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Best Practices Pamphlet

CORPORATE GOVERNANCE: A CHALLENGE FOR SLOVAKIA*

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To many observers, the Slovak economy was a puzzle for several years, as its growth backed by low inflation and stable exchange rate was accompanied by weak interest of foreign investors and persistently high unemployment rate. The Slovak growth was not sustainable, however, for permanent postponement of essential structural changes. The country has not been able to secure adequately protection of the private ownership, execution of ownership rights by means of corporate governance regulation, and hard budget constrains. These were the main reasons why enterprise restructuring was delayed and the new owners often robbed enterprises and searched for rents. As a result, a major part of enterprising agents now produce losses, do not render their liabilities vis-a-vis banks, trade partners, state and employees, and represent social risk intensified by current high unemployment rate.

The current program of revitalization of the Slovak economy assumes the unlocking of financial flows and the extensive reform of the enterprising environment. By releasing financial flows, current unfavorable situation will be improved, while by reforming enterprising environment, return of current problems will be avoided.

In this study we address important part of enterprising environment design, corporate governance of enterprises. Slovakia urgently needs to strengthen rights of investors and creditors.

1. INTRODUCTION

The Slovak economy may serve as a textbook example of how a high preference of immediate economic growth and postponement of necessary

structural changes lead to economic recession. The country focused on GDP growth with low inflation and stable exchange rate under almost exponential rise of indebtedness. The delay in microeconomic reforms at the same time was reflected in inadequate investment influx. Resources available to the country were used inefficiently thanks to the existing legislation. A *tunneling* became a rational behavior of owners and managers, and is only nicer term for robbery and fraud of vested property.

The Slovak growth as not sustainable for lack of new resources and bad employment of existing resources. The reason lies in design of legal and institutional framework of enterprising, which motivates economic agents to seek rents rather than combine efficiently production factors in order to create profit. Still problematic is security of private ownership and creditor rights protection, execution of ownership rights by means of corporate governance¹, and enforcement of hard budget constraints. Schematically, regulation of the following areas is considered:

- *Company - suppliers of inputs.*

Bad payment discipline is liquidating especially small suppliers. The companies often took commodities and services, converted them into cash and by self-liquidation avoided reimbursement of their liabilities towards suppliers. There were some speculations that some suppliers knew it well in advance that receivers would not pay them for their commodities and services, but used this way as a certain form of pressure against the government. They wanted to show their ability to produce and sell, while it was only the purchaser who temporarily and innocently became unable to cover its liabilities. This implied good backing for requirement that the government should help such a company to bridge existing temporary problems. If managers of the supplier firm were financially involved in the transaction, they intentionally contributed to the bad payment discipline in order to enrich themselves. At the same time, the purchaser who converted inputs into cash had intention not to pay. It has been very difficult to prove particular persons within the company a bad intention and therefore they were not prosecuted. This area is solved by an Execution law no.233/1995 and amended Bankruptcy Act by its 30-days limit: para.1 (2) "*A debtor shall be declared bankrupted if it has more creditors and is unable to cover its liabilities for more than 30 days after agreed maturity day.*"² According to the Reasoning report of the amendment, the measure "*...pursues an improvement in payment discipline and prevention of chain payment inability because of defaulted mature liabilities.*" It is also necessary to regulate personal responsibility of managers towards owners and other stakeholders of a company in cases, when managers acted in ways harmful to the latter.

- *Company - banks.*

In this relationship, a problem in the regulation was on both sides. The Bank supervision was a weak point, since it allowed both large and small banks to

systematically issue credits disadvantageous from the very beginning to minority shareholders and creditors of banks.³ In essence, it neglected and therefore allowed *tunneling* of banks. It is probable, that bank supervision was all the time exposed to pressure from bank owners, especially state owned companies, and government policy in regional unemployment, but this cannot excuse its inactivity. Bank supervision has other goals defined than to look after unemployment and interest of state owned companies.⁴ On the side of banks, there was no effective assurance of rights of commercial banks as creditors, so that commercial banks had no disposal of tools for recovery of unpaid credits. At the same time, valid tax legislation forced banks to replace bad credits by new credits in order to decrease their tax base by fictitious income from principle, interest and penalties. In that way, banks certainly reported better but misleading results on their portfolio quality. One of the results of weak regulation of relationship company - bank and insufficient activity of bank supervision is for example 100 billion debt in recovery organization Slovak consolidation,⁵ complication in privatization of Slovak Telecom for the state help to the Post Bank and bailing out of several smaller banks indirectly by the government. The other result, that concerns enterprise sector very directly, is a credit crunch. It is rational reaction of banks to the situation, in which they do not have secured their rights in any legal way. Therefore, on the one side are banks that exist only to accumulate free finances and give credits, on the other side are enterprises, which urgently need finances, but there is no mechanism on the market that would allow banks to issue credits. In this area, it is necessary to improve efficiency of bank supervision, currently in responsibility of the National Bank, introduce criminal recourse to managers of banks and enterprises, and increase interest of savers in bank prosperity by reduction of credit insurance to level lower than current 100%. If mechanism regulating relationships bank supervision - bank and bank - company will not be improved, bank privatization may lead to disappointment and renewal of current situation.

