

PRINCIPAL-AGENT PROBLEMS IN PUBLICLY OWNED ENTERPRISES: THE FAILURE OF THE SHAREHOLDER

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Abstract

How to cite this paper: Zejnullahu, N. (2021). Principal-agent problems in publicly owned enterprises: The failure of the shareholder. *Journal of Governance & Regulation*, 10(4), 70-83.
<https://doi.org/10.22495/jgrv10i4art6>

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ISSN Print: 2220-9352
ISSN Online: 2306-6784

Received: 03.06.2021
Accepted: 06.09.2021

JEL Classification: H4, K2, P2
DOI: 10.22495/jgrv10i4art6

The presence of principal-agent problems in publicly owned enterprises is highlighted by many scholars. Unfortunately, such problems are present in publicly owned enterprises (POEs) in Kosovo too. Capture, rent-seeking, moral hazard, information asymmetry, and adverse selection are some of the agency problems that POEs in Kosovo are facing, negatively impacting their performance and citizens' welfare. Recently, one of the POEs that used to be the most profitable is on the verge of bankruptcy with bank accounts blocked. This paper aims to explore the relevance of principal-agent problems in the governance of publicly owned enterprises and the failure of the shareholder to play its role and pursue the best interest of POEs. The paper also questions the applicability of the principal-agent model in POEs when the shareholder fails to play its role as a principal by concluding that the lack of "real" principal in publicly owned enterprises undermines the applicability of principal-agent theory and there is a need to make the Government more responsible by taking some measures such as the inclusion of private sector as a shareholder. The paper concludes that the Government must act as a responsible shareholder and exercise its role properly while also raises the opportunity of the inclusion of the private sector as minority shareholders in POEs, which may help in increasing the responsibility of the shareholder in the oversight of the management of POEs. Conclusions of the paper may be relevant for further studies regarding the corporate governance and structure of publicly owned enterprises from the perspective of the agency theory and hence exploring possibilities of reducing principal-agent problems in POEs.

Keywords: Publicly Owned Enterprises, Agency Problems, Principal, Agent, Legal, Performance, Shareholder, Failure

Authors' individual contribution: The Author is responsible for all the contributions to the paper according to CRediT (Contributor Roles Taxonomy) standards.

Declaration of conflicting interests: The Author declares that there is no conflict of interest.

Acknowledgements: This research was finalised during the visit of the author as a Fulbright scholar at the University of Iowa, Faculty of Law. The author thanks Fulbright and the University of Iowa for enabling the use of the library of the University of Iowa.

1. INTRODUCTION

Publicly owned enterprises (POEs) in Kosovo provide electrical energy supply, telecommunications

services, railway transport services, air control services as well as water and wastewater services, mainly at the municipal level. Telecommunications and energy companies currently are estimated as

the biggest employers in Kosovo, with Kosovo Energy Corporation JSC (KEK) that employs about 5,000 people (KDI, 2014) and Kosovo Telecom employs about 2,400 people (KDI, 2014). These companies have a significant impact on the performance of other economic sectors.

Agency theory encapsulates the structure of the relationship between the principal and the agent, with the former delegating to the latter the authority to act on his behalf. This theory is based on the concept of rationality, with two main rational models serving as a basis on which to explain the actions of agents and principals under agency theory.

The principal-agent model (PAM) is one of the methods for explaining corporate structure and relationships in POEs. Public enterprises are corporations, albeit with different ownership and organizational structure. The first question that may arise is who the principal is and who the agent is and the answer is that there are multiple principal-agent relationships in POEs, but one of the most important is the one between the Government acting as the shareholder on behalf of the state (principal) and the board and management of POEs (agents).

PAM provides that principal-agent problems may occur due to a conflict of interest between the principal and the agent since both parties are driven by their personal interests.

The current situation of POEs in Kosovo indicates a strong presence of principal-agent problems such as capture, rent-seeking, information asymmetry, and moral hazard that adversely affect the performance of POEs and cause social costs rather than benefits, in addition to the lack of enforcement and accountability (Zejnnullahu, 2018). With the current performance of POEs in Kosovo, it is questionable as to whether a balance in the principal-agent relationship takes place, if the agent acts in the principal's best interest and if the oversight and monitoring process works properly. Many recent studies highlight the influence of politics in appointing board members in POEs (KDI, 2021).

Reducing principal-agent problems and therefore their negative consequences is a constant interest of the scholars in all types of governance and enterprises. However, when it comes to POEs the problem becomes more complex. Should we rely only on the principal-agent model on explaining some of the problems in POEs or can more be done? What if the shareholder does act in the best interest of the enterprise and hence does not act as a principal?

This paper aims to highlight the importance of the role of the shareholder in the functionality of POEs and assess the applicability of a principal-agent model in cases when the principal does not act as principal with traditional interests on the performance of the enterprise, in the case of Kosovo.

This remainder of the paper is structured as follows. Section 2 focuses on the literature review while Section 3 describes the research methodology. Section 4 provides results and a detailed discussion on the topic and Section 5 concludes.

2. LITERATURE REVIEW

2.1. Previous research assessment

Principal-agent problems are present in all types of organizations irrespective of the type of organizational structure, as well as in POEs. However, to date, most research papers have focused on examining principal-agent problems in privately owned enterprises.

Previous research was mainly conducted by NGOs and other institutions analysing legal, economic, and policy problems and issues in Kosovo. In this regard, there are few policy papers addressing the commercial performance of the POE, corporate governance in general terms, and the impact of politics on the overall performance of POE in Kosovo.

Some of the policy papers and other publications include amongst others the following:

- boards of politics (KDI, 2021);
- corporate governance in publicly owned enterprises in Kosovo (improving transparency and governance of public funds in Kosovo) (Riinvest Institute, 2012);
- publicly owned enterprises legislation and cooperation with official institutions (GAP Institute, 2015);
- management of publicly owned enterprises (GAP Institute, 2015);
- institutional and public enterprises transparency in Kosovo III policy research: Evaluation of the transparency of municipalities (Lëvizja FOL, 2012);
- improving the corporate governance framework and transparency in publicly owned enterprises in Kosovo (Riinvest Institute, 2006).

However, to date, there is no available article, paper, or study related to the subject of principal-agent problems in public enterprises in Kosovo. Since there is not yet a study addressing the principal-agent problems and to date, there are only above listed policy studies regarding POEs in Kosovo.

Although there is no previous research related to POEs in Kosovo in particular, there are previous research attempts in approaching state-owned enterprises from the perspective of corporate governance and agency problems in particular from many authors.

