Corporate governance in transitional economies: Business groups in Croatia[1*]

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Croatia has a transitional economy that contains conditions for the evolution of business groups. Business groups are legally independent firms that typically are joined by equity ownership, and co-ordinating their use of resources, such as capital and managerial labour. They have evolved and exist in most European and Asian countries. The aim of the paper is to explain the corporate governance aspect of the privatised firms in Croatia, with special reference to the evolution of business groups. We argue that these groups function as a mean for the governance of the firms, solving the problems of capital and managers, handling the relationships with the state, and representing a socially legitimate organisation, thus producing institutional stability in a transitional economy. The theory is applied on archival data, and two case studies.

Kroatien ist eine Transformationswirtschaft, die prinzipiell Bedingungen für die Entwicklung von Holdings aufweist. Holdings sind rechtlich unabhängige Firmen, die typischerweise gemeinsames Eigentum aufweisen und sich zur Koordinierung ihrer Ressourcen, wie Kapital und Managementarbeit, zusammenschließen. Diese haben sich in den meisten Ländern Europas und Asiens entwickelt. Das Ziel dieses Aufsatzes ist, den Aspekt der Unternehmensführung von privatisierten Firmen in Kroatien zu erklären, mit besonderem Augenmerk auf die Entwicklung von Holdings. Wir legen dar, dass diese Firmengruppen als ein Mittel zur Steuerung der Firmen fungieren, um Kapital- und Managementproblemen zu begegnen, dieBeziehungen zum Staat zu regulieren sowie eine sozial legitimierte Organisation zu repräsentieren und folglich, institutionelle Stabilität in einer Übergangswirtschaft zu produzieren. Die Theorie basiert auf Archivmaterial und zwei Fallstudien.

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Introduction

The textbook version and the western ideology of a corporation is an autonomous corporation surrounded by markets. This is, however, a truly Anglo-American phenomenon. Continental and Northern Europe have a widespread use of constellations of dependent corporations, belonging to constellations of corporations, mostly with a financial corporation in the centre. This constellation of corporations is here termed business groups. When Eastern Europe turns 180 degrees, orienting themselves towards the European Union and towards capitalism, they construct their own institutions of capitalism through cruising between economic facts and economic ideology. Due to the transitional economy characteristics, among them, uncertain property rights, we expect to find a stronger orientation towards capitalism with business groups than with autonomous corporations. In this paper, we will examine the presence of business groups in Croatia's transitional economy.

The subject matter of corporate organisation, such as business groups represent, has been given the term 'corporate governance'. As a research subject, it has been oriented towards ownership structures and board composition and behaviour. There are no, to the authors knowledge, specific theory covering all possible aspects of corporate governance. We are therefor left with a typology of different corporate governance mechanisms that will guide our attention when trying to find explanations towards business groups existence and indication of their presence in Croatia. Thus, we start the paper in section I. by offering a definition of the subject of corporate governance, and a typology that lists the relevant governance mechanisms that are conducive in forming the corporate organisation.

As far as the research is today, we can distinguish between two main systems of capitalism corporate governance, sometimes labelled the bank system and the market system. The transitional economies are travelling from a state planned governance system towards a capitalist system. In section II. of the paper we describe the alternative modes of capitalism that they can assume.

Since the hypothesis of the paper is that the transitional economies are headed towards a business group system, section III. explicate the basis of the business group system by presenting four hypotheses explaining the existence of business groups. These hypotheses are detailed in section IV. where they are fitted into the special circumstances and situations of a transitional economy. Thus, as a result, we gain a collection of hypotheses about the creation of business groups in transitional economies.

The case of Croatia, with special emphasis on the two largest banks, is described in section V. Scant data access makes it hard, and in some cases impossible to examine every hypothesis. We find, however, as outlined in the concluding section VI., that the large banks appear to have characteristics of business groups. One difference, however very important, is that the banks do not appear to be engaged in business ventures at the level of expectations, and they appear to be passive in the privatisation. Thus, we find some of the structural properties, but not all the expected behaviour.

