The Role of Corporate Governance in Transition Countries

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***Abstract* - Corporate governance has come to the forefront of academic research due to the vital role it plays in the overall health of economic systems. The wave of U.S. corporate fraud in the 1990s was attributed to deficiencies in corporate governance. The recent 2008-2009 global financial crisis, triggered by the unprecedented failure of Lehman Brothers and the subprime mortgage problems, renewed interest in the role corporate governance plays in the financial sector. The development of a strong corporate governance framework is important to protect stakeholders, maintain investor confidence in the transition countries and attract foreign direct investment. This paper looks at the role of corporate governance in European transition countries in their transformation to a market economy. The paper compares the different levels of corporate governance established among the transition countries. Using synthetic taxonomic measures a study is conducted to look at the degree of corporate governance development by the new EU 2004 and 2007 accession transition countries and the convergence of corporate governance regimes across the countries. Our results indicate that transition countries that are closer to the English legal origin made greater strides in capital market and corporate governance development.**

Keywords *– corporate governance, transition countries, emerging economies, legal heritage and transitional reforms, market transition*

1. Introduction

Corporate governance generally refers to the set of rule-based processes of laws, policies, and accountability that governs the relationship between the investor (stockholder of a company) and the investee (management). Corporate governance attracted a great deal of attention in the aftermath of the Asian financial crisis of 1997-1998 and the early 2000s U.S. corporate scandals, like Enron and World Com. However, once the threat of global contagion financial crises passes, corporate governance was relegated to the back of academic research. The current global financial crises of 2008-2009 caused by the "excesses of capitalism" once again brought attention to the importance of effective corporate governance practices. With ever more closely integrated globalized financial markets, the newly emerging European transition economies particularly have been hit hard by the adverse impact of the current global financial crisis. Both the European Bank for Reconstruction and Development (EBRD)and the OECD promote the development of sound corporate governance for transitioning economies and developing economies through their initiatives, the *Corporate Governance Sector Assessment Project* (CGSAP begun in 2002) and *Principles of Corporate Governance* (1999, 2004, 2009), respectively.

A strong corporate governance foundation is important for a growing market economy. It has to include the integrity and transparency of financial and corporate operations, checks and balances in compliance with applicable laws, the practices of sound financial and corporate operations and accounting practices that are in accordance with international standards. In the legal sector, laws that are enacted must be timely and consistently enforced. The laws must be clear and consistent: in areas of orderly entry and exit of firms, property and asset protection of investors and transparency of the legal system. Establishing effective corporate governance is of particular importance for transition countries because its success is crucial not only for the growth of a healthy corporate sector but also for sustaining a healthy market economy. Bekaert et al (2001) find that the liberalization of financial markets in transition countries increases economic growth by about 2 percentage points per year. Some countries like Romania, Ukraine, and Georgia have very low effective corporate governance with high incidences of corruption and fraud in the political and economic systems. Other countries like Poland, Hungary and Latvia have established relatively effective corporate governance with greater achievements made toward market-based economies.

The problems facing transition countries are different from those facing other emerging countries by their nature of transforming from a centrally planned economy to an open market economy. For transition countries with no initial capitalistic framework in place, institutional frameworks in all sectors, both private and public, which support a capitalistic business environment, have to be created simultaneously: securities laws, corporate laws, accounting standards, sound business practices and ethics, and a judiciary and regulatory system. The importance of corporate governance for transition countries revolves on transitioning to private ownership and control. The parallel creation and quality of a system of corporate governance and institutions are therefore crucial for the development of a sound private market economy. A healthy business sector then promotes and sustains

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productivity and long-term economic growth. Although transition countries swiftly established political and economic market institutions in the early 1990s in the first phase of transformation, the transition from a relationship-based to a rule-based political and economic system is more difficult and slower. In particular, "crony capitalism" tends to be more prevalent in transition and emerging economies with the politically well-connected parties able to influence business practices and legislations in their favor.

The focus of this paper is the challenge that transition countries face moving from a politically-based relationship to one of a rule-based relationship and the role of corporate governance as a major factor in the unprecedented transformation of transition countries to a market economy. The question of interest is to what extent corporate governance has, or the lack thereof, contributed to the transformation and development transitioning to a market economy. The question of corporate governance therefore extends well beyond the corporate sector to impact national economic development as well for the transition countries.

2. Literature Review

The Asian crisis brought the issue of corporate governance to the forefront of research. Most of the studies on the developing and emerging countries focus on the agency problem and weak, dispersed investors. Later studies focus on corporate governance in developed economies especially after the U.S. corporate fraud scandals. The topics range from internal and external governance, the role of the Board of Directors, incentives and compensations, ethics and transparency. Most are based on the Anglo-American (common law) models (Chew and Gillan, 2005). This model of widely dispersed shareholders where no single shareholder owns a majority stake is the basis of most corporate governance studies. Most authors argue that the protection of investors' interests can be effectively enforced through a strong corporate governance system (Shleifer and Vishny, 1997; Glaeser et al, 2001; Hanousek and Kocenda ,2003).

