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# Do outside directors and new managers help improve firm performance? An exploratory study in Russian privatization

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## Abstract

In the context of privatization and restructuring in Russia, we test two standard agency theory hypotheses, namely, (1) outside board members and (2) new managers are positively related to firm performance. Based on a survey of 314 privatized firms, the evidence offers little support for the hypotheses. Historically, results refuting theories have been launch pads for scientific progress. Our findings, therefore, raise interesting questions about whether the underlying theory is appropriate, whether there are methodological problems, or whether there are institutional factors in Russia's transition economy that need to be accounted for when we test agency theory in a new setting. We address these questions and discuss their implications for corporate governance theory, practice, and public policy.

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## 1. Introduction

In the last two decades, the worldwide scale and scope of privatization have grown tremendously (Meggison & Netter, 2001). The participation of Russia and other transition economies in this movement has truly made it global (Svejnar, 2002). Yet, after the initial euphoria associated with political and ownership transitions is over, how to govern the privatized corporation becomes an immediate concern

(Wright, Hoskisson, Filatotchev, & Buck, 1998; Young, Peng, Ahlstrom, & Bruton, 2002). More than a decade after large-scale privatization was unleashed throughout transition economies, we now have a cumulative body of empirical knowledge from a variety of countries (reviewed by Meggison & Netter, 2001; Djankov & Murrell, 2002; Estrin, 2002; Havrylyshyn & McGettigan, 2000; Wright, Buck, & Filatotchev, 2002) suggesting the following three propositions concerning the privatized firm:

1. Privatization to insiders (managers and employees), without external governance pressures, is hardly conducive for needed restructuring (e.g., Buck, Filatotchev, & Wright, 1998; McCarthy & Puffer, 1995).
2. Outside ownership, preferably concentrated in the hands of blockholders, funds, foreigners, and/or

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banks, is more likely to facilitate restructuring (e.g., Filatotchev, Hoskisson, Buck, & Wright, 1996; Filatotchev, Buck, & Zhukov, 2000).

3. When incumbent management fails to deliver desirable performance, performance is likely to improve when new managers are brought in (e.g., Barberis, Boycko, Shleifer, & Tsukanova, 1996; Frydman, Gray, Hessel, & Rapaczynski, 1999).

Underlying these three propositions is agency theory, which concentrates on the inherent conflict between principals and agents (Jensen & Meckling, 1976). While private ownership is believed and shown, in general, to be superior to state ownership (Megginson & Netter, 2001), a single round of privatization does not appear to solve agency problems at many firms in Russia and other transition economies. In this regard, privatization may be best viewed as a necessary but insufficient condition for improved performance. Overall, these three propositions highlight the significant post-privatization challenges in corporate governance.

Extending the literature, we raise a critical question: Do outside owners and new managers *actually* improve performance in privatized firms? This exploratory study addresses this question by testing the second and third propositions above. Grounded in agency theory, we hypothesize the positive impact on firm performance made by new owners (represented by outside directors) and new managers, and present evidence from 314 privatized firms surveyed in Russia. Our provisional results challenge the validity of these propositions, and raise interesting new questions with regard to how to govern the privatized firm in Russia and other transition economies.

## 2. Privatization: theory and practice

In *theory*, privatization may help minimize agency problems and lead to greater efficiency by improving monitoring systems and providing agents with better incentives to perform (Boycko, Shleifer, & Vishny, 1995, 1996). Upon privatization, effective restructuring by the new owners would presumably follow (Boycko et al., 1995: 150). However, in *practice*, the first phase of privatization in Russia, from 1992 to 1994, only partially solved problems of state-owned

enterprises (SOEs). As shown by a voluminous literature, such privatization, resulting in extensive insider control, does *not* necessarily lead to restructuring of former SOEs, especially the large ones (Djankov & Murrell, 2002; Estrin, 2002; Wright et al., 2002). Much of what has been reported about the resurgence of new entrepreneurship in Russia applies to smaller privatized firms, usually in the retail and service sectors, as well as private start-ups (Barberis et al., 1996; Havrylyshyn & McGettigan, 2000; Peng, 2001; Puffer & McCarthy, 2001). At large former SOEs, the objectives of new inside owners typically have little to do with restructuring for better performance. Rather, nonmanagerial employees (hereafter “employees”) are mostly interested in job security. Although they now control substantial shares, employee control may not necessarily be an optimal governance structure, since the heterogeneity among employees increases the costs—and reduces the speed—of reaching restructuring decisions (Earle & Estrin, 1996). Moreover, employees are in “a particularly vulnerable position” as shareholders wishing to influence important decisions and threatening to “exit” (Buck et al., 1998: 96). Many of them rely on the ex-SOE not only for income but also a host of other benefits, such as housing, health care, and recreation. The tradition of “one factory, one town” in many parts of Russia leads to few viable, alternative employment opportunities in the local labor market. As a result, employee ownership poses few restraints on management’s power. Most bluntly, Boycko and colleagues (1996: 317) argue that employee control may simply be “bad for restructuring.”

