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The motivation of business leaders in socialist and market-based systems (An essay to celebrate the 90th birthday of János Kornai)[1]

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Abstract: Janos Kornai was well ahead of mainstream economic thought in comprehending that senior executives have been operating in an intrinsically contradictory situation both in socialist and market-based economies and that there is no full remedy to handle conflicts of interest which arise. Kornai presented a comprehensive theory on this in his most important book, the *Anti-Equilibrium,* as early as 1971. The difficulties experienced by state-owned enterprises (SOEs) were not rooted merely in the socialist ownership form, but they were, to a significant extent, caused by the fact that SOEs were typically very large firms.

Keywords: comparative systems, corporate governance, principal-agent theory.

JEL codes: B31, G32, P31.

Introduction

The upcoming 90th birthday of the Hungarian economist János Kornai, evidently the most widely known and acknowledged representative of the profession in the entire post-communist world is a first-rate opportunity to summarize the implications of his magnum opus, *Anti-equilibrium* (Kornai, 1971) on the behaviour of senior business executives. Even with the benefit of hindsight it seems that Kornai's theory has important messages for present times, when the socialist planning system has not been functioning for a quarter of a century. The rest of the paper follows a simple logic. In Section 1 an interpretation of the recurrent crises in Western market economies is discussed. Section 2 is devoted to a new interpretation of the principal-agent theory, as a standard framework for discussing the intrinsic conflicts of interest of managers. In

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Section 3 the pros and cons of individual as opposed to collective leadership are discussed. The last section concludes.

1. The recurrence of crises in Western market economies and the rise of corporate governance theories

As an after-effect of the global financial crisis in 2007, corporate governance – the ways and means as to how high-ranking company managers govern business firms day after day – has once again become the centre of public interest. The last time this happened was during the aftermath of the Enron and WorldCom crisis in 2001-2002. Prior to these the Maxwell scandal was a similar wake-up call. As readers may recall, the Maxwell media-empire collapsed at the beginning of the 1990s. Thousands of jobs disappeared together with the accumulated pension contributions paid in by the firm's employees over decades. This was frightening, because the totally unexpected collapse of the firm was triggered by the sudden death of a single reputable business leader, namely Robert Maxwell, the main owner and undisputed leader of the media-empire. Going further back in time the Asian financial crisis of 1977 was a similar milestone, which was then attributed to the peculiarities of the Japanese and Korean ways of running businesses.

In reality, the term "corporate governance" (CG) has a 40-year history. Systematic content analysis of the English-language press showed that the term CG first arose in the wake of the Watergate scandal (1972) – a strictly political event, which led to the resignation of US President Richard Nixon who in the mid-to-late 1970s was involved in corrupt payments both at home and abroad. Prior to the Watergate scandal competitive markets and good governance of business enterprises had been regarded as two sides of the same coin. It was a tacit understanding that well-run companies are ethically run companies, and vice versa. Suddenly this equation was broken as it became clear that fraud, corruption and various forms of self-dealing are intrinsic elements of competitive markets. Since then the fast-growing amount of CG literature has had a moral loading.[3]

The most frequently stated **mainstream academic** opinion was that the fundamental messages of CG literature were all in line with the neoclassical (Walrasian) perception of perfect competition. According to this view the managers of WorldCom, Enron, the Maxwell Empire, etc., as well as their auditors

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[3] More recently it has become increasingly fashionable to expect positive, charity-like actions from corporations under the umbrella expression „corporate social responsibility" (CSR) within a broader interpretation of CG. Companies pursue actions that appear to further some social good beyond the interests of the firm and that which is required by law. This development goes much beyond the scope of the present paper.

and the analysts who satisfied the investors' vigilance were all unethical or corrupt. They all knew what should have been the correct behaviour. The rules of CG were good but bad people disobeyed them. Some fine-tuning, more stringent enforcement rules and enhanced vigilance should solve all these problems. Everything else is pure anecdotal evidence. Interestingly, the business literature in the 1970s already challenged this tacit understanding. When company management methods in Japan were contrasted with standard Anglo-Saxon practice, business analysts and management gurus took it for granted that different CG schemes were equally compatible with the notion of the free market economy.

For decades mainstream economic literature did not react to this challenge. It took time to acknowledge the importance of investigating the concept of "private ownership" (Fama & Jensen, 1983; Demsetz & Lehn, 1985). Only then did it become fashionable again to distinguish between ownership and control, to see a conflict between the interest of shareholders and managers, as some authors had already posited several decades earlier (Berle & Means, 1932; Galbraith, 1967). The emerging new stream of research started from two trivial assertions which were in direct conflict with the mainstream academic textbooks: (i) there is more than one market economy model; (ii) the German, Japanese and Anglo-Saxon models peacefully coexist, but are not equally efficient.