The Anglo-American corporate governance system differentiates the shareholders from the stakeholders with a well-developed external equity market system to monitor the manager. The additional protection and voice afforded a dispersed shareholders group in the Anglo-American model is the liquidity of the market to allow exit strategy in the event of weakening internal corporate governance. The well developed financial market in developed economies with rating agencies, market scrutiny and access to timely information is another layer of protection for the dispersed shareholders. Another body of studies tests the adoption of common laws (Anglo-American) versus civil laws (German-French) in the protection of investors (Coffee 1999, Pistor, 2000; Mahoney, 2001). Mahoney (2001) finds that nations that adopted the common laws (English) rather than the civil laws (French) system of corporate governance provided better protection for investors and have better developed financial markets. Mahoney concludes that, during the period under study from 1960-1992, common law countries experienced faster economic growth than civil law countries because common law is more supportive of private economic enterprises and property protection while civil law is more oriented toward government intervention and restrictions.

Corporate governance studies naturally move to focus on the transition countries in their unprecedented mass privatization of state-owned enterprises (SOEs) and the structure wherein they operate to transform successfully to a market economy. Studies on corporate governance structures in transition countries debated various issues: the type of ownerships (concentrated versus dispersed), the mode of privatization, adequacy of shareholder protection and whether legal structures must precede privatization. Ownership structures in transition countries are still evolving. Widely held firms are not the norm due to the small and relatively illiquid underdeveloped capital markets. Corporate governance studies performed on developed countries therefore may not be applicable to transition countries with such different initial conditions. The corporate governance problems in transition countries are likely to be different from developed countries. Studies on corporate governance in transition countries may therefore have to take this into account.

A body of studies looks at whether a transition country's past legal heritage (German, French) influences the adoption of the current legal structure and corporate governance or whether the Anglo-American system is more prevalent (Pistor, 2000; Martynova and Renneboog (2009). In Romania and Poland, the mass privatization and dispersed ownerships to employee owners and institutional intermediaries help to promote the development of the capital and securities markets (Gray and Hanson, 1993). Their main argument is that the German-Japanese model of active shareholding monitoring through intermediaries (banks, outsider, employee-owners) can develop closer ties to firm managers, better access to information, and deeper business knowledge than the Anglo-American model of dispersed shareholders. The German-Japanese model of more concentrated ownership with corporate governance assigned to intermediaries may therefore be more appropriate for transition countries. This argument is supported by other studies. Shleifer and Vishny (1997) and Rajan and Zingalies (1998) maintain that concentrated corporate ownership structures are a response to the agency problem and poor ownership protection for investors. Studies by La Porta et al (1997, 1999, and 1999) also support this hypothesis and that the degree of ownership rights and protection affects corporate behavior and, consequently, economic development. On the other hand, Miwa and Ramseyer (2000) argue against concentrated shareholders and creditor banks but rather dispersed shareholders are more effective in controlling managers in transition

countries where the legal environment is ineffectual, a situation similar to late nineteenth-century Japan. This body of literature looks at the differing degree of legal protection with different corporate governance structures depending on whether concentrated or dispersed ownership is present.

Privatization of state-owned enterprises goes beyond just transferring the assets to private ownership in transition countries. Privatization has to be evaluated in terms of three areas: the creation of a system of corporate governance to foster a healthy environment for businesses to flourish, the advancement in legal and enforcement infrastructure, and self-sustaining economic growth. There are a number of studies on the positive and negative effects of privatization in transition countries (Table1).

Table 1 - Studies on Privatization Effects on Corporate Governance in Transition Countries

Study	Country of Study	Positive Findings
Estrin et al (2009)	CEEB	For CEEB countries, mostly positive effects but quantitatively smaller for foreign owners; For CIS countries, positive or insignificant effects for foreign owners but negative or insignificant effect.
Frydman, Hessel and Rapaczynski (1999)	Czech Rep., Hungary and Poland	Privatization to outsider owners rather than corporate insiders has greater performance effects because of greater entrepreneurial skills.
Coffee (1999)	Poland and Czech Rep.	Slower privatization and state-created monitors through investment funds (Polish National Investment Funds - NIFs) subscribed to by individuals and common law system outperforms the rapid privatization and inadequate legal structure.
Study	**Country of Study**	**Negative Findings**
Hanousek and Kocenda (2003)	Czech Rep.	Disperse ownership and lack of regulations created a weak management environment; Improvement in corporate governance after 1995 improved firm profitability
Black et al (1999)	Russia	Asset stripping by insider mangers, massive theft by kleptocrats, self-dealings, no restructuring, corruption. Effective institutional structure matters more and must precede privatization.

Privatization of state-owned enterprises is seen to be the vehicle by which transition countries are transformed to a market economy and takes different forms. The expectation is that private ownership would spur profit-oriented managers toward market restructuring leading to economic growth under the presumption of the principal-agent model. In most transition countries this expectation has been unfulfilled due to the lack of effective corporate governance and a major obstacle to a friendly business environment (Meyer, 2003). In transition countries, the problem of corporate governance progress is exacerbated by the vested interest of the powerful and highly concentrated owners with ties to the political structure. This cronyism relationship breeds corruption that plagues the early transformation efforts of most of the transition countries. This is particularly prevalent in transition countries like China, Russia, and Bulgaria. In China when the state-owned enterprises were "corporatized" with majority government ownership still[1], moral hazard incentives, *kwangsi* (relationships), and agency problems outweighed emerging corporate governance practices. Lin (2001) finds that managers, while gaining greater autonomy from the "corporatization" of Chinese state-owned enterprises, manage the company badly and misuse it for self- dealings and embezzlements.

