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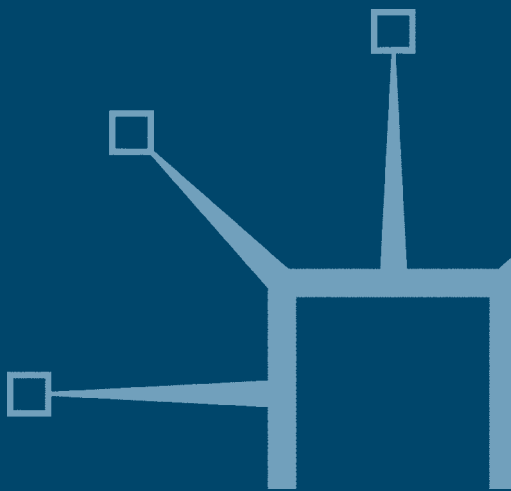
Corporate Restructuring and Governance in Transition Economies

Edited by

Bruno Dallago and Ichiro Iwasaki



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List of Abbreviations

BSE	Budapest Stock Exchange
CEE	Central and Eastern Europe
CG	corporate governance
CIS	Commonwealth of Independent States
CSR	corporate social responsibility
CZK	Czech koruna
CZSO	Czech Statistical Office
EBRD	European Bank for Reconstruction and Development
EMS	European Monetary System
EMU	European Monetary Union
EU	European Union
FCSM	Federal Commission on the Securities Market of Russia
FDI	foreign direct investment
FE	fixed effects
FSU	The former Soviet Union
FSSS	Federal Service of State Statistics of Russia
FY	fiscal year
GDP	gross domestic product
GNP	gross national product
GM	General Motors Co.
HFSA	Hungarian Financial Services Authority
HPSHC	Hungarian Privatization and State Holding Company
HUF	Hungarian forint
IAS	International Accounting Standards
IMF	International Monetary Fund
IPF	investment privatization fund
IPO	initial public offering
KOB	Konsoridacni Banka
LTL	long term liabilities
JSC	joint-stock company
MNC	multinational company
NUMMI	New United Motor Manufacturing
OECD	Organization for Economic Cooperation and Development
OLS	ordinary least squares
RE	random effects

ROA	return on assets
ROE	return on equity
R&D	research and development
SME	small and medium-sized enterprise
SOE	state-owned enterprise
STL	short term liabilities
TA	total assets
TFP	total factor productivity
TL	total liabilities
TPCA	Toyota Peugeot Citroen Automobile
TPS	Toyota Production System
UNCTAD	United Nations Conference on Trade and Development
VSE	Vienna Stock Exchange
WCI	working capital investment
WSE	Warsaw Stock Exchange

Introduction: Reasons for Focusing on Corporate Restructuring and Governance to Understand Transition Economies

Bruno Dallago and Ichiro Iwasaki

As a result of substantial efforts by the governments and citizens in the former socialist countries, the shift to a market economy is now entering its second phase. If the first phase of the economic transformation was to constitute the social and economic institutions that are vital for establishing a 'minimum' system of market economy, then the present aim should be to enhance these hastily introduced institutions for the further development of capitalism.

This is also the case with corporate systems. There is no country in Central and Eastern Europe (CEE) or the former Soviet Union (FSU) that does not have secured legal freedom of private ownership, labor contracts, profit distribution, and business competition. Despite being in the early stages of developing market economies, most of these countries have laid the groundwork for their banking systems, securities markets, accounting systems, and bankruptcy procedures. Moreover, the position of private capital in these countries has become nearly stable, judging from the fact that the private sector share of the GDP in 2004 reached 63.9 per cent, using a simple national average of 27 countries in the region (see Table I.1). Thus, in a number of countries where the formal institutional framework has been established and private businesses have begun to lead production activities, the focus of policy debate has shifted from 'traditional' measures for the economic transformation, such as privatization of state-owned enterprises, to how to shape the existing business firms, including their organizational architecture and governance mechanism.

In the context of the economic transformation and development of the corporate system in CEE and the FSU, economists have paid considerable attention to the role of foreign direct investment (FDI).[1] According to Table I.1, 27 countries in the region received a total of

US$ 262 billion of net FDI from 1989 to 2004. As a result, the cumulative FDI per capita reached US$ 647. There is a broad consensus among researchers that this huge influx of foreign capital has brought about a great impact on the expansion of the private business sector and the

Table I.1 Development of the private sector, enterprise reform, and FDI inflows in the CEE and FSU states

	Private sector share in GDP, 2004 (in %)	*EBRD index of enterprise reform, 2004* [a]	*Cumulative FDI inflows, 1989–2004 ($ US million)* [b]	*Cumulative FDI inflows per capita, 1989–2004 ($ US)* [b]
CEE and Baltic states				
Albania	75.0	2.0	1,457	455
Bosnia and Herzegovina	50.0	2.0	1,661	437
Bulgaria	75.0	2.7	8,309	1,071
Croatia	60.0	3.0	9,102	2,049
Czech Republic	80.0	3.3	41,704	4,080
Estonia	80.0	3.3	4,046	2,995
FYR Macedonia	65.0	2.3	1,155	577
Hungary	80.0	3.3	37,294	3,693
Latvia	70.0	3.0	3,910	1,686
Lithuania	75.0	3.0	4,193	1,217
Poland	75.0	3.3	57,352	1,502
Romania	70.0	2.0	16,185	747
Serbia and Montenegro	50.0	2.0	4,150	498
Slovak Republic	80.0	3.3	11,444	2,128
Slovenia	65.0	3.0	3,130	1,573
CIS states				
Armenia	75.0	2.3	1,069	333
Azerbaijan	60.0	2.3	9,828	1,190
Belarus	25.0	1.0	2,147	218
Georgia	65.0	2.0	1,781	386
Kazakhstan	65.0	2.0	21,301	1,413
Kyrgyz	75.0	2.0	573	112
Moldova	55.0	1.7	862	255
Russian Federation	70.0	2.3	7,843	54
Tajikistan	50.0	1.7	495	76

Turkmenistan	25.0	1.0	1,951	300
Ukraine	65.0	2.0	7,924	168
Uzbekistan	45.0	1.7	1,104	42
Average of 27 countries [c]	63.9	2.4	9,703	647

Notes
[a] The reform index ranges from 1 to 4. The value of 1 represents little or no change from a rigid centrally planned economy, and the value of 4 represents the standard of an industrialized market economy. For more details, see page 202 in EBRD (2005).
[b] Net inflows recorded in the balance of payments.
[c] The private sector share in GDP, EBRD index of enterprise reform, and cumulative FDI inflows are simple national averages. The cumulative FDI inflows per capita are weighted by population.
Source: EBRD (2005).

promotion of corporate governance reform in the host countries. In fact, Table I.2 indicates a positive and statistically significant relationship among the private sector share, progress in enterprise reform, and FDI inflows in the CEE and FSU states. In particular, the correlation coefficient between the European Bank for Reconstruction and Development (EBRD) index of governance and enterprise restructuring and the cumulative FDI inflows per capita rose to a value of 0.795. This close association among three elements provides an interesting challenge for the empirical examination of the impact of FDI on corporate restructuring and governance reform in the post-communist economies.

Table I.2 Correlation matrix of the private sector share, enterprise reform, and FDI inflows in the CEE and FSU states

	Private sector share	*Enterprise reform*	*Cumulative FDI inflows*	*FDI inflows per capita*
Private sector share in GDP, 2004	1.000			
EBRD index of enterprise reform, 2004	0.796**	1.000		
Cumulative FDI inflows, 1989–2004	0.394*	0.526**	1.000	
Cumulative FDI inflows per capita, 1989–2004	0.526**	0.795**	0.621**	1.000

Notes
**: significant at the 1% level
*: at the 5% level.
Source: Author's calculation based on Table I.1.

In this book, while keeping the above discussions in mind, we aim to analyse and assess enterprise restructuring and corporate governance reforms as the core issues for the CEE and FSU countries as they go through the second stage of systemic transformation into a competitive market economy. Special attention is given to the role of FDI and multinational companies (MNCs) in this regard.

Our main objectives are as follows: (a) to gain insights into the microeconomic and institutional complexity of economic development in the post-communist world; (b) to determine the interdependencies among the various factors of the transformation on the microeconomic level and their diversity, including the internal control system of public corporations, corporate ownership and control, corporate finance, capital structure, and foreign investment; (c) to grasp the interplay between formal and informal economic processes, including the influence of the informal economy on corporate restructuring and governance; and (d) to illustrate the influence of the European Union (EU) enlargement towards the East and FDI inflows on the development of corporate governance and restructuring. Consequently, the main objectives of this study include: (a) the formal and informal mechanisms of corporate governance; (b) the evolution of corporate ownership and control; (c) the development and actual circumstances of corporate finance; and (d) the significance of FDI and MNCs in enterprise reforms.

Among the 27 states listed in Table I.1, this volume casts a light on three countries, i.e. the Czech Republic, Hungary, and the Russian Federation, each of which has unique and specific features of enterprise restructuring and corporate governance from the viewpoint of institutional and empirical economics. Indeed, these three countries were chosen for the remarkably different structural reforms implemented in the 1990s and early 2000s, with particular concern for enterprise privatization, legal framework of corporate governance, the development of a banking system and capital market, market liberalization policies, and the promotion of FDI and MNCs (see Table I.3); this gives us a unique chance to grasp the dimension and consequences of enterprise reforms in transition context. To keep the situation in post-communist countries in perspective, a broad comparison of the CEE and FSU states is conducted regarding corporate governance and finance in the introduction of this study.

This volume consists of 11 chapters. The first two chapters in Part I provide general views of corporate governance and finance in CEE and FSU regions.[2]

Chapter 1 deals with the corporate governance issues. Although the role of corporate governance in transformational countries goes beyond the tradition in well-established market economies, dominant paradigms have strongly influenced corporate governance reform. In these countries, there is a particular context consisting of reforms under stress, i.e. under the pressure of prevailing reform paradigms. This fact creates a choice dilemma between reforms aimed at transplanting institutions known for having been successful in other cases and those reforms that can be considered as organic. The cases analyzed in this

Table I.3 Comparison of three transitional countries in terms of enterprise reform, 2005

	Czech Republic	*Hungary*	*Russia*
Methods of enterprise privatization [a]			
Direct sales	Secondary	Primary	Secondary
Voucher privatization	Primary	n.a.	Primary
Management-employee buyout	n.a.	Secondary	n.a.
Ownership structure			
Insiders	Medium	Low	High
Foreign investors	Medium	High	Low
Financial institutions	High	Medium	Low
Legal framework of corporate governance			
Quality of CG law	Medium	High	High
Quality of insolvency law	Medium	Low	Medium
Secured transaction law	Inefficient	Advanced	Malfunctioning
Minority shareholder protection	Low	High	Low
Competition office	Yes	Yes	Yes
Corporate finance			
Quality of securities market laws	Medium	Medium	Medium
Asset share of foreign-owned banks (%) [b]	84.9	63.0	7.4
Non-performing loans (% of total loans) [c]	4.1	3.7	49.9
Domestic credit to private sector (% of GDP) [c]	27.1	46.0	24.6
Stock market capitalization (% of GDP) [c]	25.7	25.5	44.4
Stock trading volume (% of market capitalization) [c]	79.0	60.0	53.0

Table I.3 (Continued)

	Czech Republic	*Hungary*	*Russia*
Liberalization and market regulations			
Controls on inward direct investment	Yes	No	No
Interest rate liberalization	Full	Full	Full
Exchange rate regime	Managed float	Fixed with band	Managed float
Wage regulation	No	No	No
FDI and multinational companies			
FDI inflows (% of GDP)[c]	3.7	3.6	0.0[d]
Market share of MNCs in the domestic market	Medium	Medium	Low
Market share of MNCs in the export market	High	High	Low

Notes
[a] For medium-sized and large state-owned enterprises.
[b] The figure for the Czech Republic and Hungary corresponds to 2004. The figure for Russia corresponds to 2003.
[c] Figure for 2004.
[d] 0.0 means negligible.
Source: Based on World Bank (2002), EBRD (2005), and authors' assessment.

book – those of Hungary, the Czech Republic, and Russia are examined by placing corporate governance reform in the context of reforms under stress, with particular regard to privatization. From this comparison some teachings on the constraints that corporate governance reforms have met are derived.

Chapter 2 is a comparative study of corporate finance in post-communist countries. The corporate finance in systemic transformation has two distinctive features: the high ratio of inter-enterprise credit in capital structure and the dependence of retained earnings as a source of investment. That is because, on the one hand, financial institutions are prudent in providing credit for companies of low profitability with a high risk, and, instead, they give higher priority to the speculation to foreign currency transactions or government bond markets. In addition, they prefer to gain market share in the number of loans made to consumers. On the other hand, the companies despise the leaking of information to potential rivals that occurs through financial institutions, and they are preoccupied with the small scale of investment

in preparation for bankruptcy risk. Thus, it is suggested in this chapter that the less intense relationship between companies and financial institutions has not promoted corporate restructuring or improved the efficiency of the companies, which was expected as a function for nascent corporate governance structure.

Parts II, III, and IV contain the outcomes from our case studies of the Czech Republic, Hungary, and the Russian Federation, respectively. These parts share three topics: (a) the formal and informal mechanisms of the internal control system, (b) corporate ownership and control, and (c) the possible impacts of these factors on corporate performance. Because the Czech Republic and Hungary enjoy a large inflow of foreign capital and relatively rapid development of financial systems and capital markets, albeit at different times and in different ways, Parts II and III offer individual analyses of the role of FDI and corporate finance in the restructuring process of the former state-owned enterprises and companies founded during the transition period.

Chapter 3 in Part II is an examination of corporate governance in the Czech economy, with special attention to ownership concentration and foreign participation in management. Issues of corporate governance were seen as the key barriers for further enterprise development and credit policy of banks within the Czech Republic, and they also had a significant influence on the shape of foreign investments. The Czech institutional prerequisites and a transitory 'Czech-biased, bivalent form' of corporate governance generated an internationally high degree of ownership concentration. Foreigners gradually increased their foreign direct investments and decreased their portfolio investments. Foreign-controlled companies seemed to exhibit long-term standard behavior, which might have been partially eroded by the environment with prevailing incomplete contracts having been used by a number of controlling shareholders to consume their private benefits of control. The adopted institutional changes in accordance with the EU '*acqui communautaire*,' a huge inflow of foreign direct investments and privatization of remaining state banks resulted in the standardization of the Czech corporate governance marked by the rapid improvement.

Chapter 4 is an examination of the Czech emerging financial markets in the second half of the transformation process (late 1990s) and their roles in corporate finance. The focus is on the investment behavior of Czech firms during the latter part of the transition process (1996–2001), which itself provides important insights in this regard. Specifically, using firm-level panel data, we investigate whether there is underinvestment due to financing constraints (at least partly stemming from the capital

market not functioning properly) among Czech manufacturing firms. The empirical results show that, within the period under review, the internal finance played a larger role for investments made by small firms and corporations not owned by foreign capital. These findings corroborate the results of, and are generally consistent with, earlier studies on the subject focusing on the beginning of the transition process, i.e. on the early and mid-1990s. Taken together, both sets of studies tend to provide a more complete picture of the overall state of the Czech corporate sector and financial markets as they describe both the early and the latter period of transition from a centrally planned to a market economy.

Chapter 5 is an examination of the role of FDI in the Czech transition processes, taking Japanese MNCs as an example. This chapter consists of two parts. The first focuses on the economic policy of the Czech Republic from the perspective of corporate restructuring and outlines features of the Czech manufacturing industry. This first part also contains a discussion on the important role of foreign-controlled enterprises in the Czech economy. In addition, this part contains a comparison of the policy stance to corporate restructure between the cabinets of Klaus and the social democrats. The second part of the chapter is a discussion of FDI, especially with regard to Japanese automobile investors in the Czech Republic and the implications of Japanese investment, which are of interest relating to the potential for the adaptation of Japanese management systems (such as the 'Toyota Way') into not only the Czech Republic but also the Slavic society.

Attention is given to Hungary in Part III. An overview is presented in Chapter 6 of the Hungarian corporate governance system, the features of the Budapest Stock Exchange, the ownership structure of listed companies, and the identity of major owners. The Hungarian corporate governance system is largely based on the continental-type European model, and related regulations follow the directives of the European Union (EU). The concentration of ownership is high on the Hungarian equities market, which implies that the conflict of interest between large blockholders and small investors remains the main corporate governance issue. The Budapest Stock Exchange is dominated by foreign institutional investors, whose behavior is restrained in corporate governance matters.

The characteristics of the capital structure of Hungarian firms are dealt with in Chapter 7. In the 1990s, the Hungarian economy as an emerging market economy experienced significant changes that are reflected in the transformation of the corporate capital structure. The main capital

structure theories are highlighted in the first part of this chapter; the second part covers the capital structure decisions in the transformation period; and the third part is an analysis of the most typical characteristics of the corporate capital structure in the Hungarian manufacturing industry. The share of long-term funds in the capital structure of Hungarian manufacturing companies was found to be extremely low and resulted in problems of maturity matching, liquidity, and stability. The regression analysis verifies that large companies and companies with foreign majority ownership have a better chance of having long-term loans. The main conclusion in Chapter 7 is that, in Hungarian manufacturing companies, similarly to more developed economies, corporate capital structure decisions cannot be explained by a single theoretical approach and the tradeoff theory, the agency theory, and the information asymmetry models complement each other in explaining the capital structure decisions.

Chapter 8 is a survey of the impact of FDI inflows and MNCs' embarkation on the restructuring of the Hungarian business sector. Large-scale foreign direct investment and intensive business activities by multinational companies have played a crucial role in Hungary's transition to a market economy. The massive inflow of foreign capital has supported the national economy by spurring effective demand, contributing substantially to its long-lasting and stable economic growth as well as to dramatic changes in the corporate sector through the conversion of the ownership structure, improvements in the production system, the strengthening of market competitiveness, the modernization of management systems, and the revitalization of research and development (R&D) and innovation activities. In spite of all this, it is emphasized that Hungary still has many problems with corporate restructuring. The Hungarian government and the business sector are now at a turning point in their passive strategy of economic transformation.

Part IV of this book features Russian corporate governance. Chapter 9 examines the legislative framework of the internal control system in Russian joint-stock companies. The legal form of business enterprises in contemporary Russia is diversified to almost the same extent as those in major advanced countries. Joint-stock companies are now the most common form of incorporation among leading industrial enterprises. The law on joint-stock companies in Russia provides for the governance mechanism of joint-stock companies in order to implement the concept of a 'self-enforcing' organization in which the legal code of business management should be observed voluntarily by managers and large stockholders. This fundamental idea is embodied in many aspects

of the current system, including the mechanism of management and supervision characterized as 'diarchial leadership' (i.e. a separation of company president and board chairman positions), the balance of power between stockholders and corporate officers, and the internal audit system. However, the self-enforcing nature of the Russian enterprises has been undermined by a number of factors, including the overwhelming expansion of closed joint-stock companies, the predominance of insider ownership, the short history of internal auditing, and the lack of legal enforcement power. As a result, breaches of company law are rampant in Russia today. This raises serious problems for the Russian corporate system, along with the legal peculiarity of privatized firms and people's enterprises, which complicates the system of joint-stock companies and deprives it of transparency.

Chapter 10 is an empirical study of ownership structure and board composition in Russian firms. Joint-stock companies in Russia have been created in the course of privatization, by the foundation of new businesses and as a consequence of corporate reorganizations. Voucher privatization played a special role in the development of corporate ownership and control. The author identified the trends in the redistribution of ownership over the last decade. Along with the growing concentration of capital, share ownership was transferred from the state and employees to managers and outside shareholders. In most companies, corporate control is held by a dominant owner who either is the head of a company himself or keeps managers whom he/she appointed under strict supervision. Joint-stock companies are closed for potential investors; their capital structure and performance indicators lack transparency. Mechanisms for internal corporate control are defined by dominant owners, and the role of the stock market is minor.

Chapter 11 is devoted to an analysis of the evolution of corporate governance mechanisms in Russia. Here, special attention is given to the causes of dramatic discrepancies between the expected outputs of institutional reforms implemented by the Russian government with the World Bank and IMF support and the actual behavior of Russian companies. This chapter seeks the reason why the model of interaction between enterprises and investors and owners and managers, which had been successful in other countries, was actually rejected by Russian business in the 1990s. Furthermore, this chapter tries to evaluate the degree of positive change that has recently occurred in corporate policies of major Russian companies. The answers to these questions are based on an analysis of economic agents' motivation at different stages of development of corporate structures in Russia. In this chapter, it is argued that

the need for a comprehensive organizational and technological restructuring of enterprises resulted in the necessity for a concentrated ownership structure. The formation of such a structure in the late 1990s (which occurred, in fact, contrary to government activities) created the preconditions for extending the horizon of interests of dominating owners and managers and for positive qualitative changes in the relationships between major Russian companies and their shareholders and investors.

It is our hope that this volume will contribute in a meaningful way to the progress in institutional and micro-economic studies of transitional countries.

Notes

1. For instance, see Marinova & Marinov (2003), Manea & Pearce (2004), and Stephan (2006).
2. The outline of chapters mentioned hereinafter is prepared by each author.

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Part I

General View

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1

Corporate Governance in Transformation Economies: A Comparative Perspective

Bruno Dallago

Introduction

Standard economics has supposed for a long time that the economy is coordinated by the price mechanism and that no explicit governance problem is involved. However, Coase has proven that this description is only partial, Berle and Means have stressed that ownership and control of firms are often separated, and later on Williamson has demonstrated that hierarchies play a fundamental role. Coase's path-breaking contribution has been the starting point of a burgeoning literature on the nature of the firm. This literature splits the problem into two parts that concern first, the firm boundaries and their determination, and, second and given those boundaries, the way in which the different constituents of the firm are coordinated and the residual income or residual decision-making power (given incomplete or missing contracts) is allocated.

The latter goes to the core of corporate governance, but both boundaries and coordination are central to transformation countries. However, the prevailing mainstream literature presupposes a well working market context and this may raise both positive and normative problems in countries in transformation where that precondition does not fully held.

Corporate governance identifies how rights and duties are distributed within and around the firm. Rights and duties define how the distinct actors are organized, coordinated, and motivated, decision-making power and control are defined and allocated and residual income is distributed. In a dynamic perspective, corporate governance deals with the way in which those actors change their mutual relationship and promote and adapt to change in the context and within the firm. In transformation conditions, when rights and duties (property rights, to begin with) are subject to comprehensive and deep change, corporate

governance must be considered in the context of rights and duties transformation, particularly privatization.

Corporate governance comprises formal and informal institutions, which together – i.e. in a coordinated way so to form a system – govern the relationship between the people who manage (managers, boards) and all those who invest resources (stakeholders) in the firm. These institutions include the country's company and securities laws, accounting rules, corporate governance principles, generally accepted business practices and prevailing business ethics (see also Oman *et al*. (2003, p. 6)).

In transformation countries corporate governance became important lately, when it was clear that privatization and liberalization alone were not enough to improve the performance of firms and in some cases were responsible for the dramatic worsening of performance due to 'transitional recession' (Kornai, 1994) or 'disorganization' (Blanchard & Kremer, 1997; Marin & Schnitzer, 2005). For Central European countries the access first and membership then to the EU were critical factors. For all the countries in general and Russia in particular the problematic outcome of privatization – particularly the 'loans for shares' schemes – and the 1998 financial crisis were important factors that prompted government authorities and firms alike to give proper weight to restructuring and corporate governance.

Corporate governance in economies in transformation should pursue three aims. First, it must support coordination and cooperation among the various components of the firm and lead the latter to take the best possible decisions in the most effective way. The decision-making process has to be as cheap as possible and give the best possible incentives to those who provide the firm with critical assets. Critical is in the sense that they are particularly important for the performance of the firm or difficult to control and keep loyal to the firm.

Second, corporate governance has to support the growth and expansion of the firm by adapting to changes in the firm environment and taking advantage of new opportunities. In this way good corporate governance supports economic growth and change. Third, it must foster transformation of the firm role in the economy and its relation to other firms. In this way sound corporate governance supports transformation. By structuring corporate governance along these three dimensions corporate management can effectively pursue its goals and avoid disruptive internal conflicts.

Dominant paradigms strongly influence corporate governance reform. However, in the next section we shall see that those paradigms have been identified looking at developed market economies, which may

present context features, and policy goals not coinciding with those relevant in transformation economies. Section 1.3 deals with the particular context of corporate governance consisting of reforms under stress, i.e. under the pressure of prevailing reform paradigms. In section 1.4, I discuss the dilemma that has confronted transformation economies in choosing between reforms aimed at transplanting institutions known for having been successful in other cases (the 'Washington Consensus' reforms) and those reforms that can be considered as organic. Section 1.5 takes a more detailed consideration of the cases analysed in this book: those of Hungary, the Czech Republic and Russia. Indeed, it is more and more difficult to consider transformation economies as one case, since they have implemented different privatization solutions and corporate governance reforms. This section places corporate governance reform in the context of reforms under stress, with particular regard to privatization. Section 1.6 compares the three cases and derives some teachings on the constraints that corporate governance reforms have met. Section 1.7 concludes the chapter.

Corporate governance paradigms

The literature on corporate governance distinguishes three paradigms (Dallago, 2002). The distinctiveness of each paradigm lies in their considering the nature and functions of the firm in dissimilar ways and generating distinct governance choices.

The first paradigm, the standard shareholders' value, is based in the agency theory and concentrates on the consequences of dispersed ownership and the separation between ownership and control and of contract incompleteness. Most chapters in this book either are based on this paradigm or give it overwhelming importance, since this is formally – although not always actually – the dominant paradigm in most countries in transformation. As equity investors, shareholders are the only actors investing in the corporation without any contractual guarantee of a specific return (Williamson, 1985). Therefore, they have an interest in allocating corporate resources to the best possible use (Fama & Jensen, 1983). In this perspective, corporate governance concerns incentives to the suppliers of the mobile equity capital in the form of residual control rights and includes the set of conditions that shape the ex post bargaining over the quasi-rents generated by a firm with incomplete contracts (Grossman & Hart, 1988).

However important for the success of the firm in a competitive market, this paradigm may shorten the time horizon of the firm and

may decrease the importance of industrial goals to the advantage of financial strategies, also by illegitimate or illegal means. It disregards the external and internal consequences of the firm adaptation to the transforming context, the change this generates in the capabilities and competences that human actors contribute to the firm and the need to commit resources to transformation. Indeed, this paradigm says nothing on restructuring, production and innovation, nor does it consider the contribution of other parties in the firm activity.

According to the second paradigm of the stakeholders' interest, the firm is a coalition of different stakeholders with different competences, capabilities, roles and interests and who, in order to contribute to the firm's activity and value, have to implement some kind of risky firm specific investment, such as in human capital. Consequently corporate governance concerns incentives to and protection of these investments and how the allocation of residual rights of control, i.e. how power to different stakeholders affects economic performance (Aglietta & Rebérioux, 2005; Rajan & Zingales, 2000). The allocation of power depends on how valuable are in the firm the resources that individuals bring, i.e. how unique they are and how costly is to replace them. As a consequence, power relations and corporate governance should evolve with the change in the relative value of different resources. The greater number of stakeholders has some undesirable consequences (Tirole, 2001), which may have a critical significance in transformation economies: (a) incentives may be weakened because residual income has to be divided among a great number of claimants; (b) managerial incentives become less focused and less sharp; and (c) control may be divided and softened. Although it is necessary that corporate governance rewards particularly investment in firm-specific assets that support transformation, no stakeholders' interest theory exists of the process that generates adaptation to and learning from systemic transformation.

These two paradigms start from different views of the production process and the nature of the firm, lead to different explanations of how profit is maximized, and differ remarkably as whom the property rights over the stream of income generated should be allocated to. Since both paradigms focus on the governance structures that facilitate the optimal utilization of existing productive resources, they neglect the most fundamental issue of transformation: the governance of the process through which resources are transformed, increased, and utilized in the economy and through which the firms nature, role, and activity is changed and restructured.

The latter aspect is the main concern of the (post-)Schumpeterian innovative firm paradigm (Lazonik & O'Sullivan, 1997; O'Sullivan, 2000). This paradigm is largely based on the concept of the firm as a learning organization and deals primarily with governance solutions that support innovation, particularly in firms on the technological frontier. The approach can be easily extended to the case of institutional innovation so central in countries in transformation. A theory of corporate governance must create the developmental, organizational and strategic conditions pushing decision-makers to use resources to pursue innovation. The developmental dimension deals with resources commitment to irreversible investments with uncertain returns. In transformation countries one should add institutional and organizational uncertainty to the standard productive and competitive uncertainty, in the sense that firms must take decisions without knowing how the economic system will really be by the time when those decisions bear fruits. The organizational dimension consists of the complementarities of individual processes of learning, which is specialized and asset-specific, that are integrated as new collective knowledge in the firm. In such a way the firm develops integrated structures of capabilities and incentives for their participants that are unique to that firm and cannot be replicated through the market co-ordination of economic activity. Through the strategic dimension resources are allocated in a creative way to overcome market and technological conditions that other firms take as given and which, in transformation countries, firms inherit from the old system. Consequently, strategic control within firms must be in the hands of those who have the incentives and the abilities to allocate resources to innovative investments. Moreover, decision-makers must have firm control of resources in order to commit them to a developmental process until the learning process has generated the conditions for reaping higher returns. Finally, the firm must be organizationally integrated.

This third paradigm should be integrated with the significance of procedures and the fact that innovation processes vary greatly according to industry maturity and technology conditions (Dietl, 1998) and the features of industries in terms of visibility, novelty and appropriability of innovation (Tylecote & Conesa, 1999). Both issues put different requirements upon governance and the financial system and are particularly important during transformation. Although this approach has been unable so far to produce an operational theory of corporate governance that includes innovation and transformation, it has suggested some important features that corporate governance should have and has

clearly presented the reasons why such innovative corporate governance is important. However, this paradigm was largely absent in the debate on transformation and corporate governance. There are various reasons for this, including the initial subalternity of the debate and reform implementation to the mainstream. This outcome has also to do with the rather mechanic conception of the transformation process, that was supposed to be based on standard policies and their proper sequencing and was aptly labeled as 'transition.' Another important reason is that innovation as an autonomous activity of the firm lost importance since it came largely under the influence of foreign investors or firms were simply trying to survive. Although this paradigm may become important as far as firms regain control over their production process, it is perhaps not particularly useful to explain what happened so far with corporate governance.

Reforms under stress

Institutions establish the 'rules of the game' (North, 1990), define incentives to actors, and address their activity to productive, unproductive or even destructive ends (Baumol, 1993). If institutional reforms are late to come, chances are that those who were able to inherit economic, political or social advantages from the position they occupied in the old system or took advantage of the first phase of transformation, unrestrained by institutions, will get windfall gains and conquer strategic advantages (Dallago, 1996).

Indeed, transformation is a non-routine event (Kornai, 2005, pp. 197–8) in the sense that transformation consists of a unique, not-recurrent event. Under these conditions, opportunism, grabbing and rent-seeking strategies (Fries *et al.*, 2003; Hellman *et al.*, 2000; Steves & Rousso, 2003) have no endogenous constraints and strategies based on reputation, trust or tit-for-tat are ineffective.

Most transformation countries privileged, in a constructivist way but in different measure, the privatization of state-owned enterprises (SOEs) over creating the institutional and practical conditions for starting and supporting new firms. Partial exceptions were Hungary and Poland. Under the influence of powerful interests and a simplistic interpretation of the Coase theorem, 'creative destruction' was seen as a more or less automatic outcome of privatization and reforms were implemented under stress.

According to the Coase theorem (Stigler, 1966), if there is a unique socially efficient allocation of resources, that allocation will be reached

through the market independently from the initial allocation of property rights provided that rights are properly defined and enforced, actors are free to transact, and there are no transaction costs. However, if transaction costs exist (Coase, 1960), the possibility to reach an efficient (not unique) outcome through the market depends on the initial allocation of property rights. This stresses how important is the role of institutions and the state enforcing them, particularly so in countries in transformation. Indeed, these are characterized by particularly relevant transaction costs, the initial inability of the state to enforce rights, and the existence of a critical component of rights, particularly in unknown or undefined contingencies, that cannot be contracted and transacted simply because markets for rights are missing or contracts can only be incomplete. Consequently the assignation of residual rights of control over assets (Grossman & Hart, 1986; Hart & Moore, 1990) is fundamental to define who has right to what. Residual rights make the strategies of using the valuable assets inherited from the old system or those accumulated during the first stages of transformation (in particular, political capital) all the more important to acquire property rights through distributive strategies.

The stress of reforms derives from the perceived and politically motivated need to be fast in reforms implementation in order to capture a window of opportunity that may not last for a long time and make change irreversible (Gaidar & Pöhl, 1995); establish a private property regime with priority; respond to the supposed and revealed citizens' preferences for enjoying the advantages from the new system (see, however, Alesina & Fuchs-Schündeln, 2005); and avoid production disruption deriving from institutional and organizational change. The stress was embodied in the chosen method of transformation; the goals pursued and sequencing chosen, with institutional reform getting barely any relevance; the attempt to transplant institutions that were successful in different contexts.

However, implementing reforms under stress makes difficult implementing measures and devices (such as rules and control) to prevent grabbing and rent-seeking strategies from taking over. In addition, stress generates uncertainty, which shortens time horizon and pushes actors to rely on deeply rooted routines. Indeed, socialist firms had governance routines that descended from institutional features and adaptation to the centrally planned economy. These routines were quite different from those required in a market economy, with the partial exception of the relatively few cases of successful pre-transition reforms. Differences

derived from operating in a shortage economy and the structurally different firm boundaries compared to market economies.

While shortage disappeared soon following transformation, firms boundaries could only be changed via restructuring, that was mostly supposed to follow privatization. Firm boundaries depend on institutions, human actors, policies, and technology, all bound to change during transformation. This makes effective corporate governance a moving target. Firms in foreign ownership may perhaps be different, in particular if they are part of transnational companies and produce for the foreign market.

Reform under stress have pushed governments to look for 'real' owners, i.e. owners supposedly endowed with market goals who could manage the firm independently from the government. Without proper market institutions, including competition, this may give opportunities to economic and political insiders, well introduced into the state and business machines, to capture state ownership without any commitment or pressure to accumulation, restructuring, competition and development (Scase, 2003; Smallbone, 2005). Reforms under stress often resulted in a ritual establishment of formal market institutions without much concern for their effectiveness. Although it was supposed that effectiveness would result from progressive adjustments through time by the action of market forces, this took place only where pre-transition reforms established basic institutions, the state took on the job, and the EU had a fundamental role or a threatening crisis revealed the unsustainability of the previous course. It seems that there is a kind of circular process here.

Reforms under stress, then, slowed down and distorted the development of effective market institutions in two ways: by establishing barriers to and compressing the time disposable for institutional development; and by transplanting institutions. The latter is well known in the literature. The former deserves some attention, since it has been noticed in more recent years. The attempt at implementing reforms alien to the existing context makes reforms ineffective, jeopardizes the firms activity and increases costs of adaptation and learning for firms (Berkowitz *et al.*, 2003; Djankov *et al.*, 2003). Corporate governance reform in the Czech Republic, Russia, and Hungary offer important examples.

Organic and transplanted institutions

Transformation economies were confronted with the choice between reforms aimed at transplanting institutions known for having been

successful in other cases and those reforms that, following Hayek, can be considered as organic.[1]

The supporters of a liberistic approach to transition, who prevailed in many countries including the Czech republic and Russia, but not Hungary,[2] apparently preferred the latter choice. In their view the state was unable to play any significant role due to: the Hayekian failure to manage dispersed information; the grabbing propensity of politicians (Shleifer & Vishny, 1998); the low legitimacy and the discredit of the state when transition started; and the existence of various obstacles to the rapid emergence of an appropriate and effective legal infrastructure during transformation (World Bank, 1996).

In this view, the rapid creation of institutions is not a priority because they would remain ineffective lacking the support of market processes based in an already functioning private property regime. Institutional development is in fact the unconscious outcome of individual actions in market competitive processes (Frydman & Rapaczynski, 1994; Pejovich, 1994; Rapaczynski, 1996; for criticism see Nivet 2004). The necessary priority to rapid privatization follows suit.

A variant of this approach considered that, due to the particularly unfavorable features of transformation countries there is a (transitory) need for a strong role of politics, possibly curbed by international influence. The goal is to establish and enforce few institutions. These are prohibitions, private enforcement of public rules, voluntary compliance, self-protection and self-discipline, intended to support direct action by private actors without reliance on specialized public organizations such as courts. Privatization can start based on those rules (Black *et al.*, 1996; Hay & Shleifer, 1998).

Quite predictably this approach met disappointment soon and looked for more radical measures (Black *et al.*, 1999). Indeed, given the ailing power of the state, the nature of actors, and their 'old boys' (and new boys) networks, the outcome was bound to be far less virtuous than desirable. The problem with privatization has been that someone decided which was the best privatization type and privatization strategy and who was to become owner. If this was not explicitly decided, it came out of pre-existing asymmetries of information, knowledge, and bargaining power. In both cases there were no guarantees that the outcome was the most favorable for the performance of the economy. Even when privatization was carefully designed, as in former Czechoslovakia, a highly concentrated control of the economy resulted.

Organic processes necessitate mechanisms of inter-firm relations to function, like reputation, trust and authority mechanisms. However,

during the first critical stages of transformation the fear of losing reputation and the prospective advantages of long-term cooperation are uncertain, and the advantages of gaining by breaking the rules are sizeable, since the game is not repeated. Sooner or later this situation requires the intervention of the state to be fixed.

However, in most cases, including Russia, the actual strategy was institutional transplantation (see Chapter 11 in this volume), or so it ended up. Since no theoretical blueprint existed, the debate failed to generate a shared one, the public hand was in disarray, and strong established interests pushed in that direction, ready-made recipes were the easiest solution and many politicians and experts thought they were the most reliable ones since they were tested, albeit elsewhere. However, such strategies imposed high adaptation and learning costs upon actors since they were mostly based in alien institutions.

Under these circumstances, corporate governance is not a priority issue for reform policies, since it is considered to be in the interest of private actors to take and implement the best possible decisions and protect the most critical providers of inputs. Adaptation and learning processes are considered relatively unimportant and capital is the most critical factor, being dramatically needed to implement transformation and being less specific and more mobile. Hence the typical and dominant paradigm of corporate governance in this strategy is shareholders' value. However, actors must interiorize corporate governance mechanisms to make the latter effective. This may require a long time and may be individually and socially costly in a stress context.

This approach disregards the complexity of transformation processes. Within a truly organic strategy, corporate governance must address firms to pursue efficiency and innovation by supporting learning, adaptation, and commitment of resources to transformation and innovation. Much of this investment has the nature of sunk investment in human and organizational capabilities and competences. The corporate governance paradigm best apt to pursue these goals is the innovative enterprise one, although also the stakeholders' interest paradigm can be useful. This is a demanding aim in transformation conditions that require a competitive context and an authoritative and technically skilled role of the state, albeit mostly indirect. Obviously, this situation should not be mixed up with the laissez faire and neglect that was found in various transformation countries.

Organic processes may leave firms in a corporate governance limbo for some time, due to their length. However, organic developments give incentives to transformation and predictability to adaptation and

learning costs, and allow actors to better internalize the new (formal) institutions and support their interaction with informal institutions. Such developments also offer less and more modest opportunities for grabbing and rent-seeking strategies. Yet the core of organic processes is the foundation and development of new firms, be they domestic or the result of foreign investment. Being new, they may embody the new market institutions and corporate governance since the beginning, getting an advantage in the market game. Their competitive pressure will force other firms to adapt.

Comparison of three transformation strategies

Different countries in transformation chose to follow different strategies (Andreff, 2005). The outcome is quantitatively similar in the three countries considered: three quarters to four fifths of the economy belongs in the private sector (Vagliasindi & Vagliasindi, 2003). In this and the following section I sketch the basic features of the post-transformation development that are useful to understand the present situation as depicted in the following chapters. The three cases can be summarized as follows.

Czech Republic

When transformation started, the Czechoslovak economy was macroeconomically well balanced and firms, nearly all large and state owned, were disciplined under the control of central planners (Bönker, 2006). This created a favorable context for institutional experimentation, supported by the great democratic and theoretical tradition of the country. The primary method of privatization was mass privatization based on the free distribution of vouchers to all citizens. This was intended to do away with the intractable problem of market evaluation of SOEs and to disperse ownership of privatized firms. Direct sales were also used, but were less important. The typical method of insiders' privatization, i.e. management and employee buy-out, was not used.[3]

Voucher privatization is a sort of textbook experiment expected to have the benefits of a competitive market economy and to create a large class of share owners loyal to the government. The Czech experiment, then, can be seen as a kind of inductive transplantation of institutions, i.e. from a model. This was in contrast with the traditional concentrated character of the Czech economy and the population's lack of interest. The outcome has been consequently full of unwanted and unforeseen consequences (see Chapter 3 in this book). In spite

of guarantees that the government wisely introduced (prohibition of secondary markets of vouchers), together with benign neglect of others (e.g. the original owners and capital of funds), large investment funds and banks have taken easily control of the firms, initially as proxies of individual citizens.

The advantage of this solution is to stop soon the uncertainty that typically dominates firms during the privatization process. The latter has been reasonably fast and orderly. The disadvantage is that it did not create true owners. The owners (the citizens) have been passive and interested in getting satisfactory rents, not competing for profit.

Prolonged fights have ensued for the control of firms among investment funds, banks and the firms' management. The numerous investment funds, often established by (state-owned) banks, started to specialize and restructure their control over the firms and increase their independence from the funding banks. They have become soon involved in mutual share trading to simplify their profile. The consolidation of the sector has decreased the number of investment funds and increased their size.

Banks have been interested in controlling the funds and cleaning their portfolio from the bad debts that the government left in the banks to avoid jeopardizing the privatization of firms. This prevented banks privatization and sound management for many years. So banks could only hope to solve the problem by keeping the control of investment funds and extracting rents from them, i.e. from the firms they controlled.

The firms' management has tried to reach independence from the controlling investment funds and strengthen their control over the firms. They also pursue a decent performance, but this is not their primary goal, since few shares are freely traded in the market and their controllers, the investment funds, have been short of the necessary control skills for time and have engaged in more essential games.

Economic performance has suffered from the prolonged uncertainty not over the ownership of firms, but over their control. Resources have been used to gain or strengthen control, not to finance investments and innovation. It has also suffered from the postponement of cleaning of the banks portfolio from bad debt, strengthening competition, delaying bankruptcies. Economic performance has remained a secondary goal until the primary issue of control was solved, which happened only in this decade.

Hungary

In Hungary deep reforms were implemented since the Sixties. Before transformation started, the most important market laws were approved and enforced, many institutions were already in place, actors were transacting in a quasi-market context and an entrepreneurial culture existed (Bönker, 2006, pp. 70–4; Laki, 2006). This made possible to use, and the large domestic and external debt prompted the country to choose, a piecemeal pragmatic process of privatization, close to an externally enforced organic process (see Chapter 6 in this book).

There has been also an important case of transplantation of institutions. Foreign ownership became very important since the beginning via privatization and even more so via greenfield investment. Indeed, direct sale particularly to foreign investors was the primary privatization method. Management and employee buy-out was also largely used, while mass privatization, although proposed and debated, was never implemented.

Foreign-owned firms have thus embodied the new quasi-transplanted institutions that have spread to a part of Hungarian-owned firms by means of competition and cooperation, including the establishment of joint-ventures and vertical integration. One important consequence of this development has been the establishment of a dualistic economy whereby competition and cooperation have remained primarily *within* each separate segment (Farkas, 2000; Szanyi, 2002; Tóth, 1998), although counterexamples can be found (Radosevic & Yoruk, 2001; Stark & Vedres, 2006). Apparently the fault line goes between branches more than ownership: expanding branches are increasingly integrated, while mature branches are dualistic. Thus the inflow of foreign capital has solved momentarily macro-imbalances at the cost of endogenous development opportunities.

The foreign sector has resulted exceedingly successful, and has pulled a dynamic growth path. However, this success is mostly limited to the foreign-dominated sector: the remarkable growth and export performance of the Hungarian economy since mid-Nineties is largely due to some 200 foreign owned companies. This massive and successful inflow of foreign capital has pushed the development of corporate governance in Hungarian firms both directly (in foreign owned or mixed firms) and indirectly in domestic owned firms operating in dynamic branches. The latter effect took place by means of competition, imitation, integration, cooperation, and a skilled governmental regulation. The development, hence, was mainly organic.

Russian Federation

The Soviet economy was apparently characterized by a high degree of centralization. However, in particular after Gorbachev's reforms individual managers had an effective control of enterprises, also by means of strong political and social interpersonal networks. Since enterprises were regionally concentrated and dominated the life of the locality, managers and local politicians shared effective autonomous power. Russia represents then a third important case, different in many senses from the preceding ones.

First, the Russian economy was in the most difficult situation, due to a prolonged stagnation, the destabilizing effects of Gorbaciov's *perestrojka*, and political fights. The macroeconomic situation was unbalanced, and the government's control over firms was nearly lost. The planning system became largely ineffective and no alternative coordinating mechanism replaced it.

Second, the beginning of transformation coincided with the disappearance of the Soviet state and the secession of all the non-Russian republics. This had dramatic implications for the economy that went beyond the need to rebuild public administration. Indeed, the huge monopolistic companies that characterized the Soviet economy had establishments dispersed in different republics. With the disruption of the Union, most companies were truncated of entire production processes or had the headquarters in other republics. The most urgent goal of Russian firms on the eve of transformation was to rebuild production chains or develop new trade ties to replace the lost parts.

Third, there was a urgent need to stabilize the economy. However, Yegor Gaidar's government implemented a harsh stabilization plan when the prevailing budget constraint was still soft. Increasing interest rates, introducing credit crunch, liberalizing foreign trade, pursuing exchange rate stability which led to real appreciation of the ruble without far-reaching institutional reform led to booming interenterprise and other types of arrears without changing substantially the behavior of companies. The economic situation worsened substantially.

Fourth, political and economic uncertainty and the negative consequences of macroeconomic stabilization policies discouraged foreign investment. With the important exception of the mining and energy industry, it was difficult for Russian companies to export, due to the low quality of their production and the strong ruble. At the same time, the important domestic market shrank due to: the critical situation of nearly all enterprises, lack of payment means, high unemployment

and low incomes, the strong ruble, the preference of Russian consumers for imported goods. Only the 1998 financial crises have re-established a decent situation for Russian firms.

Fifth, the privatization process was more difficult, disorganized and corrupt (see Part IV in this volume). Two privatization methods stand out for their important consequences. One was mass privatization through vouchers and included management and employee buy-out. Contrary to the Czech approach, vouchers trading was allowed since the beginning on a secondary market. Due to high inflation the real value of vouchers diminished rapidly, managers could buy a great amount from other employees, and a concentrated control dominated by managers progressively replaced the initial widespread distribution of ownership among different types of insiders. Contrary to typical buyback operations in well-established market economies, whereby managers buy shares to gain control, in Russia managers used their control to acquire ownership and make their control undisputable. Until this process was over, however, owners remained weak and intent in dealings other than restructure and compete.

The other privatization method consisted of 'loans for shares' schemes. Due to the government's inability to repay the credit obtained by selected banks belonging in financial–industrial groups under the control of a core bank or an 'oligarch'[4] (i.e. a major shareholder of the group), the collateral, typically the shares of 21 among the most valuable firms in the mining and energy industry, was transferred to those groups for a cost that was a share of their value. Although the new owners were powerful and could provide firms with strong corporate governance structure, transparency was less then tolerable and the dealings under constant threat by justice, the press, and the government. The new owners were consequently intent in consolidating their control and protecting their ownership.

These developments led to the 1998 financial crisis, which has represented an important turning point in the Russian economy and corporate governance (see Part IV in this volume). As a consequence of the crisis, ownership redistribution and concentration have accelerated through different channels (including bankruptcy procedures, hostile acquisitions, corporate stock manipulations) and new market actors emerged, particularly business groups (holding companies). These business groups – including regional and local groups and also involving external investors – became the main buyers of shares in Russia, typically outside the stock market. Overall, through these processes dominant owners strengthened their dominance over minority shareholders,

although the real nature of external investors and their relation to insider dominant shareholders remain to be clarified.

These developments have had important consequences for corporate governance in each of the three countries.

Corporate governance and transformation strategies: a comparative view

The three cases discussed in this book represent three different types of transformation. The Czech Republic offers a nearly textbook case of technically successful, nearly bureaucratic transformation ridden with unforeseen consequences. Hungary – similarly to Poland – represents a case of quasi-organic transformation with an embedded institutional transplantation via direct foreign involvement that was preceded by the enactment of new laws addressed to preventing, with partial success, the private misappropriation of public assets through self-dealings and sale to related parties. Finally, Russia is the prototype of disorganized transformation starting from orthodox macropolicies disregarding the institutional context. This situation was partially adjusted at a later time and made economically viable through the shock of the 1998 crisis. From these different strategies three different types of corporate governance derived.[5]

Corporate governance in the Czech Republic became a three level game. First was the issue of the governance of investment funds or, better, of who between investment funds and banks controls whom (Stiglitz, 2001). Investment funds were typically established by state-owned banks, thus had often a unique owner. However, they acquired soon dispersed ownership by voucher owners. They became the potential controllers of Czech firms, having concentrated about three-quarters of the vouchers that citizens preferred to redeem into shares through investment funds. However, their portfolio was initially dispersed due to the limitations that the law imposed against excessive concentration of ownership and control. This situation was unstable, since banks were bound to be privatized and their portfolio was ridden with bad debts of SOEs. Consequently, banks strategies were addressed to extract benefits from ownership to stabilize their financial situation. Investment funds strategies were to become independent or, during the banks' privatization, to reverse the ownership relation.

Second was the issue of the governance of firms by investment funds. Investment funds were new actors without experience in controlling privatized firms in a new, market context. Their portfolio was initially

dispersed among many firms, so their control was soft. Further on they started to trade shares to concentrate their portfolio and strengthen control.

Third was the issue of governance within firms. Firms were at the crossroad of complex relations among different powerful stakeholders. One should also remind that the firms' employees were often shareholders of those same firms or of the investment funds that controlled those firms. The dominant paradigm was therefore a rather complex version of the stakeholders' interest paradigm with secondary interest for growth and innovation issues.

In Hungary the most prominent feature is the dualism that developed between foreign-owned and those domestic firms that operate in the stagnating branches of the economy. The former group of enterprises is a remarkable success story, although corporate governance is largely outside Hungarian control (see Chapter 6 in this book). In these firms a rather normal shareholders' value paradigm can do a good job, supported as it was by a continuous and sustained inflow of financial resources, technical skills, and human capabilities. Although this success relies heavily on the outcome of economic reforms since the late Sixties, important aspects of the innovative enterprise paradigm have been introduced through foreign investors when some of them decided to base part of their innovative strategies in Hungary. In the stagnating domestic branches corporate governance remains a marginal issue, since survival is the dominant game together with the attempt at obtaining some form of government protection, and at least a benign attitude towards tax evasion. According to the finding of comparative research (Kaplan, 1997), in stagnating branches corporate governance may make the difference, but in Hungary the prevailing paradigm is a sort of entrenched stakeholders' interest, aimed at granting survival. The good news is that this weak sector is progressively shrinking, also thanks to firms restructuring.

During the Nineties, in Russia insiders (typically managers) and the financial–industrial groups dominated most firms and branches. The nature and role of corporate governance is different in these two cases. In insiders' dominated firms a kind of stakeholders' interest dominates, the fundamental stakeholders being managers and employees, but also regional and local governments. As far as managers are able to strengthen their position and new external owners enter, the structure and function of corporate governance change. Initially corporate governance was aimed at keeping the balance of the dominant insiders' coalition of managers and employees to protect employment

by typically bargaining with governments, most often regional governments. As far as managers strengthen their position and control over firms, they concentrate more on extracting private gain, often in coalition with friendly outsiders. In the sector they dominate, oligarchs have no competitors for the control of the firm and corporate governance is entirely in their hands, except for the government, with which they have to find an accommodation. When the latter have become stronger and threatened the dominance of the oligarchs, the latter have used their control to transfer their assets in places and forms that provide better protection from governmental interference and justice prosecution. Therefore corporate governance in this sector is particularly attentive to the value of dominant shareholders, although hardly so to the needs of minority shareholders and innovation.

The situation changes considerably following the 1998 crisis (Iwasaki, 2005). The main changes are the selling of shares by employees; a significant increase of shareholding by external investors; and the weakening shareholding by the state. Notable are also the launching of initial public offerings (IPOs) by a number of Russian companies on Western stock exchanges, and high growth in the market of corporate bonds (see Part IV in this volume). However, as Dolgopyatova shows, there is a tendency to decrease the number of the board's members, insiders' representatives are predominant in the boards, and internal (workers' teams) and external (regional and local governments) stakeholders have important roles in corporate governance and often form coalitions with the management. As a consequence the monitoring role of boards remain largely formal.

Although ownership concentration after 1998 has had important positive consequences for corporate performance and restructuring, in particular in firms belonging in business groups, corporate governance remains problematic. Indeed, these developments pointing at a formal, more than structural evolution of corporate governance shed a shadow on the real meaning of external investors. Also the paternalistic and sometimes interventionist role of the state apparently pushes the latter's role beyond formal ownership in influencing the firms' governance. As a consequence, the critical issue of corporate governance is the relation between dominant (insider) shareholders and minority shareholders and the private gain from control to the advantage of the former, also by use of illicit or illegal means (Iwasaki, 2005, p. 7). The structuring of majority owners in multi-level chains strengthens their control, covers the true structure of ownership in many firms, and protects dominant owners from the threat of takeover. Managerial entrenchment is also pursued by

the managers' representation within boards, which is typically higher than their shareholding. Since managers typically dominate boards, external suppliers of finance are extremely reluctant from financing firms, which have to rely on alternative channels and particularly self- and group financing. However, one should be careful and take in due consideration the different typologies of firms that are an important feature also of Russian capitalism (cf. Part IV in this book).

Conclusion

In no country corporate governance has become really and fully sound. The best results have been obtained by foreign investors, including many transnational companies, although this is so when institutional transformation paved the way. Since foreign influence can hardly spread to the entire economy – except perhaps in the case of tiny countries – this development can create dualism within the corporate governance system of a country. When the domestic sector is stagnating and perhaps shrinking, firms find it impossible to imitate successful firms and competition loses strength.

The most problematic outcome is when the distance between existing (informal) institutions and the new (formal) institutions is great. In this case reforms and policies are either irrelevant, or actors in a favorable position use them to pursue their private goals. The Russian case has shown that corporate governance reform fails when the institutional framework is blurred. In this case the dominant game is either wait and see whether the government is willing to soften the budget constraint or use any opportunity to plunder the state through grabbing and rent seeking. Only a dramatic financial crisis could establish the conditions for partially streamlining corporate governance to the needs of a modern market economy.

An institutional game such as the voucher privatization in the Czech Republic has proven that there are no shortcuts even in this case and even starting from disciplined and macroeconomically favorable situation. The enforcement of new (formal) institutions can be relatively rapid, but a long time elapses until those institutions become actually effective, a period that is replete with complex and costly processes of adaptation and learning. Costs and difficulties may be higher if the initial success nurtures the illusion that the game is over. In this case unforeseen consequences may create uncertainty and make adjustment processes lengthier and costlier and related policies less effective. In

this case careful policy guidance may be necessary to reach satisfactory corporate governance.

Another important comparative conclusion is that the paradigm that will prevail when the fundamental transformation processes are over depends upon the privatization strategy and policies, and the nature and capabilities of the new owners, given external influence. The most important of the latter is EU access and membership, since this gives standards and predictability. If privatization relies on organic processes, if the new owners have long run productive strategies, and if the external influence is virtuous (in the sense of pursuing an orderly corporate governance of firms in a competitive context), chances are that the new corporate governance system will be effective and will direct firms to innovate and compete.

A last issue remains: how stable are the three different types of corporate governance here considered? Are they transitory structures that converge towards a 'Central Eastern European model of corporate governance' (Andreff, 2005, p. 29). This is a complex issue that perhaps needs some maturation before an answer is possible. However, the convergence perspective underplays the role of institutions. Since institutions matter (Bennedsen *et al.*, 2005; Engerman & Sokoloff, 2003; Rodrik, 2003; Rodrik *et al.*, 2004; Rodrik & Iyigun, 2005), and differ among countries in transformation, chances are that no Central Eastern European model of corporate governance is likely to develop or that such a model is so differentiated that it loses any theoretical and practical meaning.

An obvious caveat regards the influence of the EU. Two of the countries here discussed are members of the EU and are adopting EU institutions. However, both present remarkable differences in their transformation and privatization paths, economic structure, firms size, role of foreign capital, nature and role of governments, economic and political culture, and their corporate governance systems must reflect these differences. Moreover, the basic EU principle of subsiadiarity does not require institutional uniformity. As to Russia, her size and culture makes quite unlikely that EU institutions will have any important influence. Convergence, if proper conditions do not exist, is a costly and ineffective game.

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Notes

1. According to Andreff (2005) the supporters of an 'organic development' strategy in transformation countries in early 1990s included himself, Wlodzimierz Brus, David Ellerman, János Kornai (1990), Kazimierz Laski, Ronan Mc Kinnon, Lubomir Mlcoch, Peter Murrell, Gérard Roland, David Stark and, later, Joseph Stiglitz (2001). This list also includes Hans-Jürgen Wagener and myself (Dallago, 1991).
2. For an interesting political economy interpretation see Müller (1999), Bönker (2006).
3. Management and employee buy-out is usually considered a sub-optimal strategy on theoretical grounds. There are also reasons to attribute this outcome to negative selection effects, since this kind of privatization is often limited to the most problematic state-owned companies. However, this is not always the case. The Polish case shows that this kind of privatization may have provided powerful incentives to critical stakeholders to increase their effort and employee ownership has protected many firms from asset stripping by incumbent managers.
4. According to Radygin (2000), by 1994 insiders controlled nearly two thirds of Russian industrial assets and outsiders a share between one eighth and one fourth. In 2000 these shares changed respectively to one-third and slightly more than half. Since outsiders are mostly financial-industrial groups, the two methods discussed above account for the large part of the Russian economy.
5. Andreff (2005, p. 27) adds a fourth, mixed model based on an 'employee and start up' control typical of Poland leading to capital and liquidation privatization creating new start ups and an inner supervision of the firm by its employees.

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2

Economic Transformation and Corporate Finance in the Post-Communist World

Fumikazu Sugiura

Introduction

A systemic transformation has two aspects. One is to abandon and overthrow the conventional socialist economic system with centralized planning, and the other is to construct and institute a new capitalist market economy system. In this chapter I will describe how and what a systemic transformation has destroyed and created in the field of corporate finance system. Corporate finance is an economic phenomenon produced by the interaction of two economic agents: the first is a non-financial enterprise that raises financial resources, and the second is a financial institution which is the provider of funds to the former. During the process of drastic conversion of the economic rules of the game, both entities change their behavioral patterns dramatically.

A non-financial company was able to get funds without almost any condition under the communist planned economic system. In that system banks provided working capital for current activities of non-financial companies and the state budget was supplied for the required financial resources for investment activities according to the plans made and endorsed by the planning authorities. Therefore, whether or not the funds were available for companies solely depended on the negotiation results with the planning agencies, or superior level, of the line ministries and it was necessarily of a secondary significance in their decision making process because in the formulation of plans material balance was a main factor to be considered. The crucial determinants in that process were in principle political justification, or the order of priorities for the construction of socialism. On the other hand, when the plan was abolished during the transition to a market economy, each company had

to henceforth procure its funds at its own risk. First, demand for fund needed to be measured correctly, and second it had to decide which part should be provided with the retained earnings and which from the external sources. Furthermore, in order to retain external sources of funds it was required to demonstrate creditworthiness from a point of profitability and stability. That is, the justification of self demand for funds in terms of both costs and risks was to be clearly presented in order to raise funds. Under a planned economy, these kinds of consideration were completely unnecessary, because political justifications were more important for a socialist movement, which resulted in the dramatic turnabout in enterprise activity.

In the market economy, however, two elements, i.e. competition and bankruptcy, play an important role. Although in a world without competition there is a choice to survive by way of diminishing equilibrium, the simple reproduction in which they keep the same production profile in the world with competition means to lose competitiveness and thereby threatens their existence. Therefore, competition must always be won through management and technological innovation, but for that purpose investments, or financial resources are required and a risk always follows with the investment. It might result in being bankrupt eventually. In other words, it has become indispensable for the company to calculate risks and investment costs.

