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Equity culture development in Central and Eastern Europe: The role of institutional and managerial factors

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ABSTRACT

In this paper we argue that the development of equity culture in the CEECs is dependent on the presence of a combination of factors stemming from the external institutional and internal managerial environments of the firm. We adopt an inductive approach by firstly analysing two levels of data followed by a conceptualisation based on gained results. We examine data for ten CEECs (all current EU members) for four years 1996, 2000, 2004, and 2008. To examine the characteristics of the institutional and managerial environments of the CEECs and assess their similarities to four benchmarks (UK, USA, Germany, and Japan) we apply a Co-Plot methodology. We find that the presence of an advanced and well developed institutional framework together with the existence of specific managerial conditions is a necessary condition for equity culture development. One could argue that in the CEECs the transition process of institutional conditions necessary for the development of a sound financial system is in place but with some limitations. Furthermore, we find that managers in countries with the best potential for equity culture development are highly motivated, high-skilled people with international corporate experience.

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1. Introduction

Equity culture[1] is underdeveloped in Central and Eastern Europe (Kim and Kenny, 2007; Bekaert et al., 2002). The corporate sector's dependence on debt as an external source of capital, scarce and illiquid capital markets and distrust in corporate sharing are the key reasons for this. Yet, according to a number of surveys, firms are dissatisfied with the existing forms of debt driven external capital (Djankov and Murrell, 2002; Filatotchev et al., 2007). The barriers of access to capital and the high cost of capital are resulting in unattractive and inflexible financing options. However, the availability of capital is a necessity for corporate existence and economic growth (Beck et al., 2006; Bekaert and Harvey, 2002). The question of the viability of equity financing development as an alternative to the more traditional debt financing in the transition economies of Central and Eastern Europe puzzles many academics (Delcoure, 2007; Hermes and Lensink, 2000) and practitioners (EBRD, 2006).

Within this context, the aim of this paper is to examine the conditions that are necessary for equity culture development in Central and Eastern Europe, by focusing on institutional and managerial factors. In particular, we address the following research questions: *What institutional and managerial factors are necessary for equity culture development in Central and Eastern Europe? Are there specific country clusters regarding the potential for equity culture development in the Central and Eastern European countries (CEECs)? What are the characteristics influencing the formation of these clusters? How can policy makers and managers encourage equity culture development in the CEECs?*

We focus on the institutional and managerial factors as drivers of equity culture development in the CEECs for several reasons. Firstly, studies (Myer and Peng, 2005; Hancke et al., 2007) show that extant corporate structure theories are not applicable to the CEECs, due to the specific institutional context of these transition economies. Instead, in order to account for the increased transaction costs that firms incur in their financing process, as a result of the transformational processes the CEECs have faced, we follow Stone et al. (2012) who suggest drawing on institutional theory when investigating the determinants of equity culture development in the CEECs. Furthermore, we focus on managerial factors to reflect the fact that equity culture development is co-driven by the financing decisions at firm level and to account for the increasing importance of managerial resources and capabilities in business decisions (Lockett and Thompson, 2001). As managerial factors reflect aspects of corporate culture (Buck and Shahrim, 2005) and corporate culture is often embedded in the national culture (Shao et al., 2009), we are able to complement recent research that investigates the impact of culture on firm financing decisions (Aggarwal and Goodell, 2010; Kwok and Tadesse, 2006; Chui et al., 2002). Secondly, organisations such as the International Monetary Fund (IMF), the World Bank and regional development banks such as the Asian Development Bank (ADB) and the Intra-American Development Bank (IADB) are concerned with the economic development of transition economies. As the availability of capital is a necessity for corporate existence and economic growth (Beck et al., 2006; Bekaert and Harvey, 2002), investigating the determinants of equity culture development in the CEECs is paramount in order to put forward practical recommendations for other groups of transition economies. Thirdly, the CEECs are still in the processes of financial system development (EBRD, 2008b) and they represent an important group of countries with a significant contribution to the world economy in terms of economic growth, inward (approximately 2.35% of the world's total) and outward (approximately 0.66% of the world's total) Foreign Direct Investment (FDI) (UNCTAD, 2011). This ensures the relevance of our research for both academics and practitioners.

In this exploratory paper we argue that the development of equity culture in Central and Eastern Europe is dependent on the combined presence of factors stemming from the external institutional and internal managerial environments of the firm. In this study we aim to detect country clusters with institutional and managerial commonalities and identify typical characteristics these may carry. Furthermore, we aim to ascertain whether, and if so, how these clusters reflect the institutional and managerial characteristics detected in countries with stronger and weaker equity culture. We provide a conceptual framework highlighting those factors that could potentially influence equity culture and

[1] We define *equity culture* as a financing culture adopted by a country's corporate sector implying this sector's bigger freedom to opt for equity-oriented financing as a result of present feasible conditions.

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