Privatization of former state-owned assets to private ownership does not guarantee that the agent will act in the best interest of the principle in transition countries with no existing institutional foundation to support private ownership. Questions of the role and rights of various stakeholders (manager-employee owners, government, outsiders, managers, investors, employees) of the privatized firms with differing interests have to be determined within a legal and regulatory structure.

The Russian experience questions whether mass privatization is the answer in transforming from central-planning to a market economy. Russia's mass privatization to concentrated manager ownership was the antithesis of privatization success: insider self-dealings, corruption, incompetent management, asset stripping and the destruction of minority shareholders' value. Rapid mass privatization without the preceding legal and enforcement infrastructure to prevent insider self-dealings and corruption impedes effective corporate governance and the development of an honest business climate (Black et al, 1999).

Glaeser et al (2001) finds that prior to 1990s reforms the Czech securities market was much larger

[1] The four state-owned Chinese banks were privatized through IPO offerings in mid-2000s raising unprecedented capital funds globally with majority stakes still held by the government.

than the Polish market. The creation of an independent, strong securities commission by Poland to enforce corporate governance promoted rapid capital market development and a growing business sector. Today the Polish stock market, the largest of all the transition countries by market capitalization, has two tiers of trading: the organized market and the over-the-counter market (launched in December 2008), In contrast, the Czech Republic experience of employing a small ineffective securities commission office in the Ministry of Finance and extensive corruption led to corporate asset stripping and expropriation of wealth from minority shareholders by controlling shareholders and the politically connected government officials, undermining investor confidence and financial market development (Hanousek and Kocenda (2003).

Another study shows that Poland and Hungary's effective centralized regulatory enforcement of securities laws through a strong securities commission is more effective than judicial enforcement in the protection of the principle's rights (Oman et al, 2003). This body of literature questions the benefit of mass privatization before effective legal and corporate governance structures are in place, and should precede privatization. The good news for transition countries is a study by Durnev and Kim (2005). They find that despite a weak institutional environment firms with good future investment prospects would involuntarily practice good corporate governance attracting more shareholders and increasing firm value. They find that a firm's market value increased by 9% if the firm's governance score increased by 10 points out of the maximum 100 points.

2. Corporate Governance in Transition Countries

The difference in the corporate governance problem in transition countries is one of controlling versus minority shareholders problem. The early privatization of the state-owned enterprises (SOEs) resulted in mostly concentrated ownership by dominant or block-shareholders, (institutional investors - Hungary, management buyout (MBOs) or management-employee buyouts (MEBOs) - Poland, employee-owners – Czech), giving these controlling shareholders considerable greater control over corporate assets than their stock ownership warranted. Of even greater concern than the concentrated ownership is the prevalence of complex ownership structures through cross-shareholdings, multiple-class shareholdings with different voting rights, pyramidal corporate shareholdings. A landmark study by Bebchuk et al (1999) shows that "expropriation costs" are very large when such complex shareholdings are used to increase control rights beyond their cash-flow rights, even larger than concentrated ownerships.

The role of corporate governance to under girth weak competitive market mechanisms and democratic political institutions is the complementing factor necessary to sustain the long-term modernization of the transition countries. In other words, the "principal-agent" relationship that governs most capitalist societies that provides the incentives and environment in which investors (principals) can reap the profits of their investment through their corporations (agents) and the behavioral relationship are determined by a set of corporate governance standards. EBRD's *Legal Indicator Surveys* reports that transition countries have an implementation gap between the enactment of laws and its enforcement.

Unlike developed countries in the United States and United Kingdom with widely dispersed shareholders, the principal-agent corporate governance problems are primarily due to the agent (manager) perpetrating embezzlement and fraud. The corporate governance regime of the English legal origins (US-UK) emphasizes the protection of shareholders from being expropriated by the firm's management. In contrast, the European legal origin countries (French-German) emphasize the protection of stakeholders (state, blockholders, employees) from expropriation.

A relationship-based system and investor expropriation tends to prevail in emerging economies. In Russia, Bulgaria and elsewhere mass privatization enriched the oligarchs and the politically well connected. The "cronyism" and relationship-based structure carried over from the communist era with most of the post-communist corporate owners part of the politically connected or political elite is difficult to root out. The lack of effective corporate governance, in particular, Russia, engenders a hostile business environment: corruption, organized crime, a bias judicial system and government interference.

In the post-socialist European countries, the set of corporate governance standards adopted varies which may depend on past legal heritage. The group of Central and Eastern Europe and Baltic (CEEB) nations has a German legal heritage which includes the Czech Republic, Estonia, Croatia, Latvia, Lithuania, Poland, Hungary, the Slovak Republic and Slovenia. The group of South East European (SEE) nations has a French legal heritage which includes the Bulgaria, Yugoslavia, Romania, Bosnia and Albania. The last group consists of most of the Commonwealth of Independent States (CIS). Pistor (2000) finds that past legal heritage is not significant in explaining what predominant system of legal structure will be adopted by the transition countries. Rather, the adoption during the initial transformation period is driven more by the desire to converge with the EU legal system with an eye to attaining accession or the US system. Pistor also observes that differences in legal reforms among the transition countries are due primarily to policy makers responding to economic changes: greater privatization engenders better protection of creditor's and stockholder's rights or whether the dominant external advisors are from the US or EU. Mahoney (2001) similarly argues that a nation directly or indirectly

adopts a set of legal structure in response to change rather than solely because of its past legal heritage.