On the other hand, when we look from the side of financial institutions, one of the biggest conversions lies in the fact that their management decision have now become crucial in supplying financial resources to their clients. In contrast to the former system, the financial institutions can now decide whether or not to supply funds independently without any intervention. As the phrase 'control by ruble' was repeatedly emphasized in the former Soviet Union, financial institutions had a role to monitor the plan to be carried out by socialist enterprises. However, although the Soviet State Bank, or Gosbank, urged corporate borrowers to reimburse bank credits with interest and within the period of contract, this was almost always neglected in practice and the supply of investible funds from banks was hardly different from budget funds, which proves the passivity of banks in supplying funds during the communist era.

As the transformation to a market economy progresses, a financial institution, on the contrary, becomes more responsible for extending credit to firms. It could sometimes refuse funds because of the low profitability of the borrower and/or a high risk involved. They start to hesitate to give an unconditional loan to firms and in fact many of the banks have actually moved away from the credit market and rushed to more

profitable foreign currency speculations. Furthermore, it is important to note that the old mono-bank system was restructured and numerous financial institutions were established. First were commercial banks and then non-bank financial institutions also began to operate in corporate finance with a formation of capital markets.[1] As a result, the competition started amongst the financial institutions in the pursuit of highly profitable companies itself. This also brought about a change in the relation between firms and banks that had been formed under the old regime, and in consequence this installed a hard budget constraint to their relation.

Last but not least from the viewpoint of the corporate finance during systemic transformation, it is necessary to underscore the fact that every corporation has a right to set up its own financial institution. Hardening budget constraint and the great transformation of the rule of a game have made the corporation found a so-called pocket bank. Although such a movement shows a certain anti-market movement, and is far from desirable, it may well be considered as being a normal reaction.

As we have seen very briefly, both firms and financial institutions have undergone great changes, which resulted in a formation of a new type of corporate finance. Three sections will follow this introduction: in the next section I will characterize the development of a financial sector in the transition period and examine its effect on corporate finance. Then, I will depict a mechanism of corporate finance in the transition countries based on the preceding research and available data. Finally an implication of the corporate finance system on the corporate governance in the region will be discussed, followed by our conclusion.

Financial sector development in transition economies[2]

The level of development in the financial sector is an important precondition for the formation of corporate finance system. The corporate finance in the communist regime was secondary to the enterprise's decision making process and was not an object of economic calculation or consideration. But with a transition to a market economy, and the function of resource allocation being transferred to a market based on the price mechanism, the role of capital market, along with these goods, service and labor has become more and more important. Only the efficient as become function of the capital market can determine the profitability and risk of any financial needs or investment projects on the basis of economic calculation, which also requires high technology in foreseeing future developments. At the same time, the effect of

economies of scale begins to work, and the accumulation of a financial capital is indispensable for further development of a financial sector. From these viewpoints, the corporate finance in the transition period has two tasks: one is to foster and develop a financial sector which can facilitate resource allocation in an efficient manner, and the other is to keep financing to the corporate in the unstable macro economic conditions typical of a transition period.

Establishing a sound and efficient financial sector

Bank-based or market based?

Most of the economies in transition used to have a mono-bank system in the communist system, and the transformation of the system means that it should be restructured to a two-tier banking system, which consists of a central bank and commercial banks. Without any doubt a transition from a mono-bank system to a two-tier one has taken place, but there still remain divergent ideas of how to foster securities markets. Discussions between advocators of a bank-based financial system and those who insist on a market-based one have continued even now (Levine, 1997; 1998; Levine & Zervos, 1998). However, the main argument in favor of a bank-based system lies in the fact that enterprises could establish a more stable relation with banks and thereby facilitate investment activities with longer-term perspectives. On the contrary the case against such a system argues that not only the stable relation between banks and firms may hinder quick and flexible responses to a rapidly changing external environment but also banks are not adept at finding a high-potential and/or innovative project (from small and medium-sized enterprises (SMEs) in particular), due to the lack of track records of such start-ups. These shortcomings should, as the argument goes, be overcome with the introduction of venture capital.

The proponents of a financial system based on a securities market expect this to be able to determine the risk of the project more accurately. This argument fits very well with high uncertainties of the transition period. However, it may be irrelevant in practice, because the size of the capital market is generally very small in the transition economies and the volatile movement of the foreign capital has made the securities market even more vulnerable to various external shocks. In fact several countries of the transition economies have experienced this kind of financial crises induced mainly by rapid changes in the evaluation toward them and their policy measures by foreign investors. The Czech Republic, Bulgaria, and Russia are among them. Furthermore, it should

also be mentioned that these securities markets are highly dependent on market fluctuations in the developed countries, such as in the London Stock Exchange and the New York Stock Exchange. It might be safe to say that due to such defects inherent in nascent securities market they may not necessarily fulfill the function of a resource allocation, as expected in the beginning. Accordingly, in the early stage of the transition, when the securities market has not reached appropriate levels of maturity, a financial sector needed to be based on the banking sector. Indeed, the securities market in the region only started to develop rapidly after 2000.

Under these apprehensions, policy makers and researchers shed light on a banking sector as an institution for speeding up corporate sector restructuring (Bonin & Leven, 2001). Since transforming the economic structure from a centrally planned system to a market-based one means a large-scale redistribution of both resources and property rights, an efficient financial system based on banks was expected to assist it. However, contrary to such an expectation, due to mainly a stringent stabilization policy a financial flow from banks to firms somewhat waned. It means that on paper banks kept lending money to their clients but that in practice they just kept rolling over the older loans. That is why the flow of funds never accompanied the transaction. The reasons banks are reluctant to lend money to firms lie in excessively high risks for lending and the lack of effective measures to collect outstanding loans. This argument leads us to the understanding that beyond the discussion over a bank-based or a market-based financial sector, the legal environment that regulates the financial transactions is fundamentally important. This is also applicable while discussing the effects of corporate governance in the transformation period.

Legal aspects of finance

In a communist world, where private ownership was in principle prohibited, fulfilling the ownership interests in his/her properties was restricted. Therefore the owners usually did not pay adequate attention to making use of their asset and hence not only hindered the efficient economic development as a whole but also led to an overheating of the investment activities (Kornai, 1992). On the contrary, in a market economy that approves of private ownership and income from assets, people want to maximize their property income. Such a drastic change in a transition period made it necessary to set up a bankruptcy law to protect creditors' rights. This shows the importance of the discussion

of principal–agent problem in the enterprise where the owners and the managers have a different incentive structure.

As there was no legislation stipulating a private ownership in the former regime, it is quite natural to introduce from scratch. It is well-known that in the modern market economy there are two types of the legislation: one is for the protection of the creditors' rights and the other is for the protection of the debtors' rights. In the transition economies it was necessary to choose between these two, keeping in mind the *pros* and *cons* of each system. In the case of the legislation giving more weight to protecting creditors' right, bankruptcy would accelerate redistribution of the resources and facilitate the replacement of bad managers with good ones. However, over-protection of creditors could threaten the long-term stability of management and lead to opportunistic behavior (Demirguc-Kunt & Maksimovic, 1998; La Porta *et al.*, 1997; 1998; Pistor *et al.*, 2001).

Acquis communautaire and the financial system

On 16 December,1991 Czechoslovakia, Hungary and Poland signed the Europe Agreements, which covered the themes of political dialogue, economic integration, and cultural and financial cooperation and which were to establish their association with the European Community. Introduction of the economic legislation had much to do with the accession process of the CEE countries aspiring to become a member of the EU. Since compliance with the *Acquis communautaire*, which represents the whole legislation system and institutions in the EU region is a precondition for them to accede to the EU a financial sector of transition countries has become 'based on the premise of universal banking and an open internal market' (EBRD, 1998, pp. 109–10) and 'most countries have adopted civil-law-type institutions to facilitate accession to the EU' (Berglof & Bolton, 2002, p. 90; Kager, 2002).

Foreign strategic investors and non-performing loan

Looking back the development of financial sector, and the banking sector in particular, of EU accession countries, it should be mentioned that most of the former state-owned banks have been sold to foreign strategic investors. This trend started as early as in the first half of 1990s in Hungary, and even after 2000 state owned banks were sold in the Czech Republic and the Slovak Republic. Hence the banking sector in the region is almost entirely dominated by foreign capital. As Berglof & Bolton (2002) write, 'financial architecture appears to have converged to a bank-based system with substantial foreign ownership' (p. 97).

What effects then does this situation have in the field of corporate finance? It is true that each foreign investor has its own strategy of development, but in general they don't seem eager to lend money, especially for the domestic capital. The main obstacle for providing credit is the low profitability of the corporation without the participation of foreign capital. If foreign capital participates in companies, the banks with foreign capital are more likely to give them credit. However, most of them have come to the region for the higher profit margin in the retail market. Therefore they acquired a nation-wide branch network and were able to conduct business in the retail market, which has a relatively lower credit risk and a higher profitability. This situation kept foreigners from lending actively toward the real sector. Foreign capital, especially from Austria, is clearly targeting good customers in the retail market.[3] Therefore, it is quite natural to see consumer credit growing the region after the privatization (Cottarelli *et al.*, 2005).

Fostering capital market without institutional investors

In the socialist period private capitalists had never existed in a realistic sense. Therefore, there never existed institutional investors. Under such circumstances, it was very difficult to establish a capital market in a concrete manner, because the vital players were missing. Therefore, the transition economies have endeavored to make capital markets first through transactions of foreign currencies and government bonds. Banks were the only reliable participants in the market.

A rapid privatization policy has been one of the policies used to foster a securities market. By way of so-called mass privatization the entire population can participate in the securities market as a shareholder of any privatized enterprise. But, as other chapters of this book show, this effort does not necessarily bring about efficient corporate governance and meaningful shareholders. Highly dispersed ownership does not result in effective governance. Then it began to be considered necessary to bring up institutional investors so that they can become a core player in the market. Hence, the transition countries, who started to have a rapidly aging population because of the drop in the birthrate, tried to introduce a three-pillar pension system. The essence of the system is the funded pension scheme. As the research shows the outcome of the pension reform is not better than expected before (Iwasaki & Sato, 2005), and will take some time to further develop capital market. In fact since 2000, both the market turnover and market capitalization have been expanding rapidly (Köke & Schröder, 2003).

Corporate finance in the transition malaise

Budget deficit and crowding out

The system of corporate finance in the transition period has had to go through unstable political and economic conditions. Indeed unstable macro economic situations have had much to do with the formation of the new system. First, the effect of curtailing budget deficit has been affected. As in an economic environment with soft budget constraints the deficit of companies has had to be made up with the budget finance, which resulted in the rise in inflation. Most of the transition economies recorded high inflation as well as the decline in production, especially in the early stage of transition. High inflation itself has affected corporate finance; at the same time the policy to reduce inflation also had an influence on the finance activities of enterprises. The governments in the region have tried to reduce inflation, taking austerity measures and cutting subsidies to the real sector. Second, they have stopped financing the deficit through direct credit from the central bank. Financing deficit through central bank credit means additional issuing of money which leads to the further inflation. The measure taken to prohibit central bank's financing budget deficit is to issue government bonds. In the well-developed financial market, it is quite natural to issue government bonds, but in the nascent equivalents such government bonds have dominated the market because of their low risks. As a result, budget deficit crowded out other financial needs, especially ones from the real sector. Increasing interest rates stopped companies from financing their needs with bank credit.

Privatization policy

One of the most important and difficult policies in the transformation period is how to privatize a great number of state-owned enterprises in a short period of time. However, privatization has been regarded as a gospel truth and retarding privatization even due to its technical difficulties has been considered as a step backwards in the process of the transition. Too hasty a privatization might have had a negative impact on formation of the corporate finance. It should be underlined that privatize-first-restructure-afterwards policy means that privatized firms are not viable and hence not creditworthy. Although proceeding restructuring needs financial resources these firms lack access to credit. No wonder political consideration surpassed the economic rationality of the policy.

Hyper inflation and the depreciation of financial assets

High inflation caused financial repression as well as other problems closely linked to corporate finance. Financial repression means such a high inflation rate that hinders the prompt calculation of interest rate in real terms and brings about a situation of real negative interest rates. Under this condition the more companies borrow from banks the more banks lose. As companies have no incentive to make the most of the bank credit borrowed, effective resource allocation is possible.

At the same time, inflation brought about the need to revaluate the asset of companies. When banks are asked to give credit to a certain company, they have to assess the company accurately to know its creditworthiness. However, high inflation and rapid changes in relative prices of assets have made it very difficult to assess them accurately. In the early phase of the transition, banks lack the know-how and human resources to appraise assets, and this is also a reason they shy away from lending to the real sector. An accurate evaluation of discounted net present value of cash flow that would be expected from an investment project is extremely difficult.

Banking crises

Repetitive banking crises can be seen as the result of macro economic imbalances and unexperienced policy makers. Banking crises hit depositors most severely. They lose faith in financial institutions during the first wave of crises, and subsequently prefer to keep their savings under their mattresses. For the banking sector, this causes a serious problem because they cannot retain long-term financial resources on their liability side. Furthermore, they become hesitant to give longer-term credit for the investment projects.

The legacy of the communist regime also affected the following development in the banking sector. The weak interrelation between saving banks and other specialized banks prevents a coordinated welfare effect from both sides. If the interbank market functions very well as an arbitrator, both institutions play their parts respectively and more benefits would be available in macro terms. However, due to the high volatility of the economy and overshadowing distrust among the participants of the market, division of labor in the banking sector does not produce the anticipated results.

Arrears problem

Non-payment problems seem to be one of the most annoying problems of the transition. This problem is on the one hand the reason

behind the underdevelopment of the financial sector, and on the other hand, its result. In the former economic system payment issues were not a matter of concern for corporations, because fulfilling the norm of plans was a first priority and payment followed accordingly. However, in a transition period in which planning has been abolished, payment issues are a serious restraint to their activities. An instant reaction to the change was to sell and/or buy on credit. But it is more than obvious that the almost dried-up cash flow in the corporate sector forced them to delay payments. At the same time, most of the companies have any form of the trade relations and an eruption of delayed payment influenced the whole circle of transactions in no time. The only possible countermeasure to the non-payment would be to impose stringently with a realistic threat of bankruptcy. This measure was taken by the Hungarian authorities as from 1992, but political and social outcome caused by massive bankruptcy would make most policymakers in the region hesitate to follow suit. Banks have become also reluctant to give credits, because the payment gridlock cannot be eradicated with only a small injection of financial resources. Consequently, the business relation between banks and enterprises has been disrupted, and this has brought about a disintermediation of financial institutions. It should be mentioned that even now the impact of the arrears problem is felt in the corporate finance structure, which we will see later in the next section (Perotti & Gelfer, 2001; Schönfelder, 2001; Sugiura, 2006)

As we have seen already, the system of corporate finance has been formed under a variety of influences from political and economic situation in the transition period. Now we will see in more detail the corporate finance in the region, based on data available.

Data analyses

Following the previous discussion, the development of the financial sector in the transition countries will be examined based on the available data. Then I look into the data on funds for investment activities of the corporations. Trends in the capital structure of the firms will also be discussed later.

Now the role of banking sector in each of transition economies will be analyzed. Table 2.1 shows the ratio of claims of banking sector in a national economy. It is found that in the early stage of transformation banks gave a larger part of lending to the general government whereas by year they turned to claims on private enterprises. The shift did not occur in a straight manner but rather in a moderate U-shape. This means

Table 2.1 The role of banking sector in the economy, 1991–2004 (% of GDP)

	1991	*1995*	*1998*	*2000*	*2001*	*2002*	*2003*	*2004*
Czech Republic								
Claims on general govt (net)	n.a.	0.7	−2.3	0.4	5.1	10.8	16.0	11.3
Claims on private enterprises	n.a.	70.8	62.4	49.9	41.3	31.4	32.1	33.2
Hungary								
Claims on general govt (net)	61.7	59.0	38.6	22.1	16.0	17.7	14.4	11.7
Claims on private enterprises	39.2	22.6	24.2	32.0	33.5	35.4	42.8	46.5
Poland								
Claims on general govt (net)	10.8	12.3	9.8	6.1	7.6	7.1	7.7	6.6
Claims on private enterprises	24.0	16.9	22.6	26.6	27.3	27.5	28.1	26.6
Slovak Republic								
Claims on general govt (net)	n.a.	10.2	8.0	5.5	22.7	12.0	11.4	11.9
Claims on private enterprises	n.a.	36.8	53.9	51.3	37.6	39.6	32.4	31.2
Slovenia								
Claims on general govt (net)	1.8	7.9	6.1	7.2	7.8	5.2	6.4	7.3
Claims on private enterprises	34.9	25.4	30.5	35.8	38.1	38.6	41.0	45.9
Estonia								
Claims on general govt (net)	−3.3	−3.6	−2.0	−2.0	−1.8	−2.4	−1.9	−2.8
Claims on nonfinancial public enterprises	46.6	0.8	0.3	0.3	0.1	0.2	0.2	0.5
Claims on private enterprises	18.8	14.1	23.8	23.9	25.2	27.0	32.8	42.4
Latvia								
Claims on general govt (net)	n.a.	4.6	2.0	3.3	1.2	2.4	4.0	2.8
Claims on nonfinancial public enterprises	n.a.	1.0	0.6	1.1	1.6	2.0	1.5	1.5
Claims on private enterprises	n.a.	7.1	13.7	16.9	21.1	26.2	37.4	54.8
Lithuania								
Claims on general govt (net)	n.a.	−1.1	0.6	1.4	1.5	1.1	−0.3	0.3
Claims on nonfinancial public enterprises	n.a.	0.9	0.6	0.7	0.5	0.4	0.3	0.1

Claims on private enterprises	n.a.	14.3	11.0	11.4	11.4	13.9	20.2	25.7
Bulgaria								
Claims on general govt (net)	35.7	28.9	5.0	5.1	5.1	3.9	2.1	−1.0
Claims on private enterprises	82.8	39.9	10.6	12.6	15.0	19.8	27.5	37.1
Romania								
Claims on general govt (net)	n.a.	1.2	5.9	4.7	2.1	1.3	−0.3	−2.2
Claims on nonfinancial public enterprises	62.4	22.3	3.1	1.4	1.4	1.6	1.6	1.3
Claims on private enterprises	n.a.	0.0	11.6	7.2	7.7	8.3	9.5	10.0
Croatia								
Claims on general govt (net)	n.a.	15.4	5.2	7.3	7.7	8.4	7.6	6.7
Claims on nonfinancial public enterprises	n.a.	1.9	1.7	1.6	1.9	2.1	2.1	2.4
Claims on private enterprises	n.a.	31.2	41.2	37.4	42.3	50.8	54.3	57.5
Russia								
Claims on general govt (net)	n.a.	11.7	27.6	10.1	7.9	7.6	5.2	n.a.
Claims on nonfinancial public enterprises	n.a.	4.4	1.5	1.1	0.9	1.1	1.1	n.a.
Claims on private enterprises	n.a.	9.4	15.6	13.3	16.5	17.7	21.0	n.a.

Source: Calculated by the author based on IMF (2006).

that the banking sector reduced its lending first to some extent, and only after that started increasing its portfolio to the private sector. This process clearly reflects a number of the transition issues. That is, banks started to be reluctant in giving loans to the firms because they identified the clients' low creditworthiness, and because they had to face a prudential regulation by the financial authorities. They were forced to accumulate provisions in preparation for payment insolvency and to increase their capital. Therefore enterprises went through hardening budget constraints from the side of a banking sector.

As the case for stock exchanges, the outcome is less than previously expected. It is true that the number of listed companies grew rapidly

in countries that had adopted a mass privatization policy, but the level of market capitalization is still not high (Table 2.2). Trade turnover was in a sorry state, except for Poland. We find that capital markets in the region had low liquidity and were highly volatile and failed to serve as a stable provider of financial resources. However it should be emphasized that the markets began vitalizing after 2000. This trend has much to do with the financial inflow from abroad at that moment. Transition economies have been active in introducing foreign capital. It goes without saying that there have been very active foreign portfolio investors from Western Europe. Indeed the portfolio investment into the region has been growing since 2000, which coincides with the development of securities market there. Apart from that, some major enterprises have even raised funds in the western market. This has particularly been the case of enterprises closely related with oil and gas sector. By way of issuing bonds abroad the firms may benefit from a good reputation and this could be an appropriate strategy in a more and more globalized business society.

Next, we turn to the data of corporate finance, which consists of two phases: one is to secure cash flow for the purpose of the firm's current activities and the other is to finance an investment activity to help develop in an uncertain world. As has already been pointed out, companies have to make an investment in order to develop by themselves and such activities are of their sole responsibility. Hence we will explore investment financing will be explored.

Sources of finance for investment activities

How has enterprise investment been financed in transition economies? (see Table 2.3) Even under such undesirable conditions as an underdeveloped financial sector and unstable macro economic conditions, firms had to plan and execute their investment activities. The initial observations provide some indication of how enterprises were financed under the previous regime. At the very beginning of transition practically free financial resources from state budget or Gosbank dwindled. However, as mentioned above banks in turn did not increase lending, but rather restricted providing money. This naturally led to a high dependency on internal sources of funds. Since the firms in transition suffer from a lack of cash flow, the halt of bank credits damaged investment activities in a direct manner, and accordingly was responsible for a dramatic decline in production.[4]

When we look into a funding structure of western market economies, high dependence on internal sources is also characteristic of developed

Table 2.2 The development of stock markets, 1995–2005

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Czech Republic											
Number of listed companies	54	82	91	92	74	57	47	44	37	33	23
Market capitalization (% to GDP)	20	26.7	24.4	19.3	22.6	19.2	n.a	13.9	17.1	25.0	n.a
Hungary											
Number of listed companies	42	44	47	53	64	58	55	47	48	46	44
Market capitalization (% to GDP)	5.8	12.2	35.2	29.4	35.9	26.1	20.0	17.3	22.8	25.1	n.a
Poland											
Number of listed companies	65	83	143	198	221	225	230	216	202	225	234
Market capitalization (% to GDP)	3.7	6.2	9.1	13.0	19.9	18.9	14.8	14.3	14.5	24.3	n.a
Slovakia											
Number of listed companies	15	14	10	10	8	7	9	11	9	8	7
Market capitalization (% to GDP)	6.5	6.4	6.9	3.2	2.4	2.3	n.a	3.8	4.0	5.9	n.a

Table 2.2 (Continued)

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Slovenia											
Number of listed companies	17	45	78	90	130	149	150	135	134	140	116
Market capitalization (% to GDP)	n.a	n.a	n.a	n.a	n.a	n.a	18.4	23.4	25.8	27.5	n.a
Russia											
Number of listed companies	n.a	n.a	n.a	n.a	n.a	n.a	46	51	676	412	596
Market capitalization (% to GDP)	n.a	n.a	n.a	n.a	n.a	n.a	n.a	38.7	59.2	39.2	n.a

Note: For Russia, the data are sum of MICEX and RTS stock exchanges.
Source: Figures for 1995–2000 are quoted from Köke & Schröer (2003, p. 8). The rest are calculated by the author based on the data available at each stock exchange's internet sources.

Table 2.3 The structure of external corporate funding relative to gross fixed capital investment

	Poland		*Hungary*		*Czech republic*		*Russia*		
	1998	*2000*	*1998*	*2000*	*1998*	*2000*	*1999*	*2001*	*2003*
Domestic sources									
Bank credit	17.1	11.4	20.4	18.9	5.5	−8.6	4.5	3.7	6.1
Bond issues	2.3	1.7	1.2	0.1	2.1	2.9	–	–	0.2
Equity issues	2.8	1.3	0.4	0.0	0.0	0.9	–	–	0.3
Foreign sources							5.1	4.6	4.0
Intercompany loans	4.0	4.0	4.1	3.1	6.3	4.1	n.a.	n.a.	n.a.
Bank loans	2.8	3.3	3.2	13.6	5.3	3.7	n.a.	1.5	2.1
Bond issues	2.2	1.4	−0.3	−0.1	1.8	1.0	n.a.	n.a.	n.a.

Sources: Figures for Poland, Hungary and the Czech Republic are quoted from Reininger *et al.* (2002, p. 425), and figures for Russia are calculated by the author based on Rosstat, *Financy Rossii* and *Statisticheskii Edzegodnik* (various years).

market economies (Corbett & Jenkinson, 1994). But we cannot consider this as an identical phenomenon. While in western economies the high ratio of the SMEs, which are not always active or able to raise external funds, explains this situation, the problem in the transition countries lies in the fact that large scale (former) SOEs, not SMEs, are dependent only on retained earnings. Banks have good reasons not to lend money to them. Large scale (former) SOEs might have potential, but at the same time they have accumulated a large portion of liabilities, too. Naturally, in order to get loans it is always necessary for firms to present banks with a reliable track record of good performance, which is something they usually lack. The transition period means by its definition a period during which those necessary institutions are to be formulated. Also, it should be underscored that in order to develop a financial sector an accumulation of financial resources among the population is to some extent is necessary. Now that the macro economy has been stabilized and a financial sector has begun to expand, it could be expected that corporate finance in the region will develop further as a financial sector expands.

Capital structure

Now we focus our attention on capital structure of firms and working capital in particular in relation to current operation. This is not always easy, but we approach this problem from the angle of asset structure

Table 2.4 The capital structure of firms in Hungary and Russia

	Hungary		*Russia*		
	1998	*2000*	*1996*	*2000*	*2002*
Invested assets					
Intangible assets	1.5	2.0			
Tangible fixed assets	44.8	43.2	69.2	48.3	46.3
Invested financial assets	8.5	9.1	8.8	13.9	15.9
Current assets					
Inventries	13.0	13.0	6.2	9.3	9.4
Receivables	20.5	21.6	7.0	15.7	17.0
Securities, for sale	3.2	2.7	0.3	3.1	2.9
Liquid assets	6.8	6.6	0.5	2.0	3.2

Note: Invested financial assets in Russia are the sum of long-term financial investment and construction in progress.
Sources: Author's calculation based on Rosstat, *Statisticheskii Edzegodnik* (various years) and KSH (2001; 2003).

of non-financial firms, making use of aggregated accounting data in Hungary and Russia (Table 2.4). A frequent revision of accounting rules, an issue of accurate assessment of assets, and a change in relative price structures have been obstacles in analyzing this issue.[5]

The data in two countries show a high ratio of receivables. It is because, whereas the former regime almost automatically assured financing for the current activities of firms, they had to make up their financing needs on their own responsibility. This is also a reaction to the hardening budget constraints from banks. Firms tried to escape from a severe external pressure through buying and selling on credit. (Cornelli *et al.*, 1998)

Another characteristic is the low rate of current assets, particularly, in Russia. Excessively austere monetary and fiscal policies were responsible, in part, for this drying up of enterprise liquidity and it also most probably accelerated a historically large decline of production in the Russian Federation. At the same time, this situation brought about a myopic and even criminal behavior of the incumbent management. (Titman & Wessels, 1988; Harris & Raviv, 1991; Rajan & Zingales, 1995)

Implications for corporate governance

These arguments lead us to a preliminary conclusion that the financial sector in the region has only started to develop. In other words, it is doubtful whether or not it could have driven the restructuring

of corporations and accelerated transformation to a market economy, as expected at an the early stage (Bolton & Scharfstein, 1998). We will discuss the synergy between corporate finance and corporate governance.

Fostering a sound financial sector has been one of the most important policy agendas of transition. Nevertheless activating a financial sector has been hindered by too many difficulties and legacies of the past. A financial sector and a real sector are inextricably linked. When a real sector faces a deep crisis, it is, in principle, impossible for a financial sector to grow separately. It may be worthwhile to remind readers of the Russian financial crisis in 1998, which seriously damaged the Russian financial sector. It is after more than a decade from the start of transition that both the real sector and the financial sector overcame their segmentation and began to develop side by side.

The effects of developing corporate finance on corporate governance

As we have seen in the previous section, the system of corporate finance is at present developing from weak relations to strong ones. Due to unstable relations and a standstill in providing loans at the earlier stages of transition, financial institutions have been transformed into a market entity that is sensitive to a budget constraint. It is of no surprise that banks stop lending loans to a non-viable company because they themselves are subject to external pressure to be strict on a budget constraint. As a result, the banks exert this pressure on their clients. However, this is not equal to the enhancement of the effects of corporate governance. When firms leave a credit market, which is what actually occurred in the transition period, the influence from financial institutions stops to affect the behavior of the corporation. Firms in an isolated business society are free to choose their orientation. Banks are no more able to control their clients in any manner and the governance by banks through debt finance turns out to be ineffective.[6] Although 'debt finance has a useful role to play in the transition, while the equity markets are weak or non-existent' (Day & Taylor, 2004, p. 79) potential stakeholders, such as financial institutions, had only a minor role to play in this condition.

It is also important to note that the capital market has been negligible for corporate governance structure. These faults were almost certainly responsible for in the failure to improve company performance after privatization in many countries, as has been stressed (Estrin, 2002, p. 113).

Conclusion

The corporate finance in systemic transformation has been characterized by two distinctive features: the high ratio of inter-enterprise credit in the capital structure and the high dependence on retained earnings as a source of investment. The former was the background of overwhelmingly rampant practice of selling and buying on credit. Furthermore, firms have been indifferent to prompt payment. As for the second feature, on the other hand, financial institutions are prudent in providing loans for firms of low profitability with a high risk, and they prefer to put their money on the foreign currency market or the government bonds market. In addition, they prefer to gain market shares in the loans made to consumers. Firms, for their part, are also hesitant to borrow loans from banks because they fear the risks of leakage of business information on the business to potential rivals and of being taken-over, in addition to the high financial burden of borrowing. For some countries, the state budget still plays a vital role in providing financial resources to the real sector. We might conclude that the corporate finance in each transition country has its own characteristic, based on each unique political and business environment.

Thus, the less intense relationship between companies and financial institutions has not promoted corporate restructuring or improved the efficiency of the companies, which was expected to be a function for nascent corporate governance structure in the first place. Lack of governance tools for financial institutions prevents effective governance. Furthermore the formation of conglomerate with the participation of financial institutions might further emasculate the controlling effect of financial institutions, because financial institutions in a conglomerate they have to provide credits without any condition.

Now the corporate finance in the region has come to a crossroads for further development. It becomes more and more important to foster a sound financial sector so that it can assess risks and profitability in an accurate manner and implement proper governance to the borrowers.

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Notes

1. In such countries as the Czech Republic and Russia where mass privatization policy was implemented, the privatization investment funds soon played a vital role.
2. For further reading on the development of a financial sector in transformation countries, refer to Bonin & Wachtel (2003).
3. However, Konopielko writes that 'the most appealing vehicle of entry into CEE banking is through setting up a subsidiary' (Konopielko, 1999, p.469)' For the role of foreign capital in the CIS countries see Interfax (Interfax).
4. In the Russian federation the financial sources from the government budget still play a vital role in financing investment. They have been curtailed so as to diminish budget deficit. But now the budget accumulates surplus and policy makers start working out how to use them for investment purposes.
5. Of course, it should be noted that simple arithmetic average disregards the vast variety of size, sector, and ownership structures of firms. For example the access to external finance differs tremendously between domestic firms and those with foreign capitals.
6. It might be also applicable when banks keep their outstanding claims on (former) SOEs. Some countries like Hungary have introduced a tight mechanism to expel companies with a lax attitude to discipline. However, generally speaking, as such a policy has a large number of setbacks politically and socially, it is not always possible to introduce such a policy.

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Part II

The Czech Republic

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3

Corporate Governance, Ownership Concentration and Foreign Direct Investment in the Czech Republic

Kryštof Mejstřík and Michal Mejstřík

Introduction: the theory of corporate governance and its application in the Czech transitional economic environment

Any in-depth analysis of rapidly transforming post-communist economies might find inspiration in the process of 'creative destruction,' first defined by Joseph Schumpeter in 1942, in describing a period of economic and social restructuring that eventually led to an imbalance in economic development in CEE countries. For a number of obvious reasons, these wholesale systemic changes have caused various problems, for example, shortened time frames for the individual's planning period. In addition, they have left economic agents inexperienced in estimating the probability of outcomes or the stability of prevailing external circumstances. As a result, unknown long-term costs and benefits are heavily discounted, which often results in establishing a one-off game. While these imbalances have been caused by the conscious economic policy diagnosis of various participants in the political process, they have also produced new, unexpected imbalances, the solution of which requires new major economic policy responses (Mejstrik, 1997; 1999). The resulting historical track record of both wide-reaching economic institutional developments and crucial government policies, as demonstrated, for example, in the key ownership changes of core companies and the efforts made to ensure their long-term political support by a wider constituency, has inevitably influenced the behavior of companies, their corporate governance and their performance.

The accepted definitions of term '*corporate governance*' itself, although commonplace since the 1990s, vary among their different users. In its narrowest sense, the term describes the formal system of accountability of the senior management to the shareholders. In its broadest sense, the

term stretches to include the entire network of formal and informal relations involved in the sector of joint stock companies, as well as their social consequences. In this chapter, we will base our arguments upon the definition of corporate governance established by Keasey *et al.* (1997; 1999) as 'the structures, process, cultures, and systems that engender the successful operation of the organizations.' This definition is in line with the notion of the firm as a set of contracts (Jensen & Meckling, 1976) subject to limited liability. Keasey *et al.* (1997) has also stressed that the absence of consensus on the definition of corporate governance has led to fundamentally different analyses and solutions, causing disagreements over important issues, most notably the question as to what, if any, restrictions should be placed upon the contractual freedom of the shareholder, as a resource owner, to maximize his financial reward from such sources.

In the process of their transition to a market economy, all Central and Eastern European countries inevitably experienced problems with corporate governance. The emergence of tradable shares and the opening of the capital markets required both the existence of certain prerequisite conditions as well as a demand for efficient corporate governance. Not until relatively late did most politicians and theoreticians acknowledge that the pure act of transferring ownership of assets from the state to the private sector does not establish of itself the conditions in which enhanced corporate governance generates greater enterprise efficiency and produces strong evidence of private ownership.[1]

Mejstrik (1999) compiled a list of specific Czech institutional characteristics that suggested that the basic conditions necessary for the existence of well-functioning markets – particularly the markets for capital, managerial labor, and corporate control–were absent at the time of the study. There were no efficient banking or non-banking institutions; both institutional and legal frameworks were underdeveloped; and, most of the contracts 'shaping' the corporations, including market exit, or bankruptcy, law, were not only incomplete, but vague and hardly enforceable. Most of these inadequacies were typical for a number of CEE countries in the 1990s and consistent with the general framework set by Shleifer & Vishny (1997) and La Porta *et al.* (1998; 2000; 2002) or Klapper & Love (2002). The primary determinant of corporate behavior was, of course, ownership changes.

The initial ownership structure as a result of the Czech privatization model

The most significant task facing transitional economies was the transformation of SOEs into value-maximizing concerns. In the Czech Republic,

this was initially addressed through a rapid change of ownership induced by both standard sales, most frequently used among small and medium-sized SOEs, and coupon privatization, which was favored by a significant number of medium-sized and large SOEs. Coupon privatization entailed the redistribution of blocks of shares in the SOEs through the single multistage auction process. Many foreign analysts came to the rather superficial conclusion that coupon privatization generated homogeneous, highly dispersed ownership, which has negatively affected their further arguments based upon that premise. More careful analyses demonstrated that, besides firms with dominant insider ownership by managers and employees, 'the most pervasive governance structure resulting from the mass privatization program in the Czech Republic was outside ownership, either dispersed among private coupon holders or more concentrated with unregulated investment privatization funds (IPFs) [investment privatization fund] and the National Property Fund. The incentives and governance structures of the IPFs, and in particular their financial relationship with banks, greatly influence the restructuring outcome in the privatized sector.'[2]

In the first coupon wave alone, 842 of 973 Czech companies offered more than 50% of their shares for coupons, making the coupon investors their most important owners, followed by non-coupon investors, like direct investors. Some 429 coupon investment funds were legally registered in the Czech and Slovak Republics, attracting 72 per cent of all coupons invested by coupon holders. However, 55 per cent of coupons placed with the IPFs went to just 14 investment fund groups, mainly subsidiaries or affiliates of well established financial institutions, such as the large commercial state-owned banks, savings banks, insurance companies, or, much less frequently, around privately owned financial groups that emerged in reaction to the opportunities provided by coupon privatization.[3]

Frequently, ownership relations were not separated hierarchies but mutually interconnected non-transparent cross-ownerships (Mejstrik *et al.*, 1997). The incentives and governance structures of the IPFs, and in particular their financial relationship with banks, greatly influenced the restructuring outcome in the privatized sector. The core ownership rights were, however, dominated by a few institutional owners, namely IPFs and their principals. Given the characteristics of corporate governance and its institutional framework, which are also discussed in Mejstrik (1999), at general meetings, the coalitions of those funds dominated unorganized dispersed shareholders, who could exercise very little influence through their voting rights. Hence, the initial largely heterogeneous ownership

structure was multiplied by a voting scheme. Table 3.1 specifically illustrates the analysis of effective voting strength at 919 Czech firms privatized in the first coupon privatization wave. We have intentionally subtracted the votes of very small shareholders, who did not usually take part in voting. Potential coalitions of one to four funds were capable of achieving a majority in 727, or 80 per cent, of privatized joint stock companies. However, while waiting for the competitive groups to consolidate, the major alliances would also potentially have been able to govern the corporations which they controlled by maintaining clear prerequisites for behavior.

As a result of coupon privatization, a substantial portion of the Czech and Slovak economies fell under the control of a relatively small number of founders of investment privatization funds via closed, or silent, investor consortiums. Individually founded or financial institution-founded funds were originally often seen (e.g. by EBRD (1995)) as 'outside investors.' As demonstrated in an insightful analysis by Simonson (1999), the bank investment companies especially were expected to exercise 'arms length' corporate control over portfolio companies by using their funds to overcome the dilution of oversight expected when remaining holdings are thinly spread among many individual citizens and a passive state. It was feared that if an effective outsider group did not have control, owner-managers would behave in a self-serving manner and neglect the cleaning up and restructuring of firms. This raises two significant questions: who,

Table 3.1 Relative power of investors in Czech companies after the first coupon privatization wave (%)

Investors' voting strength	*50*	*40*	*30*	*20*	*10*
Foreign investors	33	40	45	45	51
Domestic direct investors	24	30	40	47	58
Temporary holdings of FNP	56	88	135	173	293
Permanent holdings of FNP	3	7	11	11	21
Shares to be sold by banks	12	17	30	47	61
Additional restitutions	4	6	7	11	52
Single largest fund	146	231	442	737	895
Two largest funds – cumulative	473	644	782	974	916
Three largest funds – cumulative	669	760	847	892	918
Four largest funds – cumulative	727	790	860	897	918
Five largest funds – cumulative	754	809	867	900	918
Six largest funds – cumulative	761	817	869	902	918
Ten largest funds – cumulative	768	821	872	903	919

Source: Lastovicka *et al.* (1995).

then, controlled those banks or related investment groups, and exactly what types of mutual impacts have evolved due to the presence of outsider groups? Given the dominant position of state holdings in the largest of them, financial institutions might be perceived as having remained state-controlled institutions. The continued dominance of the state was reflected in the importance of the state-appointed management, which suffered from a specific agency problem as a result of the inevitably ambivalent goals inherent to any state principal, namely that the tensions between efforts to maintain bank efficiency and the demands of national and regional interests articulated for better or worse, through the actions of politicians. Thus, Czech coupon privatization paradoxically contributed to a sort of temporary 're-nationalization' enacted by dominating financial co-owners and state-controlled banks, struggling with the typical conflicts of interests inherent to those structures. In addition, the inadequate protection of private shareholdings in joint-stock companies and a rigid institutional structure stimulated a system of corporate governance of both non-financial and financial companies which lacked efficiency incentives due to the long-term combination of both rigid direct banking control through their position as main creditors and indirect bank control through the shares owned by the banks' subsidiary investment companies. This suggests that the Czech corporate and banking governance model was much closer to a German model than to an American.[4]

The coupon privatization was merely an artificial primary issue or IPO by which ownership interests were initially transferred from the state to private entities. Transfer of stock to the hands of individual or corporate coupon shareholders did not by any means mean finding ultimate owners, or contributing to any increase of corporate capital (Mejstrik, 1997; Mejstrik *et al.*, 1997). At the same time, coupon distribution did not add to the financial burden typically caused by privatization through leveraged buy-outs and neither sanctioned nor motivated enterprise restructuring.

Corporate governance models within the transition environment

Within such a problematic institutional framework and ownership concentration, Western corporate governance models need to be reassessed so as to highlight the fundamental role of ownership patterns in the definition of key corporate governance issues.[5]

The Anglo-Saxon (or Anglo-American) widely-held shareholder model

In the Czech Republic, implementing the Anglo-Saxon 'finance model' approach, which focuses primarily on the role of corporate governance in supporting reasonable dynamic risk-sharing behavior of shareholders and managers, as a solution to the corporate governance problem has met insurmountable difficulties, chiefly because the suitable preconditions necessary for a change to the Anglo-Saxon finance model had not been met. There is no means of granting shareholders access to liquid stock markets in such a way that ensures the transferability of shares and gives shareholders unrestricted, low cost exit opportunities. In particular, there was only negligible liquidity of trading for small fragments of shareholdings, and there was no take-over barrier to management discretion or significant acquisition premium.[6] Only in 1996 was a mandatory bid in the case of a takeover by a 50 per cent majority shareholder introduced. Buy-out prices, based on the easily manipulated public market price, had been low.

In most cases, however, in spite of ownership concentration, the distribution of shareholding into the hands of two or three legal entities was sufficient to preclude all regulated buy-outs. While coupon privatization represented the artificial IPO of around 2,000 issuers, there was a general tendency to leave public markets and go private, not only for small and medium size companies, as one might expect, but also for many large corporations for which this model appeared to be appropriate, either because it allowed them to escape the restrictions on their activities which a share listing entails, or, in the case of companies taken over by foreign capital, in adherence to the parent company's policy. This tendency to switch to private markets reveals a mistrust of and loss of interest in the related corporate governance finance model. Of the total number the originally 'publicly tradable' companies in the Czech Republic have been delisted 90 per cent. These factors combined (further developed in Mejstrik (2003)) made the cost of financial intermediation through the stock market prohibitive.

The stakeholder model

In the Czech Republic, this model was explicitly applied to a limited number of cases, e.g. in the privatization of large and smaller corporations with a regional monopoly, such as local companies distributing energy, gas and water, where the client-municipalities' interests had been acknowledged through the issue of minority parcels of shares.[7] In keeping with

Czech law, these shares were intended to represent a blocking minority vote of 34 per cent in order to increase minority shareholders' voice in company management. However, limited minority shareholder protection and the inability of the legal framework to guarantee minority shareholder rights, plus expected low dividends, led the most of money-starved municipalities to submit to the temptation to sell out their shareholdings to international investors. This was further evidence of the mistrust of the administratively enforced corporate governance stakeholder model.

The implicit use of the stakeholder model could be seen in the growing frequency in cases of swapping of large debts for equity, as part of the process of the financial restructuring of companies with excessive bank debt and unpaid arrears to suppliers. Due to weak legal support for the position of creditors *vis-à-vis* the controlling shareholders, there has always been a danger that such a solution, when enforced by a particularly large bank creditor with a special relationship to the company management, might harm minority shareholders.

If we take the stakeholder model in its more general meaning, as companies behaving in a way which maximizes more than the direct interest of its shareholders, it must be said that little official encouragement was given to the notion of 'corporate social responsibility' (CSR) in the 1990s. Nevertheless, companies did on many occasions go beyond their legal duties in curbing environmental emissions and in supporting sporting and other welfare activities in their communities.[8]

Single owner or fully concentrated ownership solving the problem?

The stocks of many corporations were accumulated by a single investor, either an individual or a company, the public tradability of their shares was cancelled and companies went private. In other words, the single owner-manager approach typical for closely-held or privately-held companies and its modifications became widespread. Single-owner control is often considered as the most straightforward way to govern an enterprise by reducing the firm's direct information provision costs without having to satisfy the requirements of public financial markets. The firm's limited reporting, however, makes the firm less transparent to its business partners and allows for unsanctioned non-compliance with low information disclosure requirements. The decisive role in external financing was taken by bilateral loans provided by banks, which thus became the only monitoring institutions.

In the Anglo-American world, this model has only been used by small and medium-sized companies or strategic investors. Until recently in the German or Japanese environment, such a model was used in the

governance of large corporations. Recent discussions (represented by La Porta *et al.* (1999) and Caprio & Levine (2002)) have concluded that outside of a handful of countries (e.g. the United States and the United Kingdom), concentrated ownership is the standard mechanism for exerting corporate control, reducing the need to rely upon a weak legal system. If not held by a single owner, concentrated ownership raises other corporate problems both for owners and creditors, however, Caprio & Levine (2002), and number of other analysts, do not clearly distinguish between the former and latter case.

Czech transitory corporate governance model – large shareholder (dominant block holder) behaving as single owner with private benefits of control

Specific problems arise in the case of significantly, but not fully, concentrated ownership in countries with weak legal systems. As demonstrated in analyses by Simonson (1999) and Stiglitz (1999), although coupon privatization distributed share ownership widely, enterprises have routinely come under the control of managers, closed investor consortiums and the state. As described by Mejstrik (1999), the markets for capital and corporate control in a number of Eastern European countries, including the Czech Republic, transformed themselves into a bivalent 'all-or-nothing' form, where '0' or '1' were the only values for corporate control. As an illiquid market with 'smooth' quantities of shareholdings was the only market for majority or corporate control in the Czech corporate world, gaining a voting majority enabled the controlling majority shareholder to feel, or imagine, that he could dispose of the entire profit ('1'), not just his own share. This was possible because the managers of controlled companies were either tempted or forced to enter into disadvantageous contracts with interposed trading vehicles set up by the dominant shareholders.[9] Then profits, and not infrequently assets, could be stripped from the company. However, this level of control over the enterprise's cash-flow extended well beyond the moment, when enterprise met the conditions requiring filing for bankruptcy.

In the opinion of commercial lawyers, police prosecutors and judges, until the end of the 1990s, there was no viable way in which this practice could be deemed illegal. Managers of many investment management companies were able to take advantage of passive investors' behavior and enjoy all the benefits of controlling industrial holdings without the consent of their minority shareholders, often to the detriment of their interests. Quite a number of investment companies conducted themselves in a manner that would elsewhere be deemed unethical, to say the least.

Nevertheless, they escaped any adverse repercussions. Judges were the other obstacle. In Czech jurisprudence, to succeed in a prosecution on charges of profit or asset stripping requires that intent to do so be established. Czech judges showed little ability to impute intent to the accused, no matter how obvious the intent was from the circumstances of the case. In the early 1990s, there was therefore little chance of obtaining a conviction unless the accused actually confessed. Instead, 'bad commercial judgment' as an explanation for the losses became the defense of even those bankrupts who had ruined one company under their control by selling its assets at artificially depressed prices to another company directly under their control.

Given the unrepeatable or one-off character of privatization, the ambiguous nature of most contracts and lack of clarity within the institutional framework itself, there were additional strong rationales for 'cheating'–i.e. for exploiting any contractual ambiguities in a largely unregulated environment to one's own advantage – as a dominant strategy in a one-shot game. Redistribution, the 'tunneling' of 'other people's money' invested into corporations and investment funds by those that should have managed them, was practiced by a number of corporate and private money managers and trustees whose personal ethical values did not prevail over the temptations posed by the rigid, weak and un-enforced legal framework. At the same time, state-controlled financial co-owners were exercising property rights in very passive manner. Such a model seems to describe the wider Central and Eastern European environment during the 1990s.

Private benefits of control and their drivers

The 'wild' concentration of Czech ownership structures and the banks' behavior as subject to the Czech transitory corporate governance model

The Czech transitory corporate governance model was characterized by the existence of a controlling shareholder, or dominant blockholder, that behaved as a single owner privately benefiting from his control to the detriment of minority shareholders. Hence, the agency relationship between controlling and minority shareholders has overshadowed conventional shareholders-managers issues. As illustrated in Table 3.1, in contrast to many analysts, since 1995, we have recognized a relatively high degree of ownership concentration in the hands of a few funds, whose alliances represented only a handful of controlling blockholders. In spite of the

general advantages of diversified ownership, the blockholders behaved in different manner and further gradually concentrated their ownership rights.

We agree with Hajek (2006) and Holderness (2003) that large-block ownership can be motivated by two factors: (i) the shared benefits of control and (ii) the private benefits of control:

> These two factors are not mutually exclusive and usually are at work together. The shared benefits of control stem from the improved management and monitoring that can result from the existence of the blockholder.[10] Private benefits of control[11] in this respect play a similar role. If getting private benefits of control is relatively easy, incentives to form blocks and restrict others to gain control of the company and transfer value out of the company are high; increased productivity accrues to shareholders proportionally to their equity, while private benefits of control are allocated based on governance power.

Unsurprisingly, in the institutional framework of 1990s, getting private benefits of control was relatively easy; hence incentives to form groups of controlling shareholders were high. As we have seen, in the absence of any capital market rules, the managers of many investment management companies were able to replace passive investor's behavior and enjoy all the advantages of controlling industrial holdings without the greater consent of their minority shareholders, and often to detriment of their interests. The new investment company-controlled investment privatization funds were sometimes perceived not as portfolio investors, but as vehicles for concentrating ownership in an effective governance structure that would exercise close supervision and compel firms and their managers to become efficient and competitive. While a diversification rule to protect investment fund shareholders limited IPF's ownership of the total nominal value of securities issued by the same issuer to 20 per cent, several funds were usually controlled by one investment management company that also jointly kept their shareholdings in the same companies and resigned for diversification. The equity capital of the private parent companies was low, but was multiplied inside financial groups created through subsidiaries and 'sub-subsidiaries,' or by explicit and implicit loans, which they extracted from controlled companies. At the same time, more serious funds, usually with bank principles, formed the associations, and imposed the international standards of self-regulation on them.

A more disturbing example of this transition 'bivalent' corporate governance model occurred in the modification of behavior of banking

institutions, including major banks with majority state shareholdings. Through informal channels, politicians, bureaucrats and the use of their own common sense, the executives of these banks, who were in fact state appointees, were successfully convinced to violate prudential banking rules and provide unviable loans to acquire or privatize large companies,[12] preserving their client's indirect control via granted acquisition/privatization loans. News that a controlling portion of a company's shareholding was held by one domestic shareholder was almost invariably followed by a rapid decline in that company's share price. In effect, the costs of takeovers in the Czech Republic were reduced by half because the acquisition of 50 per cent, and sometimes less, of the issued shares allowed the dominant shareholder to appropriate all of the potential profit. Although legislation was eventually implemented requiring a shareholder to make an offer to purchase the shares of the other shareholders after passing the 50 per cent threshold, it was easily circumvented by acting through more than one corporate entity. As a result, the dominant shareholder came to possess all the advantages of a single owner, riding on the backs of those remaining shareholders who had been unwilling or unable to sell while the dominant shareholdings were being accumulated. Moreover, since the acquisition was typically financed by bank loans, there was no downside risk if the company subsequently failed through bad management or asset stripping. The loans often remained unpaid, while companies relied on increasing accumulated non-performing assets to bail them out, and the banks ended up owning worthless shares that had been pledged as loan security. However, these loans, which were often bailed out by the state, contributed significantly to further private ownership concentration.

Many dominant shareholders went a stage further and used their voting power to cancel the public tradability of the shares, a practice only possible before legislation was passed mandating an offer to purchase the shares of the other shareholders at net equity value. This spared the dominant shareholders the cost and nuisance of having to comply with the informational requirements imposed on publicly traded companies, although these were negligible in comparison with the requirements prevailing in Anglo-American capital markets. As mentioned above, given the unrepeatable nature of privatization and the vague formulation of most contracts and of the institutional framework itself, many actors in the corporate sector, not only managers, but also investment funds and asset management companies, played a one-shot game at the expense of managed companies and their minority shareholders. The dominant strategy of a number of controlling shareholders was 'cheating,' that is, exploiting any

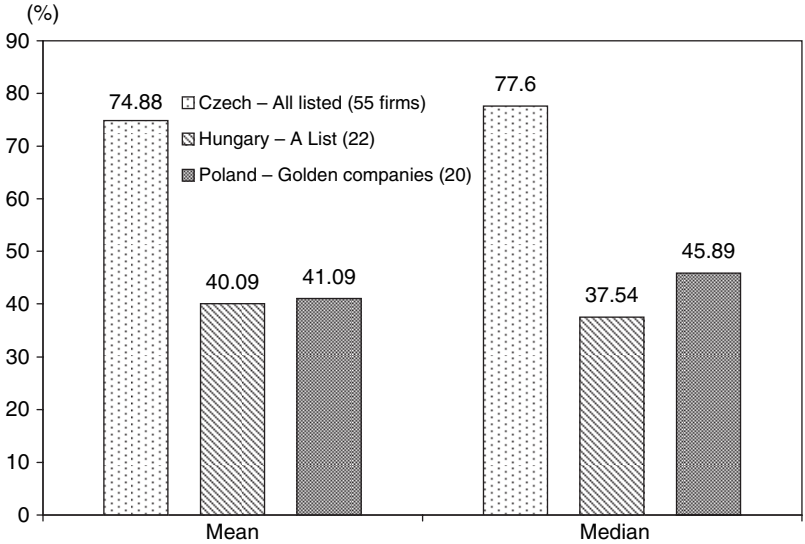
contractual incompleteness in a largely unregulated environment to one's own advantage.

Minority investors were not protected. They were unable to rely either on sufficient information or on the profit sharing to which they were entitled. The extremely limited role of the shareholder voice in this model, which was guaranteed only through the right to vote at general company meetings, was further limited because at general meetings no proxy voting was allowed. Decisions regarding important issues, such as takeovers, which most authors agree necessitates shareholder participation, were decided at remote locations with limited and very costly access for small shareholders. Class actions were prohibited, further increasing the transaction costs for dissenting shareholders. While some attempts were made to create associations of small shareholders, in practice, a small shareholder's only feasible option was to exit with a loss. There was a general tendency among small to medium sized companies, as well as many large corporations, to leave public markets and go private, either to escape the restrictions on their activities which a share listing entails or, in the case of companies taken over by foreign capital, in adherence to the parent company's policy. Of the originally 'publicly tradable' companies in the Czech Republic, 90 per cent have been delisted.

The ownership landscape in the Czech and CEE capital markets

In order to trace the evolution of corporate governance ownership both globally and in Central Europe, we will draw from the analysis of ownership concentration levels in CEE as presented in Mejstrik, K. (2005). This study, which examined the largest voting blocks in all 55 companies that had their shares listed on the Prague Stock Exchange in January 2005, found that the largest voting block was on average 74.9 per cent and the second largest on average 11.2 per cent. These findings were then followed by a comparison with the ownership concentration levels within all of CEE.

The findings of this study, as presented in Figure 3.1 show that the average and median sizes of the largest voting blocks among the Polish Golden Companies are again substantially smaller than the ones among the Czech listed firms and are rather similar to the ones among Hungarian A List Companies. Although the median value is somewhat higher for Poland than for Hungary, it is still below 50 per cent and significantly smaller than the median value for the Czech Republic.[13] A further comparison between ownership concentration in the Czech Republic and that of the rest of the world is summarized in Table 3.2, which shows the sizes of largest and second largest voting blocks in public companies in some



Source: Authors' illustration based on Mejstrik, K. (2005).
Figure 3.1 Largest voting blocks in the Czech Republic, Poland and Hungary, 2004/2005

European countries and the USA. While the majority of the data presented is from 1995 and 1996, dates may vary from country to country.

Most importantly, this table shows that the ownership concentration on the Czech stock market has considerably exceeded the concentration levels on all recorded markets of the developed world. Because the vast majority of firms listed on the PSE are rather illiquid, the average size of the largest shareholding weighted by the market capitalization and by the trade value in 2004 was recalculated so as to better represent ownership concentration in important liquid share issues. Yet, even after weighting the first and second biggest voting blocks with respect to companies' market capitalization (76.0 per cent, 3.4 per cent) and with respect to companies' trade values (63.7 per cent, 3.4 per cent), the Czech concentration still remained the highest compared to the developed markets mentioned above. Many sources, however, have confirmed the common sense notion that to this date, widely held, dispersed ownership has prevailed mainly on Anglo-American and Japanese markets.

This is no surprise considering the level of reasonable protection offered to investors and the preservation of the private benefits of control granted by the legal framework in these countries, as described in a several studies,

Table 3.2 Largest voting blocks around the world

	No. of public companies	*Largest voting block*		*Second largest voting block*	
		Median	*Mean*	*Median*	*Mean*
Austria	50	52	54.1	2.5	7.8
Belgium	140	56	55.9	6.3	10.3
Germany	327	57	49.6	<5	2.9
Spain	193	34.5	40.1	8.9	10.5
France	CAC40	20	29.4	5.9	6.4
Italy	214	54.5	52.3	5	7.7
Netherlands	137	43.5	42.8	7.7	11.4
Sweden	304	34.9	37.6	8.7	11.2
UK	207	9.9	14.4	6.6	7.3
USA					
NYSE	1309	5.4	8.5	0	3.7
Nasdaq	2831	8.6	13	0	5.7
Czech Republic[a]	55	77.6	74.9	3.5	11.2

Note: [a] As of January, 2005.
Source: Barca & Becht (2001) and authors' calculations.

including Shleifer & Vishny (1997), La Porta *et al.* (1998; 2000), Dyck & Zingales (2002), etc. The EU situation can be explained by the fact that world-wide, ownership concentration is now seen as endogenous.[14]

Improved institutions and indications of diminishing private benefits of control

McKinsey's Global Investor Opinion Survey from 2002 demonstrated that, when evaluating investment decisions, institutional investors believe that corporate governance issues are very important, often on a par with financial data.[15] The survey showed that 77 per cent of investors were willing to pay a premium for a well-governed company. That premium was much higher in emerging than in mature markets. For example, the premium for Poland was estimated at about 23 per cent, while the average in Western Europe was 14 per cent, which is consistent with our findings on the shared benefits of control.

And, this is an even more accurate indication of the importance of the legal framework as a means of providing reasonable protection to investors and of upholding the private benefits of control, as described in the above mentioned series of papers. Since Mejstrik (1999), we have characterized investors' behavioral optimization as an institutional adaptation of the

investments' structure and focus, as determined within the context of their legal framework.

Hajek (2006) formulated a hypothesis that Czech corporate law and regulation have achieved similar qualities and shareholder protection as the countries in Western Europe. Results of his preliminary empirical research based on analysis of premiums for control show that private benefits of control in the Czech Republic were on average 20.8 per cent or 26.1 per cent, depending on the selected sample in the 2000–2006, and even smaller in the 2003–2006 period, but much larger in 1990s. His results are very close to those observed in Western Europe by Dyck & Zingales (2002), and put the Czech Republic among the countries with a legal framework derived from French and German civil law jurisdiction. This suggests a significant improvement from the situation observed in 1990s, when the private benefits of control measured by the acquisition premium for control in the Czech Republic were among the highest in the developed world, as demonstrated by the figures provided above. We share the belief that this improvement can be explained by the increased quality of corporate law and its capacity to enforce and regulate, but that these legal framework improvements are still insufficient and require better enforcement. Compliance with corporate governance standards by the Czech firms listed at the stock exchange also requires better transparency for the shareholders through web presentation. Only then will their attractiveness for external individual and institutional shareholders further increase.[16]

Resulting foreign direct investments and restructuring

As stated above, the transformation of SOEs into value-maximizing concerns, which is the key task facing any transitional economy, was first addressed in the Czech Republic in terms of a change of ownership, through both enterprise sales and coupon privatization. The transfer of stock into the hands of coupon shareholders (natural persons or legal entities) was followed by the wave of ownership consolidation, which did not necessarily entail finding definite owners or increasing corporate capital. Many of the investment management and company executives pursued short-term profit rather than the long-term interests of their investors. A variant was enterprise ownership by alliances of funds sponsored by the large state-controlled banks. They usually supported at least a reactive restructuring and viable enterprise development. Deeper restructuring was, however, impeded by the banks' conflict of interest as

owners and creditors, and they had no interest in external injections of additional equity capital opposed letting enterprises under their control go public. Economically, this contributed to the seriously biased corporate governance regime in the Czech Republic, as described above, the departure of many portfolio investors, and the poor performance of the Czech capital market. In turn, this further limited the possibility of restructuring the SOEs privatized by coupons. Consolidation of shareholdings in a non-transparent environment attracted leveraged takeovers by financially weak but well-connected players, who counted on making short-term speculative gains by reselling their shares, preferably to foreign investors. Thus the more stable ownership structures were stepwise dominated by foreign, strategic shareholders. One of the developments reflecting the 'Czech structure' of privatization and corporate governance has been a rapid but fluctuating inflow of FDI, into both privatized companies and greenfield projects (Table 3.3). These are also reflected in the country's balance of payments account (Table 3.4), in contrast with the rather limited and highly volatile foreign portfolio investments injected into the non-transparent environment of the Czech capital market. Foreign investors have adjusted their behavior to fit the Czech institutional framework and model described above has started to dominate the corporate sector.

