Economics and Management
ISSN: 2683-1325
Volume: XVII, Issue: 2, Year: 2020, pp. 61-71

THEORIES OF CORPORATE GOVERNANCE AT STATE-OWNED ENTERPRISES

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Received: 9.07.2020 Accepted: 30.08.2020

Abstract

The aim of the article is to present the application of basic theories of corporate governance in state-owned enterprises. The modern theories of corporate governance were developed and applicable in the private sector only. State ownership fulfills more than one goal and makes it difficult to apply a specific theory of corporate governance.

The results of the article give grounds for applying a specific theory to an individual state-owned enterprise. For the correct application of a given theory, it is necessary to disclose information to determine the goals of the state enterprise and to specify the stakeholders. The mechanical application of theories of corporate theories from the private sector to state-owned enterprises reduces the significance of each theory and leads to incorrect conclusions.

Keywords: *agency theory, stewardship theory, stakeholder theory*
JEL Codes: *D86, G34, L33*

Introduction

The debate over corporate governance of state-owned enterprises offers a “puzzling irony” (Chen, 2016). The reason for such a reaction is the ignorance that the failure of state-owned enterprises is as common an event as the failure of the private sector (Toninelli, 2000). The main justification for ignorance of the issues of state-owned enterprises is the less attention they receive compared to private companies (Kowalski et al., 2013). The surveys for state ownership are disproportionate to the volume of surveys on private sector companies (Bruton et al., 2015). In practice, there is a constant demand for empirical research on the corporate governance of state-owned enterprises (Whincop, 2005). Differences in corporate governance research for private companies and state-owned enterprises have been likened to a “gap” (Grossi, Papenfuß & Tremblay, 2015).

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The dynamics in society determine the development of state ownership. With each change in society, the theories of corporate governance of state-owned enterprises are adapted and upgraded[1]. According to A. Hirschman, society goes through periods of public ownership to solve common problems and periods of achieving individual and private goals (Hirschman, 1982). According to the origin and evolution of a nation, the form of ownership changes, which is supported by scientific theories for each stage. Regardless of the stage of development in any society, state ownership raises reasonable questions about its justification, as well as about the benefits generated by it. For this reason, the assessment of state-owned enterprises must be both economic and social (Kim et al., 2019).

The theories and terminology of corporate governance of state-owned enterprises are in the field of political science and public administration rather than in economics and business administration. This may explain the difficulties in using terms and techniques applicable to the private sector in the analysis of state-owned enterprises. The modern practice of corporate governance of state-owned enterprises has points of contact with the private sector in the application of the universal principle for finding cases through standardized requirements for disclosure of information. The application of the "comply or explain" principle comes down to knowledge of global good practices and gives rise to attempts to introduce foreign practices into the national environment, as legislation and dependence on historical development and inertia remain secondary.

Corporate governance of state-owned enterprises is characterized by national differences. The features of individual countries differ significantly, as they are contextually rooted and historically determined (Backer, 2017). Case reporting and benchmarking of state ownership often do not lead to convergence of practices. The analysis of good practices should be conducted by rethinking the evolutionary models of state institutions and national economies (Berger & Dore, 1996).

Dynamics of state ownership

The dynamics of state ownership can be considered according to the views of various authors expressed over the years:

– One of the first opinions to justify the existence of state ownership is in four directions: promoting and accelerating economic development, ensuring national security and defense, organizing control over monopoly industries and the existence of political ideology (Friedmann & Garner, 1970).

[1] Corporate governance of state-owned enterprises has the function of increasing their efficiency in terms of value creation, while ensuring compliance with applicable law and regulations (Schneider, 2019).

– Later, state-owned enterprises are seen as a consequence of ideological reasons, the acquisition or consolidation of political or economic power, historical heritage and inertia, and as a pragmatic response to existing economic problems (Jones & Mason, 1982).