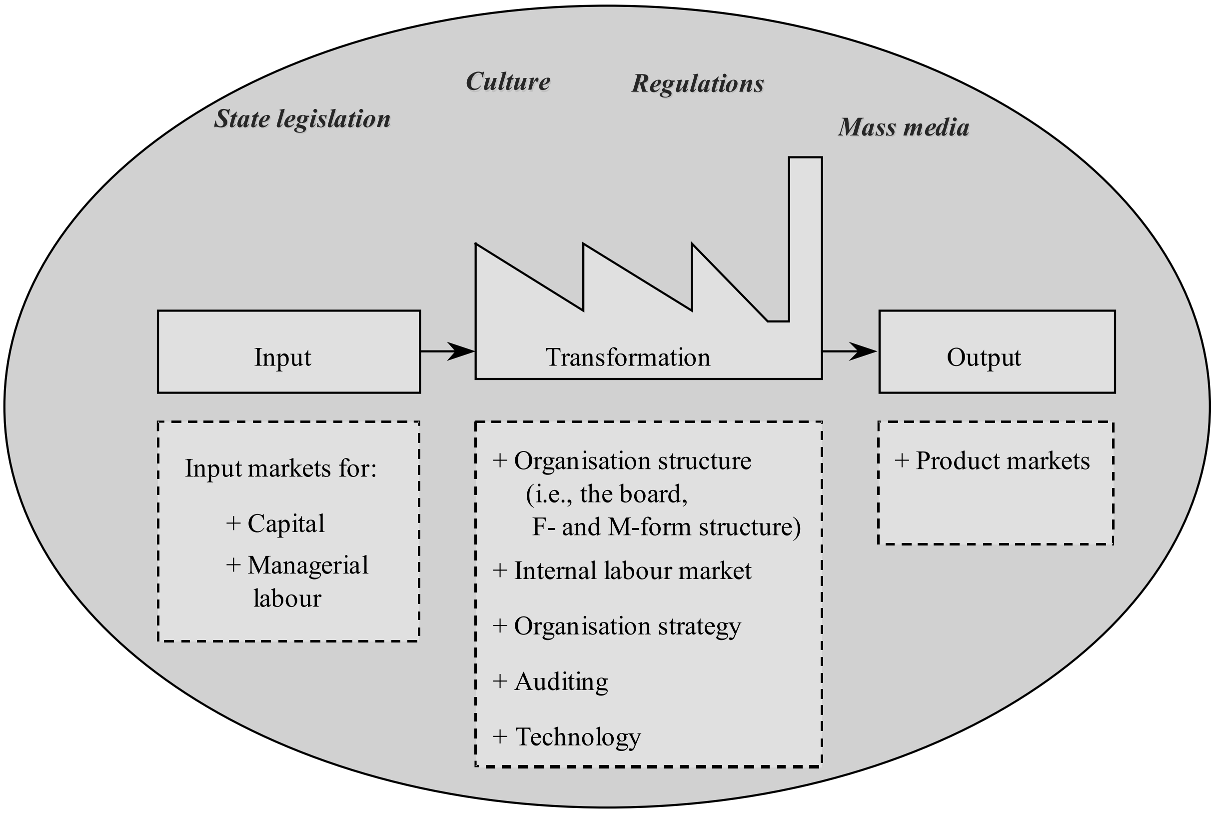
1. Corporate Governance defined

Corporate governance can be defined, according to the Cadbury report (1992), as: *"The system by which companies are directed and controlled…"* The definition stresses that there is not one sole principal subject governing the company, but the company is embedded in a system that influences the corporation. Of course, it is not denying that there are actors that are the prime principals of the company. Irrespective of economic system, managers of the company belong to the group of prime principals. The owners of the company, be it the people through the state in the communist system, or capitalists, directly or indirectly through holding companies, funds etc, in the capitalist system, can influence the company. These actors are embedded in an institutional milieu, consisting of 1.) behavioural rules such as habits, regulations and laws, 2.) markets, and 3.) organisations. The two groups of actors have interest that is a function of a.) their individual preferences such as need of prestige and wealth, and b.) their position in the economic system. Thus, as is commonplace in agency theory and transaction cost theory, there are two groups of actors, where we cannot assume goal congruence, but conflict. The focus of corporate governance, both as a research subject and as social praxis, is how this conflict is mediated through different corporate governance mechanisms and what results it produce, ultimately the efficiency of the company.

In research (cf. Keasey, Thompson and Wright, 1999) the focus has been on the single entity, the company organised as a corporation, with a stock of tradable shares with limited liability. Constellations of corporations, such as business groups, have in large part been neglected. Another limitation of the research is that it has been focused on the monitoring and supervising aspect of governance, summarised as the disciplining of the management. The other aspect of governance, at least when in the hands of the owners of the company, is the enabling function, the development of the management, which has been neglected at worst, or not treated in a theoretical fashion. The present paper deals with companies in a transitional economy, an economic system moving towards capitalistic principles of companies and their governance. Thus, the dominating research stream dealing with capitalistic firms can be used when building theory. The focus on control, and the resulting disregard of the enabling function is a limitation that is not appropriate, and we will make an effort of including the enabling function when appropriate.

The conception of corporate governance in this paper is that it is a collection of mechanisms that govern the corporation, mainly through mediating the conflict between the owners and the managers, and that these mechanisms are supporting the interest of the owners. The level of theoretical development has not reached the level where there is one theory dealing with all governance mechanisms. Thus, we are left with a typology of mechanisms.

Figure 1.: A Typology of Corporate Governance Mechanisms



The typology of corporate governance mechanisms in Figure 1 (Collin, 2000) is based on the idea that the corporation is an organisational form embracing the company. The output of the corporation is created through the input factors being transformed by the company. Thus, the conception is that the corporation is mainly a dress of property rights that covers the production body of the company.

The main input factors are listed in Figure 1. They are related to stakeholders who occupy influential positions in the firm, namely, the capital suppliers, i.e., those that supplies credit capital and risk capital, and the management, with its market for managerial labour. These markets are supported by different intermediaries that can function as efficiency enhancing organisations, such as investment funds at the stock market, and headhunters operating at the managerial labour market. In the transformation process, the board (supported by a market for directors) aligns the strategy of the corporation with the organisational structure, and the use of an internal managerial labour market carries out the management of managers. To these mechanisms, one has to add the monitoring devise of auditing, and the regulative devise of technology. On the output side, the product markets competitive pressure disciplines the corporation.

These governance mechanisms are embedded in economic and political institutions that could differ from industry to industry, and certainly differ from country to country. This implies that all these mechanisms are not equally relevant or accessible to every actor in every corporation. Important institutions are: the mass media that creates information about the corporation and its stakeholders, state legislation that mainly influence through court sanctions, regulations provided by state or business associations that influence through sanctions mainly by legitimacy, and finally culture that bound rationality through traditions.

The mechanisms that are active in governing the corporation could be expected to evolve over time and balance each other in a developed capitalistic economy. There is, however, no theory about the balancing of the mechanisms, and there are no empirical studies known by us that deal with all of them simultaneously in a systematic manner. So, we are left with a set of mechanisms that needs to be scrutinised when studying corporate governance.

II. Transitional economies, transition to what?

When turning the attention to transitional economies, it goes without saying that the capitalistic corporate governance mechanisms are not at hand or they are poorly developed. In fact, that is the very meaning of the concept 'transitional'. The economy is transformed from a communistic economic system, characterised by state property, production determined mainly by planning decrees, and consumption determined by administered prices, to a capitalistic economic system, characterised by private property, production and consumption determined mainly by market prices. But the list of governance mechanisms and the general characteristics of capitalism are too general to correspond with reality since capitalism is an economic system with great diversity. The different factors are not equally important in all capitalistic countries. It is commonplace to distinguish between market-oriented and bank-oriented financial systems (Berglöv, 1990). Here we will follow this convention, but we will grade it with more detail. Since we emphasise the organising principle of Business Groups, we divide capitalism into two main capitalistic systems, Autonomous Corporation System abbreviated as ACS, and the Business Group system abbreviated as BGS.

In a situation where the autonomous corporation is the basic unit of economic organisation, that is, in ACS, each corporation is an autonomous entity quite independent of its external stakeholders. Anonymous financiers in a volatile market for equity and debt, thus, confront it. The main arena of control for such a corporation is the stock market and it relies on strong external markets for managerial labour. The organisation of a large independent corporation is formed as multi-divisional, and it has boards that are quite independent of the shareholders and other major stakeholders, such as the suppliers and the employees. These corporations are situated in systems characterised by strong financial markets, small governmental direct intervention and a competitive culture. ACS appear in US, UK, and Australia, i.e., the Anglo-American cultures.