- *Company - state.*

If enterprise stopped to pay taxes and fees for its employees to the Social insurance, health insurance funds and National labour office, these institutions had very little possibilities to recover their claims. According to the estimations of Ministry of Finance, indebtedness of enterprises towards the state and public institution reached about 130 billion SK. This is almost 40 billion SK more that one year ago. The true uncovered loss on the side of private sector can be much lower, because state institutions themselves often are the source of insolvency. The aim of Ministry of Finance is to improve and unite current legislation so that above mentioned institutions could restructure their claims (by sale to the third person, asset swap and following sale and mandating the third person to recover existing claim), forgive penalty fees and part of principle if claim cannot be recovered. In this area it is necessary that government uses reform momentum to gain unambiguous reputation with enterprises that they cannot delay payments to the state without good

reasons. The other problem of claims of the state and public institutions towards enterprises was that by law they had priority over claims of other persons in case of bankruptcy declaration, but the state did not have enough resources to administrate bankruptcies and other creditors had no incentives to bear costs of such administration for small residual value which would have to cover their claims.

This, together with slowness and corruption of courts⁶ prevented fast declaration of bankruptcies and sale of enterprises as on going concern or by parts. Nor claims of the state, neither of other creditors were satisfied. Enterprises were *tunneled* and led to liquidation and labor force at first stayed artificially bounded and then uselessly dismissed. Amendment of Bankruptcy act solves also co-ordination of the state and public funds with other creditors (see especially changes in para.54).

- *Company - investors.*

Apart from partners' investment, bank credits and share capital, an enterprise may receive finances also by bond issue according to the law no.530/1990. Bond gives its holder no ownership rights towards the enterprise. Other investors are investment funds, that do not have real interest in execution of their ownership rights in enterprises, because their goal is to maximize portfolio value by purchase and sale of shares.

- *Managers - owners.*

Shareholders are owners of joint stock company, while partners are owners of limited liability company. Enterprises with lower amount of capital are usually owned by a single person, who is able to perform monitoring and management. Enterprises that for their optimal operation need bigger amount of capital use as the source of financing issue of shares which bear certain rights to their holders. This is because of diversification of risk connected to the deposition of capital in company on the side of investors. If rights of shareholders are in reality not enforced, enterprise cannot use this source of financing. This model requires delegation of part of rights of owners to managers, creates complications in monitoring and control of managers and a need of complex system of legislative norms and institutions regulating the relationship. Its advantage is, however, possibility to accumulate "any" amount of capital. Relationship between owners and managers is a subject of corporate governance in its narrow understanding. This area is covered by many laws, but especially by Commercial Code, Bank Act, Bankruptcy Act, Stock Exchange Act, Securities Act, Bonds Act, Act on Collective Investment and Act on Competition. Stock exchange, together with the Office of state supervision of capital market and Department of capital market within Division of financial market of Ministry of Finance supervise duties of publicly traded companies. Central register of securities registers transfers of ownership of shares. In Slovak environment, understanding of position of manager and owner is usually distorted because of privatization method - majority owner

often takes over managerial function. One can often see also misunderstanding of importance of minority shareholders and necessity to establish their special standing within the company. At the same time, overestimation of majority owners necessarily diminishes volume of disposal capital and insolvency of enterprises. We analyze relationship between managers and owners in more detail in the fourth section of this study.

- *Managers - employees.*

Special attention should be paid to the relationship between a company, represented by managers, and employees. Investment of employees into specific human capital (collection of knowledge and abilities, which in combination with particular capital produce output of the enterprise) should be considered sunk.⁷ This is a source of interest of employees in good operation of enterprise and herewith employees became together with owners and other interested parties those, who have stake in the company.

- *Managers - other stakeholders.* Other stakeholders are municipalities, suppliers of inputs and other parties, whether persons or institutions, that share the interest in good operation of the company, even if this interest is not linked with ownership or employment in the company. It is generally accepted, that the company and its management must act responsibly also towards these stakeholders.

Apart of mentioned laws, whole area is touched by legislative regulation of income tax, prescribed chart of accounts, differences between the Slovak and international accounting standards, quality of work of auditors and ability of their punishment, differences in understanding of scope and frequency of publication of enterprise and bank information, and in understanding of content requirement of reports, that currently are more seen as information for tax purposes rather than about financial situation in enterprise.⁸

In this study we address especially relationship between managers and owners, i.e. the question of corporate governance (in its narrow understanding). This is defined by Shleifer and Vishny (1997, p.737) as a subject that “...deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” The OECD (1999a) defines corporate governance more broadly as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders.” According to Zingales’s definition (1997), corporate governance system “[is] the complex set of constraints that shape ex-post bargaining over the quasi-rents generated in the course of a relationship.”

It is obvious that relationship between manager and owners cannot be studied separately from relationships between the company and bank, and the company and investors. At the same time, these relationships cannot be considered as a matter of companies alone, because corporate governance mechanisms, that try to overcome the problem of separation of ownership and

control, are economic and legal institutions that can be altered through the political process.⁹

The structure of this study is: In the second section we explain briefly development of currently prevailing ownership type in Slovakia, because proper model of corporate governance depends on ownership type. In the third section we demonstrate consequences of applied corporate governance. The fourth section analyze in more detail regulation of relationship of company in both directions, outside and inside it (broader and narrow understanding of corporate governance), and necessary changes in legislation.

