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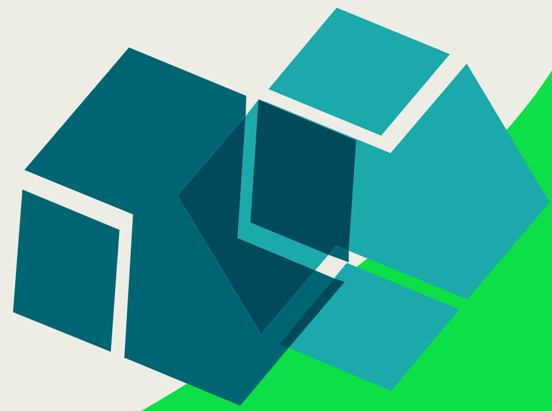

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Corporate Governance in Central Eastern Europe – a Comparative Political Economy Approach

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Abstract

This paper deals with several aspects of corporate governance in three Central Eastern European countries. We followed that strand of literature which focuses on the CG of public companies. This prompted us to give equal attention to the evolution of capital markets in CEE-3. The equity market-CG relationship is bi-directional. On one hand, the rules and instructions from the stock exchanges improve many corporate governance characteristics, while on the other a high CG reputation certainly contributes to the development of local bourses.

Content

Introduction 2
1. Varieties of Capitalism – the theoretical framework 2
2. Privatization 6
3. Stock exchanges 8
4. Ownership structure 10
5. The impact of the EU regulation 12
6. Within-group similarities and differences 14
Summary 16
Literature 16

Introduction

As part of broader research on institutional convergence within the European Union this paper analyses the evolution of corporate governance (CG) in three new member states: the Czech Republic, Hungary and Poland (CEE-3).

Governance issues are important for all types of companies but in accordance with the mainstream literature this paper limits its scope to public joint stock companies. The analysis then considers local stock markets as inseparable variables in understanding the nature of CG characteristics and the importance attached to them in CEE countries, in the spheres of both regulation and academic research.

Ever since ownership and management were separated, corporate governance emerged as an essential institution of capitalism. The topic has been extensively researched and there are several well-established theories of CG. These theories, however, are based on the experiences of developed market economies. It is much more difficult to find convincing insights into the peculiarities of CG issues in emerging, post-socialist economies. The mainstream research agenda of CG, revealed by our survey of the literature, are matters such as the principal-agent problem, board composition and independence, the analysis of common law vs. civil law legal systems and so on. This approach is less helpful in revealing and explaining the peculiarities of CG in CEEs than it had been previously assumed. This is why, in search for an alternative theory, we turned to the „varieties of capitalism" school of thought and used it as a theoretical point of departure in section 2.

Looking back at the two-decade long evolution of CG in CEE-3 we have identified three main factors that shaped their course. The first was the choice of privatization methods by which the leap in the radical systemic transformation was accomplished. The lessons learnt from the first big wave of privatization led to the introduction of the corporate governance theme in CEE-3 with which we deal in section 3. The development of equity markets and its impact on the main CG characteristics, including ownership characteristics are described in section 4 and 5. The path of change in the formal structures and regulation of CG was heavily influenced by the transnational concepts current at the time, and here a crucial role was played by the EU reform ideology and harmonization requirements, as considered in section 6.

Given the similar evolutionary path, the three CEE countries share many features of country-level CG characteristics, catalogued in section 7. This research has revealed such similarities but also important differences. Thus, as the main message of this paper, we shall emphasise the diverging trajectories that Poland on the one hand and Hungary and the Czech Republic on the other have been following, both in the development of capital markets and in the recognition of the importance of high quality corporate governance.

1. Varieties of Capitalism – the theoretical framework

As a theoretical framework for this paper the extended varieties of capitalism (VoC) approach was chosen. To begin with we shall give a short description of the original VoC theory with a special emphasis on its financial system and corporate governance component. This will be followed by pointing out the limitations of the theory in its classical form, especially when applying it to the emerging markets of East-Central Europe. In the course of its refinement the original VoC theory went through substantial modification by adding new sub-fields of economic institutions. Several

extended versions of VoC have been developed including the concept of Nölke and Vliegenhart (2009) who made a useful contribution to the theory by establishing the category of „dependent market economies". A distinct stylized model of CEE's capitalism was thus formed, and a description of it makes up the third part of this introduction.

The „varieties of capitalism" (VoC) school of thought has become a popular tool for the analysis of the institutional differences and similarities among various national economies. The most influential book in this field is Hall and Soskice's *An Introduction to Varieties of Capitalism* (2001). The authors offered ingenious insights on the reasons for the persistence of different models of capitalism.

The basic dichotomy in the firm-centred VoC is that the coordination of the subsystems of an economy can be effectuated either directly by the market or by non-market means that is by so-called „strategic" interaction between the crucial actors of the economy. From this follows that national economies can be compared in relation to the ways the firms achieve the required work of co-ordination. The original model consists of five sub-fields: financial system and corporate governance; the internal structure of firms; industrial relations; education (skill formation); inter-firm relations. Hall and Soskice distinguished two ideal types of capitalism: Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs). Both types can be efficient and can have outstanding competitive advantage (albeit different) provided there is strong supportive match between the subfields of the economy. This principle of complementarity is considered to be the cornerstone of the VoC theory.