For East European economists raised in the Marxist tradition the question of ownership and the links between ownership and the ways firms operate were central issues of the Marxian heritage. The question "does ownership matter" (Pejovich, 1990) had always been considered and the answer was an unconditional "yes". East European economists – whether dogmatic Marxists or liberal reformers – could have congratulated themselves saying that "our Western colleagues have now discovered what we always knew". As public ownership had always had a variety of sub-forms (state owned enterprises, industrial trusts, industrial co-operatives, state farms, agricultural co-operatives, etc.), they performed differently in terms of technological progress, productivity and quality. Policy debates in the eastern countries always centred on the question of ownership.

This East-West discrepancy was partially linked to the difference in methodology traditionally used by eastern and western economists at the turn of the 1980s and 1990s. The Marxist political economy always looked at the world from a macroeconomic (or more traditionally: a political economy) viewpoint. The alleged superiority of state ownership *vis-à-vis* the operation of free markets was always meant in this sense. This superiority was "proven" with a reference to the "planned and balanced development of the entire national economy", rather than the superiority of a representative socialist firm compared with a representative capitalist firm. This was in contrast with the mainstream (western) microeconomic approach through which the efficiency of the representative firm was discussed in the context of competition with all other firms. In Western literature, it was only occasionally discussed whether, in a competi-

tive capitalist environment, efficiency is influenced at all by the type of private ownership of a given firm.

In the Western perception, Eastern European managers were not taken seriously, meriting rigorous analysis and evaluation. In this interpretation SOE managers were not qualified experts. They were merely politically trustworthy bureaucrats designated by the communist party. These managers were only interested in plan fulfilment and they were totally unconcerned by the profitability of their firms. Innovation or the satisfaction of consumers was not important. As will be shown later, this was a distorted view. But in an important way the Western perception was correct, nevertheless: the legal-institutional setups of the two systems were indeed different, as illustrated by Table 1.

Table 1. The different institutional models of SOEs and Western-type business corporations

	State-owned enterprises	Corporations
1	Separation of firms is formal, their assets and liabilities are not precisely registered. Enterprises can be merged or separated at any time	Incorporated firms are independent entities. Their assets and liabilities are unequivocally separated from each other and from the assets of their owners
2	The totalitarian leader's and the state apparatus' responsibilities are not defined. The management' decision-making power is limited to labour issues (e.g. hiring and firing)	Owners have limited liability up to the amount of their invested capital. Creditors know that in case of bankruptcy they cannot rely on owners beyond this limit
3	The three owner groups are simultaneously responsible for the daily operation of the enterprise	The company is controlled by bodies, which are chosen by owners. Shareholders cannot directly intervene in the daily issues of the firm
4	The one-man manager of the company is appointed by the party-state. The manager has unlimited right to sign and to appoint. There are two other important players as well: the Chief Engineer and the Chief Accountant	Strategic decisions are made by the General Manager or the Director appointed by shareholders. The Board and/or the Supervisory Board can limit decision rights of the Managing Director
5	The capital invested in the enterprise is indivisible. Fixed investment is a government "gift". There are no mechanisms to reduce (sell) the capital stock	The invested capital can be revoked at any time through the sale of shares
(6)	Company names serve the interests of the central governance (for example marking of place or product)	Company names are sales and marketing instruments; they are often identified with the founder's name

Source: Author's compilation.

Emphasising the differences between the institutional forms of the two systems on the one hand and emphasising the similarities in the behaviour of the leading managers operating in the two systems, on the other, help to explain why the socialist system survived for so many decades. Hence my answer, based on Kornai's work, is that it is essential to separate two questions:
(i) The institutional analysis, describing the legal setup of firms in socialist and market economies (Table 1); and
(ii) The behavioural analysis of leading managers working in the two systems (see Table 2).

2. The principle – agent theory is not enough

The recent experience gained in post-communist countries brought many surprises for observers. Now it seems that the lessons learned from studying socialist firms remain partly relevant in the present, capitalist environment, too. With the benefit of hindsight, it seems that the difficulties experienced by the large SOEs are not rooted merely in the form of socialist ownership, but they arised, to a significant extent, from the fact that SOEs were typically very large firms.