Okhmatovskiy, Grosman, and Sun (2021) highlight that in state-owned enterprises aside from principal-agent problems; there are also principal-principal problems that may arise when the Government as a dominant shareholder elects the CEO.

Ginting and Naqvi (2020) claim that based on the principal-agent argument, state-owned enterprises suggest being not run by their owner but instead by managers who have fewer incentives to manage them efficiently.

Ratnasabapathy (2019) argues that greater efficiency of state-owned enterprises may only be expected through "better governance, addressing the fundamental weaknesses in the political system and adopting a comprehensive system of corporate governance for State enterprises".

Wagner (2019) mentions that multiple owners — shareholders and the Government — “significantly exacerbates what is referred to as the principal-agent problem” in state-owned enterprises.

Rajavuori (2017) argues that governance of state-owned enterprises may be based on guidelines, however, such guidelines are mainly focused on governing shareholders (in this case the state) while the account of public functions of state shareholders is incomplete. In this regard, the author argues that there is a need for extensive regulation for the governance of state-owned enterprises.

Vagliasindi (2008) emphasizes the importance and the positive connection between the composition of the board of directors and the financial performance of state-owned enterprises. A sufficient number of independent board members and the exercises of effective monitoring are identified as considerable milestones and challenges for state-owned enterprises. Further, the author calls for more attention on the board procedures, the selection of the board, and the evaluation process, in order to keep the board away from the interference of the Government.

Challenges in the governance of state-owned enterprises are identified also by Macias (2009) in his paper. Musacchio and Flores-Macias (2009) maintains that although there are some institutional advances recently in the management of state-owned enterprises, still the interest of politicians to interfere in the management of state-owned enterprises will not disappear. The interest for interference in the management of state-owned enterprises is seen as a tool for politicians to seek geopolitical gains mainly through state-owned enterprises in strategic sectors such as energy.

Smith and Otto (2011) highlight that the principal-agent problem has already met the public sector, in particular the Government entities including enterprises, since the intervention of the Government to save such entities from dying creates an opportunity for principal-agent problems.

Jia, Huang, and Zhang (2019) recognise the presence of agency risk in state-owned enterprises. Authors based their research on a case study in China’s state-owned enterprises and they found that better alignment of private incentives of agents, stronger monitoring, and higher-quality corporate governance through better corporate governance tools, reduces the agency risk in state-owned enterprises.

Kamal (2010) also identifies lack of transparency, conflicting objectives, and agency issues as major problems in state-owned enterprises, identifying agency issues as political interference. Kamal (2010) highlights that agency issues appear in state-owned enterprises due to the fact that politicians and bureaucrats tend to pursue their personal interests as agents and they do not work in accordance with the best interest of the society as the real owner of such enterprises. Kamal (2010) suggests that corporate governance is designed to deal with agency problems in state-owned enterprises with dispersed shareholders rather than in other state-owned enterprises having only the state as a shareholder. In his study, the author concluded that the Indonesian code on corporate governance failed to address critical problems in state-owned enterprises mainly agency problems (political interference).

Hongying (2014) argues that state-owned enterprises in China faced with major problems such as inefficiency and management lack of energy. According to Hongying (2014), principal-agent problems remain unsolved in state-owned enterprises in China, mainly due to the infinite loop of principal-agent problems, since ownership rights in these enterprises are not effectively exercised, and no actor really cares for the interest of state-owned enterprises, which leads to the lack of responsibility for managers.

Mengistae and Xu (2002) in their study confirm the applicability of agency theory in state-owned enterprises management since they found implications of agency theory mainly on the managerial compensation in state-owned enterprises.

Xu, Zhu, and Lin (2002) emphasize the effects of political control and the presence of agency problems in state-owned enterprises in China. Authors conclude that the performance of enterprises is positively affected in cases when the control of politicians is lower that leads to better flexibility of the enterprise in labour deployment, leading to reduced agency costs through more effective mechanisms of corporate governance.

Aside, from the challenges and problems identified in the corporate governance of state-owned enterprises, the authors also provide some best models. Frederick (2011) points out successful models of corporate governance such as in Nordic countries. The author highlights limitations on the decision-making powers of the board as a positive element since board members still feel that they have enough autonomy and still pursue best practices.

It is also important to highlight Frederick’s (2011) findings that in such states like Norway, the state still operates through the board but what is more important is that such boards function independently from the state. Although ministers that represent Government as a shareholder may issue directives, still this happens very rarely, that shows the independence of boards in governing state-owned enterprises.

Studies show that in some countries such as Nordic ones, Australia, New Zealand, and the United Kingdom, state-owned enterprises function with successful models since boards are truly independent, they operate autonomously and the influence of the state through Government is “measured, transparent and bounded by clear procedures”.

2.2. Principal-agent problems in POEs

In POEs in Kosovo, there are different principals and different agents, due to the different roles of shareholders and management. For this paper, we have focused on the main agency relationship: the Government (principal) vs. board of directors (agent).

The very first principal in the case of POEs may be the citizens, whose welfare is supposed to be maximized by the operations of POEs. In this respect, citizens as principals elect (Fukuyama, 2015) their representatives (agents) in the Assembly and the Government to represent them and ensure such maximization.

In the second instance, elected officials in the Assembly and the Government will not be able to run and administer POEs by themselves. As such, they hire a board of directors to run and administer

the POE on their behalf, again with the final purpose of maximizing benefits from POEs.

The question here is whether and to what extent elected officials and boards of directors act as agents and make decisions for maximizing the welfare of principals by ensuring the effective operation of POEs. Back in 1962, Buchanan and Tullock (1965) argued that public officials are not different from other actors in private companies. Therefore, public officials act in the same manner and their actions are oriented towards self-interests (Buchanan & Tullock, 1965).

The question raised at this point is whether shareholders and management will act differently in running a POE, supposed to be in the service of maximizing welfare and protecting the best interests of the public.

Therefore, board members and management will work for the benefits of the POE if such benefits are in line with self-interest or help them to achieve their personal goals. Later, in this paper, we will provide some thoughts on the applicability of the principal-agent model in cases when the shareholder fails to play its part as a principal.

The board and management in POEs have the same agent duties, with a focus on fiduciary duties — duties to perform in accordance with the best interests of the POE and compliance with the instructions of shareholders (Law No. 03/L-087 on Publicly Owned Enterprises).