Having largely become “agents without principals,” managers may be most interested in establishing significant control of the newly privatized firms. This may have resulted in the self-interested entrenchment of former SOE managers, who may be unqualified for their new roles and able to delay restructuring (Filatotchev et al., 1996, 2000). These agency problems are magnified in the context of most privatized Russian firms, which generally lack other governance mechanisms such as securities markets whereby different teams of investors and managers can contest for corporate control. Overall, despite privatization, little restructuring has occurred to improve efficiency and performance in many large firms controlled by incumbent managers after the first phase of privatization

(1992–1994) (Buck et al., 1998; Filatotchev et al., 1996, 2000). McCarthy and Puffer (1995) argue that these managers are simply “muddling through” responding to the crisis of the day as it occurs while not being interested in deep restructuring. Overall, instead of reaching a “triumphant completion” as claimed by Boycko and colleagues (1995: 8), the challenges to govern and restructure the privatized firm in Russia seem to be far from over (Aslund, 1995).

### 3. The role of outside directors and new managers

#### 3.1. Introducing outside directors

Influenced by an agency theory proposition that “the presence of large outside investors is conducive to efficiency” (Boycko et al., 1996: 318), the Russian government launched a second phase of the privatization program in 1994 with the objective of attracting more outside investors to restructure former SOEs. In order to make such investment more attractive to outside investors, the government set a limit of 10% share ownership for insiders, rather than the 51% cap allowed during the first phase (McCarthy & Puffer, 1995: 59). Given that outside investors are typically reluctant to provide capital to restructure firms whose boards are completely controlled by insiders, it is common practice for outside investors to insist on certain control rights through their representatives on the board. Among these outsiders, “small” outsiders are individual investors, while “large” ones are blockholders, who control more than 5% of the shares, such as strategic investors, investment funds, banks, holding companies, and foreign investors. While shares held by small outside investors have remained relatively stable, large outside investors have substantially increased their share, which may facilitate more restructuring (Barberis et al., 1996; Frydman et al., 1999).

Largely shaped by agency theory, corporate restructuring research places an emphasis on the monitoring role of outside board members (Dalton, Daily, Ellstrand, & Johnson, 1998). Outside directors are expected to be more closely aligned with outside investors’ interests, to monitor top management decisions more effectively, and thus, to lead the firm to better performance. Research in the West suggests that

following poor performance, firms typically add outsiders to their boards (Hermalin & Weisbach, 1988). Similarly, in Russia, it is precisely poor firm performance that has led to increased outside investment, and hence, the introduction of outside board members, who may facilitate more restructuring (Filatotchev et al., 2000). Thus:

**Hypothesis 1:** In privatized Russian firms, the presence of outside board members is positively associated with firm performance.

#### 3.2. Introducing new managers

Privatized Russian firms not only need new outside board members, but also new managers capable of restructuring and leading firm growth (Puffer, 1992, 1994; Peng & Heath, 1996). Jensen (1987: 104) argues that “[incumbent] managers often have trouble abandoning strategies they have spent years devising and implementing, even when these strategies no longer contribute to the organization’s survival. It is easier for new top-level managers with no ties to current employees or communities to make changes.” In privatized Russian firms, a number of studies document the entrenchment of existing managers, who obtained most of their experience during the socialist era (Blasi, Kroumova, & Kruse, 1997; Filatotchev et al., 1996, 2000; McCarthy & Puffer, 1995; Earle & Estrin, 1996). Such managerial control, “while far superior to state ownership, ... gives managers too much control relative to what is needed to speed up efficient restructuring” (Shleifer & Vasiliev, 1996: 77). Although some incumbent managers may be interested in restructuring, they typically lack the necessary skills and capabilities (Puffer, 1994).

As a result, there is an urgent need to replace the old guards with a new generation of managers. Approximately 10% of the Russian CEOs<sup>1</sup> were removed at the *first* shareholder meeting by coalitions of outside investors and employees (Shleifer & Vasiliev, 1996: 74). Overall, between 1992 and 1996, one-third of the privatized Russian firms replaced their CEOs (Blasi et al., 1997: 203). While such a pace of managerial

<sup>1</sup> The Russian term for CEOs is “general directors.” In this article, we use the term “CEOs” to avoid confusion with the directors on the board.

turnover is very impressive, Russian firms may need even faster turnover of old-guard managers (Shleifer & Vasiliev, 1996).

