Residual State Property in the Czech Republic

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Abstract

Privatization in the Czech Republic was carried out under three programs: restitution, small privatization and large privatization. By far the most important privatization program in the Czech Republic was large-scale privatization that began in the spring of 1991.

Large privatization allowed combinations of several privatization techniques. The largest firms were transformed into joint stock companies, the shares of which were distributed within voucher privatization (almost one half of the total number of all shares of all joint stock companies was privatized), sold for cash or transferred for free to municipalities.

Despite the massive scale of the voucher privatization, there still remains a substantial number of companies where the state has been involved. The total number of 1849 companies of a book value of 367.5 billions entered both waves of voucher privatization. In 1998 the state has kept its involvement in 369 companies with the overall book value of more than 440 billions crowns. The book value of the state share in these companies amounted to almost 177 billions crowns. A great number of these companies was "privatized" through voucher privatization but the state did not privatize them entirely. An analysis showed that 76% of the assets (book value of the above companies) is possible to be influenced by the state.

One cannot but to conclude that, despite the voucher privatization, the state sustained its influence over the significant part of the Czech economy. In view of the facts it seems legitimate to question the official success of the voucher privatization. There exist a clear consensus that further privatization of the residual state property is both necessary and inevitable.

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1. Rationales and Origins of Residual State Property

1.1 Introduction

In 1989 the former Czechoslovakia had one of the smallest private sectors in the communist world, employing only about 1.2% of the labor force and producing a negligible fraction of the national output. Often cited as one of the major success stories of the transition in Eastern Europe, the Czech privatization program resulted in almost 75% of productive capacity being transferred to the private sector by the first quarter of 1995 after the mass privatization program was completed (for preceding overview see Aghion, Blanchard, and Burgess (1994) and Blanchard et al. (1991)). This is comprehensively captured by Table 1.1.

Table 1.1
Registered Corporations According to Ownership

Type of Company	1991	1992	1993	1994	1995
Number of Incorporated Individuals	891,872	982,075	1,044,635	856,509	1,000,375
Total Number of Corporations	57,083	83,965	116,706	153,937	196,434
Privately Owned	16,913	30,097	47,446	64,343	88,582
Cooperatives	4,031	4,148	4,638	5,227	6,172
State Owned	16,762	14,125	11,113	9,733	9,432
Municipality Owned	876	5,490	8,099	9,199	9,980
Foreign or Joint Ventures	6,349	8,780	13,970	22,715	33,687

Source: Ministry of Finance, Hanousek and Kočenda (1998)

Privatization in the Czech Republic was carried out under three programs: restitution, small-scale privatization and large-scale (or mass) privatization. This comprehensive privatization program resulted in a remarkably high share of the Gross Domestic Product (GDP) being eventually produced by the private sector. Prior to the January 1, 1993 split of the former Czechoslovakia, privatization was carried out jointly in the Czech and Slovak Republics. Generally, however, data is available for each republic independently and it makes an analysis easier to do. For other references related to macroeconomic aspects of privatization see Frydman, Rapaczynski, and Earle (1994) and Kotrba (1995) among others. As a summary of the official macroeconomic outcome of the privatization process Table 1.2 compares the role of the private sector as a percentage share of the GDP in various Central European countries from 1990 to 1997.

Table 1.2
Contribution of Private Sector to the GDP (in Percent)

Year	Czech Republic	Bulgaria	Hungary	Poland	Romania
1990	12	9	25	31	16
1991	17	12	30	42	24
1992	28	18	42	45	26
1993	45	25	50	48	32
1994	56	30	60	70	39
1995	64	32	68	75	45
1996	74	35	75	78	50
1997	78	37	79	81	59

Source: IMF, Hanousek and Kočenda (1998)

1.2 Privatization Methods

The Czech government pursued three major programs of privatization: property restitutions, small-scale privatization and large-scale privatization. The first two started in 1990 and were most important during the early years of transition.