The fifth section contains a summary of main conclusions: a concentrated ownership in Slovakia has in majority of cases rational justification and also in future these companies will not enter a public market. Other, larger companies will look for part of resources on public markets at home and abroad, and therefore will have to adjust to international standards. Original owners (privatizers) will sale their percentages to foreign investors either voluntarily, or involuntarily in case of bankruptcy. Model of corporate governance that has been applied led to great economic damage, with which Slovakia will have to cope several decades. In order to allow enterprises operate properly, many laws and conduct of many institutions must be changed. This will mainly influence commercial code, definition of personal criminal responsibility of individual managers, improvement in quality of work of auditors, change in reporting on financial data of enterprises (transparency) and availability and integrity of commercial register.

2. TYPES OF OWNERSHIP

Current ownership structure is a result of two waves of privatization and consequent development, given by the existing legislative and institutional framework of corporate governance. Here we recognize the following ownership types, relevant to our subject:

- Solo owner.
 - Majority shareholder with at least 67% of shares and residual owners. Majority owner usually is (i) a private person or a company (strategic owner), (ii) a group of private companies and (iii) a group of state owned companies, banks and insurance companies. It could also be (iv) a group of hardy defined shell companies. Here we count also what remained from former investment privatization funds.
 - Dispersed owner.
- These main types of ownership intersect. Importance of particular types can

be estimated from development of privatization.

2.1. Development of ownership structures

Ideally, there would be three main forms of prevailing ownership structure in Slovakia: Solo owner, majority strategic owner and dispersed owner. The solo owner developed either from establishment of de-novo smaller size firms (from point of view of required volume of capital), or by direct sale privatization of property and almost 100% shares of joint stock companies especially in the second wave of privatization. The strategic owner¹⁰ is typical for privatization of public utilities, banks and generally all enterprises that require fast influx of know-how and finances. The dispersed owner originated in voucher privatization. It was assumed, that small investors together with investment funds will be able to monitor existing management and undertake corporate control. Investment funds were expected to become an important source of capital for enterprises and an engine of trading on capital markets.

The true situation has diverted from this ideal conception for the following reasons:

- Non-existing protection of minority owners. The situation went that far that smaller than 67% shareholder could in fact be considered as a minority shareholder.
- Corrupted courts. They are, next to political instability, perhaps the second largest obstruction to economic development in Slovakia.¹¹ Corruption at courts may explain the best why influx of foreign direct investment to Slovakia stayed so low.
- Non-existing market tools for forced exit of companies from market, for example by bankruptcy. This area is linked to rate of corruption at courts and state interference to business sphere.
- Reluctance to disclose information, unavailability of records from commercial register, design of financial reports that serves more for taxing purposes than for analyses of financial condition of companies, reluctance of institutions to demand information from companies and make them public.
- The state support of rent seeking and different forms of the state assistance like toleration of tax and prescribed funds arrears, state guarantees, loans from state-owned banks under special conditions, public orders and toleration of *tunneling* of state-owned companies and banks.

The development of ownership structure happened in two phases - privatization and post-privatization. During the privatization phase, nomenclature *insiders* struggled at securing the best position in the process.

So for instance they achieved to cancel the second wave of voucher privatization and to replace it by direct sales at symbolic prices. In post-privatization phase, new owners maximized their income in different ways - from resale of a company to drafting of legislation (like a Revitalization law).

The privatization phase started soon after November 1989. Till the end of 1998, National property fund (FNM) received property in total book value 349.4bn. SK.¹² From total privatized property (see table 1 in appendix), 74% was privatized like joint stock companies and 21% by sale of assets. The largest share of total property (26%) keeps privatization by vouchers. The same percentage stayed as shares in administration by FNM. Standard methods, especially direct sale, were employed for sale of 13% of property.

The share of foreign investors was minimal. They privatized property in book value of 4.7bn. SK (1,5% of total privatized property) in twenty-seven cases.¹³

The voucher privatization involved 503 joint stock companies. About 2.6 million of Slovak citizens took part in the scheme. Simplifying, one can say that a problem of voucher privatization was in creation of too dispersed ownership, that had negative impact on capital cost and performance of companies.¹⁴ In 93% of companies privatized by vouchers, small investors (voucher booklet holders) and investment privatization funds acquired majority stake (see table 2 in appendix). Small investors had majority in 49% of companies privatized by vouchers, which is about 10% of all privatized companies and 31% of all joint stock companies privatized. Investment companies enjoyed majority in 7% of all companies and in 22% of all joint stock companies privatized.

Because no regulation that would allow minority shareholders to defend their rights was in place, their influence on governance of companies or investment funds was equal to zero. Their exit by sale of shares was possible only till the moment until ownership relations were settled - typically until majority shareholder acquired 67% of shares. But also other, much larger shareholders had problems to exercise their ownership rights. Thanks to corrupted courts, that were willing to recognize dubious results of general meetings, even 51% owner could not be certain about his position. It was enough if minority shareholders called a general meeting such that majority owner could not participate at, they nominated only their representatives to the executive and supervisory boards, adjusted articles of the company so that two thirds of votes would be required to recall by them elected representatives, and achieved fast registration in the commercial register.

Investment privatization funds (IPF) were expected that within management of their portfolio they would either actively restructure companies, or sale their shares to direct investors. However, there were two problems of governance on the side of IPF: On the one hand, owners of funds had no real chance to influence closed-end funds and usually had no chance of exit, so that the true

owners of funds were their managers with small percentage holdings. On the other hand, funds themselves appeared in a bad position of minority shareholder in companies. We shall claim that managers of funds, given the existing economic environment, took rational decision to fraud entrusted means and maximize their private income. First, they were selling shares of portfolio to decrease its value. Later, funds and investment companies transformed themselves into joint stock companies with a different subject of enterprising in order to escape state supervision over the financial sector.