Initially in textbooks of business economics the conflict between senior executives and shareholders was simplified to an epistemological question. With reference to the principle-agent theory it was argued that the conflict between managers and owners was rooted in the existence of information asymmetry. If managers are lazy or make a decision contrary to the interest of the firm shareholders do not necessarily notice this because they do not have an insight into the daily management of affairs. This interpretation goes back to a frequently quoted remark of Adam Smith speaking of early capitalist shareholding companies.[4] This explanation was later claimed to hold good in the case of SOEs as well.

For a while it seemed that the solution was simple: managers should be given the possibility to receive a certain part of the profits. Once managers become shareholders themselves they will have no interest in harming the interests of shareholders. Eastern European economists, however, remembered very vividly that this had already been tried for decades in socialist countries. Since the Soviet Liberman (1962) reforms it was a widely used practice in many countries in Eastern Europe that top SOE managers were given a certain percentage of the enterprise's profit as a bonus. Unfortunately it very quickly turned out

[4] "[T]he directors of such [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery watch over their own. Negligence and profusion, therefore, must always prevail." (Smith, 1976, pp. 164-165).

that, whatever bonus-systems were tried, they did not much help to improve the productivity and product quality, while the growing earning gaps between workers on the one side and managers on the other, led to political discontent. In China in the 1980s and the 1990s some SOEs experimented by awarding shares to employees but the government stopped them, fearing that senior executives were siphoning off state assets, as had happened in Russia.

In contrast to all the above Kornai's starting point was different. In *Anti-equilibrium*, he built his argumentation on the managers' self-identification with their jobs – a single factor, which is sufficient in itself to generate a sequence of different contradictions. Kornai's model is more comprehensive than the standard neoclassical framework. It includes – *inter alia* – the fact manifest both in market and non-market economies that the objectives of top managers are not constant in time. It is simply not true that managers always maximise profits. This is not what is expected from them. In the socialist system the political leadership's preferences alternated between growth acceleration at certain times and growth deceleration when balance-of-payment constraints so required. On other occasions, product quality improvement and innovation or aiming at self-sufficiency in certain sectors (e.g. military, food, or energy) were

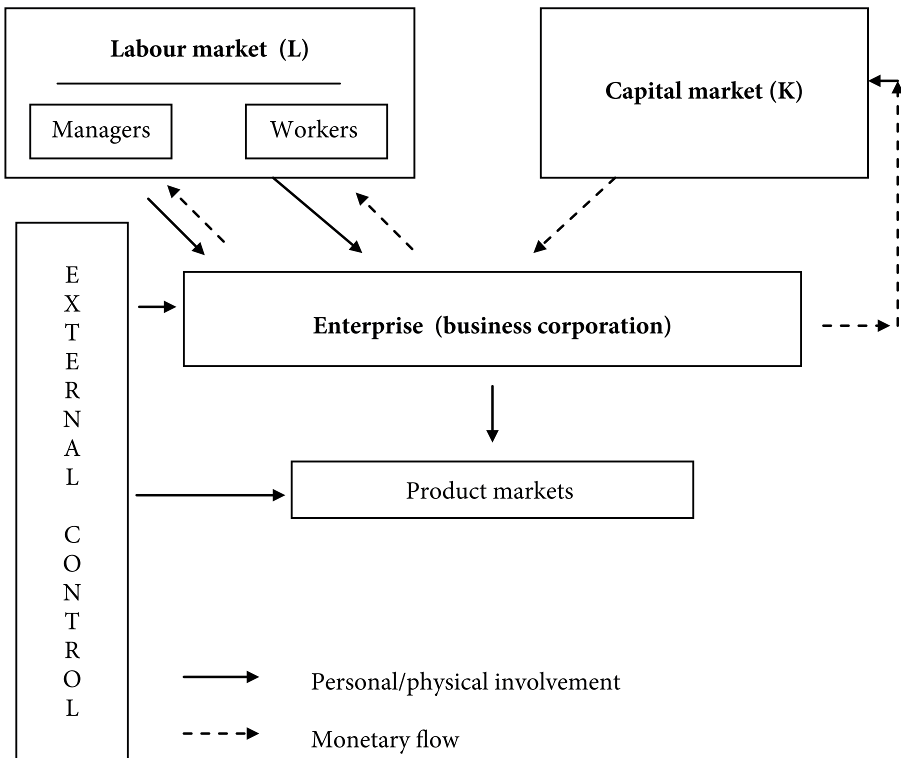

Figure 1. The neoclassical model of enterprise

declared as top goals. In developed market economies company managers are sometimes encouraged to increase profitability and at other times to increase market share disregarding the temporary loss of profit.