Strategic owners have been able to control their companies much more directly through FDI, leading to a much smaller agency problem. FDI volume and fluctuations are caused by three factors: privatization sales, which were, for example, 95 per cent in 1995, but only 60 per cent in 2000, reinvestments and greenfield investments, all of which are influenced both by government policies, such as the tax level and FDI incentive policy, and by other factors, such as country creditworthiness or territorial differentiation targets of investors. While the largest individual foreign direct investments usually resulted from a limited number of case-by-case privatizations, the coupon privatization inspired large numbers of medium-sized investments by strategic investors, who gradually took over many companies privatized through the coupon and temporarily controlled by investment funds. Since 1997, there has also been a growing number of greenfield foreign investments attracted by macroeconomic features and government FDI incentives. At the end of 2005, the Czech stock of FDI in the form of equity capital totaled Euro 31.2 billion. The overall FDI volume including reinvested earnings and credit relations with foreign investors stood at Euro 50.4 billion.

From 1990 to 2004, the Czech Republic achieved one of the highest FDI amounts per capita within Central and Eastern Europe, as evidenced by

Table 3.3 Selected indexes of the foreign direct investment in the Czech Republic, 1993–2005

	1993/1/1	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Annual FDI inflow (million Euro)	–	559	734	1,982	1,140	1,152	3,317	5,933	5,404	6,296	9,012	1,863	4,007	8,837
Reinvested earnings (million Euro)	–	–	–	–	–	–	161	647	1,035	1,695	2,088	1,912	2,375	2,626
Accumulated FDI stock (million Euro)	2,391	3,054	3,732	5,741	6,910	8,367	12,255	17,479	23,323	30,717	36,884	35,852	42,035	50,404
Annual FDI inflow per capita (Euro)	–	54	71	192	111	112	322	577	526	616	883	183	393	862
Accumulated FDI stock per capita (Euro)	231	296	361	556	670	812	1,190	1,700	2,270	3,004	3,616	3,514	4,118	4,917

Note: Until 1997 data included FDI in equity capital, starting from 1998 data on reinvested earnings and other capital have been included in FDI flows.
Source: Czech National Bank.

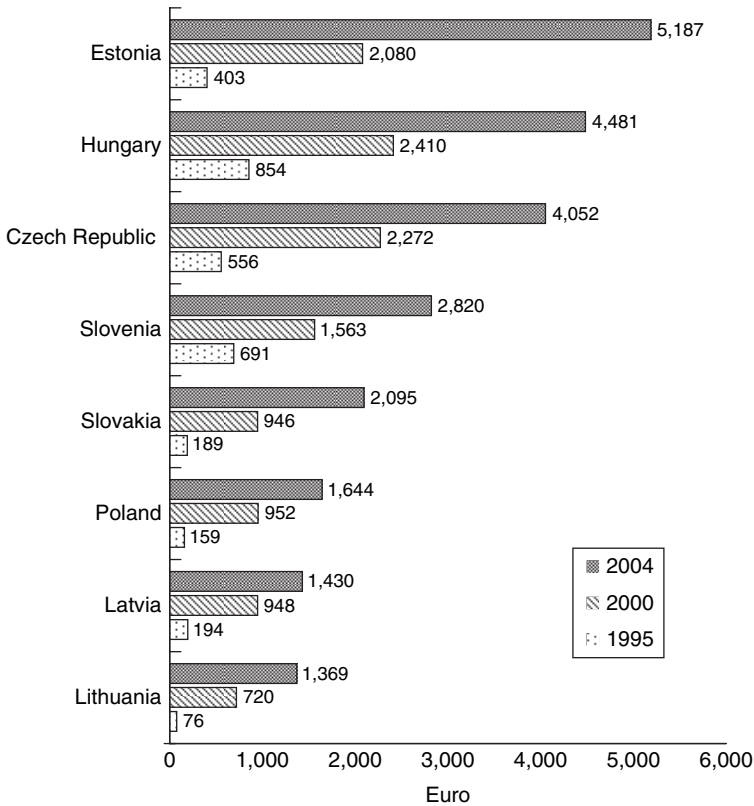
Table 3.4 Balance of payments of the Czech Republic, 1993 – 2005(million Euro)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
A. Current Account	389.6	−664.8	−1,059.0	−3,289.8	−3,157.3	−1,119.7	−1,371.9	−2,945.2	−3,652.2	−4,426.1	−5,043.8	−5,245.4	−2,070.6
Trade balance	−449.0	−1,167.0	−2,845.0	−4,555.1	−4,335.3	−2,322.8	−1,784.9	−3,393.0	−3,423.6	−2,314.8	−2,191.7	−828.7	1,354.9
Balance of services	864.0	412.6	1,424.9	1,535.0	1,562.4	1,712.6	1,125.2	1,532.1	1,701.3	709.2	415.6	393.0	651.8
B. Capital Account	−474.3	0.0	5.2	0.5	8.8	1.8	−2.0	−5.6	−9.7	−3.9	−2.6	−439.3	169.9
C. Financial Account	2,585.7	2,848.4	6,363.0	3,340.2	958.6	2,608.2	2,889.4	4,157.5	5,071.5	11,288.7	4,933.2	5,756.6	4,630.8
Direct investment	481.5	632.7	1,953.6	1,018.3	1,129.9	3,203.9	5,848.5	5,357.1	6,111.5	8,793.0	1,680.1	3,190.1	8,148.9
Portfolio investment	1,368.1	722.1	1,053.6	579.1	961.9	954.2	−1,308.7	−1,914.4	1,022.7	−1,517.2	−1,121.7	1,861.2	−2,417.5
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	−39.4	−94.5	−138.9	121.2	−100.6	−94.1
Long-term capital	688.3	936.9	2,604.5	2,482.7	361.2	−1,773.2	−682.4	−137.3	−86.1	1,024.4	863.7	1,786.2	1,137.5
Short-term capital	47.8	556.7	751.3	−739.9	−1,494.4	223.3	−968.0	891.5	−1,882.1	3,127.4	3,389.9	−980.3	−2,144.0
D. Net errors and omissions[a]	88.5	−179.7	459.9	−711.8	624.6	241.1	33.7	−319.5	560.7	182.2	518.4	140.7	387.4
E. Change in reserves (−increase)	−2,589.5	−2,003.9	−5,769.1	660.9	1,565.3	−1,731.4	−1,549.2	−887.2	−1,970.3	−7,040.9	−405.2	−212.6	−3,117.5

Note: [a] Valuation changes.
Source: Czech National Bank.

the comparison in Figure 3.2. The significant Euro 8.8 billion FDI inflow for 2005 will further cement the Czech Republic's position with respect to the rest of Central and Eastern Europe.

Foreign investors have derived confidence from the political stability of the country, its almost completed privatization program and an improved legal environment gradually incorporating elements of the EU's *acquis communautaire*. Over the period 1990–2005, FDI sectors have been highly diversified, with a focus on the service and production sectors (especially car production), which has generated a certain mix of positive and negative structural and trade impacts. As a result, it can be seen from Table 3.5 that the share of foreign controlled companies in corporate sector equity



Source: Author's illustration based on Vienna Institute for International Economic Studies (2005).

Figure 3.2 FDI inward stock per capita of 8 CEE countries, 1995–2004

Table 3.5 Financial performance and market share of domestic private and foreign controlled companies within the Czech corporate sector, 2000–2004

A. Financial performance (%)

	2000	*2001*	*2002*	*2003*	*2004*
Domestic private companies[a]					
ROA	0.6	1.6	2.7	2.9	5.2
ROE	1.5	3.2	5.4	5.9	9.9
Value Added/Assets	25.0	25.4	25.5	26.7	27.8
Equity/Assets	42.8	48.2	50.7	49.4	52.6
Foreign controlled companies[b]					
ROA	4.1	4.0	4.5	5.7	6.5
ROE	11.0	10.6	10.9	12.9	14.4
Value Added/Assets	26.8	28.0	27.9	27.9	29.2
Equity/Assets	37.4	38.1	40.8	44.0	45.3

B. Shares of domestic private and foreign controlled companies on total financial data for non-finacial companies (%)

	2000	*2001*	*2002*	*2003*	*2004*
Domestic private companies[a]					
Total equity	38.0	46.3	46.2	41.9	39.7
Total sales	49.8	51.2	49.7	46.1	42.7
Value added	49.1	51.5	51.6	47.2	43.0
Total profit	15.9	33.1	43.0	33.4	39.5
Total taxes	33.2	43.8	46.0	23.2	39.5
Foreign controlled companies[b]					
Total equity	20.1	23.9	25.5	31.9	35.1
Total sales	36.5	41.1	43.5	47.1	50.5
Value added	31.8	37.0	38.6	42.1	46.3
Total profit	60.6	56.0	48.5	55.3	51.0
Total taxes	36.1	45.1	47.0	62.2	51.0

Notes

[a] Domestic private companies are defined as those with 50 per cent or more of domestic capital in total registered capital.

[b] Foreign controlled enterprises are defined as those with 50 per cent or more of foreign capital in total registered capital. ROA: return on assets; ROE return on equity.

Source: Czech Ministry of Inustry and Trade.

has grown to nearly 35 per cent, while nearly 95 per cent of banking sector assets are now directly or indirectly foreign-controlled, and constitutes over half of total sales. In the last several years, those companies are generating not only the majority of net profits, but also the majority of total taxes. They are import intensive, but export oriented, which

Table 3.6 Comparison of corporate ownership in terms of ROE (%)

	2000	*2001*	*2002*	*2003*	*2004*	*2005*
Industry, total	5.21	6.01	7.01	8.01	10.56	10.17
Public enterprises	−0.42	4.73	4.77	6.64	6.77	7.64
Private domestic enterprises	3.35	4.02	4.78	3.69	8.57	8.82
Enterprises under foreign control	12.25	9.92	11.48	12.48	14.00	12.66

Note: Data for industry excluding construction.
Source: Czech Ministry of Industry and Trade.

contributed to putting the 2005 trade balance in black after many years in red (Table 3.4).

Partially due to their export competitiveness, but also to the selection bias (foreign investors acquire potentially more productive assets), they dominate also in performance measures, such as the return on equity (ROE) ratio in Table 3.6. Outside of growing, but still limited, dividend repatriation, earnings are mostly retained through more efficient reinvestments in the Czech Republic (Table 3.3). In contrast to the earlier tendencies of limited, adaptive restructuring (Zemplinerova & Mejstrik, 1998 or Hanousek, *et al.*, 2004), some industrial companies, mostly foreign controlled, have appropriately responded to the stronger demand and market signals of OECD countries by deep restructuring through labor and cost adjustments, including a temporary stagnation of real wages succeeded by quick wage growth after a rapid growth in productivity, new products and costly technologies, and more active marketing, among other things, all within the framework of a new 'contract architecture.' They have significantly increased their non-price competitiveness (e.g. VW–Skoda and Toyota-Peugeot cars) and have become the engine of outward-looking, export led growth stimulated by specific foreign demand growth. Sectors exporting market segments with higher added value, mainly machines and equipment, sell mostly on the highly competitive OECD markets. These companies also have a lower cost of capital, as they can borrow more cheaply at the international markets via their parent companies.

Conclusion

Typically, economic relationships have either a cooperative game or a prisoner's dilemma characteristic: full cooperation maximizes the participants' joint pay-off in the long-term 'repeated game', but

'cheating' – that is, exploiting any contractual incompleteness to one's own advantage – will remain the dominant strategy in any one-shot game. The behavior of foreign-controlled companies in the Czech Republic confirms the hypothesis that firms that build a reputation for ethical collaboration are able over a long period of time to substitute cooperative outcomes for unsatisfactory cheating ones. The internal and external relationships of the firm, as determined by its 'contract architecture,' are undoubtedly the source of considerable competitive advantage.

Furthermore, from the start, firms which have fostered a reputation for ethical behavior have established themselves as islands of microeconomic institutional stability. They have enjoyed an advantage in attracting new trading partners as customers, suppliers or employees precisely because they can be relied upon to maintain their current standards of behavior. Nevertheless, the one-shot advantages based on legal imperfections, such as capital market legislation protecting all shareholders, can hardly be ignored by rational foreign investors, in spite of their long-term orientation.

Ethical temptations are always present in situations characterized by unrepeatable opportunities for individual gain, such as a privatization process based on incomplete contracts within an imperfect institutional framework. The Czech example shows that a cheating strategy that exploits vague and ambiguous contractual relationships triggers an increase in the private benefits of control, diverts the outflow of needed capital away from companies, undermines their attempts at restructuring and throws them deeper into debt. An economic recession then arises, followed by the collapse of holding company structures, resulting in serious economic losses. As we have already mentioned in the past, in historical situations of this type there is an acute need for government activity to speed up institutional changes that clarify rules of law and prevent unacceptable behavior on the part of managers, owners and also government officials.

Von Mises saw the basic institutional characteristic of a market economy as direct owner liability, where the owner mostly absorbs the damage caused by mismanagement of the enterprise.[17] This characteristic of a market economy should be taken into account in the formulation of government policies such as the amended bankruptcy law and careful regulatory and subsidization policies, and policy makers should take care not to spoil the institutional environment of Central and Eastern Europe by introducing more unnecessary one-off measures with hidden heterogeneous impacts that impede dynamic enterprise restructuring.

A reasonable legal environment should also indemnify companies for any regulatory contract breach (confirmed by the court).

Acknowledgement

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Notes

1. For instance, see 'the climate issue' in EBRD (1999; 2000), Shleifer & Vishny (1997), Keasey *et al.* (1997; 1999), La Porta *et al.* (1998; 2000; 2002). Mejstrik *et al.* (1992) suggested early on the introduction of a simplified law setting the rules of game for investment companies, but without success.
2. See EBRD (1995). Also, Mejstrik (1997; 2003; 2004) provides a detailed description of the concentration of the most powerful groups, their principals and the lack of their reasonable regulation.
3. The capital market generated overnight through the coupon scheme was thin and heavily artificial. The accelerated creation of a capital market for around 2,000 shares declared to be publicly tradable and held by more than 6 million small investors resulted in significant transaction costs, in particular the temporary expansion of numerous service personnel, including 520 securities dealers, several hundreds of closed end investment funds and 153 investment management companies that were for the most part later liquidated or transformed into a handful of open-ended funds. The mass initial public offering (IPO), which overlooked the role of fresh cash, led to a terribly undercapitalized market that was bound to die gradually unless it could create a more normal environment and attract new external and financially strong investors.
4. See Lastovicka, *et al.* (1995) on government ownership of banks, see Allen & Gale (2000), La Porta *et al.* (2000) and Caprio & Levine (2002).
5. Divisions based on ownership patterns/concentration are not common, but in our opinion better demonstrate the importance of the legal and whole institutional frameworks in the models. Ownership concentration is also more easily measured than the primary objectives of the firm, which provide the basis for more standard models.
6. See the discussion of private benefits of control in Richter (2002), Hajek (2006) and below.
7. In fact, these were registered (non-tradable) shares allocated to municipalities proportionately to the number of inhabitants. Municipalities intending to sell the options to their registered and barely transferable shareholdings had

to enter into very complex option, future or loan contracts. Most of them absorbed the risk.

8. Deeper CEE interest in CSR has been closely followed by Mazullo (2006) and can be demonstrated by UNDP–UNIDO 2006 conference on 'Responsible Investing – A forum to promote corporate social responsibility and facilitate multi-stakeholder partnerships in Southeast Europe, the New EU Member States and the CIS.'
9. Czech authors Richter (2002) and Hajek (2006) open the issue of enforcement of agency problems. Sometimes, CEE managers would comply with duty of care but not with fiduciary duty (duty of loyalty). What further complicated the problem was that some shareholders groups themselves had little interest in restructuring non-viable firms, most of which either descended from the Soviet era or were started up, often with government support, rather too hurriedly in the early transition years.
10. 'As the stake of block-holder increases, *ceteris paribus*, he has more incentives to increase firm value and to overcome the 'rational apathy' that small investors have. These value increases are then shared with other shareholders and thus constitute shared benefits of control' (Dyck & Zingales, 2002).
11. As discussed by Hajek (2006), the broad definition of private benefits of control is given by Coffee (2001) as 'all of the ways in which those in control of a corporation can siphon off benefits to themselves that are not shared with the other shareholders'. Coffee's examples include above-market salaries, non-pro rata payments, self-dealing transactions, insider trading, and the issuance of shares at dilutive prices.
12. The other option was to 'rescue' such companies by giving them breathing space while they adjusted to the new competitive environment. The conflicting goals of the state-controlled banks – prudential banking versus honoring the contract with state principal – only made things worse (Mejstrik, 2004).
13. The average largest Polish voting block size is still much lower than the Czech block size, even when weighted by market cap or trading volume. Thus, these differences do not result from the fact that only the most important Polish companies (Golden Companies) were analyzed.
14. Hajek (2006) appropriately refers to the spirit of Demsetz & Lehn's (1985) pioneering work.
15. Corporate governance was defined by McKinsey as 'effective boards of directors, broad disclosure, and strong rights and equal treatment for shareholders'.
16. For more details, see Mazullo (2006) and Mejstrik, K. (2005).
17. In spite of the existence of a limited liability company.

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4

The Czech Emerging Financial Markets and Their Roles in Corporate Finance

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Introduction

The Czech Republic was the first post-communist country to experiment on a large scale with mass privatization and financial markets institutions in the early 1990s and one of the few for which enough time has elapsed and enough data is available to permit a tentative assessment. In this section we focus on the more recent developments on financial markets. To understand how these markets in the Czech Republic function and what role they play in corporate finance we examine the investment behavior of Czech firms during the latter part of the transition process (1996–2001).

The capital-market research has long ago shown that real investment may depend on financial factors (Bratkowski *et al.*, 2000). Prompted by the finding, over the last two decades a number of studies has appeared that discusses the effects of financing conditions on the investment behavior of private firms.

A major line of this research has focused on the existence of financing constraints as the most important determinants of firms' investment behavior. Several papers have shown that investment is (relatively more) sensitive to the availability of internal funds for the groups of firms that are (relatively more) subject to the presence of asymmetric information or agency problems in financial markets. These firms include, among others, small and young firms and/or firms without credit history (Masso, 2002). The presence of financing (or, liquidity) constraints has several important implications for industrial organization (e.g. corporate take-overs), public finance (e.g., tax policy), as well as for the various channels of macroeconomic policy (Hubbard, 1998).

There has been a widespread view among economists that capital market imperfections have been particularly severe in the new market economies of Central and Eastern Europe (Cornelli *et al.*, 1996). This is due to the fact that many firms in these emerging economies were newly established without credit history, track record, collateral, etc. Also, the weakness of the banking sector created problems due to the banks' 'inexperience in monitoring and gathering information about loan participants' (Masso, 2002) and/or their tendency to prefer 'lending to the existing state-owned enterprises which had political leverage and with which they had developed long-term relationships before the transition' (Bratkowski *et al.*, 2000). Economic uncertainty has on the other hand often lead to an unwillingness or inability among the banks to lend long-term (Pissarides, 1998).

A large body of theory (e.g. Gertler, 1988) would have initiated the view mentioned. Central to the theories concerned is the notion of asymmetric information that leads to adverse selection and/or moral hazard and may result in credit rationing (Stiglitz & Weiss, 1981). The argument draws on the distinction between 'insiders,' who have full information about a particular firm's investment prospects, and 'outsiders,' who may correctly perceive the prospects for a population of firms but are unable to distinguish the quality of individual firms. During the transition process, the asymmetric information was one of the major reasons that caused lenders to ration credit as either higher interest rates lead relatively good firms to leave the applicant pool (adverse selection) or induce firms to undertake riskier projects (moral hazard).

There have not been many studies on the topic of capital market imperfections (or, financing constraints) in the transition economies, mainly due to a lack of enterprise-level data. The first detailed analytical studies of the investment behavior of firms in these economies were launched in the late 1990's with the works of Anderson & Kegels (1997) and, Perotti & Gelfer (1998), and later also in works of Bratkowski *et al.* (2000), Budina *et al.* (2000), and Masso (2002). In the Czech Republic, arguably the 'best' and most detailed papers have been written by Lízal & Švejnar (1998, 1999).

Perotti & Gelfer (1998) have shown that investment in firms belonging to financial–industrial groups in Russia is less sensitive to cash flow than investment in independent firms. On the other hand, Lízal & Švejnar (1998) did not find evidence of a positive link between internal finance and gross investment, although in their later study (2000) the retained profits were shown to have positive effect. Anderson & Kegels

(1997) also found evidence of the influence of financial variables such as cash flow, beginning-of-period bank debt and trade credit on the fixed investment of Czech enterprises. Bratkowski *et al.* (2000) argue that imperfections in capital markets in Central European economies do not seem to affect the growth of new private firms. For Bulgaria, Budina *et al.* (2000) found liquidity constraints to be important for small firms but not for large companies. This finding was explained by the inefficiency of the financial sector because of loans granted to large unprofitable firms. Conceivably, one common weakness of these studies appears to be that their inferences have been based on reduced form investment regressions, rather than explicit conditions of optimal capital accumulation.

In this study, we try to analyze the investment behavior of Czech industrial firms using a sample of firm-level data for the period from 1996 to 2001. Specifially, we focus on the supply side of the investment process and try to examine whether the investment behavior of Czech firms is linked to their ability to finance profitable investment projects and if this effect varies across size and ownership structure of firms. The switch from central planning to a transition period forced firms that traditionally received centrally allocated investment funds to face the commercial banks and other 'emerging' financial institutions. Operating in a highly protective and concentrated environment, the new commercial banks often imposed high spreads between deposit and lending rates in order to increase their low initial capitalization. They also had to develop their project appraisal capability from start and establish international accounting standards (Lízal & Švejnar, 1998). In this regard, it appears that many of the existing (large) firms continued receiving credit even for non-performing projects, while new firms tended to face expensive external finance for investment or were denied such finance from the very start. Moreover, foreign firms are reported to have been been supplying themselves with investment funds from their parent companies and western as well as domestic lenders. The data from transition economies hence lend themselves readily to testing the financing hierarchy and credit rationing hypotheses advanced about the supply side of investment in the western literature (see Gertler 1988, Kaplan & Zingales, 1997, or Fazzari *et al.*, 1998), and also put forth as a leading explanation of the sharp decline of investment in the early transition period by Calvo & Coricelli (1994).

We test for the existence of financing constraints by estimating (standard-type) simple reduced-form investment regressions in order to observe whether internal finance affects investment positively. The large

panel of firm-level data that we use permits us not only to examine how the severity of financing constraints varies across different types of firms but also to avoid the aggregation bias. Our results show that the availability of internal finance plays a bigger role for investments of small and domestically owned private companies.[1]

The study at hand and its conjectures may be interesting in two ways. First, by using a relatively reliable set of firm-level data, our work provides credible estimates by being able to eliminate biases introduced by data selectivity and aggregation, reduce measurement error, and take into account heterogeneity across firms and over time. This appears to fill existing void in the context of the recent investment literature. Second, as a direct (albeit less extensive) continuation of the work of Lízal & Švejnar (1998), it provides an updated and more complete overall picture of the investment behavior of Czech industrial firms during the transition period.

The remainder of this chapter is organized as follows. The next section provides some stylized evidence of investment and financing behavior of Czech firms. Then the dataset of Czech manufacturing firms is described. Section 4.4 describes the method and results of the reduced form investment equations. The concluding section discusses the findings.

Investment and financing problems of the firms: stylized facts

We could infer that financial factors seem to constrain capital investments more in transition economies than in developed western economies. In particular, the availability and price of external (new debt and equity) versus internal financing (internally generated cash flow) is an issue. According to the financing hierarchy hypothesis firms prefer to use internal financing due to asymmetric information between managers and potential new equity investors or creditors; external funds are only used after internal sources are exhausted (Fazzari *et al.*, 1988). As no survey has been made so far in the Czech Republic, we can only speculate whether a similar financing hierarchy is also present withing the Czech firms although in Estonia, for example, the non-financial firms ranked internal equity as the most preferred source of financing (Raudsepp *et al.*, 2000).

Many studies in developed economies show internal finance or cash-flow to be the primary source of funds. For example, Fazzari & Petersen (1993) found that cash-flow constitutes 71 per cent of net sources of

finance for US public firms paying dividends less than 10 per cent of earnings.

For the Czech Republic, it has been argued that internal financing constitutes a smaller part of funds than in developed countries because of a lack of internal funds and unstable economic development. Lízal & Švejnar (1998, 1999) who had examined the (net) investment behavior using a sample of medium and large industrial firms during the early stages of transition period (1992–95) provide the first general view of this kind among the Czech firms. In their studies, Lízal & Švejnar conclude that it is the retained profits that seem to be a major determinant of new investment and that the enterprise profitability has a strong positive effect on investment in all types of firms except for privately owned-limited liability companies and foreign owned and mixed ownership firms. Their results are consistent with the financing-hierarchy and credit-rationing hypotheses which indicate that Czech (domestic) firms cannot easily borrow investment funds externally and that net investment varies with retained profits.

Data and summary statistics

In the study we use firm-level financial statements panel data collected by the Czech Statistical Office (CZSO). The original dataset includes quaterly observations for a total of 2,896 industrial enterprises for the period from 1996 to 2001.

We restrict our analysis only to the firms in the manufacturing industries.[2] As a result, our sample reduces to 2,318 observations. We subsequently run a series of *consistency checks* in order to assemble a dataset without errors and/or significant inconsistencies.[3] The total number of companies used in the study thus further reduces to 2,210 companies. This corresponds to a total of 13,260 (yearly) observations.

We also note that our sample includes only the companies with over 100 employees: this said, one might conclude that the sample is biased towards large rather than small firms. Considering that financing constraints can prevent business from starting (so that some survivorship bias is introduced), it can be suggested that the present study tends to underestimate rather than overestimate the importance of financing constraints.

Table 4.1 presents summary statistics for some of the regression variables as well as the relative importance of different sources of finance for different sub-samples of firms (the two last rows of the table).[4] First, the total sample was split into three equally-sized groups by the average

Table 4.1 Summary statistics for selected variables (period 1996–2001)

	Small	*Medium*	*Large*	*Ownership*		*Total*
				Czech	*Foreign*	*Sample*
No. of firms	*900*	*460*	*850*	*1 923*	*287*	*2 210*
Total Assets (CZK m)	12.6	46.2	189.6	53.6	165.2	96.8
Capital (CZK m)	8.6	18.4	56.8	32.1	58.2	43.2
Average Tangible Assets						
Minimum (CZK m)	15.8	58.9	1 156	725	1 156	1 156
Maximum (CZK m)	0.13	16.2	23.1	0.13	0.29	0.13
Sales growth	0.18	0.30	0.18	0.17	0.30	0.22
CF/Capital	0.32	0.36	0.23	0.35	0.28	0.30
Fixed investment/Capital	0.26	0.19	0.24	0.26	0.18	0.23
CF/Net sources	0.65	0.61	0.31	0.54	0.32	0.48
Chng. in Debt/Net sources	0.21	0.25	0.22	0.20	0.15	0.21

Note: The sample is divided by average value of real assets and forms of ownership.

value of real assets. As we can observe from the table, small and medium sized enterprises grow faster and invest more, so the need for extra financing is greater. As expected, cash-flow plays a bigger role as a source of financing for smaller firms.[5] Both cash-flow and investments are more volatile for smaller firms. Only for the third group is new equity an important source of funds.

In total (last column of the table), the firms have been investing quite actively: average investment to capital ratio is 0.23. This has been financed in large part by cash-flow. Still the relative importance of cash-flow is much smaller than in studies made with developed countries' data. For example, Fazzari & Petersen (1993) estimated the average cash flow to the net sources ratio to be 0.715. Masso (2002), who did similar study on Estonian firms (Estonia is also considered to be an emerging economy, albeit a latter-stage one), found the ratio of 0.56.

In addition, we can observe that firms belonging to – or controlled by – foreign capital are on average much bigger in terms of total assets and capital, and tend to grow faster. Again, both findings are similar to those of Masso (2002). The first observation can be explained by the fact that Czech residents do not possess enough capital to privatize large state-owned firms. Both investments and cash-flows are more volatile for domestic firms. Foreign firms also got remarkably more new equity capital: this indicates their better access to external financing. Here the firm is defined as belonging to foreign or Czech capital if in all years (1999–2004) more than 50 per cent of the share capital belonged to foreign or Czech residents respectively.

Examining the liquidity constraints with investment equations

In general, the existence of liquidity constraints is tested by regressing the investment on variables that measure the availability of financing generated inside the firm and some proxy for the investment demand (affected by productivity of capital, expectations, required rates of return).

As the part of the latter we often find Tobin's q that theoretically should capture all relevant information and is basically the ratio of market value of firm's equity and debt to replacement value of assets.[6] Unfortunately, as the firms in the current sample are not listed on the stock market, we are unable to calculate such a measure. Instead, we use employment growth to control for the existence of investment opportunities, as with Bratkowski *et al.* (2000) and Masso (2002).

In addition, we also use cash-flow and cash stock in place of liquidity variables. The liquidity variables proxy for internal net worth (liquid assets plus the collateralizeable value of illiquid assets) also convey information about what proportion of investment spending can be internally financed (Schiantarelli, 1996). Firms with a higher level of liquidity can better collateralize debt issues and receive loans at lower interest rates as well as exploit more relatively cheap internal funds. It means that we are testing whether internal and external financing are perfect substitutes or not. The expected impact of cash-flow and cash stock on investment is positive. The intuition for including the leverage variable is that agency costs incurred due to diverging interest of lenders and borrowers (e.g. monitoring and bankruptcy costs) are assumed to increase in the amount of debt used. Given there is a limit to the debt a firm can have, a higher level of debt in the beginning of the period then makes it more difficult for the firm to finance new investment projects.

Thence, we estimate the following empirical function:

$$\frac{I_{it}}{CAP_{it-1}} = \alpha(LG)_{it} + \beta\frac{CF_{it}}{CAP_{it-1}} + \gamma\frac{CS_{it-1}}{CAP_{it-1}} + \delta\frac{D_{it-1}}{A_{it-1}} + \kappa_i + \kappa_t + \mu_{it}, \qquad (1)$$

where I denotes gross investment, LG employment growth measured in logarithms, CF cash-flow, CS cash stock, CAP capital stock and D/A is the ratio of short- and long-term debt to total assets. The intercept coefficients, κ_i and κ_t allow for firm specific and year intercepts; u_{it} is a random error term. Firm dummies γ_i control for the effect of variables that are constant over time but are excluded from the model (e.g. industry classification of firm). We measure the investment as change

in fixed tangible assets plus depreciation; cash-flow is the sum of net income and depreciation. All variables (except debt and employment growth) are normalized by the initial size of capital in order to control for possible heteroscedasticity arising from varying size of firms. Capital stock (*CAP*) is measured as the net value of fixed tangible assets. The stock variables are measured at the end of the year; for instance, CAP_{it} is the value of capital stock of firm i at the end of year t.

A standard criticism to interpreting positive cash-flow coefficients as evidence of financing constraints is that cash-flow might actually proxy for the profitability of new investment projects. One way how to cope with this problem is to split the sample by some criteria associated with problems of raising funds on the credit and capital markets and compare the relevance of inside *firm liquidity* between different sub-groups. Plausible criteria include *inter alia* firm size, firm age, the existence of close relationships with industrial or financial groups, the presence of credit rating or commercial paper programs, dividend policy, et cetera. If for the class that is *apriori* classified as financially constrained, the cash-flow sensitivity is significantly bigger and statistically more significant, then this is interpreted as evidence of the presence of financing constraints, assuming that profits have the same relevance as measure of profitability of new investment for different firms.

We split the sample in two ways. First we use firm size as a proxy for the ability to raise funds through external financing. The rationale is that firm size could be a proxy for firm age and other unobservable firm attributes that affect the degree to which public information about the firms' investment projects is available. Small firms probably include many newly created companies which lack credit history and collateral. It is also plausible that the transaction costs of obtaining funds contain a significant fixed cost component. The presence of such increasing returns suggests that the cost of obtaining external funds are higher for small than for large firms.[7] It has also been emphasized in earlier studies that in transition economies the financing of small and medium sized firms is an important obstacle to growth (Pissarides, 1998). The sample is divided into three equally sized groups ('small,' 'medium' and 'large') according to the average size of real assets over the sample period. Real assets were calculated with GDP deflator.

A possible criticism to the use of a firm size as a criterion of whether particular firm is liquidity constrained or not, is that the costs of financing could decline with size due to a lower perceived risk for the bank, not necessarily due to smaller information problems. Smaller firms in particular usually have a lower survival probability than large firms

(Audretsch *et al.*, 1999) and banks' loan losses are found to be much higher for loans made to small firms in comparison to large firms (Churchill & Lewis, 1985). We provide two arguments against this criticism. First, as Masso (2002) notes, the aggregate risk for banks is smaller in a portfolio consisting of several small loans than just a few big loans, because in the former case, due to the law of large numbers, the total return is more stable and the overall risk is smaller. Similarly, in the insurance industry smaller risks are considered to be more insurable than large ones due to a better spread of claims over time. Secondly, if firms' owners and banks had exactly the same information about project risk, then the required rate of return from the risky project is probably higher anyway, so the owners are less willing to finance these projects. The source of liquidity constraints (or that firms internal funds and profits are correlated) is the asymmetric information concerning projects returns, not just the possibility of the failure of the project.

After investigating the effect of firm size on investment-cash flow sensitivity, we also try to examine the possibility of different investment behavior of the firms owned by foreign capital versus those belonging to private domestic capital. As the companies from the first group are at least partly subsidiaries of foreign parent companies, they could have a direct access to the funds from the internal capital market of the international corporation, or receive cheaper and longer-term credits from foreign credit markets. We define firms as belonging to foreign or Czech private capital if in all years of the sample period (1996–2001) more than 50 per cent of the share capital belonged to foreign owners or Czech private capital respectively.

We also note that in either of the two classifications, the firms are not allowed to change their group affiliation, although we realize that in a rapidly developing economy this may be inadequate: small firms grow, their net worth increases, and more information on them becomes available, so firms' financial constraint status may change.

We report the results of estimating equations (1) for different sample splits in Tables 4.2 and Table 4.3, panel A and B. As already stated, 'fixed-effects' or 'within-groups' estimators were used in our estimations. This means that the deviations of variables from their firm-means were used in regressions. Given that the regression equation was not derived explicitly from any structural model, the parameters should be interpreted as partial correlation coefficients rather than estimates of structural coefficients.

Table 4.2 Effects of employment growth, cash-flow, cash stock and leverage on firm investments according to firm size (period 1996–2001)

	$CF(t)$ / $LG(t)$	$CS(t)$ / $CAP(t-1)$	$D(t-1)$ / $CAP(t-1)$	$A(t-1)$	R (sq)
Small firms	0.112	0.536	0.603	0.003	0.31
(t-stat)	(2.314)*	(8.268)	(5.268)*	(1.992)*	
Medium firms	0.089	0.436	0.052	−0.354	0.16
(t-stat)	(1.714)*	(5.265)*	(2.223)*	(1.167)	
Large firms	0.123	0.404	0.024	−0.271	0.29
(t-stat)	(1.914)	(3.568)	(1.947)*	(1.992)*	

Note: * significant at 0.05 level.

Table 4.3 Effects of employment growth, cash-flow, cash stock and leverage on firm investments according to firm size and ownership size (period 1996–2001)

A. Firms owned by domestic capital

	$CF(t)$ / $LG(t)$	$CS(t)$ / $CAP(t-1)$	$D(t-1)$ / $CAP(t-1)$	$A(t-1)$	R (sq)
Small firms	0.003	0.854	0.653	0.235	0.18
(t-stat)	(1.514)	(4.328)*	(2.268)*	(1.992)*	
Medium firms	0.219	0.572	0.326	0.001	0.21
(t-stat)	(2.001)*	(2.601)*	(2.735)*	(0.932)	
Large firms	0.127	0.590	0.852	0.056	0.19
(t-stat)	(1.873)	(3.268)*	(3.104)*	(2.292)*	

B. Firms owned by foreign capital

	$CF(t)$ / $LG(t)$	$CS(t)$ / $CAP(t-1)$	$D(t-1)$ / $CAP(t-1)$	$A(t-1)$	R (sq)
Small firms	0.101	0.309	0.296	−0.316	0.22
(t-stat)	(1.314)	(2.268)*	(4.003)*	(−0.049)	
Large firms	0.391	0.014	−0.039	−0.067	0.22
(t-stat)	(0.775)	(0.981)	(−1.938)*	(−1.986)*	

Note: * significant at 0.05 level.

The results for different size groups shown in Table 4.2 indicate that the coefficients of both measures of internal liquidity (cash-flow and cash stock) decrease with firm size. We regard this as an evidence in favor of the hypothesis that large firms can more easily finance their investments and face less severe financing constraints. It is important to emphasize that because cash-flow may actually proxy for the firms' investment demand, it is the difference in the estimated values of parameters that matters rather than just the size of the individual parameters. The t-statistic under the null hypothesis that small and medium size firms have the same cash flow coefficient is 2.04. The t-statistic under the null hypothesis that large and medium sized firms have the same cash flow coefficient is 2.94. This means that the difference is also statistically significant.

Coefficients of leverage variable are negative for medium- and large-sized enterprises, although they remain significant only in case of the latter. It suggests that strength of balance sheet is perhaps less important for smaller firms. Parameters of the employment growth variable are significant in two out of three regressions; hopefully we have been able to control for the existence of investment opportunities at least partially.

We now present the results for firms belonging to Czech vs. foreign capital. Let us first note that foreign firms tend to be much larger than domestic in terms of average value of assets (see Table 4.1). In order to control for the firm-size effect we split the sample of domestic corporations ordered by the period's average real assets into three groups (480 firms each): small, medium and large enterprises. Similarly, the sample of foreign corporations was split into two groups (15 firms each). The foreign firms were divided into two groups of about 140 companies each due to a much smaller number of foreign-owned firms in the dataset.

As we can observe from Table 4.3, both cash-flow and cash stock have a strong positive effect on investment for different groups of Czech firms. In comparison to domestic firms, the coefficients are in general smaller for both small and large foreign firms. This finding is also robust to other specifications of the model not reported here (e.g. in the regressions of investment on cash-flow and cash stock). It is interesting to note that the cash-flow parameter for small foreign firms is smaller than that of large Czech firms although the firms in the second group are much larger in terms of total assets. Given that only firm size affected the cash-flow – investments relationship, then the cash-flow parameter would be bigger among large Czech firms, not among small foreign firms. The medium Czech firms are almost of equal average

size (US$1.73 million) to small foreign firms, but the cash-flow parameter is about twice as large in the former group. We can conclude that affiliation to foreign capital significantly loosens financing constraints, increases investment and thereby supports firm growth. On the other hand the results should be treated with caution since the sample of foreign firms is quite small and several coefficients remain statistically insignificant.

It is possible that estimating equations such as (1) underestimate the full long-run effect of financing constraints on fixed capital investments since firms smooth investment with working capital to maintain desired investment levels (see Fazzari & Petersen, 1993). Thus, we also estimated the investment regressions that were augmented with the working capital investment (WCI) variable.

In order to account for the endogeneity of WCI, we first used a two-stage least squares estimation with the WCI variable instrumented with cash-flow, employment growth, beginning of period stock of working capital, and firm and year dummies. (We do not report the results due to space constraints). In general, the unreported cash-flow coefficients increased in size but the pattern across size and ownership classes remained similar to the previous findings. The sign of the WCI variable after inclusion in the left side of regression (1) turned out to be negative. According to Fazzari & Petersen (1993) the last outcome should address the criticism that 'positive correlation between investment and cash flow arises because cash flow proxies for investment demand.' The intuition is that if it is less costly to decrease WCIs than fixed investments, liquidity constrained firms should in the periods of temporary cash-flow shortfall decrease rather investments in working capital (up to drawing these to negative levels) than in fixed assets that generates the negative relationship between the two kinds of investments.

Another way to account for the endogeneity of WCI is to modify the model with respect to how far the variation of parameters is tested. Instead of dividing firms into sub-groups and then estimating the same equation separately for each group one could also use the expansion method defined by Casetti (1986).[8] Let us have the initial model of the form and the expansion equation for parameters of the form:

$$\kappa_t = \lambda_1 + \lambda_2 FC + \lambda_3 ASSETS,$$

where *FC* is the dummy variable indicating whether particular firm belongs to the foreign capital and *ASSETS* is a measure of firm size

defined as the natural log of the average value of firm's assets. The modified model can then be formulated as:

$$\frac{I_{it}}{CAP_{it-1}} = \varphi_1 (LG)_{it} + (\varphi_{21} + \varphi_{22} FC + \varphi_{23} ASSETS) \frac{CF_{it}}{CAP_{it-1}} +$$

$$(\varphi_{31} + \varphi_{32} FC + \varphi_{33} ASSETS) \frac{CS_{it-1}}{CAP_{it-1}} +$$

$$(\varphi_{41} + \varphi_{42} FC + \varphi_{43} ASSETS) \frac{D_{it-1}}{A_{it-1}} + \kappa_i + \kappa_t + \mu_{it}. \quad (2)$$

In this case, only the financial variables are expanded with respect to firm size and ownership, as it is the variation in these variables in which we are interested. The main advantage of model (2) is that it saves degrees of freedom, keeps the data together and explains the differences due to size and due to ownership in one model. Alternatively, we can also argue that in the first model some variables are omitted, which we expect to be of importance (size, type of owners), and hence we would expect biased estimates. We present the estimation results from this modified model in Table 4.4.

Clearly, the qualitative results still hold in the model: both cash-flow and cash stock variables have significant positive effect on investments (as shown by the positive values of parameters φ_{21} and φ_{31}). For the

Table 4.4 Effects of employment growth, cash-flow, cash stock and leverage on investments: the parameters of financial variables expanded with firm size and ownership

coef.	*explanation*	*value*	t-*stat*
φ_1	*LG*	0.21	2.689
φ_{21}	*CF/CAP*	0.44	6.385
φ_{22}	*(CF/CAP)*FC*	0.00	1.941
φ_{23}	*(CF/CAP)*ASSET*	–	3.192
φ_{31}	*CS/CAP*	0.42	1.87
φ_{32}	*(CS/CAP)*FC*	0.01	1.989
φ_{33}	*(CS/CAP)*ASSET*	–	–
φ_{41}	*D/A*	–	–
φ_{42}	*(D/A)*FC*	0.20	1.09
φ_{43}	*(D/A)*ASSET*	0.03	0.73
	AdjR^2		0.19

Notes: * significant at 0.05 level, p-values available upon request.

domestic firm with an average size ($ASSETS = 6.72$) one CZK increase in cash-flow increases investments by *CZK* 0.45 (i.e. the value of parameter φ_{21} plus 6.72 times the value of φ_{22}). The positive effect of liquidity remains almost unchanged with firm size (parameter φ_{22}), and declines for foreign owned firms (negative φ_{23}). The impact of the leverage or indebtedness variable on investments is still negative, but diminishes with the firm size (negative φ_{41} and positive φ_{42}, although the latter is statistically insignificant). Finally it does not seem to be of significant relevance for the results whether the effect of liquidity is assumed to change with firm size continuously (as here) or discretely.

Conclusion

In this chapter, we use the population of Czech manufacturing firms operating in the years 1996 to 2001 to analyze the investment behavior of firms with respect to their size and ownership. We argue that financing constraints were of significant importance for the determination of investment levels of many firms operating within the period, in particularly small firms and domestically incorporated firms (as compared to firms owned by foreign capital).

Using simple ordinary least-squares regressions, we find that small (and Czech) firms were, during the period under consideration, more dependent on their cash-flow and cash stock than larger (and foreign-owned) firms. We take these results to be the evidence of the presence of financing constraints because internal firm funds influenced significantly (more exactly) those companies that we assumed to be more financially constrained. Indirectly, these results also confirm the findings of Lízal & Švejnar (1998) who used a similar dataset to examine the Czech corporate sector earlier in its transition process (1992 to 1995). This way, the study at hand can be looked upon as providing a more complete overall picture of the Czech corporate sector development in the transition to a market economy.

In addition, our analysis shows that cash-flow is not an important determinant of investment for foreign firms. Again, this is not a new result in the Czech literature as Lízal & Švejnar (1998, 1999) reached the same conclusion. As Masso (2002) points out, one way in which the financing constraints could be relaxed is 'through the development of the banking sector [in the transition economies].' If banks become more capable of monitoring loan applicants then the asymmetric information problems will be reduced and profitable investments are more likely to receive outside funding.

Notes

1. Our conclusions are directly comparable to the study of Masso (2002) who used a similar reduced-form investment regression to analyze the investment behavior of Estonian firms.
2. For instance, we only consider the companies with a 2-digit EMTAK activity codes between 15 and 39. The codes correspond to section 'D' of European Union NACE classification.
3. First, all firms with negative or zero fixed tangible assets were deleted. Second, the possible effect of outliers on regression estimates was controlled by excluding firms with observations of sales growth, investment to capital ratio or cash flow to capital ratios below or above 5% upper and lower tails of distribution. The justification for excluding firms with extreme growth rates in sales or investment is that if both investment and cash flow grow at a rate similar to growth rate of sales, then part of the co-movement could be due to the scale factor. This effect would bias the estimates of investment-cash flow sensitivities towards unity, particularly in firms with higher annual growth rates (Kaplan and Zingales, 1997).
4. More detailed information on the dataset is available upon request from the author.
5. In earlier studies other researchers have found similar evidence for classes of a-priori constrained firms (Fazzari *et al.*, 1998).
6. See, *inter alia*, a study by Fazzari *et al.* (1988).
7. Oliner and Rudebusch (1992) found that transaction costs account for up to 25% of the gross proceeds of small stock issues and one-seventh of the proceeds of small debt issues.
8. Schiantarelli (1996) has also discussed and suggested the usage of interaction terms in the single investment equation when testing for liquidity constraints instead of grouping firms into sub-samples and then estimating the equation separately for each of them.

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5

Corporate Restructuring, Foreign Direct Investment, and Japanese Multinationals in the Czech Republic

Shuichi Ikemoto

Introduction

The transformation process in the Czech Republic began under the leadership of then Prime Minister Vaclav Klaus (now president), who placed emphasis on implementing market mechanisms and so-called radical economic reforms from 1990 to 1997. In 1998, the Social Democratic Party took the post of political power from the Klaus administration, and since then the political and economic conditions of the Czech Republic have changed significantly.

A general survey of the situation in the Czech Republic from 1989 to the present (March 2006) shows a significant change occurring in 1998 within both the political and economic spheres. The turning point was the currency crisis of May 1997, which was triggered by the exposure of huge bad loans in the financial sector and related insufficient restructuring of enterprises, resulting from economic reforms that focused on macro-level factors and neglected the micro level. As a result of the economic crisis and other problems, Klaus was forced to resign at the end of 1997 and the Social Democratic Party came to power in June 1998. However, the new government faced an uphill battle for reform considering the country's hard economic situation (Ikemoto & Matsuzawa, 2004).

While the government's main concerns during the initial stages of the economic transformation process were focused on macro-economic policy and reform, from the second half of the 1990s, restructuring and privatization of state enterprises became the main targets of reform. At present, during the second half of transformation, such reforms have generally been completed, regardless of their success or failure: FDI and social security reform are currently the most pressing issues.

This chapter consists largely of two parts. The first section focuses on economic policy of the Czech Republic from the perspective of corporate restructuring and outlines features of the Czech manufacturing industry. Here we also discuss the important role of foreign controlled enterprises in the Czech economy. Second, we discuss FDI, especially in regards Japanese automobile investors in the Czech Republic and the implications of Japanese investment, which is of interest relating to the potential for the adaptation of Japanese management systems (such as the 'Toyota Way') into Slavic society.

The Czech economy and corporate restructuring

Background

Recent economic data for the Czech Republic shows generally sound growth. However, from 1997 to 1999, growth of GDP was negative (−0.8 in 1997, −1.2 in 1998 and −0.4 in 1999) as was gross industrial production, according to the data of the Ministry of Finance.[1] This was largely due to the lack of industrial policy including neglect of corporate restructuring and FDI. At the beginning of the transformation process, most state enterprises had a huge amount of debt owing to the government and the central bank. The state enterprises were radically privatized under the coupon privatization system without any organizational or financial restructuring. Some of the debt of the state enterprises was transferred into the government's special bank for consolidation, Konsoridacni Banka (KOB),[2] but an enormous amount of debt was left with the enterprises. Moreover, the commercial banks then lent further amounts to the enterprises without conducting strict credit evaluations.

Some economists point out that the Czech government might have prevented latent problems from surfacing because it subsidized enterprises in a variety of ways and systematically avoided bankruptcy proceedings (Anderson & Kegels, 1998) (Table 5.1). These 'façade' arrangements of the Czech government of that time are indicative of some data as follows. It is possible to recognize the general tendency of a decreasing volume of classified loans and the improvement of financial fundamentals in the financial sector from 1997 to 2005 from the data of the Czech national bank. At the end of 1997, the volume of classified loans was 266.4 billion CZK while the volume of loss credits reached 149.6 billion CZK, which was 56% of all classified loans. In 2005, the volume of classified loans was 127.6 billion CZK while the volume of loss credits was 21.5 billion CZK, which was 16.8 per cent of the classified

Table 5.1 Size of non-performing loans in Czech Republic, Hungary and Poland, 1991–94

	1991	*1992*	*1993*	*1994*
As % of bank loans to enterprises and individuals:				
Czech Republic	2.7	19.3	22.1	38.8
Hungary	9.4	20.7	42.6	30.2
Poland	16.5	26.8	27.4	29.0
As % of total assets:				
Czech Republic	1.2	10.4	10.5	20.1
Hungary	4.1	7.5	15.7	11.0
Poland	6.9	10.2	9.7	9.8
As % of GDP:				
Czech Republic	1.9	14.2	9.3	30.4
Hungary	3.5	5.4	11.9	7.9
Poland	2.2	3.3	2.7	3.2

Source: Anderson & Kegels (1998), p. 252.

loans that year (Table 5.2). The reduction in loans from 1997 to 2005 was a result of the restructuring of the financial sector itself and at the same time the policy of the government to transfer a portion of the bad debts of the former state enterprises into KOB, which was established by the government as a center of clearing up bad debt and restructuring the former state enterprises.

However, as evident in the total loans of KOB between 1993 and 1999, while it is true that the amount of total old bad debt decreased gradually, in contrast, new credits to the enterprises from KOB increased (Table 5.3). In 1991, total old loans reached 80.1 billion CZK, and in 1999 they decreased to 53.3 billion CZK, of which all were classified loans. What is more, 98.3 per cent of that was categorized as loss. In addition, new loans to the enterprises from KOB reached a total volume of 2.3 billion CZK in 1993 and gradually increased to 107.5 billion CZK in 1999.

It is possible to point out that the new loans became mostly classified. As Table 5.3 shows, in 1996, the volume of classified loans reached 13.6 billion CZK, which was 74.7 per cent of total new loans, and in 1999, they reached 72.2 billion CZK, which was 67.2 per cent of total new loans. What is worse, in 1999, 49 per cent of the new loans were categorized as loss. This indicates that KOB was regarded not only as a center of corporate restructuring, but also as an entity that helped the old enterprises survive (at least those that had good connections in government and the banks) when they should have failed under free

Table 5.2 Credit portfolio quality (credits assessed individually), 1997–2005

	31 Dec. 1997	*31 Dec. 1998*	*31 Dec. 1999*	*31 Dec. 2000*	*31 Dec. 2001*	*31 Dec. 2002*	*31 Dec. 2003*	*31 Dec. 2004*	*31 Dec. 2005*
Classified credits, total, in CZK millions	266,390	258,004	291,061	257,762	209,866	147,102	114,009	118,826	127,641
of which: watch credits	60,595	58,721	92,124	85,814	75,984	71,332	64,400	74,320	80,965
substandard credits	26,811	33,427	39,379	54,910	32,295	27,515	19,298	19,344	17,572
doubtful credits	29,386	35,538	38,433	27,276	29,725	11,689	6,913	5,306	7,623
loss credits	149,597	130,318	121,125	89,762	71,862	36,566	23,398	19,857	21,481
Classified credits as % of total credits	26.95	26.45	32.15	29.83	21.53	15.78	11.15	10.84	11.72

Source: Compiled by the author based on CNB (various years).

Table 5.3 Loans of Konsoridacni Banka, 1991–99

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Total old loans (CZK bn)	110.4	107.8	74.6	67.9	63.8	60.8	59.4	58	53.3
of which: classified (CZK bn/%)						50.8/83.6	54.6/91.9	54.7/94.3	53.3/100
loss (CZK bn/%)						39.7/65.3	44.9/75.6	51.8/89.3	52.4/98.3
New and newly assumed loans (CZK bn)			2.3	10.3	13.6	18.2	34.7	67	107.5
of which: classified (CZK bn/%)						13.6/74.7	14.6/42.1	35.5/53.0	72.2/67.2
loss (CZK bn/%)						4.3/23.6	9.3/26.8	14.3/21.3	52.7/49.0
Total loans in CZK bn	110.4	107.8	76.9	78.2	77.4	79	94.1	125	160.8
of which: classified (CZK bn/%)				46.2/59.1	48.3/62.4	64.4/81.5	69.2/73.5	90.2/72.2	125.5/78.0
loss (CZK bn/%)				39.5/50.5	41.3/53.4	44.0/55.7	54.2/55.7	66.1/52.9	105.1/65.4

Note: The total loans in 1991and 1992 were including Slovak prat, of that Czech part 80.1bn CZK in 1991, 81.2 bn in 1992.
Source: Compiled by the author based on KOB (various years).

market principles. It could be argued that the soft-budget constraints relationship between the government and the enterprises and between banks and enterprises had survived even several years into the transformation process. Officially, the Klaus government insisted on market-oriented economic policy based on the idea of the 'invisible hand,' but at the same time it shrewdly and prudentially introduced other 'invisible hands' when it came to corporate restructuring.

After the Social Democrats replaced the Klaus government

When the Social Democratic Party came into power in 1998, the macroeconomic situation of the Czech Republic took a turn for the worse and it emerged that the big enterprises, such as Skoda Plzen, CTK Prague and Komercni banka among others, had huge amounts of debt. In response, the government had to shift the main privatization method from coupon privatization to direct sale in order to clear such debts. As a result, it sold about 200 billion CZK worth of state assets over the 3-year period 2000–2002 (Table 5.4). In April 1998, the government had also introduced FDI incentives for the purpose of shrinking debt, enhancing economic growth and creating new jobs. As for Czech enterprises, after the currency crises of 1997, they moved to restructure themselves, which included large-scale labor adjustment, liquidation or bankruptcy of companies, sale of part of their organizations, changes to production and management systems and so on.

The former state enterprises and even the enterprises that had been privatized in the first-half of the 1990s did not have clear objectives on their finances. In the second half of the 1990s, the enterprises at best set up targets for income, turnover and production. In other words,

Table 5.4 Results of enterprise privatization, 1991–2002 (million CZK)

Type of transformation	*Sale to domestic investors*		*Sale to foreign investors*	
	1991–1999	*2000–2002*	*1991–1999*	*2000–2002*
Public auction	6,976	11	88	0
Public order	20,503	355	35	0
Direct sale to assets	44,147	1,491	5,219	0
Sale of shares	51,911	6,933	55,164	196,450
Total	123,540	8,789	60,507	196,450

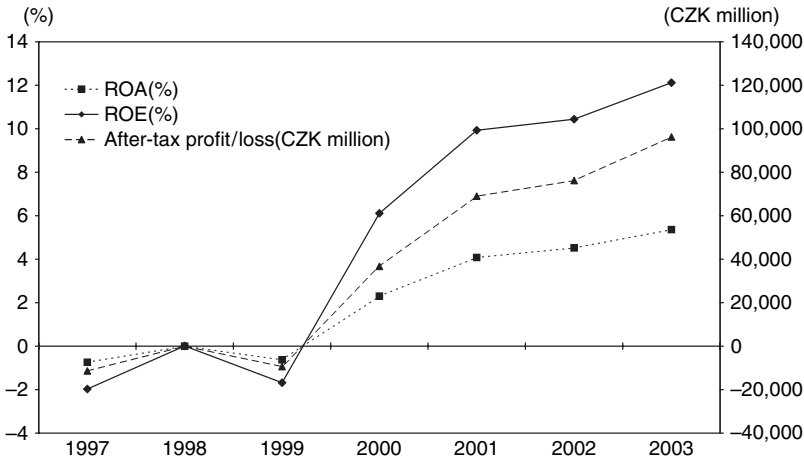
Source: Compiled by the author based on FNM (various years).

balance sheets based on the structure of capital and liability were not really being taken into consideration.

The traditional goal for state enterprises during the former socialism era was expanding the scale of production. For this the enterprises had to seek strong connections with bureaucrats in order to secure the funds for investment and so on. It was also important to have a connection in the state bank. As mentioned earlier, the relationship between the government and the enterprises, that is, the soft budget constraint, has arguably been retained to a certain extent even after the collapse of the socialist system.

In other words, the role of corporate financing in the Czech Republic before 2000 was regarded as a second priority, or back-up support, in the activities of enterprises. There were financial targets for maximization of funding, production, turnover and profit, and such kind of behavior could succeed if the expansion of the scale could be realized. However, today it is not enough to merely secure the funds and to improve the balance sheet. It is necessary to make the right decisions on the scale and subject of the investment under a time frame that will generate the best possible return on investment.

Figure 5.1 indicates the general financial development of corporate restructuring in the Czech manufacturing sector based on ROA, ROE and after-tax profit.[3] As shown, there are negative values of all three



Source: Based on CSU (2002; 2005).

Figure 5.1 Evolution of financial performance in the manufacturing sector, 1997–2003

Table 5.5 After-tax profit/loss of manufacturing sector, 1997–2003 (million CZK)

	1997	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
Public enterprise	4,020	7,587	–8,856	205	9,845	13,586	16,105
Private enterprise	–20,800	–12,743	–19,625	3,629	11,876	30,318	37,056
Foreign controlled enterprise	1,654	8,192	16,003	33,614	41,694	43,636	57,934

Note: Foreign controlled enterprises are defined as those with 50% or more of foreign ownership in total shared capital.
Source: Compiled by the author based on CSU (2002; 2005).

indicators from 1997 until 1999. However, ROE turned positive reaching 6 per cent in 2000, 10 per cent in 2001 and 12 per cent in 2003. ROA also turned positive to 2 per cent in 2000, 4 per cent in 2001 and 6 per cent in 2003. After-tax profit changed in a similar pattern. Since, in general, corporate performance and finance is considered good at an ROE value of 10 per cent or more, we can conclude that corporate performance in the Czech Republic has improved steadily between 2000 and 2003.

Next, we would like to discuss the performance of the manufacturing sector to estimate the role of the foreign controlled enterprises. Table 5.5 shows after-tax profit by the type of ownership. From 1997 to 1999, the balance of after-tax profit for private enterprises stayed in the red, but from 2000 it shifted dramatically into the black. Concerning the public enterprises, as the large bad debt write-offs by KOB had been mostly completed by 2000, the balance of after-tax profit showed a sound surplus except in 1999. In comparison to both private and public enterprises, the foreign controlled enterprises kept a surplus steadily since 1997, and recorded 58 billion CZK in 2003 which was 5 times of the profit of the public enterprises and 1.5 times that of the other private enterprises.