Rhee (2018) highlighted the importance of the so-called “shareholders primacy”. In a nutshell, shareholders primacy is the concept of having shareholders with priority interests in both the economics and governance of the enterprise (Rhee, 2018). The concept of shareholders primacy is judicially embraced in the United States of America, starting with the Dodge case (*Dodge v. Ford Motor Co*, 1919), and it is also perceived as a concept with a legal foundation and not a social norm (Rhee, 2018).

In the case of Kosovo’s POEs, the shareholder primacy has its legal foundations in the applicable law on POEs. It is expressly required in the law that POEs’ performance shall work to maximize long-term enterprise and shareholder value.

The duty to maximize the shareholder value is amongst other fiduciary duties of the board and management acting as agents for the Government (shareholder). Rhee (2018) defines fiduciary duties as liability rules, where the breach of such rules may result in legal liability.

Although agent duties are expressly specified in POEs in Kosovo as fiduciary duties, there are concerns in relation to the fulfilment of such duties and the performance of the board and management as agents in POEs, and more concerning is the fact that no legal liability is raised in such cases¹.

The mechanism of shareholder primacy may be useful to balance the interests of principal and agent when applied properly, which will be discussed later in this paper.

¹ It is concerning the fact that to date no board member or management member was dismissed or subject of legal liability for breaching fiduciary duties and poor performance of POEs in Kosovo. In 2018, there was a dismissal of board members of certain POEs but only for the reason of having them appointed in violation with the law and only after the pressure of the European Union Office in Kosovo after the Anti-Corruption Agency decided that their appointment violated the applicable law. All other dismissals that followed later were based on changes in the Government: different ruling political parties replaced board members with new ones (mainly political affiliated).

The presence of principal-agent problems is obvious in Kosovo’s POEs. The tendency for the capture of POEs by certain groups of interest, mainly political parties, is obvious. It starts with the appointment of board members, which are in most cases directly or indirectly connected with political parties, and ends with decision-making, which leads to the fulfilment of interests of certain groups, mainly ruling political parties. In all POEs, most board members have clear political connections.

In a previous study, we found that out of 101 board members in 17 POEs only 29 are independent or at least no data is publicly available for their political connections, while the remaining 72 are connected directly or indirectly with political parties. Some of them are only members of political parties while some of them have run in elections on behalf of certain parties. In principle, the law does not prohibit members of political parties to serve on the boards of POEs; however, the problem is not their membership in the party the problem is that such membership is a criterion to serve in the board instead of professional requirements established by the law.

Having this said, the concept of “capture” comes on board. Although in principle, the concept of capture is mainly associated with the concept of “regulatory capture”, capture may be used also in explaining current problems in POEs in Kosovo.

The presence of capture in POEs in Kosovo may be elaborated in the sense that the Government acts indirectly as a regulator (through legislation) and thus principal is “captured” by a certain group of interests and its actions as the principal and regulator are dictated by such a group. Actions and policies of the Government will be reflected in the board’s work and, therefore, the POE, having the latter serving the interests of a certain group instead of public interests.

A few arguments in the current situation of the POEs in Kosovo support the assumption that POEs are “captured” with the focus on the above-explained appointment of board members. The argument of the “capture” of POEs by interests of political parties is strengthened by the publication of interceptions that were clear about the influence of particular political parties in the appointment of board members and in controlling their actions and decision-making by making them act and decide in accordance with the best interests of the group².

In addition, in coalition agreements deriving from negotiations to establish the Government, the political parties stated clearly that all public positions must be separated between two parties, although the law on POEs states that board members’ positions are independent and merit-based³.

² In 2016, a daily news portal published wiretapped conversations of officials of the biggest political party in the country from August to September 2016. Released wiretapped conversations led to suspicions that officials of the ruling party exert strong influence over public sector positions by deciding on who will be appointed to which position. The wiretapped conversations should focus on 4 conversations from over 20 published, which are directly related to the appointment of board members in Kosovo’s POEs.

The origin of the wiretapped conversations is not clear, nor is the authorization for such interception. The portal that published such tapes claims that the tapes were made between November and December 2011, when one of the members of the political party was under investigation for alleged corruption by the EU Rule of Law Mission (EULEX) in Kosovo.

³ The coalition agreement that ruled during 2014–2017, between two political parties — PDK and LDK — expressly states the following: “PDK and LDK agreed to equally share all management positions in the central level, according to the law”. In addition, the agreement states “the principle of equal sharing of positions applies to all positions established by the Government and the Assembly of Republic of Kosovo” (Institute for Development Policy, n.d.).

Payment of significant amounts of money to board members in the form of salaries, bonuses, and payments for serving on board committees provides a clear picture of the rent-seeking element in Kosovo's POEs bearing in mind that POEs have a negative performance and losses (The National Audit Office of the Republic of Kosovo, 2019).

Annual reports and reports of the Auditor General on the performance of POEs identify a few elements that find POEs in violation of the applicable law and making unjustified payments to board members, in addition to payments in the form of bonuses and other benefits that are mainly driven by rent-seeking, especially when POEs are helped by the Government through subventions or investments to keep them alive (Office of the Auditor General, 2014).

The Government is still providing subventions and capital investments to POEs in Kosovo. Such unconditional assistance provided by the Government creates opportunities for moral hazard.

Having the Government as a shareholder in central POEs in Kosovo creates an easy environment for information asymmetry, which leads to adverse selection. Due to the lack of an effective controlling mechanism that the Government (as a shareholder) exercises over the board, information asymmetry is present. This information asymmetry creates an advantage for the board and management in that they share with shareholders only the information that they think should be passed to the shareholders. Not having complete information causes the shareholder, which is the Government, in this case, to make decisions that would not be taken if they had access to complete information. In addition, due to this information asymmetry, the Government is not able to identify proper problems in POEs and, therefore, address such problems by taking the necessary measures.

The data from the Ministry of Economic Development (MED) shows in detail the financial and operational performance of POEs for the three years (Office of the Audit General, 2014). Such data show that during 2015-2017 there have been only slight improvements in the financial and operational performance of POEs, while in some of them the performance is weaker (Office of the Audit General, 2014).

The importance of the operational and financial performance of POEs to provide quality services and ensure the protection of public interests is obvious. Such importance is crucial due to the impact of POEs on the Government's budget.

If POEs' performance is satisfactory, this will have a positive impact first, on the welfare of citizens and second, on the Government's revenue in the forms of a dividend and tax payments. If the POE has negative financial and operational performance, this will be a burden on the budget of the Government, since the latter, as a shareholder will have to provide financing in the form of subventions or capital investments in the case of Kosovo.