Financial systems and corporate governance feature strongly in explaining the differences in various national modes of capitalism. And, as the VoC theory proves, these two subsystems are tightly interlinked. In liberal production regimes (the ideal type of LMEs is exemplified by the United States) capital markets are highly developed, stock exchanges are important sources of finance, the ownership of public companies is dispersed, delivery of shareholder value is strongly advocated and there is a relatively frequent occurrence of hostile takeovers. In co-ordinated production regimes (the closest fit of which is Germany), another mode prevails: CMEs financial intermediation is predominantly bank-based, the ownership structure of companies is concentrated and hostile takeovers are rare. Stakeholder orientation is a crucial feature of the CME type CG.

The VoC framework for the taxonomy of capitalist models has been widely acknowledged and generated a large amount of further thinking and attempts at empirical verification. Subsequently, more and more critical work has been published which pointed out the limitations along several lines of the original VoC. An often repeated criticism was that the VoC model is only meaningful when it is applied to a developed market economy. Moreover, the closer the given economy resembles the ideal-type variants (US and Germany) the better is the reflection of reality. The great majority of economies around the world, however, are hybrids, where the complementarities among the institutional subsystems are either weak (in the sense of Hall and Soskice's proposition) or need a more complex analysis with the addition of stronger variables. As we move further away from the developed capitalist core to the periphery, it becomes even more questionable that the LME/CME dichotomy could be helpful in finding out the differentiating systemic linkages and the real drivers of institutional evolution.

As for the most developed Central Eastern European economies, a general consensus has emerged that they represent a distinct variety of capitalism. They share similarities which justifies treating them as a separate model of capitalism instead of regarding them just as a variation of CME.

To understand better the nature of CEE capitalism it is necessary to add new variables to the analysis. A crucial new dimension emerges by lifting the constraint of the closed nation state approach of the original VoC. The importance and peculiarities of the transnational ties of these countries have been recognized and pointed out. A number of authors considered this approach productive, including Nölke & Vliegenthart whose article (Nölke & Vliegenthart, 2009) has been widely cited on the subject. The authors extended the taxonomy of Hall and Soskice original VoC by introducing a third variety in the coordination of firm activities which, in turn, logically implied a third type of innovation pattern and competitive advantage. Nölke & Vliegenhart labelled the variety of capitalism that the CEE represent as „Dependent Market Economies" (DMEs).

The authors rightly pointed out that the large amount of foreign investment the CEE countries absorbed during the first one and a half decades of transition had a decisive impact on their integration in the global economy and also on the evolution of a great number of institutions in their economies. At beginning of transition, Hungary, Poland and the Czech Republic (like all other transition countries) had the ambitious goal of restructuring and of catching-up growth, but this goal was not supported by an adequate amount of domestic savings. To bridge the gap between low savings on the one hand and the need for capital accumulation and modernization on the other, the best available strategy was to engage in FDI-led development. The preparation for and the accession to the European Union enhanced further this type of transnational investment pattern. Indicators depicting the role of FDI in many areas of the economy show that the three countries (the subjects of our analysis) stand out in international comparison as achieving the highest rates of FDI-dependency. The emergence of external dependence was especially striking in the banking sector where the market share of foreign owned banks in total banking assets reached 96 per cent in the Czech Republic, 95 per cent in Hungary and 70 per cent in Poland by the mid-2000s. (EBRD 2007)

The weight of the multinational companies in the real economy and the high degree of foreign ownership in the financial sector created linkages in the rest of the system, and draws the CEEs away from being classified as hybrids of CMEs and LMEs. (For the summary comparison of the characteristics of the three models see Table 1.) The main institutional complementarities in the DMEs were formed between (a) the skilled but cheap, poorly organised labour, (b) the transfer of technological innovations within transnational enterprises and (c) the provision of capital via foreign direct investments. (Nölke, 2011). According to the logic of the „extended variety of capitalism" paradigm, these complementarities were conducive to strengthening the comparative advantage of industries which act as assembly platforms for semi-standardized products.

The next question is what implications FDI dependency has on the financial systems and corporate governance of the CEEs. Compared to other market economies at similar levels of development, capital markets have remained relatively underdeveloped in CEEs. That the role of local exchanges for financing domestic companies has not gained much importance during the course of the last two decades, follows partially from the excessive reliance on FDI and credit from foreign-owned banks as prime means of finance in these economies. In the present paper, however, we contend that this pattern applies less and less to Poland (the largest country among the CEEs) where the development

of the equity markets has taken a remarkable expansionary course, thus changing the character of the entire financial system of the Polish economy. (We will elaborate more on the Polish distinctness in section 7.)

Table 1. Three varieties of capitalism

	Liberal market economies	Coordinated market economies	Dependent market economies
Distinctive coordination mechanism	Competitive markets and formal contracts	Interfirm networks and associations	Dependence on MNC intra-firm hierarchies
Financial system	Domestic and international capital markets	Domestic bank lending and internally generated funds	Foreign direct investments and foreign owned banks
Corporate governance	Outsider control: dispersed shareholders	Insider control: concentrated shareholders	Control by headquarters of multinational enterprises
Industrial relations	Pluralist, market-based, hardly any collective agreement	Corporatist, rather consensual, sector-wide or even national agreements	Appeasement of skilled labour, company level collective agreements
Skill formation	General skills, high research and development expenditures	Company- or industry-specific skills, vocational training	Limited expenditure for further qualification
Transfer of innovation	Based on markets and formal contracts	Important role of joint ventures and business associations	Intra-firm transfer within transnational enterprise
Comparative advantages	Radical innovation in technology and service sectors	Incremental innovation of capital goods	Assembly platforms for semi standardized industrial goods

Source: Nölke (2011)

The DME model of the extended VoC theory holds that, owing to the weight of the multinational companies in the economy, a particular coordination mechanism exists in the DMEs. There is a subordinate relationship between multinational corporations and their local subsidiary companies. The ultimate control and chief corporate governance mechanisms stay with the home basis of the MNCs. The managerial decisions in subsidiary companies are closely monitored by the headquarters of multinational companies. Local subsidiaries of MNCs are rarely listed on CEEs stock exchanges and thus they are not exposed to outside scrutiny and influence in the host countries.