Poland and the Czech Republic are good examples of differences in privatization, corporate governance development and economic growth. An interesting study by Coffee (1999) compares the differences between Poland and the Czech Republic experience (Table 2). Both countries adopted corporate law system based on the German civil law heritage. The important difference is that despite the German heritage, Poland's securities regulations and practices follow the common law system of the Anglo-American more closely: greater private ownership protection, stringent disclosure standards and a strong enforcing securities commission agency. Coffee concludes (1) that better securities regulation to protect minority shareholders from expropriation is more effective than ineffective corporate laws, (2) that the Anglo-American common laws structure of corporate governance outperforms the German-French civil law structure despite their legal heritage. The result is the successful growth of equity financing for businesses in Poland with a growing healthy growing stock market. The Polish stock market is one of the largest among the transition countries with a market capitalization of U$175.85 billion in 2010; in contrast, the Czech Republic stock market capitalization is only U$68,831.

Table 2 shows that none of the EU2004 or 2007 countries achieved "Very High Compliance" in meeting the OECD Principles fully. Poland, Hungary and Latvia are rated "High Compliance" with Lithuania moving from "Medium Compliance" to "High Compliance" from 2002 to 2005. Countries with "High Compliance" have existing laws implemented that fulfill the majority of OECD Principles. Capital markets are well established, existing legislation have to be improved and enforced, and an enhancing of the judiciary system to adjudicate corporate governance issues competently and fairly. In "Medium Compliance" countries, most of the laws meet the OECD Principles but requiring consistent and effective implementation and enforcement and further reforms needed, and capital markets are established but small: the Czech Republic, Estonia, Slovakia, Slovenia, Bulgaria and Croatia. In the "Low Compliance" category, Romania, basic corporate laws are established but of questionable quality, capital markets are under-developed or non-existing, and legal institutional structures in the enforcement of the laws are needed (Chen, 2004).

A recent study by Martynova and Renneboog (2009) creates corporate governance indices to capture the major factors of corporate governance as reflected in the country's capital market laws. The study looks at whether 30 European countries and the US, including

Table 2. EBRD Corporate Governance and Market Indicators in Transition Countries

Country EU Accession	EBRD Corporate Governance Ranking 2002	EBRD Corporate Governance Ranking 2003	EBRD Corporate Governance Ranking 2005	Stock Market Capitalization 2008 (% of GDP)	Domestic Credit to Private Sector 2008 (% of GDP)	Projected Foreign Direct Investment 2008 (US$ mils)	Projected Real GDP Growth 2008 (%)
Czech Republic (2004)	C	C	C	25.5	51.0	5,500	4.6
Estonia (2004)	C	C	C	8.6	91.9	800	3.5
Hungary (2004)	B	B	B	12.1	67.6	1,000	1.7
Latvia (2004)	B	B	B	4.9	89.6	2,000	3.5
Lithuania (2004)	C	B	B	8.0	60.0*	1,300	6.5
Poland (2004)	B	B	B	21.0	55.0	15,000	5.1
Slovakia (2004)	C	C	C	5.4	44.7	2,000	7.0
Slovenia (2004)	C	C	C	22.5	85.6	592	4.3
Bulgaria (2007)	C	C	C	18.5	74.5	7,937	5.5
Romania (2007)	D	D	D	11.2	38.5	10,963	5.0
Croatia (likely)	C	C	C	40.4	67.1	4,806	4.5

Rating Legend**:** A - Very High Compliance ; B - High Compliance; C - Medium Compliance ; D - Low Compliance
Source: EBRD Transition Reports; Chen, 2004; Transition Report 2005-Annex 1.2.
* 2007

the new EU countries, over 15 years have converged in corporate governance regimes. In particular, the authors take into account the heritage of common laws or civil laws of the respective countries in constructing the indices. In particular, their indices are constructed by applying "…unique corporate governance database that comprises the main changes in corporate governance regulation in US and all European countries […] over the last 15 years. The database is based on the study of various corporate governance regulations, on the results from a detailed questionnaire sent to more than 150 legal experts, and on direct interviews with some of these experts (Martynova and Renneboog 2009, p. 9)." The study concludes that countries of German legal heritage and the EU 2004 accession countries give more decision rights to shareholders. In contrast, countries of English legal heritage and the EU2007 accession countries provide trustees and representatives (Board of Directors) of the stockholders with more control. Creditor protection is stronger among former communist countries and less in French, German and Scandinavian legal origin countries. Continental European countries are mostly characterized by stakeholder-based regime compared to the US-UK stockholder-based regime. Scandinavian and German legal origins, and the EU2004 accession countries, afforded the least protection for investors. Lastly, the authors find that countries of English legal origin provide the highest protection for shareholders.

The question is to what degree has corporate governance development progress among the new EU transition countries. Our paper is based on the Martynova and Renneboog (2009) study. Using the indices created by the Martynova and Renneboog (M-R) study, we investigate the degree of corporate governance development among the EU2004 and EU2007 accession countries. We seek to confirm if the results from our study indicate a convergence of corporate governance among the new EU countries and if legal heritage plays an important role in the adoption of corporate governance emphasis and whether one regime has comparative advantage over the other. This has implication as to which direction of corporate governance regimes the transition countries should continue to emphasize and adopt.