There is a nexus between the weak performance of POEs and principal-agent problems. Aside from the general financial and operational performance of POEs, principal-agent problems have a negative impact on budget implications, such as the burden on the Government to fund POEs through subventions and capital investments, the small amount of dividends paid to the Government, and the tendency towards a decrease in the number of employees instead of creating more job opportunities.

Principal-agent problems are a part of the reason why the POEs' performance is weak. Due to the presence of capture in POEs, the board and management are mainly appointed based on political connections and, thus, act on and represent the interests of certain groups, which in this case is a political party. Since POEs' management is captured, there is no motivation towards decision-making and management of the POE in a way that would have positive results in performance. In addition, board members and management knowing the way, in which they are appointed, will not perform well since they are not afraid of possible dismissal due to weak performance. Although the law provides for such a possibility, the group of interest that has appointed them to such positions based on rational choice theory will act based on their preferences and not based on what we call public interest. For this group there is no common or public interest; such interest exists only if the POE is seen as a tool with which to satisfy personal interests and interests of the certain group.

The presence of rent-seeking indicates that this principal-agent problem has a negative impact on the performance of POEs. Board members and management of POEs seek to benefit as much as they can financially from the resources of the POE, usually by using POE's funds for their own financial interest to increase their wealth.

The same situation appears when it comes to moral hazards. Moral hazard leads the management of POEs to make decisions that are not in the best interests of POEs, all the while knowing that there is a backup plan. Since the Government of Kosovo exercises shareholder rights in POEs, in the majority of cases, although POEs have negative financial and operational performance, the Government intervenes to assist the POE with funds in the form of capital investments or subventions, which creates, at the same time, a financial burden for the Government and liability.

All the above lead to the weak financial and operational performance of POEs in Kosovo because of principal-agent problems between the government as the principal and the board as the agent.

Kosovo Telecom, one of the largest POEs in Kosovo since 2000, with more than 2,600 employees has collapsed since the private enforcement agent has blocked its bank accounts for the enforcement of 25 million Euro debt based on an award of international arbitration (Begisholli, 2019).

2.3. Shareholder's role as a principal

A major problem in POEs in Kosovo is the shareholder itself, the Government, for central POEs. As it is a practice in corporate law, shareholders usually have certain goals that they want to achieve with the help of the enterprise.

This "tradition" continued also with the latest coalition agreement between three political parties establishing the Government in September 2017. The coalition agreement same as previous one provides that public positions will be "shared" between the parties. During an interview with the local press, the ex-Prime Minister of Kosovo answered the critics which say that boards of POEs are highly politicized, admitting it in a way that makes it reasonable due to the fact that "in Kosovo there is nothing non-political" (Spahiu, 2016).

In the case of POEs, the goals are regulated by the law, which provides that the shareholder must have an ownership policy in place that defines the overall objectives of the state with respect to its ownership of POEs, including, if the Government desires, its strategic guidelines on the development of the business activities of such POEs, and its role in the corporate governance of central POEs; and shall also contain detailed provisions on how such ownership policy will be implemented.

The Government of Kosovo approved the ownership policy for POEs in 2008 and since then it has not been reviewed. The ownership policy of 2008 is good on paper although vague and too general, but even that is not being implemented. For example, the ownership policy provides that the main goal is maximizing the value for the shareholder and proper inclusion of the private sector, while the first one is not happening due to weak commercial and financial performance, the latter is nowhere on the horizon (Decision of the Government of the Republic of Kosovo no. 11/39 of 8 October 2008). The ownership policy calls for the governance of POEs in line with principles of the OECD, which in practice are not implemented (Decision of the Government of the Republic of Kosovo no. 11/39 of 8 October 2008).

In view of the above-mentioned challenges, the question is whether something can be done to improve this chaotic situation. In 2005, Fukuyama (2015) argued designing institutions to optimally align principal-agent problems are not possible for the following reasons: the ambiguity of goals, high transaction costs of monitoring and accountability, and issues with delegated discretion.

In principle, POEs are corporations just like the private ones; the only difference is the ownership. To explain the POEs through the principal-agent model and based on the shareholder's primacy principle we can see that the role of ownership is more challenging than it appears, and may impact the applicability of the principal-agent model in POEs.

Clear separation between ownership and management is one of the OECD principles that are critical for the effectiveness of corporate governance, in terms of providing proper autonomy for the management and having the state separate the roles of the owner and the market regulator (OECD, 2015).

This OECD principle also calls for the autonomy, transparency, and accountability of POE's boards, which should act separately from the Government as a shareholder (OECD, 2015).

There are many issues with the implementation of this principle in POEs in Kosovo. First, there is no clear separation between the Government and the management, but the question is whether the Government is aware and willing to have such separation. Although in the private sector, there is a concern that principal-agent problems occur due to the separation of ownership and management, by separation, it is not meant separation of goals but separations in terms of having the owner exercise the shareholder's role as monitoring and not interfering with day-to-day management of the enterprise.

One of the very first prerequisites for the Government to act as a shareholder is to have clear and realistic ownership goals. Without ownership

goals, it is difficult for the Government to act as a shareholder not knowing what the objectives are.

In previous sections, we have mentioned the concept of shareholder primacy as a recognized concept in corporate law also recognized by judicial practice, as explained in the Dodge case in the US (*Dodge v. Ford Motor Co.*, 1919). However, what is shareholder primacy and why is it important for the governance of POEs in Kosovo?

Shareholder primacy, in a nutshell, is the primary "role" of the shareholder in terms of having supremacy over other interests and in the function of maximizing the profit of the shareholder, assuming that maximizing the profit is one of the shareholder's goals.

The Law on Publicly Owned Enterprises (LPOEs) in Kosovo provide that a POE shall engage in its activities with a view to maximizing long-term enterprise and shareholder value. Furthermore, the law requires that the Government must adopt an ownership policy that will set forth the main objectives of the state as an owner. The Government of Kosovo approved its Ownership Policy for Central POEs in October 2008 (Decision of the Government of the Republic of Kosovo no. 11/39 of 8 October 2008). The ownership policy states that one of the main purposes of ownership of POEs is to maximize the value of shares by seeking to provide sustainable and positive profits.

