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## **GDAŃSK INSTITUTE FOR MARKET ECONOMICS**

63, Do Studzienki Street, 80-227 Gdańsk  
tel. (0048) 58 341-15-35, 58 341-39-77  
fax. (0048)58 341-06-20

### **Corporate Governance for Poland's Growth**

J.Szomburg  
P.Tamowicz  
M.Dzierżanowski (\*)

#### Non technical summary

Efficient corporate governance is usually understood as a system providing balance between interests of different parties (managers, shareholders, debt providers, employees etc.) involved in a corporation. The fair price obtained for provided "inputs" is a precondition for a stable, long-term development of a company. Efficient corporate governance system should therefore allow companies access the outside financing and provide investors with the ability to monitor managers and minimise the risk of exploiting a company.

The comparative studies of different governance systems have led to separation of two models of corporate governance having strong implications on economy characteristics like ability for strategic restructuring, innovation and new economy development.

In an outsider system - mostly associated with the United States and the Great Britain - the ownership and control are dispersed. A control mechanism is provided by capital markets (combined investors` activism and take-over threat) composed of a large number of institutional investors (investment and pension funds, life assurance, etc.). The operational control of companies is associated with relatively independent managers. The outsider system is characterised by a greater capital mobility combined with permanent verification of directions of its allocation and higher ability for companies' restructuring. This is due to the high transparency of public companies on a capital market and liquidity of the market.

In an insider system - dominating in most of the countries - the ownership and control are highly concentrated in hands of one shareholder (mainly another firm, an individual or a family), who is independently able to control managers. The capital market as a control mechanism (especially hostile take-overs) is insignificant. In the insider model the economic relations are rather not very transparent and the decisions on allocation of resources are taking more individually - by blockholder.

Polish corporate governance system was affected - within last decade - by many, separate measures aiming at solving specific economic and social issues. For example preferences for employees in privatisation process was the price paid for its social acceptance rather than a way to establish instruments (employee ownership) for controlling managers or dominant owners. The process of bad debts restructuring (debt workouts) has not effected in increased bank involvement in corporate monitoring. Moreover stock market was launched mostly as privatization vehicle and not a tool in solving some governance puzzle (currently it is very weak in providing control functions, illiquid and quite narrow).

The important question is whether Polish corporate governance system allows and stimulates companies' growth. Unfortunately our knowledge of the system as a whole is not very deep. Paradoxically, we know how its separate elements work themselves but to our surprise do not know how the whole system works. The Institute's expertise based on some empirical work and both theoretical and empirical literature (also on CEE countries) allows us to formulate a preliminary diagnosis.

**Hypothesis 1** - Ownership structures of Polish corporations show characteristics of insider model of corporate governance

The Institute's research revealed that ownership and control (measured by voting power) of Polish corporations are rather concentrated. Additionally, it could be noted that generally the separation between ownership and voting control is not significant, however in many cases, especially in small caps, we could observe using dual class shares.

For public companies (210 being reviewed) the median for the first largest shareowner was 39,5% of votes. If stakes of company's founders are combined into one block then the median goes up to 45% of votes. For comparison the median for the first shareholder is: 43% in Netherlands, 50% in Belgium, 51% in Italy, 52% in Austria and 9,9% in Great Britain and 0% (below first notification threshold) in United States [Becht, Mayer 2000].

For non-public companies being reviewed (as for the year-end 2000) median for the stake of a first shareholder was 70%, however it should be treated as a peculiarity of that group of companies.

The question put forward by Becht and Mayer (2000) in respect to continental European public companies whether they are really public or rather private [Becht, Mayer 2000] may be repeated in Poland.

**Hypothesis 2** - Managerial opportunism is currently not the biggest problem of Polish corporate governance

High concentration of ownership and control in many companies reduces the agency problem and the risk of unaccountable managers engaging in ineffective activities against the interest of shareholders.

In many cases the ownership consolidation that took place on the market could be treated as a corrective action. Privatisation often increased power of company's old management thanks to the dispersion of ownership (public offers

and employees' preferences for acquiring shares). There are a lot of examples of big companies, which strategies and activities in mid 90`s reflect opportunistic behaviours of managers (increasing a company's scale and scope without economical reasons).

**Hypothesis 3** - The main problem for Polish corporate governance system is currently behaviour of dominant shareholders

While the concentration of ownership and control reduces the agency problem, it may also result in expropriation of minorities by dominant owner (self-dealing, transfer pricing, extracting private benefits etc.). Unfortunately that is a noticeable problem in Poland with many examples of value transfer, paying significantly lower prices for minorities' shares than for controlling stake, taking-over companies without calling a bid, preventing minorities involvement (board representation, electing auditor for special cases, etc) or votes execution. In spite of resent amendments the legal framework needs a very detailed review to eliminate the loopholes and inconsistency and addressing some issues (information transparency) in a new way. Precedent lawsuits against the dominant owners and increased activism of institutional investors (especially pension funds - new players on the market) should improve situation, however improving law enforcement and ineffective juridical system (making defending the rights time consuming and costly) will persist as a big challenge.

**Hypothesis 4** - The biggest challenge for Polish corporate governance system is improving the liquidity and shifting into more open system

The consolidation of ownership and control has also a negative effect on liquidity of the market and its attractiveness to institutional investors - the most important (and promising) group for Polish capital market in our view. Illiquid market does not provide fair value to corporate assets, does not allow to spread risk. Takeover threat to managers is illusive.

Illiquidity of stock market was also caused by the way the market was born and blockholder oriented privatization strategy employed by state treasury. There is a real threat that stock market - launched as privatization vehicle - will decline when privatization is over.

Improving liquidity is likely most difficult, long term task and politically risky process. It will require the re-considering of the whole model of capital market. It seems to be clear that we need both blockholders, and more liquid stock market which protects the best minorities rights by allowing them to exit. In that respect we should probably reject the philosophy of combining ownership with voting power, while introducing measures allowing to correct the control balance if minorities interests are being abused. If the ownership is to be more dispersed, we will probably also need to liberalise the market for corporate control to allow hostile take-overs as a control mechanism. Than we should also decide whether not to shift the threshold for calling a mandatory bid for the rest of the shares from crossing 50% of voting rights to crossing 33%.

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The authors work at the Gdańsk Institute for Market Economics, private research institute set up in 1989.*