Table 5.6 shows the share of foreign controlled enterprises in the Czech manufacturing sector by turnover, production, book value added and number of employees. As for turnover, the share of the foreign controlled enterprises over all manufacturing sectors was 17.8 per cent in 1997, but grew steadily to 47.86 per cent in 2003. Notably, the share of foreign enterprise turnover in the electronic machinery sector and the transport machinery sector were quite large at 73.8 per cent and 85.2 per cent, respectively, in 2003. Concerning production and book value added, the same trends can be observed as for turnover. As for number of employees, in 1997 the share of employees of foreign controlled businesses in all manufacturing sectors was only 10.71 per cent, but in

Table 5.6 Share of the foreign controlled enterprises, 1997–2003 (%)

	1997	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
A. Share in turnover							
Manufacturing	17.8	21.69	27.15	39.47	43.3	45.64	47.86
Electrical and optical equipments	18.85	27.39	37.58	57.42	63.61	70.55	73.83
Transport equipments	–	–	–	–	83.44	83.17	85.2
B. Share in production							
Manufacturing	17.87	21.78	27.63	39.99	43.69	46.13	48.4
Electrical and optical equipments	18.95	27.36	37.67	56.47	62.31	70.93	73.84
Transport equipments	–	–	–	–	85.07	83.46	85.27
C. Share in book value added							
Manufacturing	16.81	19.47	25.55	38.49	42.12	42.08	44.57
Electrical and optical equipments	18.02	25.31	32.96	49.67	54.09	53.23	54.15
Transport equipments	–	–	–	–	74.94	76.66	79.6
D. Share in number of emploees							
Manufacturing	10.71	13.16	16.2	24.9	28.2	30.36	32.38
Electrical and optical equipments	19.55	25.55	29.85	43.31	48.55	50.01	53.62
Transport equipments	–	–	–	–	58.78	59.38	62.67

Note: Foreign controlled enterprises are defined as those with 50% or more of foreign ownership in total shared capital.
Source: CSU (2002, 2005)

2003 the proportion reached 32.38 per cent. By sub-sector, in 2003 the share in the electrical machinery sector was 53.62 per cent, while the share in the transport machinery sector was 62.67 per cent.

To sum up, it was observed in this section that the Czech manufacturing sector has improved since 2000 in terms of production, turnover, ROE, ROA and after-tax profit (Tables 5.5, 5.6 and Figure 5.1). This finding suggests that FDI is a crucial component of the Czech manufacturing sector and by extension a major influence on the national economy.

In the following section, we consider the development and features of FDI in the Czech Republic, especially Japanese investment in light of the

recent high inflow of Japanese investment into the Czech automobile sector. Furthermore, we look at the influence of the unique management system and corporate philosophy of Japanese companies – specifically Toyota and its affiliates, the core Japanese investors in the country – on Czech corporate culture.

Japanese FDI in the Czech economy: focusing on Toyota Motors and its affiliates

General remarks

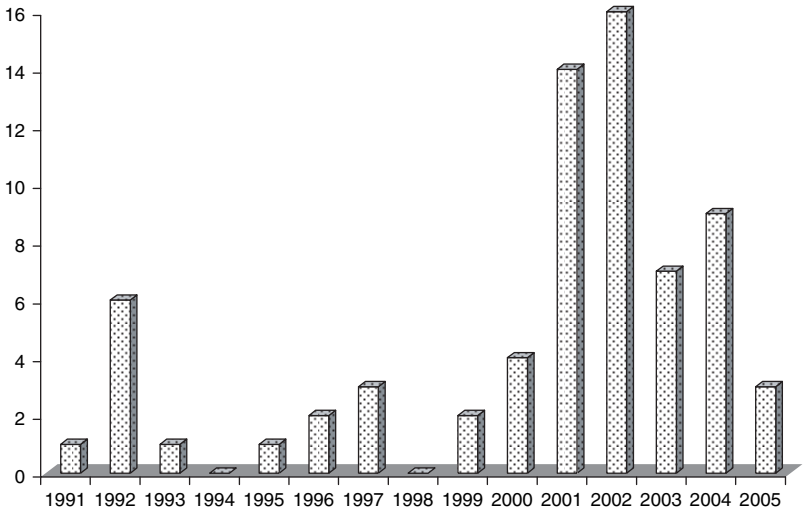
After joining the European Union, the Czech Republic and other nine countries have made remarkable progress with structural reform, and they are now considered good invest targets for foreign investors including Japanese enterprises, especially, Hungary, Poland and the Czech Republic.

In Hungary, most of the state enterprises have already been sold to foreign investors, and the high inflows of FDI have resulted in shortages of skilled labor in the country's western regions. In the Czech Republic, the direct sale of big strategic enterprises to foreign investors has almost been completed, and Greenfield FDI is near the saturation level, as is the case in Hungary. The most serious problem in both countries is the shortage of skilled managers. In Poland, there is still room for investment since there remain many uncompetitive state sectors in need of restructuring and relatively young skilled workers are abundant.

Japanese investors have a strong need to support and enhance their global manufacturing structures. There are three regions in which they pursue strategies for developing their production and sales networks: Asia, North America and Europe. There is much room for improving their networks in Europe, where the EU is the target market.

The Czech Republic can be considered one of the best locations for local production for the EU market for the following reasons: (1) the country's tradition of manufacturing; (2) many qualified and skilled workers; (3) qualified production managers; (5) advantageous geographical location for the EU market; (6) relatively well established infrastructure (roads, railways, electric power, etc.); (7) lower labor costs than EU-15 countries; and (8) FDI incentive programs (several years' tax holidays, duty free import of equipment, job creation grants, site development support, etc.).

As mentioned above, Japanese investment in the CEE is focused in the manufacturing sectors. In terms of proportional receipt of investment



Source: Based on CzechInvest (2006)
Figure 5.2 Number of new Japanese investors in the Czech Republic, 1991–2005

in the manufacturing sector, Hungary has been until recently the top recipient of Japanese FDI among the CEE, with Poland following until the latter half of the 1990s. In 2000–2003, the Czech Republic surpassed Hungary and became the top recipient nation. As Figure 5.2 illustrates, the increase of Japanese investment into the Czech economy in recent years is remarkable. However, although Japanese FDI in the CEE region is concentrated in these three countries, Hungary and the Czech Republic are now facing gradual increases of wages, so we can expect a shift to further eastward countries such as Slovakia, Romania and Ukraine.

We can observe a variety of industrial sectors for Japanese investment in Western Europe, but in the case of the CEE there is a strong concentration in the automobile-related and electric machinery and electronics sectors. In particular, investment related to the automobile industry has been very active in the CEE and this region is becoming one of the centers for Japanese automobile manufacturing in Europe. The amount of Japanese investment in the Czech Republic in this sector is now the second largest in Europe next to that in the UK.

Japanese investors in the CEE

Now we examine the behavior of Japanese companies in the CEE. Looking at the history of European business activities of the Japanese

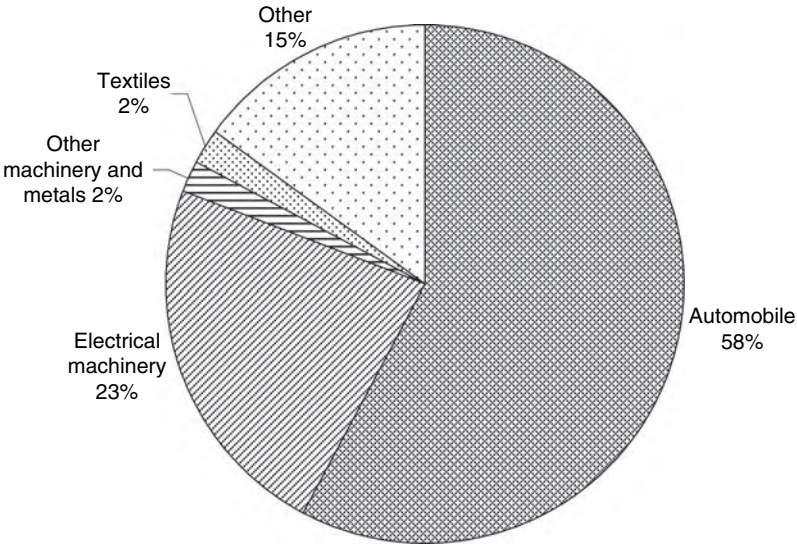
companies that have made investments in the CEE, we see that many companies started their business operations in a Western European country before setting up operations in the CEE. This means that a move to CEE for them is not a first experience in Europe, but rather an enlargement or transfer of their European business activities after operating in one or more other European country. Consequently, we can project that many Japanese enterprises that have invested and will invest in the CEE are companies that already have facilities in Western Europe (Wada, 2002).

While in the case of consumer goods, market size can be estimated by population size and GDP, industries such as automobile parts require more specific customers. Their customers are not individual consumers but specific car manufacturers and large parts producers.[4] They need information about their potential customers for making a decision of investment. Investment in the CEE by large Japanese manufacturers for their first European operations or the enlargement of their existing production capacities in Western Europe will not only induce large and medium-sized parts manufacturers to locate there, but will also encourage smaller parts manufacturers who do not have enough experience for doing business in Europe to come to the CEE (Wada, 2002).

The Czech Republic saw a relatively late increase in FDI compared to Hungary and Poland over the past decade. A main reason why the FDI boom has come later to the Czech Republic is that the previous government's reform strategies neglected industrial policy such as FDI incentive programs as mentioned before.

Even before the Czech Republic and the other newest members joined the EU, Japanese investors, influenced by rapid globalization, were looking for good locations to invest in the CEE. It was difficult for newcomers to find good places in Hungary, since companies that invested earlier had taken the better locations. Toyota, for example, had the two candidate locations of Poland (southern region) and Czech Republic (central region), and decided to set up their assembly facility with Peugeot in the Czech Republic.[5]

According to Czech Invest, the number of the foreign-capital enterprises being established from 1993 until the 3rd quarter of 2004 reached about 55,000. The manufacturing sector saw a particularly high proportional increase in foreign-capital among the 1200 companies in this sector. Czech Invest points out that 65–70 per cent of the amount exported by the Czech machine industry sector is by foreign-capital enterprises.[6]



Source: Based on CzechInvest (2002).
Figure 5.3 Japanese FDI by sector, 2002

In fact, there has been somewhat of a Japanese FDI boom in the Czech Republic recently, with 25 Japanese enterprises making investments over the two years just prior to the country's accession to the EU. As mentioned, compared to FDI of other countries, Japanese FDI has been mainly concentrated on the automobile and electrical machinery sectors. As Figure 5.3 indicates, for Japanese FDI alone (volume base, 1990–2002), there is 58 per cent in the automobile sector, 23 per cent in electrical machinery, 2 per cent in other machinery and metals, and 2 per cent in textiles.

Behavior of Japanese investors in the Czech Republic[7]

The frontier group for Japanese FDI consists of three major investors: Matsushita Electronic Components, Showa Aluminum and Toray Textile. Their role has been and remains very important for encouraging subsequent investors, most notably Toyota and its affiliates. Matsushita had a key role in pressing the Czech government to introduce investment incentive policies and also advised other Japanese companies considering investment here. Matsushita established itself in Pilsen in 1996 with a cathode-ray tube television production facility in which 1700 people are presently employed. The company's production has

been expanding yearly, along with the establishment of its R&D department in 1999 and the new production of plasma and LCD televisions in 2004. Though Matsushita invested in the Czech Republic before the FDI incentives had been introduced, Matsushita now receives not only the normal incentives but also newly introduced incentives for R&D.[8] When the Czech Republic joined the EU, Matsushita decided to close its UK factory and shift the center of its European production and R&D there due to the country's reduced wage costs and liberal framework for manufacturers. The production shift from the UK to the Czech Republic presents an interesting case for a study on the Greenfield investment lifecycle.[9]

The recent boom of Japanese FDI in the Czech Republic results primarily from the investment of Toyota in Kolin city. Toyota is famous for its unique production system, known as the Toyota Production System (TPS), which is actually composed of two elements: its 'just-in-time system' and its 'autonomation system.'[10]

From the database of Czech Invest, among the 58 Japanese companies that have invested in the Czech Republic as of 2004, there are 35 automobile companies, which have a total stock investment of $1.77 billion and total employees numbering 9000. TPCA (Toyota Peugeot Citroen Automobile) alone has invested $850 million and employs 3000 workers, while its biggest affiliate, Denso, has invested $254 million and employs 950 workers.[11]

In general, 30,000 parts are needed to assemble an automobile, so the industry needs a number of suppliers. Consequently, the investment of one large automobile maker such as Toyota results in a high generation of employment as well as technology transfers and increased exports, which all contribute to a higher GDP. Therefore, for an emerging country, such as the Czech Republic, the investment of a large automobile company can contribute greatly to its economic development.[12]

Background to Toyota's behavior in the Czech Republic

Toyota is now aiming to increase its worldwide production in the near future to 10 million cars a year, which will exceed the production of General Motors allowing it to become the world's largest auto maker. Along these lines, the company is aiming to increase its present 3.7 per cent share (as in 2003) of the European market. As part of the strategy, it constructed a new plant in France in 1998, where it has been producing the Yaris, a new compact car. After succession of the sale of the Yaris, Toyota stepped into the second stage of its strategy for expansion in

the European market in 2001 with the start of construction of a new joint-venture plant in the Czech Republic with the Peugeot Group for the production of small cars (with each side having 50 per cent equity stake). The facility began operations in 2005 as planned. Toyota is now planning for close cooperation between its existing UK and Turkish plants and the French and Czech plants.

In order to enhance distribution and production efficiency, Toyota is also creating a wide-area supply network for components within the EU, with distribution centers located at four different locations. In 2003, the company also started construction of a new plant in Poland which will produce major components such as engines and steering wheels for its French and Czech plants.

At present, as Figure 5.4 shows, components manufacturers, mainly Toyota's affiliates, are actively moving towards investment in the Czech

Figure 5.4 TPCA and its main affiliates

Republic and Poland, largely due to the influence of Toyota. As the number of units produced in Europe increases, there will be a need for a higher level concentration of components and raw material producers, such as that which is required in the American market. Toyota's partnership with the Peugeot Group will certainly present demand for components while at the same time Toyota's affiliated components manufacturers will be given new business opportunities in supplying their products to the Peugeot Group and other automobile companies.[13]

We should review the history of Toyota's overseas investment strategies to observe the behavior of Toyota and his affiliates in CEE. In particular, we see 'the lessons' of the investment in the USA, the company decided to go ahead with its joint venture in 1984 with GM, named NUMMI (New United Motor Manufacturing). Through this joint venture, Toyota learned two important lessons about adopting the TPS abroad; the first relating to supplier relations, the second to trade union relations.

The TPS aims to increase production efficiency and eliminate waste. As mentioned, the fundamental component of the TPS is the 'just-in-time' production system where necessary items are received just in time as they are needed in the production line. In other words, every manufacturing process produces only the necessary parts in the necessary quantity at the exact time needed. Therefore, to eliminate unnecessary inventories, affiliate suppliers must be located near the Toyota factories and there must be a close exchange of production information. In NUMMI, Toyota was not accompanied by some of its major suppliers. It had to negotiate with the American suppliers where the business relationship was not one of TPS style but of independence and basically short-term transactions. It is said that at the first stage Toyota had trouble receiving the items it needed to satisfy its just-in-time system.

The second problem that Toyota faced was labor management, especially the labor policy of the United Auto Workers (UAW), which is a very strong and influential trade union in the USA. As mentioned above, one feature of the TPS is elimination of all waste, and therefore Toyota introduced high-performance labor-saving machinery and technology and manpower-saving methods by developing and training highly multi-skilled workers who can be responsible for handling several processes. The UAW, however, restricts multi-tasking and stipulates that workers have a single responsibility, such as lathe worker, press worker and so on (there are around 100 such categories). As these 'single-skilled'

workers generally cannot be allowed to handle other processes without the permission of the UAW, it is difficult to form the flexible framework that the TPS requires. In the case of NUMMI, Toyota had to accept that its workers belonged to UAW because of its partnership with GM.[14]

After the experiences of NUMMI in the USA, Toyota has been accompanied by its main suppliers and other affiliated companies where it sets up new operations, as in the case in the Czech Republic with TPCA.[15] We might be useful for researching the behavior of Toyota and its affiliates in CEE in the future.

On the other hand, Toyota's affiliates may need to find other clients and decrease their share of supply to Toyota gradually to survive themselves in CEE. Because they cannot survive depend solely on TPCA.[16] For example, Denso (Czech) now supplies more than 50 per cent of its products to German automobile companies, and Koito and Aisan also have German or French clients. Toyota's affiliates must keep a good relationship with Toyota, and at the same time they must find new sound clients within the EU.

Implications of TPCA

In general, FDI can help the recipient country conduct economic activities more efficiency and facilitate new R&D, production technology, management expertise and so on. Moreover, FDI can increase competition in individual sectors and show local firms how to meet that competition. The current Czech government of the Social Democrats has therefore introduced FDI incentives to enhance economic growth and support corporate restructuring. In addition to these contributions, Toyota's investment in TPCA presents two other implications: corporate governance and production system architecture.

By nature, Japanese companies tend to place importance on stakeholder based corporate governance rather than stockholder based. In fact, they tend to keep out the power of strong outside stockholders and labor unions.

In the Czech Republic the enterprise category of Japanese-capitalized companies is almost always the limited liability type due to the above mentioned reasons. TPCA is an exception; it is a joint-stock company in which Toyota and the Peugeot Group each have a 50% equity stake. The corporate governance of TPCA is interesting in that Peugeot is in charge of the financial department and parts purchasing department, while Toyota is in charge of the production department. The TPCA president is from Toyota, and the vice president is from Peugeot. The steering committee is the supreme decision-making board which is attended by

not only top TPCA management but also executive directors of Toyota in Japan and Peugeot in France through TV satellite.

This is the second case in Toyota's history that the company and its affiliates face a situation quite different from the standard relationship within the keiretsu. As mentioned, the fundamental component of the TPS is the just-in-time system which is based on close relationships with affiliate companies. Therefore it is quite significant that Peugeot has taken charge of the purchasing department (Table 5.7).

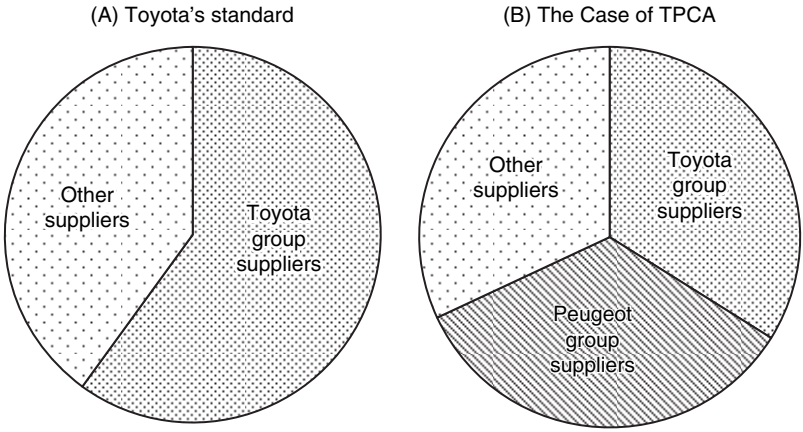
Though the TPS is an effective cost-saving system and takes into account the long-term relationship with suppliers, Peugeot has a quite strict budget constraint policy based on the cost-plus method. During the open tender for parts at the first stage of TPCA operations, Toyota affiliates faced difficulties due to the severe cost-base criteria presented at the Peugeot headquarters in Paris. Some were beaten out by their European counterparts. For example, one of the biggest Toyota affiliates, Denso, a producer of car air-conditioners, was beaten for the bid by a French company. It is the first time in Toyota's history that its car will be fitted with a non-Japanese made air-conditioner. What is more, Koito in the Czech Republic which is also a main affiliate of Toyota, at the present, has no business with TPCA.[17]

In standard cases, the share of parts purchased from Toyota's affiliates for its facilities in the USA and other countries is about 60 per cent of all purchases. But in the case of TPCA, the share of parts purchased from the affiliates is only one-third (Figure 5.5). The executives of Toyota never expected this outcome.[18] Apparently, the Toyota side makes strong efforts to persuade the Peugeot side into accepting their production plans each time, and consequently it takes more time to come to agreements here compared to Toyota's other foreign plants.

Table 5.7 Comparison of Toyota and Peugeot in TPCA

	Toyota	*Peugeot*
Capital	50%	50%
Charge	R&D, Production	Finance, Procurement
Relation with affiliates	Long-term contract (*Keiretsu*)	Short-term cost base contract
Architecture of production	Integral	Module

Note: TPCA: Toyota Peugeot Citioen Automobile.
Source: Based on the interview at TPCA.



Source: Based on the interview at TPCA.
Figure 5.5 Source and share of parts purchased in Toyota's standard and in the case of TPCA

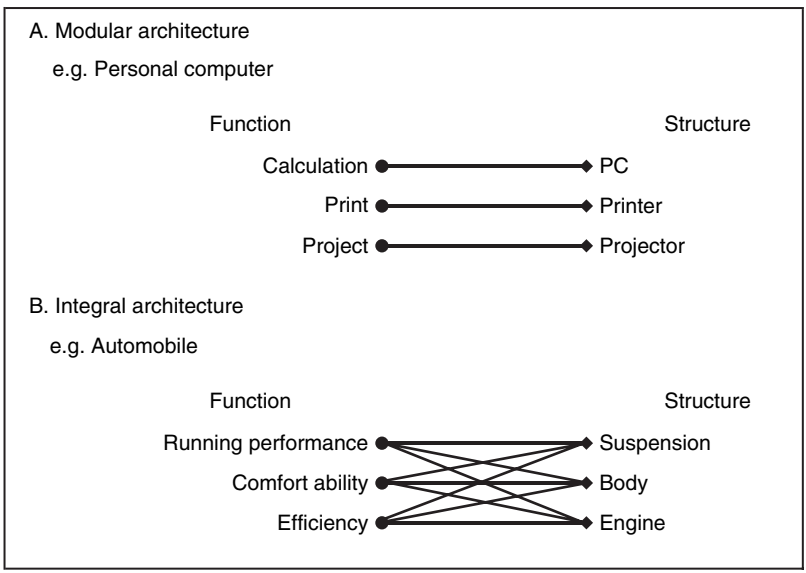
The second implication of TPCA is the question of whether unique Japanese production architecture, such as represented by the TPS, is adaptable or not in the CEE. As discussed by Fujimoto, when we evaluate the Japanese production system, namely the TPS, 'architecture' is the basic design philosophy for products, organizations and various processes, and is one approach for assessing the strength and weakness of a certain industry or company. He explains the conceptual framework of architecture is a way of looking at an industry, focusing on design information embodied in products (Fujimoto, 1999; 2004).

Before proceeding with a discussion on integral and modular architecture, we should briefly give a few more details about the 'just-in-time' production system. As mentioned, the core concept behind the system is increasing production efficiency and decreasing waste. To fulfill this objective, Toyota and its affiliates promote an ongoing workplace campaign called 'kaizen,' which aims to improve the production process in all areas. Under kaizen, every process must be continually improved through the continuous efforts of all employees, which means the implicit character of the campaign is not easy to outline in a standard manual and it takes time for employees to master. Moreover, in the TPS, one operator takes care of various machines to keep the processes simultaneously flowing. In other words, the 'single-skilled'

workers that are standard in the USA and Europe are in general not suitable for the TPS.

The TPS is a typical categorization of an 'integral architecture' production system, which is in crucial need of implicit know-how and common knowledge among employees.[19] In contrast, 'modular architecture' provides standardized interfaces linking different parts and modules. Thus, one can produce various products by selecting and putting together existing parts as long as they are compatible with these interfaces. 'Open architecture' is a kind of modular architecture having industry-wide standardized interfaces, under which parts and modules can be gathered across corporate borders.[20] These kinds of strengths are best demonstrated in a product with an 'open modular' architecture, for which the overall architecture is pre-designed in a way to eliminate the need of coordinating part designs so that parts and business segments can be flexibly mobilized for mass production or modification (Figure 5.6 and Figure 5.7).

It would be interesting to research which type of architecture is optimal for the Czech Republic, but unfortunately we do not have enough data as yet, as TPCA started operations just in 2005. It is possible,



Source: Fujimoto (2005).

Figure 5.6 Architecture and coodination – modular versus integral architectures

	Integral architecture	Modular architecture
Closed	Advanced sector of Japan Automobile Game soft High value-added TV, Video	Machine tool
Open		Advanced sector of US and China PC Internet Financial tool

Source: Fujimoto (2005).
Figure 5.7 Matrix of integral and modular architecture

however, to point out that the Volkswagen group introduced a modular type production system at Skoda in 1996 – the first in Europe – and also requested its suppliers to develop a modular operating system. In the Czech Republic there are typically two types of production architecture in the automobile sector: the open-modular type of Skoda and the closed-integrated type of TPCA (Figure 5.8).[21]

It might be too early to evaluate the implication of Toyota's and its affiliates' investment in TPCA. However, as mentioned above, the impact of the Toyota group from the perspective of corporate culture will have an influence in the Czech Republic. We should point out the

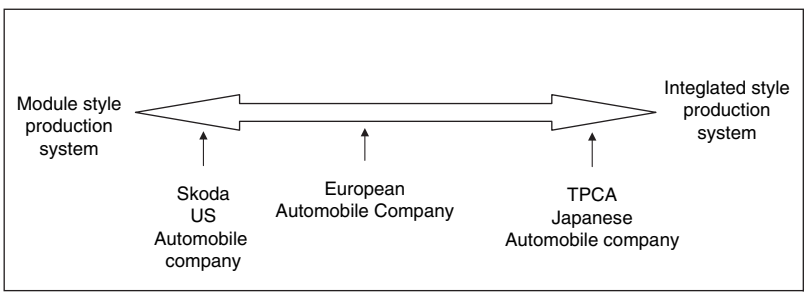


Figure 5.8 Forms of production architecture used by automobile makers

vitality of Toyota from the point of the decision to have a joint venture with Peugeot. Toyota has already long established itself as a company with a famously sound management and product system. While generally it is difficult to integrate businesses having quite different corporate cultures, in order to evolve, Toyota is intending to adapt European corporate culture, and in relation to this, Toyota regards its investment in the Czech Republic as the first important step into the Slavic world.[22]

Conclusion

Recently, the economic performance of the Czech Republic has been improving soundly, with the indicators of production, turnover and financial position showing good progress from 2000 onward. In the 1990s, the previous government headed by Klaus neglected industrial policy and insisted officially on market-oriented economic policy based on the idea of the 'invisible hand,' but, at the same time it introduced another 'invisible hands' shrewdly and prudentially relating to corporate restructuring through KOB and the commercial banks, which helped the former state enterprises survive in spite of their inefficiency. Due to such this 'hidden' policy, the corporate restructure of the Czech manufacturing sector lagged behind that of the other CEE.

The present Social Democrat government initiated a new policy that introduced direct-sale privatization and FDI incentives among other measures relating to industrial policy. Largely due to an inflow of FDI over the past few years, corporate financial standings and production have been improving to date, particularly in the automobile and electrical machinery and electronics sectors, both of which play a major role in the national economy.

In 2003, Toyota announced its investment into the Czech Republic, and since beginning operations the company and its affiliates have had a solid positive effect on the Czech economy. At the same time, Toyota has introduced its unique production system, which includes integrated architecture. It is too early to conclude whether the TPS is adaptable to Slavic society or not. However, for the present, the Czech Republic will have the opportunity experience the TPS in TPCA and at the same time to experience the modular method used at Skoda.[23] In future, when data becomes available, it would be interesting to compare Toyota's experience in the Czech Republic to that in Poland and Russia.

Acknowledgement

I gratefully acknowledge helpful discussions with Jan Klacek, Milan Sojka and Jiri Havel, and for providing me with materials from Professor Takahiro Fujimoto.

Notes

1. See the data of '*Makroekonomicka predikce Ceske republiky' 2006*, Ministerstvo Financi, Ceske republiky (2006).
2. KOB was transformed into the present organization: Ceska konsolidacni agentura (CKA).
3. ROA and ROE are the most significant indicators of corporate restructure to judge investment profitability and efficiency. ROE, which is the value of after-tax profit divided by stock capital, is the financial indicator that shows how efficiently the equity capital acquired by the enterprise from the capital market or stockholder is generated. Of course, it is easy understanding that the higher the value of ROE, the better the corporate restructure. However, even with high lending debt capital, the value of ROE can be high. Therefore it is necessary to take into account another indicator, namely ROA, which indicates how efficiently an enterprise uses its total capital, including debt capital.
4. This is the comment of Seiji Nakagoshi, former president of Denso (Czech).
5. Toyota also established a transmission-producing center in the south of Poland.
6. The general trends of FDI based on CzechInvest are as follows. The share of FDI inflows by country from 1993 to 2004 is as follows: Germany 31%, the Netherlands 13%, Austria 11%, France 8%, USA 7%, Belgium 6%, Switzerland 5%, UK 4%, and Japan 2%. Looking at the share of FDI by sector in the same period, the manufacturing industry accounts for 33%, the financial sector 20%, the transportation and communication sector 14%, the commerce, hotel and restaurant sector 13%, the real estate sector 9%, and the electricity, gas and water service sector 6%. We should point out that the financial sector was the leading recipient of FDI until 2002, but since 2003 the manufacturing industry took the leading position due to the rapid growth of Greenfield investment, which is the common type for Japanese investors. The total amount of FDI in 2004 was €3586 million, with the totals by country being €850 million from the Netherlands, €700 million from Germany, €361 million from Austria, €227 million from the USA, €212 million from Japan, €139 million from France, €121 million from Sweden and €115 million from Switzerland. FDI by sector over the same period was €11.8 billion in the manufacturing sector, €5.18 billion in the financial sector, €5.17 billion in the commerce, hotel and restaurant sector, €4.12 billion in the real estate sector and €2.42 billion in the electricity, gas and water service sector. These figures indicate that the FDI from Japan has been increasing and that inflows to the manufacturing sector are rapidly growing.

7. I would like to thank the companies I visited (Matsushita, TPCA, Showa-alumi, Aisan, Toray, Denso, Koito, Matsushita Communication and Onanba among others in 2003, 2004, 2005, 2006).
8. For details on FDI incentives in the Czech Republic, see the Czech Invest website at: www.czechinvest.org.
9. Matsushita UK took care of finding new jobs for the employees of the factory in corporate with the local government, in order to minimize the troubles for moving his production center into the Czech Republic. Mr. Ashahi, the former president of Matsushita Pilsen, said that the lifecycle of this case is 25–30 years.
10. The just-in-time system supplies only the necessary items in the necessary quantities at the necessary time. 'Autonomation' is the addition of an element of human intelligence to automated machinery. From the point of FDI, the former is the crucial element.
11. See website of Czech Invest: http://www.czechinvest.org.
12. In fact, the former CEO of Czech Invest, Martin Jahn, became deputy prime minister and was put in charge of foreign economic affairs in light of his achievement to help facilitate the success of the TPCA investment and other automobile investors.
13. Other reasons for their marriage exist as follows. For Toyota and other Japanese car makers it is not easy to move into the European compact car market. For example, CO_2 emission regulations in the EU are quite strict compared with Japan. These and other local market conditions made partnering with a European manufacturer a practical choice for Toyota. For the Peugeot Group, the partnership offers a good opportunity to gain understanding of Toyota's unique TPS. In the initial stages, production targets for the plant are 100,000 cars for Toyota and 200,000 cars for Peugeot, for a total of 300,000.
14. Since the establishment of NUMMI, Toyota has independently set up several factories in the USA in which the workers are not unionized.
15. These affiliated companies are called keiretsu. The main keiretsu are Denso, Aisin, Toyoda Gousei, Koito, Aisan, Aoyama, Fuji Koki, Futaba, Koyo Seiko, Tokai Rika Toyoda Machine Works, Toyoda Tsusho and others.
16. Planned production of TPCA is 300,000 cars per year, with the Toyota side producing 100,000 and the Peugeot–Citroen side producing 200,000. For suppliers, optimal production scale is 200,000–300,000 cars per year.
17. Interview with Denso and Koito in March 2006.
18. This comment was made in the author's interview with Masatake Enomoto, the former president of TPCA, at TPCA on 16 March 2005.
19. Japanese companies still remain competitive in such fields as automobiles, in which integrating and coordinating ability directly leads to product competitiveness.
20. American companies tend to have superiority in systemization, establishment of de-facto industry-wide standards and flexibility in reorganizing business structures.
21. We should point out that one of Toyota's main affiliates, Aisan, opened a plant in the Czech town of Louny in 2000 and succeeded in introducing the TPS there. Many Toyota affiliates have since come to Aisan to learn about its adaptation of the system. On the other hand, some affiliates have had

difficulties in introducing Toyota-style management in the Czech Republic. Though it is very difficult to access the real situation of TPCA, the management from Toyota is likely to be satisfied in quality of Czech employees who, in general, are learned TPS method faster than Toyota management is expected. TPCA, Denso and other affiliates established the training center or department for the Czech employees too.

22. Toyota also invested in a new facility in Russia in April 2005, which is forecast to start operations in 2007.
23. Toyota faces French and Czech corporate culture inside of TPCA which is quite different from itself. We are interested in Toyota's next stage in Russia how to introduce TPS and adapt it in quite deep Slavic corporate culture.

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Part III
Hungary

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6

Corporate Governance and Ownership Concentration on the Budapest Stock Exchange

Zsolt Bedő and Éva Ozsvald

Introduction

The importance of good corporate governance has only recently been recognized in Hungary and efforts to implement modern structures have been slow. Moreover, it has been an 'imported product,' not a result of endogenous evolution. The lack of organic development in Hungary is understandable given the history of central planning up to 1990. During the subsequent ten-year transition period all the essential features of a well-functioning market economy were established. Notwithstanding this, strong corporate governance was treated as a low priority ingredient in the newly created capitalist institutions. The updated Company Law contained the necessary prescriptions for the formal corporate governance structures but for closely held private Hungarian companies – the dominant form of those domestically owned – the structures remain more or less an empty shell.

Since 2000, the influence of two factors has sharply increased the awareness of the benefits of genuine good governance. One was the recognition that corporate governance failures were prominent in the underlying causes of the East Asian and Russian currency crises in the late 1990's. The other factor was Hungary's preparation for the accession to the EU. To become a member, candidate countries' legislation and regulations had to be aligned with the requirements of the EU and with this Hungary has successfully complied. It was a coincidence that at this time issues of corporate governance were focused on and became a fashionable topic in the western half of continental Europe. (The much referred to document of the period *The OECD Principles of Corporate Governance*, was published in 1999). The stimulus for raised awareness of the necessity for good governance thus came from outside

Hungary and those primarily affected were companies that relied on or required external financing, first and foremost listed companies.

In contrast there was little incentive for the majority of Hungarian owned private companies, to improve their internal governance mechanisms – high transparency, good treatment of non-controlling shareholders and stakeholders or the establishment of efficient and independent boards. All continued to be honored more in the breach than in the observance.

Most economists analyzing the problems in Hungarian corporate governance used to link them to the privatization process, its methods and outcomes. Since a large body of literature covers the subject of privatization and the resulting corporate governance mechanisms as two inseparable issues, an approach justified for the 1990s, this chapter does not intend to repeat the story of ownership transition.

One reference, however, seems to be essential to understand the relative lack of interest (across companies and the economics profession in Hungary) in corporate governance matters. Hungary's openness towards foreign investors during the crucial years of privatization helped her to become an attractive destination for foreign direct investment. As a result, today foreign firms control two thirds of manufacturing, 90 per cent of telecommunications, and 60 per cent of the energy sector. The MNC whose subsidiaries have this heavy weighting in the Hungarian economy are not present on the Budapest Stock Exchange: they are listed on bourses in the US, UK, Germany, etc. Their corporate governance in theory and practice is thus determined by the rules that prevail on those exchanges in conjunction with the national laws of the countries where the head office of the given MNC is located. While foreign subsidiaries have to comply with a range of Hungarian laws, their corporate governance is in the main outside Hungarian influence.

The next section looks at the legal framework of corporate governance: both laws-on-the-book and their enforcement will be considered. The third section introduces the Budapest Stock Exchange and offers an explanation why its role has remained very modest linked as it is with slow progress in 'broadening and deepening' the financial architecture. The fourth part provides an empirical analysis of the high degree of ownership concentration in publicly traded companies. The fifth part identifies the major investors on the Budapest Stock Exchange (BSE) and finds that foreign institutional investors dominate this market. The sixth section deals with the characteristics of minority shareholder protection. The final section draws conclusions.

Legal arrangements

Laws on the book

The pillars of corporate governance structures are laid down in the Company Act. This law governs the creation and the basic rules for companies. Promulgated in 1988, Hungarian company law had to be created almost from the scratch because while certain forms of companies already existed during the forty years of central planning, they were not designed for market conditions. Since its inception, the Company Act went through several modifications. In 1997 and 1998 it was adapted to the needs of a full-fledged market economy and subsequently (2001, 2003) was made more flexible. Most of the changes related to companies limited by shares. The precondition of accession to the EU was the harmonization of the national law to the body of European law, the so-called acquis communaitare. This process however, was not simply the adoption of the European company law Directives since those only cover the core rules. The member states were left with a non-negligible degree of freedom, allowing them to maintain the national variations of forms and institutions in company laws. The preservation of the internal consistency of the law, however, must have been observed.

Judged from the legal origin point of view, by and large, Hungarian company law, which constitutes a part of a civil law system, corresponds to the logic of the relevant German legislation.

The Company Act determines the corporate forms that business activities can take. They are the following: limited liability company, company limited by shares, joint enterprise, limited partnership and unlimited partnership. Of these five forms of business associations the first three have legal personalities.

The most widely used company forms are the limited liability company ('Kft') and the company limited by shares ('Rt'). In 2004 176,973 limited liability companies and 3,751 companies limited by shares operated in the country. Only a company limited by shares may issue securities representing ownership in the company. These companies are either closed or public, the former being established through a private placement, while the shares of public companies are wholly or partially traded on the stock exchange. Foreign companies operating in Hungary prefer to choose the limited liability company form.

All companies registered in Hungary are under the Court of Registration's legal supervision. The Court maintains the company register

and provides public access to company information. The customary (but not mandatory for Kft-s) form of corporate governance for domestic companies is the two-tier system with a supervisory board (dealing with the strategic direction of the company and the monitoring of the management) and a management board (carrying out the operational management of the company).

In case of limited liabilities companies the supreme body is the member's meeting or general assembly which must be convened at least once a year. The members approve the company report and take decisions on issues such as the appropriation of after-tax profits, election and removal of the managing director, alteration of the articles of association etc. The members' meeting has quorum if at least half of the initial capital or the majority of the eligible votes are present and resolutions are passed by a simple majority of votes. A limited liability company is managed by one or more managing directors. A Kft. need not appoint a supervisory board or an auditor as a main rule; however, the law determines the conditions when it becomes mandatory.

Compared to limited liability companies, companies limited by shares are more strictly regulated. The initial cash contribution of each member of an Rt is much higher than in the case Kfts. The Rt form of incorporation is mandatory for all companies operating in banking, investment or insurance sectors. Shares in Rt. can be of various types and different types embody different ownership rights. Companies may issue ordinary, preferred, employee, and interest-bearing shares. Preferred shares (which include the 'golden' share of the state) may be issued up to 50 per cent of registered capital.

The Annual General Meeting (AMG) has authority over key decisions. The most important exclusive rights of the AMG are:

- creation and modification of the statute (75 per cent + 1 vote)
- decision on the modification of the legal form (75 per cent + 1 vote)
- decision on the transformation or termination without legal successor of the company (75 per cent + 1 vote)
- election and removal of the members of the Management Board, the Supervisory Board and decision on their remuneration
- decision on the transformation of share type
- acquisition of own shares, acceptance of the public offer for the company's own shares (Act CXLIV of 1997 on Business Associations).

The Board of Directors of an Rt. is the executive body of the company. The Board represents the company *vis-a-vis* third parties and before the

authorities. The Board of Directors is also responsible for supervising the working organisation of the Rt. and it exercises the rights of employer. In the case of companies limited by shares it is obligatory to establish a Supervisory Board and to have an auditor.

As far as the formal corporate governance structures that follow the rules established by law are concerned we can conclude that they closely resemble the pattern established in continental Europe. While the form is much in order, there is a number of inadequacies when the content is explored. A few empirical analyses, such as the one carried out by. Torok and his team (Torok, 1998) drew attention to this fact. In case of limited liabilities companies the author saw the lack of transparency and the 'façade-like' corporate governance structures as a typical phenomenon. The explanation for this is that the majority of Hungarian Kfts are controlled by one or a few very strong owners who can afford weak corporate governance mechanisms.

Analyzing the CG structures of joint stock companies, Torok (1998) arrives at a conclusion that supervisory boards hardly have any 'teeth' at all and the Board of Directors do not depend on them in any respect. The real role of supervisory board is limited to monitoring the conformity of the company's functioning with the law and to some other purely formal tasks. The World Bank Report (ROSC, 2003) which benchmarks Hungary's practice of corporate governance against the OECD Principles (see Appendix 6.1) also finds the role of supervisory board fairly weak, pointing out that main power of these boards is to refer issues to the general meeting of shareholders. In fact, the weakness of supervisory board was found to be the main shortcoming among just a few that the Report established when Hungary's observance of corporate governance standards and codes were evaluated. (The second was the conflict between law and practice in the area of share registration.)

Besides the Company Act the other basic law affecting listed companies is the Capital Markets Act (CMA) enacted 1 January 2002. It regulates all activities and institutions related to capital markets (except for insurance company and pension fund regulations). The Capital Markets Act was born out of a thorough legislative reform the main aim of which was to bring Hungarian legislation in line with EU laws.

The capital markets supervisor is the Hungarian Financial Services Authority (HFSA), an independent and self-financing body. It was created in April 2000 and was modeled on the FSA in the UK and it regulates all the financial and securities markets (ROSC, 2003).

In 2003 the Budapest Stock Exchange has adopted detailed recommendations and rules regarding corporate governance issues for the listed companies. A basic goal was to assure that investors receive adequate information about the corporation and its activities so that may make investment decisions and exercise shareholder rights appropriately.

Hungarian accounting principles are regulated be the Accounting Law which took effect on 1 January 2001. This act and its subsequent modifications intended to align Hungarian financial reporting practices with the International Accounting Standards and the corresponding EU directives. Since 1 January 2005, listed companies prepare their consolidated financial statements in accordance with international financial standards.

Legal experts agree that the Company Law in Hungary has caught up with western standards and is of fairly good quality. In the context of corporate governance, however, the question emerges: what is the degree of protection that this law provides for investors (and creditors)? Based on the tenets of the theory developed by La Porta *et al.* (1997, 1998) we can hypothesize that since Hungary's legal system has its origins in German legal traditions, the protection of investors must be relatively weak compared to those in Anglo-Saxon countries. Also, the protection of creditors is supposed to be stronger than that of the equity owners. These two hypotheses were confirmed in an empirical study by Czajlik & Vincze (2004). The authors replicated the indicators of shareholder and creditor rights constructed by La Porta *et al.* (1998) and developed further by Pistor *et al.* (2000) and applied them to the Hungarian case. A sample of their findings is provided in Appendix 6.2.

Law enforcement

Gap can exist between laws on the books (law extensiveness) on the one hand, and law enforcement (law effectiveness) or 'law in action' on the other. This is a general phenomenon in emerging market economies as discussed and empirically proved by Pistor *et al.* (2000). Referring to a number of empirical research, Berglof & Claessens (2004) arrive at a conclusion that the 'enforcement of the rule of law is a, perhaps *the*, central functional difference between developed market economies and developing economies.' In Hungary too, the weaknesses of enforcement of regulations impede the move towards better corporate governance practices. For example, the settlement of legal disputes is very slow due in part to the significant overload on courts and sometimes also to the contradictory attitudes of authorities.

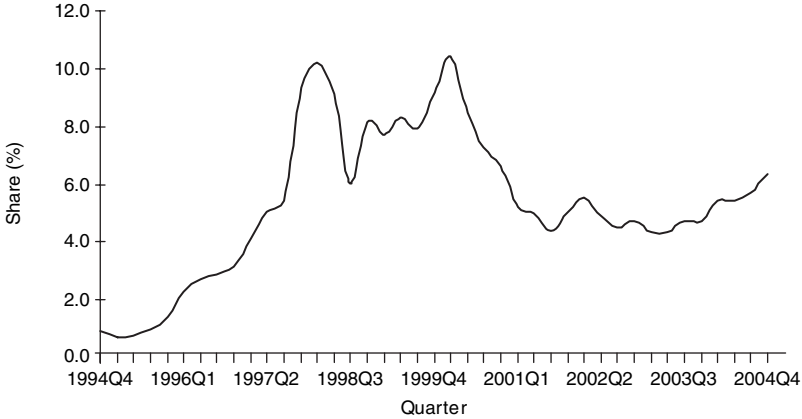
The capital market

The BSE was first established in 1864 and it operated until 1948. Under the system of central planning it ceased to function but was re-opened in June 1990, almost as soon as the transition to a market economy started. In the beginning there were only 6 listed companies on the BSE. By 1999 this number reached 64 companies: this was the year with most listed companies so far. As of September 2004 the Budapest Stock Exchange listed 51 firms – 25 as Category 'A' and 26 as Category 'B.' Of this only 'A' which has higher listing requirement is important, since it represents 93 per cent of market capitalization. The three largest Hungarian companies – MTELECOM (telecommunications), MOL Rt. (oil industry) and OTP (banking) – account for 66 per cent of the market capitalization of the BSE. Cross-listing is typical: domestic firms which are large enough and have a sufficient track record to borrow on the capital market are also listed on bourses abroad. The above mentioned companies, for example are listed on the New York Stock Exchange. The growing importance of cross-listings is the sign of: (1) capital requirements of large companies cannot be satisfied on the local market; and (2) these companies are ready to meet the high corporate governance requirements of the renowned foreign stock exchanges.

As far as the size of the firms on the BSE is concerned they are mostly large firms in Hungarian measure: the average firm had around 2000 employees between 1996 and 2000.

Protection of outside investors, good corporate governance and the development of financial markets are in strong relation with each other and the causality runs in virtuous circle. The countries of Central Eastern Europe have caught up with old members of the EU in many respects, yet they remain laggards as far as the degree of financial intermediation is concerned. This feature applies for Hungary as well, although this country is doing relatively well compared to other CEEs if the focus is narrowed to credit markets. The preference for bank financing over equity financing is obvious and with this Hungary follows the continental European tradition. Figure 6.1 shows the share of equities in total financial assets. The peak of 10, 2 per cent was reached in 1998 which was followed by a sharp decline and prolonged stagnation. At present the share of equities in financial assets fluctuates around 6 per cent.

This low degree of market capitalization has several explanations among which the most frequently cited are feeble income levels, households' preference for depositing savings in banks (result of conservatism



Source: Hungarian National Bank, authors' calculations.
Figure 6.1 Share of equity in total financial assets in Hungary in the period 1994 Q4–2004 Q4

and ignorance) and low level of institutional savings (those of pension funds and insurance companies).

Most local companies are self-financed and their second choice is bank financing. They find the price of going public too expensive and the rules of the stock exchange too demanding. They also do not want to give up the benefits which result from preserving the opaqueness of their businesses.

Another indicator of capital market development is the proportion of market capitalization to GDP, which shows the relative weight of the exchanges in domestic economies. This is presented in Table 6.1, which also contains other indicators in regional comparison. Not considering the actual number of listed firms the capitalization per GDP ratio indicates that the BSE (with a smaller number of listed firms) occupies a rather similar position in the overall economy as the Vienna Stock Exchange which is based in one of the most developed (measured by per capita income) countries in the EU. Concentration of the three markets is also quite similar, which is not some 'small exchange' phenomenon, since the Deutche Börse exhibits a similar degree of concentration of most capitalized and most traded shares. Interestingly enough the average value of transaction in millions of US dollars is significantly higher for BSE than for Warsaw Stock Exchange, which is known to be dominated by powerful pension funds. Comparing the turnover velocity of shares

Table 6.1 Features of selected regional exchanges Budapest Stock Exchange (BSE), Warsaw Stock Exchange (WSE), and Vienna Stock Exchange (VSE)

Categories	*Hungary (BSE)*	*Poland (WSE)*	*Austria (VB)*
Market capitalization/GDP (% of GDP in 2004)	28.54%	29.61%	30.03%
No. of listed companies in 2004	47	230	120
Concentration of 5% most capitalized shares (average for 2000–2004 period)	57.74%	69.06%	47.56%
Concentration of 5% most traded shares (average for 2000–2004 period)	63.46%	73.46%	62.48%
Average value of transaction in 2004 (US million)	17.2	4.1	29.7
Turnover velocity of shares in 2004	62.60%	34.10%	34.90%

Source: OECD, International Federation of Stock Exchanges (available at: http://www.fibv.com).

we can conclude that the BSE is the most liquid market from the three, which can also imply the most efficient spread of information.

Control by blockholders

There are two basic models of ownership concentration: blockholder dominated corporations and widely held corporation. The majority of firms listed on the BSE clearly fit in the first category. With this characteristics Hungary belongs to the group of the majority of countries all over the world and Europe. Becht & Mayer (2001) showed that in more than 50 per cent of European countries there is a single voting block of shareholders, which disposes over a majority of shares. In contrast this figure in the US and UK is only 3 per cent.

The theory developed by La Porta *et al.* (1998) states that concentrated ownership is a response to deficient regulation. This means that in the absence of adequate protection, shareholders secure their investment with the direct exercise of control through large share blocks.

In a market environment where ownership structure is highly concentrated, instead of the classic agency problem between owners and managers a second conflict that of between large blockholders and small investors emerges. If corporate governance does not have a solution

Table 6.2 Ownership concentration on the BSE in the period 2001 Q4–2005 Q2 (% holdings)

Definition	*Mean*	*SD*	*Minimum*	*Median*	*Maximum*
First largest blockholder	44.6	24.3	0.0	50.0	99.5
Second largest blockholder	18.0	8.5	0.0	16.1	39.6
Third largest blockholder	9.8	3.7	0.0	8.4	21.0
Largest two blockholders	56.8	26.3	0.0	58.7	99.6
Largest three blockholders	60.6	26.6	0.0	60.9	99.8
All blockholders	62.3	27.4	0.0	62.8	99.8

Notes: N (no. of firm-years) = 375. N varies by half year with the maximum of 48 in 2002 Q2, 2003 Q4, 2004 Q2, 2005 Q2. SD – Standard deviation. A blockholder is defined as an owner with higher direct ownership than 5%.
Sources: Budapest Stock Exchange; Magyar Tőkepiac; website of listed companies; authors' computations.

for this potential conflict small investors will stay away from acquiring direct ownership in companies.

In order to draw an accurate picture of the concentration of voting rights on the Hungarian equities market, data were collected from the database of BSE and of the monthly newsletter 'Magyar Tőkepiac', which is the primary vehicle of information distribution by the Hungarian Financial Supervisory Authority (HFSA). The results of our computation for the 2001 Q4–2005 Q2 period are presented in Table 6.2 We arranged our indicators in such a way that they were easily comparable with Table 6.3 which is taken from Earle *et al.* (2005) and which covers the 1996–2001 period.

Table 6.3 Ownership concentration on the BSE in the period 1996–2001 (% holdings)

Definition	*Mean*	*SD*	*Minimum*	*Median*	*Maximum*
First largest blockholder	39.4	19.4	0.0	42.2	87.1
Second largest blockholder	13.5	9.7	0.0	14.7	42.5
Third largest blockholder	4.8	5.1	0.0	3.9	22.7
Largest two blockholders	52.9	23.1	0.0	55.9	99.0
Largest three blockholders	57.7	23.7	0.0	62.09	99.4
All blockholders	60.9	24.6	0.0	67.2	99.4

Notes: N (no. of firm-years) = 168. N varies by year, with a maximum of 66 in 1999–2000. A blockholder is defined as an owner directly holding at least 5% of the company's shares. SD = standard deviation.
Source: Earle *et al.* (2005).

Comparing Table 6.2 and Table 6.3 we can state that the level of concentration has intensified during the last four years, measured by the mean in all definition categories. Median figures on the other hand for the 'largest three blockholders' and 'all blockholders' categories in the second period are lower than in the first period. In the second period the largest two blockholders possess absolute power over the company with 58.66 per cent of voting rights. This high concentration most probably decreases the liquidity of shares traded on the exchange, which lowers the attractiveness of BSE as a whole. Voting power of 'all blockholders' that is above the 50 per cent threshold in the 2001 Q4–2005 Q2 period is present in 60 per cent of the companies in 2001 Q4, while in 2004 Q2 79, 59 per cent of examined companies fell in this category. 'All blockholder' category means maximum of 7 blockholders only for two companies, 5 blockholders for 5 companies, and 4 blockholders for 13 companies. We found only one corporation that's shares were widely held in 5 out of the 8 and half years. Table 6.4 shows the ownership characteristics of the four largest companies (representing 75 per cent of total market capitalization) on BSE in the second half of 2005.

Table 6.4 Blockholders of the four largest companies on BSE in Q2 2005

Company	*Name*	*Voting right (%)*	*Market capitalization in local currency (HUF) (m)*	*Market share (%)*
Országos Takarékpénztár (OTP)	Bank of New York	25.0	2,030,000	26.0
Magyar Olaj- és Gázipari Rt. (MOL)	ÁPV Rt.	12.7	2,170,974	28.0
	JP Morgan Chase Bank	13.7		
	Slavintegra-Slovbena	7.9		
	OMV	10.0		
Magyar Telekom (MT)	MagyarCom Holding GmbH	59.5	971,900	13.0
	JP Morgan Chase Bank	8.0		
Richter Gedeon	ÁPV Rt.	25.0	637,253	8.0
	Bank of New York	20.3		

Note: ÁPV Rt. is the Hungarian Privatization and State Holding Company Market capitalization of BSE in the examined period was 7,696,188 million HUF
Source: Quarterly reports of companies, Reuters, International Federation of Stock Exchanges (available at: http://www.fibv.com).

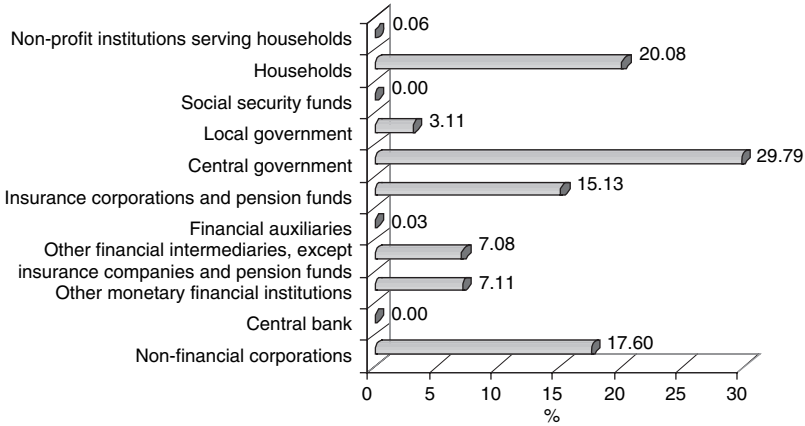
Dominant investors on the BSE

In the previous section the concentrated ownership pattern of companies listed on the BSE was presented. We now proceed to the identification of major owners. It is well known that different investor groups behave in various fashions as owners and/or traders, which, in turn, seriously affects the firm's internal relations and external valuation. The identity of blockholder is also important for the evolving characteristics of corporate governance. Especially interesting is the behaviour of institutional investors whose shareholder activism serves as a base for the political model of corporate governance. On a number of stock exchanges around the world institutional investors currently choose to voice their concerns of firm performance instead of exiting (selling the shares of poorly performing corporation). Under the category of institutional investors investment banks, credit institutions, investment funds and pension funds are considered. This particular group also provides enhanced liquidity to markets, which stimulates the spread of private information.

Assets held by institutional investors have been growing in all parts of the world. By the end of the 20th century their market share exceeded the 50 per cent in the US; 76, 5 per cent of outstanding equities in the UK, 60 per cent in France and 39 per cent in Germany In emerging markets this share is smaller but shows a growing tendency. This applies to CEEs as well, where due to the ongoing pension reforms funds are being channeled into equities through this particular group of investors.

Data on the equity holdings of different investor groups was collected from the database of the Hungary National Bank's (HNB) Table on Financing and Investment (TFI), which fully complies with the guidelines of the European Central Bank. The methodology is based on the European System of Accounts (ESA 95), which records flows and stocks of funds in a quarterly fashion. The ESA 95 groups the institutional units of a national economy into five resident sectors: non-financial corporations, financial corporations, general government, households and non-profit institutions serving households. The category 'rest of the world' covers the flows and stocks between the resident sectors and non-residents.

Observing the equity ownership distribution of the domestic sectors (Figure 6.2) the biggest share is represented by the central government (29,79 Per cent). Central government ownership is concentrated in the institution called Hungarian Privatization and State Holding Company



Source: Hungarian National Bank, authors' calculations.
Figure 6.2 Ownership distribution of domestic investor categories by 2004 Q4

(HPSHC). HPSHC is responsible for the privatization of state owned enterprises. Privatization has been conducted outside BSE until recently, when the divestiture of some listed corporations has been initiated. Central government's stake in public corporations shows a steadily diminishing tendency and at present it appears as a major owner in five out of 46 corporations listed on the BSE.

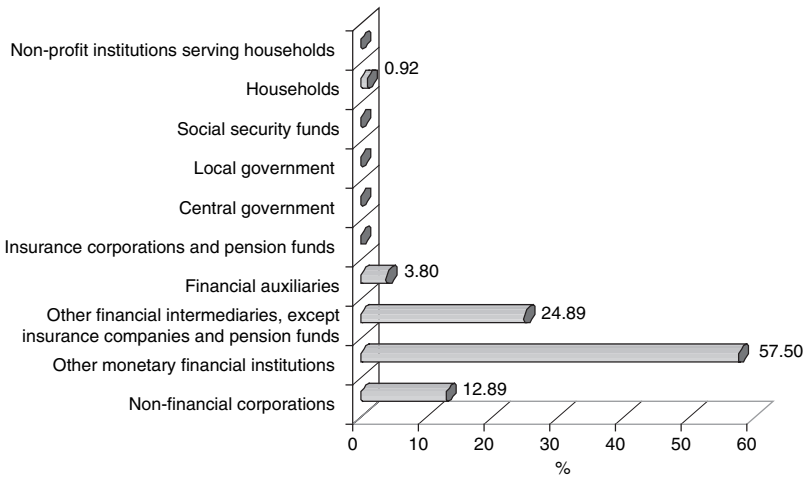
Among resident sectors the share of households (20,08 Per cent) and non-financial corporations (17.6 per cent) is similar to those observed in the developed markets. The sector of 'other monetary financial institutions' possesses a low level of ownership in public companies. This is partly explained by the fact that credit institutions, such as commercial banks prefer state debt financing instead of equity investment due to the higher risk the latter involve.

We have been dealing with the composition of owners originating from the domestic sector. General conclusions based on this analysis, however, would be grossly misleading since the Budapest Stock Exchange is dominated by foreign owners. The non-resident sector which is called in official statistics the 'rest of the world' has a massive share of 78.1 per cent on the BSE. Replicating the analysis which we did for the domestic sector for the non-resident investors, an entirely different picture emerges. 'Other monetary financial institutions' ownership is by far the highest (57.5 per cent), which implies the dominance of foreign commercial banks on the BSE.

At first glance it seems that foreign insurance companies and pension funds stay out of the BSE completely. The 24.89 per cent ownership share of investment funds (which are included in the category 'other financial intermediaries, except insurance corporations and pension funds') however, suggests otherwise. In the pension fund industry outsourcing portfolio management activities is rather common, which implies the indirect presence of non-resident pension funds on the BSE.

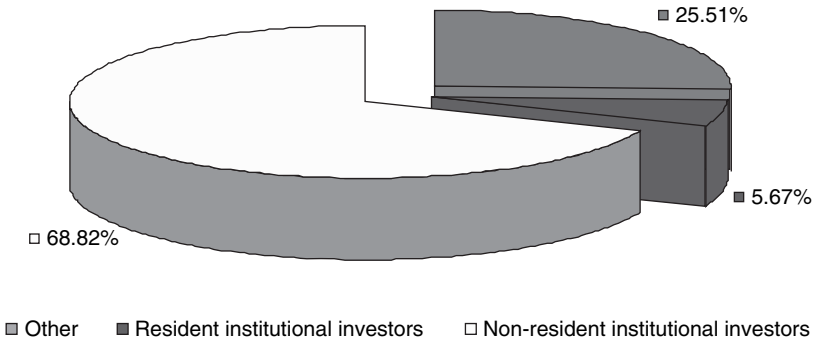
Considering results displayed on Figure 6.3 and 6.4 we can state that the BSE is dominated by non-resident institutional investors. Adjusting the total non-resident sector with the share of non-resident institutional investors we obtain a 68.82 per cent ownership share on the BSE for this sector.

The significant overweight of institutional investors on the BSE raises the issue of institutional investor activism as a means of management control and minority shareholder representation. Our investigation into this matter showed that this increasingly popular tool of monitoring and controlling in Anglo-Saxon countries has not yet been applied neither by resident nor non-resident institutional investors in Hungary.