Nölke succinctly summarizes the finance and CG aspects of the three models in a comparative way: ”Given the extremely high volumes of FDI (foreign direct investment), transnational corporations prefer to hierarchically control local subsidiaries from their headquarters, as an alternative mode of finance and governance when compared to LMEs (financing by international capital markets and outsider control by dispersed shareholders) and CMEs (financing by domestic bank lending as well as internally generated funds and insider control by networks of concentrated shareholders)”. (Nölke 2011).

Our paper looks at the CG characteristics of CEE from a different angle. We concentrated our analysis on the CG of public companies which do not appear separately in the DME model. In the case of the Czech Republic and Hungary the lack of analysis may be justified by the small (and stagnant) number of listed companies. In Poland, on the other hand, there are hundreds of companies of various sizes which are not only quoted on the booming Warsaw Stock Exchange (WSE) but also rely on equity financing. In recent years the WSE is a leading market in the number of yearly IPOs. This orientation (atypical for a DME) induces complementarity in other institutions, including first of all, corporate governance. The CG of public companies is strongly influenced by securities regulations and investors' demands and is expected to follow international standards in such issues as transparency and management accountability to all shareholders, including minority owners. Poland being a positive outlier among the CEE has become especially visible in the post-global financial crisis world. (The statistical basis of the original DME draws on the data from the first half of the 2000s).

2. Privatization

The first set of factors, chronologically, which had a durable impact on both the country and firm level characteristics of CG in CEE-3 were the direct and indirect consequences of the privatization of the state owned enterprises (SOEs) inherited from the era of central planning. Given its complexity and the preeminent role it played in system transformation, post-socialist privatization has given rise to a vast amount of research literature. In this section we will overview only issues which can be linked either to the CG theme or to the new-born stock exchanges.

From among the privatization methods, mass privatization which involved the free distribution of assets was very popular in a number of Eastern European countries. The main advantage was seen in its speed and ideological-political appeal. It was fully embraced in the Czech Republic, to a much lesser extent in Poland and not at all in Hungary. The differences among the applied methods of privatization of each CEE are summarized in Table 2.

Table 2. Distribution of companies' assets according to privatization methods up to 1998 per cent

Country	Sales to foreign investors	Sales to domestic investors	Vouchers	Other	Still state property
Czech Republic	15	15	40	5	20
Hungary	48	13	-	21	15
Poland	20	5	6	29	40

Source: Kalotay-Hunya (2000)

The Czech experience with mass privatization provides an instructive lesson as to how the negligence of corporate governance issues and regulation leads to perverse incentives, huge efficiency losses and looting. Also, the Czech case is a good example of the interconnectedness of privatization, stock market development and CG regulation under the circumstances of post-socialist transition.

The story of the Czech privatization is that of the high hopes attached to the unique experiment with mass (voucher) ownership transfer, turning sour. It is within the broader category of large-scale privatization that the voucher scheme was put into practice. The first step was turning large and many medium-sized state owned firms into joint stock companies. Next, the shares (almost 50 percent of the total number of all the shares of these new joint stock companies) were distributed to every eligible Czech citizen through the voucher method of privatization. (Kocenda, Svejnar 2003). These „investment points" could then be sold – and the majority were indeed sold - to the newly

established Privatization Investment Funds. In many cases these investment funds were controlled by state-dominated commercial banks. In their role as the new owners of corporations these investment funds were unable and did not have the proper incentives to exercise efficient control to prevent management from looting and asset stripping. The biggest mistake with voucher privatization on the part of the authorities was thus their failure to set up beforehand a proper regulatory framework. Such a framework could have directed and enforced transparency, internal controls, equitable treatment of shareholders, in sum, appropriate corporate governance standards.

By 1997 it had become obvious that the Czech approach to privatization could be regarded more or less a failure. In their assessment of the Czech mass privatization program World Bank experts wrote: 'the lack of appropriate accompanying institutional polices and lagging banking sector reform made mass privatization unnecessarily costly in equity, transparency, and microeconomic efficiency". (World Bank, 2000).

Bokros (2013) touched upon the essence of how to evaluate the success of any modality of ownership transfer into private hands when he pointed out that the chosen method must fulfil the twin requirement of creating incentives to channel new investments into the former SOEs and establish efficient governance and management of the privatized companies. Judged by these two criteria the Czech voucher scheme failed on both.

Among the numerous reasons that were put forward in explaining the rushed and unprepared (in terms of regulation) mass privatization was the stimulation of the development of the domestic capital market. At the beginning it seemed to work. Since mid- 1993 the stocks involved in voucher privatization streamed to the Prague Stock Exchange (PSE), and its market capitalization reached almost 30 percent of GDP by 1997. The subsequent chain of negative events changed the tide and led to mass delistings. In 2001 the stock market capitalization of PSE stood at a mere 15, 7 percent, the lowest among the CEE-3. As the stock market shrank so did the reputation of the PSE and the trust of investors.