3. Methodology and Empirical Investigation

In our paper we construct the synthetic taxonomic measure (SMR) to evaluate eleven transition countries (EU2004 and EU2007 accession countries in Table 2) in terms of the degree of corporate governance development. The SMR measure defines the distance between the certain benchmark and the analyzed countries (i.e. objects) in a multidimensional space. The corporate governance regimes are characterized by four variables that represent the corporate governance indices constructed by the M-R study in the four areas: (i) anti-director index (LLSV), (ii) shareholder rights protection, (iii) minority shareholder rights protection and, (iv) creditor rights protection. The benchmark is defined as the hypothetical object that is characterized

- either by the maximal values of indices evaluated for the 11 transition countries under study,
- or by the averages of indices benchmark evaluated[2] for the countries that are classified by M-R according to their respective legal origin: English (Ireland, UK and USA (Delaware)), French (Belgium, France, Greece, Italy, Luxemburg, the Netherlands, Portugal and Spain), German (Austria, Germany and Switzerland) and Scandinavian (Denmark, Finland, Iceland, Norway and Sweden) legal origin.

Employing these indices we construct the synthetic measure that contains partial measures of corporate governance development to obtain the ranking of the eleven transition economies over four years[3]: 1990, 1995, 2000 and 2005.

The taxonomic measure SMR_{it} for the *i*-th country in *t*-th period of time (see Hellwig, 1968):

$$SMR_t^i = 1 - \frac{q_t^i}{\bar{q}_t + 2 \cdot S_{qt}} \quad i = 1, 2, \ldots, n; \; t = 1, 2, \ldots, T \tag{1}$$

Where q_{it} is the distance of the *i*-th object from the benchmark:

$$q_t^i = \sqrt{\sum_{j=1}^{k} (z_{jt}^i - z_{jt}^0)^2} \tag{2}$$

evaluated for standardized variables z_{jt}^0, z_{jt}^i that describe the benchmark and the *i*-th investigated country, respectively, for each period *t* and the *j*-th variable: $z_{jt}^i = \frac{x_{jt}^i - \bar{x}_{jt}}{S_{jt}^x}$ - standardized variables, x_{jt}^i, $\bar{x}_{jt}$, S_{jt}^x - observations of for the *i*-th country, average and standard deviation, respectively.

The benchmark is defined as:

$$z_{jt}^0 = \begin{cases} \underset{l=1,2,\ldots 4}{average}\left\{z_{jt}^l\right\} \text{ for } x_{jt}^l; l-\text{"type" of legal origin} \\ \underset{i=1,2,\ldots 11}{\max}\left\{z_{jt}^i\right\} \text{ for } x_{jt}^i \text{ describing transition countries} \end{cases} \tag{3}$$

[2] These averages were calculated by Martynova and Renneboog (2009) p. 31 – 34.

[3] We choose the corresponding years and the transition countries that were considered in the Martynova and Renneboog study.

Other symbols denote: $\overline{q}_t$, S_{qt} - the average and the standard deviation of distances q_{it} , respectively:

$$\overline{q}_t = \frac{1}{n}\sum_{i=1}^{n} q_t^i \tag{4}$$

$$S_{qt} = \sqrt{\frac{1}{n}\sum_{i=1}^{n}(q_t^i - \overline{q}_t)^2} \tag{5}$$

As mentioned, the synthetic measures SMR^i for each transitional country are constructed employing k = 4 variables using the M-R corporate governance indicators: (i) anti-director index LLSV, (ii) shareholder rights protection, (iii) minority shareholder rights protection and (iv) creditor rights protection in Eq.(2) for five different benchmarks in Eq.(3).

Using as the benchmark maximal value of each of the four variables in Eq. (3),

$$z_{jt}^0 = \max_{i=1,2,...11}\left\{z_{jt}^i\right\} for\ x_{jt}^i\ describing\ the\ transition\ countries$$

the country ranking is constructed only for comparison within the group of transition countries. Employing the averages of the countries with the different types of corporate governance legal origins (English, French, German and Scandinavian) as the benchmarks, we compare each transition country to the corporate governance of countries with these legal origins, respectively.

The countries under study are grouped according to the specified four ranking classifications (Table 3):

Table 3. Classifications of SMR Country Rankings

$SMR^i \geq SMR + S_{SMR}$	Class I - Best
$SMR + S_{SMR} > SMR^i \geq SMR$	***Class II - Good***
$SMR > SMR^i \geq SMR - S_{SMR}$	Class III - Average
$SMR^i < SMR - S_{SMR}$	***Class IV - Bad***
where: SMR is the average of SMR^i , S_{SMR} is the standard deviation of SMR^i	

The country rankings results based on the SMR^i measures, evaluated for the different benchmarks, are presented in the tables below. A comparison of the SMR results to the EBRD country rankings for 2005, where data is available for the same year, is also performed (Table 2). However, all transition countries are classified only to the three classes of B (High Compliance), Medium Compliance (C), and D (Low Compliance).