According to our estimations (see table 3 in appendix), originally about 1.3 million people owned now transformed funds, while nominal value of their portfolio was 43bn. SK. It is very likely that current value of their portfolio is minimal. Only twenty funds with original book asset value of 5.1bn. SK and number of shareholders 108,000 operates under our estimations within the sector.¹⁵ We can assume that companies originally privatized by voucher method are currently owned typically by majority shareholder.

A comparison of post-privatization development in companies originally privatized by different methods (table 1 in appendix) leads to the estimation that almost all companies are, or soon will be (after privatizing public utilities) owned by majority or solo owner. This estimation is based on assumption that originally dispersed ownership from voucher privatization meanwhile became concentrated, and there will be concentration in companies with important stake by FNM (natural monopolies that were already mentioned). Residual minority shares are not important, because allocation into restitution investment fund usually was only 3% high and reserve and other funds were insignificant as percentage on company equity.

Apart from expected sales of FNM and the state holdings to strategic investors, the current ownership rights will be clarified by the recent amendment of Bankruptcy act and bail out of bad loans in volume of 100bn. SK to the Slovak consolidation agency. The amendment of bankruptcy act will allow dying companies to find new investors. Because usually smaller size companies are involved, we can assume that they will be taken over by either firms specialized at restructuring and resale of vital parts to the new solo owner, or by foreign direct investors. The amendment will at the same time allow rather fast change in ownership in companies that their main problem is represented by their bad owners. As far as assets in Slovak consolidation agency are considered, they should be understood as a sum of contracts in total value of 100bn. SK, rather than true cash value. It will be very essential part of the consolidation agency to clarify and legally finalized several thousands of cases of dying but also of vital companies, whether by sale of assets in parts or whole companies to direct investors.

Another question, that should be asked in connection with a development of ownership structures, is position of companies on capital market. A majority of

the Slovak companies were forced to enter bourse because of voucher privatization and they do not consider (especially Slovak) bourse as a source of capital, but rather only as a source of displeasure, as capital market statistics indicate (table 7 in appendix). Number of listed shares decreased to eleven, while this number also contains some duplicity of shares of the same companies. Since 1997, other shares are split between two markets - market of registered securities and free market. At the free market, *„all publicly tradable securities issued in accordance with valid legislation are admitted... The stock exchange informs the State supervision department for the capital market about the non-fulfillment of the issuer's obligations.“*⁴⁶ It is the market where the worst shares are deposited, and bourse in fact does not possess tools to exclude such shares from the market. In 1999, majority of shares belonged in this category: 786 from a total number of shares 830. The frequency and volume of trades at bourse is minimal. Volume of trades with shares reached maximum in 1996, almost 19% of GDP, but in 1998 it was only 6% and in 1999 3% (see table 5 in appendix). There are several reasons for that:

- Many companies are in fact closely held and do not have interest to be publicly traded. They should leave the bourse, but there is a requirement that 100% of shareholders must agree to cancel public trading of shares. It is certainly very difficult to meet this requirement. It is necessary to regulate better exit of joint stock company from the public market - decrease limit for approval to and find a key for compensation of minority shareholders.
- Loss of confidence in collective investment - directly and through investment companies. It is a result of non-existing protection of investors. Paradoxically, although voucher privatization was intended to promote collective investment, it became a reason of its decay. The regulation is such, that Joint evaluation of midterm priorities of Slovak economic policy by the Slovak government and European commission (2000, p.28) states: *„manipulation with prices of shares and abuse of confidential information in trading with securities have become a norm.“*
- Small and poor domestic market. Does country of five million people really need its own stock exchange? The bourse may represent certain national sentiment and pride, but in reality it is rather costly institution which may become an obstruction to the economic development. The cost of national bourse is not only its operation expenditure, but also a complex of necessary legislation. Especially small transition countries, where a need of new legislation is great but resources too limited, should consider whether existence of national bourse has any rational ground. If the government preferred that enterprises place their issue of shares at foreign stock exchanges, these enterprises would necessarily adjust to relevant legislation and international standards. A domestic bourse may become an obstruction, if the very fact of its existence is the reason to limit activities of companies and

investment funds. For example, funds that offer supplementary pension insurance may according to the law no.123/1996 buy only shares registered at Bratislava stock exchange, what in practice is almost impossible, if one considers small liquidity of that market, and at the same time it would increase risk of their portfolio. If Slovakia should reform its pension insurance system, domestic bourse may become true obstacle to operation of funds.

As we maintain that majority of companies in Slovakia will be owned by solo or majority investor, that will not have interest to enter public market, we shall also ask a question about a significance of corporate governance reform. As we will show, corporate governance regulation is connected with development of existing companies and establishment of new companies. Therefore, from the current point of view, the reform is necessary for correction of ownership structures (usually concentration and exit of small shareholders) and restoration of trust in collective investment. From the close future perspective, the reform is necessary for development of innovative enterprises.

3. RESTRUCTURING OF ENTERPRISES

Several studies analyzed level of restructuring of Slovak enterprises.¹⁷ In this section we analyze restructuring only from the two aspects, the ability to produce profit and development of volume of past-due liabilities and claims. We analyze trends in development, whether the economy, and manufacturing within it, produces still higher volume of profits and lower volume of losses, whether number of profit making companies grows and number of loss makers declines, and whether volume of past-due claims and liabilities continues to decline or whether it already reached certain equilibrium level. We shall assume that if adequate restructuring of enterprises was happening in Slovakia, it would be possible to observe improvements in all analyzed trends already now. Data of Infostat, that we use, are not as accurate, as data of DataCentrum,¹⁸ but according to our observations from 1996-1999, they follow the same trend. A selection of period 1996-1999 is given only by availability of data.