Source: Hungarian National Bank, authors' calculations.

Figure 6.3 Ownership distribution of non-resident sub-sectors in the 'rest of the world' sector by 2004 Q4



Source: Hungarian National Bank, authors' calculations.
Figure 6.4 Ownership distribution of resident and non-resident institutional investors on BSE by 2004 Q4

The protection of minority shareholders

When the ownership of the company is dominated by large blockholders – as it is the Hungarian case described above- there are chances that the controlling owners of the company would enjoy private benefits at the expense of small shareholders. Thus, the presence of the large blockholders in listed companies puts minority rights on a top place among corporate governance issues.

When evaluating the Hungarian practice of the protection of non-controlling shareowners in the light of requirements put forward by the OECD Principles – 'the corporate governance framework should ensure the equitable treatment of all shareholders' – the World Bank experts found that this condition was 'largely observed.' Yet, Hungary does not follow the 'one-share- one vote' principle; this is why it was recommended for policymakers to move further toward this principle by phasing out golden shares[1] and veto shares and removing the possibility for issuance of preferred shares with multiple voting rights. Procedures that make voting easier for small shareholders are also expected to be improved.

Transparency about the company's affairs is of utmost interest for small shareholders and institutional investors who often represent them. Therefore, a strong disclosure regime is essential for the exercise of shareholders' right. According to the OECD Principles: 'Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.'

Hungary was somewhat late in the introduction of this rule but since July 2001 shareholders have primary responsibility for disclosing ownership details to the company and HFSA if their holdings exceed certain limits. Disclosure thresholds are the five percent and multiples thereof up to 50, 75, and 90 per cent. Issuers must disclose their ownership structure in flash and annual reports. The CMA requires nominees/custodians to disclose ultimate owners. Cross-holdings are prohibited and shareholders agreements must be disclosed (ROSC, 2003).

Conclusion

This chapter concentrated on factors which have direct relevance for the state of corporate governance in Hungary: legal arrangements which include both laws on the book and their enforcement, the ownership structure and the identity of owners of listed companies on the domestic exchange.

Since Hungary has joined the European Union in 2004 she possesses most of the legal requirements[2] that are the basis for efficiently functioning corporate governance mechanisms. Yet, in practice corporate governance has remained a weak link among the institutions of a newly built market economy. Some elements of strong governance, such as the market for corporate control are almost completely missing.

A typical privately owned Hungarian firm is a closed company that relies mostly on self-finance, is managed by its owner(s) and operates boards that fulfill only formal tasks. These types of companies do not have the incentives to improve their internal corporate governance mechanisms. The strict legal framework of the Budapest Stock Exchange makes a difference: the quality of many elements of corporate governance of the few dozens publicly quoted companies meets the western European standards. Corporate governance problems arise mostly from the concentration of ownership and control that continues to characterize the companies on the BSE. To improve this, stronger regulations that affect transparency and conflict resolution between large blockholders and minority investors are expected to come into force.

The future development of corporate governance in Hungary is largely influenced by the EU membership and the country's openness towards foreign capital. As the economy matures, the importance of external finance will grow with an eventual positive feedback on corporate governance.

Notes

1. Golden shares were employed during the privatization of Hungarian state-owned enterprises to retain state control over major strategic decisions.
2. The latest important step in this field was the amendment of the Companies Act effective as of 1 July 2006. With it a clear distinction has been made between private companies limited by shares and public corporations. For the latter it is no longer mandatory to have a supervisory board, thus they may opt for a unified management system with a single board. It is also required that the majority of the members of the board be independent. An audit committee with at least three members must also be set up. Furthermore, the new Act improves the rights of minority shareholders. Listed companies are expected to include a corporate governance statement in their annual reports or publish it separately.

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Appendix 6.1: Summary of Observance of OECD Corporate Governance Principles in Hungary

Principles	*O*	*LO*	*PO*	*MO*	*NO*	*Comment*
I The rights of shareholders						
Basic shareholder rights			X			Inconsistency between law and practice in updating registry from KELER. Some voting disallowed as a result
Rights to participate in fundamental decisions	X					Some authority for capital increases can be delegated to board
Shareholder AGM rights			X			Some reports of companies setting meetings that are difficult to attend
Disproportionate control disclosure		X				Shareholders required to disclose at 5% + levels; companies disclose ownership in annual reports.
Control arrangements should be allowed to function.		X				Strong takeover rules with squeeze-out provisions.
Cost/benefit to voting				X		Institutional investors tend to use exit over voice.
II Equitable treatment of shareholders						
All shareholders should be treated equally	X					Voting caps can be empolyed Multiple voting rights, golden shares, and veto shares complicate voting rights
Prohibit insider trading	X					Strong definitions of insiders and inside information. – AGM must approve large transactions.

Board/Mgrs. disclose interests		X		Limited disclosure of related part transactions under Hungarian accounting regulation.
III Role of stakeholders in corporate governance				
Stakeholder rights respected		X		1/3 of supervisory board seats reserved for employees
Redress for violation of rights		X		
Performance enhancement		X		Employees can own shares and options.
Access to information		X		Based on public disclosure; see section IV below.
IV Disclosure and transparency				
Disclosure standards		X		Disclosure standards quite completed. – No disclosure of material risk factors.
Standards of accounting & audit			X	Most listed companies use IAS. – All companies must meet new EU standard (IAS in 2005)
Independent audit annually			X	Most listed companies use Big 4 (and ISA). – Review/oversight body being created in 2002
Fair & timely dissemination	X			
V Responsibilites of the board				
Acts with due diligence, care			X	Two-tier board (one-tier optional), but few active sup. boards. Supervisory role poorly defined.
Treat all shareholders fairly		X		Fair treatment principle often violated in practice. No barriers to preferential treatment.
Ensure compliance w/law		X		Board required to comply with all legal requirements.
The board should fulfill certain key functions			X	Board and management nomination and remuneration left to 'AGM', effectively to management board. Unclear liability for non-disclosure of information.

Appendix 6.1 (Continued)

Principles	*O*	*LO*	*PO*	*MO*	*NO*	*Comment*
The board should be able to exercise objective judgment				X		Two-tier board means supervisory board is non-executive.
Access to information	X					Law grants access to information and special expertise.

Notes: O = observed; LO = largely observed; PO = partially observed; MO = aterially not observed; NO = not observed.
Source: 'Report on the Observance of Standards and Codes' (ROSC, 2003)

Appendix 6.2: Indicators of shareholder protection as derived from the Company Law

One-share one-vote principle = 0
Proxy by mail = 0
Shares cannot be blocked = 1
No registration cut-off date before the meeting = 1
Cumulative voting or proportional representation = 0
Other rules to ensure proportional board representation = 0
Judicial recourse against decisions by executives, supervisory board = 0.5
Judicial recourse against taken by the shareholder meeting = 1
Pre-emptive right to new issues for current shareholders = 1
Shareholders representing less than 10 % of total shares may demand the convocation of and extraordinary shareholder meeting = 1
Mandatory dividends = 0
Executives are appointed and dismissed by the supervisory board, rather than by the shareholder meeting = 0
Management and supervisory board members can be dismissed without cause = 1
50% minimum quorum requirement for a shareholder meeting to take binding decisions = 1 .
The right of minority shareholders to call an audit commission = 1
Supermajority requirement (at least $^3/_4$) for adopting decisions that affect the existence of the corporation in its current form = 0.75
Supervisory board members are elected only by shareholders = 0
Right to transfer shares may not be limited = 1
No formal requirement exists for the transfer of shares = 1
Minority shareholders have a put option = 0
Mandatory takeover bid threshold exists = 0,75
Conflict of interest rules = 0
Shareholder register must be conducted by an independent firm = 0
Insider trading is prohibited by law =1
Threshold for mandatory disclosure in case of acquisition of large block of shares =1
A state agency conducts capital market supervision =1
Capital market supervision is independent =1

Note: The numbers attached are the following: 1= strong rotection 0= lack of protection.
Source: Czajlik & Vincze (2004).

7

The Determinants of Capital Structure of Hungarian Firms in Transition

Andrea Balla and Iván Bélyácz

Theoretical approaches to capital structure decisions

The corporate capital structure decision, in spite of its 'derived' nature, has been in the focus of theoretical interest for decades. Its 'derived' characteristics means that corporate managers rarely make capital structure decisions to achieve optimum structure explicitly. The corporate managers make decisions on production, market and financing; the latter directly affecting the current corporate capital structure.

According to the traditional theory of capital structure, the weighted average cost of capital changes in a form of U shaped cost curve depending on leverage. Durand (1952), one of the most significant representatives of this theory, assumed that the weighted average cost of capital at its minimum defines the optimum capital structure, because the corporate value is maximized at the minimum of the average cost.

The theoretical approach by Modigliani & Miller (1958) was the first to question the existence of a single optimum capital structure. With the assumption of no taxes, the Modigliani–Miller theory based on arbitrage logic was in line with Fisher's (1930) separation theory. In Fisher's view, in a perfect and efficient capital market the production-investment decisions are independent of the owners' intertemporal consumption-saving decisions. In effect, it means that the corporate profit maximizing production-investment decisions are not affected by the owner's lending-borrowing decisions, i.e. the production-investment decisions are independent of its financing decisions. The possibility for arbitrage means that the 'law of one price' is temporarily violated, from which participants of capital market can benefit. So, if we assumed that the corporate value of firms financed by different capital structures might vary, then this value would be offset by arbitrageurs' transactions using

these opportunities. With this arbitrage argument Modigliani and Miller proved that the corporate value is determined by its cash flow generating potential and the firm's value is independent of its financing structure.

Taking taxes into consideration alters the very essence of this approach; Modigliani & Miller (1963) came to the conclusion that if taxes are taken into consideration, the after-tax corporate value is increased by the net present value of tax savings. Due to the market imperfections and the fear of default, corporate managers are forced to limit their need for external financing. As the debt-to-total assets ratio increases, so does the probability of default on interest and principal payment to the creditors.[1]

The theoretical approach by Modigliani and Miller inspired concepts on capital structures; new theories have been developed for the past decades. This theoretical evolution gives way to two important implications. The first is that there is no unquestionable evidence to define a single optimum capital structure for a firm; the second is that the foundation of corporate capital structure decisions cannot be explained by a single theoretical approach. The latter means that several, competing capital structure theories can have real relevance for the incentives concerning corporate capital structure.

The corporate financing decisions are a combination of owners' equity and external debt in a certain proportion. Therefore, it is a corporate endeavor to use debt finance on a regular basis. The debt is not only the supplement for owners' equity capital financing the firm, but also has advantages for decision makers. The interest payments on debt are deductible before tax, thus the use of debt capital makes tax savings possible. However, increasing the degree of debt capital bumps into the obstacle of earnings before interest and taxes (EBIT), which can limit further indebtedness by narrow interest coverage. The fear of financial distress or default is the protection against excessive continuation of corporate indebtedness process. This concept stands on the bases of the trade-off theory for capital structure. According to this theory – first developed by Myers (1984) – assuming capital market equilibrium and behavior maximizing corporate value, the firms borrow funds up to a point when tax savings from further borrowings are equal to the net present value of the costs of the potential financial distress. The trade-off theory for capital structure shows the choice between owners' equity and external debt as a selection between the tax savings from interest tax exemption and the costs of financial distress. Many representative of this theory considered the moderate debt-to-total assets ratio something to be followed.

It is a paradox for the capital structure theories and especially for the trade-off theory that the permanently profitable companies use the opportunity for leverage effect provided by the debt capital to the least extent. Permanently profitable companies could increase their debt-to-equity ratio continuously because the asset coverage and the interest coverage by the EBIT would provide enough guarantees. This phenomenon cannot be explained by the trade-off theory for capital structure. So the profitable company does not go as far as the limit where the tax saving advantages exceed the potential costs of financial distress. The trade-off theory is able to express the basic theoretical stream of capital structure behavior but less able to grasp the momentums valid for the masses of firms.

In corporate financing decisions the choice between equity capital and debt finance results in an inevitable conflict of interest between owners and creditors/managers. The agency theory by Jensen & Meckling (1976) is based on the existence and management of this potential conflict arising from information asymmetry.[2] Myers (1997) thinks that the more dynamic the increase in the corporate assets becomes, the more probable is the possibility of the conflict between owners and creditors. This happens simply because a company can embark upon more and more risky projects to add value to the shareholders' wealth at the expense of the creditors. Similarly, Jensen (1986) states that the managers make efforts to increase the company size while shareholders are interested in increasing the corporate value.

The basic consideration of agency theory is that financing decision makers are informed on a different scale, and developing capital structure requires costs for all the participants. If necessary, funds are raised by issuing shares; timing of IPOs, security market pricing or market absorption, and the IPO effects on corporate value will turn into a conflict zone. Myers & Majluf (1984) pointed out that if managers have more information compared to the market actors and want to finance corporate investments by issuing shares, then the stock price will decrease, assuming all the other factors constant. In connection with corporate decision-making it has been an experience for several decades that the managers are prone to abuse their advantageous situation from information asymmetry. In decision making positions managers know more about the real situation of a company, its future possibilities, riskiness, and real value than external investors, or creditors do. This advantage raises the issue of moral hazard in relation to certain decisions.

The agency theory of capital structure describes the financial fund allocation conflict, which coincides with costs. The increasingly

indebted company is menaced with financial distress and the potential chance of default, but controlling all these processes would require substantial monitoring costs. This is the area where the trade-off theory and the agency theory are combined. The return on tax exemption from borrowing debt is more and more offset by the potential and real costs from increased indebtedness. Both the trade-off theory and the agency theory state in unison that the increase in debt ratio has a limit, which is hard to define. The agency theory is significant in determining the reasons for costs of information asymmetry beyond the conflict between the capital structure decision participants. The possibility of conflict between actors leads to alternating directions and results in the battle with the temporary prevalence of either equity or debt component. Neither the trade-off theory, nor the agency theory and nor their combination provides acceptable explanation for the choice of optimum capital structure. The tendencies for conflicting structure formations define an outcome of capital structure, but the next step, in general, is adjusted not to the assumed optimum, but to the corporate financing requirements, to the owners' interests, and to the corporate growth needs.

One of the most practical capital structure theory is the pecking order theory, developed from the group of signaling models based also on information asymmetry. This theory developed by Myers & Majluf (1984) describes a hierarchical choice of funds: companies prefer their own internal funds to external financing sources when financing new investments. If retained earnings do not cover the financing requirements set by the investments, then cash and marketable securities are activated first; so companies postpone borrowing or issuing shares. Then if necessary, the company can issue bonds, convertible bonds, and, in the end, shares. The pecking order theory is based on the corporate consideration that if the firm has exhausted its internally generated sources and if it still has advantageous investment opportunities, the latter may be financed by external funds. New equity capital as external resource stands at the end of the pecking order chain, which can be explained by the riskiness of issuing new equity due to information asymmetry. In a financial environment where not all of the investors have access to the relevant information on a company, the intention to issue new equity may have negative signaling effect to the investors. Consequently one may think that, a company raises funds in this way because it does not have enough internal capital, and the negative reaction by investors may result in falling stock prices (Myers, 1984).

Growth companies adjust their decision on dividend payments to the existence or non-existence of profitable investments when determining the use of realized profit. If the retained earnings with planned amount exceed the financing requirements set by advantageous investment opportunities, the companies will increase the level of their current assets or pay substantial dividends. Both the dividend payment and equity issue give signals to the actors in the capital market. The potential investors might consider the dividend payment the lack of profitable investment projects at the moment, which does not necessarily serve the purpose of adding value to the shareholders' wealth. They might come to the conclusion that the new equity issue would finance promising projects or it might show disturbances in raising funds for the company.

This chapter aims at testing the validity of some of the above-mentioned theories on Hungarian corporate sample, rather than providing a thorough survey on modern capital structure theories.[3] Further on, the specific characteristics for financing assets in transition economies will be analyzed.

The characteristics of capital structure decisions in the economic transition period

In emerging economies the capital structure decisions show specific characteristics beyond the explanatory power of the above-mentioned theories. Studies on less developed countries analyze the validity of traditional capital structure theories based on previous researches in developed countries. To our knowledge, five research projects have been accomplished on similar topic, using Hungarian corporate sample, but these have covered a shorter period (1990–96), therefore, our research is more relevant for the role of long term liabilities in capital structure.

Csermely (1996), Cornelli *et al.* (1996), Csermely & Vincze (2000), Balla & Mateus (2002) and Balla & Bélyácz (2004) came to an unanimous conclusion that domestic companies do not have the same capital structure choices as the ones in developed countries do. The characteristics of capital structure policies in emerging and transition economies are as follows:

- Uncertainty in tax system and tax holidays.
- Unclear property rights discourage investors from equity investments and make future cash flows uncertain.

- Capital controls can impede foreign investments and have negative effect on cost of capital.
- The volatility of capital markets can make future fund raising activities uncertain.
- The inadequate amount of commercial bank lending, its structure and high costs, or lack of it, may result in the violation of maturity-matching principle. Because of the lack of long term loans only limited number of companies are willing to undertake investment projects, or short term investments prevail, which endangers future cash flows in the long run. Higher cost of capital and less tax saving result in lower expected rates of return than in developed countries.
- The risk factor in real returns is high owing to political risk.

From the very beginning of economic transition, the heritage of asset-finance from the socialist planned economy has to be taken into account. During the decades, prior to the transition period, in the investment projects fixed assets were financed by funds from the state budget in large proportions, and current assets were covered by bank loans. Although, over the years the rate of internal corporate capital sources reached a higher extent, their prevalence in total investments appeared to be significant only short time prior to the transitions. During this period, bank loans were assigned to projects supported by the state budget, but in a period of not market economy regulations the determining role of 'coverage principle' remained valid. From the onset the economic transition was financed with capital structure significantly different from that of highly developed economies. To highlight the main differences it is worth referring to the relative shortage of financing sources, the complete lack of capital markets as possibilities for raising funds, and the heavy reliance on financing from internal funds. In the early phase of economic transition, masses of corporate defaults increased the lending risk for the commercial banks. Another negative effect on the potential lending came from the extremely short saving time horizon in this period. The majority of the savings deposited in the banks lapsed within a couple of months, which explains the lack of long term financing sources. Issuing debt or equity in the capital markets was marginal not only in the early phase of transition, but also later on. The internal financing sources from depreciation and retained earnings proved to be noteworthy in their importance. The internal corporate sources represented great significance in the early period despite of the low level of corporate profit after tax during the transition crisis. Beyond the natural productivity and market disturbances concomitant with the

transition period, the fact that companies had to cover several costs explicitly tied to the developing market economy played a role in the low profitability.

Cornelli *et al.* (1996) states that Hungary has lower credit ratio than the developed countries.[4] At the end of 1992 the overall total liabilities per total assets ratio was 32 per cent for the Hungarian companies. This ratio is higher for less profitable companies, provided that their bad debt was a heritage from the planned economy.[5] Analyzing a group of manufacturing companies Balla (2005) found that the total liabilities per total assets ratio was ranging in average between 30 and 40 per cent in 1992–95 for companies with domestic majority proprietorship. This ratio became higher (around 45–50 per cent) starting from 1996 and the variability of the leverage between the industries decreased significantly.

Since market values were not available, the authors calculated with book values of debt and equity.[6] These book values of debt and equity would be less on the credit market, which would reduce the leverage ratio even further. As far as current assets are concerned, receivables and inventories are up-to-date, therefore, their market and book values do not differ significantly. The majority of fixed assets were installed during the socialism at their former book values, therefore, inflation can be viewed as a compounding factor. Cornelli *et al.* (1996) also find that fixed assets amounted to 50 per cent of total assets. So if we assume the extremity that fixed assets are of zero market value, total debt to total assets would rise to 60 per cent, this rate is still low compared to the developed countries, which can be explained by the tendencies that in transition economies the shift to market economy was financed by mainly equity (former state property) and retained earnings and not by debt.[7] As a result, even profitable companies failed to form an optimal capital structure.

Analyzing the financial strategy of Hungarian companies between 1991 and 1994, Csermely (1996) found that the shift in ownership affected the corporate capital structure the most, and equity was prevalent in the capital in 1992, which complies with the results of Cornelli *et al.* (1996). At the beginning of the privatization process equity capital was dominant, but later as profitability increased retained earnings became the main source of finance. During the period, the average cost of credit exceeded the corporate return on equity, which can provide explanation for the low leverage ratios in 1991–92, but in 1993–94 banks decreased the credit supply for less effective companies.

The explanatory factors for low leverage are classified by Colombo (2001) into demand and supply groups. On the supply side, he mentions

factors like asset coverage, possibility for profitability, growth potential, size, market share, and ownership; on the demand side cash flow and inter-company loans can be found. He took short term bank loans into consideration because between 1992 and 1996 80 per cent of all bank credit was short term.

Balla & Bélyácz (2004) notes that on the supply side, debt finance was hindered by the declining level of domestic savings, high banking risk, and significant agency costs; on the demand side equity finance was impeded by the threat of financial distress, high costs of capital, and the improper credit ratings of companies applying for loans, while firms with good credit scores were not in dire needs of external sources, which corresponds to the findings of Csermely & Vincze (2000). Raising external funds via bank credits and bond issues were both limited. The average profitability of investment projects was surpassed by the flotation costs of IPOs. Issuing new shares was scarce for a decade among companies.

The dominance of retained earnings and depreciation just as well as refraining from equity finance have proved to provide evidences for the implications of pecking order theory. The huge number of bankruptcies, the high risk in banking, and the fear of financial distress reinforced the assumption that the effects of agency theory can be traced. The well known concept in capital structure theories, i.e. the low debt capital ratio coupled with high profitability cannot be proved. The concept related to mature companies in developed economies is not valid for the corporate structures of firms in the emerging economies, because at the latter advantageous profitability is connected to good chance for growth potential, so the very profitable companies can grow by investments.

On a critical stance, we have to state that the dominant weight of corporate internal funds and financing long term assets with short-term liabilities can rather be viewed as forced capital structure decisions than as the realization of possibilities from the freedom of choice. The foreign direct investment, loans provided by the international parent companies, internal funds, and realized profit played the main role in the mass restructuring of firms. Debt capital from banks and the capital market was less important in the structural transition. Beside the relative scarcity of sources the ability to manage information asymmetry was also lacking in the capital and money markets.

During the economic transition the parallel shrinking of financial intermediaries influenced the corporate capital structure decisions. The essence of this process was that commercial banks and capital markets had weaker positions in pooling savings and converting them to credit.

Disintermediation reflects the more and more intense flows of funds from savers towards insurance companies and mutual funds, thus the savings level in commercial banks decreased significantly. The permanent decline in lending long term loans had both supply and demand causes. It is not only about that the companies refrain from borrowing permanent capital but also the supply by commercial banks was quite scarce. During the early phase of economic transition this tendency was especially strong, since the average deposit time hardly exceeded one year for a long time. Later the deposit time increased, but this change did not influence the weight of long term lending in the capital structure significantly.

Empirical analysis of capital structure decisions in Hungarian manufacturing companies

Data set and applied statistical methods

Our research was based on the balance sheets and income statements of Hungarian manufacturing companies using the double-entry accounting for the period from 1992 through 2001 to define dependent and independent variables. Multi-variable regression methods were used to define the significance of several factors influencing the corporate capital structure. We ran regression in two cases. In the first case we applied the simple panel method, then in the second, we used fixed effects panel models to handle characteristics. Provided that we found such explanatory variables that per se cannot be determined for every year – for example growth and business risk – in another analysis we excluded these variables. We defined the correlation matrix among variables to scrutinize the relationship among explanatory variables and to exclude multicollinearity.

Three dependent variables have been determined to depict capital structure in the light of credit component. Compared to the previous studies[8] the scope of explanatory variables have been substantially enlarged, involving such factors which have been inevitable for characterizing companies. The variables and their definitions were as follows:

Dependent variables

- Debt ratio: the well-known classical ratio of total liabilities to total assets (TL/TA).
- Long-term liabilities to total assets (LTL/TA).
- Short-term liabilities to total assets (STL/TA).

Independent variables

- Asset tangibility: the degree of tangible assets is calculated by dividing the difference between total assets and current assets by total assets (ATN). Another measure for tangible assets is the ratio of inventory to total assets (INV/TA). Inventory is easier to be priced and sold in the market.
- Profitability: it is measured by the return on total assets as a ratio of pre-tax earnings to total assets (ROA).
- Liquidity: the debt servicing willingness and ability is measured by the ratio of current assets to current liabilities (CA/CL).
- Average tax rate: it is derived as the ratio of difference between pre-tax and after-tax income and pre-tax income (ATR).
- Size is defined as natural logarithms of sales revenue (LnS).
- Signaling effect value: the ratio of dividend paid to earnings before interest and taxes (DIV/EBIT).
- Capital intensity: the ratio of sales to total assets (S/TA).
- Uniqueness of product: the ratio of indirect costs to sales (COST/S).
- Business risk: it is defined as the standard deviation of return on assets (ROA). Only one value for risk can be identified in the period analyzed so it functions as a dummy variable (ROAS).
- Growth potential: it is measured by two variables. One is the annual change in after-tax earnings divided by the sales revenue in the base year, while the other is the ratio of the annual change in sales to sales in the base year (DEAT, DS).
- Foreign ownership: the value of the dummy variable is one if the company is owned by foreigners in 51% ownership or more, otherwise the value equals to zero (FRGN).

Panel analysis to identify the factors influencing the capital structure of Hungarian manufacturing companies

To execute a regression analysis we built up our model based on the study of Booth *et al.* (2001). The set of variables were largely extended with regard to the characteristics of the Hungarian economy during the years of transition to market economy. The cross-sectional and time-series analysis covered 3690–4959 company groups[9] Our basic model is given as follows:

$$\frac{D_{i,t}}{TA_{i,t}} = (\alpha_i + \alpha_t) + \sum_{j=1}^{n} \beta_j X_{i,j,t} + \varepsilon_{i,t}$$

where $D_{i,t}/TA_{i,t}$, the dependent variable, is one of the leverage ratios of company i at time t from the three ratios defined earlier (TL/TA or LTL/TA or STL/TA); α is a cross-section; $X_{i,j,t}$ is the explanatory (independent) variable j of company i at time t; β_j is the coefficient of the given explanatory variable, while $\varepsilon_{i,t}$ is a random variable depicting disturbance effects at time t on company i. $\alpha_i + \alpha_t$ cross-sectional element can vary in time and by companies.

The model was tested in two ways: with a simple panel and a fixed effects panel model. Certain factors like the costs of financial distress, the R&D expenses, and other industrial parameters, which influence the chosen capital structure, unfortunately could not be captured in this analysis, however the fixed effect model incorporates their effect on capital structure choices

One of our assumptions is that in the Hungarian economy in the period of transition and even nowadays we should talk about financing structure rather than corporate capital structure because short term liabilities are composing the lion share of external sources. Although, the question of capital structure exists, we should not ignore one phenomenon: the already existing long term liabilities are supplemented by the permanent portion of short term liabilities for financing long term projects. Therefore, we define the short term and long term leverage components of total liabilities as dependant variable, being aware of the substituting function of short term sources financing fixed assets. Analyzing the three, 'most practical' capital structure theories we make an effort to find relation between the dependent variables and the parameters of the models. The three models involved are as follows: pecking order theory, trade-off theory, and agency theory. The available cross-sectional and time-series models make it possible for the variables supporting one theory to explain the other ones. During the analysis we compare our findings with that of studies in similar areas.

Table 7.1 and Table 7.2 summarize our findings with both the simple and the fixed effects panel models on dependent and independent variables. The selected independent variables explain the capital structure, the relationships are significant and robust, since the adjusted R^2 values are high.[10]

In the developed industrial countries companies with more fixed assets have more liabilities, and vice versa; companies with a relatively high portion of intangible assets – such as cost-intense R&D or marketing - have less liabilities. These conclusions are in accordance with the agency theory and the theory of financial distress because owing to collateral the danger of financial distress or default driven risk and

Table 7.1 The simple panel model explaining the ratios of total liabilities to total assets (TL/TA), long term liabilities to total assets (LTL/TA), and short term liabilities to total assets (STL/TA)

Independent variables	*TL/TA*	*LTL/TA*		*STL/TA*	
	All variables	*All variables*	*Without DS, DEAT*	*All variables*	*Without DS, DEAT*
Constant	0.441435 (0.0000)	−0.009204 (0.6651)	−0.024381 (0.2664)	0.450639 (0.0000)	0.458585 (0.0000)
ATN	−0.253533* (0.0000)	0.195946* (0.0000)	0.223562* (0.0000)	−0.449479* (0.0000)	−0.452185* (0.0000)
ROA	−1.016157* (0.0000)	−0.018226 (0.1292)	−0.018173 (0.1745)	−0.997931* (0.0000)	−0.996557* (0.0000)
CA/CL	−0.000649* (0.0067)	−9.33E−05* (0.0000)	1.61E−05 (0.7964)	−0.000556* (0.0190)	−0.000698* (0.0099)
INV/TA	−0.070807 (0.1506)	−0.085232* (0.0005)	−0.036294 (0.2178)	0.014426 (0.7508	−0.023739 (0.6090)
ATR	−0.158081* (0.0000)	−0.069008* (0.0000)	−0.069468* (0.0000)	−0.089073* (0.0005)	−0.081973* (0.0010)
LnS	0.015021* (0.0000)	0.001588 (0.3749)	0.000798 (0.6607)	0.013433* (0.0001)	0.013018* (0.0001)
DIV/EBIT	0.021446* (0.0087)	−0.006068* (0.0370)	−0.004455 (0.1192)	0.027514* (0.0004)	0.024990* (0.0010)
S/TA	0.112905* (0.0000)	−0.001852 (0.2141)	−0.001056 (0.5473)	0.114756* (0.0000)	0.113082* (0.0000)
COST/S	−0.098035* (0.0116)	0.048409* (0.0164)	0.043829* (0.0296)	−0.146445* (0.0004)	−0.131329* (0.0015)
FRGN	0.056115* (0.0000)	0.023863* (0.0000)	0.024845* (0.0000)	0.032252* (0.0000)	0.027881* (0.0001)
σ ROA	0.314450* (0.0005)	0.027338 (0.1624)	0.020213 (0.2773)	0.287112* (0.0004)	0.276321* (0.0003)
DEAT	−9.18E−06 (0.9038)	−3.17E−06 (0.9492)		−6.01E−06 (0.9279)	
DS	0.003232 (0.8022)	−0.032654* (0.0016)		0.035886* (0.0001)	
Total pool observations	3690	3690	4214	3690	4214
R^2	0.681361	0.091344	0.089524	0.769192	0.753863
Adjusted R^2	0.680234	0.088130	0.087141	0.768376	0.753219
F-statistic	604.6576	28.42569	37.56095	942.3600	1169.981
Prob(F-stat.)	0.000000	0.000000	0.000000	0.000000	0.000000

Notes: Significant * at 5% significance level, ** at 10% significance level. *p*-value is in parentheses.
Source: Authors' calculations.

the agency costs of debt are lower. The relationship between the asset tangibility and the debt ratio of Hungarian companies is negative and robust. This finding is in line with the results of Cornelli *et al.* (1996) and Booth *et al.* (2001). During the transition period the fixed assets did not

Table 7.2 The fixed effects panel model explaining the ratios of total liabilities to total assets (TL/TA), long term liabilities to total assets (LTL/TA), and short term liabilities to total assets (STL/TA)

Independent variables	*TL/TA*	*LTL/TA*		*STL/TA*	
	Variables without DS, DEAT	*All variables*	*Variables without DS, DEAT*	*All variables*	*Variables without DS, DEAT*
Constant	0.216491 (0.0007)	−0.162502 (0.0008)	−0.174240 (0.0002)	0.328734 (0.0000)	0.390732 (0.0000)
ATN	−0.183833* (0.0005)	0.195319* (0.0000)	0.221203* (0.0000)	−0.353475* (0.0000)	−0.405036* (0.0000)
ROA	−1.024478* (0.0000)	−0.094288* (0.0000)	−0.079632* (0.0000)	−0.951857* (0.0000)	−0.944845* (0.0000)
CA/CL	−0.000466* (0.0079)	−5.30*E* − 05 (0.4760)	1.75*E* − 05 (0.8518)	−0.000344** (0.0902)	−0.000483* (0.0331)
INV/TA	−0.130860** (0.0555)	0.043120 (0.2732)	.049761 (0.2942)	−0.085125 (0.2104)	−0.180621* (0.0098)
ATR	−0.099311* (0.0001)	−0.014199 (0.3650)	−0.022062 (0.1615)	−0.083092* (0.0005)	−0.077249* (0.0007)
LnS	0.028638* (0.0000)	0.017446* (0.0000)	0.013176* (0.0000)	0.017265* (0.0010)	0.015462* (0.0005)
DIV/EBIT	0.018671* (0.0032)	0.003211 (0.2544)	0.003235 (0.2173)	0.016496* (0.0047)	0.015435* (0.0071)
S/TA	0.132659* (0.0000)	−0.008252* (0.0000)	−0.006857* (0.0006)	0.142828* (0.0000)	0.139516* (0.0000)
COST/S	−0.089630* (0.0433)	−0.033372 (0.2997)	−0.040124 (0.1684)	−0.042895 (0.1130)	−0.049506** (0.0788)
FRGN	0.190889* (0.0008)	0.175394* (0.0031)	0.202525* (0.0004)	−0.014304 (0.1929)	−0.011636 (0.2625)
DEAT		−7.86E − 05** (0.1093)		−7.78E − 05 (0.1106)	
DS		−0.031935* (0.0004)		0.018078** (0.0796)	
Total pool observations	4214	3690	4214	3690	4214
R^2	0.808642	0.483103	0.447100	0.868790	0.852720
Adjusted R^2	0.780985	0.395615	0.367192	0.846582	0.831435
F-statistic	29.23903	5.521961	5.595161	39.12065	40.06069
Prob(F-stat.)	0.000000	0.000000	0.000000	0.000000	0.000000

Notes: Significant *at 5% significance level, **at 10% significance level. *p*-value is in parentheses.
Source: Authors' calculations.

prove to be enough as collaterals for commercial banks, since their book value was significantly different from their market value. At the same time, in the phase of transition to market economy the market of fixed assets was underdeveloped, thus their sale was difficult. Concerning the role of inventory as collateral, its relationship with total debt is also negative. We argue that neither the asset tangibility, nor the total liabilities to total assets ratio comply with the financial distress theory, or the agency theory. The relationship between asset tangibility and the ratio of long term debt to total assets is positive and significant, which complies with the trade-off and agency theories. In the transition economies the large companies that were assets intense and difficult to restructure, enjoyed priorities in lending from commercial banks. The relationship between the inventory and the short term leverage ratio is positive, but not significant, so the higher the level of inventory, the lower the portion of short term liabilities, and the reason is that inventory can be used as collateral, and can be converted into cash easily. This result is in accordance with the capital structure experiences in advanced countries (see Rajan & Zingales, 1995), and with the findings of Colombo (2001).

Companies with higher profitability have less liability. Myers & Majluf (1984) argued that it is in accordance with the pecking order theory, i.e. the companies prefer internally generated sources to external ones. In contrast, the trade-off theory of capital structure assumes positive relationship, because the more profitable company is making efforts to benefit from the tax savings of interest. In the case of Hungarian companies the relation between profitability and leverage is negative and robustly significant, so the pecking order theory is valid, but the trade-off theory is not. In transition countries the initial corporate restructurings were financed by retained earnings and equity. Later, the more profitable companies tried to distinguish themselves from the less profitable ones by lower level of liabilities, which consisted mainly of bad debt in the case of the latter group.

Liquid assets can finance investments, so they should yield negative relationship with the debt ratio – in accordance with the pecking order theory. In the case of Hungarian manufacturing companies, the relation between liquidity and leverage is negative and significant, so the pecking order theory holds.

The interest is tax-deductible, this way, the higher the tax rate, the more advantageous the debt position, and positive relation between tax rate and leverage is assumed. In contrast, we find negative and robustly significant relation in our regression analysis. When the companies are profitable, the average tax rate is paid, but if they are making losses, they

cannot count on compensations, this way the average tax rate refers to profitability in an indirect way. Both coefficients are negative.

The company size is in reverse relationship with the probability of default. Compared to the smaller companies large ones are less prone to face the danger of default due to higher diversification and less probability of financial distress. In the Hungarian manufacturing companies the empirical findings are in accordance with the financial distress theory because there is positive and robustly significant relation between company size and leverage. Colombo (2001) stressed that in the case of Hungary the explicit subsidy by the state should be considered, which is used for saving the company from default to prevent severe social and economic consequences of ceasing the operations. This is why these companies are preferred by commercial banks in loan evaluations considering corporate risk.

In the case of Hungarian companies the signaling effect value is expressed in the share of dividends. Dividends can refer to good financial position, thus positive relationship is assumed between signaling effect value and debt ratio. This corresponds to the information asymmetry models. In the case of manufacturing companies, the relationship between total and short term debt ratio, and signaling effect value variables is significant and positive. The amount of dividends refers to profitability as well. If the dividends paid are associated with the dynamic profitability, we see that in the Hungarian corporate capital structure there is negative relationship between the signaling effect value and the long term debt ratio because companies mainly covered their capital needs by internal sources during the years of corporate restructuring due to the lack of long term loans. In the fixed effects panel analysis, the relationship is positive, but not significant. This fact proves that the fixed effects panel takes into consideration other, not mentioned factors affecting the capital structure as well.

Jensen's (1986) free cash flow theory – which belongs to the group of information asymmetry theories – states that companies would rather issue bonds instead of equity. The interest payment encourages the managers to make use of the assets in the most efficient way, so positive relationship between capital intensity and leverage is anticipated. In the case of total and short term debt ratios both the information asymmetry model and the expected positive and robustly significant relationship is valid for the Hungarian corporate sample. This relationship is especially true for the transition period when interest burden was higher and the danger of default was more menacing. At the same time, the relationship between capital intensity and long term debt ratio is negative,

which refers to the corporate violation of maturity matching principle, so short term liabilities were used for financing fixed assets when enough internally generated sources were not available.

Titman (1984) states that a company manufacturing an individual product would use less liability because it is more difficult to find an alternative activity in the case of default. For Hungarian companies the relationship between the uniqueness of products and debt ratio is significant and negative, so our results correspond to the agency theory and the financial distress theory.

As the theories taking tax effect, interest expenses, and default costs into account would predict, companies with high volatility in earnings before interest and taxes use less liabilities in the capital structure. The benefit from the tax savings is not so significant for them because the pre-tax earnings would not be enough for covering the high interest expenses. Consequently, when the operating income is uncertain or volatile, debt would increase the probability of financial distress or default, therefore the financial manager would make a decision considering indirect and direct default costs. So negative relationship between business risk and debt ratio is anticipated. In Hungarian manufacturing companies the relationship between business risk and leverage ratios is positive and significant, which contradicts the trade-off theory. Higher variability refers to the increasing level of short term component of risk. In the light of agency theory higher risk taking with higher debt level might yield higher profitability, but in the case of a not profitable project would result in higher risk and higher losses. In transition economies the positive relationship might have occurred due to the limited supply of long term loans.

For companies with good growth potential the agency conflicts are more pronounced between debt holders and shareholders. Companies with less dynamic growth should have lower level of liabilities, so a negative relationship between growth variable and debt ratio is expected. Myers (1977) alludes to agency costs decreasing short term liabilities, therefore the relationship is positive in compliance with the agency theory. In the case of the Hungarian corporate sample we used two variables to quantify growth: DS and DEAT. In the regression analysis the DS independent variable calculated from sales seems to be significant several times. The relationship between total debt ratio and growth variables is positive, but non-significant, which appears to prove agency theory in terms of DS, while the relationship between long term debt ratio and growth is negative and significant; and between short term debt ratio and growth potential is positive and significant. The

positive relationship between total debt ratio and the growth potential can be justified by the large share of external sources being financed with short term ones in the transition period.

The regression analysis prepared by Csermely & Vincze (2000) have proved that the knowledge about foreign ownership conveyed information for commercial banks concerning creditworthiness. Our research incorporates foreign ownership as a dummy variable into the model, and we found that the relationship between the information on foreign ownership and leverage is positive and significant – referring to the initial communication problems between banking and corporate sectors – which corresponds to the findings by Csermely & Vincze (2000). We assume that companies with majority of foreign ownership used more debt and the amount of long term liabilities is significant towards the end of the analyzed period. These companies had better chances for raising funds via foreign bank loans, intra-company loans, better credit ratings, and increased willingness to take risk.

For the multicollinearity analysis we defined the correlation between the dependent and independent variables in question. We found strong relationship only between total liabilities and short term liabilities which can be explained by the significant portion of short term liabilities in the capital structure of Hungarian manufacturing companies. We did not perceive multicollinearity problem between dependent and explanatory variables (see Table 7.3).

Conclusion

From the analysis we could see that an optimum capital structure valid for every company couldn't be found for Hungarian companies. Every approach observed so far covered parts in the complexity of capital structure decisions, so the relevant factors related to decisions are suitable for partial explanations. The maturity matching principle was continuously violated. In the transition period a certain portion of the permanent assets were financed with short-term liabilities due to the lack of long term debt. The mass appearance of this aggressive financing approach is one of the most important financing experiences in the economic transition in Hungary.

As a summary of panel analysis, we can conclude that in the case of Hungarian manufacturing companies both total and short term debt ratios (TL/TA and STL/TA) increase with the corporate size, the signaling-affected dividends, the capital intensity, the business risk and the information on foreign ownership; while these ratios decrease

Table 7.3 The correlation matrix between the variables for the manufacturing companies for the period 1992–2001

	TL/TA	*LTL/TA*	*STL/TA*	*ATN*	*ROA*	*CA/CL*	*INV/TA*	*DIV*	*S/TA*	*Dummy*
TL/TA	1									
LTL/TA	0.3379	1								
STL/TA	0.9062	−0.09172	1							
ATN	−0.1333	0.279501	−0.26655	1						
ROA	−0.5896	−0.08634	−0.58499	−0.15375	1					
CA/CL	−0.0573	−0.01173	−0.05536	−0.05682	0.003956	1				
INV/TA	0.0073	−0.14486	0.072771	−0.43413	0.017614	−0.01138	1			
DIV	−0.0067	−0.0419	0.011562	−0.03465	0.034898	−0.00168	0.013316	1		
S/TA	0.6272	−0.08517	0.701809	−0.28896	−0.26389	0.009668	0.015718	0.01182	1	
Dummy	0.02272	0.132211	−0.03535	0.126643	−0.01399	0.004439	−0.12132	−0.00237	−0.14086	1

Source: Authors' calculations.

owing to the asset composition profitability, liquidity, tax rate, and the uniqueness of the product. The regression analysis shows that long term debt ratio is influenced positively and significantly by asset composition, company size and the information on foreign ownership, while negatively and significantly affected by liquidity, inventory, dividends, average tax rate, and capital intensity.

As far as asset composition, profitability, and company size are concerned, our result are the same as that of Cornelli *et al.* (1996) and Booth *et al.* (2001), while regarding the information on foreign ownership our findings are equal to that of Csermely & Vincze (2000). The trade-off – the agency – and the pecking order theory – one by one and jointly – give explanations on the Hungarian corporate capital structure in manufacturing industry.

Notes

1. See also King (1977), Miller (1977) and DeAngelo & Masulis (1980).
2. The conflict between owners and managers is discussed also by Jensen (1986), Masulis (1988), Williamson (1988), Stulz (1990), Hunsaker (1999) and Vilasuso and Minkler (2001), etc. while the conflicts between owners and creditors are also discussed by Galai & Masulis (1976), Hart & Moore (1990), Wald (1999) and others.
3. For theories on signalling effect see Ross (1977), Leland & Pyle (1977), Heinkel (1982); for the interrelationship between management and capital structure see Harris & Raviv (1988), Stulz (1988) and Israel (1991); for the link between product and financing policy see Brender & Lewis (1986), Maksimovic (1988) and Chevalier (1995), etc. For behavioural finance see Welch (2002) and Baker & Wurgler (2002).
4. For G7 countries, see Rajan & Zingales (1995).
5. Bonin & Schaffer (1995) find that the least profitable Hungarian companies, employing 10% of the work force, had a total debt to total assets ratio ranging between 45% and 61%.
6. Myers (1984) notes that market value is important in terms of the future growth of present value, but increasing debt level under these circumstances can affect future investment decisions.
7. The same ratio for G7 countries is 66% (Rajan & Zingales, 1995).
8. Harris & Raviv (1991), Rajan & Zingales (1995); for CEE countries: Cornelli *et al.* (1996), Csermely (1996), Carare & Perotti (1997), Hussain & Nivorozhkin (1997), Revoltella (1998), Csermely & Vincze (2000), Booth *et al.* (2001), Colombo (2001) and Balla & Mateus (2002), etc.
9. A group usually consists of three companies.
10. These values exceed the adjusted R^2 values of previous studies, which are usually below 0.30.

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8

Corporate Restructuring and the Role of Foreign Direct Investment in Hungary

Ichiro Iwasaki

Introduction

In May 2004, Hungary joined the EU with seven other former socialist countries in CEE and the Baltic region, materializing the countries long-cherished dream of re-integrating with Europe. The fifteen-year reform efforts to tackle systemic transformation by the Hungarian government and its citizens finally paid off after their decision to break away from the socialist regime. The road to the EU accession has not been easy since the 'European Agreements', which proclaimed that the European club would allow membership from CEE countries, were signed in December 1991. However, Hungary had always been a 'front runner' in the process of the EU enlargement towards the east.

One of the main reasons why Hungary has been able to promote its systemic transformation is that this small country attracted relatively large amounts of FDI. The Hungarian government has been making great efforts to increase foreign investment from the very early stages of its economic transformation including the end of socialist era. In fact, Hungary had been a leader in the region in terms of the total accumulated FDI inflows through to 1997. Although Poland and the Czech Republic have ranked higher than Hungary since 1998 in that category, the country received US$40.7 billion as FDI during the twelve years from 1992 to 2004, accounting for 25.3 per cent of the total in Central Europe and 19.8 per cent of the total in CEE region (UNCTAD, 2005). This vast influx of foreign capital strengthened the Hungarian economy by spurring effective demand, contributing significantly to the restructuring of domestic firms through the conversion of corporate ownership structure, improvements in production system, strengthening market competitiveness, modernization of management systems,

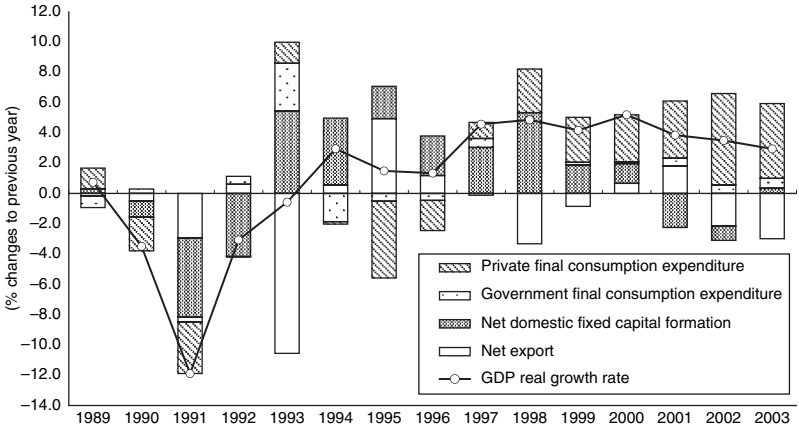
revitalization of R&D and innovation activities. In other words, FDI has been a powerful 'driving force' for Hungary to create an effective market economy, which was one of prerequisites for joining the EU. As Kárpáti (2003) states, the success of the Hungarian economy during this period was largely dependent upon foreign investment.

This chapter examines economic development and corporate restructuring in Hungary during the transition period with a special attention to FDI. The next section presents an overview of the roles of FDI in the growth and stability of the macro-economy. The third section describes the effects of foreign investment and business activities of multinational corporations on reforms of corporate ownership and governance and on the improvement of efficiency in the management and production systems in the Hungarian firms. The fourth examines the contributions of foreign companies to R&D and innovation activity. Concluding remarks follow.

Roles of FDI in the stabilization and growth of the national economy

Hungary has enjoyed positive economic growth for eleven straight years through 2005 after coming out of a debilitating economic slump which had continued until 1994 due to the confusion arising from the abandonment of its planned economy. According to official statistical data issued by Hungary's Central Statistical Office (KSH), the real GDP growth rate for 2005 reached 4.1 per cent, with the last twelve year average standing at 3.6 per cent. This long-lasting economic boom has steadily pushed up Hungary's national income, leading to an increase in its per capita GDP on a purchasing power parity basis to 53 per cent of the average of 15 EU economies in 2002 (Havlik, 2002).

Investment activities have been a key factor in Hungary's long-term and stable economic growth. In contrast to its flagging private consumption, domestic investment has continued to expand at a rapid pace after reaching its lowest point in 1992, and, in 2004, it had grown 55 per cent larger than in 1989, the last year of the socialist period.[1] As a result, according to Figure 8.1, fixed capital formation contributed to economic recovery from 1993 through 2000 by pushing the GDP real growth rate by an annual average rate of 3.3 per cent. It is no doubt that Hungary's booming economy of recent years has been driven by these intensive investment activities with their multiplying effects. Moreover, even it was possible that foreign enterprises have contributed



Source: Author's illustration based on KSH, *Magyrország Namezeti Számlái* (various years).
Figure 8.1 Changes in GDP real growth rate and contribution of demand components, 1989–2003

significantly in the form of FDI with positive crowd-in effects that have led to additional investment by domestic corporations (Mišun & Tomšík, 2002).[2]

The concentration of FDI in Hungary during the early 1990s is considered the result of political efforts to broadly open up its domestic market to foreign investors and intensely involved them in the privatization of state-owned enterprises. According to some analysts, such policies may have been taken not because the Hungarian government was prescient about the future of its national economy, but largely because of Hungary's political and economic situation at the time, such as the large amounts of foreign debt, serious current-account and budget deficits, mounting pressure from international organizations that feared the government would default on the official aid loans, and active lobbying activities by multinational corporations and by their supporting governments in order for the corporations to take part in the privatization program. Regardless of the above factors, however, it is a fact that the Hungarian government succeeded in attracting large amounts of foreign capital especially in the privatization of the state-owned enterprises by continuously offering investment incentives such as large scale corporate tax holidays and the establishment of custom-free zones in line with the basic principle of opening up the market and letting foreign investors participate in privatizing state-owned businesses.[3] In fact, 66 per cent of the total amount of FDI for Hungary

between 1990 and 1999 was invested in privatizing state-owned enterprises (Antalóczy & Sass, 2002). The Hungarian government's desicion to sell off its largest public corporations to strategic foreign investors led to the expansion of greenfield investment as well as to export-driven economic growth, as noted by Mihályi (2001).[4] Moreover, as Antalóczy's (2004) detailed case study of the FDI promotion activities in Tatabánya City suggests, local goverments carried out various industrial policies to attract foreign investments and multinational enterprises as well.[5] Indeed, their measures were manifold and included (a) the formation of a special local agency for FDI promotion, (b) the maintenance of roads and the sewerage system for foreign customers, (c) human resource training, (d) the establishment of a transportation system for the labor force between the city and remote areas, (e) soil improvement for the sites of former state enterprises, and (f) site development and mediation for new factories. It can be asserted that the political efforts made by both the central and local governments had remarkably synergistic effects on the inflow of foreign capital and the entry of multinational firms into Hungary.

As Oblath & Richter (2002) and Szanyi (2004) stress, foreign companies in Hungary are now actively reinvesting the earnings they obtained within the country (i.e., reinvested earnings).[6] As a result, the gap between the amount of capital inflow from the outside and that of investment by foreign companies, including those in Hungary, has been widening at a rapid pace. In fact, as shown in Table 8.1, such reinvested earnings from 1995 to 2004 accounted for as much as 44.8 per cent of the total amount of annual FDI inflow during the same period. This means that investment by foreign companies in Hungary is still active enough to stimulate economic growth by shoring up effective demand on the same large scale as that of the mid-1990s, although sources of capital investment are becoming more sophisticated as foreign companies expand.

FDI and corporate restructuring

Large-scale and continuous foreign capital inflows have completely changed the supply side of the Hungarian economy, that is, the corporate sector. The number of Hungarian companies with foreign participation increased 4.5 times from 1990 to 2004, and the amount of investment by foreign investors and their capital participation rate in these firms reached 9,762 billion HUF and 76.5 per cent, respectively, during the same period (Table 8.1). The role of foreign enterprises

Table 8.1 Selected indexes of the FDI in Hungary, 1990–2004

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Annual FDI inflow (million EUR)[a] [b]	244	1, 186	1, 142	2, 039	966	3, 399	2, 143	3, 165
Reinvested earnings (million EUR)	–	–	–	–	–	−164	397	1, 155
Accumulated FDI stock (million EUR)[a] [b]	244	1, 430	2, 572	4, 610	5, 576	8, 975	11, 119	14, 284
Annual FDI inflow per capita (EUR)[a] [c]	24	114	110	197	93	328	208	307
Accumulated FDI stock per capita (EUR)[a] [c]	24	138	248	445	539	865	1, 077	1, 387
Direct investment income (million EUR)[a]	−19	−26	−34	−48	−98	−120	−698	−1, 619
Number of foreign affiliated enterprises	5, 693	9, 117	17, 182	20, 999	23, 557	24, 612	25, 670	26, 083
Total equity capital (billion HUF)[d]	274.2	475.6	713.1	1, 113.2	1, 398.2	1, 994.0	2, 467.9	4, 260.3
Total foreign capital participation (billion HUF)[d]	93.2	215.0	401.8	662.9	833.5	1, 432.1	1, 882.7	3, 202.3
Foreign capital participation rate (%)[d] [e]	34.0	45.2	56.3	59.5	59.6	71.8	76.3	75.2

Notes
[a] Net figures based on a balance-of-payments basis.
[b] Figures from 1990 to 1994 exclude reinvestment earnings.
[c] Calculated by the author based on total number of population of each year.
[d] Figures from 1990 to 1994 are on a subscribed capital basis.
[e] Share of foreign capital in total equity capital.
Source: Compiled by the author based on KSH, *Magyar Statistikai Évkönyv* (various years), KSH (2005, p. 166), official statistics available at the Magyar Nemzeti Bank website (http://www.mnb.hu/) and the Hungarian Central Statistical Office website (http://www.ksh.hu/).

1998	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
2, 381	2, 489	2, 645	2, 575	3, 068	1, 133	2, 948
1, 009	1, 054	1, 135	1, 479	1, 911	1, 797	1, 840
16, 665	19, 154	21, 798	24, 373	27, 442	28, 574	31, 523
232	243	259	252	302	112	291
1, 621	1, 868	2, 132	2, 390	2, 697	2, 817	3, 116
−1, 888	−2, 057	−2, 117	−2, 570	−3, 275	−3, 049	−3, 823
26, 265	26, 435	26, 634	26, 809	26, 796	26, 793	25, 506
4, 994.2	6, 603.6	7, 109.7	7, 884.4	8, 663.4	10, 057.3	12, 763.8
3, 913.8	5, 031.5	5, 576.6	6, 292.1	7, 019.9	8, 706.6	9, 761.9
78.4	76.2	78.4	79.8	81.0	86.6	76.5

has rapidly expanded in the production, employment, investment, and trade activities (Table 8.2). In addition, as shown in Table 8.3 indicating the sectoral brakedown of FDI in 2004, foreign capital has made inroads into every area of the Hungarian economy, especially in manufacturing, wholesale and retail trade, and real estate and renting businesses.

The same can be said about the financial sector. The share of the FDI of the total subscribed capital in the financial service sector expanded from 44 per cent in 1996 to 89 per cent in 2001 (Hamar, 2004). According to Várhegyi (2001; 2004), by the end of 2000, foreign capital increased to 66.6 per cent of the total subscribed capital in the banking sector, and the number of banks with a foreign participation rate of more than

Table 8.2 Position of foreign companies in the corporate sector (%)

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
Net sales revenue	38	41	43	45	47	47	49	47	45
Added value	33	36	41	43	44	44	44	43	43
Employment	25	24	27	27	27	27	26	25	25
Investment	51	53	53	52	51	53	50	43	41
Exports	51	62	69	75	77	73	81	83	80
Imports	56	62	68	70	72	71	79	79	75

Notes: Figures indicate share of foreign-affiliated enterprises with 10% or more of foreign ownership in the overall corporate sector.
Source: KSH, A *Külföldi Működö Tőke Magyarországon* (various years).

Table 8.3 FDI by industrial sector, 2004

Industry, branch	*Enterprises*		*Total equity capital*		*FDI share in total equity capital (%)*
	No.	*Share (%)*	*Billion HUF*	*Share (%)*	
Agriculture	774	3.0	48.1	0.4	81.5
Mining and quarrying	69	0.3	14.0	0.1	98.6
Manufacturing	3,364	13.2	6,316.9	49.5	68.2
Food, beverages and tobacco products	401	1.6	575.2	4.5	89.3
Textiles	346	1.4	87.4	0.7	91.4
Leathers	76	0.3	13.6	0.1	97.1
Wood and wood products	147	0.6	48.9	0.4	95.1
Pulp, paper, paper products and printing	354	1.4	154.6	1.2	90.9
Fuel and chemical products[a]	125	0.5	2,208.7	17.3	31.2
Rubber and plastic products	251	1.0	166.3	1.3	95.8
Other non-metallic mineral products	137	0.5	171.4	1.3	95.2
Basic metals and fabricated metal products	461	1.8	342.4	2.7	84.1
Machinery and equipments	309	1.2	272.1	2.1	96.5
Electrical and optical equipments	436	1.7	1,162.8	9.1	74.4

Transport equipments	116	0.5	1,088.0	8.5	97.6
Others	205	0.8	25.5	0.2	94.5
Electricity, gas and water supply	75	0.3	530.6	4.2	74.5
Construction	950	3.7	97.8	0.8	76.7
Wholesale, retail trade and repair	10,308	40.4	1,005.3	7.9	95.1
Hotels and restaurants	1.175	4.6	82.8	0.6	93.4
Transport, storage, post and telecommunications	753	3.0	1,492.9	11.7	66.0
Financial intermediation	209	0.8	1,122.3	8.8	92.8
Real estate and renting and business activities	7,019	27.5	1,817.2	14.2	90.4
Others	810	3.2	235.9	1.8	96.7
Total	25,506	100.0	12,763.8	100.0	76.5

Note: [a] Includes coke, refined petroleum products, nuclear fuel and man-made fibers.
Source: KSH, *Magyar Statistikai Évkönyv 2004* (2005), pp. 298–9.

50 per cent surged to 68.1 per cent of all Hungarian commercial banks. This active foreign participation remarkably mitigated the high market concentration in the banking sector from 1991 to 2002 and encouraged the competition between banks, especially in corporate deposits and financing services.[7]

In Hungary, 'foreign companies' (*külföldi érdekeltségű vállalkozás*) are defined as those with a foreign participation rate of more than 10 per cent.[8] Almost all foreign companies in the country, however, far exceed such standard, as seen in the fact that the share of 100 per cent foreign-owned enterprises in the total number of Hungarian foreign companies increased from 1.8 per cent in 1989 to 61.8 per cent in 2000 while the share of joint venture companies with a domestic participation rate of over 50 per cent sharply fell from 86.7 per cent to 17.2 per cent during the same period (Inzelt, 2003). By the end of the 1990s, 76 of the top 100 of the world's largest corporations had entered the Hungarian market in some form (Antalóczy & Sass, 2003b). Currently, establishing a 100 per cent-owned subsidiary is the most common way of doing business in Hungary for major multinational companies. This trend can be seen also for Japanese companies operating in Hungary. As of March 2003, 61 or 70.1 per cent of 87 Japanese-capital-affiliated enterprises in Hungary were wholly owned subsidiaries of Japanese

Table 8.4 Types of Japanese enterprises in Hungary by industrial sector, as of March 2003 (no. of enterprises)

	Manufacturing	*Trade*	*Finance*	*Others*[a]	*Total*
Subsidiaries/Affiliations	33	33	1	7	74
Wholly owned Japanese corporations	19	11	0	3	33
Joint venture enterprises	5	5	0	3	13
Others[b]	9	17	1	1	28
Liaison offices	5	5	0	3	13
Total	38	38	1	10	87

Notes
[a] Includes construction, consulting services and software development.
[b] Includes corporations in European countries.
Source: Compiled by the author based on JETRO Budapest Office (2003).

parent companies or those of Japanese companies' affiliates in Europe (Table 8.4). This trend has been gaining momentum against the background of an increasing number of Japanese companies coming to the country as suppliers for European affiliates of Japanese electronic and auto manufacturers. Hungarian affiliates of these Japanese corporations such as Panasonic, SONY, SANYO and SUZUKI, as well as those of other multinational enterprises such as Audi, Philips, Nokia, GE, Opel and Samsung, have now become the leading companies in Hungary. This is why Hungary is known as a country, along with Ireland and Malaysia, whose industry is overwhelmingly dominated by foreign capital (Hunya, 2002).