Table 4. SMR^i Values and Country Rankings Comparison to EBRD Indicators (Benchmark: Maximal Values of 11 Countries)

Country	SMR^i 1990	Country	SMR^i 1995	Country	SMR^i 2000	Country	SMR^i 2005	EBRD 2005
Poland	**1**	**Lithuania**	**0.849579**	**Lithuania**	**0.802455**	**Croatia**	**0.857103**	C
Lithuania	**0.835432**	**Poland**	**0.842124**	**Croatia**	**0.754699**	***Czech***	***0.643115***	C
Latvia	***0.652312***	**Croatia**	**0.74272**	**Poland**	**0.647564**	***Lithuania***	***0.610393***	***B***
Croatia	***0.638329***	***Latvia***	***0.623543***	***Slovenia***	***0.492673***	***Latvia***	***0.486355***	***B***
Slovenia	***0.610588***	***Slovenia***	***0.520134***	Bulgaria	0.42807	***Poland***	***0.455114***	***B***
Slovak	0.489508	Slovak	0.491794	Romania	0.369786	Romania	0.434137	D
Romania	0.423409	Czech	0.466147	Czech	0.344482	Hungary	0.400301	***B***
Hungary	0.400041	Estonia	0.345724	Latvia	0.31596	Slovenia	0.392329	C
Bulgaria	0.271779	Romania	0.306983	Hungary	0.308682	Estonia	0.30624	C
Czech	0.212065	Bulgaria	0.180464	Estonia	0.194933	Bulgaria	0.251406	C
Estonia	0.104785	Hungary	0.061291	Slovak	0.081475	Slovak	-0.03024	C
SMR	0.512568	SMR	0.493682	SMR	0.43098	SMR	0.436932	
S_{SMR}	0.256284	S_{SMR}	0.246841	S_{SMR}	0.21549	S_{SMR}	0.218466	
$SMR - S_{SMR}$	0.256284	$SMR - S_{SMR}$	0.246841	$SMR - S_{SMR}$	0.21549	$SMR - S_{SMR}$	0.218466	
$SMR + S_{SMR}$	0.768852	$SMR + S_{SMR}$	0.740523	$SMR + S_{SMR}$	0.64647	$SMR + S_{SMR}$	0.655399	

Table 4 shows the SMR rankings for all the eleven countries taking the maximal values of the variables for the eleven transition countries as the benchmark. Poland is consistently classified in class I except in 2005 (class II). Based on the EBRD 2005 ranking, Poland is ranked as meeting high compliance of OECD principles in corporate governance.[4] This corroborates the literature indicating that Poland's corporate governance in legal reforms and practice is much further in development than most of the other new EU countries. Poland may represent the convergence of corporate governance regulations among the European transition countries. After achieving 2004 EU membership, Poland may have less incentive to improve on their corporate governance practices. Political inertia in reforms is a major factor in stalling reform efforts after post-accession. Lithuania and Croatia are also consistently classified in class I. Croatia is still an accession country and may be making greater efforts to implement a corporate governance regime that induces investor confidence and favorable EU scrutiny. The Slovak Republic (2000 and 2005) and Estonia (1990 and 2000) are consistently classified in the last class with a medium compliance rating by EBRD. The Czech Republic (1990), Hungary (1995), and Bulgaria (1995) are also classified in class IV.

Based on the assumption of English heritage origin of corporate governance, Poland is consistently classified in class I (1990, 1995 and 2000) (Table 5). Poland seems to be evolving closer to the English heritage in corporate governance regime. Although the EBRD ranking in 2005 is still ranked as high compliance the 2005 SMR ranking grouped Poland in class II, indicating a decrease in corporate governance practices. The furthest from the English legal origin of corporate governance by SMR ranking are the Czech Republic (in all years), Latvia (2000 and 2005), Hungary, Estonia, and Slovak Republic (in various years). Croatia seems to be consistently ranked in class II in all years except 2005 and ranked by 2005 EBRD as medium compliance.

Table 5. SMR^i Values and Country Rankings Comparison to EBRD Indicators (Benchmark: English Legal Origin)

Country	SMR^i 1990	Country	SMR^i 1995	Country	SMR^i 2000	Country	SMR^i 2005	EBRD 2005
Poland	0.918058	Poland	0.763707	Poland	0.78206	Bulgaria	0.900395	C
Lithuania	0.748956	Slovenia	0.739397	Bulgaria	0.760754	Lithuania	0.81125	*B*
Latvia	*0.616791*	*Lithuania*	*0.627971*	*Croatia*	*0.603225*	*Romania*	*0.729487*	D
Croatia	*0.557151*	*Estonia*	*0.573946*	*Romania*	*0.583021*	*Estonia*	*0.719269*	C
Slovenia	*0.52724*	*Croatia*	*0.511059*	*Lithuania*	*0.577751*	*Slovenia*	*0.675227*	C
Romania	0.409534	*Slovak*	*0.49512*	*Slovenia*	*0.52486*	*Hungary*	*0.548224*	*B*
Slovak	0.356412	Romania	0.365029	*Estonia*	*0.524576*	Croatia	0.481943	C
Bulgaria	0.330519	Latvia	0.361139	Hungary	0.351828	Poland	0.422198	*B*
Hungary	0.279237	Bulgaria	0.274213	Slovak	0.168429	Slovak	0.362373	C
Estonia	0.174498	Czech	0.207345	Czech	0.141036	Latvia	0.151583	*B*
Czech	0.13651	Hungary	-0.00679	Latvia	0.084246	Czech	0.010951	C
$\overline{SMR}$	0.459537	$\overline{SMR}$	0.446558	$\overline{SMR}$	0.463799	$\overline{SMR}$	0.528445	
S_{SMR}	0.229768	S_{SMR}	0.223279	S_{SMR}	0.231899	S_{SMR}	0.264223	
$\overline{SMR} - S_{SMR}$	0.229768	$\overline{SMR} - S_{SMR}$	0.223279	$\overline{SMR} - S_{SMR}$	0.231899	$\overline{SMR} - S_{SMR}$	0.264223	
$\overline{SMR} + S_{SMR}$	0.689305	$\overline{SMR} + S_{SMR}$	0.669837	$\overline{SMR} + S_{SMR}$	0.695698	$\overline{SMR} + S_{SMR}$	0.792668	

