corporate governance”, *The Journal of Finance*, Vol. 52, pp. 737-783.
- J. Tirole (2017)**  
*Economics for the Common Good*, Princeton University Press.