Since the managerial labor market is underdeveloped in Russia, most new managers are likely to be insiders (Earle & Estrin, 1996). Blasi and colleagues (1997: 203) find that only less than 20% of the new CEOs came from outside. Although new, inside managers may continue to pose agency problems associated with insider control discussed earlier, these new managers may still be better than old ones. This is because new managers are typically younger, more adaptive, and less influenced by the old way of SOE management. More importantly, some of them may have acquired skills that would enable them to function better in a more competitive, market-driven economy (Puffer, 1992, 1994; Peng, 2000, 2003). As a result, they may be more likely to undertake aggressive restructuring aimed at performance improvement.

In this regard, managers' age may be a good measure to assess the influence of the old system and exposure to the new environment (Hambrick & Mason, 1984). Blasi and colleagues (1997: 203) report a steady decline of Russian CEOs' age over the years. Specifically, the average age of CEOs in office before 1992 was 52 years old, and the average age of those in office since 1992 declined to 47. Among the latter group, the average age of those named CEOs in 1995 went down to 45. In addition to the CEO, the average age of other top managers in privatized Russian firms also experienced a decline (Blasi et al., 1997). Therefore, it is reasonable to expect that even in the case of continued insider control, the presence of new managers may still lead to relatively more restructuring and better performance. Stated formally:

**Hypothesis 2:** In privatized Russian firms, the presence of new top managers (both insiders and outsiders) is positively associated with firm performance.

## 4. Methodology

### 4.1. Research design

The study was carried out in late 1995 and early 1996, approximately 3 years after the beginning of the first phase of privatization in Russia. Building on

previous surveys in Russia published elsewhere (Buck et al., 1998; Filatotchev et al., 1996, 2000), a questionnaire was first constructed in English, and was then translated into Russian by one of the authors who is a native speaker of Russian and by an official in the Center for Economic Reform in the Russian government. The Russian version was then back translated into English to ensure accuracy.

The questionnaire was first piloted in face-to-face interviews with two respondents at each of ten privatized firms in Moscow. Given the sensitive nature of our inquiry, a mail survey would probably have led to a low response rate. Therefore, we relied on trained interviewers to survey managers on site. The selection of this method was also driven by our interest to gather more insightful data from face-to-face interviews. One senior manager, usually the CEO, was interviewed. After covering survey items, respondents were invited to provide additional, open-ended information. The pilot study revealed, with the falling novelty value of Western surveys, the general infeasibility of multiple respondents from a single firm in Russia. The method of single-respondent surveys thus became unavoidable and is consistent with almost *all* other published surveys conducted in Russia (e.g., McCarthy & Puffer, 1995; Barberis et al., 1996; Earle & Estrin, 1996; Filatotchev et al., 1996, 2000; Blasi et al., 1997; Buck et al., 1998).

Besides difficulties in obtaining multiple responses from a single firm, other problems require unique methodological solutions in Russia due to the breakdown of the Soviet Union. While the State Commission for Statistics (*Goskomstat*) was able to supply information on SOEs and their characteristics in the USSR before 1991, privatization in Russia and most of the former Soviet republics tended to be decentralized and regional in character, with no national body collecting detailed statistics. This effectively ruled out quota and stratified sampling and left only reliance on the central limit theorem: If samples were randomly drawn, then as their sizes increased, sample means tended to be normally distributed around the population mean. Such a sampling methodology corresponded broadly with the methodology used by the World Bank (Blasi et al., 1997) as well as a host of other surveys. In our case, six independent groups of Russia-based professional surveyors were instructed to collect large samples of manufacturing firms of

Table 1  
Distribution of sampled firms ( $N = 314$ )

|                                   | Frequency | Sample percentage |
|-----------------------------------|-----------|-------------------|
| <b>Industry</b>                   |           |                   |
| 1. Machinery (engineering)        | 102       | 32.5              |
| 2. Light manufacturing            | 64        | 20.4              |
| 3. Food processing                | 44        | 14.0              |
| 4. Construction                   | 21        | 6.7               |
| 5. Chemical and petrochemical     | 20        | 6.4               |
| 6. Forest products                | 14        | 4.5               |
| 7. Building materials             | 12        | 3.8               |
| 8. Transport and communications   | 12        | 3.8               |
| 9. Energy                         | 10        | 3.2               |
| 10. Metallurgy                    | 9         | 2.9               |
| 11. Fuel and power                | 3         | 1.0               |
| 12. Glass, porcelain, and pottery | 3         | 1.0               |
| <b>Region</b>                     |           |                   |
| 1. Moscow                         | 83        | 26.4              |
| 2. Nizhni Novgorod                | 76        | 24.2              |
| 3. St. Petersburg                 | 74        | 23.6              |
| 4. Ekaterinburg                   | 42        | 13.4              |
| 5. Perm                           | 36        | 11.5              |
| 6. Chelyabinsk                    | 3         | 1.0               |

different sizes and a variety of industries in different locations. The result was a sample of 314 relatively large firms (Table 1) in six major industrial regions (Chelyabinsk, Ekaterinburg, Moscow, Nizhny Novgorod, Perm, and St. Petersburg). Even intended random surveys in Russian could result in convenience samples because of surveyors' local contacts. However, one could expect differing patterns of convenience in six different regions, thus leading to "quasi-random" samples.