– The current view of the need for state-owned enterprises is associated with government intervention to address market failures that arise in the development of new strategic industries, limiting excessive monopoly profits from infrastructure services and the need to provide social security at low cost (Davids & Van Zanden, 2000).

Modern state ownership began to take shape in the 1930s due to following reasons:

– The effects of the Great Depression were caused by private sector errors, which necessitated government regulation, including through the acquisition or creation of state-owned enterprises for an infrastructure monopoly (Millward, 2006).

– After the end of the World War II, state ownership is a symbol of the modernization of the national economy and prosperity of society.

– In the 1970s, the oil crisis increased public attitudes towards the accountability of state-owned enterprises (European Commission, 2016).

– The global financial crisis of 2008 changed the perception of the effects of state ownership – state-owned enterprises are less in need of recovery.

– At the beginning of the 21st century, state ownership is at the heart of government programs for the competitiveness of national economies.

Modern views on property are focused mainly on the relation "ownership – responsibility", which is directly related to the rights of every member of society. This takes into account the change in the stereotype of shifting the financial burden on taxpayers.

Depending on the model of state ownership, three main ideal types describe the role of the state (Bellini, 2000):

– "Expert state", which has a monopoly on the legitimacy of identifying and achieving common interests. The status of “expert state” is based on both political and social factors. Characteristic of this type of state is the combination of open and effective achievement of common goals in line with business.

– "Referee state", which creates the framework in which the economy operates and exercises control over the relations between social actors. The "referee state" is based on economic structures and social networks.

– "Bargaining state", which is a political body aimed at preserving power structures and ensuring the survival of its controlling groups. In such situations, there are state subsidies to support and finance political activities.

State ownership has three organizational models depending on the phase of its historical development (Rajavuori, 2016):

– The state as an entrepreneur acts as a supplier of goods and services that cannot be generated by the private sector. For example, in a poorly developed financial system, the state assumes the function of owner for economic development and social policy[1].

– The state as a majority investor is the second phase. In this phase, the privatization of state-owned enterprises from the first phase is carried out.

– The state as a minority investor is the last phase. The state retains a minority share in sectors of strategic importance to the national economy. Holding structures and national development banks are used.

All these features create serious difficulties in using traditional theories of corporate governance, designed for private corporations, to study state-owned enterprises. In the following statement will highlight the main problems arising from attempts at such adaptation.

Application of the principal-agent theory to state-owned enterprises

Agency theory is deductive in its methodology, so it can be successfully applied when sufficient empirical material has been accumulated and theoretically summarized. The application of agency theory to state-owned enterprises is problematic due to conflicting interests in carrying out the owner and control functions by the state (Wicaksono, 2009).

The agency theory can be applied in state-owned enterprises when there is a clear definition of participants in corporate governance[2]:

– Principal. For state-owned enterprises, ownership rights are “poorly defined” (Ramamurti, 2000). There are limited ownership rights in state-owned enterprises (Sokol, 2010).

In theory, society is the ultimate principal of state-owned enterprises, and the state is the second principal, while in practice only the state performs the functions of principal[3]. Difficulties in determining the ultimate principal of state-owned enterprises prevent the development of appropriate mechanisms to align the agent's interest with that of the

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[1] E. Reinert justifies the participation of the state in the first stages of industrial development with the need to put the nation in the "right business", to supply infrastructures, to create demand for modern technological products and to act as an "entrepreneur of last resort" (Reinert, 2000).

[2] The application of the principal-agent theory has a negative attitude towards state-owned enterprises due to the presentation of corporate governance as a top-down policy model (Waterman, Rouse & Wright, 2004).

[3] The agency problems of large state-owned enterprises and large private corporations with dispersed ownership are similar due to the many and overlapping layers of hierarchy (Chang, 2007).

principal[1]. The existence of multiple goals and their difficult definition at the level of society and the state make it difficult to account for and assess the degree of their implementation[2]. On the other hand, the presence of many interests leads to many principals[3]. The existing opinions in the literature that society is an investor and the state is an entrepreneur in the corporate governance of state-owned enterprises can be summarized[4]. Another problem is related to the encapsulation sometimes from the external environment in which state-owned enterprises operate, which acts as a disincentive to the development and implementation of new technologies and a reduction in investment for innovation (Brons & Tomasi, 2016).

