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# Capital budgeting practices: A survey of Central and Eastern European firms ☆

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ABSTRACT

We survey 400 executives in ten countries in Central and Eastern Europe (CEE) and report the results of their companies' capital budgeting practices. We find that capital budgeting practices in CEE countries are influenced mostly by firm size, multinational culture, firms' goals, and the presence of code of ethics, and to a lesser extent, by executive ownership, number of projects analyzed, and target leverage. We compare our results with prior studies and find significant variations in capital budgeting practices across 35 countries, among high, upper middle, and lower middle income countries, and across seven geographic regions.



## 1. Introduction

Capital budgeting decisions are among the most important decisions that the financial manager of a firm has to make. Capital budgeting process refers to the process of selection of investment projects that maximize shareholder value. Prior studies related to capital budgeting practices have mostly focused on developed

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economies (e.g., U.S., Canada, Australia, and Western European countries). However, much less is known about how capital budgeting decisions are made in transitional economies (e.g., post-communist countries in Central and Eastern Europe), which is the topic of this paper.

Previous research (e.g., Bennouna et al., 2010; Brounen et al., 2004; Graham and Harvey, 2001) addresses how corporate finance theories have been adopted by financial managers in practice. However, one would argue that most of the stylized facts are likely to be rooted in the U.S. and Western European empirical evidence. Several studies document fundamental differences between financial markets, legal systems, and institutional settings, when comparing the U.S. with Western Europe (e.g., La Porta et al., 1997, 1998). Among countries and regions, there are significant differences in the extent to which investors are protected from expropriation by managers (e.g., La Porta et al., 2000). Rajan and Zingales (2003) indicate that institution-heavy relationship-based system is more prevalent in continental Europe, while the market-intensive arms' length system is more prevalent in the U.S. and Canada. Chew (1997) finds that market-based corporate governance system differs significantly from the insider-based or relationship-based governance system. For example, Brounen et al. (2004) provide survey evidence that firms in the U.K. and the Netherlands strive to maximize shareholders' wealth, while German and French firms attach a low priority to this corporate goal. Licht et al. (2005, 2007) show how culture, law, and corporate governance mechanisms affect corporate management decisions. Stulz and Williamson (2003) suggest that corporate financial practices are influenced by national culture. Similarly, Li et al. (2013) provide theoretic model and empirical evidence on how national culture influences corporate risk-taking behavior. Finally, most of corporate finance theories have been developed under the assumption that capital markets are "semi-strong" efficient. However, this assumption seems to be questionable when it is applied to emerging markets that are typically characterized by higher information asymmetries, higher transaction costs, relatively concentrated ownership with small and medium enterprises, and relatively low market liquidity. For example, Maquieira et al. (2012) and Mendes-Da-Silva and Saito (2014) find evidence that capital budgeting practices of firms in Latin America where capital markets are still emerging are significantly different from those of developed countries.

In this study, we conduct a comprehensive survey that asks business executives from a wide range of firms in the Central and Eastern Europe (CEE) region[1] to describe their choices related to capital budgeting analysis and decisions. We measure the extent to which corporate finance theories explain the capital budgeting practices in Central and Eastern European countries. The CEE region consists of several small, open economies where most of the GDP is produced by small- and medium-sized companies with a strong interdependence on multinational companies. We include ten CEE countries in our survey. These countries are considered either high or middle income countries based on the OECD classification.[2] CEE countries are characterized by diverse culture, languages, legal systems, institutional settings, and corporate governance mechanisms. These countries tend to have a well-developed banking system, but they tend to have less developed capital markets that are likely be less efficient and less liquid than developed capital markets. The levels of economic and financial development in CEE countries tend to be lower than those of developed countries in North America and Western Europe. Most firms in CEE countries tend to be small or medium private enterprises. Given the significant differences between developed and emerging economies; between efficient and less-efficient capital markets; between market-based and relationship-based corporate governance systems; between levels of economic and capital market development; and given significant differences across national cultures, we argue that capital budgeting practices in CEE countries are likely to be different from those in the U.S. or Western Europe.

Prior studies indicate that the difference in the level of economic development between two countries can significantly affect corporate finance practices (e.g., Hermes et al., 2007; Rajan and Zingales, 2003), so we also investigate whether capital budgeting practices differ significantly across country income groups and geographic regions. We compare our results with that of prior field studies which examine capital budgeting practices of firms in North America: the USA, and Canada (Bennouna et al., 2010; Graham and Harvey,

[1] Central and Eastern European (CEE) countries in this article (Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia) are referred to as the Eastern bloc countries west of the post-WWII border with the former Soviet Union. These countries made the transition from communist to capitalist systems and experienced rapid socio-economic and cultural changes over the past two decades while gradually integrating into the European Union (EU).

[2] High-incomes: Croatia, Czech Republic, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia; upper-middle-incomes: Bulgaria, Hungary, and Romania. (Source: The World Bank, http://data.worldbank.org/about/country-classifications, 2013.)