Restitution restored assets to those from whom they had been nationalized by the communist regime after 1948. Estimates of the amount of property involved in restitution are sketchy since implementation was carried out by direct negotiation between current and former owners. There have been at least 200,000 claims for agricultural land. In addition, about 70,000 apartment buildings have been returned to their former owners. For our purposes, the most important feature of the restitution program is that owners of industrial property incorporated into larger enterprises (or expanded by new investment since nationalization) were entitled to receive a share of the enterprise when it was privatized. In addition, they could purchase an additional part of the enterprise on preferential terms (usually at book value and without having to compete with other potential buyers).

Small-scale privatization dealt primarily with small economic units such as shops, restaurants or smaller industrial enterprises that were sold at public auction. Bidding was restricted to Czech citizens or corporations formed by such citizens. Buyers were forbidden from transferring property to foreigners. By the end of 1992, over 22,000 units with a total sale price of about $1 billion had been privatized through small-scale privatization. At least additional 10,000 units were approved for later sale. Although there was no explicit limitation on the size of property that could be auctioned in small-scale privatization, the program focused on small businesses engaged primarily in retail trade. By the end of 1993, when the program was officially terminated, 30.4 billions crowns worth of property had been sold to private owners.

1.3 Large (Mass) Privatization

By far the most important privatization program in the Czech Republic was large-scale privatization. This process began in the spring of 1991. Enterprises not privatized through restitution or small-scale privatization were divided into four groups:

- firms to be privatized in the first and second waves of large-scale privatization,
- firms to be privatized later (after five years), and
- firms to be liquidated.

It is evident that the first two categories of firms form the core companies where the state kept its share. At the beginning it was the Ministry of Privatization that executed the process. Later on, the Fund of National Property (FNP) was established as a state institution that was entitled with legal power to exercise property rights over the companies that were fully or partially owned by the state.

Large-scale privatization allowed combinations of several privatization techniques: small businesses were typically auctioned or sold in tender; medium businesses were sold in tender or to a predetermined buyer (direct sales). The largest firms were transformed into joint stock companies, the shares of which were distributed within voucher privatization (almost one half of the total number of all shares of all joint stock companies was privatized), sold for cash or transferred for free to municipalities. Municipalities also benefited from transfers of property, namely unused land within their territory.

As mentioned earlier, large-scale privatization was launched in 1991. Its evolution in nominal monetary units is presented in Table 1.3.

Table 1.3

Large Scale Privatization in the Czech Republic

	Property June 93 mil.CZK	Units June 93	Property June 94 mil.CZK	Units June 94	Property June 95 mil.CZK	Units June 95	Property June 96 mil.CZK	Units June 96
Total Property	607,635	4,893	922,041	16,071	950,463	20,917	963,453	22,190
Auction	5,634	431	10,057	1,714	9,378	2,110	9,360	2,054
Tender	16,434	424	27,931	887	31,236	1,351	36,544	1,750
Direct Sale	38,016	1,359	86,407	7,713	90,463	10,899	90,156	11,436
Joint Stock Comp.	534,779	1,327	756,008	1,897	765,941	1,875	774,955	1,914
Free Transfer	12,772	1,352	41,998	3,860	53,445	4,700	52,438	5,036

Source: Ministry of Finance, Hanousek and Kočenda (1998)

Over 2,400 firms in the Czech Republic (about half of all firms eligible for large-scale privatization) were assigned to the first wave, which began in June 1991. For each firm assigned to the first wave, the firm's management (under the supervision of its founding or supervising ministry) had to submit a proposal by October 31, 1991 for how the firm would be privatized. This proposal could involve one or more methods of privatization, including direct sale to a domestic or foreign buyer, public auction, public tender offer, unpaid transfer to a municipality or other agent, transfer to workers, or participation in the voucher scheme. Shares not allocated to the voucher scheme could be sold directly to a chosen buyer or offered to the general public on the securities market. In addition to indicating the preferred method(s) of privatization, each firm's plan had to present basic financial and operational information, including employment, wages, capital, sales, costs, profit or loss and foreign trade during the period 1989-1991.