The Polish experience with the first wave of privatization was in many respects the opposite of the Czech case. It was slower and more gradual process with paying attention to the importance of prior institution-building and the sequencing of reforms. Experts and bodies in charge of privatization were aware that creating a proper legal, supervisory and regulatory environment ahead of privatization was the right order. As elsewhere in the region, several methods of privatization were available for choice. From among the alternatives the commercial concept of the sale of the state property which included the reliance on capital market and public offering of shares received strong support in the first economic program of the new regime, the renowned Balcerowicz Plan. The large SOEs were first transformed into joint stock companies, with the state as sole shareholder. The next step was offering certain amounts of shares for sale to strategic investors or selling through IPOs on the stock exchange. (It should be noted that the state has retained considerable ownership and control rights in companies quoted on the stock exchange.)

Giving an account of the history of emerging capital markets in Central Eastern Europe Rozlucki (2013) emphasised the essentiality of highly professional approach in establishing a modern infrastructure (such as central securities depository, licensed brokers, etc.) and efficient regulation for the proper functioning of the emerging exchanges. As local expertise was missing, the necessary know-how had to come from the experts from various international institutions and individual

countries. The Warsaw Stock Exchange was created with French assistance within a framework of an intergovernmental agreement in 1990. At the end of the same year the first initial public offering was introduced on the WSE. The expansion of the Warsaw bourse was not fast in the first decade of transition but it soon acquired the reputation of being the most reliably regulated in the region.

Subsequent privatization laws took care of the popular support for privatization-cum-equity market development (sacrificing thus a part of the state budget revenue that could have been obtained from the process). Insiders of large SOEs to be privatized, managers and employees alike, were entitled to buy up to 20 percent of the shares at a 50 percent discount. With lesser shares and discount this method was repeated during the next privatization rounds.[1]

The centrepiece of the Hungarian privatization was the direct sale of the assets to strategic investors. Most often these strategic owners were foreigners as it can be seen in Table 2. Unlike in the Czech Republic and Poland capital markets were not considered as an essential tool in privatization techniques. The growth and institutional conditions of the Hungarian economy and her openness towards investors during the crucial years of transition helped her to become the most attractive destination for FDI in the region (the need for external equity finance was thus diminished). Soon foreign firms controlled two thirds of manufacturing and 90 percent of telecommunication services. The multinational companies whose subsidiaries had (and still have) this heavy weighting in the Hungarian economy are listed on the bourses of US, UK and Germany and obviously were not interested in the BSE. While foreign subsidiaries had to comply with a range of Hungarian regulations, their governance attributes have remained outside Hungarian influence.

3. Stock exchanges

This section deals with the equity market development in the CEE-3. We attach particular importance to this because the core features of stock markets on the one hand and the attributes of CG on the other, are inseparably linked. First, it follows from our focus on the CG of public companies exclusively that the bigger the number of companies quoted on local exchanges and the more actively their shares are traded, the weightier the consequences for the need of good quality CG on both the company and national level are. Second, the equity market-CG relationship is bi-directional since the rules and impulses from the stock exchanges improve corporate governance characteristics (such as transparency) while having good CG reputation certainly contributes to the development of local bourses.

Theory holds that the depth of the financial system, which includes vibrant capital markets, is an important ingredient of successful long-term development. This positive nexus between financial development and growth is supported by the majority (although not all) empirical studies. Levine-Zervos (1998), for instance, prove a positive relationship by regression analysis on a big sample of countries. After controlling for numerous factors associated with growth, the authors showed that the two main stock market indicators (market capitalization to the GDP and the value of stocks traded relative to the total) positively predict growth, capital accumulation and productivity

[1] Among the newest examples of practicing this approach is the privatization of the JSW, a Silesian coalmine in 2011. 17 percent of the company's total shares were given free to JSW's 22 000 workers by Poland's Treasury. (The Economist 6th July 2011)

improvements. In another research Rajan and Zingales 1996) found that financial development boosts economic growth through a number of channels from among which they stressed the importance of the reduction of the costs of external finance to firms.

The level of equity market capitalization differs substantially around the world, even within the group of developed economies. The differences are explained to a large extent by institutional factors and the complementarities among institutions. We have brought up this notion in the second section of this paper which part deals with the varieties of capitalism paradigm. In liberal market economies (in the Anglo-Saxon model of capitalism) stock exchanges have significantly more weight than in the European continental type of coordinated market economies. The most popular argument to explain the differences in these two ideal-type financial regimes was put forward by the law and finances subfield of institutional economics which emphasises the connection between legal origin, the strength of investor's protection laws, the resulting ownership structures and equity markets' dynamism. Although the varieties of capitalism approach makes a clear distinction between „market-based" and „bank-based" finances it does not imply substitution: in countries where stock markets are well-developed, the banking sector ranks high as well.