– The existence of an agent (manager) has been accepted as a guarantee of success since the origin of state ownership – Herbert Morrison (1933) stated that managers of public corporations must be the “high custodians of the public interest” and governments must stay at “arm’s length” from public corporations.

The agent in state-owned enterprises is neutralized from the external environment and very often cannot be replaced in case of negative results[5]. The lack of a market of control over the managers of state-owned enterprises further determines the agent's behavior towards free riding and moral hazard[6]. Such a situation without real control over management is the basis of another theory – "agents without principals" (Toninelli, 2000). To reduce agency conflict in state-owned enterprises, it is necessary to introduce a periodic reporting procedure (van Slyke, 2007).

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[1] Remuneration in state-owned enterprises is "semi-elastic" in terms of profitability and is similar in formation to that of regulated industries. Incentives in Chinese state-owned enterprises can only be compared to those in Bulgaria (Mengistae & Xu, 2004).

[2] State-owned enterprises perform both economic and social functions. This dual nature leads to the need to disclose information through both public and private reporting styles (Royoa, Yetano & García-Lacalle, 2019).

[3] The multitude of principals leads to a situation in which the agent has an information advantage and is able to choose a specific principal as an ally. In addition, the agent has incentives to respond to different principals in different ways and means (Waterman & Meier, 1998).

[4] The use of accounting information (annual financial reports) for external users who do not have access to inside information derives from agency theory (Allini, Manes Rossi & Hussainey, 2016).

[5] The external environment is a mandatory element in agent theory: “The principal's gross (random) wealth is a linear function of the agent's total effort and the exogenous risk” (Cauley & Sander, 1992).

[6] Citizens, as the ultimate owner of state-owned enterprises, have no incentive to monitor agents and are defined as “free riders” (Thukral, 2015).

Another limitation for applying the principal-agent theory to state-owned enterprises is the difficulty of exercising control over management[1]. In most cases, control is neglected or overlaps with the ownership function. There is no “divorce of ownership and control” (Domberger & Piggott, 1994), which partly explains the poor performance of state-owned enterprises compared to the private sector.

"State-owned enterprise" does not automatically mean "state-managed enterprise", for example, there is a possibility for a private company to be managed as a state-owned enterprise, i.e. when the state appoints executive directors and managers (Toninelli, 2000). Thus, the only situation in which the application of the principal-agent theory to state-owned enterprises is justified is their listing on the stock exchange and the entry of new principal-investors[2].

Application of the stewardship theory to state-owned enterprises

The stewardship theory is built around the understanding that managers are good stewards who work for the interests of owners (Donaldson & Davis, 1991). These authors argue that executives are good owners of corporations and work hard to achieve a high level of corporate profits and shareholder returns (Donaldson and Davis, 1994).

With these statements, the stewardship theory opposes the thesis of lack of good faith of managers and denies the need to develop special mechanisms to control their decisions. Lex Donaldson and James Davis suggest: "There is a belief that companies would perform better if their boards of directors were to be made up of independent outsiders, that is non-executives” (Donaldson & Davis, 1994). Corporations would improve their efficiency if managers were given the widest possible powers, which is a process of empowering them by delegating powers.

The stewardship theory is based on mutual efforts to achieve common goals and requires cooperative behavior of all participants in corporate governance (Papenfuß et al., 2017). The guarantor for the application of this theory is the exchange of information for building trust through transparent communication and reporting between the participants about the set goals and the achieved results. The stewardship theory has the most positive results when co-decision procedures are adopted (van Slyke, 2007).

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[1] Agency theory recommends a large number of independent external directors on the board and the separation of functions of CEO and chairman of the board in order to increase the independence of the board and effectively perform its supervisory role over managers (Donaldson & Davis, 1991).