In modern mainstream theory, which is based on the theoretical unification of micro and macroeconomics, the underlying motivation of managers is depicted in the opposite way. It is assumed that work – all types of work, including the work of managers – is a disutility. This is the reason why everybody needs to be constantly incentivised: workers must be paid salaries and managers must be paid extra high salaries (Figure 1).

According to the neoclassical model, a firm operating on competitive markets both as a buyer and seller, is always capable of maximising the welfare (utility) of its main stakeholders: employees, customers and its owners. The employees receive wages amounting to the monetary value of their marginal products; the customers pay a price equal to the marginal costs, while the owners of capital are rewarded with the full amount of the firm's residual income. The flow of information and the competition among companies are all guaranteed by forces of the free market. Together with Kornai it can be stated that the neoclassical (Walrasian) model assumes that the firm is a black box with the task of fulfilling all the textbook-defined marginal conditions, including the maximisation of the present value of profit flows (Kornai, 1971, p. 22).

This is obviously a false start in many respects,[5] but the attention of this paper is only focussed on the behaviour of managers only. Their motivations and behaviours differ from those of the rest of the employees. This is not merely a quantitative difference. In the *Anti-equilibrium* (AE) and in his later works, Kornai argued at great length that it is simply wrong to assume that top managers work for money only. It is empirically not true that better paid managers always work better: "In the final analysis it can be said that on average a firm's manager tries *to do his job properly*, simply because a large proportion of people do so in most situations without any special motives (Kornai, 1980, p. 62; emphasis in the original). "Why do people do the right thing? Kornai's answer in Chapter 13 to this question rests on his concept of "autonomous function",[6] as one very important component of the control system that regulates economic and social activities irrespective of the system of ownership.

In Kornai's terminology, autonomous function means the routine, day-to-day operation of a system. However, the process of decision-making is entirely different when non-recurring, irrevocable decisions are made in private life or in business. When people make the choice of buying a car every three or four

[5] Kornai in the *Anti-equilibrium* provided a detailed criticism of many other suppositions of the Walrasian model (Mihalyi, 2013; 2017).

[6] It is worth noting that the Hungarian, original edition, used a biological metaphor here ("vegetative control") which is closer to the concept of evolutionary economics than the English translation which directs the readers' mind toward mechanics and computer science.

year, deciding to purchase a house once or twice in their life, or choose a lifetime marriage partner, make a decision on having children, they are driven by considerations, which are very far from the *homo oeconomicus* model underlying the various models of the general equilibrium theory (GET) (Arrow & Debreu, 1954). The same holds in business. Large, business-critical investment decisions such as building a new plant, merging with a major industrial competitor, or investing millions of dollars in a new innovation are never based on price information alone, as the representatives of GET contend in their argumentation. Many decades after AE this differentiation between recurring and non-recurring decisions has become a triviality as a result of the well-publicised results of experimental psychology (Kahneman, 2011), where the title of the book already underscored the same, fundamental difference: *Thinking Fast and Slow*.

Returning to Kornai's *Anti-equilibrium* his assertion is that this autonomous function is based on the average capabilities and diligence of participating co-workers, on the one hand and on their self-identification with the job on the other (Kornai, 1971, pp. 177-178). Leading executives behave in the same way. They keep on fighting for their job, for maintaining the power of the firm they manage. This requires – *inter alia* – calmness, the capability to manage conflicts, as well as the contest for securing the maximum amount of resources for himself and his firm (Table 2). In other words, it is not true that work is a sac-

Table 2. The identical motivation of senior executives in market economies and socialist planned economies

	Motivation	Explanation
1	Political and moral conviction	Leaders generally accept the prevailing political ideology of the nation state
2	Identification with scope of activities	Managers, as with people in general, usually like working properly and are committed to their profession
3	Power	Only those people become leaders who are, at least, a little bit attracted by power
4	Prestige	Social prestige depends on the person's place on the social ladder and the company's size and importance
5	Financial benefits	Payments are usually proportional to the person's place in the hierarchy and the company's size and importance
6	Calmness	Corporate leaders try to avoid conflicts with their bosses, suppliers, buyers or authorities
7	Fear from punishment	Corporate managers also have their bosses and other external monitoring authorities, which have the possibility to reprimand

Source: Own compilation based on: (Kornai, 1992, pp. 118-121).

rifice for managers, which needs to be compensated with pay. The managerial work is itself a source of enjoyment, an activity which carries its own utility for the manager. This is equally true in a market economy and in the socialist system. Furthermore, experience has ascertained on thousands of occasions that the salary of managers does not depend on the marginal product of their work. Their salaries are proportional to the size of the firm, where they work and the relative position which a given manager holds in the firm's hierarchy (Girma, Thompson, & Wright, 2002).