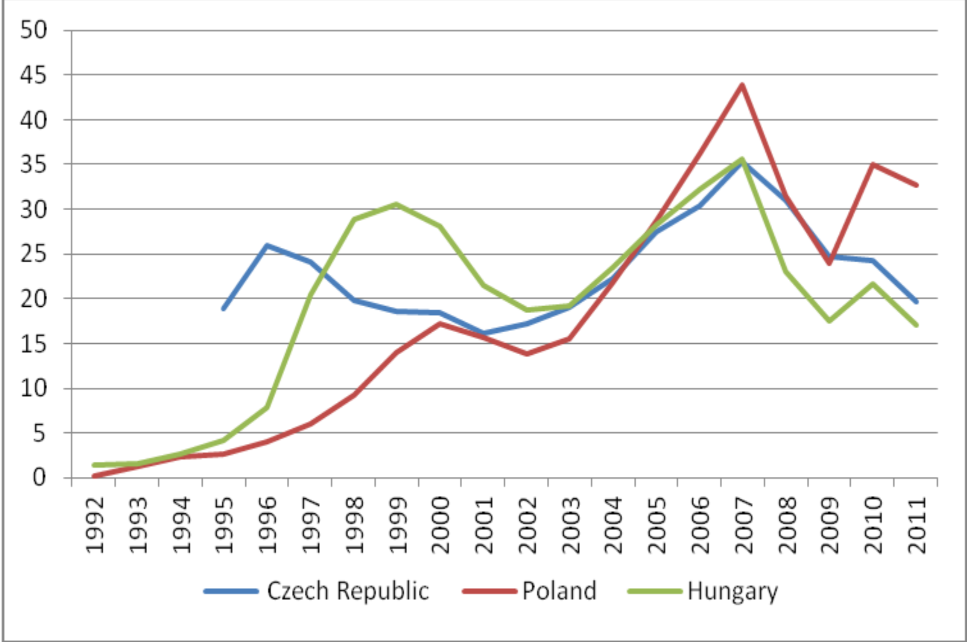
The 1990s saw a remarkable boom on equity markets in countries classified as emerging market economies. In spite of the rapid expansion of the emerging markets' stock exchanges, however, they are still considerably lagging behind the OECD group. Research carried out by Yartey (2008) who used a panel data of 42 emerging economies for the period 1990 to 2004 revealed that beside macroeconomic variables institutional factors play a crucial role in promoting or hindering the development capital markets. The typical institutional constraints include political risk, inadequate laws and regulations, poor law enforcement, lower quality of bureaucracy, higher levels of corruption etc. These impediments to the growth of equity markets are cited to apply for post-socialist countries as well.

Aggregate financial depth is one of the fields in which the CEE-3 is still considerably lagging behind the old member states of the EU. This relative underdevelopment applies to both the credit and securities markets, with the gap being larger in the latter case. The analysis of Adarov-Tchaidze (2011) confirms that „financial markets in the CE4 countries are significantly shallower than what one would expect given their stage of economic development as measured by real GDP per capita and controlling for other relevant macroeconomic characteristics". The financial intermediation in CEE-3 is strongly bank-based with the specifity that the banking sector is overwhelmingly foreign-owned.

All three countries established formal capital markets at the beginning of transition. The Budapest stock exchange (BSE and the Warsaw stock exchange (WSE) re-opened in 1990, and the Prague stock exchange (PSE) in 1993. In the previous section we confirmed that there was a deliberate policy of connecting privatization and the development of local stock markets in the Czech Republic and Poland. In Hungary mandatory listing was not required. In the first decade of transition, however it was the BSE which bourse was the most popular among foreign investors. Market capitalization, liquidity and turnover were significantly higher on the BSE compared to the other two exchanges. After the temporary setback at around the turn of the millennium the optimistic international investment climate and the accession of the CEE-3 to the European Union gave a strong impetus to the boom of the three exchanges – this time with Poland leading the group (Figure 1).

The 2008 financial crisis took its toll on the stock markets around the globe, including the CEE-3 bourses: the steepest decline (to a mere 15 per cent in 2011) was experienced on the BSE, followed by the PSE. The Polish exchange on the other hand showed a remarkable resilience compared not only to their regional but all European peers[2] . In 2008, in addition, the WSE launched an alternative trading platform called NewConnect which was created for smaller and innovative companies.

Figure 1. Stock Market Capitalization to GDP (1992-2011)



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Low liquidity of the market is a feature shared by all the three CEE-3 stock exchanges. This is explained by the concentrated ownership structure of the listed companies and also by the preponderance of a few large corporations. The share of the five largest companies in per cent of total market capitalization was 88.6 in the Czech Republic, 83.2 in Hungary and 38.4 in Poland. (Iorgova-Li Lian Ong, 2008)

Another reason for the low liquidity of stocks on the WSE is a relatively large number of firms with small capitalization which are less preferred by the investors than the bigger companies. The average capitalization of the companies on the WSE is much smaller than the average of the European markets. (Kalinowski, 2012)

4. Ownership structure

The ownership structure of publicly traded companies is one of the most important internal corporate governance elements. For outside investors and for stakeholders, too it strongly matters whether a corporation is widely held or dominated by blockholders; what categories of owners

[2] The global financial crisis changed the ranking of the stock markets in Europe as measured by the capitalization / GDP ratio. Poland had moved swiftly forward from the 21st place in 2005 to the number 13 position in 2010. (Source: Kalinowski, 2012)

prevail; or under what type of structure (pyramids, cross-shareholding etc.) the company is controlled. There is a great variety in ownership characteristics around the world and it is so within the European Union, too. In the ownership typology of listed corporations the starting point is to distinguish between dispersed ownership and concentrated (or dominant) ownership. Let us refer back here to the VoC theory (discussed in section 2) which shows neatly that widely held companies are complementary to developed equity markets and are an inherent part of the Liberal Market Economies model, while the insider-type, concentrated ownership with less weighty and less liquid capital markets are the conspicuous feature of the Coordinated Market Economies category.