On average, sampled firms had been privatized 31 months earlier, with a standard deviation of 9 months. Almost a third of them were in machinery, 20% in light manufacturing, and the remainder in a variety of manufacturing industries. The average employment size of our sampled firms was 1,632, which was similar to the average size of firms reported in other major surveys (e.g., 1,983 in Blasi & Shleifer, 1996 and 1,802 in Blasi et al., 1997).

## 4.2. Measures

### 4.2.1. Dependent variables

Previous research suggests that, in the absence of archival data, self-reported performance measures are

acceptable and often equally reliable when care is taken to obtain data from reliable informants (Dess & Robinson, 1984). In this case, most respondents were CEOs, who were in the best position to know their firms' performance.

While in general performance measures can be accounting- or market-based, the underdeveloped financial markets in Russia rendered accounting-based measures to be our only choice. We focused on pre-tax profits and return on investment (ROI) as two key performance measures. These were widely used by managers in making capital decisions. Unfortunately, the Russian economy experienced annual average consumer price hyperinflation of 1,526% in 1992. During the survey years of 1995 and 1996 it was still at levels of 198 and 48%, respectively (EBRD, 1997: 233). With inflation at such high levels, obtaining an accurate measure of firm performance based on "constant price" calculations was almost impossible. Therefore, we used a seven-point Likert scale to measure relative changes in these two measures. Specifically, respondents were requested to indicate whether their firms' real pre-tax profits and return on investment, during the past 12 months (a) decreased more than 20%, (b) 10–20%, (c) less than 10%, (d) had no change, or (e) increased less than 10%, (f) 10–20%, or (g) more than 20% (see Appendix A).

Besides hyperinflation, another problem with managers' perceptions of financial performance was that this measure might be influenced by the systematic under-reporting of profits in the face of exorbitant corporate tax rates (Maddy & Ickes, 1998).<sup>2</sup> The use of Likert scale rather than ruble measures of profit and returns reduced but did not eliminate this problem (we will refer to this problem again in the discussion of findings).

### 4.2.2. Independent variables

The board structure of privatized Russian firms is complex. While the majority of firms seem to have a single board comprising executives and outside directors in an approximation to the Anglo-American

<sup>2</sup> For example, one enterprise reported that "it had to pay a basic profit tax of 38%. This is in addition to a municipal tax of 1%, 3% for garbage collection, 2% in property tax, and 10% in ecological tax amounting to a total of 54% of its profits. In other cases, the basic profit tax could be much higher" (Aslund, 1995: 204).

model, a minority have adopted German-style, two-tier boards, where the shareholders appoint a supervisory board, which in turn appoints managers to an otherwise separate executive board. In practice, however, these distinctions are often blurred. Russian supervisory boards can be manned entirely by inside managers and employees without any outsiders, just as executive boards can include outside directors and a few insiders. Under these circumstances, it was decided to observe the presence of outside directors on the single board and/or supervisory or executive boards, whenever appropriate. In this regard, our method of relying on on-site interviewers was far superior to other methods such as a mail survey, since interviewers could clarify with the respondents about the *actual* board structure and then guide them through the answers.

At the time of our survey, 84 of the sampled firms were classified as “closed joint stock companies,” which were not legally able to have outside directors. Therefore, only 230 respondents provided information on outside directors on the board. Respondents were asked to indicate whether a particular category of outside investor was represented on the board(s). Among the 230 firms whose respondents provided information, 33% had outsiders on a supervisory board, and 27% reported outsiders on an executive board.

With respect to managerial turnover, we asked (a) whether the CEO had been replaced, and (b) whether other top managers had been replaced. Since the construct of “top managers” may entail a relatively large number of people, we limited the measure to those executive directors who were on either a single-tier board or on the lower, executive board in a two-tier board structure. The rationale was that if a manager sat

on the board as an inside director, he or she would naturally be a top manager. Among sampled firms, 24% had new CEOs, and 34% had some new executive directors on the board.

#### 4.2.3. Control variables

Firm size has long been recognized in corporate governance research (Dalton et al., 1998). The size effect may be especially relevant in Russia, in light of anecdotal evidence suggesting that larger privatized firms are more entrenched while smaller ones are more entrepreneurial (McCarthy & Puffer, 1995; Barberis et al., 1996). Firm size can be measured by assets or employment. Given Russia’s hyperinflationary economy, measuring firm size according to their asset values would introduce too much noise. Despite the wide fluctuation of asset values, the employment level at most large Russian firms has been relatively stable (Aukutsionek, 1997). Therefore, we used the firms’ employment level as a measure for firm size, which on average had 1,632 employees and a standard deviation of 2,919.