As mentioned in the previous section, the priority of selling off state-owned enterprises to strategic investors, as well as greenfield investment activities by multinational corporations, has led to the emergence of strong corporate ownership of Hungary's core businesses. In fact, of the top 100 non-financial corporations in terms of net annual sales in 2000, 63 were owned by multinationals, and their majority was incorporated as non-listed joint-stock companies or limited liability companies and operated under a very rigid ownership structure (Mihalyi, 2004). Direct corporate control by these new types of owners has been effective in alleviating so-called 'agency problems' and has prevented Hungary from being troubled by serious corporate governance woes, especially, those arising from heavy insider-control ownership, which other post-communist countries have confronted. In this context, it is remarkable that Török (1998) presented the view that, in Hungarian

companies, management and supervisory organs, including the Board of Directors, do not have a substantial influence on corporate strategies except for daily management issues. Moreover, according to Perotti & Vesnaver (2004), who closely examined the relationship between investment activities and financial constraints of 56 listed Hungarian firms in the period of 1992–98, foreign participation relaxed the dependence of these firms on internal reserves as the source of investment and enabled them to increase their fixed capital much more than companies that were 100 per cent domestically owned. In this sense, foreign capital played a positive role in restructuring Hungarian firms also from the viewpoint of corporate finance. Considering that, in the first half of the 1990s, Hungary was mired in a credit crisis triggered by a vast quantity of non-performing loans in the state banks, the effects of FDI should not be underestimated.

Foreign companies, thus, formed a 'mega economic sector' in Hungary (Nishimura, 2000) and brought about significant changes in the corporate ownership and governance structure of Hungarian firms. The increased number of foreign-owned companies has had a remarkable influence on Hungary's industrial and trading structures, especially in its manufacturing sector, and greatly contributed to the improvement of its productivity.

The penetration of foreign capital has resulted in drastic changes to Hungary's industrial structure. From 1996 to 2003, the share of the manufacturing sector in the total industrial production increased by 8.9 per cent to 89.9 per cent. During the same period, the machine industries, in which about half of Hungary's total FDI has been concentrated, jumped phenomenally to 28.7 per cent in terms of the share in the total industrial production, while the share of traditional industrial sectors in the socialist era including food, wood and papar, and light industries combined declined by as much as 10.8 per cent (KSH, 2004, p. 254). The market environment also greatly changed during this time. For example, according to estimates by Éltető (2001, pp. 6–10), the market share of 100 per cent domestically-owned enterprises was completely surpassed by that of foreign-affiliated companies during the seven years from 1993 to 1999. The share of foreign enterprises in the manufacturing sector and in the export market increased to 71.8 per cent and to 88.6 per cent respectively in 1999. Based on a review of financial data of Hungarian manufacturing companies from 1996 to 2000, Hamar points out that there was a significant positve relation between these companies' foreign participation rates and their degrees of export orientation, which is consistent with the findings of Éltető (2001).[9]

Under these circumstamces, the total trade volume of Hungary in US dollars surged 6.3 times from 1990 to 2004, while that with fifteen old EU members rose at a more rapid pace, marking a 13.3 times increase over the same period.[10] It is obvious that such dominance of foreign enterprises over the export activities is closely related to the fact that the affiliates of multinational corporations in Hungary have continued to actively supply their products to EU markets in line with their global marketing strategies.

Many previoius studies indicate that foreign firms greatly contributed to the improvement of productivity of the Hungarian corporate sector. For example, Hunya (2002) estimates that labor productivity of foreign companies was as much as 3.1 times higher than that of domestic firms in 1999, the largest difference noticed among ten CEE countries.[11] The statistical office also recognized that a significant labor productivity gap does exist between the two groups (KSH, 2003b). They estimate that the average added-value per employee of foreign firms was 1.8 times higher than domestic corporations, adding that much larger gaps were observed in several industrial categories (Table 8.5). Moreover, Hamar (2004)

Table 8.5 Labor productivity by industrial sector and by forms of corporate ownership, 2000 (average added-value per employee of foreign-affiliated enterprises = 100)

	100% domestically-owned enterprises	*Foreign companies (Foreign ownership rate)*		
		100%	*50–99%*	*Less than 50%*
Overall corporate sector	56.7	90.0	119.9	92.1
Food, Beverage	42.5	126.3	98.8	70.9
Chemical	35.1	106.8	99.6	94.4
Electronics	63.1	99.0	96.8	124.3
Transport equipment	20.5	112.5	86.4	23.5
Power generation	84.3	101.1	99.9	101.2
Agriculture	47.8	115.1	81.5	75.8
Construction	49.8	900.6	50.0	86.9
Wholesale	44.2	104.2	90.3	91.6
Retail	83.3	111.6	60.5	101.8
Land transport	52.9	97.5	161.9	67.9
Post/ Telecommunications	11.6	33.9	87.4	243.6
Real estate	18.9	142.6	37.4	144.2
Services	51.9	97.6	111.3	87.8

Source: KSH (2003d), p. 29.

estimates that the difference between foreign corporations and domestic firms in productivity, added-value, wage level and capital equipment ratio per employee reached 2.9 times, 4.0 times, 1.6 times and 3.2 times respectively in 2000.

There also have been many quantitative analyses on this topic. By estimating Cobb-Douglas production functions based on cross-section data of 1994–97, Szekeres (2001) showed that total factor productivity (TFP) tended to improve in proportion to the growth of the foreign participation rate. Using a large-scale database covering about 90 per cent of all Hungarian manufacturing and construction firms, Sgard (2001) confirmed that TFP showed a significant increase of 38.5 per cent on average when the foreign ownership rate was expanded from 0 per cent to 100 per cent. Using regression analysis of the productivity of foreign-owned corporations by estimating three quantitative models, including a simultaneous equation model designed to treat the endogeneity of the investment decision-making process of foreign firms, Novák (2002) also found that Hungarian corporations with a foreign ownership rate of over 50 per cent probably succeeded in improving their productivity at a faster pace than other enterprises. Furthermore, conducting panel-data analyses based on enterprise-level data covering 1,965 manufacturing firms in 1986–2002, Brown *et al.* (2004) verified that former state enterprises that were more than 50 per cent foreign-owned remarkably improved in productivity after ownership transformation in comparison with privatized firms owned by domestic investors.

The above-mentioned research strongly suggests that there is a close relationhip between the facts found by Oblath & Richter (2002), according to which the productivity of the Hungarian manufacturing sector rose at an average annual rate of 15.4 per cent from 1993 to 2000 – a much faster pace than that of any other CEE countries – and the large inflows of foreign capital into Hungary during this period. However, the dichotomy of categorizing Hungarian firms into only two groups, 'foreign-affiliated corporations' and 'other domestic corporations', is insufficient. As Halpern & Kőrösi (2000) and Novák (2003) noted, it is impossible to strictly verify the relationship between the growth of foreign investment and the improvement of productivity, considering the selection bias that foreign investors may choose domestic companies for investment, because such companies have a significantly greater potential to improve their own management efficiency and productivity than their competitors.[12] In fact, the empirical evidence provided by Brown *et al.* (2004) confirms that former state enterprises that were more than 50 per cent foreign-owned significantly outperformed other

privatized firms and remained state companies in terms of an average productivity of the pre-privatization period. Thus, it is quite likely that a selection bias of this kind did exist in Hungary. In addition, attention must be given to the possibility that the improvement of profitability and productivity of foreign corporations in their accounts might be largely due to preferential investment incentives given to foreign investors by the Hungarian government.

A way to mitigate these problems is to compare newly established FDI-based companies and major domestic corporations. Here, we discuss Hungarian affiliates of multinational corporations. As already mentioned above, those local subsidiaries – almost all of which were established in the framework of greenfield investment – can fully utilize management know-how and production technologies devised by their parent multinational firms. Therefore, such wholly-owned companies of multinationals could easily dominate privatized, formerly state-owned enterprises and other domestic corporations – both of which have been afflicted with a negative legacy from the socialist era – in terms of management efficiency and productivity. The results of our empirical analysis support this presumption.

Table 8.6 compares 153 of Hungary's major corporations listed in the *Figyelő* magazine in 2003 by using representative management and financial indexes. This comparison reveals that there is a clear difference

Table 8.6 Performance of 153 largest Hungarian enterprises, FY2003

	Annual sales per employee (million HUF)	*Operating profit per employee (million HUF)*	*Gross pretax profit per employee (million HUF)*	*ROE*[a] *(%)*	*ROA*[b] *(%)*
All 153 enterprises	156.09	5.30	4.26	21.08	5.71
Subsidiaries of multinational enterprises[c]	*245.83	*8.71	*6.71	18.46	*8.43
Other enterprises	101.29	3.22	2.77	22.67	4.05

Notes
[a] Return on equity = current profits / equity capital.
[b] Return on assets = current profits / total assets.
[c] *: Statistical significance of difference in mean values from domestic enterprises at the 1% level.
Source: Author's estimation based on *Figyelő* (2004).

with statistical significance at the 1 per cent level in the average performance between multinational-affiliated corporations and other companies except for ROE, demonstrating that affiliate companies of multinationals enjoy a remarkable advantage in terms of labor productivity and profitability over foreign-owned and domestic companies.

Next, we examined the effects of the organizational form as a multinational affiliate company on TFP by regression analysis. Following Szekeres (2001), we estimated log-linear Cob-Douglas production function with a constant dummy *MNCs*, which controls the recognition of being a 100 per cent multinational-affiliate, and checked its value and statistical significance. Here, an unbalanced panel of 277 corporations, which are listed on *Figyelő* magazine's leading corporation rankings through to 1999, were used for estimation. We conducted cross-section analyses for each of the 1999–2003 data and panel-data analyses using all observations. In the latter case, individual effects of samples were taken into consideration by estimating ramdom and fix effects models.

The main results shown in Table 8.7 are almost satisfactory, because signs of explanatory variables are consistent with theoretical assumptions and the hypothesis of constant returns to scale is virtually met in all cases.

The effects of *MNCs* on TFP are very positive throughout the analysis period with statistical significance. In addition, the panel-data estimations of RE II and FE indicate that there is the 1 per cent level of significant difference between the above two sampling groups regarding the mean of individual effects. That is to say, multinational corporations had much larger individual effects than other corporations.[13] These findings verify the superiority of multinational corporations as production organizations compared to other Hungarian enterprises. Therefore, our empirical results – which strongly suggest that the expansion of multinational corporations contributed to the improvement of efficiency in the overall corporate sector in Hungary – supports assertions by preceding studies by Hunya (2002) and others.

It was found from the above consideration that the large-scale FDI inflow and massive embarkation of multinational corporations changed the corporate ownership and governance structure in Hungarian firms as well as played a crucial role in improving export competitiveness and streamlining its management and production activities. The next section will further demonstrate FDI effects by focusing on R&D and innovation activities, both of which are also important aspects of corporate restructuring.

Table 8.7 Regression analysis on efficiency of local subsidiaries of multinational enterprises[a]

Estimation period	*1999*	*2000*	*2001*	*2002*	*2003*	*1999–2003*			
Estimation method	*OLS*	*OLS*	*OLS*	*OLS*	*OLS*	*Pooled OLS*[b]	*RE I*[b]	*RE II*[c]	*FE*[c]
Const.	7.691***	7.949***	8.320***	7.857***	8.276***	7.807***	7.459***	7.585***	7.014***
	(22.68)	(24.12)	(28.71)	(27.43)	(24.97)	(52.81)	(43.46)	(45.32)	(29.38)
ln(K)	0.286***	0.214***	0.200***	0.228***	0.224***	0.228***	0.168***	0.168***	0.164***
	(5.41)	(4.25)	(4.71)	(5.37)	(4.94)	(11.08)	(10.18)	(10.17)	(9.00)
ln(L)	0.705	0.899*	0.735*	0.724**	0.615	0.715***	0.865***	0.811***	0.813***
	(1.17)	(1.62)	(1.64)	(2.29)	(1.31)	(3.23)	(7.68)	(7.43)	(8.22)
MNCs	0.398***	0.336**	0.316***	0.303***	0.205*	0.305***	0.282***	–	–
	(2.80)	(2.50)	(2.83)	(2.93)	(1.82)	(5.77)	(3.02)		
00D	–	–	–	–	–	0.148*	0.203***	0.203***	0.200***
						(1.79)	(9.48)	(9.49)	(9.32)
01D	–	–	–	–	–	0.282***	0.356***	0.356***	0.351***
						(3.54)	(16.78)	(16.79)	(16.41)
02D	–	–	–	–	–	0.254***	0.395***	0.396***	0.395***
						(3.22)	(17.84)	(17.87)	(17.58)

03D	–	–	–	–	–	0.334***	0.470***	0.471***	0.466***
						(4.06)	(19.78)	(19.82)	(19.23)
Mean of individual effects									
Multinationals[d]	–	–	–	–	–	–	0.000	0.180†	0.166†
Other firms	–	–	–	–	–	–	0.000	−0.092	−0.153
R^2	0.329	0.297	0.279	0.345	0.272	0.321	0.809	0.805	0.969
Adj. R^2	0.315	0.283	0.267	0.335	0.258	0.315	0.808	0.804	0.955
F	22.920***	22.089***	23.846***	34.806***	20.511***	57.836***	520.004***	590.422***	72.712***
N	144	161	189	202	169	865	865	865	865

Notes

[a] The estimation equation is formulated as follows: $\ln(Y) = \mu + \alpha_1 \cdot \ln(K) + \alpha_2 \cdot \ln(L) + \alpha_3 \cdot MNCs[+\alpha_4 \cdot 00D + \alpha_5 \cdot 01D + \alpha_6 \cdot 02D + \alpha_7 \cdot 03D] + \varepsilon$; Y is total annual sales (million HUF). K is total equity capital (million HUF). L is annual average number of employees adjusted differences in average work hours per employee based on Fazekas and Koltay (2003, pp. 216–217). *MNCs* is a dummy of multinational corporations. *00D, 01D, 02D* and *03D* are year dummies. μ and α_i are constant terms. ε is an error term.

[b] Breusch and Pagan Lagrangian multiplier test for the specification of the pooled estimation and random effects model I (RE I): $\chi^2 = 1290.11$, $p = 0.000$.

[c] Hausman test for the specification of the random effects model II (RE II) and fixed effects model (FE): $\chi^2 = 15.88$, $p = 0.014$.

[d] †: Statistical significance of the mean differences from domestic enterprises at the 1% level.

[e] The *t*-statistics are given in parentheses. ***: significance at the 1% level, **: significance at the 5% level, *: significance at the 10% level.

Source: Author's estimation based on *Figyelő* (various issues).

FDI and R&D/innovation activities

In the late 1980s, Hungary spent 2.5 per cent of its GDP on R&D, which is a large percentage by international standards of the time (Balázs, 1994). However, the ensuing full-fledged transition to a market economy brought about a drastic reduction in Hungary's R&D activities. By 1996, the R&D expenditure as a percentage of GDP dropped to 0.7 per cent and the total number of researchers fell by 53.2 per cent. In particular, the number of corporate researchers diminished sharply by 76.6 per cent during the same period (Table 8.8). Even during the high economic growth after 1997, R&D activities stagnated at low levels. In 2004, the R&D expenditure as a percentage of GDP was almost 0.9%, which is much lower than those recorded during the socialist era. This scale is much smaller than the average of developed countries, as well as that of 15 EU nations (Figure 8.2). Figure 8.3 indicates that although R&D activities in Hungary have been on the rise over the past few years, their growth rates have been very moderate. The R&D expenditure for 2004 was still below the 1990 level.

The full-scale transition to a market economy, the disappearance of the COMECON market and the drastic reduction in the government's R&D spending including those for corporate subsidies were grave 'external shocks' which led to the rapid downsizing of the national R&D sector. At the initial transition stage of economic transformation, the Hungarian government did not initiate consistent policies to stimulate R&D and innovation activities due to the lack of clear recognition regarding the linkage between economic growth and technological development – which also accelerated the stagnation of its R&D sector (Havas, 2002).

Meanwhile, as many researchers point out, Hungary's R&D system during its socialist era was far from effective, since it did not strongly motivate researchers to pursue their R&D and innovation activities.[14] In addition, the size of R&D sectors in CEE countries including Hungary was too large in relation to their economic scales.[15] Therefore, it is no surprise that those countries had to reorganize and downsize their R&D units to suit their national wealth along with changes in their socio-economic systems. Inzelt (1998; 2003), Szalavetz (1999), and Nikodémis (2003) emphasize the importance of the 'spontanenous adjustment processs' relative to 'external shocks' in the modanization of the industrial technology, recognizing that a substantial reduction of R&D expenditure and research staff at the corporate level had produced restructuring effects necessary for the Hungarian firms to adapt to a market economy. As already clarified in the previous section, FDI

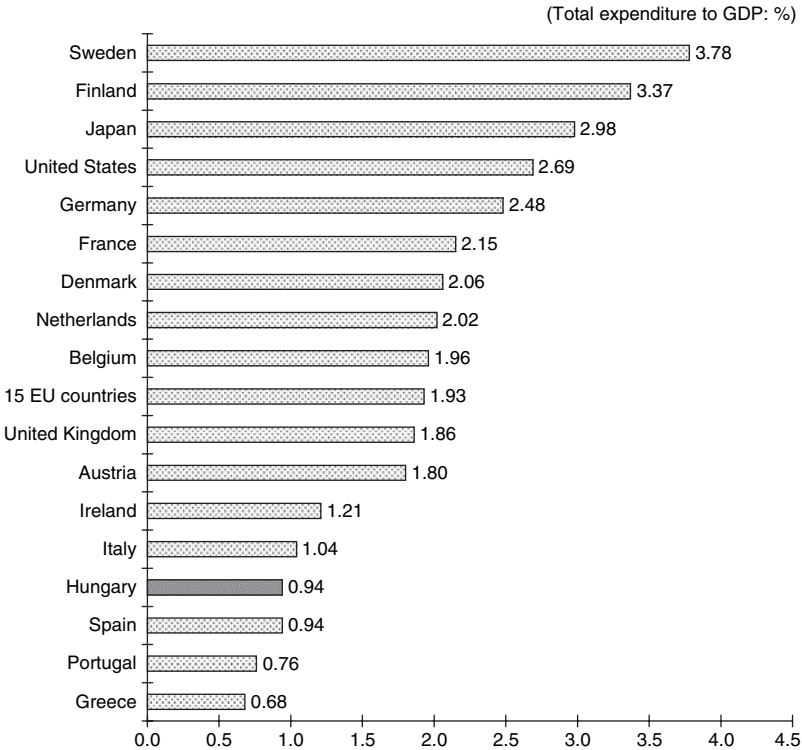
Table 8.8 Selected indexes of R&D activities in Hungary and its corporate sector, 1990–2004

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Total staff number	36,384	29,397	24,192	22,609	22,008	19,585	19,776	20,758
in R&D institutions	14,524	11,909	10,235	9,164	8,343	7,739	9,080	8,866
in R&D units of higher education	8,843	8,458	7,917	7,776	7,611	6,310	6,558	7,210
in R&D units of enterprises	13,017	9,030	6,040	5,669	6,054	5,536	4,138	4,682
Share of enterprise R&D staffs (%)	35.8	30.7	25.0	25.1	27.5	28.3	20.9	22.6
Total number of R&D units	1,256	1,257	1,287	1,380	1,401	1,442	1,461	1,679
R&D institutions	142	133	118	124	112	107	121	131
R&D units of higher education	940	1,000	1,071	1,078	1,106	1,109	1,120	1,302
R&D units of enterprises	174	124	98	178	183	226	220	246
Share of R&D units of enterprises (%)	13.9	9.9	7.6	12.9	13.1	15.7	15.1	14.7
Total R&D expenditure (HUF/million)	33,725	27,100	31,600	35,300	40,289	42,310	46,027	63,591
From state budget	18,108	9,100	11,000	12,000	14,700	19,975	20,562	31,992
From governmental funds	10,132	–	–	–	–	3,302	2,996	2,862
From other domestic sources	538	–	–	–	–	1,744	3,172	2,929
By international organizations	346	–	–	–	–	1,997	2,076	2,655
By enterprises	13,075	13,085	10,921	9,891	10.096	11,563	17,221	23,153
Share of R&D expenditure by enterprises (%)	38.8	48.3	34.6	28.0	25,1	27.3	37.4	36.4
Total R&D expenditure to GDP (%)	1.6	1.6	1.1	1.0	0,9	0.8	0.7	0.7
Total number of international patent applications	–	–	–	–	17,039	18,777	24,938	30,069
By Hungarian residents	–	–	–	–	1,178	1,059	796	737
By non-Hungarian residents	–	–	–	–	15,861	17,718	24,142	29,332

Table 8.8 (Continued)

	1998	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Total staff number	20,315	21,329	23,534	22,942	23,703	23,331	22,826
in R&D institutions	7,815	7,978	8,204	7,766	7,979	7,859	7,595
in R&D units of higher education	7,561	7,452	8,859	8,397	8,528	8,272	8,527
in R&D units of enterprises	4,939	5,899	6.471	6,779	7,196	7,180	6,704
Share of enterprise R&D staffs (%)	24.3	27.7	27.5	29.5	30.4	30.8	29.4
Total number of R&D units	1,725	1,887	2,020	2,337	2,426	2,470	2,541
R&D institutions	132	130	121	133	143	168	175
R&D units of higher education	1,335	1,363	1,421	1,574	1,613	1,628	1,697
R&D units of enterprises	258	394	478	630	670	674	669
Share of R&D units of enterprises (%)	15.0	20.9	23.7	27.0	27.6	27.3	26.3
Total R&D expenditure (HUF/million)	71,186	78,188	105,388	140,605	171,470	175,773	179,750
From state budget	35,305	37,518	48,170	75,386	100,392	102,008	92,273
From governmental funds	3,625	4,106	4,037	4,591	6,455	7,651	–
From other domestic sources	2,022	2,131	2,189	3,317	2,441	991	1,334
By international organizations	3,375	4,363	11,202	12,918	17,773	18,847	18,791
By enterprises	26,859	30,070	39,790	48,984	50,864	53,926	67,351
Share of R&D expenditure by enterprises (%)	37.7	38.5	37.8	34.8	29.7	30.7	37.5
Total R&D expenditure to GDP (%)	0.7	0.7	0.8	0.9	1.0	1.0	0.9
Total number of international patent applications	38,628	44,913	71,049	93,053	99,077	101,762	101,976
By Hungarian residents	694	727	810	919	842	756	738
By non-Hungarian residents	37,934	44,186	70,239	92,134	98,235	101,006	101,238

Sources: Compiled by the author based on KSH, *Magyar Statistikai Évkönv* (various years) and information available at the WIPO (http://www.wipo.int/ipstats/) and the Hungarian Patent Office (http://www.hpo.hu/) websites.



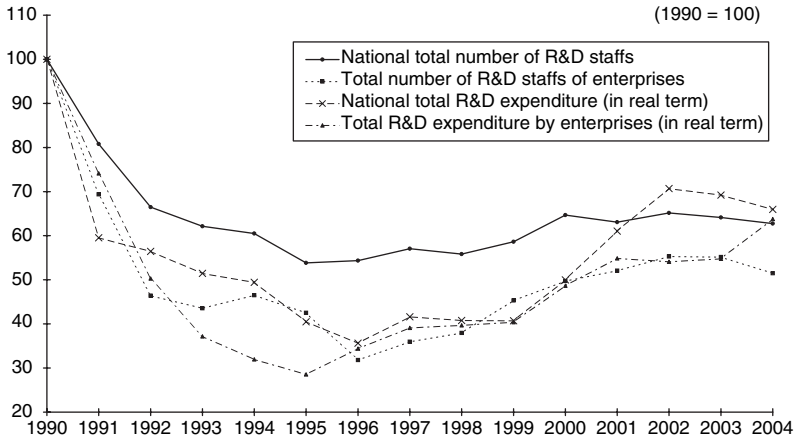
Notes: Figure for Hungary is in 2001. Figure for Greece, Ireland, Italy, Belgium, Netherlands, Denmark and Spain are in 1999. Figures for the average of 15 EU nations and other countries are in 2000.

Source: *Népszabadság*. 2003. Április 12., p. 5.

Figure 8.2 R&D expenditure by country

and foreign-affiliated companies played a crucial role in the revitalization of the Hungarian economy. Therefore, the preceding studies paid considerable attention to the relation between ownership forms of enterprises and their R&D/innovation activities.

According to these studies, foreign-affiliated corporations may have been more engaged in R&D activities than the wholly domestic enterprises from the early stage of transition. For instance, Inzelt (1998) refers to the strong link between foreign ownership rates and R&D expenditure based on the enterprise survey conducted by the statistical office in 1996. Furthermore, she suggests that foreign investors have been constantly utilizing many of R&D units of Hungarian companies



Source: Based on KSH, *Magyar Statistikai Évkönyv* (various issues) and Table 8.8.
Figure 8.3 R&D activities in Hungary and in its corporate sector, 1990–2004

they bought with the aim of introducing new production licenses and know-how. Moreover, Nikodémis (2003) points out that multinational corporations in Hungary boosted their R&D spending by five times in real terms over the six-year period from 1995 to 2000. As a result, the share of multinational companies in the total R&D spending in the corporate sector increased from 22 per cent to almost 80 per cent during the period. The proportion of R&D spending by multinationals in the Hungarian corporate sector is extremely high by international standards. Nikodémis (2003) states that this is further highlighted by the fact that domestically-owned corporations, especially small and medium size enterprises, were substantially cutting or restraining R&D expenditures in that period.

The same trend can be seen for innovation activities. The survey by the statistical office (KSH, 2003b) covering 26,495 manufacturing companies reveals that there is a certain gap between domestic and foreign companies in terms of achievements in innovation activities. Table 8.9 shows that 3,441 or 15.1 per cent of 22,186 wholly domestically-owned corporations surveyed conducted innovation activities during 1999 to 2001, while 1,055 or 28.7 per cent of 3,679 foreign-affiliated enterprises carried out such activities during the same period, which is about 1.9 times larger than that of the former on a percentage basis. Meanwhile, the statistical office obtained similar results to the above based on another enterprise survey for 1997 to 1999 (KSH, 2001). Hence

Table 8.9 Innovation activities by form of corporate ownership, 1999–2001

		Innovative enterprises						*Non-innovative enterprises*	*Grand total*
		Innovation activities completed				*Unfinished or cancelled innovation activities*	*Total*		
		Products only	*Processes only*	*Products and processes*	*Total*				
Actual numbers	100% domestically-owned enterprise	1,230	669	1,169	3,068	373	3,441	19,375	22,816
	Enterprise with foreign participation[a]	279	122	255	656	56	712	1,368	2,080
	100% foreign-owned enterprise	123	40	118	281	62	343	1,256	1,599
	Total	1,632	831	1,542	4,005	491	4,496	21,999	26,495
Share (%)	100% domestically-owned enterprise	5.4	2.9	5.1	13.4	1.6	15.1	84.9	100.0
	Enterprise with foreign participation [a]	13.4	5.9	12.3	31.5	2.7	34.2	65.8	100.0
	100% foreign-owned enterprise	7.7	2.5	7.4	17.6	3.9	21.5	78.5	100.0
	Total	6.2	3.1	5.8	15.1	1.9	17.0	83.0	100.0

Notes
[a]Excluding 100% foreign-owned enterprises.
Source: Based on KSH (2003b), pp. 23, 29.

foreign-affiliated enterprises may have been continuously more active in innovation activities than domestic corporations.

Szalavetz (1999), who conducted an in-depth interview survey of fifteen manufacturing companies under the control of German capital, advocates that 'the technological benefits of being owned by multinational corporations can be summarized by the fact that domestic firms were able to accelerate their technology accumulation process with the help of foreign direct investment', adding that the 'Hungarian economy has been modernized at a remarkable scale as a result of technology transfer through foreign investment.'

In addition to this paper, there are many other studies focusing on the achievements of technology transfer and spillover effects stemming from R&D and innovation activities by foreign corporations. For example, Antalóczy & Sass (2003b) found the effects of technology transfer in qualitative changes in Hungary's export structure from the late 1990s. As indicated in Table 8.10, Hungary's top 10 export goods for 2002, five of which were high-tech products, are products of foreign-affiliated enterprises that carried out greenfield investments within custom-free zones. The total export volume of high-tech products increased by as much as 5.3 times on a US dollar basis from 1992 to 2002. The total imports of high-tech products also expanded by 7.6 times during the same period partly due to foreign corporations' rising demand for plant and equipment investment. Based on statistical data, Hamar (2004) examined the role of foreign capital from the viewpoint of Hungary's technological catching-up and confirmed that industrial sectors requiring higher technologies have larger foreign participation rates (Table 8.11). These findings indicate the benefits of technology transfers brought about by FDI.

Szanyi (2002) focused on technological spillover effects arising from outsourcing contracts and from supplier agreements between multinationals and domestic companies, which has been rapidly spreading among Hungarian industrial firms in recent years. He found that small and medium size firms are actively involved in businesses outsourced from multinational enterprises, and aim to adapt to a market economy as well as undergo restructuring. That is, these domestic enterprises regard outsourcing contracts with multinationals as 'the most important sources of technologies, competitive products and markets, each of which is necessary for their modernization' (p. 20). Meanwhile, multinationals are also actively promoting their subcontractors to introduce new management techniques and carry out other organizational innovations (Havas, 2002). In addition, these domestic corporations are devoting

Table 8.10 Top 10 export commodities, 2002

Rank/commodities	*Export volume (1,000 USD)*	*Share in total export volume (%)*	*Manufacturing by foreign-affiliated enterprises*	*Greenfield investment*	*Production in custom-free zones*	*High-tech products*
1. Mobile communication devices	2,691,198	7.84	△	△	○	○
2. Piston engine-type manufacturing	2,114,963	6.16	○	○	○	×
3. Passenger vehicles	1,481,180	4.31	○	○	△	×
4. Input/Output devices	766,262	2.23	△	△	○	○
5. Parts for TV sets, radios and communication devices	706,874	2.06	○	○	○	×
6. Computer memory devices	550,146	1.60	○	○	○	○
7. TV sets	533,894	1.56	○	○	○	×
8. Video recorders	529,641	1.54	○	○	○	○
9. Automatic data processing equipment/units	508,393	1.48	△	△	○	○
10. Conductors	431,424	1.26	△	○	△	×
Total for 10 commodities	10,313,975	30.04	8.0	8.5	9.0	5.0

Notes: ○ indicates 'applicable', × indicates 'not applicable' and △ indicates 'partially applicable'. For the numerical estimate of the total for 10 commodities, each ○ mark is given 1.0 point, △ mark 0.5 point and × mark 0.0 point.
Source: Antalóczy & Sass (2003b), p. 26.

Table 8.11 Shares of foreign companies in manufacturing sector by technological level, 2001

	No. of enterprises	*Fixed assets*	*Sales*	*Exports*	*No. of employees*
High-tech industries	10.4	80.5	91.5	97.5	66.5
Upper medium-tech industries	11.7	86.0	84.9	93.9	58.4
Lower medium-tech industries	10.7	74.6	71.6	73.7	42.5
Low-tech industries	8.2	58.3	57.0	71.8	36.3
Total	9.5	74.5	75.1	89.2	46.1

Notes: The following industries are included in each sector. (The numbers in parentheses are OECD industrial classification codes.) High-tech industries: aircraft and spacecraft (35.3), pharmaceuticals (24.4), office and computing machinery (30), communications equipment (32), and medical, precision and optical instruments (33.1). Upper medium-tech industries: electric machinery and apparatus (31), motor vehicles (34), chemicals (excluding pharmaceuticals) (24 excl. 24.4), railway locomotives and other transport equipment (35.2 + 35.4), general machinery and devices (29), Lower medium-tech industries: manufactured fuels (coke, refined petroleum products and nuclear fuel) (23), rubber and plastic products (25), non-metallic mineral products (26), basic metals (27), fabricated metal products (28) and ships and boats (35.1). Low-tech industries: Food, beverages and tobacco (15+16), textiles, apparel and leather products (17 + 18 + 19), wood products, paper products and printing (20 + 21 + 22), other manufacturing (36 + 37).
Source: Selected by the author from Hamar (2004, pp. 48–9).

themselves to renewing their production facilities, developing new products, preparing to meet domestic needs, streamlining production systems, and improving designs on the basis of outsourcing contracts.

There have also been several empirical works on technological spillover effects brought about by foreign capital. For example, Novák (2003) confirms the existence of the FDI spillover effects by detecting a significant positive correlation between the TFP and the share of multinational corporations in the total sales in each industrial sector.[16] Furthermore, Sgard (2002) shows the high statistical significance of these spillover effects by introducing the share of foreign capital in the total equity capital by sector into the production functions.[17] On the other hand, he also reports that the northwest region between the border of the EU and Budapest is enjoying more positive spillover effects than the southern and eastern regions, which might have widened the regional gap in the productivity of local enterprises. This is noteworthy from the viewpoint of the role of FDI in the regional development in Hungary, as discussed later.

The above studies highlight the major role played by foreign capital and multinational corporations in the restructuring process of industrial

technologies in the corporate sector. As mentioned in the previous section, drastic structural changes in the Hungarian manufacturing sector as well as the significant improvement of its export competitiveness were leveraged by the introduction of foreign capital. In addition, it is clear that foreign-affiliated corporations supported the overall industrial sector in terms of R&D and innovation activities. It is also a noticeable trend that in recent years, foreign companies in Hungary have been actively hiring Hungarian researchers and strengthening ties with domestic universities and research institutes, as pointed out by Havas (2002).[18]

However, the above series of positive moves does not imply that an internationally competitive R&D sector is now emerging in Hungary. Firstly, the quantitative analyses performed by Török & Petz (1999) and Knell (2000) show that R&D activities are not a strong explanatory factor for Hungary's enhanced export competitiveness and its improved productivity in the late 1990s.[19] Secondly, the number of international patent applications by Hungarian residents per 100 corporate researchers, a common indicator of productivity of R&D and innovation activities, dropped by 44 per cent from 19.5 in 1994 to 11.0 in 2004. Thirdly, the already mentioned enterprise survey (KSH, 2003a/b) indicates that 83 per cent of manufacturing companies polled did not carry out any innovation activities from 1999 to 2001, almost the same percentages as that recorded in the previous investigations by the statistical office (Inzelt 1994; KSH, 2001; Nagaoka & Iwasaki, 2003). These findings strongly suggest that Hungary still has a long way to go before achieving rationalization and revitalization of R&D and innovation activities. FDI and multinational corporations are expected to make a great contribution to this field.

Concluding remarks

This chapter presents analysis of the roles of FDI in the corporate restructuring in Hungary from a multilateral standpoint during the process of the EU accession of Hungary after the abolition of the socialist planned economy. From what has been discussed above, we can say that foreign capital and multinational enterprises made a significant contribution to this development. Namely, active investment activities by foreign corporations lowered hurdles for Hungary to transform its economic system to a market economy by overcoming capital shortage, boosted the domestic corporate sector, and greatly improved the position of

Hungary in the world economy through the substantial expansion of exports (Szekeres, 2001).

Notwithstanding, relying on the FDI to carry out economic transformation and to promote corporate restructuring poses many problems. First, there has been an increasing amount of profit repatriation by multinationals in recent years, which might further increase the current account deficit. In this sense, it is shocking that the direct investment income balance recorded a deficit of 3.82 billion Euros in 2004, which vastly exceeds the total FDI gross inflow in that year (2.95 billion Euros) according to Table 8.1. Secondly, financial strains on domestic corporations and on the public arising from the preferential measures for foreign-owned enterprises have been distorting resource allocations and generating economic inequity between those who can enjoy the benefits of the FDI and those who cannot. Thirdly, regional disparity in income and unemployment has been widening due to the concentration of the FDI in particular regions. Fourthly, behind the rapid growth of the foreign corporate sector, technology networks and inter-industrial relations forged during the socialist era have been completely abandoned, leading to the emergence of 'technological economic dualism' (Farkas, 2000). Szanyi (2004) reports that, even today, the alliance between domestic companies and multinationals through supplier contracts and others is still a long way from being desirable in terms of scale and depth. Hence, resolving this problem remains a difficult policy challenge for the Hungarian government. Fifthly, the national economy's dependence on foreign capital has been creating anxiety among Hungarian citizens about the future of the country, putting them in fear of losing their national identity. Finally, the large-scale foreign capital inflow cannot solve many problems related to corporate restructuring in the country, as suggested by the analyses in the previous section referring to R&D and innovation activities. The remaining problems that have not been examined in this chapter include: (a) the underdevelopment of small and medium-size enterprises, (b) the unbalanced corporate capital structure heavily dependent on retained earnings, and (c) the insufficiency of supervision activities over managers by shareholders and financial institutions.

The following remarks were made by Szalavets (2002) regarding policies to be taken up by the CEE countries after EU accession:

> The transforming countries, in the 'long transition decade', have achieved remarkable success with minimal state intervention. By adapting a passive policy approach, they have allowed themselves to be driven forward by the modernizing effects of foreign direct

> investment. However, the challenges that follow EU accession will compel them to adopt an approach of more active state involvement. Local economic policy decision-makers will need to work out how to redefine the position of their countries in the world economy (p. 5).

Inspired by recommendations such as those presented above, more people in Hungary are calling for the modification of the current policies that focus on attracting foreign capital in order to achieve sustainable economic growth over the medium and long term. Currently, the revision of the development strategy is beginning to assume an urgent character in Hungary. Against the background of the recent revaluation of the Hungarian forint and the rapid increase of the real wage level,[20] the decline in attractiveness of Hungary in comparison with other host countries, such as China, now sharply reflects the decision-making process by foreign investors and multinational corporations that has resulted in the failure of the realization of new greenfield investment projects and continuous closure of big factories established by companies such as IBM, Flextronics, and Salamander. Therefore, it seems reasonable to conclude that the passive strategy for a transition to a market economy driven by the Hungarian government and the business sector is at a crucial turning point.

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Notes

1. Author's calculations based on KSH, *Magyar Statistiki Évkönyv 2004* (2005), p. 12.
2. Mišun & Tomšík (2002) verified FDI's spill-over effects on domestic investment in Hungary, the Czech Republic and Poland by using panel data and investment models based on the mix of the stock adjustment theory and the adaptive expectation theory regarding investment for economic growth, which revealed that Hungary from 1990 to 2000 and the Czech Republic from 1993 to 2000 both enjoyed FDI's crowd-in-effects while Poland from 1990 to 2000 had crowd-out-effects.

3. Regarding the policy measures taken by the Hungarian government to enhance investment incentives, see Antalóczy & Sass (2003a) and Iwasaki & Sato (2004).
4. The ratio of FDI to the total amount of privatization earnings obtained by the Hungarian government had rapidly declined as follows: 1996: 32.3%, 1997: 15.1%, 1998: 0.8%, 1999: 0% (Antalóczy & Sass, 2002).
5. Tatabánya is the largest city in the Komárom-Esztergom region, and its total population as of 1 January 2005 is 71,000 (KSH, 2005). At the begining of the transition, Tatabánya fell into economic difficulties due to the closure of a coal factory, the key indusrty of the city in the socialist era, and other problems. By grace of successful policy efforts, however, the Tatabánya government attracted 22 foreign manufacturing firms by the beginning of 2004 and created new jobs for about 6,000 workers, or 15% of the total labor force in the city.
6. 'Reinvested earnings' are: (i) earnings of Hungarian affiliates/subsidiaries of foreign corporations that are not allocated to investors as dividends; and (ii) earnings of Hungarian branch offices of foreign corporations and those of foreign non-corporate entities that are not directly remitted to investors.
7. Várhegyi (2004) confirmed that, during this period, the market share of the largest three (five) commercial banks decreased from 58 (76) to 45 (59) % and the Herfindahl index notably fell from 1565 to 986.
8. More exactly, a direct investment enterprise is defined as an incorporated or unincorporated enterprise in which a foreign investor owns 10% or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise.
9. The 'degree of export orientation' is defined as the share of exports in total net sales.
10. Calculated based on KSH, *Magyar Statistikai Évkönyv*.
11. Judging the context, the estimation was conducted only for manufacturing firms.
12. While Halpern & Kőrösi (2000) state, based on their estimates of Dynamic Cobb-Douglas frontier production functions using dataset from 1990 to 1997, that selection bias effects can be observed only during the initial few years of the transition period, Novák (2003), who came up with estimated production functions in fixed effect models by using 1992–98 panel data on industrial firms, suggests that selection bias effects are universal. In this way, there are different views on selection bias effects over time.
13. The results of cross-section analyses show that the explanatory power of *MNCs* declines yearly. This finding is regarded as a good sign of progress in the restructuring of Hungarian firms because it indicates that the TFP gap between the multinational corporations and others is steadily diminishing.
14. For more details, see Tanaka (1993), Balázs (1994), Matsui (1996), and Inzelt (1998). These researchers point out the following as causes of the previous ineffective R&D sector in Hungary: (a) Localized division of roles by academic research institutions, high educational insitutions and industrial research institutions. (b) Domestic enterprises' low consciousness of the benefits of R&D activities. (c) Non-availability of economic institutions and agents able to build a bridge between the R&D sector and the industrial sector.

15. According to Knell (2000), as of 1990, scales of R&D activities in CEE countries and in Russia were comparable to those of Western developed nations, such as Germany and France.
16. The coefficients of spillover effects had a positive sign with statistical significance regarding enterprises with 100 or more employees throughout the analytical period, while with enterprises with fewer than 100 employees, it had a negative sign with statistical significance for the first half of the 1990s and had no significance for the second half of 1990s.
17. However, from the panel-data analysis of 882 firms for the period of 1993–97, Bosco (2001) could not find positive spillover effects at all. Thus, this subject could be examined further.
18. Nevertheless, the collaboration among industry, universities, and government in the R&D sector is far from the desirable level. Therefore, Inzelt (2004) presses the Hungarian government for policy intervention to strengthen the ties of these entities.
19. Török & Petz (1999) regressed the export-orientation ratio (ratio of exports to imports) to the R&D input ratio (ratio of R&D expenditures to GDP), skilled-labor ratio and foreign capital investment ratio, while Knell (2000) conducted regression analysis using the labor productivity improvement rate as a dependent variable and the R&D imput ratio and the manufacturing productivity growth rate as regressors. As a result, the former research confirmed that the coefficient of the R&D input ratio does not have economically-meaningful explanatory power, and the latter led to the conclusion that the R&D input ratio has no statistical significance.
20. According to Szanyi (2004), the productivity growth always exceeded the increase of the real wage level in the period of 1992–98. From 2000 to 2002, however, the real wage rise represented an increase of 30% although the labor productivity was improved only by 10% in the same period. Consequently, Hungary now surpasses other CEE countries by 40% in terms of labor unit cost.

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Part IV

The Russian Federation

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9

Corporate Law and Governance Mechanism in Russia

Ichiro Iwasaki

Introduction

Understanding the formal corporate structure and the legal rights of stakeholders is needed when examining the problems of corporate governance. In Russia, recent enhancements to the legal system have helped to alleviate the conflict between ownership and management, and the situation is improving. Economic studies on the legal structure of Russian firms, however, are not sufficient to date. Thus, this chapter aims to illuminate the legislative framework, with special attention to the governance mechanism of the joint-stock companies.

The remainder is organized as follows: the next section examines the present forms of business firms and the prevalence of joint-stock companies in the industrial sector. Then the formal structure of joint-stock companies is clarified, and the legal specificity of privatized enterprises and workers' joint-stock companies, is explained (people's enterprises). the concluding section summarizes the major implications of the findings.

Business organization in contemporary Russia

The current legislative structure of the Russian commercial organization are shown in Figure 9.1.[1] It is clear that the legal forms of incorporation in contemporary Russia are not substantially different from those in advanced countries. If there are any notable characteristics of Russian firms, they would be the followings:

1. There is a category of 'unitary enterprises', which are commercial organizations whose assets cannot be divided in ownership

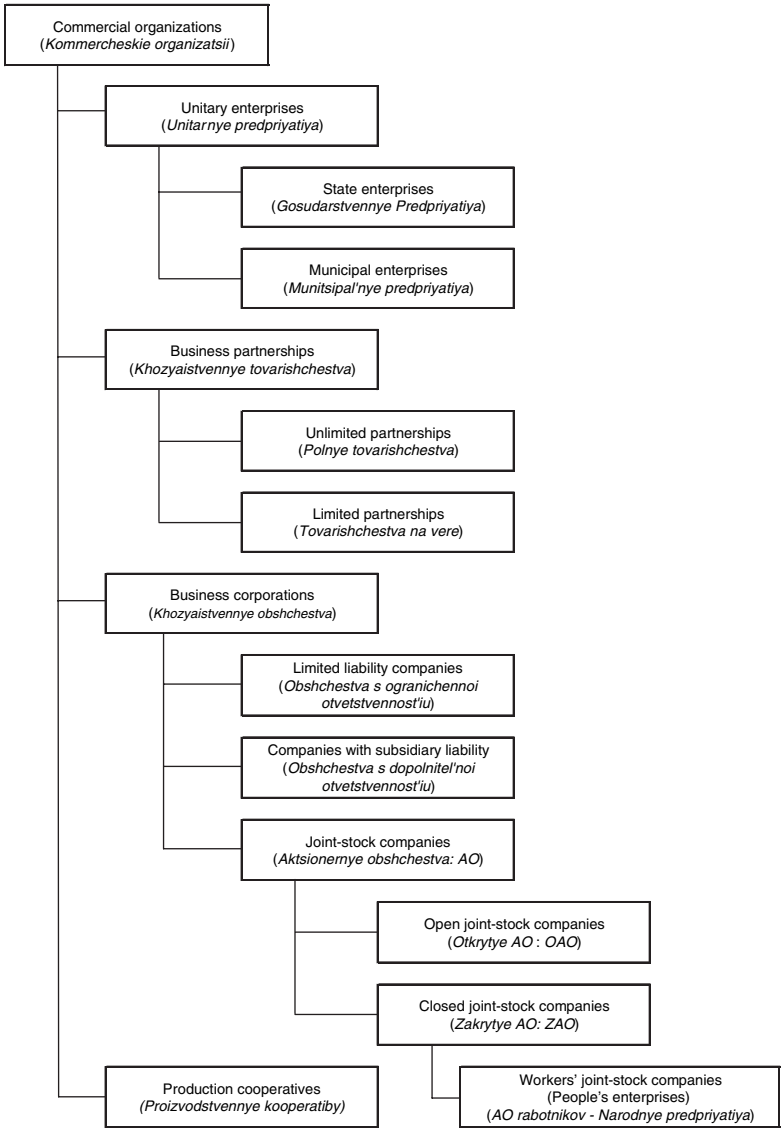


Figure 9.1 Legal forms of commercial organization in Russia

shares and under which only state and municipal enterprises fall (Civil Code, Art. 113).

2. Joint-stock companies are classified as of either 'open' or 'closed' type depending on how company stock is assigned. Closed joint-stock companies also include a special form known as 'workers' joint-stock companies (people's enterprises)'.
3. 'Companies with subsidiary liability' may be established as a type of limited liability company (Civil Code, Art. 95). 'Companies with subsidiary liability' are a form of organization that requires the members (investors) of each company to assume additional liability for the company's debts in excess of its assets in proportion to their participatory shares. This form of organization has been introduced into some former socialist countries, including Russia and Hungary (Oda, 2002, pp. 93–94).

Official Russian statistics disclose only extremely limited information on the form of incorporation. According to Table 9.1, the number of registered commercial organizations on 1 April 2005 was approximately 3.6 million, but the share of joint-stock companies in the total is no more than 12.6 per cent (about 460,000 companies). In numerical terms, limited liability companies represent the most common form of enterprise. However, if discussion is limited to leading industrial enterprises, the situation seems substantially different. Here, we present two studies as empirical evidence.

Table 9.2 shows the results of the social survey that the Higher School of Economics in Moscow conducted on 356 industrial enterprises located in 39 regions across the country in the second half of 1999. The prevalence of joint-stock companies is as high as 87.8 per cent. In terms of

Table 9.1 Composition of commercial organizations by form, as of 1 April 2005

	Number of firms (000)	*Share (%)*
Commercial organizations	3,625.1	100.0
Unitary enterprises	69.1	1.9
Business partnerships and companies	3,115.4	85.9
Joint-stock companies	457.3	12.6
Others	440.6	12.2

Source: *Rosstat* (2005b), p. 147.

Table 9.2 Composition of 356 industrial enterprises by form and descriptive statistics on number of employees

	Form of incorporation[a]		*No. of employees*[b]			
	No.	*Share (%)*	*Mean*	*Min.*	*Max.*	*Standard deviation*
Joint-stock companies	316	87.8	3,313	25	113,944	10,003
Open joint-stock companies	268	75.3	3,634	25	113,944	10,804
Closed joint-stock companies	48	13.5	1,522	70	8,324	1,909
Unitary enterprises	31	8.7	2,011	13	9,873	2,365
Limited liability companies	6	1.7	844	142	2,351	839
Others	3	0.8	187	144	240	48
Total	356	100.0	3,132	13	113,944	9,464

Notes
[a] At the time of survey.
[b] At the end of 1998.
Source: Data provided from Dr Tatiana G. Dolgopyatova, project leader involved in the social survey undertaken by the Higher School of Economics of the National University in Moscow with the support of the Ministry of the Economy of the Russian Federation, summer to autumn 1999. Her support is greatly acknowledged.

employment, the average size of the joint-stock companies is 1.6 times larger than unitary enterprises and 3.9 times larger than limited liability companies.

To obtain a more detailed picture of the actual composition of Russian joint-stock companies, we attempted to calculate descriptive statistics on the number of employees as well as the amount of share capital (*ustavnyi kapital*)[2] of 1,336 industrial joint-stock companies by using an enterprise database, which is originally based on the report on securities (AK&M List, 2002). The results are listed in Table 9.3. While this classification confirms that the sample group represents only 0.9 per cent of all industrial enterprises, it comprises no less than 34.2 per cent of all workers when compared with official statistics (Table 9.4).[3] From these figures it becomes clear that joint-stock companies are extremely common in almost all industrial sectors. In addition, this trend is most notable among a group of industrial enterprises classified under the Russian statistical standards as 'large enterprises' (those with 500 employees or more) and 'superlarge enterprises' (those with 1,000 employees or more).

Table 9.3 Composition of 1,336 industrial joint-stock companies by sector and descriptive statistics on number of employees and share capital

	No. of enterprises[a]		*No. of employees*[b]				*Share capital (m rubles)*[c]			
	No.	*Share (%)*	*Mean*	*Min.*	*Max.*	*Standard deviation*	*Mean*	*Min.*	*Max.*	*Standard deviation*
Industry, total	1,336	100.0	3,397.3	1	121,084	7,114.8	419.6	0.001	118,367.6	3,963.1
Electric energy	77	5.8	7,345.7	423	47,760	7,071.5	2,064.6	16.075	28,267.7	4,133.1
Fuel	88	6.6	6,122.9	1	85,685	12,952.5	2,143.1	0.015	118,367.6	13,387.6
Steel	33	2.5	12,195.4	150	48,506	12,644.2	159.7	0.035	2,500.0	509.2
Non-ferrous metallurgy	71	5.3	5,002.0	23	65,190	9,479.0	211.6	0.014	4,073.4	655.9
Chemical & petrochemical	135	10.1	3,604.5	5	19,538	3,485.6	449.5	0.015	34,757.3	3,052.7
Mechanical engineering & metal-working	395	29.6	3,698.3	7	121,084	8,296.9	301.8	0.002	39,287.4	2,372.0
Wood, wood-working & paper	131	9.8	1,382.4	5	24,700	2,518.5	16.5	0.001	846.6	84.5
Construction material	87	6.5	1,958.9	9	14,449	2,915.7	41.3	0.004	1,922.9	212.1
Light industry	165	12.4	1,363.5	6	9,276	1,791.1	20.5	0.002	1,123.7	103.4
Food industry	154	11.5	1,086.0	1	9,652	1,587.7	24.1	0.001	1,176.9	103.4

Notes
[a] A total of 1,336 companies are composed of 1,335 open joint-stock companies and 1 workers' joint-stock company (people's enterprise).
[b] As of 2001/2002.
[c] As of August 2002.
Source: Author's calculations based on AK&M List (2002).

Table 9.4 Employees of 1,336 industrial joint-stock companies by sector (000)

	No. of employees		*Size of sample (%)*
	Official statistics, 2001	*1,336 industrial enterprises*	
Industry, total	13,282	4,539	34.2
Electric energy	942	566	60.0
Fuel	806	539	66.9
Steel	727	402	55.4
Non-ferrous metallurgy	582	355	61.0
Chemical & petrochemical	877	487	55.5
Mechanical engineering & metal-working	4,685	1,461	31.2
Wood, wood-working & paper	1,054	181	17.2
Construction material	677	170	25.2
Light industry	814	225	27.6
Food industry	1,492	167	11.2

Sources: Author's calculations based on Table 9.3 and Goskomstat RF (2002), pp. 115–18.

The above-mentioned survey results strongly suggest that most leading Russian industrial enterprises are managed as joint-stock companies. This fact is not, as it would seem at first glance, the result of a voluntary decision by investors and managers. Rather, it is the result of an almost obligatory conversion of state and municipal enterprises to joint-stock companies, which the federal government promoted as part of its privatization policy before the enactment of the current Law on Joint-stock Companies. As discussed later, this factor has complicated the present state of Russian joint-stock companies. Keeping this point in mind, in the following sections, we will examine the formal corporate structure of the Russian joint-stock company with reference to these relevant laws and ordinances.

Legislative structure of joint-stock companies

This section will discuss the fundamental framework of joint-stock companies under the Civil Code and the Law on Joint-Stock Companies (hereinafter Law on JSC), including (1) the organizational form, (2) the mechanism of management and supervision, (3) the division of power among shareholders, directors and executive officers, and (4) the internal audit system. Workers' joint-stock companies (people's enterprises), which are a special type of joint-stock company along

with privatized enterprises, will be discussed separately in the following section.

Open and closed joint-stock companies

As stated earlier, joint-stock companies in Russia are legally classified as either 'open' or 'closed' (Civil Code, Art. 97 and Law on JSC, Art. 7). Whereas the former are allowed to transfer their shares to a third party and offer their shares to the public, the latter are allowed allocating or transferring shares only among founders and other specific investors. In addition, there are certain differences between them in terms of (1) minimum capital, (2) number of shareholders and (3) obligations of disclosure. First, the nominal capital of open joint-stock companies must be not less than 1,000 times the official minimum monthly wage in effect at the time of their registration as a juridical person,[4] while that of closed ones has only to be not less than 100 times (Law on JSC, Art. 26).[5] Second, there must be no more than 50 shareholders in a closed joint-stock company. If a company exceeds the limit, it must be converted to an open joint-stock company or dissolved within one year of the exceeding this limit (Art. 7(3)). Third, open companies are obliged to publish their annual reports and financial statements and other information required by laws and ordinances and government agencies, such as the Federal Committee for Securities Market (Art. 92).

It has been reported that the number of closed companies is extremely high, at more than 370,000 entities, compared with about 60,000 open companies as of 1 July 2001 (Shapkina, 2002, p.5). Moreover, in spite of the restriction on the number of shareholders, many large companies are of the closed type, as shown in Table 9.2. This is largely the result of a special measure that Article 7(3) above will not apply to closed companies founded before the Law on Joint-stock Companies came into force (Law on JSC, Art. 94(4)). For example, ZAO Izumrud (Timashev Sugar Plant), established in 1991, remains a closed company despite having had over 1,000 shareholders while the law has been in effect (Sukhanov, 1997). There are numerous cases like this.

Furthermore, there are also a significant number of former state and municipal enterprises converted to closed companies in the relatively early stages of privatization. For these closed companies, the Presidential Decree of 18 August 1996 directed that they should be converted to open companies by the end of 1996 if the government has a share of 25 per cent or more in ownership. But this provision was regarded merely as a recommendation from the government because it did not

specify effective penalties or disciplinary measures for breaches of the provision (*Ekonomika i Zhizn'*, No. 36, 1996, p. 43). Still today, large companies often remain closed despite being former state enterprises. Evidently the management of such companies did not observe the provisions of the decree or obtain support from private shareholders. At any rate, the overwhelming spread of the organizational form that shuts out external investors probably complements the prevalence of insider ownership. However, this is an extremely distorted form of organization if the intrinsic functions of joint-stock companies are taken into consideration. Furthermore, there are a number of critical issues related to developing capital markets and improving the transparency of corporate management.

At the end of 2004, the committee on property of the State Duma (Lower House) advocated the complete abolishment of the legislation concerning closed joint-stock companies, including people's enterprises, at a congress hearing on the future modernization of corporate laws (Osipenko, 2005). Such an action by the Federal Assembly can be regarded as a response to serious problems caused by the institutional distortion of the Russian corporate system.

Management and supervision bodies

Five organs within a joint-stock company are legally prescribed for supervising and making decisions on a business's affairs: (1) the general shareholders' meeting (*obshchee sobranie aktsionerov*), (2) the board of directors (*sovet direktorov*) or the supervisory board (*nabliudatel'nyi sovet*), (3) the single executive organ (*edinolichnyi ispolnitel'nyi organ*), (4) the collective executive organ (*kollegial'nyi ispolnitel'nyi organ*) and (5) the audit committee (auditor) (*revizionnaya komissiya, revizor*). The board of directors is responsible for general leadership in corporate management, with the exclusion of the competence granted to the general shareholders' meeting. The single executive organ (the general manager or president) and the collective executive organ (the management and administration division) are responsible for performing ordinary tasks (Law on JSC, Art. 64 and 69). In the statute, the term 'board of directors' is always referred to with 'supervisory board' in brackets. This is the result of having transplanted the concepts of Anglo-American corporate law into Russia, which has historically been influenced by continental European law. In assessing the main functions of this body, some people argue that it is not proper to use the name 'board of directors' solely (Torkanovsky, 1997, p. 27). The audit committee (auditor) inspects

financial and managerial activities jointly with the general shareholders' meeting (Art. 85).

Joint-stock companies are not always required to have all five organs. When less than 50 people are holders of voting shares, the general shareholders' meeting may substitute for the function of the board of directors (Law on JSC, Art. 64(1)). It is left to the discretion of the company whether a collective executive organ will be set up or not (Art. 70). Moreover, the minimum number of directors varies with the number of voting shareholders (Art. 66(3)). Accordingly, if the workers' joint-stock companies (people's enterprises) are included, there are a number of possible combinations of organizational forms and corporate bodies for joint-stock companies (Table 9.5).

The interrelationships between the executive and the supervisory bodies are illustrated in Figure 9.2. To secure the independence of the latter from the former, the Law on Joint-stock Companies imposes relatively tight restrictions on holding several posts concurrently. For instance, the single executive organ may not assume the chairmanship of the board of directors, and the members of the collective executive organ may not account for more than one-quarter of all directors (Art. 66(2)). Also, the members of the audit committee may not serve as directors or as any other officers (Art. 85(6)). Prior to the revision of the Law on Joint-stock Companies in January 2002, members of the executive bodies were permitted to assume the directorship, unless they held the majority on the board. As this case suggests, the shift from the Provisions of 1990 to the Law on Joint-Stock Companies, and subsequent revisions of the law are apparently intended to reinforce the supervisory power over corporate management. Russian researchers have responded favorably to these legislative controls (Ignatov & Filimoshin, 2002; Shitkina, 2002, p. 4).

However, as already pointed out, the restriction against executive officers assuming directorship can be easily eluded to by refusing to adopt a collective executive organ (*Economica i Zhizn'*, No. 9, 1996, p. 38). According to Aukutsionek *et al.* (2003), who traced the evolution of the ownership structure of industrial enterprises in the transition period, it is highly likely that the management's share of company ownership was remarkably increased, while employees' shares were mostly distributed widely in small amounts from 1995 to 2003 (Table 9.6). This may have occurred because managers could buy shares from their employees by taking advantage of the pre-emption rights accorded them by closed companies.

