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Corporate governance following mass privatization

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ABSTRACT

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Using vouchers to privatize state-owned firms was an innovative but controversial aspect of transition. In the Czech Republic, voucher privatization created a large group of minority shareholders who coexisted with large shareholder–managers who controlled firms. Critics allege that the structure of shareholdings and regulatory failures allowed pervasive theft of corporate assets, much of it financed by irresponsible bank lending, and led to a financial crisis and an economic downturn. I argue that neither anecdotal evidence of managerial malfeasance nor the theories of tunneling and looting provide strong evidence for this view of corporate governance in the Czech Republic. A lack of small shareholder protection seems to have imposed small costs on the economy, and it may have facilitated rather than hampered the restructuring of firms. *Journal of Comparative Economics* **44**(4) (2016) 1132–1144. Arizona State University, Tempe, USA.
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1. Introduction

A number of formerly-Communist countries implemented privatization strategies that distributed shares in state-owned enterprises to the general public. In many countries, such mass-privatization programs were combined with other means of privatization, including sales of firms to workers or mangers, to foreigners, etc. (Brada, 1996). Whether the voucher programs were the main vehicle for privatization or merely one of many means used, they were seen as being, in many ways, the most radical way of privatizing state-owned firms. The process was pioneered by the privatization process in Czechoslovakia and the Czechoslovak experience is often seen as providing the most telling evidence about the effect of mass privatization on corporate governance. However, the Czech Republic's process of transition through a mass privatization process in which citizens could purchase, for a symbolic price, vouchers that allowed them to bid for shares of firms that were privatized in two so-called waves between 1991 and 1995 has been steeped in controversy because of the widespread perception that the ownership structure that emerged led to ineffective corporate governance and, as a result, to poor financial sector development and lagging overall economic performance (see, for example, Estrin et al. 2009, especially section 2.3).[1]

During the privatization process, it became evident that many Czech citizens were either eager for greater diversification than the bidding process offered or uninterested in bidding for the shares of individual firms, and 72% of the participants

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[1] For descriptions of the voucher privatization process, see Mejstřík (1997). The first wave of privatization occurred when the Czech Republic was part of Czechoslovakia, but because the analyses of the subsequent outcomes deal entirely with developments that took place in the Czech Republic, from now on I refer to the process as the Czech privatization to avoid needless terminological complications.

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in the first wave and 63.5% in the second wave chose to take part in the privatization process by giving their vouchers to mutual funds who then assembled their portfolios by bidding for the shares of individual firms being privatized. Critics of this process have argued that the resulting ownership structure left many firms with dominant owners and a group of minority shareholders who were open to exploitation by the majority shareholder and that it created close ties between a commercial bank's investment fund and the fortunes of the firms whose shares it owned, leading to a perverse sort of "relationship banking" that facilitated managerial looting of firms.[2]

Svejnar (2007, p. 6) sums up the mainstream view of corporate governance in the Czech Republic thus: voucher privatization in the Czech Republic "resulted in dispersed ownership of shares and, together with a weak legal framework, it resulted in poor corporate governance. The poor corporate governance often permitted managers or majority shareholders to appropriate profits or even assets of the firms at the expense of minority shareholders."[3] Many observers further argue that corporate governance after the Czech voucher privatization was so poor that it had significant negative macroeconomic consequences, including the so-called *kuruna* crisis of the late 1990s and the accompanying recession.[4] Moreover, it is alleged that Czech banks, not as yet privatized in the early and mid-1990s, continued to lend to firms that were being stripped of their assets by majority shareholders, allowing the asset stripping process to continue for longer than it would normally have and creating a financial crisis (Cull et al. 2002; Desai, 1996). In addition, lax regulation of financial markets failed to protect minority shareholders and, according to some observers, finally led to a collapse of share prices in the Czech Republic in the late 1990s (Coffee, 1999; Glaeser et al. 2001).

The central argument of this paper is that the above-mentioned analyses of Czech corporate governance reflects what Depkat and Steger (2015) identify as a pervasive characteristic of the Western literature on Central and East European corporate and managerial behavior. In their review of this literature, they conclude that its analytical approach entails the construction of two "selves". One is the "West", whose business practices and institutions are seen as a modern and progressive system where economic and managerial processes and practices are rational, well governed by laws and institutions and characterized by managerial accountability and professionalism. The managerial and economic practices and institutions of the transition economies represent the "other", the antithesis of the "West". Thus, in East Europe, according to the Western literature, managerial attitudes and behaviors are characterized as opportunistic, tainted by the Communist past, and distorted by remnants of the irrationality of practices that existed under central planning. Institutions and laws are seen as inadequate, poorly implemented or embryonic. Moreover, the more East European practice differs from that of the idealized construction of managerial practice in the "West", the more it is seen in a negative light. Since the voucher privatization was arguably the most unique or "East European" of the transition strategies, in the light of Depkat and Steger's findings it is not surprising that it has attracted so much criticism.

The global financial crisis of 2008 offers an opportunity to reconsider criticisms of the Czech privatization because it, again, raises the question of the limits on the effectiveness of corporate governance that any economic system can offer. The global crisis, too, was driven by failures in corporate governance as owners of banks and financial institutions were unable to restrain managers from undertaking risky financial bets that gave rise to huge bonuses for mangers but, ultimately, to massive losses for minority shareholders.

In this paper I reexamine the theories of tunneling and of looting as well as the arguments that corporate governance was so bad as to materially impair restructuring and economic growth in the Czech Republic. I argue that the evidence reported in the literature is open to alternative interpretations that are more favorable to this method of privatization than conventional wisdom suggests and that the corporate governance that evolved in the course of mass privatization may have, in fact, facilitated the restructuring of firms. Specifically, in Section 2 I argue that anecdotal evidence of poor corporate governance is both ambiguous in nature and common to all corporate governance regimes. Thus, identifying cases of alleged managerial malfeasance in the Czech Republic tells us little about whether corporate governance was adequate to meeting the goals of the voucher privatization. In Section 3, I examine the theories of tunneling and looting, the two methods by which majority owners were believed to have exploited the minority owners created by the voucher privatization. I note that the two theories reach opposite conclusions regarding the structure of corporate governance, with the former implying as small a share of stockholding by the majority owner as is compatible with corporate control while the latter calls for the majority shareholder to seek as large a share of stockholding as possible. The two theories do have a common conclusion and that is that both looting and tunneling require extensive bank lending to firms and that the eventual outcome of either process has to be a large number of bankruptcies. I examine the evidence on bank lending and bankruptcies in the Czech Republic in Section 4 and show that lending to firms decreased but there was no major wave of bankruptcies among large Czech firms. The costs of tunneling and looting are examined in Section 5, and I argue that efforts to link the Czech Republic's poor macroeconomic performance to its corporate governance are open to question and that the statistical evidence suggests that the costs of tunneling and looting were small and, in any case, less than the costs of delaying privatization. In Section 6 I argue that there is a tradeoff between the protection of minority shareholder rights

[2] A study by Koleva and Vincensini (2002) provides a more positive view of the governance role of funds in both the Czech Republic and Bulgaria.

[3] Other expressions of this view include Coffee (1996, 1999), Estrin et al. (1999), Megginson (2005), Nellis, (1999), Spicer et al. (2000).

[4] See Cull et al. (2002), Desai (1996), Glaeser et al. (2001) and Spicer et al. (2000) for such claims. Nevertheless, Gouret's (2007) cross-country study reaches a somewhat contrary conclusion, injecting a note of caution about these early findings, and Bennett et al. (2007) also conclude that mass privatization was associated with better macroeconomic performance.

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