The most commonly cited explanation for this type of dichotomy in ownership structure is derived from the law and finance literature. La Porta et al. (1998) in their highly influential work point out legal traditions as the main factor that shaped the evolution of ownership structures in the majority of countries. In the Anglo-Saxon world of common law tradition the high degree of ownership rights and legal protection has been conducive to the dispersed ownership patterns of public corporations. Contrary to this, in the civil law environment of Continental Europe shareholders secure their investment with the direct exercise of control through large equity blocks.

Similarly to the majority of EU countries, the ownership structure of public companies in CEE-3 is typically concentrated (although there are examples of widely held companies in each country.) Usually ownership is regarded as concentrated, if a single blockholder owns at least 20 per cent of all shares. Table 3. reports the ownership concentration data of companies listed on PSE, BSE and WSE. The highest concentration is exhibited by the Czech companies in which the average for the first largest block of shares is 56.7 percent and for the three largest blockholders is 80.7 percent for the period 2004-2008. The same data for the Hungarian companies are 48.7 and 68.0 percent, respectively. Compared to their regional peers the equity ownership of Polish companies is the least concentrated: on average the sizes of the first block is 41.0 while for the three largest block is 56.9 percent.

Table 3. Ownership concentration of listed firms in CEE-3 (2004-2008), percent

	Czech Republic			Hungary			Poland		
	Largest block holder	3 largest block holders	Foreign share holders	Largest block holder	3 largest block holders	Foreign share holders	Largest block holder	3 largest block holders	Foreign share holders
2004	53.1	80.9	32,5	46.0	64.3	47.2	40.9	57.9	20.4
2005	52.4	80.4	31.5	43.8	64.6	53.4	41.0	57.6	22.3
2006	56.7	75.7	48.4	41.8	60.2	57.2	42.4	59.5	20.6
2007	63.4	82.6	57.7	49.6	65.4	62.2	40.4	59.3	19.7
2008	60.6	76.0	58.6	54.2	71.5	70.6	36.2	50.4	21.9
Mean	56.7	80.7	43.0	48.7	68.0	57.2	41.0	56.9	21.9
SD	20.4	20.0	-	25.1	27.6	-	24.0	28.4	-
Min	1.7	0.6	-	4.5	6.7	-	3.5	3.5	-
Max	100	100	-	100.0	100.0	-	100.0	100.0	-
N	71	71	71	96	96	96	1228	1228	1228

Source: Aguilera et al. (2012)

From the point of view of efficient CG concentrated ownership can have merits over diffused ownership structure. With the presence of controlling owners the problems emanating from asymmetric information can be significantly reduced. Large shareholders can go as far as to be

involved in the daily activities of the management. A thorough empirical research of Polish listed companies conducted by Aluchna (2013) shows that individual investors (usually the founders of the companies) often combine the role of the majority shareholder with the role of the executive management. On the other hand, we can cite opposite examples from the BSE: the experience of a few Hungarian companies shows that concentrated ownership is not necessarily a hindrance to strong managerial power.

On the negative side high ownership concentration is usually associated with the low liquidity of shares and the increased likelihood of the expropriation of minority shareholders. Large shareholders may be entrenched and pursue their private benefits of control at the expense of overall shareholder value, i.e the small investors' interest. If CG rules do not convincingly constrain this type of business behaviour, minority investors do not take the risk of buying shares in these companies, which in turn, negatively influences the company's reputation and liquidity of its shares.

The majority of studies marks the consequences of the high information asymmetry between majority and minority shareholders as one of the main weaknesses of CG systems in CEE-3. A series of legal and regulatory reforms have been introduced in all three countries to improve the minority shareholder protection problem. However, while regulations on paper are in place, their enforcement is still lagging behind.

The other factor that has influence on CG characteristics of the firms is the identity of owners. The proportions among different owners (families, institutional investors, state etc.) shows a great variety among individual countries. Different investor groups behave in different fashions as owners and/or traders which in turn affects the firm's internal relations and external valuations. The preferences and the time-horizons of different types of shareholders can vary significantly. The harmonization of these different objectives is also a challenge for good CG.

As for the identity of owners Poland differs from the other two CEEs significantly. In Poland during the last 15 year many newly founded, family-owned companies went public. By the mid-2000 they already represented around 30 per cent of all companies on the Warsaw Stock Exchange. This category of owners is absent from both BSE and PSE. As Table 3. indicates in the latter two countries foreign blockholders (investment funds and commercial banks in the first place) dominate the market whose share in 2008 reached 70.6 per cent on the BSE and 58.6 on the PSE. The respective indicator for the WSE is much lower at 21.9 per cent. In Poland a significant number of companies still have the government as an influential owner. From among the 30 largest companies quoted on the WSE 7 have the state as a largest blockholder. This proportion is lower in the Czech Republic and in Hungary (although during the last few years the state's presence as an owner of stocks has increased on the BSE).

5. The impact of the EU regulation

Constraining and enabling regulation plays a crucial role in corporate governance structures and workings. Company acts, capital market and security laws are of primary importance pertaining to CG in all developed countries. This section deals with the regulatory aspects CG in CEE-3. At first glance basic laws together with other formal rules show remarkable similarities across CEE-3. The explanation for this lies mainly in the common source for their formation: the assistance of international institutions at the beginning of transition and the strong impact of the EU requirements

from the second half of the 1990s. Instead of a home grown development of CG regulations (like in the case of the OMS of the EU) in CEE-3 the main driving force in the setting of the rules was transnational influence and pressure.