The ownership policy for POEs has four main goals: 1) to ensure that the Government has a better understanding of the performance of POEs through better corporate governance, transparency, and performance management; 2) to develop proper capital structures that provide financial rules for POEs by ensuring that POEs have enough capital for operational investments with minimal resources from the state budget; 3) to ensure that capital requirements are developed in accordance with commercial needs of POEs. Such capital requirements must be in line with the preference of the Government that major investment is considered related to other capital requirements in the Government through the incorporation of POEs' requirements of equity in substantial investment in the regular state budget. And 4) to include the private sector in operations of POEs in order to be in a position where ownership is held by the Government only when necessary for the protection of public interests and not due to historical inertia (Government of Kosovo, 2008).

The ownership policy is also focused on the corporate governance of POEs. In this regard, it is stated that the Government of Kosovo seeks to establish effective and responsive corporate governance (Decision of the Government of the Republic of Kosovo no. 11/39 of 8 October 2008). Such effective corporate governance must be for the benefit of owners and shareholders and the overall economy and welfare of Kosovo (Decision of the Government of the Republic of Kosovo no. 11/39 of 8 October 2008).

The ownership policy also guarantees that by exercising ownership rights over POEs, the Government of Kosovo intends to follow recommendations provided by the OECD. The focus will be on OECD Principles of Corporate Governance and OECD Guidelines for Corporate Governance of State-Owned Enterprises (Decision of the Government of the Republic of Kosovo no. 11/39 of 8 October 2008).

Therefore, shareholder's primacy in the case of POEs in Kosovo is a law, not a social norm, which means that as law, its implementation is not optional, and the non-implementation is a violation of the law. Nevertheless, why is shareholder primacy important for this study? Its importance is mainly of legal nature, since understanding the concept of shareholder primacy may be useful to improve the governance and efficiency of POEs in Kosovo.

Shareholder primacy may be used as a tool to maximize the wealth of the shareholder and have interests of the shareholder in the center of the performance of POEs, thus having the interest of the shareholder (the Government) serving the welfare of its citizens. The Government, as a shareholder, must be aware that the law has provided for the shareholder primacy, and also corporate law and judicial cases recognized such a concept, that managers must serve to the maximization of wealth and best interest of the shareholder. In private corporations, there are

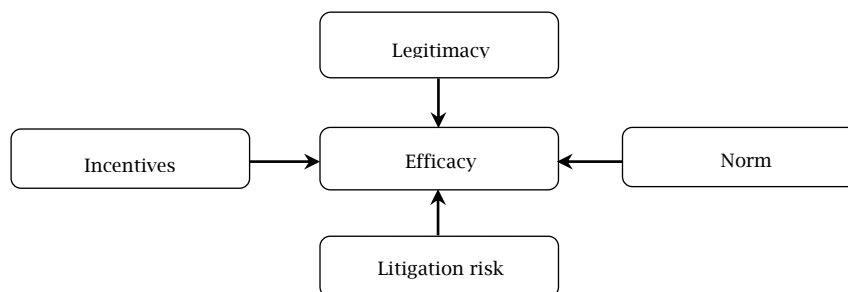
discussions about whether shareholder's primacy is a law or social norm and whether it is a rule-sanction (Rhee, 2018).

In the case of POEs in Kosovo, shareholder's primacy is a rule-sanction since the law is clearly authorizing the shareholder to dismiss board members in case of the breach of fiduciary duties, with the maximization of shareholder's profit being one of the fiduciary duties.

The maximization of the profit for the shareholder is embraced as a fiduciary duty in corporate law. There are also judicial cases that embrace it, such as the case of 2010 in the Court of Delaware where the judge ruled that "directors are bound by fiduciary duties and standards including acting to promote the value of the corporation for the benefit of its stockholders" (*eBay Domestic Holdings Inc. v. Newmark*, 2010).

Rhee (2018) has developed the model of making the shareholder's primacy work in practice through the following:

Figure 1. Model for shareholder's primacy



Source: Rhee (2018).

Therefore, according to Rhee (2018), the shareholder's primacy may be achieved if there is a legitimacy of such obligation, incentives for managers, litigation risks, and social norms. In the case of POEs in Kosovo, all three may be applicable while the social norm idea is different.

2.4. Shareholder's failure in Kosovo's POEs

Legitimacy requires the embracing of the concept of shareholder's primacy by the judiciary both at legal and factual levels (Rhee, 2018). Shareholder's primacy already is both legitimate and legal in Kosovo's legal system. The law in force expressively provides that interests and wealth maximization of the shareholder is one of the goals which represents a fiduciary duty for the board of directors. Therefore, in this regard, the first pathway towards implementing the shareholder's primacy concept effectively and having performance from POEs that would serve the best interest of the Government and indirectly the citizens in Kosovo is established.

Incentives consist of both positive and negative incentives inherent in performance-based compensation (Rhee, 2018). The pathway of incentives for implementing shareholder primacy is imbalanced and difficult in the case of POEs in Kosovo. First, it is imbalanced since so far, the shareholder was not interested in applying negative incentives while the positive incentives are present and highly flexible. Most board members that serve in POEs are taken out of their position only upon termination of their mandate. There are no significant cases in

Kosovo's POEs where the shareholder would exercise the legal right to dismiss board members for poor performance and breach of fiduciary duties, while, in turn, board members have received considerable amounts of salaries for Kosovo's economic standard. They are also free to decide on establishing additional committees in the enterprise, serve in such committees, and get paid extra.

Recently Kosovo changed three Governments within a period of fewer than 12 months. One of the Governments that took the mandate in February 2020 while the same experienced a no-confidence vote in April 2020, during its short life, the new Government undertook few measures by dismissing boards of POEs during a period of few weeks.

In the beginning, this action seemed positive, however, the same was an object to criticism based on two grounds. First, it is considered that the process of dismissal is not done based on documents and performance evaluation but only based on political preferences. Second, the disappointment happened when the new Government that proclaimed the dismissal of board members as success and as measures to improve POEs, their management, and performance, replaced dismissed board members with individuals affiliated and related to the political party running the Government (Fana & Dahsyla, 2020). The same course continued with the next Government, which, again dismissed board members appointed by the previous Government, and, again, appointed as board members individuals close to the ruling political party (Gazeta Express, 2020). The same practice is continuing after the new

Government was voted in March 2021, while board members are being dismissed and new ones are being appointed with the criticism that such appointments are not being made based on the merits but based on the connection with the ruling political party (Freedom House, 2021).

These actions again showed that politicians in the Government see POEs as instruments to control them and place individuals with political affiliation and preferences and continued the same practice that has taken place in Kosovo at least since 2008 when the country declared its independence and the law on POEs entered into force.

Rhee (2018) argues that the combination of performance-based executive compensation, rules of corporate law on determining the liability of the management motivate the management to comply with shareholder's wealth maximization.