On graph 1 (in appendix) we can observe maximum profit of whole economy in 1997 and then decline even below the 1996 level (columns in the graph denote annual values, while lines quarterly values). We have to emphasize that data are in current not constant prices, so that the picture is even worse. Positive turn happened in a volume of produced loss, when in 1999 its increase stopped and losses declined below the 1996 level. Sectors of manufacturing produced profits almost equal to losses in 1996 and 1997. The situation worsened in 1998 when loss was higher than profit by 29%, while the switch happened again in 1999 when profit was at 19% higher than loss. Differences between profit and loss for all categories are depicted on graph 2

(in appendix). Although whole economy generated all four years positive profit, manufacturing generated except of 1999 losses. While an improvement in development of profit and losses was registered in 1999, a small volume of profit indicates that in the best case it could be considered as end of recession but still not as the beginning of recovery.

Number of profitable companies was in 1996 and 1997 in economy and manufacturing lower than number of loss companies (graph 3 in appendix). A switch, according to the Infostat, happened already in 1998, however, both number of profit and loss makers continued to grow.

From the point of view of past due claims in whole economy there is an improvement, since the 18% growth between 1998 and 1997 was followed by only 3% increase between 1999 and 1998 (graph 4 in appendix). A similar development happened also with past due liabilities. In manufacturing, volume of past due claims even decline to its minimum level in studied period, and volume of past due liabilities to the level of 1997, which is an annual decline at 13%. An improvement in this area is most likely given by a new attitude of companies that require cash advance payments (with all negative consequences for business conduct) rather than by improvement in contract discipline which would be associated with higher amount of finances in circulation.

In 1999, certain improvement was registered in restructuring of enterprises, but still most likely it was a year of the end of recession (which went through observed period) rather than a beginning of recovery. Total loss declined significantly, but at the same time also profits declined, too. Number of profit making companies exceeded number of loss makers, but at the same time, also number of loss makers increased. A payment (or contract) discipline improved, but most likely because companies switched to cash payments which is good emergency solution, but is not enough to make economy to recover.

4. CORPORATE GOVERNANCE

Corporate governance mechanisms are economic and legal institutions that can be altered through the political process.¹⁹ These mechanisms try to overcome the problem of separation of ownership and control.

Incentive contracts (management share ownership, stock options, or a threat of dismissal) require that performance measures that are well-defined and verifiable by court are correlated with managerial effort. This is difficult. In addition, incentive contracts create opportunities for managers' self-dealing.

The most significant *legal rights of shareholders* include the right to vote on important corporate matters and on the election of supervisory board (that, however, do not necessarily represent shareholders' interests). The voting at general meetings is expensive to exercise and enforce, and its efficiency depends on legislation and court protection of shareholder voting rights. In many countries, shareholders' voting rights are supplemented by managers' duty of loyalty to shareholders. Courts in OECD countries generally accept this approach.

Large shareholders concentrate shares. They have an incentive to collect information and monitor management, thus avoiding free rider problem typical for spread ownership, where monitoring costs are private but acquired information is a public good. Large shareholders have interest in profit maximization and enough control over the assets, but their real power depends on the legal protection of their votes. The problem with this mechanism is that large shareholders have an incentive to expropriate the wealth of other, minority shareholders.²⁰ If minority shareholders are not sufficiently protected by law, they will not invest in shares.

Large creditors, usually banks, retain control similar to large shareholders. This control comes from short-term lending (forcing firms to come back) and creditors' rights when firms default or violate debt covenants. Large creditors are significantly involved in the governance of firms in Germany and Japan, where they have well-secured legal rights. The problem of this mechanism is that bank ownership is associated with conflict of interests, which result in higher interest rates paid by affiliated firms. Alternatively, banks do not terminate unprofitable projects in which they invested when continuation is preferred to liquidation. Debt finance is typical for firms with tangible assets, as new firms usually have nothing to offer creditors as collateral.

Take-overs. Typical for Britain and United States, take-overs imply that a bidder makes a tender offer to the dispersed shareholders to acquire control over the management of a target firm. This is a very expensive mechanism that appears when major failures occur in companies.²¹

Leverage buyouts imply that shareholders of publicly traded company are bought out by a new group of investors, which usually consists of old managers, a specialized buyout firm, banks and public debt-holders.

Which type of corporate governance prevails depends on legal protections of investors. Since legal protection is weaker in Continental Europe and Japan, corporate governance in these countries depends more on large investors (sometimes families) and banks with longer-term stable relationships to the firm. This is sometimes called the *insider* model.²² The *outsider* system of corporate governance is typical for the United States and United Kingdom. Its features are: dispersed equity ownership, large institutional holdings,

recognition of primacy of shareholder interests in company law, protection of minority investors in securities law and a strong requirement for disclosure.²³ Generally, the efficiency of corporate governance depends on transparency of information generation and use, the protection of legal and contractual rights, and the accountability of management.

According to La Porta et al. (1999), the difference in ownership structures of publicly traded companies, size of capital markets, dividend policy and access of companies to outside financing in different countries is given by a design of legislation protection of investors (owners and shareholders) against expropriation by managers and large shareholders. They consider managers and large shareholders as *insiders*. An expropriation takes form either of a simple robbery of profit or a sale of output or assets to other company for lower than market price.²⁴ Even if this activities usually are perfectly legal, their effect is the same as a theft.