Table 6 presents the assumption under French legal origin. Croatia, Bulgaria and Estonia are consistently classified in class I under this assumption. Poland, in the early phase of reforms, is ranked in class I in 1990 but moved further away in 1995 (grouped in class IV). Similarly, Croatia moves from class I (1990 and 1995) to class II (2000) to class III (2005) under the French legal origin. This is consistent with the above analysis that Croatia is moving closer to the English legal origin and away from the French origin over the years under study.

[4] None of the transition countries were ranked by EBRD as having met the criterion of "Very High Compliance".

Under the assumption of German legal origin, Poland is ranked in class I in 1990, in class IV in 1995, in class III in 2000, and in class II in 2005 (Table 7). Poland had very close German ties, culturally and historically. Poland seems to be less consistent in corporate governance regime under the German legal origin unlike under the English legal origin assumption. The Czech Republic, Bulgaria, and Latvia tend to be ranked in the last class, furthest from the German legal origin. In particular, the 2005 SMR rankings indicate that Latvia, Croatia, and the Czech Republic are moving away from the German legal origin while Poland (class II) is moving closer. It is worth noting that Romania, ranked by the 2005 EBRD as low compliance, is ranked in class I under the German legal origin assumption.

The assumption of the Scandinavian legal origin indicates that Estonia, Croatia, and Bulgaria, (with the

Table 6. SMR^i Values and Country Rankings Comparison to EBRD Indicators (Benchmark: French Legal Origin)

Country	SMR^i 1990	Country	SMR^i 1995	Country	SMR^i 2000	Country	SMR^i 2005	EBRD 2005
Poland	0.933239	Croatia	0.720599	Bulgaria	0.955499	Bulgaria	0.950134	C
Croatia	0.812832	Estonia	0.697538	*Romania*	*0.806468*	Estonia	0.917265	C
Lithuania	*0.662734*	*Latvia*	*0.62765*	*Poland*	*0.793812*	*Romania*	*0.887066*	D
Latvia	*0.620844*	*Slovak*	*0.535809*	*Croatia*	*0.773079*	*Lithuania*	*0.798724*	*B*
Slovenia	*0.547685*	*Romania*	*0.528948*	*Estonia*	*0.675098*	*Hungary*	*0.694573*	*B*
Slovak	*0.54173*	*Czech*	*0.473446*	Hungary	0.496203	Poland	0.491809	*B*
Romania	*0.512885*	Lithuania	0.427126	Czech	0.465364	Slovak	0.456048	C
Bulgaria	0.327424	Bulgaria	0.413182	Lithuania	0.376983	Latvia	0.445202	*B*
Hungary	0.272488	Slovenia	0.367146	Slovak	0.364012	Croatia	0.370359	C
Estonia	0.14995	Poland	0.033136	Latvia	0.35644	Slovenia	0.337462	C
Czech	0.111506	Hungary	0.032577	Slovenia	-0.0464	Czech	-0.02028	C
SMR	*0.499392*	SMR	*0.44156*	SMR	*0.54696*	SMR	*0.575305*	
S_{SMR}	0.249696	S_{SMR}	0.22078	S_{SMR}	0.27348	S_{SMR}	0.287653	
$SMR - S_{SMR}$	0.249696	$SMR - S_{SMR}$	0.22078	$SMR - S_{SMR}$	0.27348	$SMR - S_{SMR}$	0.287653	
$SMR + S_{SMR}$	0.749089	$SMR + S_{SMR}$	0.66234	$SMR + S_{SMR}$	0.82044	$SMR + S_{SMR}$	0.862958	

Table 7. SMR^i Values and Country Rankings Comparison to EBRD Indicators (Benchmark: German Legal Origin)

Country	SMR^i 1990	Country	SMR^i 1995	Country	SMR^i 2000	Country	SMR^i 2005	EBRD 2005
Poland	**0.876171**	**Croatia**	**0.750556**	**Poland**	**0.89398**	**Romania**	**0.802215**	D
Croatia	**0.804995**	**Czech**	**0.709007**	**Bulgaria**	**0.858094**	**Hungary**	**0.801308**	*B*
Lithuania	*0.716983*	**Slovak**	**0.696155**	**Croatia**	**0.791055**	**Bulgaria**	**0.78566**	C
Slovak	*0.60327*	*Latvia*	*0.5483*	*Romania*	*0.62936*	*Estonia*	*0.72264*	C
Slovenia	*0.598221*	*Slovenia*	*0.522737*	*Hungary*	*0.513456*	*Poland*	*0.636037*	*B*
Latvia	0.445008	Romania	0.431526	Slovenia	0.496099	*Slovak*	*0.588902*	C
Romania	0.418069	Estonia	0.406909	Lithuania	0.366384	Lithuania	0.468566	*B*
Hungary	0.37304	Lithuania	0.374945	Czech	0.356701	Slovenia	0.398672	C
Czech	0.236708	Bulgaria	0.214557	Slovak	0.341297	Latvia	0.250166	*B*
Bulgaria	0.198421	Hungary	0.122887	Estonia	0.32578	Czech	0.146915	C
Estonia	0.091184	Poland	0.083275	Latvia	0.0183	Croatia	0.060792	C
SMR	*0.487461*	SMR	*0.441896*	SMR	*0.508228*	SMR	*0.514716*	
S_{SMR}	0.24373	S_{SMR}	0.220948	S_{SMR}	S_{SMR}	S_{SMR}	0.257358	
$SMR - S_{SMR}$	0.24373	$SMR - S_{SMR}$	0.220948	$SMR - S_{SMR}$	0.254114	$SMR - S_{SMR}$	0.257358	
$SMR + S_{SMR}$	**0.731191**	$SMR + S_{SMR}$	**0.662844**	$SMR + S_{SMR}$	**0.762342**	$SMR + S_{SMR}$	**0.772074**	