In terms of hypothesis testing, we deployed the ordered probit regression analysis using LIMDEP statistical package since our dependent variables are not continuous, and the analysis provides a scaled subjective evaluation of the (unobserved) continuous variables (Greene, 1993).

## 5. Findings

Table 2 presents means, standard deviations, and correlations for the dependent, independent, and control variables. Results are presented in Table 3. Positive relationships are hypothesized to exist between outside

Table 2  
Means, standard deviations, and correlations

|                                   | Mean (SD)   | 1       | 2     | 3       | 4      | 5    | 6       | 7 |
|-----------------------------------|-------------|---------|-------|---------|--------|------|---------|---|
| 1. Outsiders on supervisory board | 0.46 (0.76) |         |       |         |        |      |         |   |
| 2. Outsiders on executive board   | 0.33 (0.63) | 0.06    |       |         |        |      |         |   |
| 3. CEO replaced                   | 0.24 (0.42) | 0.12    | 0.15* |         |        |      |         |   |
| 4. Other top managers replaced    | 0.34 (0.47) | 0.11    | 0.13* | 0.39*** |        |      |         |   |
| 5. Size (employment)              | 1632 (2919) | 0.32*** | 0.09  | 0.01    | 0.08   |      |         |   |
| 6. Pre-tax profits                | 4.01 (2.14) | 0.02    | −0.05 | −0.03   | −0.11* | 0.00 |         |   |
| 7. ROI                            | 3.41 (1.66) | 0.04    | −0.04 | 0.05    | −0.04  | 0.03 | 0.62*** |   |

\*  $p < 0.05$ ; \*\*\*  $p < 0.001$ .

Table 3  
Maximum-likelihood estimation of ordered probit models

|                                            | (1) Profits    | (2) ROI       | (3) Profits    | (4) ROI       | (5) Profits    | (6) ROI       | (7) Profits    | (8) ROI       |
|--------------------------------------------|----------------|---------------|----------------|---------------|----------------|---------------|----------------|---------------|
| Constant                                   | 1.53*** (3.37) | 1.22** (2.69) | 1.26*** (3.25) | 0.99** (2.57) | 1.58*** (3.45) | 1.14** (2.49) | 1.61*** (3.48) | 1.15* (2.50)  |
| <b>Hypothesis 1: Outside board members</b> |                |               |                |               |                |               |                |               |
| Outsiders on supervisory board             | 0.06 (0.65)    | 0.08 (0.87)   |                |               | 0.10 (1.02)    | 0.09 (0.96)   | −0.15 (−0.54)  | 0.03 (0.09)   |
| Outsiders on executive board               | −0.06 (−0.45)  | −0.06 (−0.51) |                |               | −0.04 (−0.28)  | −0.08 (−0.63) | −0.24 (−0.57)  | 0.16 (0.43)   |
| <b>Hypothesis 2: New managers</b>          |                |               |                |               |                |               |                |               |
| New CEOs                                   |                |               | 0.03 (0.18)    | 0.20 (1.28)   | −0.09 (−0.48)  | 0.13 (0.67)   | −0.67 (−1.31)  | 0.28 (0.55)   |
| New top-level members                      |                |               | −0.26† (−1.79) | −0.15 (−1.05) | −0.28 (−1.55)  | −0.11 (−0.66) |                |               |
| <b>Interaction effects</b>                 |                |               |                |               |                |               |                |               |
| New CEOs × outsiders on supervisory board  |                |               |                |               |                |               | 0.17 (0.84)    | 0.05 (0.26)   |
| New CEOs × outsiders on executive board    |                |               |                |               |                |               | 0.14 (0.46)    | −0.20 (−0.74) |
| <b>Control</b>                             |                |               |                |               |                |               |                |               |
| Size (log employment)                      | −0.09 (−0.65)  | −0.04 (−0.60) | −0.05 (−0.86)  | −0.01 (−0.15) | −0.09 (−1.31)  | −0.03 (−0.40) | −0.09 (−1.31)  | −0.03 (−0.50) |
| Chi-square                                 | 2.49           | 1.18          | 4.67           | 2.26          | 7.15           | 2.26          | 5.36           | 2.36          |
| N                                          | 226            | 229           | 301            | 303           | 226            | 229           | 221            | 220           |

*t*-statistics in parentheses.

†  $p < 0.10$ ; \*  $p < 0.05$ ; \*\*  $p < 0.01$ ; \*\*\*  $p < 0.001$ .

board members (who represent outside investors) and new managers on the one hand, and firm performance on the other hand. Ordered probit estimates fail to provide support for these two standard, agency theory hypotheses at any  $p < 0.05$  level.