The CEEs signed the Accession Partnership in 1998 and from then onwards the rational choice for these countries was to comply with the rules of the *acquis communautaire*. The EU membership offered huge benefits, thus the compliance with the EU requirements in building the institutions of their new market economies was a wise choice for CEE policy makers. This implied, however, that alternative institutional configuration had not been seriously discussed and considered. Grabbe(2006) drew attention to fact that while there existed a number of different varieties of capitalist models among the old member states, the accession policy documents reflected „a remarkably uniform view of what a "market economy" should look like" (p.24). This clearly applies to the EU laws and regulations concerning the various aspects of corporate governance that were exported to the CEEs. The „best choice" was thus made and promoted by the EU. The next step is to explore what particular CG model that had been exactly.

Our arguments are based on the in-depth research of Laura Horn (2013). In her book, she reveals in great detail why and how a crucial shift in the approach of the EU to CG regulation took place between the early 1990s and a decade later. To describe it in a nutshell it was a shift from harmonization to marketization in which the shareholder value paradigm has become the main guiding principle. In the author's words „corporate governance regulation was more and more seen as subject to capital and financial market imperatives" (p.107). The traditional continental stakeholder oriented CG model was seemingly left behind. For example, issues related to workers' rights were delegated to social policies. The author arrived at the conclusion that regulatory efforts in the field of corporate governance were in fact a sub-project of a broader political endeavour of market-oriented socio-economic restructuring in the European Union. It is this ideological and political approach that had been extended to the new member states and determined the way along which their corporate governance mechanisms were expected to develop.

Traditionally, the Member States of the EU exhibited significant differences in their national models of capitalism and this diverse landscape had applied to the national CG structures as well. Since the early 1990s, however, the different European ways have been challenged by globalization and the rise of financial capitalism. For both increasing the competitiveness of European corporations and their attractiveness for global capital flows the enhancement of traditional CG practices was deemed an urgent task. The „best practice" CG at that time was to a large extent equated with the shareholder value oriented Anglo-American market-based system.

It was at the turn of the century when the importance of globally high standards of CG and the need for reform on the EU level was translated into action. The breakthrough event to which CG reform initiatives can be connected took place in May 1999, when the Commission presented its Financial Services Action Plan (FSAP). The main goal of the Action Plan was to speed up the process towards the single European financial market. As a next step in 2001 a European high level group of corporate affairs and company law experts was formed. The task of the expert group was to elaborate the main directions of the modernization of company and corporate governance practices. Based on the high level group's recommendation in November 2003 the Commission published a report entitled ''Modernising Company Law and Enhancing Corporate Governance in the EU- A Plan to Move

Forward'' and submitted it to both the European Council and European Parliament. The chapters of the Action Plan covered all the important areas of CG including transparency and reliability of corporate information, stronger shareholder rights, distinction between executive and non-executive directors, the necessity of including independent members on the board of directors, employees' representation on the boards.

The legislation in the CEE-3 duly followed the European initiatives. In all the three countries Company Laws were updated.[3] These new laws unlike their predecessors have explicit reference to the rules of corporate governance and make sharper distinction between private and public companies. In addition, the soft law regulation of public companies, in the form of „codes of good governance" has also been introduced in CEE-3 from 2004 onwards. The regulation by codes allows more flexibility by using the „comply ore explain" principle. The chapters of the CG Codes are very similar in CEE-3; they cover shareholder's rights and treatment of shareholders, responsibilities of the management and the boards, the establishment and the duties committees, and the procedures of disclosure.

There is an agreement among experts that the provisions the new EU-inspired Company Laws and other CG regulations throughout the CEE-3 are up to the levels of internationally recognized standards. Laws on the book, however, are just one part of the story. Research (Pistor, Raiser & Gelfer, 2000) has drawn attention to the fact that it is the effectiveness of the implementation of regulations, legal enforcement and the perception of legality where the real problems in the creation of efficient business environment and developed capital markets in CEEs start. The gap between regulations on the book on the one hand and the respect and enforcement of law on the other is still a recurring theme when the idiosyncrasies of CG regulation in CEEs are discussed.

6. Within-group similarities and differences

The extended varieties of capitalism literature and many other types of research treat CEE-3[4] as a homogenous group. While this approach can be justified on several grounds, the overemphasis of similarities could misdirect the course of further research. The corporate governance features of the CEE-3 have indeed numerous commonalities, yet we argue that it would be a serious omission not to account for differences as well.

The literature agrees almost unanimously that the main CG characteristics of CEE-3 are the following:

formal legal rules in accordance with the EU pattern, but weaker enforcement practice; concentrated ownership structure; weaker protection of minority shareholder rights; mostly two-tier board structure; CEO's involvement in the selection of executive and supervisory board members; the small number of independent director; relatively low degree of transparency and information

[3] As an example of the direction of legal modernization in CEE, we cite the amendment of the Hungarian Company Law (Act IV. of 2006) . A notable feature of the changes was that the protection of the interests of creditors, shareholders and minority shareholders in particular has been enhanced. The shareholders of public limited companies now have the choice to initiate the establishment of the Anglo-Saxon type unitary board system or stay with the traditional two-tier board structure. The Act deals extensively with the role of the board and prescribes that the majority of the board shall be made up of independent directors. It has been made clear that independent directors cannot be engaged in executive roles. Public limited companies are required to set up an audit board consisting of minimum three members from the board of directors elected by the general meeting.