It was possible for anyone other than the firm management to submit a competing privatization plan for all or part of each enterprise. All told, the 2,404 enterprises involved in the first wave elicited 11,349 projects, an average of 4.72 projects per firm. The founding ministry and the Ministry of Privatization decided among the competing projects, except in the case of a sale to a foreign buyer, which had to be approved by the government of the respective republic. Since a project could be for only part of a firm, the total number of approved projects was about 1.5 times the number of firms privatized. As might be expected, proposals from the management of firms were most likely to be approved. Management projects accounted for between

20 and 25 percent of all proposals, but over half of those were approved. Proposals to purchase all or part of a firm were the second most commonly approved group.

Although it may appear that the allocation of shares to the voucher scheme resulted from proposals generated "from the bottom," in fact the privatization authorities had rough goals regarding how much property they wanted to be included in the voucher program and indicated how the vouchers would be finally allocated. In the end, 988 firms out of the 2,404 firms in the first wave had some or all of their shares allocated to the voucher program. The vast majority of these firms distributed over half of their net worth through vouchers, with an average of 61.4% of capital being placed in the voucher scheme. The second largest share (23.3%) was retained by the Fund for National Property. Much of this share either has already been or will eventually be sold in the equity market.

The scale of the voucher program can be appreciated by examining the share of total assets placed in it. In 1990 the official book value of all capital in the Czech Republic was Kcs 2,604 billion[2] (about US$95 billion). Of this, about Kcs 1,000 billion was included in the first wave of large-scale privatization. Firms in the voucher program had a book value of about Kcs 331 billion, of which slightly over 200 billion was allocated to vouchers. Thus, the first wave of the voucher program included about 7.5% of the country's capital assets. The second, somewhat smaller wave, was completed by the end of 1994.

As a summary Table 1.4 shows the two-wave process of voucher privatization translated into major numbers. These numbers give only a rough sketch of the situation, though.

Table 1.4
Brief Overview of Voucher Privatization

Subject	Wave 1	Wave 2
No. of State Enterprises Entering the Voucher Scheme	988	861
Book Value of Shares Allocated for Voucher in Particular Wave (billions of crowns)	212.5	155.0
Participating Citizens (in millions)	5.98	6.16
Average Accounting Value of Assets per Participating Citizen (crowns)	35,535	25,160
% of Voucher Points with IPFs	72.2%	63.5%

Source: Ministry of Finance, Ministry of Privatization, Hanousek and Kočenda (1998)

[2] We adopt standard Czech monetary notation. Prior to the split of the country the Czechoslovak koruna (crown) was abbreviated Kcs and placed before the numeric figure. After January 1993, the Czech koruna was abbreviated Kč and placed after the numerals.

2. Controlling Institutional Structures of Residual State Property

2.1 Large Privatization and Investment Privatization Funds: Indirect Residual Property

The Investment Privatization Funds formed a popular form of how the citizens allocated their points from the large privatization. For these points the funds acquired shares in numerous companies, where the state also kept its share. At the same moment it has to be noted that a number of these funds was formed by financial institution where the state has kept its large share. Thus the funds involuntarily became to a certain extent institutional managers of the residual state property. The next part helps to understand the situation.

All Czech citizens over the age of 18 who resided in the Czech or Slovak Republics could participate in the voucher process. Each participant could purchase a book of 1,000 voucher points for a fee of Kcs 1,000 (a little over one week's wage for the average worker in 1992). Before the bidding process started, each voucher holder had the option of assigning all or part of his points to one or more Investment Privatization Fund (IPF). These IPFs had to provide basic information regarding their ownership and investment strategy. In addition, information regarding profitability, sales, growth rates, and extent of proposed foreign involvement for each firm was provided in a booklet available to all voucher holders. Anyone who brought a diskette to the privatization offices could obtain this information in a database designed to make analyses easy. A great number of citizens opted to put their stakes into the funds.