Specifically, in Table 3, the eight models, using different combinations of independent variables, yield resoundingly consistent results. In Models 1 and 2, the effect of outside directors is estimated. In Models 3 and 4, we focus on the effect of new managers. In Models 5 and 6, these two sets of independent variables are combined. To explore links between governance factors and performance further and beyond hypothesized linear relationships, in Models 7 and 8 we estimate whether there is any interaction effect between the two sets of independent variables. In particular, the interaction between outside directors on the supervisory and/or executive board(s) and a new CEO may have some positive impact on performance. However, estimates in Models 7 and 8 exploring these potential interactive effects again refute such thinking.

## 6. Discussion

### 6.1. Questions about agency theory

Is agency theory appropriate? Based on decades of research dating back to Berle and Means (1932), agency theory is not only influential among scholars, but also widely accepted by the practitioner community and the business press in the West (Jensen, 1987). Moreover, the theory has played a major role in transition economies (Peng, 2000, 2004; Young et al., 2002). Western agency theorists such as Andrei Shleifer, Robert Vishny, and Joseph Blasi have been directly involved with the Russian privatization program as foreign advisors, and Russian agency theorists such as Maxim Boycko and Dmitry Vasiliev have served in key government positions in charge of privatization.

The agency theory logic behind our hypotheses seems to be straightforward, robust, and uncontroversial. With regard to Hypothesis 1, “there is near consensus in the conceptual literature” on the role of outside board members (Dalton et al., 1998: 270). Hypothesis 2, on the role of new managers, is not only widely endorsed by agency theory (Jensen, 1987) but

also by an emerging empirical literature on transition economies, primarily from Central Europe—but less so from Russia and other former Soviet republics (Megginson & Netter, 2001; Djankov & Murrell, 2002). Therefore, given agency theory’s rich intellectual tradition, strong practitioner support in the West, and widespread application in transition economies, it may be difficult to conclude that the theory is inappropriately applied in this empirical context.

### 6.2. Questions about methodological limitations

How about potential methodological problems? Our methodology followed an interview-based, key-informant design used by virtually *all* other published surveys conducted in Russia cited earlier. One potential weakness of our methodology is our measure of the *presence*, as opposed to *proportion*, of outside board members and new top managers. While eventually, it may be the proportion of outside directors and new managers that counts, during the immediate aftermath of the first phase of the privatization program, there was widespread consensus that *some* new blood (i.e., the presence), even if they were a minority, would at least help initiate post-privatization restructuring (Shleifer & Vasiliev, 1996). In any case, most firms having outside directors on their board typically had only one or two such members and dominance by outside board members was not realistic in Russia during the time of our survey (Blasi et al., 1997: 201). Under these circumstances, our focus on the presence of outside directors and new managers is appropriate, since such presence would *qualitatively* differentiate a firm from others completely entrenched by incumbent managers (Boycko et al., 1996: 318).

Another potential methodological weakness lies in the self-reported nature of our data, which, similar to data used in other published Russian survey studies, could not be triangulated for the whole sample. It is plausible to question whether Russian managers may be used to reporting “politically correct” information (i.e., “painting rosy pictures”). Two lines of defense can be invoked. One is the assumption that managers’ bias is not *systematically* correlated with the objects of inquiry. As long as our informants, who might have bias, did not always over- or under-report data by a certain margin, the data would still be acceptable. In other words, our data, like all other data, may contain

errors, but not systematically. A second widely-used tactic is to employ large-sample data in the knowledge that biases would be canceled out to some extent. In comparison with the sample size of other major surveys (e.g., 142 in Blasi & Shleifer, 1996, 139 in Buck et al., 1998), our 314 firms represent a respectable sample size.

One feature of the Russian enterprise environment that could lead to the under-reporting of profits and rates of return is the increasingly exorbitant corporate tax rates over the period studied. Our use of managers' perceptions of returns on a Likert scale reduces the likely impact of this phenomenon, since these perceptions cannot be compared with tax returns in any detailed manner. Nevertheless, increasingly under-reported returns are a realistic problem, and it is at least possible that new outside directors may have been hostile to this established enterprise practice, thereby reducing reported performance. Subsequent studies in more stable periods with a flat-rate corporate tax rate are needed.