In contrast, dependent corporations are prevalent in BGS, where the financial markets are weak, government direct intervention is strong, and there is a rather co-operative or authoritarian culture. The large corporations tend to belong to a business group, i.e., legally independent firms that are joined together by some mechanism, mainly equity ownership, and co-ordinate their use of one or several resources, such as financial resources and managerial labour (Collin, 1998). The corporations tend to depend on the group for the supply of its board directors. The arena for corporate control is a social arena where public, hostile take-overs are rare and negotiated bids dominate. Furthermore, such group corporations depend on internal markets for managerial labour, and their boards are representative of various stakeholders and not just the owners of the shares or the management.

The BGS consists of two distinct subsets, namely, the Germanic and Latin BGS (cf. de Jong, 1991). These two subsets differ mainly with respect to the degree of government intervention and board representation. In the Germanic subset the role of government is fairly passive whilst in the Latin subset the government exerts an active role through state ownership. As far as board representation is concerned corporations in the Germanic subset are especially open to the employees' participation whilst their counterparts in the Latin subsystem are mainly preoccupied with their major stake holders, namely the family. The Germanic BGS subset is dominant in Germany and Japan, but the holding company structures found in the Netherlands, Belgium and Sweden could be subsumed under the heading of Germanic. The Latin subset is prevalent in Italy, with its pyramidal groups, France, with its industrial groups, Austria with its strong state involvement, and South Korea with their Chaebols.

The mode of financing of each of these different systems of corporations is characteristic of the way they have been organised. The financing of the corporations, apart from retentions - which is the dominating mode in every system - is performed through markets in the ACS. This contributes to the arm-length character of both the financial system and of its system for corporate governance. This arm-length character is enforced by the legal system. It promotes accounting rules governed by the principle of true and fair view, i.e., an emphasis on the information content of the accounting system, which is imperative to shareholders and other stakeholders who are positioned far from the corporation. In the ACS, the legal system discourages ownership concentration through legal restrictions on ownership by banks and other financial corporations. It, thus, contributes to the centrifugal force that puts the corporation at an arm-length distance from its shareholders.

The financing of corporations in BGS is an internal matter, in which the group in the Latin system and the banks in the Germanic system are the suppliers and allocaters of financial funds. In the Germanic system banks acts as intermediaries, functioning as the contributor or the organiser of the loans. In the Latin system, notably found in Italy, financing of corporations tends to occur through the transfer of credits inside the business group (Buzzacchi & Colombo, 1996). There are no banks playing an intermediate role, but the group functions as an organisation, by collecting and allocating capital to member corporations – which is a quite similar function as the internal capital market in the conglomerate of the ACS.

The close connection of corporations to a financial organisation in the Germanic BGS, and the pivotal role of the business group in transferring capital in the Latin BGS, creates ties of kindredness. This is not discouraged by the legal system that lacks statutory provisions proscribing the development of such close ties and their consequent concentration of ownership. On the contrary, government is active in promoting the development of business groups and fostering close ties between corporations. In Japan, the state has played an active role in certain sectors, for example, in organising technological development. Government intervention in financing Chaebols and in promoting their development through subsidised loans has recently been highlighted and offered as an explanation for the 1998 crisis in South Korea.

The field of culture which breeds three distinctive cultures, namely the competitive, co-operative and authoritarian, could also be considered to be one factor fostering different governance systems (Hofstede, 1980). The competitive feature of the Anglo-American cultural field fits well with the arm-length competitive governance system in the UK and the USA. The culture of co-operation in Germany and Japan is in tune with the Germanic type of governance. Lastly, the authoritative cultural feature of such countries as Italy and South Korea appears to go well with their Latin systems of governance.

It can be concluded that there is a variance in the corporate governance mechanisms making it fair to distinguish between at least two major capitalistic economic systems, the Autonomous Corporation System and the Business Group System, and even to distinguish between the Germanic and the Latin variant of BGS. Furthermore, we find that capitalistic systems where business groups are significantly present are very frequent. Our contention is that BGS is more likely to appear at the end of the road in transitional economies. To support that statement, we need to uncover the factors that tend to produce business groups, and compare them with the conditions prevalent in our case country, Croatia.

III. Four hypotheses explaining the existence of Business groups

Business groups appear to be a viable organisational form for the control and development of corporations. In this section, we will continue the exposition of business groups through finding factors that can explain the emergence and the existence of business groups. Collin (1998) developed a typology containing four hypotheses with the aim of systemising explanations for the existence of business groups. We will use the typology as a basis for our analysis of the transitional economies and the emergence of business groups.

The typology (Table 1.) highlights how organisational theories, which explain the existence of organisations, can assume two important and different inclinations. The vertical dimension in the typology expresses different views on organisational efficiency, and the lateral dimension indicates different levels of analysis. The dimension of organisational efficiency is scaled to account for theories emphasising the importance of institutional efficiency for organisational survival, such as Neo-Weberian theories of organisations (Perrow, 1976), institutional theory (Pfeffer & Salancik, 1978), and the old institutional school (Veblen, 1923), and theories emphasising the importance of governance efficiency for organisational survival, such as transaction cost theory (Williamson, 1975; 1996). The level of analysis refers to whether the explanation focuses on the organisation and its discrete exchanges, or on the society at large in which the organisation is embedded (Granovetter, 1985).

Table 1.: Four hypotheses to explain the existence of business groups

	Organisational level	**Societal level**
Institutional Efficiency	Power: *H1. Institutional inertia*	Isomorphism: *H2. Cultural fit*
Governance Efficiency	Corporate governance: *H3. Economic efficiency*	Governmental governance: *H4. Political efficiency*

Put together, these two dimensions create a framework where we can identify four different general hypotheses regarding the existence of organisations.

Institutional efficiency refers to the ability of an organisation to defend itself as an institution. It is accomplished at the organisational level through the capacity to be institutionally inert and at the societal level by the propensity to be culturally fitted. The institutional inertia hypothesis (*H1.*) argues that organisations survive because they have the capacity to be institutionally inert through power, be it power applied through accumulated resources (Perrow, 1986), or power exerted due to the circumstance that many peoples wealth and habits depend on the organisations survival (cf. Veblen, 1923).