[4] usually together with Slovakia (the Visegrad Four group)

disclosure; passivity of minority shareholders in governance matters and non-existent market for corporate control.

Several from the above traits have been dealt with in the previous parts of the paper and most of them apply to many public companies on the three stock exchanges. What constitutes a difference in our opinion is the difference in motivation of companies and regulators[5] to ameliorate CG characteristics – the adequate disclosure of information and the fair and equitable treatment of all shareholders (by controlling owners, boards and managers) – in the first place. In Poland where the role of external equity finance has been continuously expanding the motivation to court and attract outside investors by means of higher corporate governance scores has been also growing. The stimulus for the improvement of governance behaviour along these lines is observed to be significantly weaker in the Czech Republic and Hungary.

The main point of this section is to show the diverging trajectory Poland took in the development of the equity markets as compared to the Czech Republic and Hungary. The Polish dynamism is in contrast with the slow development in the other two CEEs and this has strong implications for the differences in the awareness of the importance of good corporate governance (both in business/investors and academic circles). The positive evaluation of Poland in within-group comparison is, however, is by no means to ignore her own apparent and persistent weaknesses on several corporate governance fronts[6] (be it on country or firm level).

The Polish government's market-strengthening approach in implementing its policies was observed during the first wave of privatization (described in section 3). The recent second wave of privatization of 2012 -2013 also had the explicit goal to stimulate the growth of the WSE. In addition, a powerful boost was given to the development of the WSE by the 1999 pension reform which prescribed mandatory contributions to private pension funds. These funds then were obliged by law to invest up to 50 percent in stocks, 95 percent of which must have been invested in companies listed on the WSE. The sizeable pension funds had positive impact on new listings. Since the mid-2000s the Warsaw Stock Exchange is counted among the most active IPO markets in the European Union. The 2008 crisis caused only a temporarily setback. As it can be seen in Table 4. in contrast with the WSE, the exchanges in Prague and Budapest are almost dormant (before and after the global financial crisis alike) regarding the activity in the new issue of shares.

Table 4. Number of IPOs in CEE-3

Stock Exchange	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Warsaw Stock Exchange	5	6	36	34	35	81	33	13	34	38
Prague Stock Exchange	0	0	1	0	2	1	1	0	0	1
Budapest Stock Exchange	0	0	1	0	3	0	1	2	1	5

Source: National Bank of Poland (2013); Meluzin et al. 2013

[5] In 2008 a new CG Code, the Code of Best Practices for WSE-listed Companies was introduced. The new Code aims at enhancing transparency of listed companies, improving quality of communication between companies and investors, and strengthening protection of shareholders' rights,including those not regulated by legislation, while refraining from imposing an excessive burden on listed companies. All listed companies are required to prepare and submit a statement on compliance with the Code of BestPractices to the WSE. (Dobija- Klimczak,2010)

[6] To cite an example: Transparency problems in relation to ownership and control has remained a major CG weaknesses in Poland. This is confirmed by a unique empirical analysis of Aluchna (2013) which study reveals the existence of pyramidal ownership and control structures in Polish public firms.

Summary

This paper dealt with several aspects of corporate governance in three Central Eastern European countries. We followed that strand of literature which focuses on the CG of public companies. This prompted us to give equal attention to the evolution of capital markets in CEE-3. The equity market-CG relationship is bi-directional. On one hand, the rules and instructions from the stock exchanges improve many corporate governance characteristics, while on the other a high CG reputation certainly contributes to the development of local bourses.

We used the Varieties of Capitalism school of thought as interpreted and extended by Nölke-Vliegenhart (2009) as the theoretical starting point of the paper. The authors introduced the concept of „dependent market economies" for explaining the shared nature of the capitalist regime of the CEE-4 countries. They adduced convincing arguments to show the far-reaching consequences heavy FDI dependence has on the other institutional building blocks and competitive advantage in these countries. In the VoC-DME approach the CEE-3 (plus Slovakia) are treated as a homogenous group and this is supported by the data from a decade ago. We contend, however, that viewed from a later and another perspective, based on the development of stock exchanges and the concomitant pressure for the improvement of CG mechanisms, the lumping together of CEE-4 conceals an important institutional divergence. Poland with the booming Warsaw Stock Exchange, the large number of IPOs and visible efforts to enhance several elements of good CG practices (such as regulations affecting transparency and minority shareholder rights) to internationally approved standards, follows a more market-oriented road, in contrast to the Czech Republic and Hungary with stagnant or less dynamic bourses in Prague and Budapest with their relatively small number of companies, high concentration and low liquidity.[7] In the latter two countries much lesser importance is attached to corporate governance issues in practice and the topic does not attract much academic interest either - unlike in Poland in this aspect also.

The bigger size of the Polish economy and growth potential of the domestic market has given Poland advantage in the expansion of its stock exchange. Government policies and incentives, however, also substantially contributed to what is called „equity" culture. The WSE now counts as the main financial hub in Central Eastern Europe, attracting a big number of domestic and foreign businesses. The steadily expanding capital market in Poland is expected to transform the structure of the whole financial system and contributes to the improvement of corporate governance practices of listed companies. Reverse causality also applies in the sense that better regulated, more transparent companies are more valued by investors and thus can attract more outside capital.

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