Finally, the lack of support for our hypotheses may be simply a matter of survey timing. Although on average, the 314 firms had been privatized 31 months earlier at the time of survey, the range was between 2 and 61 months. While the official, "top-down" Russian privatization program started in 1992, there were numerous cases of spontaneous, "bottom up" privatization before the official program began (Filatotchev et al., 1996). Unlike some other surveys which only include firms privatized since 1992 (Earle & Estrin, 1996; Blasi et al., 1997), our survey includes some firms which were privatized "spontaneously." The longest post-privatization history of the sampled firms was 61 months, which suggested that these firms were privatized in 1990. Nevertheless, the inclusion of these firms, which leads to a more *conservative* test of the hypotheses, still does not generate supportive evidence. It appears that even for firms with a longer post-privatization history, they still may not have had enough time to recover.

Overall, it is important to note that our study is not the only one that fails to support agency theory hypotheses. Dalton and colleagues' (1998: 282) meta-analysis, involving 54 studies and 159 samples (with a total *n* size of over 40,000) in the West, reaches a very strong conclusion that "the true population relationship across the studies ... is near zero." In

China, Peng (2004) similarly refutes agency theory predictions on the positive role of outside directors on financial performance. Although none of the cited surveys conducted in Russia formally tests our hypotheses, their results are similar to what we obtained. Specifically, they find that, despite a growing involvement of new investors and new managers, there has been little restructuring and negligible performance enhancement at large privatized firms. Therefore, given the care taken in our research design, the largely mixed results from empirical studies elsewhere, and the consistent findings from surveys in Russia, we believe that it may be problematic to attribute the lack of support for the hypotheses to potential shortcomings in our methodology.

### 6.3. Questions about institutional context

In the end, what about institutional factors that may need to be accounted for in the Russian context? Given the "path dependent" nature of each country's development (North, 1990), any attempt to explore managerial behavior in a country such as Russia "requires an understanding of the institutional framework in which the firm is embedded" (Peng & Heath, 1996: 501). Research has shown that the institutional structures in emerging economies differ significantly from those familiar in the West (Hoskisson, Eden, Lau, & Wright, 2000; Meyer, 2002; Peng, 2000, 2003). There are at least four unique institutional factors that may have contributed to our findings. First, Russian managers, even those relatively younger and more "Westernized," display a strong collective mentality which dates back to Czarist Russia and has been reinforced by the socialist legacy (Welsh, Luthans, & Sommer, 1993; Puffer, 1994). As a result, even those new directors and managers from the outside may be less willing to initiate large-scale restructuring, downsizing, and layoffs. In addition, standard agency theory assumes to some extent the availability of able and qualified managers on the outside labor market for executives, and this may be a heroic assumption in the Russian context (Filatotchev et al., 1996).

Second, while Russian directors and managers may be unwilling or unable to initiate restructuring, foreign investors may also be limited in their ability to push for these changes. By 1996, they only controlled approximately 1.6% of total Russian equity, thus necessarily

limiting their “voice” (Blasi et al., 1997: 193). Even when sitting on the board, they often do not challenge the Russian managers, in fear of political reaction (Shleifer & Vasiliev, 1996). In addition to their limited “voice” on boards, the discipline of an “exit” threat implicit in outside shareholders may be largely absent in Russia as a result of significant barriers to share transfers largely established unlawfully by incumbents. Under these circumstances, hypothesized agency theory-based relationships between outside ownership and firm performance may be nullified.

A third institutional reason behind the lack of support for the hypotheses may be a function of macroeconomic conditions. Privatization in Russia occurred during a period of hyperinflation, demand collapse, and penal rates of corporate taxation. For example, in 1995 during our survey period, retail price inflation averaged 198%, private consumption fell by 24%, and gross fixed investment fell for the fourth consecutive year (EBRD, 1997: 233). In such a harsh environment, even the most capable managers would have had a hard time making a difference. Given Russian managers’ general lack of familiarity with the workings of a market economy (Puffer, 1992, 1994; Peng, 2000), it is not surprising that the firms they led did not show significant performance improvement. In addition, high tax rates may have led to increasingly under-reported returns.

Finally, in a dynamic environment, outside board members may have more difficulties in assessing and monitoring top management actions. While existing research focuses on turbulent environments in the West (Zajac & Westphal, 1994; Li & Simerly, 1998), it follows that the more turbulent environmental dynamism may reduce the effectiveness of outside board members in Russia. For example, newly-appointed board members may be unable to monitor the sales performance of senior managers when inflation rates are so volatile.