The cultural fit hypothesis (*H2.*) focuses on the norms and values at the societal level, and argues that organisations exist if they are regarded as being legitimate entities, which amounts to them being isomorphic with societal values (Pfeffer & Salancik, 1978). One can reason that BG is an organisational form that is largely a consequence of the culture in which it is embedded, making the national character of the country a variable explaining it. The cultural fit hypothesis, accordingly, states that business groups, assuming that they require a high level of co-operation and trust relationships for their efficient functioning, exist in countries where norms of co-operation, consensus and equality are prevalent.

Governance efficiency, as another type of organisational efficiency, refers to the capacity of an organisation to create value, and, thereby to survive at the organisational level by economic efficiency and at the societal level by political efficiency. The economic efficiency hypothesis (*H3.*) claims, in line with the premises of the transaction-cost economics (Williamson, 1975; 1996), that organisations survive if they are governed in accordance with the imperative of minimising transaction costs. This third hypothesis concerns the economic efficiency of corporate governance, and, the fact that corporations in a business group are economic organisations which are primarily involved in a variety of different markets, such as the product market, the labour market, the equity market, and the market for corporate control. The bulk of the literature on business groups has explained it as a rational organisational form in an economic system with undeveloped, weakly efficient capital markets. Business groups become a solution when actors are facing problems such as capital shortage (Brioschi, Buzzacchi & Colombo, 1989; Buzzacchi & Colombo, 1996; Leff, 1978), absence of risk reduction possibilities (Brioschi, Buzzacchi & Colombo, 1989; Leff, 1978) and information asymmetry (Amsden & Hikino, 1991). A more general explanation that has been offered focuses not only on the capital market, but on all markets the corporation is facing. The lack of reliability and the lack of trust in those markets induce business groups with the function of producing institutional stability and goodwill (Daems, 1978; Khanna & Palepu, 1996; Leff, 1978; Ponomarev, 1995). The economic efficiency hypothesis, accordingly, considers the organisational form of a business group to be a consequence of the minimisation of transaction costs providing a solution to the corporate governance difficulties connected with measuring and monitoring the resources of credit capital and management labour in weakly efficient markets (for details, please see Collin, 1998).

The political efficiency hypothesis (*H4.*) argues that an organisation could exist if it succeeds to create value either for the central government or a regional or a local authority. It assumes that national governments strive for manageability of the economy and this could be accomplished by establishing influence through maintaining contacts with a small number of highly influential actors. The state involvement in an economy characterised by business groups is through intervention instead of regulation. Thus, the state actions in a BGS appear to be rather similar to that of the owners of the corporations in the system, to have an activist approach instead of arm-length distance. In the literature, it has been noticed that business groups can be induced by state governments (Chang & Choi, 1988), or that they are stimulated by privileged groups having access to state bureaucracy (Khanna & Palepu, 1996). Thus, we can state the political efficiency hypothesis being that business groups provide for the government manageability through a small number of core actors whose influence in business circles is very great.

Equipped with four complementary explanations of the existence of business groups, we now turn to the transitional economies, and twist the hypotheses in order to make them capable of making predictions about the emergence of business groups in transitional economies.

IV. Predictions of the emergence of Business Groups in transitional economies

Our main contention is that business groups will appear in transitional economies because of its capacity to enclose organisations and markets, creating predictability through stabilising a property right structure. In this section we will describe common features of transitional economies, and with use of our four general hypotheses, explain why and where we expect to find the emergence of business groups in Croatia.

Transitional economy is the state the economy and society is in when changing from communism to capitalism, from state property to private property, from production induced by state plans to market inducements, from consumption governed by administered prices to the governance through market prices. Transitional economy is the switch phase where the state is dismantling its power and the markets are being established. Three factors appear to be conducive in the switch phase, the state's capacity to establish a credible property right structure, establishing democracy with a free press, and the process of privatisation.

Credible property rights has been shown in modern institutional economic theory (North, 1990) to promote economic development. The evolution of property rights can appear in the economy, in the civil society or in the state, but the defence of the emerging property rights appear to be most successful if ultimately supported by the state through laws, regulations, and implemented in courts. The power of transitional states to create and to enforce credible property rights could be low since the state is expected to withdraw from intervention which could have a spill-over effect of passivism on its the regulative actions, that the state has lost its legitimacy, and that there is a change in corruption level, which create uncertainty if justice will prevail through bribes or law. An alternative to state regulation is to create an organisation capable of stabilising rights of authority, of cash flows, of credible contracts etc. A business group would thus emerge as a way of creating stable property rights; centred and governed by organisations that contains the resources that have least strong property rights tied to them. One such resource is capital, since it can be consumed immediately. Thus, banks could be expected to be a centre in a business group. But note that the argument here is not the ordinary argument, that banks control money, which is a high valued resource, and thus creates power. The argument put forward here is that capital is a vulnerable resource, thus creating incentives for protecting it, and in cases of uncertain contract enforcement's, banks have to create other linkages in order to secure repayment and interest (cf. Berglöf, 1995). The bank cannot trust the legal system to take care of sanctions, thus having to create sanctions of their own. In one tie relationship, without a reputation effect due to weak information systems, the vulnerable party has incentives to create another tie, a tie of hostage, which could function as a sanction mechanism. Thus, multiple ties can create credible commitments, for example, ownership by the bank and credit to the corporations. It has been argued that ownership and credit create an internal conflict of interest. While it is true in a well-developed capitalistic system, the function of hostage ties could be assumed far more important than the conflict of interest between interest and dividends.