This may be working in a scenario when the shareholder is interested in maximizing profit and effective performance of the enterprise, but in the case of POEs in Kosovo, it seems unlikely due to the absence of a real shareholder's role exercised by the Government. This may be easily improved if the Government would be willing and interested to act as a responsible shareholder. How we achieve this is highly questionable and we will discuss this in the next sections.

Litigation risk consists of the litigation risks in cases when managers do not comply with fiduciary duties, hence the risk that shareholders may sue managers for non-compliance and violation of the law (Rhee, 2018). The litigation risk is not only applicable to managers but also to board members in the case of POEs in Kosovo. In this regard, again Kosovo fails the implementation.

In 2018, a new Law on Business Organizations (Law No. 06/L-016 of 2018) was adopted, introducing the concept of both direct lawsuits and derivative lawsuits. The LPOEs stipulates that the provisions of the Law on Business Organizations — governing joint-stock companies, their directors, their management, their shareholders and the rights and obligations of each — shall fully apply to POEs, their directors, their management, and their shareholders unless the present law (meaning the LPOEs) specifically and explicitly provides otherwise. Since the LPOEs do not have any provision addressing the lawsuits, provisions of the Law on Business Organizations applies also to POEs, hence vesting the shareholder with the right to sue board members for compensation of damages caused to him and/or the corporation by the violation of the duties specified in any law in force (Law No. 06/L-016 of 2018).

In view of the above, we argue that the Kosovo's Government as a shareholder may use such right as a mechanism for more accountability and responsibility from the directors serving in the board. However, the Government is failing to use litigation risks as a pathway to benefit from the shareholder's primacy concept because although there is a law in force that provides for such a right, the Government is not likely to use these rights against board members with poor performance since it does not consider them as board members that have the legal obligation to perform and comply with fiduciary duties but as their "people" needed in

such positions to use the POE for personal and group agendas.

Finally, regarding the norm, its application also is challenging in Kosovo's POEs. Authors agree that shareholder's primacy is in most cases a social norm although in Kosovo it is a rule-sanction specified in the law. Social norms are not considered by laws but norms that ought to be followed and set by a certain community or society (Lapinski & Rimal, 2005). In our case, shareholder's primacy is also considered by corporate law authors as a social norm and as such may strengthen the concept of shareholder's primacy once combined with the three other features (Rhee, 2018).

The community of business in private corporations is different compared to POEs. In the case of POEs in Kosovo, it is difficult to admit that there is a social norm that board members must work in the best interest of the shareholder since the practice does not show that there is such interest amongst board members or the Government. One of the reasons may be the fact that individuals serving as board members are aware that the reason why they are appointed is not their capability but "loyalty" towards specific influential political parties.

As already emphasized, the only document that reflects the goals of the state of Kosovo as an owner of POEs is the ownership policy, which is broad and as such not implemented in practice. Since 2008, the Government has failed to address all ownership goals stated in the ownership policy. To date there is no proper and effective governance in any of the POEs in Kosovo or such effectiveness is extremely weak. The Government has failed to include the private sector in operations of POEs in order to be in a position where ownership is held by the Government only when necessary for the protection of public interests and not due to historical inertia, in the case of Kosovo it seems the other way around.

Implementing an ownership policy seems to be one of the very first steps towards effective separation of ownership and management and toward improving the performance of POEs. Why would the Government now adopt and implement a proper ownership policy since they have not implemented the one from 2008 or how do we make the Government a responsible shareholder since it is exercising shareholder's rights on behalf of the state? In a few words, how do we ensure that the Government acts responsibly?

3. RESEARCH METHODOLOGY

The qualitative research methodology was used during the research for the purpose of answering the question of whether principal-agent theory may be applicable in cases when the shareholder fails to act as a responsible principal. To answer the above-mentioned research question first, the literature and legislation was reviewed, the evidence (data) was collected and analysed.

This research aimed at exploring and understanding the applicability of agency theory in POEs in Kosovo by identifying the presence of the principal-agent problem and concluding that there are few measures that may be undertaken to make the shareholder more responsible.

Mainly, during this research using the qualitative method, different categories of data collection were used such as participant observation, statistical data, and the use of literature and legislation. The interview approach was unstructured since this approach enabled understanding of the problem from the perspective of interviewed participants.

We used the one-on-one interview method since the interaction with participants was considered more informative. During the interviews, an in-depth discussion took place with participants. The researchers decided to use interviews as one of the methods of data collection since the topic is sensitive and the experiences of participants were useful and provided an important perspective to gain a deeper understanding of the problem.

4. RESULTS AND DISCUSSION

First, politicians running the Government must understand that running the political party and running the Government are not the same thing. From the practice so far in Kosovo, POEs' board members in most cases have political connections and are appointed based on such connections. This makes them vulnerable to the interests of political parties that happen to be a part of the Government. Therefore, the interests of the Government as a shareholder and those of management serve a certain group but not the public but to a certain political party.

However, one may well ask the point: Why political parties exist to be in the Government and thus pursuing their political programs and agenda and the Constitution or the Law does not prohibit individuals affiliated to political parties to serve in the board.

There are two problems with the above statement. First, it is obvious that political parties run the Government based on the vote of the people, but the problem in the case of POEs is that the Government sees them not as a measure to advance the welfare of citizens and thus win their trust, but as a tool to employ their militants, amongst others. Nothing would be wrong if one person is appointed to a board of a POE and has all the capability required by law, and has political connections, the problem occurs when the connection with a political party is the only criterion to serve in the board of a POE, such as in the case of Kosovo's POEs⁴.

Again, the question is how we make the Government a responsible shareholder. In private corporations, this is less complicated since shareholders have a direct ownership interest, and as principals, shareholders are driven by their personal interests. In the case of POEs, it is more complicated since individuals in the Government are only exercising shareholder rights on behalf of the state and they do not own the shares. Thus, the proper question would be how you make someone that is not a real shareholder a responsible shareholder.

In this case, the applicability of the principal-agent model in explaining shareholder vs. management relations in POEs is questionable.

The principal-agent model is built on the assumption that individuals pursue self-interest, and will act in accordance with their best interest. However, although the shareholder is a principal, the applicability of the principal-agent model in POEs is questionable since the shareholder is not being a "real" principal and is not pursuing its best interest since there is no direct interest as is the case with privately owned enterprises.