Tables 2.1 and 2.2 show the most important fund groups that managed to gain more than 2% market-share and their relative position on the market.

Table 2.1
Position of the Major Funds on the Market: Wave 1

Founder	No. of Points Allocated	Market Share	Cumulative Market Share	No. of IPFs
Česká státni spořitelna	950918800	15.494	15.494	1
První investiční, a.s.	713837100	11.631	27.126	11
Harvard Capital and Consulting	565170000	9.209	36.334	6
V+B Invest, i.a.s.	500668100	8.158	44.492	1
IKS KB spol. s r.o.	465708300	7.588	52.081	1
Kapitál. invest. společnost, a.s.	334234900	5.446	57.527	1
Slovenske Investicie, s.r.o.	188041300	3.064	60.591	1
Creditanstalt, a.s.	138924800	2.264	62.854	1
Prva Slovenska Investicni, a.s	136348000	2.222	65.076	11

Source: Ministry of Finance, Hanousek and Kočenda (1998)

Table 2.2
Position of the Major Funds on the Market: Wave 2

Founder	No. of Points Allocated	Market Share	Cumulative Market Share	No. of IPFs
A-Invest, investiní společnost, a.s.	309243300	7.896	7.896	2
Investiční společnost Expandia, a.s.	306290600	7.820	15.716	3
Harvard Capital and Consulting investiční společnost, a.s.	292170900	7.460	23.176	23
O.B.Invest, investiční společnost, s.r.o.	198351200	5.064	28.240	3
KIS, a.s., Kapitálová investiční společnost České pojišťovny	186697800	4.767	33.007	3
Investiční společnost podnikatelů, a.s.	159263500	4.066	37.073	2
Investiční společnost Linh Art, s.r.o.	156432100	3.994	41.067	3
Czech Investment Company investiční společnost, spol. s r.o.	151666300	3.872	44.939	1
Spořitelní investiční společnost, a.s.	124161800	3.170	48.110	1
Investiční kapitálová společnost KB, a.s.	124063500	3.168	51.277	1
PPF investiční společnost, a.s.	119703700	3.056	54.334	2
První investiční akciová společnost	97629000	2.493	56.826	5
C.S. Fond, a.s., investiční společnost	94007200	2.400	59.226	7
Moravská agrárně potravinářská investiční společnost, akciová společnost	89932800	2.296	61.523	1

Source: Ministry of Finance, Hanousek and Kočenda (1998)

The first wave of voucher privatization started slowly. During the first two months citizens could buy voucher coupons, only a few hundred thousand did so. By January of 1992, official estimates were that only about 20% of eligible participants would purchase books before the official deadline at the end of February. However, in the next two months demand soared, largely in response to advertisements by several of the IPFs guaranteeing returns of 1,000% in one year.[3] In the end, 75% of those eligible

[3] Although these guarantees sound extravagant, they were in fact rather conservative. They were based on the artificial Kcs 1,000 registration cost for a voucher book. Since the book value of assets being sold averaged about Kcs 35,000 per coupon book, there was little risk in promising to redeem shares in IPFs for Kcs 10,000.