Rights of outsiders are in general protected by the enforcement of regulation and laws. Regulation by government agencies and stock exchange contain some critical requirements on companies like disclosure and accounting rules, which are providing investors with necessary information for executions of their ownership rights. Among other rights of shareholders, possibility to sue directors or the majority for suspected expropriation is essential. In most countries, laws and regulations are enforced in part by market regulators, in part by courts and in part by market participants themselves. Emphasis put on laws and regulations differs from traditional approach to financial contracts, which does not consider regulation as necessary, because contracts are made by sophisticated issuers of shares and investors.²⁵ But the problem is to enforce contracts - courts are often unwilling or unable to resolve complicated disputes, are slow, subject to political pressures and even corrupt.

La Porta et al. (1998) provides a list of regulations of investors rights, a percentage of countries that in their legal system posses indicated rule and average value of anti-director rights index and creditors rights (see table 8 in appendix). Countries with a common law have the strongest and countries with French civil law the weakest protection of outsiders (shareholders and creditors). Countries with German civil law are in the middle with an accent on protection of creditors' rights. La Porta et al. (1999) deduce from the table an important conclusion, that differences between legal systems are best described as better or worse protection of outsiders a not as either protection of shareholders or protection of creditors.

There are two explanations, why common law protects investors better than civil law, 'judicial' and 'political'. In a system of common law, judges usually make legal rules, based on precedents and inspired by general principles, like fiduciary duties.²⁶ Judges apply general principles even if specific conduct was not described or prohibited by law. As far as expropriation of investors is

considered, judges investigate whether insiders did not violate their fiduciary duties even in yet unprecedented way. On contrary, legal rules in civil law are made by legislatures and judges cannot go beyond the exact letter of the law. As a consequence, insider that finds a way of expropriation of outsiders that does not violate explicit wording of the law can proceed without being afraid of prosecution. Political explanation maintain that judge in common law system protect outsiders and not insiders. A common law developed to protect private ownership against the crown. In contrast, civil law was to allow the state to regulate better economic activities of private persons. As the law evolved, the dominance of the state transformed into the political conception of corporations and the limited rights of the investors against politically linked families that control companies. Judges were more dependent on the government and therefore were less likely to take the side of investors in dealing with government or companies close to the government.

There are three reasons of protection of the investors:

- Ownership model of enterprises. In countries, where protection of outsiders from expropriation is weak, control concentrates in hands of the entrepreneur.²⁷
- Development of financial markets and dividend policy. Legal protection of investors' rights helps to develop financial markets. Investors protected from expropriation pay higher prices for securities, which in turn are more attractive to issuers. This is true also for creditors and development of crediting enterprises.
- Allocation of real resources. A development of financial markets can accelerate economic growth, because it increases savings, directs them into the real investments and therefore supports accumulation of capital, and improves efficiency of allocation of resources as capital flows to more productive uses.

An important conclusion of La Porta et al. (1999) is that corporate governance reform should be directed towards protection of rights of outsiders, i.e. both shareholders and creditors, rather than only one of the two groups.

The opposition against corporate governance reform is formed at governments and families (groups) who are in control of large companies. Should necessary legislation be adopted, they would surrender their regulatory control to financiers, which would decrease the value of their control. Furthermore, large companies under the current bad protection of outsiders receive large part of credits through banks. In that way they also receive political influence and protection from competition, that would come if smaller firms had access to external capital for their development.

There is no list of steps of corporate governance reform. But there exist several principles that such reform should be based upon:

- Rules should have a form of laws. Laws do formulate financial markets.
- Legal rules must be enforceable. The goal is not to create a set of ideal rules and then think about ways of their enforcement, but rather to prepare rules that could be enforced by existing structures.
- If it is not possible to rely on enforcement of private contracts or laws by courts, then it is better to apply government regulation of financial markets. Poland can serve here as an example, as it adopted tough law on securities intended to protect shareholders. Issuers are required to disclose complex information. The law established a strong commission for securities and bourse with enforcement rights independent from courts.

Corporate governance reform is connected to convergence of systems that compete to attract foreign investment and also functionally by sales of domestic companies to foreign corporations that operate in different system. Corporate governance systems converge for several reasons:

- International diversification of a portfolio yields higher returns with lower risk than a purely domestic portfolio.
- Firms issuing shares on foreign capital markets can decrease their cost of capital.
- Institutional investors (pension funds, life insurance companies and mutual funds) demand international norms of governance.
- Globalization of product markets increases competition, forcing firms to use efficient governance. Globalization makes competition for resources more intense because domestically generated savings are no longer monopolized by domestic firms.²⁸

Obstructions to functional convergence exist especially in area of creditors' rights. Assets placed in a certain country are subject to its jurisdiction, therefore also to its Bankruptcy act. Without reform of local legislation, functional convergence may have only limited impact.