3. Individual versus collective leadership?

In the corporate governance business literature, it has been a hotly debated issue since the collapse of Robert Maxwell's Mirror Group News International, whether it is desirable that listed companies give full authority to a single person as President and CEO of the firm. Following the Report of the Cadbury Commission, in some companies the separation of the two positions was insisted upon by the UK authorities. The same dilemma was well-known in the former socialist countries. In most countries, most of the time the general rule was that a single person, the Managing Director, controlled SOEs.[7] The institutions of collective leadership were nowhere institutionalised, or if this happened, it was merely a formality. With the benefit of hindsight, the explanation is trivial: for the central state-party authorities it was easier to negotiate the allocation of economic input resources (raw materials, imports, money, etc.) with a single person rather than with an elected body of company management.

However, this controversy about individual versus collective leadership can be more meaningfully analysed applying Kornai's autonomous function concept. As was already illustrated in the *Anti-equilibrium* and later in his other writings, the autonomous function is characterised by inertia and the natural inclination to self-repetition. It is even possible to state that this is the natural state of all systems. In such situations, collective leadership, the *ex ante*, collective discussion of possible actions is the more promising approach. By contrast the two alternative situations should be handled according to a different logic. First, it is necessary to look at the dilemma in the time dimension: the example of sudden transformations. In times when the general rules of the society and the economy are changing and the number of routine decisions is diminishing, one-time decisions, sharp conflicts, sudden changes in company strategy are the order of the day. This conclusion holds good for the post-communist transition period too (Mihalyi, 1993; 1997). It is not by chance that those firms which managed to survive this turbulent epoch and stayed in business, even in the newly established market economy competition, were usually ruled

[7] In Russian, the system was called *edinonachalie*, meaning literally "one-man management".

by a single business leader for a relatively long time (5-10 years). The second dimension is geographic space. The US economy, the world's Number 1 economic and political power-centre is, in a way, in an extraordinary situation all the time. Senior executives of giant American firms cannot operate by repeating previous decisions. They need to generate change, to introduce innovations and to undertake risk, because they lead the world's leading firms in a given industry. Under such circumstances a one-person rule is simply better than a consensus-seeking, collective leadership.

Individual leadership, however, leads to intrinsic trade-offs. It is worth recalling that the principal-agent relationship is essentially vertical, while asymmetric information might well arise among horizontal partners – e.g. between heads of different divisions – or among different investor groups. The one who works more on an issue is likely to know more about the matter, hence information asymmetry is generated. There is simply no panacea, no full solution to the problem. It is the unavoidable result of specialisation, the social division of labour. The trade-offs arise because in business life there are no sharp border lines between opinion conflicts arising from

- asymmetric information (as described above),
- variation of expert opinion over the sources and causes of risk and
- the different perception of individuals concerning risk in general.

In reality, therefore, it is extremely difficult to distinguish irresponsible risk taking from dishonest management. Long-term investment projects or voluminous M&A transactions are examples, where *ex-ante assessment* of profitability held by management and outside shareholders can substantially diverge for all three reasons. As Keynes (1936) sarcastically noted in a famous passage of the *General Theory* "Business men play a mixed game of skill and chance. (…) If human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a farm, there may not be much investment merely as a result of cold calculation." (p. 150).

At this point it is worth considering one of the starting points of this paper, where the intrinsic moral loading of judging the work of business leaders was hypothesised. As they make decisions under time, pressure and stress, they often make mistakes or leave important factors out of their calculations. *Ex post*, however, when the consequences of a given business decision become clear, a wrong decision can be easily qualified as a corrupt deal by outsiders. This was again a dilemma, well known in the now defunct socialist system (Bauer, 1976), but also in the everyday practices of developed market economies of today.

Conclusions

The main hypothesis of this paper is that the motivation of business leaders in present-day market economies is in many ways similar to the top managers of state owned enterprises (SOEs) under socialism. This simple idea arises from Janos Kornai's pioneering work, the *Anti-Equilibrium*: educated humans in the modern world function similarly under all circumstances. At the same time, it is true – and this paper does not challenge this – that SOEs had a very different institutional setup when compared to large, listed corporations, let alone large multinational companies. Theses institutional differences explain the systems' capabilities to innovate and increase productivity. The record of the SOEs was poor in this regard and the gap between the economic systems therefore widened during the second half of the 20th century. Although the senior executives of SOEs did work hard, this was only sufficient to keep the system running, but not to catch up with the more advanced firms in the world economy.

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