In privately owned enterprises, the applicability of the principal-agent model works since both principal and agent have personal interests that they pursue. In the case of POEs, this is challenging, because the individuals that run the Government act on behalf of the Government while the latter exercises shareholder's rights on behalf of the state, hence, the interest is not direct since the individuals in the Government do not own the shares and they will not lose or win more money if something goes wrong with the enterprise, which is the case in privately owned enterprises.

This brings us to the argument that the ownership of enterprises matters more than it is proclaimed, and the applicability of the principal-agent model in POEs is questionable in the absence of a "real" principal.

Aharoni (1982) argues that one of the problems of POEs is not necessarily agents but multiple principals, each of them impacted by their personal interest. Furthermore, such multiple principals and agents have often "ill-defined objectives" thus making the performance measure almost impossible (Aharoni, 1982).

There are many points where improvement may take place, although such improvement will not be a magic stick for eliminating principal-agent problems in POEs, it still would be a step towards reducing them.

The first and the most important is accountability. In principle, the management of POEs requires a balance between accountability and autonomy, in the sense that POEs need autonomy to run their daily operations but also POEs should be accountable to the Government and the Assembly for achieving the goals set by the Government (Aharoni, 1982).

Nevertheless, since our focus of the paper is the principal-agent relationship between the Government and the board and from the practice, we have seen that the Government is not even exercising accountability mechanisms in force, the question of who guards the guardian comes back, and in this case, who should guard the Government on exercising its duties.

The question of who guards the guardians is challenging, not only when it comes to the Government and POEs but in general. However, the first response that comes to mind is other guardians, in this case, citizens, voters who elect the political parties to run the Government.

As a solution to the conflicting objectives of multiple principals and multiple agents in POEs, Aharoni (1982) suggests "comprehensive audit". Such comprehensive audits should not only be a classical audit with the focus on accounting but a more comprehensive one including an examination of the objectives pursued, methods used, effectiveness in stating objectives and following them, and finally, the efficiency of performance, measured by the benefits received and utilized

⁴ It is already evidenced that appointments in boards of POEs is made based on political preferences, not based on the professional and eligibility criteria provided by the law in force.

resources (Aharoni, 1982). One of the functions of such an audit, Aharoni (1982) argues, would be that the results would be the subject of a public debate and decisions of the management and other state agents. In the case of Kosovo, that would include also the Government acting as an agent for the citizens under public scrutiny. Otherwise, according to Aharoni (1982) without an open system of goals and auditing, "state ownership may degenerate into a shift of power to a new managerial or bureaucratic class instead of achieving socially desirable objectives" (p. 255).

Although, a comprehensive audit is always welcomed, in the case of POEs in Kosovo, the comprehensive audit is unlikely to work. With the current legal framework, POEs have internal audit committees and are obliged once a year to have external audits. In addition, also the National Audit Office performs audits on POEs mainly focusing on their financial statements. The gaps, violations of the law and poor performance have been stated in many audit reports. The question is whether we will have a follow-up and actions on such findings. Again, the practice in Kosovo is showing that unfortunately, a "culture" of non-punishment has taken place. Again, this goes back to the Government as the only authority that appoints and dismisses the board members. Although the management of a POE is responsible for business operations of the POE, since the Government appoints the board, they have a direct principal-agent relationship with the board, not with the management. Therefore, it is the responsibility of the board to exercise proper oversight and make sure that a certain POE complies with ownership policy, its business plan, and legislation in force. As already emphasised, to date, there is no significant case when the Government has dismissed POE board members for the reasons of violating fiduciary duties or poor performance, despite many findings in audit reports.

Thus, a comprehensive audit is welcomed and may help if it focuses on objective setting, auditing first objective goals, but it will not help if there is no proper follow-up on its findings. Otherwise, it will be one of the other audit reports filed in the drawers of bureaucrats and politicians, which seems likely to happen with the current (no) accountability atmosphere in Kosovo.

From all the above, the Government needs to be held accountable for poor governance and performance of POEs, but the question is who and how to do that. The answer is clear, those who elected politicians, the voters, the citizens in multiple roles, first as principals since they are the owners of the POEs, second as voters that have elected the Government, third as consumers or beneficiaries of services provided by such POEs and forth as taxpayers.

An interesting view in this regard has been shared by the judicial practice in the US. In the argument of whether state commissions should have a say in the regulation of municipally-owned enterprises (utilities), a few courts ruled negatively with the argument that "municipal corporations, serving its own people is controlled by the electorate, while if the people are not satisfied they can easily affect the change, either at a regular election or by the exercise of the right to recall" (Kneier, 1949, p. 76).

Although public companies in the US have a different structure from those in Kosovo, the above decisions of the court still highlight a very important aspect when it comes to the accountability of the Government regarding POEs. From such interpretations of the Court, we can underline that citizens are supposed to keep the Government accountable since there is a reason why citizens are real principals of the POEs. Bearing in mind that POEs are owned by the state and since the state is not one individual, then the Government acts as a shareholder on its behalf, therefore, on behalf of citizens.

In the case of Kosovo, accountability may help in making the Government act as a responsible shareholder on behalf of the state and its citizens. Explaining the principal-agent approach to politics, Lane (2013) argues that in cases "when political agents cause costly mistakes to the population, they will probably be voted out of office" (p. 342).

The response to the question who guards the guardians is other guardians, in this case citizens, voters who elect the political parties to run the Government. Since 1957, Anthony Down has developed the concept of "rational ignorance" to explain why people vote in certain ways.

The question is when people vote whether they pay enough attention in obtaining information on politicians that run in elections and decide how to vote based on such information. Tullock, Brady, and Seldon (2002) answer "no". As they put it, when an individual votes for the President of the United States, such an individual is aware that his vote is one of 70 million votes and, as such, will not affect the final result of the election process. Since the voter realizes that his vote has no impact on the result of the election, this will affect his valuation of using resources to collect information in order to make the "correct" choice (Tullock et al., 2002). This concept is known by Anthony Down as "rational ignorance".

Therefore, politicians are aware that voters will not exert energy in making the correct choice. They are likely to be poorly informed and will sometimes vote for politicians that are contrary to their personal interests, due to the lack of information (Tullock et al., 2002).

In addition, Brennan and Hamlin (1998) summarise two main accounts for explaining voting behaviour: "instrumental" and "expressive" accounts. An instrumental account consists of the explanation that citizens/voters are rational in their choices; thus, upon voting, they decide on how to vote based on the electoral outcome that will meet their preferences. Such a rational choice is comparable with that of consumers in the market (Brennan & Hamlin, 1998).