exception of Poland in1990) in the early years, are closest in corporate governance regime, ranked in class I (Table 8). In contrast, Croatia moved from class I to class IV in 2005 which is consistent with the previous analysis that Croatia is moving closer over time to the English legal origin. Romania is ranked in class II reflecting the least corporate governance afforded investors in 2005 which is consistent with the 2005 EBRD ranking of low compliance.

Table 8. SMR^i Values and Country Rankings Comparison to EBRD Indicators (Benchmark: Scandinavian Legal Origin)

Country	SMR^i 1990	Country	SMR^i 1995	Country	SMR^i 2000	Country	SMR^i 2005	EBRD 2005
Poland	0.913378	Estonia	0.706666	Bulgaria	0.99121	Estonia	0.920104	C
Croatia	0.860684	Croatia	0.704835	*Romania*	*0.798075*	Bulgaria	0.908508	C
Lithuania	*0.640857*	*Latvia*	*0.580987*	*Estonia*	*0.720176*	*Romania*	*0.858102*	D
Latvia	*0.562903*	*Slovak*	*0.528994*	*Poland*	*0.717598*	*Hungary*	*0.760926*	*B*
Slovak	*0.548015*	*Romania*	*0.500772*	*Croatia*	*0.667701*	*Slovak*	*0.717413*	C
Slovenia	*0.52975*	*Czech*	*0.470374*	Hungary	0.516058	*Lithuania*	*0.598138*	*B*
Romania	*0.499958*	*Slovenia*	*0.451747*	Slovak	0.489502	Poland	0.561142	*B*
Bulgaria	0.315405	Lithuania	0.429782	Czech	0.487926	Latvia	0.532547	*B*
Hungary	0.26523	Bulgaria	0.405074	Latvia	0.366541	Slovenia	0.272477	C
Estonia	0.162682	Hungary	0.053021	Lithuania	0.257995	Croatia	0.141482	C
Czech	0.127487	Poland	-0.01103	Slovenia	-0.0459	Czech	0.061239	C
SMR	*0.493305*	SMR	*0.438293*	SMR	*0.542443*	SMR	*0.575643*	
standard	0.246652	standard	0.219146	standard	0.271222	standard	0.287822	
$SMR - S_{SMR}$	0.246652	$SMR - S_{SMR}$	0.219146	$SMR - S_{SMR}$	0.271222	$SMR - S_{SMR}$	0.287822	
$SMR + S_{SMR}$	0.739957	$SMR + S_{SMR}$	0.657439	$SMR + S_{SMR}$	0.813665	$SMR + S_{SMR}$	0.863465	

However, Bulgaria and Romania are relatively late accession countries and their desire to accede to the EU membership may spur these countries to improve their corporate governance in practice to a greater degree in later years than post accession countries like Poland or the Czech Republic with fewer incentives after achieving EU membership. Therefore, Bulgaria and Romania's compliance with OECD corporate governance principles is not ranked highly by EBRD having a later start in initiating reforms than the other countries.

Comparing the SMR and EBRD rankings in 2005, the biggest similarity is seen for Tables 4 and 6. Continental Europe may be closer in convergence in corporate governance regime to the French legal origin, although it is observed by Martynova and Renneboog that "the French legal origin countries have evolved and reach a level closer to the English origin standard" (p. 20). The difference between the SMR and EBRD rankings among some of the transition countries may be due to the issue of improvement in stockholder rights and protection on the books and the actual legal enforcement of those rights. The consistent and timely enforcement of an investor's legal rights are either subverted by cronyism as in Bulgaria, or the onerous process of getting legal redress even in countries that are in the forefront of corporate governance, like Poland.

4. Conclusion

Transition countries that are more advanced in capital market development seem to be converging towards the English legal origin regime of corporate governance, in particular, Poland. The later EU2007 accession countries like Bulgaria, Romania and accession country Croatia also seem to be moving toward the English legal regime over time as well. The later EU2007 accession countries seem to learn from the experience of the earlier accession countries and lean towards the English legal origin regime. Some of the transition countries have also regressed over time as measured by the SMR rankings, in particular, Poland from the English legal regime. Other countries are the Czech Republic and Latvia. Estonia seems to be moving towards the Scandinavian and German regime of less protection for investors. Given that continental transition countries are mostly characterized by stakeholder-based regime, the paper shows that the later trend in most of the countries is towards a stockholder-based US-UK regime.

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