## 7. Implications for future research and practice

This study contributes to the literature by being among the first ones to directly test and challenge the two standard agency theory-based propositions on the positive role of outside owners and new managers in governing the privatized firm. The results, though

statistically insignificant, are not without wider importance, and lead to a number of implications for corporate governance theory, practice, and public policy. For scholars, we are not optimistic that a straightforward application of agency theory in a transition economy characterized by a great deal of institutional differences compared with the West would be fruitful. We would not, however, suggest that outside board members and new managers do not have an impact on firm performance in Russia. Under conditions of unrelenting turbulence, the few people at the top of a firm make a world of difference to its competitiveness and vitality. A potentially promising avenue for future research may be the introduction of institutional factors that may have a direct or moderating impact on the focal relationship (North, 1990). Since most scholars would agree that institutions matter in transition economies such as Russia, the next step is to tackle the harder and more interesting issues of *how* they matter (Peng, 2003: 276). As discussed earlier, future work in this area needs to take into account (1) Russian managers’ collective mentality, (2) the limited role of foreign investors, (3) the impact of macroeconomic conditions, and (4) the impact of different strategic choices moderated by the environment, among others. Such institutional dynamics may lead to more informed theory (Buck et al., 1998; Peng, 2003).

For practitioners and policy makers, our study is a cautionary reminder that the mere acquisition of shares in privatized Russian firms is likely to change little by itself. Any performance improvement as a result of outside, foreign investment is likely to occur only when insiders concede the need for new investment and when outside investors secure some degree of influence over major decisions in order to prevent incumbents from behaving dysfunctionally. This influence can be exercised through the outsider “voice or exit” threat. Although a Russian legal code is in place to protect the rights of outside investors to representation within the firm and to transfer their shares on capital markets, it has been routinely ignored by defiant inside managers. These managers, for example, may infringe the rights of genuine outside minority shareholders by setting up “pocket” companies of their own as investors in company shares, as a means of concealing their insider control (Blasi et al., 1997: 66). Policy makers should concentrate their efforts on the enforcement of shareholder rights in

order to facilitate more post-privatization restructuring and improve firm performance.

It has been argued that during the time of our survey, the only significant constraint on manufacturing firms we surveyed came from product markets, as many factories stood idle and demand for products diminished significantly (Buck et al., 1998). Financial markets exerted considerably less pressure (McCarthy & Puffer, 1995). In a market economy, it is the interaction of the product *and* capital markets that combines to discipline firms (Nickell, 1996). In the longer run, it is clear that privatization and restructuring cannot be successful without active financial markets whereby manufacturing firms, as well as their board members and managers, can be disciplined should they fail to deliver value-added to shareholder wealth (Jensen, 1987; Peng, 2004). Therefore, constructing adequately regulated financial markets would be of paramount importance.

At the same time, it must be recognized that our survey took place only a short time after the completion of the centralized privatization in 1994, and this meant only a short time for firms to achieve performance turnarounds. There is a strong case here for longitudinal surveys, although longer time periods may introduce more opportunities for exogenous events to influence performance as well as giving more chances for privatization itself to have an effect. Some of these external changes could be beneficial to the study. For example, a period of more stable tax rates could reduce any anxieties about the under-reporting of enterprise returns alluded to above. We would, however, submit that, while we recognize the need for studies that produce updated and longitudinal data, our study does offer a baseline on which subsequent studies may be developed.

## 8. Conclusions

Exploratory and provocative research tends to generate more questions for continued research than it answers. In light of the globally mixed findings on agency theory-based predictions in the West (Dalton et al., 1998) and in China (Peng, 2004), our results in Russia are puzzling: Maybe such relationships simply do not exist, or, if they do, their magnitude is insignificant. Alternatively, we may have not searched the

right place, at the right time. Historically, findings refuting theories have been launch pads for scientific progress (Kuhn, 1970). Researchers may make larger contributions by focusing on corporate governance in transition economies, since currently we know so little about them (Young et al., 2002). These economies offer fascinating grounds to test and refine existing theories and develop new ones (Buck et al., 1998; Peng, 2003). As the field matures, the last thing we need is the parochial thinking that dominates mainstream organizational research. In conclusion, we argue that a globally valid agency theory must accommodate the specific experiences of managers, directors, and firms in transition economies that have been the central focus of this study.

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## Appendix A

### A.1. Key Questionnaire Items

#### *Outside board members:*

1. Have external shareholders been members of supervisory board? (a) yes and (b) no;
2. Have external shareholders been members of executive board? (a) yes and (b) no.

*New top managers:* Since privatization,

1. has there been a new general director (the Russian term for CEO)? (a) yes and (b) no
2. have other top managers on the directorate (the Russian term for the top management office, defined as managers on the executive board) been replaced? (a) yes and (b) no.

*Firm performance:* In the last 12 months, what has been the approximate percentage change in the following measures (all nominal variables should be at January 1994 prices)?

1. Pre-tax profits: (a) decrease more than 20%; (b) decrease between 10% and 20%; (c) decrease up to 10%; (d) no change; (e) increase up to 10%; (f) increase between 10% and 20%; and (g) increase more than 20%.
2. Rate of return on investment: (a) decrease more than 20%; (b) decrease between 10% and 20%; (c) decrease up to 10%; (d) no change; (e) increase up to 10%; (f) increase between 10% and 20%; and (g) increase more than 20%.

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