In Slovakia, it is necessary to make several significant changes. Commercial code requires most urgent reform in areas of co-ordination with changes in Civil code, Act on securities and Penalty code, so that expropriation of outsiders will not be perfectly legal. It is not enough to adjust Commercial code to the Directives of European union, because yet there is no consensus in this area in the union and directives hence do not form complex legal

framework. It may be also considered to extract parts related to the company and create separate Company act as Germany and France have. Reform of corporate governance may be also based on principles recommended by OECD²⁹, which are:

- The rights of shareholders. Generally, they contain ownership rights, and the rights to receive information, vote and share profit. The OECD recommends proxy voting, including telephone and electronic voting. Each shareholder must have access to the list of other shareholders in the company for a reasonable price.
- The equitable treatment of shareholders, including minority and foreign shareholders. This implies also the prohibition of insider trading and abusive self-dealing. Shareholders should be able to initiate legal and administrative proceedings against management and board members.
- The role of stakeholders. Rights of stakeholders established by law (including labor law, commercial code, contract law, and insolvency law) should be protected.
- Disclosure and transparency. Materials regarding corporation, its financial situation, performance, ownership and governance should be efficiently disclosed.
- The responsibilities of the board. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders. They should monitor management and be accountable to the company and shareholders. In some countries, the board is legally required to act in the interest of the company, taking into account the interests of shareholders, employees, and the public good.

Current legal framework in Slovakia does not prescribe managers to be loyal to outsiders, but it merely prohibits conduct of certain pre-defined activities. At the same time, it is necessary to adjust regulation of representation of minority shareholders in supervisory board, eventually in executive board, and their cumulative voting. Minority shareholders should be given chance of exit especially in cases, when they are locked-in by qualified majority shareholder (67% of shares). The exit would be possible by sale of shares to majority owner or to the company. Act on securities indeed stipulates that the investor (or a group acting in accord) may cross limit of 30% of shares only by public promise, but this regulation do not refer to the old cases. Simultaneously, it is rather difficult to identify a group of investors that acts in accord.

It is necessary to disclose ownership and control and follow strictly transactions with persons with special relation to the company. Managers

should keep register of conflict interests. Since courts are overloaded, it is desirable to use more often commercial arbitration, for example when suspicion of violation of minority shareholders' rights arise.

Many current problems have their basis in non-existence of good commercial register and real estate register. Registration of changes is therefore tedious and corruption at registers is well known. This creates especially bad situation to smaller enterprises. The system of registration in commercial register must be, according to the example of other countries, removed from courts and replaced by administrative computer registration system. Finally, it is also necessary to pay special attention to the profession of accountants and auditors, which are essential for providing of adequate disclosure of information. Currently, a responsibility of auditors is only symbolic and Chamber of auditors has never adopted any disciplinary proceedings against any of its members. The chamber should be made by law responsible for control of audit quality. Also obstacles to entry of new potential members of the chamber seem to be more about attempt of current members to avoid competition of the new, young and foreign auditors. Practical use of Accounting act overestimate assets of companies, which decrease the value of financial reports of Slovak companies. It is absolutely unavoidable to adjust to international accounting standards (IAS) especially in areas of unrealized incomes, format of financial reports (for example classification of assets and liabilities) and accounting of leasing.

5. CONCLUSION

According to the Join report of the Slovak government and European Commission „...the main reason of insufficient restructuring and continuous loss in significant number of enterprises is weak mechanism of internal and external corporate governance.“³⁰ In 1999, certain improvement was registered in restructuring, but it was rather the year of the end of recession, then of the beginning of recovery. Total loss decreased significantly, but profits decreased, too. Number of profitable companies outmatched loss makers, but number of loss makers increased, too. Payment discipline improved, but most likely because of shift to the cash payments, that is reasonable solution in emergency situation, but not enough to truly recover the economy.

The aim of this short study was to explain the concept of internal and external corporate governance, and the origins and need for reforms in this area. Origins of the reform in our opinion are:

- Fraud at enterprises and neglected restructuring as a rational reaction of agents to the existing entrepreneurial environment and therefore it is

necessary to make systemic change in entrepreneurial environment in Slovakia.

- Concentrated ownership in Slovakia has in majority of cases rational justification and in near future majority of enterprises will not enter public market.
- Larger enterprises will try to get part of the resources on foreign public market and therefore will have to adjust to international standards.
- Reform is needed in order to modify current ownership structures (usually concentration and exit of small locked-in owners) and restoration of trust in collective investment.
- From the point of view of near future, the reform is needed for development of innovative firms.

Corporate governance reform should be based on the following principles:

- Rules must take form of laws. Laws shape financial markets.
- Adherence of new laws must be enforced by existing structures.
- If courts are not able to enforce private contracts or laws, then it is better to apply government regulation of financial markets.

Many laws and activities of institutions must be changed to allow companies to operate “normally”. These are mainly commercial code, definition of personal criminal responsibility of managers, improvement in work of auditors, change in charts of accounts and financial reporting forms and availability and complexity of commercial register.

- It is necessary to co-ordinate modifications in commercial code to modifications in civil code, act on securities and penalty code, so that expropriation of outsiders will be illegal.
- It is not sufficient to adjust commercial code to the EU directives, because there is no consensus in this area in the EU, yet, and therefore the directives do not form a complex framework. When reforming commercial code, principles recommended by the OECD may be applied.
- It is necessary to require by law the loyalty of managers and supervisory board to outsiders and define their criminal responsibility to shareholders and stakeholders.
- It is necessary to regulate representation of minority shareholders in

supervisory board, eventually also in executive board, and their cumulative voting.