Table 9.5 Variations of organizational form and corporate bodies of joint-stock companies

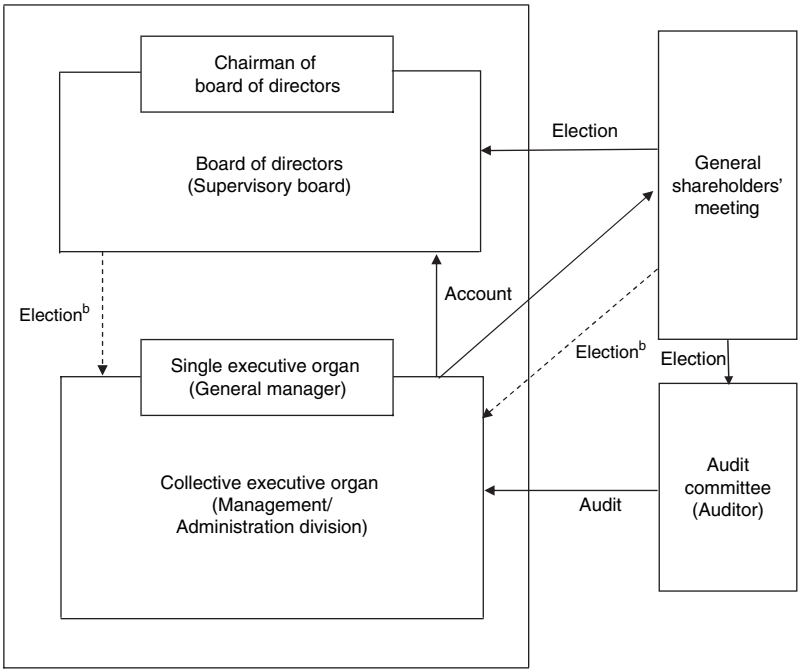
Organizational form	*Open joint-stock company*				*Closed joint-stock company*[a]		*Workers' joint-stock company (People's enterprise)*	
No. of shareholders with voting right	10,000 persons or more	1,000 or more but fewer than 10,000 persons	50 or more but fewer than 1,000 persons	Less than 50 persons	50 persons	Less than 50 persons	50 or more but not more than 5,000 persons	45 or more but fewer than 50 persons
Shareholders' meeting	○[b]	○	○	○	○	○	○	○
Board of directors (Supervisory board)	○ (9 persons)[c]	○ (7 persons)[c]	○	△	○	△	○ Supervisory board	△ Supervisory board
Single executive organ	○	○	○	○	○	○	○	○
Collective executive organ	△	△	△	△	△	△	×	×
Audit committee (Auditor)	○	○	○	○	○	○	○ (Control committee)	○ (Control committee)

Notes

[a] Closed joint-stock companies which were established prior to the enactment of the Law on Joint-stock Companies and have over 50 holders of voting shares are subject to the same provisions for management and supervision as open joint-stock companies.

[b] The symbols in this table mean as follows: ○ – companies are required to set up an appropriate organ; △ – companies are permitted to opt to set it up or not; × – companies are not expected to set it up.

[c] The numbers in parentheses are the minimum numbers of directors specified by Article 66(3) of the Law on Joint-stock Companies. In other cases, the minimum number is five persons.



Notes
[a] The case with the board of directors and collective executive organ.
[b] The menbers of executive organs shall be elected by the general shareholders' meeting or the board of directors in accordance with the articles of incorporation (Law on JSC Art. 69(3)).
Source: Based on Fukao & Morita (1997), p. 62.
Figure 9.2 Interrelationships between corporate bodies of joint-stock companies[a]

Adaptation of a collective executive organ requires amendment of the company's articles. The resolution of the general shareholders' meeting on this matter has to be adapted by a qualified majority. Such a resolution comes into effect when holders of a majority of issued voting shares are present and not less than three-quarters of all votes are affirmative. Thus, it is not uncommon for management to conspire with affiliated companies and their employees to prevent external investors from demanding the enforcement of control over corporate management. It is also possible that an executive officer as a major shareholder might appoint a person under their influence to the position of chairman of the board of directors. There have been some interesting opinions raised in this respect. For example, Torkanovskii (1997) pointed out that the

Table 9.6 Evolution of ownership structure of industrial enterprises, 1995–2003 (%)

	1995	*1997*	*1999*	*2001*	*2003*
Insiders, total	54	52	50	50	50
Managers	11	15	15	19	25
Workers	43	37	34	28	22
Affiliated firms	–	–	1	3	3
Outsiders, total	37	42	42	42	45
Outside individuals	11	15	20	22	21
Other enterprises	16	16	13	12	15
Commercial banks	1	1	1	1	1
Investment funds	4	4	3	3	2
Holding companies	4	4	3	4	5
Foreign investors	1	2	2	0	2
The state	9	7	7	7	4
Total	100	100	100	100	100
Number of surveyed enterprises	136	135	156	154	102

Source: Aukutsionek *et al.* (2003), p. 4.

directors of privatized enterprises are in reality subordinates under the direct influence of the president. Iontsev (2002, pp. 102–3) noted that the most common form of management system in Russia is currently the general shareholders' meeting – the board of directors – the single executive organ model, and that even at companies with a collective executive organ, the purpose of setting up this body is not clearly recognized in many cases.

In major industrialized countries, the systems of corporate governance can be divided into two types: 'a two tier system' where the executive function is separated from the supervisory function and 'a single tire system' where a single organ assumes both these functions (Oda, 2002, p. 121). In the case of Russia, the governance system can be characterized as a kind of 'hybrid' (Polkovnikov, 2002): it is not as independent as supervisory organs in German joint-stock companies, but it is more independent than those found in Anglo-American joint-stock companies. However, if the aforementioned legal loopholes and the insider-controlled ownership structure remain in their current state, it is very doubtful that this 'hybrid' system will effectively prevent executive officers from opportunistic management.

Shareholders' rights and their scope

The Law on Joint-stock Companies draws clear lines around corporate organs in terms of competence (Torkanovskii, 1997). Subjects of resolutions adopted during general shareholders' meetings are limited to legal matters and any other matters specified in the articles of incorporation. In addition, it is prohibited to delegate exclusive competence to the board of directors, not to mention the executive organs, although there are some legal exceptions (Law on JSC, Art. 48(2)). However, the board of directors and the executive organs are also given a great deal of authority. The allocation of power to these corporate bodies is summarized in Table 9.7. Because of limited space, we will now move on to the scope of exclusive competence of shareholders, an issue that is especially important for the governance design of joint-stock companies, and specifically, (1) the election and remuneration of corporate officers, (2) managerial decisions, (3) the restrictions on the transfer of shares and voting right of individual shareholders, (4) the rights of minority shareholders, and (5) the right of litigation against defective resolutions by the general meeting of shareholders.

The election of directors and the early termination of their power are the exclusive competence of the general shareholders' meeting and items of resolution to be adapted by a simple majority (Art. 48(1), para. 4 and Art. 49(4)).[6] The relationship between the company and its directors is regulated on a private-law basis. This means that directors may be dismissed at any time by a simple majority at the general shareholders' meeting, regardless of justifiable reason, and remuneration paid to directors based on the resolution of the general shareholders' meeting shall not be considered as wages (Tikhomirov, 2001, pp. 278–9).[7] On the other hand, the competence to elect executive officers and terminate their power may be transferred to the board of directors in accordance with the articles of incorporation (Art. 48(1), para. 8). Such delegation often takes place in the case of large companies. Therefore, this matter will be discussed in the following section, along with the issue of the balance of power between the board of directors and executive organs.

Managerial decisions may be specified in the articles of incorporation as matters to be resolved by the general shareholders' meeting, as is the case in the United States and Japan. In addition to this, the general shareholders' meeting is initially empowered to make several important decisions on a company's affairs, including increasing its capital by issuing new shares, approving transactions with interested parties (*sdelki, v sovershenii kotorykh imeetsya zainteresovannost'*) and major

Table 9.7 Division of competence between corporate bodies stipulated by the law on joint-stock companies

Organ	*Item of competence (applicable article)*[a,b]
General shareholders' meeting	Amendment of articles following capital increase (Art. 12(2))*, Amendment of articles following capital decrease (Art. 12(3)), Merger (Art. 16(2))†, Absorption (Art. 17(2))†, New division (Art. 18(2))†, Branch offices (Art. 19(2))†, Reorganization into limited liability company or production cooperative (Art. 20(1))†, Issue of convertible bonds (Art. 33(2))*, Annual dividend (Art. 42(3)), Due date of dividend (Art. 42(4)), Amendment of articles (Art. 48(1), para. 1)†, Reorganization (Para. 2)†, Liquidation (Para. 3)†, Election of the board of directors and the early termination of their power (Para. 4), Issue of shares (Para. 5)†, Capital increase by raising the nominal value of share (Para. 6), Capital increase by issuing new shares (Para. 6)*, Capital decrease by lowering the nominal value of share or by acquiring shares for redemption (Para. 7), Election of the executive organs and the early termination of their power (Para. 8)*, Election of the audit committee (auditors) and the early termination of their power (Para. 9), Approval of the external auditor (Para. 10), Approval of the annual report, balance sheet, and profit and loss report (Para. 11), Inter aggregation committee and the early termination of their power (Para. 13), Division and consolidation of shares (Para. 14), Approval of transactions with interested parties (Para. 15)*, Approval of major transactions (Para. 16)*, Acquisition of own shares by the company (Para. 17)†*, Participation in holding companies and financial industry groups (Para. 18), Approval of internal rules on corporate bodies (Para. 19), Determination of numbers of the vote aggregation committee (Art. 56(1)), Directors' remuneration (Art. 64(2)), External entrustment of the single executive organ's authority (Art. 69(1)), Audit committee's (auditors') remuneration (Art. 85(1)), Request for audit of financial and managerial activities (Art. 85(3))**
Board of Directors (Supervisory board)	Amendment of articles following capital increase (Art. 12(2))*, Approval of report on acquisition of shares for capital decrease (Art. 12(3)), Amendment of articles after opening/closing branches and affiliates (Art. 12(5)), Proposal on merger-related matters to the general shareholders' meeting (Art. 16(2)), Proposal on relevant matters to the general shareholders' meeting when absorbing any other companies (Art. 17(2)), Proposal on new-division-related matters to the general shareholders' meeting (Art. 18(2)), Proposal

on branch-related matters to the general shareholders' meeting (Art. 19(2)), Proposal to the general shareholders' meeting on matters related to reorganization into limited liability company or production cooperative (Art. 20(2)), Proposal to the the general shareholders' meeting on matters related to liquidation and appointment of the liquidation committee (Art. 21(2)), Issue of convertible bonds (Art. 33(2))*, Determination of value of assets involved in investment in kind at new issue of shares (Art. 34(3)), Determination of public subscription price for shares (Art. 36(1)), Determination of public subscription price for securities (Art. 38(1)), Proposal to the general shareholders' meeting on matters under Article 48(1), paras. 2, 6, & 14 to 19 (Art. 49(3)), Selection of items on the agenda of the general shareholders' meeting (Art. 53(5)), Nomination of candidates for corporate organs (Art. 53(7)), General leadership in corporate management except for exclusive competence of the general shareholders' meeting (Art. 64(1)), Determination of priority direction for corporate management (Art. 65 (1), para. 1), Convocation of the general shareholders' meeting (Para. 2), Approval of the agenda of the general shareholders' meeting (Para. 3), Preparation for the general shareholders' meeting (Para. 4), Capital increase by issuing new shares (Para. 5)*, Issue of bonds and other securities (Para. 6)*, Determination of price for assets and purchase price for issued securities (Para. 7), Acquisition of own shares, bonds and other securities by the company (Para. 8)*, Election of the executive organs and the early termination of their power (Para. 9)*, Recommendation to the general shareholders' meeting on remuneration of the audit committee (auditors) members and the external auditor (Para. 10), Recommendation to the general shareholders' meeting on dividend and way of allocation (Para. 11), Utilization of reserve funds and other funds (Para. 12), Approval of internal documents (Para. 13),
Establishment of branches and affiliates (Para. 14), Approval of major transactions (Para. 15)*, Approval of transactions with interested parties (Para. 16)*, Approval of the roster administrator and conclusion/cancellation of contract with them (Para. 17), Election of the chairman of the board of directors

Table 9.7 (Continued)

Organ	*Item of competence (applicable article)*[a,b]
	(Art. 67(1)), Proposal to the general shareholders' meeting on external entrustment of authority of the single executive organ (Art. 69(1)), Signature of contract with executive officers (Art. 69(3)), Permission for executive officers to work for other companies concurrently (Art. 69(3)), Election of the extraordinary single executive organ and convocation of the extraordinary shareholders' meeting for election of the single executive organ (Art. 69(4)), Election of the extraordinary collective executive organ and convocation of the extraordinary shareholders' meeting for election of the collective executive organ (Art. 70(2)), Request for audit of financial and managerial activities (Art. 85(3))**, Prior approval of annual report (Art. 88(4))
Executive Organ	Matters related to leadership in daily corporate management except for exclusive competence of the general shareholders' meeting and the board of directors (Art. 69(2)), Organization of the collective executive organ's meeting by the single executive organ (Art. 70(2)), Signature of documents resolved by the collective executive organ and the minutes of the collective executive organ's meeting by the single executive organ (Art. 70(2))

Notes

[a] The items of competence are not strictly and completely translated from the Law on Joint-stock Companies.

[b] The symbols denote as follows: † – subject of resolution of the general shareholders' meeting to be adapted by a qualified majority; * – competentce which may be delegated to the board of directors if the general shareholders' meeting resolves so, or the articles of incorporation specify so; and ** – matters under the competence of the general shareholders' meeting shared with the board of directors.

Source: Based on Dunaevskii *et al*. (2002), pp. 182–4 and Ignatov & Filimoshin (2002), pp. 119–21.

transactions (*krupnye sdelki*) involving the acquisition or disposition of assets equivalent to not less than 25 per cent of the company's total assets, and deciding on the purchase of the company's own stock, as shown in Table 9.7. Moreover, as already mentioned, the exclusive competence of the general shareholders' meeting may not be delegated to the executive body. Essentially, shareholders in Russia have relatively extensive voting rights on managerial decisions.

In restricting the transfer of shares, there is a large variance between open and closed joint-stock companies. Open companies are prohibited by Article 7(2) of the Law on Joint-stock Companies from specifying in the articles of incorporation that the company and shareholders have the right to pre-empt transferred shares. On the other hand, any shareholder of a closed company that intends to assign his/her own shares must notify in writing the company and all other shareholders involved of his/her intention at his/her own cost, and ask whether the other shareholders wish to exercise their right of pre-emption. If the assigning shareholder fails to do so, the company and other shareholders may file a complaint against the shareholder to make that transfer invalid (Art. 7(3)).[8] With regard to restrictions on the voting rights, however, the Law on Joint-stock companies is generous. For instance, regardless of organizational form, the company is empowered to set ceilings for the number and total nominal value of shares per holder in the articles of incorporation (Art. 11(3)). In practice, many cases of employing such measures have been reported. OAO Nizhneenergo, for example, limits the maximum number of shares per holder to 0.5 per cent of the nominal capital, while AO Sverdlovenergo and AO Samarenergo limit it to 1 per cent. The articles of incorporation of OAO Surgutneftegaz contain the provision that the number of voting shares per holder shall be limited to at most 1% (Shitkina, 1998).

Provisions for protecting minority shareholders and filing complaints against the general shareholders' meeting for defective resolutions, which are almost taken for granted in major industrialized countries, were actually introduced into Russia when the Law on Joint-stock Companies was enacted in 1996. The current law provides for the following rights to be accorded to minority shareholders, with stipulated requirements of holding shares: a requirement of holding 10% shares applies to the right to demand the convocation of an extraordinary shareholders' meeting (Art. 55(1)) and the right to demand an audit on corporate management (Art. 85(3)). A 2% requirement applies to the right to make a proposal for the general shareholders' meeting and the right to nominate a candidate for the executive (Art. 53(1)). A 1%

requirement applies to the right to file a suit on behalf of shareholders (Art. 71(5)) and the right to inspect the list of shareholders qualified to attend the general meeting (Art. 51(4)). Regardless of the number of shares held, shareholders are also entitled to file a suit before the court within six months to revoke a resolution passed at a general shareholders' meeting or declare the meeting null and void (Art. 49(7)). Moreover, the following measures were introduced in part to protect minority shareholders:

(1) Cumulative voting system to elect the members of the board of directors (Art. 66(4)).[9]
(2) The obligation to propose the unlimited purchase of shares and convertible bonds held by existing shareholders, which is applicable to those who intend to obtain not less than 30 per cent of the issued common shares (Art. 80).

These rights have been expanded and reinforced by revising the Law on Joint-stock companies step by step.[10] This process is also regarded as an active reaction from the legislature to society's need for effective countervailing power against management (Shitkina, 1998; Tikhomirov, 2001, pp. 330–2; Shapkina, 2002, pp. 6–7).

Division of power between the board of directors and the executive organs

As previously stated, the Law on Joint-stock Companies adapts the governance model described as 'diarchial leadership,' which prohibits one person from serving as both the chairman of the board of directors and the single executive organ at the same time. It goes without saying that the general shareholders' meeting is the supreme entity of the company. Moreover, the general shareholders' meeting in Russia has a relatively robust legal status by international standards, which has been secured by the extensive rights to vote on managerial decisions. Nevertheless, as in many other advanced countries, the general shareholders' meeting in Russia has been gradually losing substantial power (Torkanovskii, 1997). Hence, when controlling the conduct of business affairs in practice, the following two factors are particularly essential: (1) the allocation of authority to the board of directors and the executive organs, and (2) the contract relationship between the company and its executive officers.

As Table 9.7 shows, the Law on Joint-stock Companies empowers the board of directors to make many important managerial decisions.

Moreover, their decision-making rights may not be delegated to the executive organs (Art. 65(2)). This provision ensures that the board of directors may take 'general leadership in corporate management' (Art. 64(1)). However, it is illegal for all business affairs of the company to be added to the competence of the board of directors in the articles of incorporation, as the executive body plays a leading role in corporate management (Karabelinikov, 2001, p. 24). Moreover, Sergeev *et al.* (2005) espouse a stronger opinion, namely, that the board of directors has no right to have direct intervention in 'leadership in daily corporate management' (Art. 69) delegated to executive organs. Therefore, the main functions of the board of directors are limited to (1) personnel management of executive officers, (2) supervision over and advice on business affairs, and (c) decisions on management strategies (Torkanovskii, 1997). With respect to the competence and functions of the executive organs on the other hand, the current law contains no specific provisions other than the provision that when both single and collective executive organs are simultaneously set up, the authority of the latter must be specified in the articles of incorporation (Art. 69(1)). As a result, the Law on Joint-stock Companies substantially leaves this matter to the discretion of the company.[11]

The above-mentioned allocation of power is likely to bring about a conflict between the board of directors and the executive organs with regard to the business affairs of the company. In fact, it has already surfaced as a problem. For instance, Ignatov & Filimoshin (2002, p. 170) reported that boards of directors have been unable to obtain sufficient and reliable information on corporate management owing to conflicts with their respective company presidents. As a result, these directors could not make a proper judgment on matters under their competence. To cope with this situation, which was not foreseen at the time of the Law on Joint-stock Companies was enacted, the legislative authorities emphasize the explicit accountability of the executive organs to report any problems to the general shareholders' meeting and the board of directors (Art. 69(1)). However, this is not a sufficient solution. Hence, as pointed out by many Russian researchers, it is vital when designing governance systems to specify in the articles of incorporation and the company's internal documents the division of authority between the board of directors and the executive organs.

Another situation that the drafters of the Law on Joint-stock Companies did not initially foresee is the contract relationship between the company and its executive officers. According to the Law on Joint-stock Companies, this relationship can be treated like an entrustment

between the company and its executive officers, which is underlined by the right of arbitrary dismissal of executive officers given to the general shareholders' meeting and the board of directors (Art. 69(4)). This idea is also emphasized by the limited application of the labor law to the relationships between the company and its executive officers without prejudice to the Law on Joint-stock Companies (Art. 69(3)).

Nevertheless, the company's unilateral cancellation of the contract on the grounds of these provisions is neither supported by precedent nor does it have widespread support in Russia, a country where labor rights have been traditionally respected (Kondratov, 1998; Glazyrin, 1999b; Karabelinikov, 2001). From a Russian perspective, the relationships between the company and its executive officers are essentially labor relations. Thereof, an officer who complains about the company's decision on his/her dismissal is entitled to claim the protection of labor rights before the court (Bakshinskas *et al.*, 1999, p. 193). In practice, when the former president of a company claims that his/her dismissal while in office should be nullified, the hearing is concluded in almost all cases by the company 'purchasing an agreement on voluntary resignation' from the plaintiff (Karabelinikov, 2001, pp. 21–3). Hence, the company must enter into a labor contract with executive officers. If the company annuls the contract on grounds that contain neither an illegal action nor an illegal inaction by that officer, the company is obliged to pay a certain amount of compensation to the officer (Labor Code, Art. 279). In this way, the principle of the Law on Joint-stock Companies, which places the general shareholders' meeting and the board of directors above the executive organs in the hierarchy, seems to be partially in conflict with labor law.

Whomever the right of election belongs to, the contract between the company and its executive officers must be signed by the chairman of the board of directors (Law on JSC, Art. 69(3)). The period of contract shall be no longer than five years (Labor Code, Art. 58). The board of directors is empowered to determine the remuneration of executive officers on the basis of the right to sign the contract.[12] Although there is no legal ceiling, the remuneration of executive officers is actually determined to be several times as high as that of general employees in many companies (Glazyrin, 1999b). It is also reported that similar provisions to 'golden parachutes' in the United States are often written into the labor contract between large enterprises and their managers in Russia (Karabelinikov, 2001, p. 24). This applies, unless the remuneration of executive officers is not subject to the approval of the general shareholders' meeting. That is why the responsibility of the board of directors

is critically important. From the angle of corporate governance, it raises the major issue of how to secure incentives for outside directors to control the remuneration of executive officers along with the aforesaid issue of how to coordinate the balance of power between the board of directors and the executive organs through the articles of incorporation and internal documents.

Internal control over corporate management

The audit committee (auditors) and external auditor (*auditor*) are legally required to continuously check corporate management by executive organs together with the board of directors (supervisory board). The audit committee carries out a preliminary review of financial statements submitted to the general shareholders' meeting. It also undertakes extraordinary inspections of financial and managerial activities at the request of the general shareholders' meeting, the board of directors, and shareholders who holds no less than 10% of voting shares (Law on JSC, Art. 88(3) and Art. 85(3)) (Tikhomirov, 2001, pp. 346–50). The audit committee is also entitled to convene an extraordinary shareholders' meeting or a meeting of the board of directors (Art. 55(1) and Art. 68(1)). The election and remuneration of auditors are exclusively under the competence of the general shareholders' meeting. By law, the number of auditors and the rules for their activities must be specified in internal documents to be determined by the general shareholders' meeting (Art. 85(1) and (2)). Moreover, in order to secure the independence of the audit committee, auditors are prohibited from holding the post of director or any other officer of the company, and from exercising the right of voting of shares held by executive officers of the company on the election of auditors (Art. 85(6)).

Thus the audit committee, as a subordinate agency of the general shareholders' meeting, is expected to play a leading role in internal audits. However, according to observations made by Russian jurists and legal practitioners, the role of the audit committee in any company is 'obsequiously small' (Dunaevskii *et al.*, 2001, p. 317) and it is 'extremely rare to find such an audit committee able to act in an effective way.' Rather, in reality, an ordinary auditor usually appears suddenly on the eve of the regular general shareholders' meeting and 'will be never seen by anyone else for one year after reading the audit report at the meeting' (Iontsev, 2002, p. 203).

In relation to this situation, the following factors should be pointed out: (1) insider ownership is dominant; (2) the internal audit system only has a short history; and (3) the number of auditors falls short of what

is required. Since these problems cannot be easily solved, companies have little choice but to depend on external auditors selected by the general shareholders' meeting from among the licensed auditors and audit organizations for much of the company's internal audit, at least for the time being (Art 86).[13]

Article 7 of the Law on Accounting Audit Activities outlines the annual accounting audit requirements for open joint-stock companies, financial institutions, and enterprises/ entrepreneurs whose annual sales are not less than 500,000 times as much as the official minimum monthly wage or whose balance of assets is not less than 200,000 times that amount. Following the development of the private sector and the expansion of demand for approved accounting audit practices, the market of audit services in Russia grew at a rapid pace. In fact, the total gross sales of the 150 largest audit groups, which comprise about 50 per cent of the market, increased 2.9 times from about 6.8 billion rubles in 2000 to around 20 billion rubles in 2004 (*Ekonomika i Zhizn'*, No.14, 2001, p. 27; Barabanova & Krashchenko, 2005). Table 9.8 is an aggregate of the business performance of the top audit groups in 2004. The majority of these leading audit firms is based in Moscow, and many of them have expanded their services to include consulting. Furthermore, foreign affiliates actively take part in this market and compete intensely with one another for large clients who wish to attract foreign investment or issue bonds overseas. Thus, audit firms have steadily met the needs of domestic enterprises. Nevertheless, it is clear that, as the total number of professional staff in 150 large audit firms in 2004 was not above 12,000, the present pool of audit services is too small to supply the Russian corporate sector with a high-quality service, although this number represents a large increase from 7,600 in 2000.[14] Moreover, unlike audit committees, which have direct control over financial and managerial activities, external auditors are limited to scrutinizing financial statements and expressing their technical opinions on the reliability of these statements (Dunaevskii *et al.*, 2001, p. 317). In addition, it has been pointed out that the Law on Accounting Audit Activities and related regulations have so many shortcomings that they do not effectively prevent low-quality auditing services from practicing (Chumakov, 2004). Based on these factors, it can be said that the internal control of Russian joint-stock companies is still fragile and involves many problems in terms of corporate governance and the protection of minority shareholders. As a result, many people are asking whether the internal audit system for joint-stock companies in Russia is actually effective.

Table 9.8 Performances of 150 largest audit groups in Russia, 2004

(a) Locations of head offices of top 30 groups and their business performances and no. of consultants

Rank	*Group Name*	*Location*	*(000 rubles)*	*Sales increase*[a] *(%)*	*No. of consultants*[b]
1.	Pricewater houseCoopers	Moscow	3,611,018	9.8	817
2.	Deloitte	Moscow	1,709,721	66.5	589
3.	BDO IUnikon	Moscow	1,074,836	43.4	584
4.	FBK (PKF)	Moscow	735,656	24.3	390
5.	Rosekspertiza (MRI)	Moscow	702,328	33.5	327
6.	PCM Top-Audit	Moscow	694,331	40.3	456
7.	2K Audit - Delobye konsul'tatsii	Moscow	560,592	1.4	163
8.	BKR-Interkom-Audit	Moscow	497,910	250.0	512
9.	Razvitie biznes-sistem	Moscow	463,182	89.8	190
10.	Fin Ekspertiza	Moscow	459,148	46.0	287
11.	HLB Vnesh Pakk Univers	Moscow	444,806	33.0	201
12.	Gorislavtsev i K. Audit	Moscow	438,245	53.9	235
13.	MOOP STIVENS BalEN	Moscow	437,752	22.4	258
14.	Rufaudit Alliance (JPA International)	Moscow	399,471	109.3	268
15.	EKFI	Moscow	385,088	10.4	184
16.	Enerdzi Consulting	Moscow	357,503	4.7	86
17.	CB-Audit	Moscow	305,827	73.2	92
18.	Horwath MKPTSN	Moscow	304,416	36.5	220
19.	Marka Audit	Moscow	283,268	36.2	72

(b) Breakdown by location

Location of head office	*No. of groups*	*Share (%)*
Moscow	79	52.7
St. Petersburg	17	11.3
Ekaterinburg	6	4.0
Kazan	4	2.7
Ufa	4	2.7
Krasnoyarsk	3	2.0
Novosibirsk	3	2.0
Tymeni	3	2.0
Chelyabinsk	3	2.0
Others	28	18.7

(c) Sales ranking

Category	*Sales (000 rubles)*	*Share (%)*
Top 1 groups	3,611,018	18.1
Top 5 groups	7,833,559	39.3
Top 10 groups	10,508,722	52.7
Top 25 groups	15,314,693	76.7
Top 50 groups	17,946,955	89.9
Top 100 groups	19,412,066	97.3

Table 9.8 (Continued)

(a) Locations of head offices of top 30 groups and their business performances and no. of consultants

Rank	*Group Name*	*Location*	*(000 rubles)*	*Sales increase*[a] *(%)*	*No. of consultants*[b]
20.	Chto delat′ Konsalt	Moscow	279, 806	11.2	251
21.	Institut problem predprinimatel′stva	St Petersbrug	259, 861	1.4	261
22.	Sovteks	Moscow	247, 301	249.3	63
23.	Neksia Pacholi Marillion	Moscow	238, 320	18.8	150
24.	Ekfard	Novosibirsk	216, 907	117.8	97
25.	Nalogovoe biuro	Moscow	207, 400	88.5	79
26.	Beiker Tilli Rusaudit	Moscow	205, 062	−10.2	115
27.	Audit - nobye tekhnologii	Moscow	193, 012	466.7	194
28.	MKD (PKF)	St Petersbrug	191, 619	52.1	117
29.	Sovremennye biznes-tekhnologii	Moscow	187, 075	59.9	75
30.	BMK	Moscow	153, 412	*n/a*	194

(b) Breakdown by location

Location of head office	*No. of groups*	*Share (%)*
Top 150 groups	19,955,301	100.0

(d) Business services

Business services	*Share (%)*
General accountancy	40.4
Tax/legal consulting	19.8
Financial administration	10.2
Information technology	9.2
Assets assessment	8.9
Management/ organization strategies	7.2
Others	4.3

Notes
[a] Compared with the previous year.
[b] The annual average value.
[c] Including business performances in other CIS countries.
Source: Based on Barabanova & Krashchenko (2005), pp. 132–5.

The legal specificity of privatized enterprises and workers' joint-stock companies (people's enterprises)

The preceding section has described the standard type of the joint-stock company. In Russia, however, there are two groups of enterprises that deviate from the standard as a result of the country's socialist past and its current transition to a market economy. They are privatized enterprises and workers' joint-stock companies (people's enterprises). This section will expound on the legal peculiarity of each of these groups and compare it with the governance structure of the standard model of joint-stock company.

Privatized enterprises

By law, government agencies or local governments may not become the founder of a joint-stock company (Law on JSC, Art. 10(1)). The only exception to this rule is an open joint-stock company founded on the basis of a state or municipal enterprise. In July 1992 the federal government determined as the first step to the privatization of national assets that state or municipal enterprises with 1,000 or more employees or with fixed capital greater than 50 million rubles on 1 January 1992 must be converted to open joint-stock companies.[15] However, the presidential decree of 16 November 1992 reserved the right of fixed possession of voting shares, and the right to introduce 'golden shares' (*zolotaya aktsiya*) which accorded the government special management rights. The government aimed to maintain its political influence on leading enterprises, so the decree targeted privatized enterprises in specific industries, including the producers of energy, precious metals, munitions, and alcoholic beverages. According to official statistics, 29,591 open joint-stock companies were created within the framework of the privatization policy between 1993 and 2004 (Table 9.9). Of them, 1,707 companies (5.8%) were subject to golden shares. In addition, as Table 9.10 shows, since 1 July 2004, the Federal State has owned stock in 3,905 open joint-stock companies, including 1,253 industrial firms, and the ownership share of the Federal State in 1,955 companies (50.1 per cent) exceeds 25 per cent. According to the Law on Joint-stock Companies, laws and ordinances concerning privatization beyond the scope of the Law on Joint-stock companies apply to joint-stock companies in which the government holds 25 per cent or more of the shares or to which golden shares are applicable (Art. 1(5)). In other words, special attention should be paid to the legal status of joint-stock companies transformed from state or municipal enterprises, if the federal government or local administration

Table 9.9 Transformation process from state and municipal enterprises to open joint-stock companies, 1993–2004

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
No. of open joint-stock companies	13,547	9,814	2,816	1,123	496	360	258	199	125	125	314	414
Former federal-owned enterprises	5,419	4,921	1,326	538	180	101	31	36	11	10	159	121
Former federal-region-owned enterprises	6,028	3,744	859	393	221	178	203	138	93	94	120	214
Former local-government-owned enterprises	2,100	1,149	631	192	95	81	24	25	21	21	35	79
Total amount of share capital (million rubles)[a]	503	755	585	526	338	4,431	2.183	1.970	1.451	1,029	9,767	5,087
Companies with special preference (Golden shares)	204	792	429	132	58	28	42	8	2	1	10	1

Note: a Figures in 1993–2000 are in billions of rubles.
Source: Goskomstat RF (2000), p. 295; Rosstat (2004), p. 177; Rosstat (2005a), p. 179

Table 9.10 Composition of open joint-stock companies under federal ownership by industry and ownership share, as of 1 July 2004

	No. of firms	Share (%)
Total no. of open joint-stock companies	3,905	100.0
Production sector	2,124	54.4
Industry	1,253	32.1
Machine building	209	5.4
Light industry	15	0.4
Food industry	40	1.0
Construction materials	20	0.5
Metallurgy	32	0.8
Chemistry	18	0.5
Agriculture	43	1.1
Forestry	15	0.4
Transportation and communication	356	9.1
Construction	457	11.7
Non-production sector	1,781	45.6
Ownership share (%)[a]		
100	273	7.0
50–99	499	12.8
25–49	1,183	30.3
less 25	1,950	49.9

Note: [a] Subscription rate of the federal state in total share capital.
Source: Prepared by the author based on the governmental order of 26 August 2004: 'Approval of the 2005 privatization prediction plan (program).'

still holds one-quarter or more of the company's shares or a golden share as a result of delayed privatization or political intention.

Normally, government representatives will be sent from the competent administrative authority to the managerial and supervisory organs of these privatized enterprises that are subject to the government's fixed possession of shares. The post of government representative is usually assumed by the minister or a high-ranking official of the competent authority. The representative, who will attend a meeting of the board of directors, does not need to be appointed at the general shareholders' meeting. Moreover, the government or the competent authority may replace the representative at its discretion (Iontsev, 2002, p. 32). The representative will also be sent to the general shareholders' meeting and the audit committee. The exercise of his/her rights is conducted, as a rule, in accordance with the Law on Joint-stock Companies.

The use of golden shares can give the government more control than in the case of the fixed possession of shares mentioned above. According to the Law on Privatization of State and Municipal Assets enacted on 21 December 2001 (henceforth the Privatization Law), golden shares may be introduced when not less than 75 per cent of shares are privatized. Adoption and abolition of golden shares are determined by the government or the competent authority (Privatization Law, Art. 38(5)). The federal government and the local administration may not apply golden shares concurrently to a specific privatized enterprise. In addition, local governments are prohibited from introducing golden shares into an open joint-stock company established on the basis of a state enterprise under the jurisdiction of the federal government (Art. 38(1)).

Joint-stock companies into which golden shares are introduced have to secure a permanent post for a government representative on the board of directors and the audit committee. The representative is entitled to make proposals to the general shareholders' meeting; convene an extraordinary shareholders' meeting; and exercise the power of veto on the amendment of articles, reorganization, dissolution, change to share capital, and resolutions of the general shareholders' meetings on major transactions and transactions with interested parties (Privatization Law, Art. 38(2) and (3)). Thus golden shares are a synonym for the above-mentioned special management right given to the government, but not for securities in real terms. Accordingly, the government is not expected to secure dividends or convert these golden shares to common shares.[16]

As we discussed above, it is obvious that whether the government possesses shares of not less than 25 per cent or whether golden shares are introduced can provide a key explanatory variable for the governance performance of privatized enterprises. As some economists have noted, there is plenty of scope for questioning the constant monitoring capability of the government into question on the ground that the Ministry of National Assets is not particularly competent in clerical processing, and government representatives do not generally have sufficient knowledge or skills in corporate management (Torkanovskii, 1999; Lyashchenko, 2001, p. 85). Nevertheless, the role of the government should not be disregarded in that the present institutional arrangements can directly reflect government interests in privatized enterprises and enable contingent governance (Aoki, 1994) to be considerably effective.

Workers' joint-stock companies (people's enterprises)

There are still thousands of enterprises in Russia whose ownership and management are internally controlled by employees, continuing

the tradition of 'labor sovereignty' cultivated in the socialist period. They include many industrial enterprises such as Podolsk Cable Factory (Moscow region), Kaluzhsk Meat Kombinat (Kaluga region), Tursk Paper Manufacturing Factory (Sverdlovsk region), Starooskolsk Metal Factory (Belgorod region) and Arkhangelsk Breadstuff Kombinat (Arkhangelsk region).[17] Against this background, the Law on the Specificity of the Legal Status of Workers' Joint-Stock Companies (People's Enterprises; henceforth, the Law on People's Enterprises), which took effect on 1 October 1998, was introduced by 12 Russian deputies representing all political parties and groups of the State Duma (Lower House) of the Federal Assembly. This somewhat ideological law was designed so that these worker-controlled enterprises could survive and spread because these companies are run under a system that is substantially different from that of standard closed joint-stock companies. There are a number of differences, including (1) the incorporation to capital management rules, (2) the structure and power allocation of the supervisory and executive organs, and (3) the election and remuneration of corporate officers. According to the Federal Statistical Office, the number of people's enterprises officially registered as of 1 October 2004 was 140; 42,000 workers engage in business at these companies, and their total sales in 2003 were around 12 billion rubles.[18] Although people's enterprises are definitely in the minority in the Russian business sector, they have a clear presence as a unique mass of middle-size enterprises in terms of number of workers.

The establishment of people's enterprises is limited to the reorganization of existing commercial organizations by the law governing people's enterprises, Art. 1(1).[19] Such enterprises are legally required to enter a written agreement between investors and employees (Art. 2(3)). The minimum capital is subject to the same limited amount imposed on open companies (1,000 times as much as the official minimum monthly wage) (Art. 4(7)). The company may not use preference shares for capital procurement and the nominal value of shares is limited to not more than 20 per cent of the official minimum monthly wage (Art. 4(1)). The number of shareholders is also limited to a ceiling of 5,000 persons (Art. 9(4)).[20]

The 'popular' nature of people's enterprises is especially embodied in the following provisions: a group of employees are required to obtain 75% of issued shares, which must be achieved within five to ten fiscal years of the establishment of the company depending on the share of external investors. However, the percentage of holding shares per employee may not exceed 5 per cent (Art. 4(2)). New share

issues intended to increase capital are to be distributed to all qualified employees in proportion to their annual wages. Recruits may also take part in new share issues after a certain period of service (Art. 5(2) and (3)). As for shares that are widely held by employees in small amounts, there are provisions for preventing their external diffusion (Art. 6): (1) the shares of people's enterprises may not be assigned to a third person, (2) dismissed employees and the families of deceased employees are obliged to sell all their shares to the company and/or employees, and (3) creditors are prohibited from seizing shares held by employees (Zernin & Mikryukova, 1999).

The specific nature of people's enterprises can be also found in the mechanism of management and supervision (Table 9.5). First of all, almost all matters under the competence of the general shareholders' meeting are resolved on the 'one shareholder, one vote' principle. They include important items concerning corporate management, such as the election and remuneration of corporate officers,[21] amendment of articles, reorganization, salaries of employees, and internal stock distribution (Law on People's Enterprises, Art. 5(4) and Art. 10(1)).[22] Even employees who do not hold any shares are guaranteed the right to have a voice at the general shareholders' meeting (Art. 10(5)). Second, the Law on People's Enterprises rejects the idea of 'diarchial leadership' by the board of directors and the single executive organ. The former is called only 'the supervisory board', which is, as a rule, chaired by the general manager (or president) (Art. 12(4)). In addition, when the percentage of non-shareholding employees exceeds 2 per cent in people's enterprises with a total of 1,000 employees or more, the general assembly of non-shareholding employees may send one representative to the supervisory board (Art. 12(7)). Third, the Law on People's Enterprises does not provide for a collective executive organ to be set up – the executive organ is legally limited to a single individual. And finally, the audit committee of the people's enterprise is responsible not only for inspecting financial and managerial activities but also supervising the protection of shareholders' rights and the fulfillment of internal rules (Art. 14(1)). The members of the committee are limited to only shareholding employees, who are entitled to have a voice at the meeting of the supervisory board (Art. 14(3) and (6)). Thus, the audit committee of the people's enterprise, as implied by its other name the 'control committee' (*kontrol'naya komissiya*), has much more power than that of the ordinary joint-stock company to enforce the direct monitoring system of corporate management by a labor collective (Glazyrin, 1999a).

The above-mentioned provisions, especially the limitation on investment by non-employee shareholders and the 'one shareholder, one vote' principal, are excessively biased towards the protection of employees' rights. As a result, it has been said of people's enterprises that 'its legal form of incorporation cannot be squeezed into that of joint-stock companies without distorting its essence' (Zernin & Mikryukova, 1999). Some people recognize that workers' possession of shares 'matches the mentality of Russians accustomed to the collective decision-making and behavior' (Lyashchenko, 2001, p. 79) and claim the management efficiency of the enterprise belonging to workers surpasses traditional state and private enterprises (Glazyrin, 1999a). From this point of view, the Law on People's Enterprises embodies the belief of some politicians and intellectuals that the spread of this unique form of corporate organization will contribute to (1) mitigation of social tension between the management and the working class in Russia, (b) improvement in labor incentives for increasing productivity, and (c) resolution of negative problems brought about by privatization policies (Tarasov, 1998).

Concluding remarks

In conclusion, we would draw the attention of researchers to the diversity of managerial and supervisory mechanisms related to Russian joint-stock companies. This diversity strongly suggests the possibility of variations in performance among joint-stock companies, even if other conditions such as ownership structure are the same. It is well-known that numerous studies have focused on the structure of ownership after privatization in connection with the problem of corporate governance in Russia to date. Needless to say, insider-dominated ownership structure is still very problematic. However, the above examination underlines that the formal structure of corporate organization needs to be given just as much analytical consideration.

Furthermore, there are a number of other significant issues related to this subject. According to two American jurists involved in preparing a draft of the Russian Law on Joint-stock Companies, this law advocates the creation of 'self-enforcing' corporate organizations as a fundamental principle for institutional design. It aims to create a legal code on corporate management that will be voluntarily observed by managers and large shareholders (Black & Kraakman, 1996). That is why the drafters made the Russian Law on Joint-stock Companies more explicit and elaborate than the corporate laws of any other emerging economies in terms of procedural protections to control the internal

decision-making process of the company. It is neither an 'enabling statute' which allows the wide discretion of the company nor a 'prohibitive statute' which strictly prohibits or limits various commercial acts in positive law.

Positive outcomes from their efforts appear in many aspects of the governance mechanism of Russian joint-stock companies, as outlined in this chapter. It should be noted that this type of law on joint-stock companies was adopted in Russia on the basis of a realistic view of unreliable and ineffective legal enforcement. Their judgment is quite right. However, as the aforementioned jurists themselves realize, it is even theoretically impossible to set out a completely self-enforcing joint-stock company legal framework, although it is possible to reduce dependence on the courts to some extent (Black & Kraakman, 1996). Unfortunately, this has been proved by repeated breaches of the Russian corporate law in recent years, for example, (1) shareholders not being notified of the date and agenda of the general shareholders' meeting, (2) board members not being re-elected at the general shareholders' meeting, (3) external investors being refused attendance at meetings of the board of directors on various pretexts, (4) financial audits by external auditors being prevented by the company and (5) procedures for resolution not being followed at the general shareholders' meeting (Starovoitov, 2001).

As factors that inhibit Russian joint-stock companies' ability to be sufficiently self-enforcing, it should be noted, together with a number of issues previously pointed out, that (1) legal enforcement is still weak even under the Putin administration, (2) organizations and institutions that complement the formal framework of the Law on Joint-stock Companies have not yet developed well, (3) directors and executive officers have a weak sense of morals in terms of business management, and (4) insider shareholders are not fully aware of their position as owners. It seems that these factors will continue to exert a major negative effect on the governance and performance of Russian firms for some time to come.

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Notes

1. This is mainly based on federal laws concerning various types of enterprises, including the Civil Code, Part I, Chapter 4 (Art. 48-115), the Law on Joint-stock Companies and the Law on the Specificity of the Legal Status of Workers' Joint-Stock Companies (People's Enterprises), dated 19 July 1998. The term 'current laws' means laws effective on 1 July 2005.
2. 'Share capital' denotes total amount of nominal value of shares acquired by shareholders that is specified in the articles of incorporation (*ustav*).
3. According to official statistics, the total number of industrial enterprises (organizations) is 151,000 entities in the end of 2004 (Rosstat, 2005a, p. 185).
4. The official minimum monthly wage is stipulated by the Law on Minimum Wages. According to the revised law dated 29 December 2004, it is 720 rubles per month with effect from 1 January 2005.
5. Before the Law on Joint-stock Companies came into force, the minimum of 1,000 times was uniformly applied to both types of company (Tikhomirov, 2001, p. 138).
6. The number of directors may be fixed in the articles of incorporation or resolved by the general shareholders' meeting. Their term is one year, or to be more accurate, until the date of the next general shareholders' meeting. Directors must be natural persons (not juridical persons) but do not need to be shareholders (Law on JSC, Art. 66). The chairman of the board of directors shall be elected by a single majority of directors (Art. 67(1)).
7. However, one who serves as both employee and director shall be remunerated for his/her performance as an employee under the labor contract. Therefore, that part of remuneration is not necessarily subject to the approval of the general shareholders' meeting and is beyond its control.
8. For details on the transfer of shares by shareholders in closed companies, see Shapkina (2004).
9. Before the revision of the law in February 2004, the cumulative voting system was compulsory only for companies with more than 1,000 stockholders.
10. For example, the revision in January 2002 included the provisions for: (1) abolition of the limitation on the number of proposals on the agenda of the general shareholders' meeting, (3) addition of the right to nominate a candidate for the executive organs, and (c) relaxation of the requirement of holding shares for inspecting the list of shareholders qualified to attend the general shareholders' meeting from 10% to 1%.
11. According to Sergeev *et al.* (2005), the term 'general leadership in corporate management' denotes legal actions based on the authorities for the coordination of internal relationships within a company; on the other hand, the term 'leadership in daily corporate management' means legal actions based on the authorities for the coordination of the company's external relationships. Hence, the concrete affairs of the former can include: (1) adoption of internal rules and regulations of the company and economic and financial guidelines

for corporate management and (2) supervision of executive organs as they execute the decisions made at the general shareholders' meeting or by the board of directors. On the other hand, the affairs of the latter can include (1) observance of the internal rules and regulations and accomplishment of management targets set by economic-financial guidelines, and (2) execution of transactions for corporate management.

12. As a result of the revision to the Law on Joint-stock Companies in January 2002, the item of remuneration for the service of executive officers was deleted from Article 65(1), which itemizes the authority of the board of directors. However, even after the revision, the right to sign the contract still belongs to the chairman of the board of directors and, therefore, the issue of remuneration is supposed to be a matter under the competence of the board of directors (Shitkina, 2002, p. 77).
13. The remuneration to external auditors shall be determined by the board of directors (Law on JSC, Art. 86(2)). Shareholders or officers of the company and those who have any relationship with or interest in the company shall not be qualified for this position (Iontsev, 2002, p. 204). External auditors, like the audit committee, are entitled to convene an extraordinary meeting of shareholders or a meeting of the board of directors (Art. 55(1) and Art. 68(1)).
14. Besides, the examination to qualify as an auditor in Russia is not particularly difficult. Almost all applicants can pass it 'if they are practiced in accounting for three years or longer and take a course of about one month' (Saito, 2003, p. 22). Hence the average auditor in Russia is generally less competent than licensed auditors in advanced countries.
15. See article 1 of the annex to the presidential decree dated 1 July 1992: 'Provisions for the Commercialization of State Enterprises Involving Simultaneous Reorganization into Open Joint-stock Companies.' Subsequently, in August 1998, it was made compulsory for all privatized enterprises with 25% or more of shares held by the government to convert to open joint-stock companies. Its consequences are as discussed in Subsection 9.3.1.
16. When golden shares were introduced by the presidential decree dated 16 November 1992, they were incorporated as voting shares into the nominal capital specified in the articles of incorporation of privatized enterprises and initially made convertible to common shares after the expiration. Their status was revised after the Law on Privatization of State Assets and Principal of Privatization of Municipal Assets came into force in July 1997 (See Article 5 of this law).
17. Data obtained from the website of the Russian Union of People's Enterprises (*http://www.rsnp.ru/*).
18. Ibid.
19. However, all unitary enterprises and open joint-stock companies, the worker's ownership share in which is less than 49%, are prohibited from becoming people's enterprises.
20. Moreover, the Law provides that the average number of workers in a people's enterprise through one financial year be no fewer than 51 people (Art. 9(1)) and the proportion of the average number of non-shareholder workers in the total number of workers be no more than 10 percent (Art. 2(2)) on year average. Therefore, the number of workers and shareholders in a people's

enterprise can fluctuate within the ranges of 51–5,500 and 45–5,000 people, respectively.

21. Besides, it is stipulated that the general manager (president) of the people's enterprise shall not be rewarded for his/her service in excess of 10 times the average salary of employees (Law on People's Enterprises, Art. 13(3)).
22. Subjects to be resolved on the 'one share, one vote' principle are limited to the five items; namely, (1) auditors' remuneration (Art. 10(1), para. 7); (2) approval of the method of determining purchase price for shares (Para. 9); (3) approval of financial statements (Para. 11); (4) approval of a priority management policy (Para. 13); and (5) liquidation (Para. 15).

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10

Corporate Ownership and Control in Russian Companies: Trends and Patterns

Tatiana Dolgopyatova

Introduction

Issues of corporate governance were first addressed in the middle 1990s, when voucher privatization was over, giving start to dynamic redistribution of property rights. At that time, attention was focused on predominance of employee ownership and on the managers, which had enough power to discriminate against outside owners (including foreign investors who were shocked by the habits of Russian corporate governance). Economic growth, which followed the financial crisis of 1998, gave start to a new wave of redistribution of property rights and revealed the problems in Russian corporations that were caused by loopholes in corporate legislation and enforcement. In the mid-1990s, a number of studies were launched and carried out with a special focus on issues related to corporate governance in the context of the patterns of private ownership emerging in Russian industry.

Importance of these problems was predefined by their crucial role in the Russian economy. On the one hand, corporate governance is a tool to protect ownership rights; this is why its quality reveals many institutional gaps in Russian reforms. On the other hand, it has an impact on companies' capabilities for finding financial support, restructuring, and investment.

According the mainstream economic theory, the key problem of corporate governance lies in separation of ownership and control and arises from divergence of interests between managers and shareholders. This problem was described in the 'principal–agent' model (Jensen & Meckling, 1976). Another approach to corporate governance offers a concept of stakeholders, which includes not only shareholders and managers, but also other financial and non-financial investors.

In this concept, the problem of corporate governance amounts to establishment of a balance of interests among all stakeholders (Tirole, 2001). This concept has something to do with the nature of Russian corporate control, where separation of ownership and control is absent, and authorities, and sometimes employees have strong influence on companies.

The purpose of this chapter is to analyze trends in development of stock ownership and its influence on the establishment of corporate control on micro level, taking into account different motivations of agents of corporate governance.

In conclusion, we present a model of concentrated insider ownership and corporate control in Russian companies. This chapter is based mostly on empirical data taken from both official statistical monitoring and surveys of enterprises carried out in 1999–2005.

The chapter starts with an overview of formation of joint-stock businesses in Russia. The next part identifies trends in redistribution of corporate ownership and control in the industry, along with finding out driving forces and institutional prerequisites for these changes. Further, we define qualitative characteristics of ownership and corporate governance in the contemporary Russia. The final part presents brief conclusions.

Emergence of corporations in Russia

The problem of finding a balance between interests of actors in corporate governance arises as soon as we look at stock ownership (in contrast to individual private property) and activities of joint-stock companies (JSCs). Voucher privatization was the main source of founding JSCs in the Russian transition economy. It predefined redistribution of property and patterns of corporate control in Russian enterprises for many years to come. Many papers analyze this influence (Berglöf & von Thadden, 2001; Black *et al.*, 2000; Fox & Heller, 1999; Radygin & Entov, 1999; Woodruff, 2003). Along with privatization, which since the mid-1990s had been carried out through selling enterprises case-by-case, there were other ways and means to establish or to destroy corporations:

- creation of start-ups in the form of joint-stock companies, in a prevailing form of closed JSCs;
- reorganization of privatized and private enterprises by means of mergers and takeovers, split-ups, etc.

We have also to pay attention to the fact that government is actually pursuing a policy of selective re-privatization. There are many ways to do it: to revise in court some privatization dealings that had violated the law or failed to meet requirements of investment tenders; to restructure a debt with subsequent return of shares to governmental bodies; to transfer the government's shares to state-run holdings; to arrange mergers and acquisitions in order to increase government participation in new companies. The latter two methods are widely used in the defense industry. Other schemes include increasing government share in a JSC stock in exchange for budget investment; changing the structure of authorized capital by evaluation of state-owned intellectual property; creation of new JSCs (mainly with participation of regional or municipal administration).

Developments in the corporate sector cannot be quantified in full because of flaws in current statistical practices of the Federal Service of State Statistics (FSSS). Monitoring of privatization is well developed. Statistical data show (FSSS, 2004a, 2000–2005) that there was a dramatic decline in privatization activity after 1995, especially in the industry. In 2000s, one out of 15 privatized entities was in the industry. During the mass privatization, this ratio was 1 to 4. In the era of privatization in 1992–2004, about 143,000 enterprises changed their ownership type, and more than 32,000 open JSCs were created anew. In recent years, the number of open JSCs being created each year has never exceeded 200–400 companies. Almost half of them are established as partially owned by federal, regional or municipal authorities.

The Unified State Registry data show (FSSS, 2004a, 2000–2005) that new enterprises are frequently founded but rarely liquidated. In the economy as a whole, net number of enterprises (adjusted for the number of liquidated entities) has been growing at approximately 6–8 per cent a year (4–5 per cent a year in the industry). However, the Registry is inaccurate and contains quite a substantial number of 'dead souls'. In the early 1996, the number of JSCs in the Registry was more than 51,000; as of January 01, 2005, it was 456,700. For the same date, the Federal Tax Service gave the number of actually operating JSCs in the economy as 168,583, including 5,516 companies under the procedure of liquidation (FTS, 2005).

The Federal Service on Financial Markets registers new stock issues and new JSCs. However, the Service does not possess comprehensive information on companies that were created before 1995 and does not publish consolidated data on the total number of share issuers in Russia.

The ongoing wave of reorganization makes it difficult to estimate the number of functioning corporations accurately.

At our disposal are outdated results of a one-time survey of JSCs dating from the era of privatization. The survey, which was conducted by Goskomstat as of 1 January 1996, covered more than 23,000 JSCs out of the total of 26,000 privatized enterprises. At that time, these JSCs provided employment for more than one fifth of total labor force, while the share of industry in total employment was 62 per cent. JSCs accounted for nearly three fourths of total industrial output, half of construction works, 26% of the transport sector, and had less than 5 per cent in trade and catering (Alimova *et al.*, 1997).

Additionally, aggregated data of annual structural surveys[1] demonstrate that about 32,300 joint-stock companies surveyed in 2003 produced 68 per cent of total output in the enterprise sector, of which 56 per cent were produced by open companies and 12%, by closed companies. JSCs hired about 50 per cent of employees, of which 39% were employed in open companies and 11 per cent, in the close ones (FSSS, 2004b).

Russia still retains a substantial number of JSCs with state (federal or regional) or local participation in ownership. In many companies, the state holds 100% of capital or a controlling block of shares. And issuance of a 'golden share' (exclusive right) to state shareowners gives them the right to set effective veto on strategic decisions. The exact number of entities partially owned by authorities is not known. By different estimates, there are about 3,700 JSCs with federal participation, and about 40,000–50,000 companies with participation of regional or municipal authorities. However, federal authorities own blocks of shares in the stock of the largest Russian companies: data of a structural survey (FSSS, 2004b) demonstrate that by the end of 2003, total share of authorities in the entire stock of all surveyed JSCs reached about 61 per cent (including 58 per cent belonging to the Federal government).[2] In open JSCs, this share was more than 63 per cent, and in closed companies, 4 per cent.

Evolution of corporate ownership as the basis for corporate control

Main trends in property redistribution: empirical evidence

Large-scale privatization has given birth to a great number of corporations, mostly in the form of open, i.e. formally public companies. Upon completion of the privatization program in the mid-1990s, corporate

property in Russia was characterized by high diffusion of ownership rights among major groups of holders, first of all, employees. For more than ten years after the end of mass privatization in Russia, incentives for redistribution of corporate ownership are still in force:

- stakes owned by all levels of government are decreasing as a result of privatization going on case-by-case;
- stakes owned by company management are growing against substantial reduction in the combined employees' share. If immediately after privatization, workers' teams could dispose of up to 60–70 per cent of shares, just 12–18 months later their joint share was reduced to a half of the stock capital;
- stakes owned by external non-state owners are growing, mainly because legal entities are expanding their participation in the equity: business integration has encouraged formation of holding companies. Successful Russian exporters have acquired large share packages;
- concentration of equity capital has become substantially higher.

Economic growth that followed the 1998 crisis was characterized by stronger property redistribution and concentration. In many cases ownership was transferred from company managers to outside businesses. Capital consolidation continued on the basis of expansion of private sector in the Russian economy (Deryabina, 2001; Dynkin & Sokolov, 2002; Pappe, 2002a). Powerful private business groups emerged, including not only national 'oligarch' groups that are the soapbox of mass media, but also regional and local groupings. As was shown in recent studies (Avdasheva, 2004; Dolgopyatova, 2004), integration is going on among small and medium companies as well, including establishment of groups in the course of restructuring of large privatized enterprises.

Dispersed employee property becomes a thing of the past, and its place is taken by highly concentrated corporate ownership of company managers or external investors representing private sector. The status of a dominant owner turns an outside shareholder into an 'insider', for such an owner takes a direct part in management or exercises tough control over the managers it has appointed (Dolgopyatova, 2003).

Surveys of the Russian industry may be of service to illustrate these trends. Actually, distortions are inherent to any formalized survey, which depends in its results on how representative the sample has been. Empirical data illustrate very well reduction in employee and state

property, as well as capital concentration, and the role of corporate integration. The most difficult thing is to identify the results of consolidation of ownership by companies' managers.

The largest study is the structural survey of FSSS. This survey is the only official source enabling us to observe distribution of combined chartered stock in industrial enterprises. Unfortunately, the available survey results (Table 10.1) refer not only to JSCs, but also to other legal forms. Four-year dynamics reveal that stakes of authorities of all levels and of individuals are contracting, and stakes of non-financial commercial organizations, as well as of financial institutions are increasing. Growing share of the latter is an indirect evidence of greater property intertwining among organizations.

We can use individual data from a panel sample of the structural survey for more accurate calculations (the average share was estimated by summing up the shares of each enterprise).[3] In general, trends in structural indicators (Table 10.2) were similar to the above-presented results based on aggregated data. As for the last point in time, enterprise employees prevail in chartered capital of these JSCs, followed by

Table 10.1 Breakdown of chartered capital of industrial enterprises at year end (% of chartered capital) [a]

Shareholders or founders	*1999*	*2003*	*Change in % points for 4 years*
Authorities – total, including:	18.5	12.4	−6.1
Federal authorities	10.4	7.8	−2.6
Authorities of Units of Federation	7.3	3.8	−3.5
Local authorities	0.8	0.8	0
Commercial organizations (except financial institutions)	41.6	65.6	+24.0
Financial institutions	3.2	9.3	+6.1
Not-for-profit organizations	4.3	1.4	−2.9
Individuals	20.1	11.4	−8.7
For reference: contributions by foreign legal entities and individuals [b]	6.6 (40.3)	11.0 (35.0)	+4.4(−5.3)

Notes
[a] Without small enterprises, includes JSCs and other legal forms.
[b] In brackets, only by enterprises with foreign interest.
Source: Based on Goskomstat RF (2000) and FSSS (2004b).

Table 10.2 Breakdown of stock capital of industrial JSCs from the panel sample at year end (% of stock capital)

Shareholders	*1999*	*2002*	*Change in % points for 3 years*
Federal authorities	4.7	3.4	−1.3
Authorities of Units of Federation	3.4	2.5	−0.9
Local authorities	1.4	1.0	−0.4
Commercial organizations (except financial institutions)	22.2	28.4	+6.2
Financial institutions	0.7	0.8	+0.1
Not-for-profit organizations	4.2	3.3	−0.9
Individuals	63.4	60.7	−2.7
including staff	44.9	38.0	−6.9
Total JSCs	100	100	–
For reference: contributions by foreign legal entities and individuals	2.9	3.6	+0.7

Source: Author's calculation based on Goskomstat RF primary data for 790 JSCs.

non-financial organizations and individual outside investors. By the end of 2002, private outside owners were represented in 78 per cent of the sample and had, on the average, more than 70 per cent of the stock. Employees were shareholders at 74 per cent of companies, owning half of their equity. Authorities, having 40 per cent of the authorized stock, were present at 21 per cent of the sample.