Other cases where unstable property rights are conducive to evolution of business groups are resources were there is no supply competition. Asset specificity creates not only the problem of distributing the quasi-rent, but also the hold-up problem of creating a credible contract, thus creating strong incentives for integration. Integration is, however, hardly an option in transitional economies due to low acquisition power because of capital scarcity. *Thus, we expect to find business groups containing banks in the centre, focused on creating a certain supply of resources that are valuable for the firms, but where there is no competitive market for the resource.*

An extension on corruption has to be made since a focus on institutional uncertainty emphasises change of corruption level. Corruption can hardly be a problem of its own since a stable system of bribes creates the certainty that is needed. In fact, it is no more than the dilution of state property rights to individual property rights. There is hardly any difference between an official that can get your application through the bureaucracy at the price of 20 Euro, and the construction worker that steals nails for the amount of 20 Euro. As long as it is predictable, it can be included in the economic calculus of a rational actor. Transitional economies experience institutional change, towards conditions that tend to produce lower levels of corruption, including a developed economy, an unitary state, democracy and elements of common law (Treisman, 1999). The change of level of corruption creates a prediction uncertainty of the possible level of corruption, i.e., it becomes hard to predict the probability of getting caught and of being punished. To this adds the increasing contacts with and exposure to less corrupt regimes, making it hard to adjust to proper and legitimate behaviour. These changes in corruption, not the absolute level of corruption, is what produce uncertainty, and thus what fosters actions for certainty or retaining possible actions. *Thus, we hypothesise that business groups is a device for handling corruption in areas where there is a marked change in corruption levels, which presumably are in export oriented industries.*

Democracy creates competition in the ruling parties and a free press creates transparency. The non-rulers have incentives to bring information of misconduct and abuse of power to the voters, and the free press has incentives to distribute this information. It does not reduce the political risk to zero, but it makes it more predictable. Absent democracy and a free press, corporations need state access in order to be capable to predict the actions of the state. *Thus, we expect to find political connections between business groups and the state.*

The process of privatisation is the third important feature of transitional economies. The privatisation method has to balance demands of social justice and demands of economic efficiency. Social justice could be that those that have invested their labour in the firms gain the shares of the corporation. That has been the case in Russia (Shleifer & Vasiliev, 1996). It creates corporations with the characteristic defects of labour controlled firm's, such as low capitalisation and low dynamic efficiency.

Social justice could be that those that have owned the corporation through the state, i.e., all citizens or all taxpayers gain the shares of the corporation. Voucher privatisation is the preferred method in this case, and have been the dominating method in the post-communist states. It creates firms with low capitalisation, but with dispersed ownership structures in the case of direct voucher privatisation (e.g., Estonia's large scale privatisation 1992), or with more concentrated ownership structures in the case of indirect voucher privatisation, where the corporations belongs to Privatisation Investment Funds (PIF), and the voucher can be used to get a stake in the PIF (i.e., Poland and the Czech Republic). Voucher privatisation has thus the probability of creating strong ownership structures in the case of PIF privatisation, or very liquid shares in the case of direct voucher privatisation.

Methods exclusively aimed at economic efficiency are auctions and direct sales since the distribution is according to market price. In auctions bidders pay a fair price – assuming that the auction is fair. Its deficiency is that it drains investors from capital that could be used in the firm. On the other hand, it gives the firm an owner that presumably have more capital to spend in the firm, and an owner that has put its own money in the firm, thus creating stronger incentives of control and service.

Reporters of the development in the Czech Republic, Poland and Russia have reported that the privatisation has led to numerous large, more or less, constellations of corporations similar to financial groups, centred around banks or investment corporations, and in some cases in Russia, industrial groups (Akamatsu, 1995; Campbell & Jerzemowska, 1998; Coffee, 1999; Johnson, 1997). Another observation has been that the PIF:s of the Czech Republic appears to be the most efficient constructs, followed by foreign investors (Frydman, Gray, Hessel & Rapaczynski, 1999; cf. Major, 1999). They succeeded in increasing the revenues of the corporations, but not increasing the productivity or decreasing the costs. As a conclusions one can say that constellations of corporations tend to appear independently of privatisation method, and that they can be rather efficient organisations.

One reason for this occurrence is, according to our first hypothesis, that absent strong property rights, bank centred business groups or industrial business groups tend to emerge.

Another reason is that there exists not an efficient stock market. If using voucher privatisation without PIF:s, then there are a lot of shareholders, but they lack capital and face a market where there are few actors and where the information flow is small and uncertain in quality, thus hampering trade. With PIF:s, one could expect to get actors that have interest to grow through trade, thus imitating investment funds in capitalistic economies, thereby increasing the liquidity and the efficiency of the market. The number of PIF:s have apparently not been large enough to create an efficient market, and many of the PIF:s are effectively controlled by banks, presumably thereby being more inclined towards influencing the corporation than to sell the shares. To this adds the fact that in every country, PIF:s appear to have been solely equipped with shares but no money, thus restricting them from intense trading at the start. Thus, we conclude that business groups tend to emerge independently of privatisation method.

Reverting to the four hypotheses that were originally formulated in order to explain existence, not emergence, as is the case here, we will use them now in order to elaborate our predictions.

The institutional inertia hypothesis expressed that an organisation that has experienced a period of success has built up resources making it possible for them to survive despite them being inefficient. In the case of Eastern Europe's corporations, many corporations appear to experience severe resource scarcity. They are in a need of capital and of managers with experience of market economy. A business group can distribute capital within the group, and it can create an internal managerial labour market, thus enclose valuable resources. The inertia could, however, be present in the case of banks. They are an institution that were present during the communist time, that are present in the transitional state, and that are present in capitalistic systems. Thus, they are well known, have rather similar functions, and appear to be treated as legitimate organisations, capable of being entrusted capital and other financial investments, such as vouchers through PIF:s. Investment corporations, independent of banks, have to be constructed, to be established and to gain legitimacy, investments that banks does not have to make. *Due to institutional inertia, we expect to find banks at the centre of business groups.*

The cultural fit hypothesis argues that the institutional form has to fit with the social surroundings, with the culture and the institutional environment at large. Since business groups tend to exist in both authorian and in co-operative cultures, the predictive power of the hypothesis appears to be very weak.