- Minority shareholders should be allowed to exit the company especially in the cases 67% shareholder when there are locked-in by the shareholder with 67% of shares.
- Transparency. It is necessary to disclose ownership and control and strictly follow transactions with persons with special relation to the company.
- It would be reasonable to use more the commercial arbitration to resolve business disputes, for example in cases of suspected abuse of minority shareholders.
- It is necessary to establish good commercial register and real estate register. This will help especially the smaller and potentially innovative firms.
- It is necessary to pay special attention to the profession of accountants and auditors, which are essential for disclosure of adequate information.
- Slovak accounting standard should be replaced by international standard.
- Content of financial reports of enterprises must be improved and their frequency increased.
- Banks are important creditors of enterprises. It is necessary to improve efficiency of banking supervision activities, define criminal recourses for bank managers and increase involvement of savers in the bank prosperity.
- The state as a creditor needs more effective tools for enforcement of its interests. It is necessary to improve and unify legislation, so that public and state institutions could act against the debtors more actively.

It is obvious that such a deep and broad reform has and will have many opponents among those who benefit from the current situation, i.e. employers, courts and prosecution. Their arguments will be based on the fear of further increase in unemployment, a domino effect caused by bankruptcies and a necessity to support domestic entrepreneurial class. In fact, these are and will be the same arguments as were the arguments and real economic policy of the previous governments. But today there is a high likelihood that economic recession brought by postponement of reforms has already persuaded critical mass of voters that changes are necessary.

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¹ There was no corresponding term for 'corporate governance' in Slovak and Czech languages. After discussions with the Slovak and Czech colleagues, a term 'správa obchodných spoločností' was selected (literally administration of business companies), where obchodné spoločnosti means "...entities defined by Commercial Code (join stock companies, companies with limited liabilities, company commanded with shares, partnership...). Control of business companies (as a real execution of administration) then is, within this consensus, adequate to the English corporate control." Marcinčin (2000a, editorial note, p.97).

² Amendment of Bankruptcy Act no. 328/1991 available at www.justice.gov.sk.

³ Monitoring of bank management by owners of deposits was weakened by law on deposit protection no.118/1996 by 100% and relatively fast recovery of deposits.

⁴ See Act on the National Bank of Slovakia no.566/1992 para2e and para36. The situation is likely complicated by the fact that next to the supervision by NBS, also Department of banking and insurance and Department of financial market supervision of the Ministry of Finance are active in supervision of banks. As it seems, competencies and responsibility of these bodies are still not very clearly set.

⁵ See information on Slovak consolidation agency at www.finance.gov.sk

⁶ According to the study Corruption index (2000, p.VIII), entrepreneurs consider as most corrupted institution courts and prosecution, while households consider courts and prosecution second most corrupted (behind health care).

⁷ In the Slovak terminology sunk investment would usually be "utopená investícia".

⁸ Fischer and Gelb (1991) suggested on the very beginning of reforms that legislative and institutional reforms were needed. In the first case they recommended changes in tax and property laws, commercial code and laws concerning foreign direct investment. In the latter case issues of tax administration, composition of state budget and legislative and regulatory institutions were included.

⁹ Shleifer and Vishny (1997, p.738).

¹⁰ The strategic owner is usually, if not always large join stock company with dispersed ownership.

¹¹ According to the opinion poll by Žitňanský and Rintel (2000), respondents indicated as two main problems in legislation and justice enforcement of law (67% of respondents) and relations between creditors and debtors (59%).

¹² According to the Annual report 1998 of National property fund (FNM). FNM (2000) presents value 365.5bn. SK.

¹³ Source: Privatisation ministry (1999b) and authors' calculations.

¹⁴ See for example Laštovička et al. (1995) and van Wijnbergen and Marcinčin

(1995).

¹⁵ In reality, there is only one share of IPF traded at stock exchange. All political powers in Slovakia consistently avoid deep analyses of development in former IPF.

¹⁶ Annual report of Bratislava stock exchange 1999, p.15.

¹⁷ In a book of Marcinčin and Beblavý (eds., 2000), several authors touch this theme.

¹⁸ According to the data of Datacentrum (Join evaluation..., 2000, p.8.), total profit in 1995 reached 27.8bn. SK, in 1996 18.3bn. SK, in 1997 loss 2.5bn SK and in 1998 profit 31.3bn. SK. More than half of all firms in 1998 made loss.

¹⁹ Shleifer and Vishny (1997, p.738)

²⁰ See for example Claessens et al. (1999), who confirmed such expropriation on a sample of 2,658 East Asian corporations in 1996.

²¹ Dahya and Powell (1999) provide a good survey of take-over empirical studies.

²² Japan decided to move from a bank centred system to a capital market based system, and from a system of concentrated investor ownership to a system with more dispersed investors (Kanda, 1999).

²³ Mayer (1999): Total market capitalisation of firms as a proportion of GDP in UK was in average 75% in 1982-91, in France 19%, Germany 20%, and OECD 30%. Ratio of credit to GDP was in average 42% in 1980-90 in UK, 82% in France, 86% in Germany and 55% in OECD.

²⁴ Transfer pricing and asset stripping.

²⁵ Approach "law and economics" further assumes that investors recognise risk of expropriation and penalise firms which do not agree in written contract to disclose information and treat investors well. Because a penalty means to issuers more costly capital, they are stimulated to enter such contracts. Regulation then is not necessary, if these contracts are enforced.

²⁶ Fiduciary in terms of trustee that is loyal to the principal.

²⁷ Claessens et al. (1999) discovered that ten richest families in eight Asian countries controlled 18% to 58% of total volume of publicly traded assets.

²⁸ Nestor and Thompson (1999).

²⁹ See OECD (1999a) and OECD (1999b).

³⁰ Join evaluation... (2000).