Another official source was a quarterly survey of 700–800 industrial enterprises conducted by the Center for Economic Conjuncture (CEC) under the Government of the RF. The data show that in 2002, external shareholders prevailed (i.e. owned more than 50 per cent of the equity) in 38 per cent of the sample against 32 per cent in 2000. Workers' teams and managers were predominant at 18 per cent of enterprises surveyed in 2002 in comparison with 22 per cent in 2000, and the state, in 7 per cent of enterprises against 9 per cent in 2000 (TsEK, issue 37, 2002; issue 29, 2000).

Now, we are coming up to discussing other surveys. After the 1998 crisis, such surveys were conducted by the SU-HSE in 1999 and 2002; by the Bureau of Economic Analysis (BEA), in 2000; by the Russian Economic Barometer (REB), every two years starting from 1995; by the

Institute for the Economy in Transition (IET), in 1999 and 2003; by the Institute for Social and Economic Problems of the Population (ISEPD) under the Russian Academy of Sciences nearly, every year starting from 1995; by the Center for Economic and Financial Research and Development (CEFIR), in 2002. The results of these surveys (Table 10.3) refer to different periods of time, and the samples are not always representative. But the surveys demonstrate the declining share of the state and ordinary employees in equity capital, and the growing share of outside owners (non-financial organizations) and managers.[4] The results obtained by the ISEPD stand somewhat apart because of specific features of its sample, which was limited to enterprises of defense industry.

Results of the surveys (Table 10.4) also give evidence for growing concentration that has been going on since the mid-90s. A survey of 304 open JSCs conducted by SU-HSE (Golikova *et al*, 2003) demonstrates that over 70 per cent of respondents believed that their enterprises already had an owner, who exercised control over the companies' activities. A survey of more than 600 industrial JSCs (Guriev *et al.*, 2003) shows that the share of the largest outside shareholder was about 24 per cent of the equity.

As a rule, in-depth interviews conducted on small samples demonstrate that concentration of property is much higher than could have been reflected in formalized surveys. In the majority of cases, top-managers are dominant owners of businesses (Dolgopyatova, 2001, 2004; Yasin, 2004).

Thus, a comparison of corporate ownership structures in the 2000's as they were derived from statistical and survey data identifies the role of financial and foreign investors is minor. The main owners are legal entities and employees (managers) of the enterprises. Consolidation of equity capital in the hands of the largest owners who are gaining control over the companies' business is continuing.

Property redistribution: incentives and institutional conditions

Corporate ownership was initially created in a form of diffused ownership rights for capital of public companies, and Russian regulatory base was built as a system of standards and rules oriented at this type of structure (Yakovlev, 2004). Motivations of economic agents changed the course of events. In a poor institutional environment, Russian companies moved to the expected way of emergence of large shareholders (Stiglitz, 1999). Driving force of redistribution is gaining legitimate control over corporations, based not only on access to operational management, but also on concentration of property in the hands of an owner (or a stable coalition of owners).

Table 10.3 Structure of equity capital of industrial JSCs according to independent survey data

Shareholders	*SU – HSE – 1*[a]		*BEA*[b]		*REB*[c]		*ISEPD*[d]	
	% share, end of 1998	*Change in % points*	*% share, beginning of 2000*	*Change in % points*	*% share, beginning of 2003*	*Change in % points*	*% share, beginning of 2002*	*Change in % points*
Workers' team, including:	40.1	−9.7	52.5	−15.0	50	−4	31	−14
managers	9.0	1.2	17.8	4.9	[e]28	17	9	1
employees	31.1	−10.9	34.7	−19.9	22	−21	22	−15
State, including:	8.4	−1.3	5.7	−6.6	4	−5	[f]28	[g]7
federal level	4.6	−0.5	3.1	−4.5	–	–	–	–
regional and local level	3.8	−0.8	2.6	−2.1	–	–	–	–
Outside shareholders, including:	51.5	11.0	41.8	21.6	45	8	41	7

Russian non-financial enterprises	13.9	1.9	15.1	7.1	15	−1	22	9
Russian banks, investment companies, funds	13.1 (of them banks – 1.3)	2.5	4.5	2.3	8	−1	3 (of them banks – 2)	−5
foreign shareholders	3.7	1.9	2.9	2.6	2	1	2	1
others (mainly individuals)	20.8	4.7	19.3	9.6	21	10	14	2

Notes

[a] SU-HSE -1, the survey of 318 JSCs in 1999, more than 260 JSCs responded. Change for 3 years: from end of 1995 to end of 1998.

[b] BEA, the survey of 437 enterprises in 2000, over 360 JSCs responded. Change for 5–8 years: from start of privatization till 2000 (BEA, 2001).

[c] REB, regular enterprises' surveys, over 110–50 JSCs responded. Change for 8 years: from 1995 to 2003 (Aukutsionek, *et. al.*, 2003).

[d] ISEPD, regular surveys of defense industrial companies. Change for 6 years: from 1996 to 2002 (Vitebskii *et. al.*, 2002).

[e] Including 3% – affiliated firms.

[f] Of them 21% – state, and 7% – state-owned enterprises.

[g] Of them 6 percent points are growth of state-owned enterprises interest, and 1 point of state interest.

Source: Author's calculations based on survey's primary data or published data.

Table 10.4 Industrial property concentration in 1995–2003 according to independent survey data

Concentration indicators	*SU-HSE-1*[a]		*BEA*[b]		*IET*[c]		*REB*[d]		*SU – HSE – 2*[e]	
	End of 1995	*End of 1998*	*Start of privatization*	*January, 2000*	*End of 1999*	*February, 2003*	*February, 1999*	*February, 2003*	*End of 1998*	*Summer 2002*
Share of the largest shareholder,%	26.3	27.8	–	–	–	29.7	33	37	36.7	42.2
Share of 3 largest shareholders,%	40.5	45.1	–	–	[f]38.1	48.9	–	–	48.9	57.6
Share of enterprises (%) having a shareholder with interest over 25%	44.5	46.8	13.4	25.8	31.6	–	51	56	55.2	67.1
Share of enterprises (%) having a shareholder with interest over 50%	14.8	19.6	5.5	10.3	12.8	–	25	26	32.0	39.5

Notes
[a] SU-HSE -1, about 220 JSCs responded.
[b] BEA, about 390 JSCs responded.
[c] IET, the survey at the end of 1999, about 190 responded (Radygin, Entov, 2001) and the survey at the beginning of 2003, over 280 JSCs responded (IEPP, 2003).
[d] REB, over 120 JSCs responded (Kapelyushnikov, Demina, 2005).
[e] SU-HSE-2, the survey of 350 JSCs, Autumn 2002; over 220 JSCs responded.
[f] data for five shareholders.
Source: Author's calculations based on survey's primary data or published data.

The main motive of shareholders' striving for concentration of property lies in establishment (for external owners) or retaining (for managers) of control over the business. In the 1990s, in a situation of transformational recession and widespread tax avoidance schemes, stock property did not bring any benefits to shareholders. Shares were not liquid, and dividends were not paid. It was management that mainly benefited from control. By acquiring and concentrating their share packages, managers fixed their control rights and their status of director as 'master' of the business in a long-term perspective.

For outsiders, the only way to exercise their property rights was to contest the established pattern of control. Even possession of medium-sized share packages gave them no chance to overcome extreme opportunism of the managers who controlled cash flows. Outside shareholders were striving to increase their interest and to replace company's management. At the start, they wanted at least to participate in shadow schemes (e.g. to divide 'shadow dividends' jointly with the managers), to the disadvantage of other shareholders. A detailed description of how many ways were used to receive profit from property and to establish rules of interaction between big shareholders and managers is given in (Rozinskii, 2002).

Concentration of control in the hands of a dominant owner encouraged minority shareholders (among which there could be even some owners of blocking packages) to sell their shares that gave nothing in terms of control over the enterprise and provided no returns from property. If some shareholders became controlling owners, others had no other choice but to leave the business.

Recently, internal motives for development of big business have become another tangible incentive for further redistribution (mergers and acquisitions). In the first place, the purpose of transformations in property and control in big businesses is redistribution of market shares (Deryabina, 2001). Putting 'necessary facilities' under control, big corporations pursue not so much the purpose gaining profit as by the logic of business development. For this reason in particular, property is acquired for building vertical hierarchies or horizontal amalgamations in order to reduce supply or sales risks, to better protect contracts, to cut down production and transaction costs, to expand market power and win considerable market shares (Dolgopyatova, 2003). These driving forces were especially noticeable after the 1998 crisis, when big business groups became the main buyers of shares in Russian enterprises.

A whole set of institutional prerequisites underlies earlier changes and features of corporate ownership. The first precondition was provisions

and procedures of large-scale voucher privatization, which formed the institution of corporate ownership in Russia, determined the nature and balance of powers of economic agents competing for this ownership, and granted a number of specific advantages to managers (Dolgopyatova, 2001; Woodruff, 2003).

The second prerequisite is poor corporate governance. In a situation when it was impossible to obtain revenues from ownership, large-scale expropriation of shareholders' interests by company managers (occasionally in coalition with some of the owners) became a factor to encourage concentration of corporate ownership and growth in the share of external owners.

The third prerequisite is mortgage auctions and other actions, which the Russian government held to facilitate the development of large business (Pappe, 2002a). Foreign investors were avoiding the Russian market for many reasons, which are beyond the scope of this chapter. However, a large domestic player emerged who was ready to participate in acquisition of ownership, possessed financial resources and, most importantly, had leverage over the government and certain officials.

Economic attraction of enterprises for potential buyers was an important condition of redistribution of property. The 1998 crisis was a positive factor to improve potential performance of many industrial enterprises in the eyes of investors. Many enterprises got new prospects for rapid development, especially if they could be subjected to restructuring and managerial improvement. For this reason, redistribution of property went more vigorously, involving takeovers by large corporations, whose funds were abundant and quality of management was good by Russian standards.

While in the early and mid-1990s, the main way to establish control was inner corporate or privatization deals, external deals to capture control came to the forefront after the crisis of 1998. The marketplace for corporate control functions outside stock markets. It is specific in terms that it provides ways for absorption of the most successful enterprises. Corporate control is captured (consolidated) through a formal change of ownership rights at the moment of sale and purchase of shares, as well as by means of bankruptcy and debt restructuring (securitization of debt). As a result, Russia has seen a sharp rise in the number of corporate reorganizations, especially mergers and acquisitions (Radygin *et al.*, 2002). PricewaterhouseCoopers survey of mergers and acquisitions in Central and Eastern Europe (PWC, 2003) showed that Russia turned out to become a recognized regional leader in the number of publicly declared non-privatization deals implemented by big business groups.

Since the end of the 1990s, equity transactions in the interests of large shareholders, based on use of procedures for internal corporate governance under their control (resolutions of shareholders' meetings and boards of directors), have taken a prominent place among schemes of property consolidation. Dilution of the issued stock, share consolidations and swaps played a special role. As a result, positions of dominant owners have become still stronger, while minority shareholders have actually been subjected to expropriation. For instance, the above-mentioned survey (Golikova *et al.*, 2003) showed that in 2000–2002, over 20 per cent of the enterprises issued new shares, while over 16 per cent redeemed shares from minority shareholders, 7 per cent retired shares, and 5 per cent exchanged or consolidated shares.

Boards of directors under concentrated insider property

The Board of Directors of a JSC is a collegial body set up by shareholders' meeting for making strategic decisions, organization and monitoring of performance of company's executive bodies. Proportion of representatives of different groups of shareholders gives a more accurate account of power balance at the enterprise than formal ownership structure. At present, when concentrated insider ownership is prevailing, formation and activity of boards of directors in the majority of companies is characterized by the following:

- there is a tendency for decrease in the number of the board's members. This trend is limited only by the necessity to comply with the legal standards for JSCs, which are different for numbers of shareholders exceeding 1,000 or 10,000;
- insiders' representatives are predominant on the boards, and executive management plays leading role;
- important position in execution of control over many JSCs belongs to such stakeholders as workers' teams, regional and local authorities, which often form coalitions with company management.

Table 10.5 contains the results of a number of surveys characterizing the 'average' structure of the boards of directors of JSCs. Leading role on the board is played by representatives of management (from one third to 40 per cent of the members); the second place belongs to representatives of workers' teams or to outside shareholders (15–25 per cent of the members). The SU-HSE survey conducted in 2002 shows that in 1998, the average number of members on the board was 7, and four years later, 6.8. Enterprise employees prevail on the board in a half of

Table 10.5 Membership of a board of directors in industrial JSCs according to independent survey data

Shareholders	*SU – HSE – 1, 1999*[a]		*BEA*, 2000[b]		*SU – HSE – 2*, 2002[c]	
	Composition, % of no. of members	*Indicator of representation*	*Composition, % of no. of members*	*Indicator of representation*	*Composition, % of no. of members*	*Indicator of representation*
Workre's team, including:	57.4	1.43	68.8	1.31	56.2	1.45
managers	38.0	4.22	39.2	2.20	35.2	–
employees	19.4	0.62	29.7	0.86	20.9	–
State, including:	8.9	1.06	5.4	0.95	6.6	0.76
federal level	3.2	0.70	2.7	0.87	2.5	0.76
regional and local levels	5.7	1.50	2.7	1.04	4.1	0.76
Outside shareholders, including:	33.7	0.65	25.8	0.62	37.2	0.71
Russian non-financial enterprises	15.0	1.08	10.8	0.72	13.0	0.42
Russian banks, investment companies, funds	11.2	0.85	4.1	0.91	1.2	1.5
foreign shareholders	2.1	0.57	1.4	0.48	–	–
others (mainly individuals)	5.4	0.26	9.5	0.49	23.0	1.11
For reference: total average number of members	7.9	–	7.4	–	6.8	–

Notes
[a] SU-HSE-1, 278 JSCs responded.
[b] SU-HSE-2, 289 JSCs responded.
[c] BEA, 393 JSCs responded.
Source: Author's calculations based on survey's primary data.

the sample. Managers are either large owners or persons who have been recently appointed by dominant shareholders. This survey also showed a significant negative correlation between the share of a principal shareholder and the duration of general director's employment. Elections of controllable boards are used by owners for replacement and for keeping executive bodies of the company under strict supervision.

In order to analyze relative advantages of shareholders in corporate control, we can compare structures of ownership and board of directors. We have calculated a coefficient of representation, which we define as the share of each group of shareholders on the board of directors per 1% of stock capital.[5] As a rule, correlation between the share on the board of directors and the share in the stock capital for all employees is higher than unity, mainly due to corporate managers.[6] For external owners this ratio is significantly lower. This partially reflects limited control possibilities of minority shareholders. For public administration, this coefficient does not exceed 1. Higher values of this coefficient are mostly related to more active role of regional and local authorities.

In fact, other participants do exert certain influence on decision-making in corporations together with principal shareholders and managers. As demonstrated by in-depth interviews (Dolgopyatova, 2002; Pappe, 2002b), company management recognizes regional and local authorities, and sometimes workers' teams (usually at large enterprises,) as the most influential forces. At many enterprises, boards of directors include representatives of workers' teams (who are usually medium-level managers or trade union leaders), especially if they are shareholders.

In some cases these representatives pursue relatively independent policy, but more often they are closely affiliated with the management.

In the second half of the 1990s, a tendency became evident to include representatives of regional or local authorities, who are not shareholders, in the boards of directors. In this way the authorities 'add' some direct (and legitimate) methods of corporate control over operation of JSCs to administrative regulation and informal relationships. This should be taken into account in assessment of activities of the so-called independent directors.

As a result, the board of directors is formed by dominant owners and follows their directions. At the same time, the board is closely related to executive management (in certain cases, to authorities as well). As our in-depth interviews show (TTPP, 2004), activity of the board is becoming, to a certain extent, a formal organizational responsibility, while actual decisions are taken by a limited number of individuals.

In this situation, the board's role as a monitoring mechanism of executive management and protection of shareholders' rights cannot be implemented.

Specific patterns of ownership and corporate governance in contemporary Russia

Russian corporate ownership today is concentrated insider ownership. In this context, we include large external shareholders into the category of insiders as well (first of all, company groups). Minority shareholders may be regarded as outsiders. Corporate control is usurped by dominant owners. This type of non-separated ownership and control has determined many features of national pattern of corporate governance.

First of all, Russian corporate economy of the last decade was characterized by permanent redistribution of property. A number of empirical studies of SU-HSE, REB, CEC suggest that from the mid-1990s, principal owners of 6–8 per cent of industrial enterprises on the average could change every year. It established the tendency that each year from the mid-1990s, principal owners of 6–8 per cent of industrial enterprises on the average could have changed. Redistribution annually affects up to one sixth of equity capital (Kapelyushnikov, 2001).

Another fact of the real situation is non-transparency and complexity of ownership rights, when true owners are concealed in multi-level chains (5–8 levels) of affiliated individuals and companies, offshore firms, nominal holders, as well as in multi-layer systems of corporate management. The number of these levels is not expected to decrease. This was the outcome of general institutional environment in the Russian economy, the product of reliance on illegal sources of financing and not entirely legitimate ways of property acquisition. Several companies, which revealed their true shareholders in order to enter stock markets, are the rare exception. Today, non-transparency of property relations is artificially maintained by management of many companies as a barrier against possible interference of the state into their affairs or in defense from private businesses that are potential 'capturers' (Pappe, 2002b).

Non-transparency is a feature not only of ownership structure and business organization, but also of business performance. Not all open JSCs comply even with formal legal standards, which require releasing of financial reports. The existing accounting practice is oriented at the needs of tax authorities, keeping the quality of joint-stock companies' reporting low and preventing it from provision of adequate information

to shareholders, creditors and business partners (Aspisov, 2003). Adoption of international standards of accounting and financial disclosure has been performed by certain companies which deal with foreign investors or raise capital in financial markets.

Various surveys conducted by SU-HSE, CEC show that 8–15 per cent of respondents reveal their usage of such standards (Golikova *et al.*, 2003; TsEK, vypusk 36, 2002; Yasin, 2004).

As we mentioned above, corporate property did not bring any dividend payout, and dominant owners received profits mainly in non-dividend forms. In 2000, a tendency to pay dividends emerged in a number of large companies, which had consolidated ownership and practically displaced minority shareholders. In this case, dividends are a legal source of high incomes of the companies' owners and can be openly used for acquisition of new assets. Large corporations with significant stakes of state ownership (in power and telecommunications) also pay out dividends under the influence of government. At the same time, the majority of open JSCs fail to pay out dividends or do it irregularly. A survey (Golikova *et al.*, 2003) shows that about 60 per cent of companies did not pay any dividends in 2000–2002, and one fourth of the companies paid out dividends every year.

An important feature of insider corporate control executed by large shareholders is 'closeness' of a company from potential investors and protection from entry of new shareholders. The logical consequence is a policy of self-financing of business development or using financial resources of partners, which have relationship with the company in terms of shareholding or otherwise.

As FSSS data show (FSSS, 2004a, 2004c, 2000–2005; Goskomstat, 2000), in the last decade the share of external sources of financing fixed capital investment in the economy has never exceeded 50–55 per cent. This share is far from being too little, but allocations from the state budget accounted for 18–20 per cent of total external sources. The share of bank credit is still insignificant, although it has increased up to 7 per cent in 2004. A tangible part – about 18–20 per cent – consists of inter-firm credit or subsidies. Foreign investment makes about 5–6 per cent. Selling shares and bonds accounts for a minimum level of less than 0.5 per cent. In the industry, the share of internal sources was about 72 per cent in 1999, but it decreased to 60 per cent in 2003.

The data of surveys of industrial JSCs (Table 10.6) show that reliance on internal financial sources is about 80–90%.[7] There are a number of attempts to estimate bank participation in capital investment, and also the role of all layers of budgets. The shares of foreign investment and

Table 10.6 Investment process in industrial JSCs according to independent survey data

Investments sources	*Investments source composition, % of total investments*			*Frequency of using the source, % of respondents*		
	SU-HSE-1 [a] *1998*	*BEA* [b] *1999*	*SU-HSE-2* [c] *2001*	*SU-HSE-1* [a] *1998*	*BEA* [b] *1999*	*SU-HSE-2* [c] *2001*
Internal sources of investments	86.8	88.9	80.5	96.3	94.9	92.5
Bank credits	2.6	5.8	10.9	9.7	12.7	27.0
Federal budget	4.6	0.2	0.3	13.1	1.1	1.6
Regional and local budgets		0.7	1.4		1.5	6.5
Resources of Russian partners	3.6	3.5	3.6	9.7	5.1	7.5
Other Russian outside investors	1.4		2.2	4.9		4.2
Foreign direct foreign investment	1.0	0	0.8	1.5	0	1.3
Securities market (shares, bonds)	–	0.004	0.3	–	0.4	1.0
Other sources	–	0.9	–	–	3.0	–

Notes
[a] SU-HSE -1, 267 JSCs responded.
[b] SU-HSE-2, 307 JSCs responded.
[c] BEA, 275 JSCs responded.
Source: Author's calculations based on survey's primary data.

securities market have always been negligible. Partner enterprises are usually rated fairly high, although they cover a mere 3–5 per cent of investments.

Judging by the results of all available surveys, the share of JSCs using securities markets for raising funds for investment have never exceed 1% of total number of companies that had reported about making investment. Nevertheless, one survey of managers of 100 biggest Russian enterprises and investment companies that are registered as open JSC (AMR and AZPI, 2001) produced different results. It turned out that 91 per cent of such companies used predominantly own funds, while 59 per cent turned to debt financing. Although nearly 80 per cent of the respondents said they were interested in raising funds in stock market, only 14 per cent actually did.

The above mentioned evaluations confirm another specific feature of Russian corporate governance, which is a very minor role of stock market. The market is not used by the majority of open JSCs for raising investment funds, and the volume of raised funds is quite small. Russian stock market has less than 250 Russian issuers in its listings (while shares of only 8–10 companies are liquid). New companies rarely enter the Russian markets (Grigor'ev *et al.*, 2003). Shares of approximately 60–70 companies are quoted at NYSE and European bourses. There were few IPOs of Russian companies in domestic or foreign markets, and at present, Russian newcomers prefer to entry on London stock exchange.[8] Corporate bond market today has become the most dynamic sector of the Russian market, but the estimated number of bond issuers is some 100–50 companies. The purpose of bond floatation is to raise investment or to implement certain corporate dealings within business groups. It has an additional advantage to help the company acquire a credit history (Abramov, 2003; Danilov, 2003).

Recent qualitative studies demonstrate (TTPP, 2004) the emergence of new phenomena. Corporate integration is leading to separation of ownership and control. Big business groups have already turned over operational management of their companies to hired managers. At the same time, strategic issues still lie in the competence of business groups' owners. As a result, demand for legal institutions of control over executive managers (i.e. board of directors, civil contracts) is emerging.

To conclude, we should like to make two comments in regard to the specific features of corporate control in order to correct a formal approach to the definition of an open joint-stock company.

Firstly, many open JSCs which were founded in the course of privatization have gradually developed into family business. This is mainly true of small and medium enterprises, although this also happened in a number of larger companies. They are not corporations in terms of nature and objectives of their activities, corporate relations and managerial culture.

Secondly, various managing (holding) companies were created as a result of business integration and restructuring of enterprise control. As a rule, they are registered as limited liability companies or closed JSCs. Big quite often controlling stakes in open JSCs have been transferred to them for managing, or as property. Close property relationships exist in the private sector between JSCs and enterprises of other legal forms.

Concluding remarks

The prevailing pattern of Russian corporate ownership is concentrated property of insiders. Formally, dominant owners are company managers and non-financial enterprises, the latter have either the same managers or company groups standing behind them, but finally owners thereof. They can be well-known large 'oligarch' groups, or regional groups founded by domestic businesses, often with latent support and participation of regional and municipal administrations.

The prevailing type of corporate control based on concentrated property is control by a dominant owner who takes a direct part in management or strictly controls the hired managers. Separation of ownership from corporate control is a rare case at the Russian JSCs. Minority shareholders are, for the most part, kept apart from corporate decision-making.

The companies' boards of directors are characterized by prevailing role of insiders. Executive management, directors and dominant owners often form a consolidated group, where decision making is actually based on informal mechanisms of coordination. Under such circumstances the self-enforcing model of the Russian corporate law (Iwasaki, 2003) cannot successfully operate.

Investment policy is centered over reliance of internal funds, and in certain cases, partner (business group) funds are also involved. Participation of banks in the equity capital and investment activities of companies is very small. Neither is the stock market an effective instrument of control or a tool to issue an investment flow in the Russian economy. Only a few companies actually raise investment funds in

form of debt or equity in Russian or foreign markets. As a rule, redistribution of property and transactions aimed at acquisition of corporate control are going on outside organized markets. Bankruptcy procedures, hostile acquisitions, corporate stock manipulations are the frequently used methods.

Summing up, we should like to emphasize the fact that the specific features of concentrated property with insider control, including reliance of internal funds for financing, actually transform the behavior of the majority of open JSCs companies. They are really operating as private enterprises.

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Notes

1. Annual structural surveys cover about 121,000 large and medium-sized enterprises of all sectors of the Russian economy including about 27,000 enterprises in industry.
2. Calculated from published data, here and further the structure of the authorized capital can be weighted by size, so on the average, it characterizes larger objects.
3. The panel sample contained with 1288 enterprises including more then 900 JSCs. See details in (Yasin, 2004).
4. We have to stress that statistical data and majority of surveys reflect only direct ownership of state bodies. However, the transactions that are increasing indirect participation of the state in stock ownership (for example, acquisition of Sibneft by Gazprom or sale of Ugansknefteg az to a state-owned company Rosneft) fall out of quantitative monitoring.
5. The coefficient was proposed in (Basargin & Perevalov, 2000), where the authors calculated it for 43 JSCs.
6. Respondents may have overstated representation of ordinary employees in the boards of directors and their participation in ownership, and understated the share of managers' ownership.
7. Surveys record a still greater share of internal sources is given by statistics. This is due to the fact that respondents assess their investment not only in fixed assets, but also in working capital and financial assets.
8. Growth of number of IPO is on agenda. In fact, about 30 JSCs had IPO in 2005–06. Also about 40 companies have been declared to implement IPO in 2007.

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11

Evolution of Corporate Governance in Russia: Governmental Policy vs Real Incentives of Economic Agents

Andrei Yakovlev

Introduction

Corporate governance mechanisms in Russia are the result of a large-scale institutional experiment performed by the Russian government in the early 1990s with vigorous support of international financial institutions. The purpose of this experiment was to bring a certain *a priori* defined model of interaction between enterprises and investors, owners and managers to the Russian environment. The logic of law making – from defining a general privatization framework to specific activities to develop stock market infrastructure – was strongly influenced by the idea to create this model. Multi-billion loans were extended to the Russian government by the World Bank and International Monetary Fund (IMF) to pursue these objectives. Leading Russian reformers and many foreign consultants were involved in practical implementation of this model. And until the middle of the 1990s, despite all inconsistency of the Russian government's economic policy in the other areas, its activities in terms of institutional reform, especially the launch and implementation of the mass privatization, were very highly estimated (Åslund, 1995; Radygin, 1995, etc.). Besides, many experts believed that speed of implementing would compensate for the shortfalls in the institutional design of reforms. In particular, speed of privatization was thought to be critical to ensure that market reforms would be irreversible (Boycko *et al.*, 1995).

Then, however, as corporate conflicts spread and shareholders' rights were massively violated, the optimism with regard to the outputs of institutional reforms in Russia characteristic of the early and middle 1990s, was replaced with profound skepticism. This skepticism (together with doubts that Russia had chosen the right privatization model), was

expressed in a sufficiently comprehensive manner in the well-known report by Stiglitz (1999).

The obvious rejection of external investors and violation of the laws had a negative impact on the reputation of Russia and Russian business. This trend reached its peak during the 1998 financial crisis, when the major Russian banks that were close to the government and owed a lot of money to their western partners preferred to transfer all their liquid assets to their affiliated structures and to file bankruptcy.[1] And despite the significant changes that have occurred in Russia in the recent years, most investors still have a skeptical and negative attitude to Russian business and Russian corporations. The following short phrase from the April 2003 issue of US–Russia Business Council monthly report is very characteristic in this respect: 'Corporate governance in Russia is awful' (It should be noted, however, that in making this point the authors in fact refer to corporate conflicts in 1997–99).

In this connection it would be logical to ask a question about the reasons for such radical discrepancies between the reformers' expectations and the actual behavior of Russian companies. It should be underlined that this question is not new for researchers of the Russian transitional economy. To experts, the weakness and inefficiency of corporate governance in Russia in the 1990s has been a generally recognized fact for a long time.

The forms and methods of violating shareholders' and investors' rights are described in detail in many papers (see Radygin & Sidorov (2000), Black *et al*. (2000), and others). Most experts believe, however, that the unfavourable conditions for attracting investors to Russia are not the result of the poor quality legislation.

Formally, the Russian corporate legislation is well-developed. Practically, however, it is applied very badly or not applied at all (Berglöf & von Thadden, 2000; Vasilyev, 2000). In this connection, a traditional corporate governance recommendation to the Russian government is to strengthen enforcement mechanisms, to toughen requirements for protecting shareholders' rights, for disclosing information on joint-stock companies' operations, etc.

Such recommendations suggest the development of the stock market regulation and corporate governance model that was created in Russia in the second half of the 1990's and that was based, ideologically, on US and UK experience. It is this area where Russian Federal Commission on the Securities Market (FCSM) has been especially active recently. In 2000–2001, FCSM drafted amendments to the law on joint-stock companies and to the law on the securities market. The new edition

of the joint-stock company law was made effective on 1 January 2002. Amendments to the securities market law were introduced by the Government to the State Duma at the beginning of 2002. The Government has also passed the Code of Corporate Governance whose development was initiated by FCSM.

However, recent empirical studies show that the current 'rules of the game' very often do not encourage owners to restructure their enterprises, regardless of the law enforcement practice (Dolgopyatova, 2002). More general theoretical papers also reveal a strong objective nature of developing and transition economies (Berglöf & von Thadden, 2000), which limits the application of traditional corporate governance mechanisms created in countries with developed market economies.

In the context of these discussions we will try to give our answer to the question on the reasons of corporate governance failures in Russia in the 1990s and to explain what caused the recent positive changes in this area. Our analysis will be broadly based on identifying changes in economic agents' motivation at different stages of development of Russian corporate structures.

In the following section, we will look at the logic of creation and practical aspects of functioning of the Russian corporate governance model. Then we will do detailed analysis of incentives to attract investments through the stock market and motivation of open joint-stock companies' shareholders and managers depending on the performance of the business they control. Subsequenting we will address the reasons for recent improvements in corporate governance in Russia and will outline possible directions of further evolution of Russian companies' relations with their shareholders and investors. On this basis general conclusions will be presented along with policy recommendations aimed to support positive changes in the behavior of economic agents.

Russian model of corporate governance in the 1990s: theory and practice

The logic of the Russian corporate legislation in the 1990s was based on massive imports of institutions, with an orientation towards the Anglo-Saxon stock market and corporate governance model. To implement this model in the Russian conditions, the Government took the following practical steps:

- 'voucher' privatization with a forced re-organization of former state-owned enterprises into public companies and with a distribution of their shares among a great number of small-scale shareholders;
- forced development of the stock market and its infrastructure (exchanges, brokers, depositaries, and registrators);
- creating a collective investment institution (voucher investment funds, mutual funds, non-governmental pension funds, etc).

It was expected that dispersing shares across a big number of small-scale shareholders would result in high liquidity of the stock market and give outside investors access to the shares of privatized enterprises (through transactions on the secondary market). A developed infrastructure of the stock market would, in turn, reduce transaction costs and give small-scale shareholders the opportunity 'to vote with their feet' in case they do not agree with the policy pursued by the company management. The possibility of free purchase and sale of shares was also expected to encourage the creation of a corporate control market where big shareholders could replace the existing management and take control over the company by increasing their stocks when shares are 'dumped' by small-scale shareholders. Finally, investment institutions would be able to accumulate shares of small-scale shareholders and to protect more effectively their interests by controlling the management of the respective enterprises.

In practice, however, as we can see from the conditions and structure of the Russian corporate sector (see Chapter 10 by Tatiana Dolgopyatova in this volume), and from the evolution of corporate governance legislation (Redkin, 2003), these assumptions were implemented only partially.

The extensive imports of corporate legislation institutions and the 'dispersal' of property in the course of the mass privatization could not neutralize the apparent demand for the 'insider' privatization model promoted by managers of former state-owned companies. As a result, two trends could be clearly observed in the corporate sector in the mid-1990s:

- Tendency towards property and control concentration – purchasing up to 75 per cent of the shares (Kuznetsov, 2002; Golikova *et al.*, 2003; World Bank, 2005);
- Tendency towards minimum transparency in joint-stock company operations – creating sophisticated systems of corporate control

over big enterprises through multiple affiliated firms and off-shore companies (Yakovlev *et al.*, 2002).

As a most important and special characteristic of the Russian corporate governance model based on these two trends we could mention obtaining revenues from stock ownership not through profits but through control exercised by the dominating owner over the enterprise's cash flows. Using transfer pricing mechanisms you can systematically transfer profits of the head enterprise to companies affiliated either with the dominating shareholder or with top managers of the head enterprise (Rozinsky, 2002). In doing so you can obviously ignore the interests of minority shareholders (including the employees) who do not participate in the decision-making process. (For more idetails on systematic violations of shareholders' rights in Russia, see Radygin & Sidorov (2000) and Black *et al.* (2000)). It should be emphasized that such schemes of obtaining revenues were used not only by old-style 'red' directors but also by new big private shareholders.

Logically, this system of obtaining ownership revenues caused almost no payment of dividends in the 1990s. When combined with the total indifference of dominating owners and managers to creating a market for the shares of enterprises they controlled, this caused low capitalization and very low liquidity of the stock market. Even during the peak times of the Russian stock market (1996–97) less than 1,000 out of 30,000 registered open joint-stock companies could meet the moderate requirements for getting listed with Russian stock exchanges; transactions were performed with the shares of only 200–300 companies; and trading was performed for only several dozens of blue chips.

In fact, the rapid development of the stock market in the mid-1990s and its decline afterwards were caused, to a large extent, by the demand for the stock market as a mechanism of share holding consolidation. Once such share holdings were formed, the demand disappeared in a natural way.

Obviously, there were systematic discrepancies between the rules stipulated in the legislation and business practices. In a certain sense we can say that the Russian model of corporate governance was created in the 1990s against the formal policy of government and was functioning on the basis of systematic violation of formal rules.

We believe the reasons for that lie in the way corporate governance institutions were formed. These reasons will be more thoroughly addressed in the next section.

Development of joint-stock companies in Russia and motivation of owners and managers of enterprises

Critically analysing the existing approaches to the problem in economic literature, Berglöf & von Thadden (2000) propose a classification of corporate governance models characteristic for developing economies, economies in transition as well as developed market economies. Within this classification they identify key issues of corporate governance.

In particular, they showed that the spectrum of possible forms of business organizations is much wider than the traditional contraposition of widely held firm and closely held firm. Family firm is a much more widespread type, which characteristically faces problems of corporate management rather that corporate governance. In addition, developing economies have a fairly stable phenomenon of development firm, which maintains informal relations with both the state and investors. Finally, transition economies since the 1990s have produced transition firm as an original type of business organization that is distinguished, according to Berglöf & von Thadden (2000), by omnipotent managers and little resistance from the environment.

For transition economies and especially for Russia significant differences are connected with the division into 'new' and 'old' (former state-owned) enterprises. Berglöf & von Thadden (2000) believe that the problem almost does not exist in the de novo sector because enterprises in this sector have not yet reached in the course of their development a stage when it is necessary to differentiate between property and management. In actual practice, weak enforcement of law in the 1990s was favorable to manipulating investors in the de novo sector as well. Suffice is to recollect such cases of financial fraud as Ponzi schemes set up in 1994–95 by private trade companies (MMM, Olbi-Diplomat and others), which undermined people's trust in financial institutions for long.

At the same time the former state-owned sector was in that period the source of serious problems in the field of corporate governance. Privatized enterprises need serious restructuring and, theoretically, should generate demand for external sources of finance. In reality, however, they do not generate this demand, which, according to Berglöf & von Thadden (2000), is caused by soft budget constraints, which reduce this need for restructuring. In case outside investors themselves want to come to big Russian business, the weak and imperfect Soviet era legacy judicial system turns out to be unable to ensure sound protection of outsiders' rights.

The main recommendations resulting from this analysis come down to developing enforcement mechanisms and hardening budget constraints. This will create the necessary pressure on 'insiders' and conditions for giving enterprises new outside owners (including foreign ones) who can attract finance and initiate restructuring.

In our opinion, these recommendations are right on the whole; however, they are a bit one-sided and formulated from outsiders' perspective. The analysed phenomena and processes could also be looked at from insiders' perspective. This angle could be useful because it allows to better understand the actual costs and benefits of turning a company into a joint-stock company.

In the course of a natural development of a business its reorganization into a public company is possible under at least two conditions:

- The business is efficient enough. This makes it attractive for investors, secures the positions of the previous managers/owners at the initial stages of the privatization process ownership changes, and creates the proportions for exchanging property for investment acceptable to the previous managers/owners;
- The previous managers/owners of the company are interested in attracting additional funds for business development purposes in exchange for some of their stakes in the company. In practice it means readiness to co-operate with investors, including adequate disclosure of information, payment of dividends, etc.

As an example of companies developing in accordance with this pattern we could mention AO Vympelkom, which was created in the early 1990s as a co-operative, then it was re-organized into a closed joint-stock company and then it became the first Russian company to trade its shares at the NY Stock Exchange in 1996. Another examples are AO Wimm-Bill-Dann Produkty Pitaniya, which successfully placed 25 per cent of its shares in February 2002 thus attracting over $130 million in investments, and also Rambler, an Internet-portal company, and JFTC Sistema, which made a successful IPOs on the London Stock Exchange in 2005.

However, for the absolute majority of big Russian enterprises the privatization process was not natural. During the privatization they were forced to become public companies. These enterprises had been created during the Soviet period and were oriented towards absolutely different, non-market values. That's why in most cases they proved inefficient

in the new economic conditions and needed drastic restructuring. This caused several important logical consequences:

- Before the consolidation of property and control in the hands of enterprise managers their positions remained quite unstable. On the one hand, this caused hostility on the part of the previous management towards potential outsiders; on the other hand, it encouraged the transfer of liquid assets of the base enterprise to affiliated structures controlled by the managers;
- Consolidation of property and control in the hands of managers was performed by using some of the working capital of the enterprise, which only further weakened the enterprise, made it less attractive for investors, and made the restructuring process more complicated;
- After consolidation of property and control and before restructuring, enterprises' opportunities to get access to outside finance remained very limited. Low business efficiency made it unprofitable for managers to exchange shares for investments while the pure performance and old non-liquid fixed assets did not allow attracting credit resources. As a result, privatized enterprises had to use their own funds for development purposes.

To make the picture complete, we can add that during the re-organization and privatization under 'voucher' schemes enterprises themselves did not get any investment at all. It is not surprising, therefore, that from the point of view of managers and ordinary employees loyal to them all outsiders looked as spongers who claimed some profits of the enterprise without any apparent reason.

This forced privatization that did not take account of objective stages of enterprises' life cycles caused deformation of the public company institution and creation of a number of 'quasi open' joint-stock companies that did not need outside shareholders at all and, for this reason, provoked corporate conflicts. In a broader theoretical context this institution mutation process in transition economies is analysed by Kapelyushnikov (2001). It is noteworthy, though, that the interests and motivation of insiders did change as property and control were concentrated in their hands.

At the initial stage, the insiders who did not have complete control over enterprises and were involved in a struggle against outsiders were not at all interested in any restructuring and usually tried to strip assets as quickly as possible. Once they became dominating owners again and regained legal control over enterprises, insiders still did not

need minority shareholders and continued violating their rights. As regards restructuring and transfer of assets, however, their policies were completely different. They controlled businesses and were interested in making them more efficient by restricting theft (including that by medium-level managers), by reducing unproductive costs, by implementing new technologies, etc.

And only at the next stage when primary restructuring of the companies is over and their performance is improved, the owners begin to ponder over potentialities of attracting capital investment with selling large blocks of shares to outside investors (including foreigners). In such cases, there is no doubt that investor's interests were influenced by certain factors aside from ownership structure, for instance, by the level of managerial skill and education.

As demonstrated by the latest survey conducted by the Higher School of Economics, in 2005, about 25 per cent of large and mid-sized enterprises in Russian manufacturing were still at the primary stage distinguishable by absence of a controlling owner and by the maximum opportunism in the behaviour of managers. More than 70 per cent of all enterprises were controlled by a single shareholder or by a consolidated group of shareholders. However, selling of a controlling or a blocking stake of shares to outside investors was considered a possible channel for attraction of investment only by one out of five enterprises of this type having concentrated ownership structure. Meanwhile, securities issued by only 3 per cent of the surveyed enterprises were listed on the Russian stock exchanges. Nevertheless, all of them, including few newly created efficient private companies like AO Vympelkom and many inefficient privatized enterprises, have the same organizational and legal framework of an open joint-stock company and should comply with corporate legislation requirements.

In fact, most big Russian enterprises show discrepancies between their legal framework and the economic content of their activity. The costs of such discrepancies have been compensated for by a loose observance of rules and laws, which has happened for a long time. At this stage, however, big enterprises will more often face real additional costs without getting any compensating benefits since most of them are still unprepared for opening their businesses to outside investors.

We believe, therefore, that resolving corporate governance issues in Russia requires not only putting more pressure on insiders, strengthening budget constraints, protecting shareholders' rights and developing enforcement. Creating the system of indirect positive incentives for

insiders, and measures aimed at reducing the costs caused by the legislation can also play an important role here.

Recent changes in the behavior of Russian corporations and options of corporate governance evolution in Russia

In our opinion, the change in the status of insiders, the fact that they acquired legal control over enterprises [2] created an enabling framework to improve corporate governance in Russian companies. To support this point, the following recent trends can be highlighted:

- Significant improvement of shareholder relations, improved transparency, regular payment of dividends, which has already increased the market capitalization of some major companies (oil company YUKOS is considered one of first movers here);
- Real implementation of International Accounting Standards (IAS), which is especially visible against the failure of the corresponding program approved by a special government resolution in the spring of 1998;
- Vigorous issue of corporate bonds [3] and the precedents of successful IPOs not only before (as Wimm-Bill-Dann in 2002) but also after YUKOS affaire (as Rambler and especially JSFC Sistema in 2005).

At the same time, we believe, a number of other factors (apart from consolidation of ownership and control) had an effect on the behavior of Russian companies.

The August 1998 devaluation of the ruble resulted in increased competitiveness of Russian exports along with dramatic growth of prices and fall of demand for imported products. Growing sales improved the performance of Russian business. As a result, the new owners had an opportunity to recoup their investments in block shares not only by withdrawing liquid assets from their enterprises but also by generating revenues from actually doing business. This created incentives to invest in the development of enterprises, which did not exist in the 1990s. One of the consequences of the new investment opportunities in Russia was a noticeable reduction in capital outflow. While in 1997–1998 annual capital outflow from Russia was estimated at US$20–25 billion, by 2001 this figure was reduced to US$17 billion and by 2002 – to US$11 billion. According to the Central Bank and the Russian Ministry of Finance, Q2 of 2003 was the first time capital inflow had exceeded capital outflow (see interview of Minister of Finance Alexei Kudrin in *Financial Times* on

23 June 2003). At the same time contrary to the capital flight of 1990s volume of Russian FDI in production assets in other countries begun to increase significantly (Vahtra & Liuhto, 2004).

A new bankruptcy law was effected at the beginning of 1998. It triggered a new wave of ownership redistribution and acute corporate conflicts, since the law, contrary to its original purpose, was used against performing and relatively efficient enterprises (Simatchev, 2003; Radygin & Simatchev, 2005). Huge amount of mutual arrears and overdue taxes (Pinto *et al.*, 2000), which had been accumulated by enterprises in the early and mid-1990s, was the prime cause of this phenomenon. It must be emphasized that at that time, arrears to suppliers and to the government was typical of the absolute majority of enterprises, both inefficient and efficient ones. The reason is that accumulation of arrears was a rational behavioral strategy of enterprises under the macroeconomic and tax policies of the government at that time (Yakovlev, 1999).

However, for this very reason, simplification of bankruptcy procedures provided by the law of 1998 for creditors combined by gradually rising efficiency of enforcement resulted in the tendency to apply the new bankruptcy law mainly to viable, efficiently run enterprises. In fact, any overdue indebtedness of such enterprises, even the minimal one, was used for seizure of power over them and for gaining control over their liquid assets. Mass protests against this practice of 'corporate takeovers' led to passing the third bankruptcy law in 2002, which provided protection of interests not only for creditors, but also for debtors.

However, such an opportunistic use of any, however small it could be, overdue debt to 'intercept' control at successful enterprises provided their current owners with strong incentives to clear and settle the arrears accumulated in the 1990s. More adequate tax policy pursued by the government after 1998 also contributed to reducing the non-payment problem. For instance, in 1999–2000 the government wrote off a significant amount of fines and penalties on overdue tax payments and provided a debt restructuring opportunity to enterprises, which had made current tax payments on a regular basis within a certain period of time. Eventually, by 2001 industrial arrears were concentrated in inefficient 'down' enterprises, unlike in the mid 90's when they were typical of almost all major industrial enterprises.

The end of mass privatization also expanded the horizon of interests in Russian business. This reduced the size of potential rent as well as the capabilities and efficiency of rent-seeking strategies, which were popular in the 1990s.

Among other factors influencing business behavior, the effect of the 1998 crisis should be highlighted. Together with the devaluation and default the crisis caused the government to be replaced. For the first time since 1991 the government had included active representatives of the Communist party. So, Deputy Prime Minister Yu. Maslukov, eminent Communist party deputy and the leader of a State Duma Committee, was in charge of economic issues in the Primakov government.

Although the crisis mainly affected the middle class in big cities, it outlined for the 'oligarchs' the possibility of losing their capital and property – if the rules of the game did not begin to change, if they continued to enable some individuals to make huge profits without creating conditions for economic and social development (Yakovlev, 2003b). On the whole, the completion of the primary division of state property and the realization of political risks related to rent-seeking behavior encouraged business (primarily big business) to act more vigorously on the legal field which still remains highly inadequate.

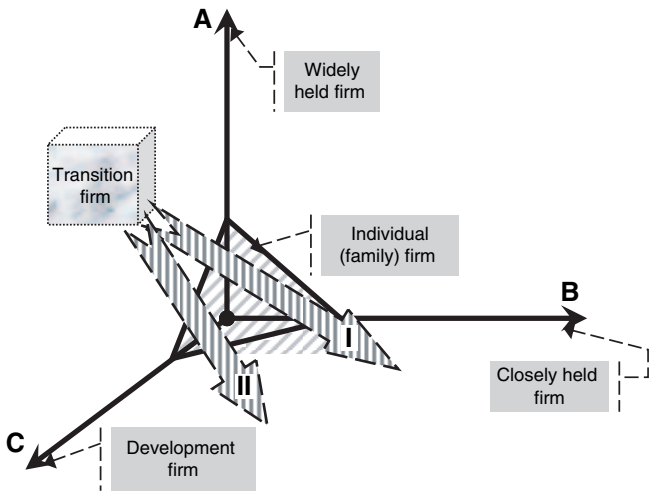
It is noteworthy that there were serious problems with the legal framework in the 1990s as well. At that time, however, they were resolved by development of different informal business practices including barter, transfer pricing, tunneling etc (Yakovlev *et al.*, 2002). All this caused a rapid development of the shadow economy and an active outflow of capital.[4]

In the recent years, the increased investment activity and the need to guarantee the protection of the existing ownership rights have encouraged business to seek more civilized and legal ways to interface with the state. Unlike in the 1990s, when 'investment' into relationships with specific officials or policy-makers paid back fairly quickly, legal interaction with the state could only be effective for individual companies under certain conditions. Such interaction is effective if it is based on collective interests and coordinated collective activities of the entrepreneurial community. The realization of such collective interests helped create demand for law on the part of business,[5] and the readiness for collective activities strengthened the role of entrepreneurial associations as representatives of collective business interests. This applies not only to the 'renewed' Russian Union of Industrialists and Entrepreneurs but also to a number of industrial associations of entrepreneurs. (For information on the interaction between the Russian Association of Household Electronics (RATEK) and the State Customs Committee, see Radaev (2002)).

The above factors created conditions for positive change in Russian companies' attitude to outside shareholders and potential investors. At the same time, while on the subject of prospects for further development

of corporate governance in Russia, we should consider to be more correct to analyze them in a broader context, starting from possible models of organization of big business. A useful tool for this analysis may be Figure 1 based on classification, which was presented in the above-mentioned paper by Berglöf & von Thadden (2000).

The family firm (sole proprietorship) is located in the center of coordinate lines of the Figure 11.1, because family business is the very foundation of both developed and developing economies. However, a firm that was originally created as a family business or a sole proprietorship can evolve in different directions along with expansion of the business and under growing need for investment from outside. Emergence of widely held firm was historically typical of the countries with a system of common law and well developed protection of investors. Creation of joint-stock companies with several dominant large blockholders was more typical of the countries with a system of civil law. In the latter, outside financing was provided for large companies by banks rather than by equity markets. Finally, specific forms of large-scale business organization such as Chebols in South Korea could emerge in the



I – trajectory of evolution preset by the first way of privatization policy in transition economies (sale of enterprises to strategic investors)

II – trajectory of evolution preset by the second way of privatization policy in transition economies (with diffusion of shares of formerly state-owned enterprises among large numbers of small private owners)

Figure 11.1 Evolution of firm models

countries where the state pursued active industrial policy and where mechanisms of informal public–private partnership were widely adopted. Axes A, B and C in the Figure 11.1 correspond to these three directions of potential transformation of the family firm (sole proprietorship). Naturally, the axes cannot be considered permanent. They are nothing more than vectors showing whatever direction is followed by evolution of relations of the firm with its investors and the state. In the real life, different intermediate combinations are possible.

For instance, concentrated ownership structure historically prevailed in big business of the countries of Continental Europe (which generally complies with the Axis B). However, in recent years, legal regulation and business practices in these countries have been gradually moving the forms of business organization towards the Axis A due to rising importance of equity markets and introduction of good corporate governance. In developing countries, as soon as stock markets are established and relationship between business and the state is formalized, large companies more and more shift to the space between axes B and C.

Against this background, large firm in transition economy had an objective feature of having been originally owned not by an individual proprietor or a family, but by the state. The original shift of 'transition firm' along the Axis C in the Figure 11.1 is explained exactly by the influence of the state, which was establishing the rules of the game and fulfilled the role of proprietor simultaneously. However, weakness of the state as an owner was the factor for initial placing of 'transition firm' in the space between axes A and C. Further transformation of 'transition firm' into a market agent in the majority of former socialist countries was closely related to privatization, which had strong influence on further evolution of organizational forms of big business according to specific approaches to privatization in various countries:

- Either orientation towards sale of enterprises to strategic investors (in East Germany, Hungary and Poland etc.);
- Or various versions of 'voucher' privatization involving free distribution of privatization checks to all citizens (Czech Republic, Russia and Bulgaria etc.).

The first option practically immediately led to emergence of the firm with concentrated ownership under control of a limited number of outside investors (very often foreigners). For instance, according to the data of an extensive study by Stark & Vedres (2006) based on investigation into changes into ownership structure of 1700 largest Hungarian

firms in 1987–2001, at half of them the share of the largest stakeholder by the end of the period under review was 98 per cent, and at the majority of the rest, two largest stakeholders had more than 76 per cent of voting shares. At the same time, more than three-fifths of the firms under observation were controlled by foreign investors. And even if an enterprise shares were initially traded on the stock market and it was run as a public company, its dominant shareholder often tended to make it private after having acquired the controlling stake. (Examples based on Bulgarian data see in TTPP (2004). So, the case in point was a model of business organization when management was placed under tough control of a new private owner, which generally corresponded to Axis B.

The second way of privatization, where the state 'diffused' its property among a great number of minor shareholders, involved more serious problems in the relations between owners and managers. Depending on the details of regulation, this property either fell into the hands of institutional investors created especially for this purpose (for example, in Czech Republic), or the majority of shares were taken by enterprise's labor collectives (in Russia). Nevertheless, real control over enterprises, as a rule, remained in the hands of old managers in both cases. Meanwhile, in the absence of a functioning equity market, new owners lacked sufficient incentives and enough instruments to influence the management of privatized enterprises. In this sense, the 'transitional firm' that emerged in the course of privatization at first glance, had no essential distinction in terms of internal organization from the late-socialist firm, already free from control of planning authorities and actually run by top managers (Kornai, 1992).

However, there was critical difference between them due to much higher uncertainty of environment. To give an example related to corporate governance, 'voucher' privatization, bringing no changes to the established model of firm management, created a fundamental possibility of transfer of ownership rights to some other owners. This potential threat of loss of control over enterprises gave managers serious incentives for opportunistic behavior. In the short run, this opportunistic behavior was expressed in moving assets from the privatized enterprises to private companies owned by the managers. In the medium term, the directors were keen to use working capital of their enterprises for buying shares from other owners (in the first place, from the labor collectives) in order to establish legitimate control over the enterprises.

In any case, diffused ownership structure gave no incentives for restructuring and improvement in enterprise performance in transition economies, where institutions were typically imperfect. This is true not

only of old directors, but also of new private owners who gained control over enterprises and devised sophisticated schemes for taking away their liquid assets. Russian experience shows that incentives for restructuring and improvement in enterprise performance emerged only after ownership rights had been consolidated in the hands of a single owner or a close group of shareholders.

Going back to Figure 11.1, we can state that the first way of privatization policy, which had been oriented towards sale of enterprises to strategic investors, actually carried the 'transitional firm' to Axis B, with mechanisms of corporate control and corporate financing typical of this trajectory. Since the role of investors of this type was, as a rule, performed by large foreign companies that were concerned mainly about transforming the enterprises they had bought into their production subsidiaries (Radosevic, 2002; Andreff, 2005), we believe that the prospect for deviation from this trajectory is minimal.

The second way of privatization policy was, in terms of ideology, oriented towards a shift of the 'transition firm' to Axis C. Nevertheless, paradoxically, taking into account the distorted motivation of old managers and new owners of privatized enterprises, the ultimate result of this policy was high concentration of ownership and control, while at the same time, the state continued to interfere into corporate affairs. Therefore, instead of movement over Axis A we have to actually speak about transfer of the 'transition firm' to the space between Axes B and C. In the framework of this trajectory, further development of corporate governance (more exactly, of models of organization of large firms) can have two outcomes. If relations with the state become more formalized, there will be a shift to axis B. On the contrary, in case of increasing state interference into the economy under attempts to establish 'state capitalism' (which, as we believe, is going on in Russia in recent years), there may be a further shift to Axis C. However, in our opinion, in the medium term there is no prospect in any case for a radical change of the trajectory and for a shift to a model with dispersed ownership – and the corresponding movement towards Axis A.

Conclusion

In this chapter, we tried to demonstrate that inefficiency of corporate governance in Russia and blunt violations of investors' and shareholders' rights in the 1990s were related not only to the 'insider' structure of ownership but also to insufficient preconditions for implementing the widely held firm corporate governance model, which the reformers tried

to transplant to the Russian environment. In our opinion, at least two requirements need to be met to make such an institutional experiment successful:

- Availability of an existing legal framework that can support the functioning of sophisticated intermediary institutions (stock market, professional investors, etc.) characteristic of the 'Anglo-Saxon' model;
- Certain level of business efficiency at which the managers are not afraid of losing their positions if the owner is changed and the original owners can obtain a sufficient compensation for their block shares.

Neither requirement was met in Russia in the 1990s. Recent studies, however, have been focused on the imperfection of legal institutions followed by the traditional recommendations to improve enforcement. These recommendations are correct but not sufficient.

It must be admitted that contrary to the common point of view, the insiders (including not only managers but also majority shareholders) play a key role in corporate processes in Russia and this is why government policy in this sphere cannot ignore their interests (which has been the case so far). This said, the interests of insiders themselves may differ significantly depending on the level of concentration of ownership and control. It is only consolidated owners that can have sufficient incentives to restructure and improve their business in the current Russian conditions. This category might be potentially interested in attracting investors and improving corporate governance. And it is for this reason that policy-making needs to take into account the interests of various groups of insiders.

The above means that the government – unlike in the 1990s – should not be looking at this or that pre-defined corporate governance model. Legal regulation should become more flexible. It should create conditions for the development of various corporate governance mechanisms and take into account the interests of market players, their evolution and differentiation. We need a transition from the model of 'political modernization' of the institutional environment, with institutional supply being generated by the government, to the 'market modernization' model where demand for institutions is generated by market players themselves (Cadwell & Polishchuk, 2001).

In the field of corporate governance business, in our view, is ready for constructive cooperation with the government based on

collective interests of the entrepreneurial community. However, for this cooperation to produce positive results, it is important that the government – and, in a broader context, the state – pursue public rather than some other interests. Unfortunately, the situation is still unclear.

Almost immediately after taking office President Putin announced his policy of strengthening 'the vertical line of power'. Since there was no real political competition, however, this policy resulted in consolidation of the state machinery. While it remained out of control of both society and supreme political power, the state machinery guided by standard bureaucratic aspirations began to play a more and more important role in the economy. As a result, the model of state capture or informal privatization of power in the interests of business typical of the 1990s is gradually replaced with that of informal capture of business to subordinate it to bureaucracy interests.

The above said is indirectly confirmed by data from managers of Russian enterprises who were surveyed on the efficiency of court procedures used to resolve conflicts with private counterparties and government agencies (Frye, 2002; Golikova *et al.*, 2003). Contrary to popular skepticism, arbitration courts are sufficiently effective in resolving disputes between enterprises while the probability of winning the case and having the court decision enforced in a conflict with government agencies is estimated by the respondents as significantly lower.

This means that today the threat of ownership rights violation in Russia comes from the state machinery pursuing its bureaucratic or political goals rather than from the insiders.[6] In this very context, detention and legal prosecution of main shareholders of Yukos oil company in 2003–2005 charged with abuses made during privatization of Apatit Co. and with tax evasion, is an important precedent. Market reaction to these events was fairly calm, including swift recovery of stock indexes and assignment of investment rating to Russia by Moody's, Fitch and S&P in the late 2004 – early 2005. Nevertheless, practically all observers agreed that the Yukos case was based on selective use of legal sanctions motivated by political reasons. At the same time, a great number of firms and individuals who had used identical schemes of tax optimization suffered nothing at all. Therefore, in our opinion, the future of corporate governance in Russia depends not only on the strengthening of the judicial system but also on whether the government will pursue the interests of the society in its interaction with business or its policies will be defined by the interests of individual agencies and political groups.

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Notes

1. These banks include ONEXIMBank, Rossijsky Kredit, SBS-Agro, and others. However some papers (see Pappe (2002) for instance) consider this asset stripping instead of debt repayment as a positive step, which enabled Russian business to retain control over the largest national enterprises.
2. It should be considered that this process was pursued both by the management (e.g. AO Severstal) and by new investors, outsiders as related to the old management (e.g. Norilsk Nickel). However, regardless of the starting point, the emerging consolidated owner continued to act as the classical insider.
3. We can point out that in some cases the main purpose of corporate bond issues was not to raise funds but to improve the company's image on the market. This is characteristic, for instance, of natural resource-based industries that have had no major problems with liquidity in the recent years.
4. According to World Bank experts, the share of the shadow economy in Russia was up to 40% in the mid 1990s (Kaufman & Kaliberda, 1996). For more detailed analysis of the influence of shadow economy on the development of economies in transition, see Johnson *et al.* (1997).
5. For more information on the development of demand for law in Russia see Hendley (1999), Pistor (1999) as well as Yakovlev (2003a), Medvedeva & Timofeev (2003), Simatchev (2003) on creating demand for legal institutions in the field of corporate governance.
6. The aforesaid does not mean that all problems of minority shareholders are already solved, but, as we believe, the situation has improved in terms of quality in recent years. While owners of large Russian companies are deliberately entering the equity market, they will use other, more civilized ways

of settling disputes even in cases of conflict with new minority shareholders. While motivation of insiders is being changed in this direction, the existing legislation and the stronger law enforcement will provide sufficient mechanisms for protection of minority shareholders in comparison with other emerging markets.

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