The hypothesis of economic efficiency argues that business groups are efficient organisations for intermediating especially capital and managerial labour in situations of market failure. In transitional economies, the stock markets are thin. The banks appear to be the most powerful organisations left, and the only one capable of handling the liquidity in the financial system. The business press is, if free, in their growing stage. The number of actors on the stock market and the number of analysts are presumably low, making the stock market rather inefficient. Thus, the conditions for an efficient stock market, that of liquidity, numerous actors, a diverse set of information channels, a large business press, is not present. With a price that cannot be expected to be fair, the corporation cannot expect to get finance when in a need, and it can be vulnerable for take-overs, not due to bad performance, but due to bad pricing. Thus, the market can not be expected to solve the corporate needs of competent owners and financiers. As history has showed, business groups can protect the corporation and allocate capital. The other main resource is managerial labour. In economic transition, absent well-developed business schools, there is presumably a lack of a business educated and experienced managerial class. To develop this competence, the firms has to invest in development of their managers, but they have to enclose them, thus protecting their investment. Business groups, offering numerous positions, can attract managers and enclose them through creating an internal managerial labour market. Thus, business groups can presumably offer institutional efficiency in transitional economies. *We expect to find internal recruitment and internal capital allocation in the groups.*

The hypothesis of political efficiency argues that a weak state, for example weak through low capacity to enforce laws, or a state that rule through intervention instead of regulation, can make use of business groups in order to ensure capacity of governance. The state in Poland has retained their influence through state ownership, and in the Czech Republic through state ownership of the bank's that controls the funds. *Thus, we expect to find a close co-operation between the state and the business groups.*

To summarise, independent of privatisation method, banks appear to become central corporations in business groups, constructed in order to secure the banks outstanding debts, and because they are the remaining legitimate organisations, being in the flow of cash and credits, closely tied to the government, capable of creating an internal capital and managerial labour market, stabilising the corruption level, offering corporations with international outlook valuable international contacts.

V. Business groups in Croatia

Croatia is a small country, less than 5 millions inhabitants, with a history of being a part of the Habsburg Empire, and then part of the socialist Yugoslavia. In 1990, Croatia got a constitution of democracy and free market, and two years later it was internationally recognised as a sovereign country. During this turbulent time the GDP were almost reduced by half and the economy experienced very high inflation (1149% 1993). By 1994 the extreme negative decline of the economy stopped, and onwards the economy has been recovering, for example, with very low inflation, 5,4% 1998, and GDP has been growing with about 6 %. The export of Croatia, 50 per cent of the GDP 1998, is mainly directed towards Germany and Italy, and includes food, textiles and petrochemicals.

The privatisation method were in the first phase distribution of the corporations to the employees of the firms and the employees in the public service. During 1997, Croatia started the second phase of its privatisation, so called the “Coupon Privatisation” (Ostovic & Ljubuncic, 1998a)., i.e., a voucher method. The companies to be privatised were within the portfolio of the Croatian Privatisation Fund (CPF), controlled by the state. The shares in the companies could be purchased either individually or through Privatisation Investment Funds (PIF). Seven PIF:s were formed, (table 2). The 471 privatised companies were, however, under-capitalised. Nominal value of the assets of the companies offered was around DEM 3.5 billions. However, total fair value estimated by the Croatian Security Commission was only 21,67% of nominal value. The state had still minority or majority ownership in many of the privatised firms through the CPF. Observers of the privatisation process reports that the state maintain share ownership in many of the privatised corporations, even retaining majority ownership (Prohaska & Vehovec, 1998), thus withholding PIF:s from more active engagement in restructuring of the corporations.

Table 2. Privatisation Investment Funds, their initial size and their founders (Croatian Security Commission, 1999)

Privatisation Fond	**Value** (mln Kuna)	**Share** (%)	**Organiser**	**Deposit Bank**
Dom Fond	800	30	Companies	Raiffeisenbank, Zagreb
EXPANDIA Fond	391	15	Companies	Bank Austria & Creditanstalt Zagreb
Slavonski Fond	334	13	Slavonska Banka	Dalmatinska banka, Zadar
Velebit PIF	340	13	Dalmatinska Banka	Slavonska Banka Osijek
Središnji Nacionalni Fond	338	13	Kaptol Banka	Kreditna banka Zagreb
Sunce PIF	253	10	Osiguranje Sunce	Bjelovarska banka
Pleter PIF	191	7	Company	Hrvatska poštanska banka Zagreb
Total	2647	100		

Noticeable in table 2 is: a.) only three banks and one insurance company where organisers of PIF:s; b.) the banks engaged are not among the largest banks, Slavonska bank is about the eight largest bank and Dalmatinska Banka is the seventh largest bank (see table 3), the rest of the banks, whether organisers or deposit banks are smaller banks; c.) two funds appear to be closely linked to each other, where the organiser of one fund (Velebit PIF) is the deposit bank in another fund (Slavonski Fond) and vice versa. The large banks appear not to be engaged in the mass privatisation programme, at least not as organisers or deposit banks. It could be interpreted as small banks strategies to gain customers and to gain access to investment banking.

A marked occurrence in the privatisation programme was the partly privatisation of Pliva in 1998, a pharmaceutical corporation with international exposure. 14% of Pliva was distributed to private investors, with the aim of educating people about shares, to show that the state can make credible commitments to international investors, thereby being a forerunner for telecom, oil and gas privatisation. In short, to brand the privatisation with a top name.

The financial system of Croatia is a bank system. Croatia has many banks, about 60, mainly universal banks, most of them are local and small banks closely connected, for example through cross-ownership, with a few single corporations or with local magnates. There is, however, a huge concentration, the two largest banks controlling 58% of the ten largest bank's assets.

Table 3. The ten largest banks in Croatia 1998 (Zagrebacka banka Annual Report 1998)

Bank	**Assets** ($mil)	**Percent of ten largest**	**Ownership**
Zagrebacka banka	3669	34	Private
Privredna banka	2579	24	State
Splitska banka	1032	10	State
Rijecka banka	782	7	State
Dubrovacka banka	720	7	Private
Glumina banka	468	4	Private
Croatia banka	388	4	Private
Dalmatinska banka	361	3	Private
Slavonska banka	353	3	State
Varazdinska banka	351	3	Private

Many banks have been facing state reconstruction, and they are still equipped with a bad loan portfolio, thus making them very dependent on well performing customers.

The alternative to banks, the market for capital, is rather small. The Zagreb Stock Exchange had 1998 five corporations' listed and 49 corporations OTC, and the Varazdin stock market had only OTC-trading. The turnover rate 1997 was 247 on a yearly basis, but 64% of the turnover were in Zagrebacka Banka (35%) and Pliva (29%) (Zagreb Stock Exchange, 1998).

There is a growing but still small business press, with KAPITAL and BANKA representing prestigious monthly papers. They appear to be independent from the state and are distributed around the country.