[2] In the analysis of the corporate governance of state-owned enterprises, the annual reports are used as a source of information, i.e. based on accounting data, while for private companies – on financial data from the stock exchange (Bova & Yang, 2018).

In practical terms, the stewardship theory very rarely finds benchmarks. The presence of socially oriented, mission-led and morally responsible successful managers is a rare exception regardless of the applied corporate governance systems and enterprise ownership.

Application of the stakeholder theory to state-owned enterprises

Stakeholder theory is interconnected and to some extent builds on the stewardship theory. Unlike the stewardship theory, as well as the agency theory, the view of the enterprise is broader and includes external stakeholders.

Stakeholder theory reflects the understanding of the corporation as a public organization. Therefore, in a broader sense, it addresses the global problems of interaction between individual, company and society. This makes it very attractive for state-owned enterprises.

The uniqueness and difficulty of looking at state-owned enterprises is the presence of many key stakeholders (Wasowska & Postula, 2018). Their presence justifies the existence of many goals, some of which are contradictory[1]. Most often, analyzes of state-owned enterprises are made taking into account the formal relationships between stakeholders and especially when making decisions, while taking into account the objectives is neglected[2].

Adequate information on the purposes and results of the use of state ownership is necessary for the adequate application of the stakeholder theory in state-owned enterprises (Donaldson & Preston, 1995). In legitimizing stakeholders, it is of interest to integrate and satisfy diverse interests (Bryson, 2004). According to some authors, stakeholder theory requires employees to have a voice in the management of state-owned enterprises (Mengistae & Xu, 2004).

At the same time, with the stakeholder theory, the tasks and problems of corporate governance become more complex and increasing. Problems arise with the management of conflicts between stakeholders, which are much more and multi-layered than the principal-agent dichotomy. On the agenda is the issue of identifying stakeholders and their interests, developing strategies for participation or neutralization in the implementation of reforms and implementation of large-scale restructuring of state-owned enterprises, which affect

[1] Sometimes the goals of state-owned enterprises are numerous, not clearly defined or contradictory (Zamagni, 1987).

[2] Accountability must go beyond ordinary economic performance, as the long-term survival and success of a corporation requires the support of all its stakeholders (Mitchell, Agle & Wood, 1997).

many stakeholders. Thus, the stakeholder theory is quite difficult, underestimated, but also a promising apparatus for application in the analysis of corporate governance.

Conclusion

The goals of state-owned enterprises determine the applicability of a specific theory of corporate governance. Having more than one goal leads to a second principal and a wide range of stakeholders. The combination of ownership and control in the state raises legitimate questions about the level of corporate governance and the goals achieved. Setting profit as the sole goal puts the need for state property to the test.

Disclosure of information and accountability in state-owned enterprises aims not only to reduce information asymmetry, but also to determine the range of participants in corporate governance and to determine the unique purpose of state ownership. In this sense, the application of agency theory to state-owned enterprises should not be done mechanically by the private sector. The existence of several goals for state-owned enterprises, the fulfillment of more than one role by the state and the lack of a market for corporate control test the applicability of agency theory to state-owned enterprises. Therefore, it is recommended to apply the agency theory to state-owned enterprises that are engaged in commercial activities for financial purposes.

In the presence of disclosed information about the set goals and the achieved results of a state-owned enterprise, it is a basis for applying the stewardship theory. The interests of the principal and the agent coincide in the use of the company's resources. In such cases, there is no need to exercise control and managers are given more power.

Stakeholder theory focuses on the interests of the external environment. While for the private sector there are a limited number of cases for the public orientation of the company, it is widely used in state-owned enterprises. The real reflection of the stakeholder theory is the constitution of more than one principal – the state and society. It is recommended to apply the stakeholder theory in enterprises, where the stakeholders and the degree of satisfaction of their needs through state ownership can be unambiguously and convincingly identified.

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