An expressive account is also considered a rational account, but with a different approach. Expressive voting is more comparable with cheering at a football match than it is with purchasing something in a market choice (Brennan & Hamlin, 1998).

Mueller (2014) argues that since the numbers of citizens in a country (as real principals) is far larger than the number of shareholders in a firm, citizens have greater incentives to free ride and avoid their "monitoring" responsibility by leaving the ground to interest groups to step in and have outcomes, not in the best interest of citizens but certain narrow interests.

Therefore, it is necessary for citizens to hold the Government accountable for the failure of governing properly and the poor performance of POEs. However, this is not an easy task, but the problem is that this seems to make the Government a responsible shareholder and accountable for its actions or non-actions. It seems that voters in Kosovo may be driven by “rational ignorance” while voting. It is likely that Kosovars vote based on the expressive account, more like cheering in a football match since the outcome, results of the actions of politicians are not the one they wish for.

Lately, the problem of accountability has been an issue in Kosovo for many reasons such as citizens avoiding monitoring and accepting the general failure. Later in this paper, some reflections on this will be provided.

The second modest choice that we would propose to help “make” the Government a more responsible shareholder is the role and inclusion of the private sector. Although the inclusion of the private sector is also one of the strategic goals of the Government stated in the ownership policy, it is not implemented in practice. With all the above in mind, we raise the question of whether we can trust our public enterprises only to the Government. Our answer is no, as the results so far have proven that the Government is not the right arbitrator for the effectiveness, performance, and success of POEs and fails in exercising its role as the shareholder.

Howard (1982) suggests that to make public enterprises more accountable we should consider the idea of “sharing responsibility and roles” by including in the board of public enterprises broader groups such as worker, community, and consumer representation.

Cumbers and Hanna (2019) also argues that one of the bases of democratic public ownership is to ensure that affected groups and individuals have democratic forms of representation in the governance structures of POEs, highlighting employee participation as a key element.

The proposal to have other affected groups represented in the governance structure of the POE seems quite useful since would help make the Government more a responsible shareholder and would not leave the entire responsibility to the Government. However, such representation requires a certain level of responsibility from employee, community, and consumer representation.

Bearing in mind the current situation, where unfortunately it seems that everyone is accepting the culture of “failure” and the Government officials not being accountable to anyone, we assume that inclusion of worker, community, and consumer representatives would only continue the trend since the later have no incentives to act responsibly in POEs influenced by a certain group of interests.

For this reason, the most efficient way to improve the governance and performance of POEs may be the inclusion of the private sector. First, the Government must develop a clear plan for the involvement of the private sector in POEs since the current statement in ownership policy is broad, vague, and not implemented in practice (Decision of the Government of the Republic of Kosovo no. 11/39 of 8 October 2008). Such involvement of the private sector may be useful since POEs must be a part of the competitive market. Being part of

a competitive market would be a matter of survival and this would automatically have an impact on the management, as an eventual failure of the POE would risk their income and individual benefits.

There are also other arguments why the inclusion of the private sector would help. By the inclusion of the private sector we mean its inclusion as a minority shareholder, therefore selling some shares to the private sector and having at least more than one shareholder, instead of only the state and the Government exercising such shareholder’s rights, which is proving to fail.

Peng, Bruton, Stan, and Huang (2016) suggest the presence of block holders in state-owned enterprises, having such block holders as the second largest shareholder able to constrain the controlling shareholder and able to provide checks and balances on the behaviour of the “controlling shareholder”.

This seems to be an option that might work in Kosovo’s POEs, although the presence of different shareholders may provoke principal-principal problems, which are different in nature. However, this seems to be a “hope” for Kosovo’s POEs. Having a different shareholder that comes from the private sector alongside the Government may increase the possibility to have a more responsible shareholder’s oversight over the board for many reasons.

First, the shareholder from the private sector, firm, individual, or fund will have more interests in the successful performance of the POE and would be a “responsible” shareholder since it has a direct financial interest by holding the shares in the POE. In this regard, also the applicability of the principal-agent model would make more sense since we would have in POEs “proper” shareholders that would pursue their best interest, thus, the profit and positive performance of the POE.

Second, the private shareholder will not have the “plan B” of the Government intervening with taxpayers’ money to “save” the POE. The private shareholder will have to pay its own money, which is significantly different from the incentive of the Government as a shareholder since individuals in the Government do not pay this money from their own pockets. Consequently, this may be also a way to avoid moral hazards when it comes to saving POEs no matter what the reasons for failure are.

Third, the inclusion of the private sector may help in making POEs part of the competitive market, which should be another incentive to perform better.

5. CONCLUSION

Clearly, for POEs in Kosovo the applicability of the principal-agent model is challenging due to the shareholder that does not act as one and hence is not a real principal as the model suggests. Our central argument is that first, principal-agent model applicability in POEs is questionable if the shareholder does not act as a principal but a few measures in form of strategies may be undertaken to reduce such problems which would positively impact the performance of POEs.

Political interference is a chronic problem in Kosovo’s POEs and these enterprises are used as tools for the employment of persons affiliated with political parties, instead of appointing qualified individuals as the criteria of the law to require.

At the same time, the Government is not exercising efficiently its role as a shareholder, hence as principal. All the above lead towards a chaotic situation in the management of POEs followed by huge financial losses, which are a burden for the budget of the country.

The Government must reflect on its role in exercising shareholder's rights on behalf of the state by playing this role properly, clearly defining ownership goals, and putting first the performance of POEs and the welfare of citizens. Improvement of existing legislation, introducing new regulatory and governance strategies would enable the shareholder to have more efficient control over principal-agent problems and thus reduce them. Enforcement plays a crucial role in this process. All rules, measures, and strategies require proper enforcement, which Kosovo must work on. Strengthening law enforcement is necessary if we want to save what is left from current POEs in Kosovo.

The Government must explore opportunities of the private sector inclusion to be able to balance

the role of the Government as a shareholder by including other shareholders that may be more active in exercising their role as shareholders.

This research has some limitations such as the lack of more empirical data and previous studies, which are missing in the case of Kosovo. Moreover, this study is limited to the shareholder's role in Kosovo but may be considered as a good start for future research.

Aside from the significance of this study in providing a deep analysis of principal-agent problems in POEs and their negative impact on financial and operational performance, there are other dimensions that may be expanded.

Future research may focus on further developing this topic and addressing the options in reducing principal-agent problems and their negative impacts on the financial and operational performance of POEs. In addition, future research may explore options in designing a management structure that would be more appropriate for POEs from a corporate governance point of view.

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