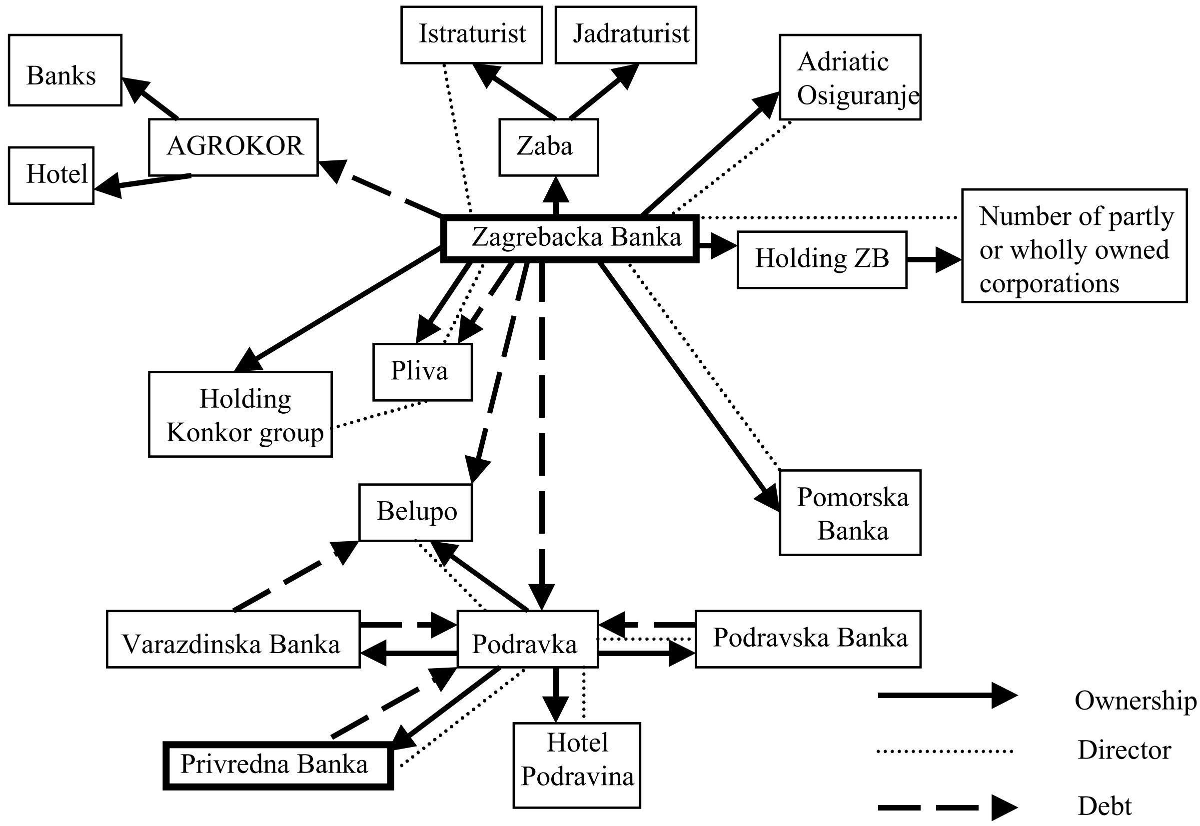
Given these circumstances, strong bank concentration, PIF:s formed by small and medium sized banks, and a weak stock market, one would expect to find a business group system. In the case of the two largest banks, this appears to be true.

Zagrebacka banka and Privredna banka are universal banks, operating over the whole country, and with international operations. They have a rather similar structure, their industrial holdings are collected in fully owned holding companies. Most of the equity was created as swaps from debt to equity. As of 1998, the banks had both large engagements in tourism, hotels, pharmaceuticals, manufacturing, and construction. Zagrebacka banka owns 12% of the largest pharmaceutical corporation, Pliva, and Privredna banka is associated through loans, ownership and directors with the Podravka group, the wholly owner of Belupo, which is the second largest pharmaceutical corporation.

Zagrebacka banka and Privredna banka differ but in a few important cases. Zagrebacka banka have ownership shares in one bank, but Privredna banka have ownership shares in one bank (Riadria Bank), and have two fully owned banks (Laguna and Krapinsko Zagorska Bank). Both banks have investments in tourism, but Zagrebacka banka appear to be focused on tourism having 7% of their lending and 44% of their equity investments in tourism. It has to be observed that tourism is a large industry in Croatia. The value of foreign tourism amounted to 31,8% of all export (1998, Ministry of Finance, Aug 1999) and the number of tourists in a year is slightly more than the number of inhabitants. The tourists are mainly coming from Germany, Slovenia, Italy and Austria. The number of tourists spending their night in the country fell dramatically during the war, presumably creating financial stress, solved by swaps from debt to equity, thus causing bank ownership to many tourism enterprises. Privredna Banka has declared that their stakes in tourism is for sale (Annual report 1998:38). Zagrebacka Banka have invested more in the industry, they have created a holding company for their shares, but their credit exposure in the tourism industry is not so large (5,4% of total corporate lending) and they have declared that they "…intend to reduce these holdings over time…" (Annual Report, 1998:13).

Figure 2 is a collection of three different governance ties of the Zagrebacka Banka group of 1998. It is for sure not an exhaustive list, but the set of ties is sufficient to show some characteristics of the group. The bank owns two holding corporations, Zaba, which organises their ownership interest in the tourist industry, and Holding ZB, that contains a collection of other corporations. The bank has ownership in other banks and in an insurance corporation. Thus, the bank has separated the different activities, financial industry and non-financial industry, and created a holding company specialised in the tourism industry. They do not govern the business of tourism, but have delegated the management of the firms to Sol Melia, a Spanish firm specialised in tourism. The Adricatic Osiguranje have been connected to the German firm Allianz AG, which is a part of an alliance between the bank and Allianze. Thus, they appear to have capacity to create international alliances, which is a resource appreciated by firms that plan to expand through internationalisation. At the same time, the alliances indicate that the group does not have industrial ambitions of their own, building their own competence in governance and business development.

Figure 2. : Some governance ties of the Zagrebacka Banka Group 1998



One large investment is in Pliva, where Zagrebacka Banka is the main bank, and has ownership ties - although small, after a sell-and-repurchase arrangement 1999 – debt ties and director ties. Pliva is listed on the Zagreb and the London Stock Exchange. On Plivas Supervisory board is the president of the Zagrebacka Banka Management board. Pliva is an internationally oriented corporation, having 49% of sales in Pharmaceuticals on foreign markets, mainly Russia, China, Poland and Ukraine, and 99% of sales in bulk Pharmaceuticals, mainly in western European markets and US. Thus, Pliva and its relationship to the bank represent a typical structure of large, internationally oriented corporations in a business group system.

The top management of the bank, i.e., those on the management board, were all educated at the university of Zagreb, three persons at the faculty of Economics, one at the faculty of Law, and one at the Faculty of electronics.

Two relationships could be noted. The bank lends capital to AGROKOR, a group of corporations that is the leading group in production of food in Croatia. They have a rather local production and sales. The bank has no ownership interest in the group, which indicates that the group has been performing well during the bad years since no swaps of debt to equity appeared to have occurred.

Zagrebacka Banka assists Podravka, a large manufacturer of branded food products and pharmaceuticals, with loans. This tie is remarkable since Podravka owns several banks themselves, and have a small stake in the second largest bank in Croatia, Privredna Banka, with which Podravka have a multitude of ties, such as loans, ownership and directors. Belupo, the second largest pharmaceutical in Croatia, belongs to the Podravka group. Belupo have loans from both Zagrebacka Banka and from one of the Podravka group banks, Varazdinska Banka. Thus, it appears that Podravka has created a group well-equipped in financial matters.

The group sales 1998 was 56% domestic, and foreign sales were mainly to former Yugoslavian states. The largest product in food was Vegeta, 27% of sales. Although the products could have been local, it appear that Podravka have international orientation.

When inspecting the boards of Podravka, the same pattern evolve as was found in Zagrebacka Banka. Of 9 members on the supervisory board and 8 members on the management board (in brackets) 3 (3) had its education from Zagreb University, Economic faculty, 1 (0) from medicine, 1 (2) from Law, 2 (2) from technology and two (1) from other institutions. It appears rather clear that the University of Zagreb, and especially the Faculty of Economics is the starting point for the business elite.

VI. Conclusions and implications

Bank oriented systems tend to have a high concentration on a few banks, that engage in the countries internationally oriented corporations. In Croatia, this appears to be true. The two largest banks are engaged in the largest, most internationally oriented corporations. The national capital market cannot satisfy the large, multinational corporations needs of financial resources such as money and financial service. But why do the large corporations create financial alliances with the national banks and not with a true international bank? One reason could be local knowledge, creating lower transactions costs when transacting between the corporation and the bank. This local knowledge could be due to institutional inertia, the corporation and the banks have had long relationship before the transition, and because of elite formation, indicated by a dominance of director’s education from the Zagreb university.

We expected to find business groups engaged in the dominant business of the country, especially with the internationally oriented firms since large banks tend to have the capacity to create international alliances. In the case of the two largest banks, it was found true. It indicates that the banks deliver financial service to its group firms.

Most surprising was the large banks absence from the PIF:s. They do not appear to be organisers of the growing private corporations in their country. One obvious reason could be that the business prospects of most of the privatised corporations are small, but the demands for capital supply are enormous. While this is true, it is also true that one of the strengths of the organisational form of a business groups is that they can use ownership, debt, directorships and managerial labour in a concerted action when structuring and restructuring a firms business, and even a whole industry. With this very strong power, unprecedented in a market system, the business group can deal with corporations that present the group with high business risks, including the risk of corruption, as hypothesised. The business group can restructure not a single corporation, but a set of corporations. Zagrebacka Banka has created such a restructuring device in Zaba, where they organise their tourist businesses. They do not, however, engage their own competence in the industry, but have hired a Spanish firm for the management of their tourist group. This is but a small indication that the bank is not fully committed to stay in the business, but plans to leave it when fully developed. Thus, the industrial engagement by the banks appears to be less than the business group system presumes. Another reason for the large banks to stay out of the PIF:s is that the ownership gained is not fully and whole, thus reducing the capacity to act and to restructure the businesses (Ostovic & Ljubuncic, 1998b). The very construction of privatisation can thus hamper a group's capacity to act as a concerted business group.

The noted discrepancy between our theory predictions and the observations made by us could have two causes. First, one has to acknowledge that our data are superficial. It is collected from publicly available documents, which are low in quantity and sometimes lacks important information, for example, annual reports lacking directors engagement in other boards of directors. Data scarcity puts a strong limit on our possibility to examine our hypotheses in any depth. This could only be accomplished through an extensive study, using primary data.

With this in mind, we can, however, point towards a second cause, and that is our theory. It is developed from a capitalistic system, with growing markets and an organic growth of the state. Transitional implies a sudden interruption of the role of the state, of mental dispositions and of business conditions. When the state resigns from power, it leaves the managers of the previously state corporations with a very strong power, uncontested by weak ownership structures and weak owners (Berglöv, 1995; Olsson, 1999). There is no new management elite to assume the management, thus leaving the corporations with the old elite. This institutional inertia could be one explanation why we did not find a strong industrial engagement in the banks. An elite lacking experience in business risk taking and restructuring cannot be expected to immediately engage in the matters of capitalistic business. Instead, rational managers realise this lack of orientation and engage, as in the case of Zaba, those that have the competence.

The passivity of the group in industrial restructuring, as indicated by their alliance building and their passive role in the privatisation, imply that they probably are not a restructuring device that the government can utilise. The hypothesis of governance efficiency is thus, in respect of state government, a failure. Indeed, a surprising conclusion - though speculative in character - because of the influential power of the state yesterday, and of the needs of restructuring today.

Our main conclusions is, thus, that Croatia is still an transitional economy, yet lacking the institutional certainty that makes it possible to analyse it with some depth according to the theories offered in this paper. We find some indications from the two largest banks that the Croatian economy could slide towards the business group system. That appears, however, to be dependent upon the PIF:s capacities to engage in industrial restructuring, involving close ties to main banks, and the states capacity to stimulate such development.

If the western world could offer any example in this respect, some advises could be that there should be

- no restrictions on ownership, thus enabling the banks to engage in powerful restructuring activities and to build its competence in industrial matters;
- democracy including a free business press, stabilising corruption on a low level;
- state activity in order to restructure the bank sector with the aim of increasing the concentration, thus creating conditions for stronger financial competition and stronger business groups
- increasing education at the Zagreb University, and stimulate build-up of Master Programs, thus increasing the output of would-be business elite persons

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