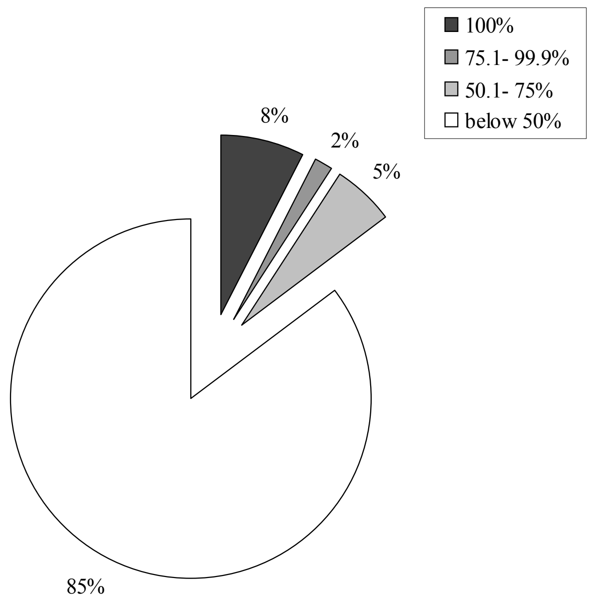
to participate did so. About 72% of the voucher points were placed for bidding with one of the 264 IPFs in the Czech Republic, while 28% were retained by individuals. There was substantial concentration among the IPFs, with over 56% of the points given to the funds being controlled by the thirteen largest funds.

2.2 Residual State Property

Despite the massive scale of the voucher privatization, there still remains a substantial number of companies where the state has been involved. From Table 1.4 we know that 1849 companies of a book value of 367.5 billions entered both waves of voucher privatization. In 1998 the state has kept its involvement in 369 companies with the overall book value of more than 440 billions crowns. The book value of the state share in these companies amounted to almost 177 billions crowns. A great number of these companies was "privatized" through voucher privatization but the state did not privatize them entirely.

The Fund of National Property (FNP), as a legal owner, is involved in different degree in a vast number of companies. Such degree is represented by the number of shares the state holds in each company that belongs to the portfolio of the FNP. An illustrative perception of such an arrangement can be extracted from Figure 2.1 that presents relative numbers of enterprises in each category of state ownership. The ownership structure is divided into four ranges of involvement depending on the percentage portion of shares that belong to the state.

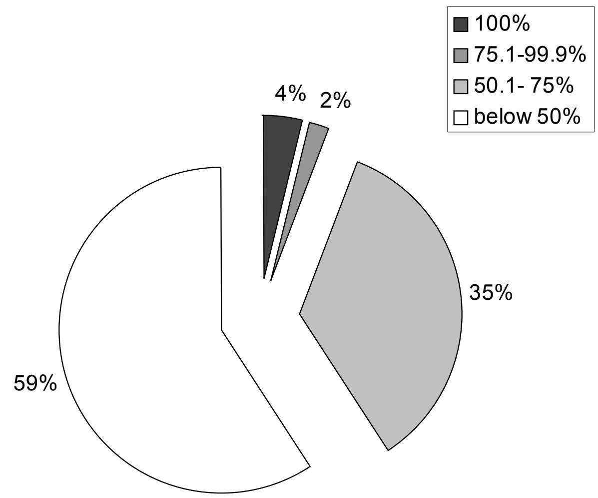
Figure 2.1
Relative numbers of enterprises in each category of state ownership



Thus, Figure 2.1 depicts *relative number* of enterprises falling into each of four categories of state ownership. These are: (i) enterprises where FNP holds 100% of shares, (ii) enterprises where the proportion of shares in FNP's ownership ranges from 75% to 99.9%, (iii) enterprises where FNP holds more than 50% but less than 75% of shares, and finally (iv) enterprises in which share of FNP amounts below 50%. One can observe that the enterprises in which the state keeps more than fifty percents of shares represent only a relatively small part of all firms, namely 15%.

However, such an assessment would be too simple for such a complicated matter as the ownership structure of the state represents. Therefore, Figure 2.2 takes into account a book value of each firm. This enables to derive perception of an economic power of the companies and consequently the extent of wealth that is controlled by the state through the amount of shares.

Figure 2.2:
Relative Book Value of enterprises in each category of state ownership



As revealed by Figure 2.2, when the *relative book value* of enterprises in each category is considered, it seriously undermines the former observation about the influence of the state. The relative book value of those enterprises which entirely belong to FNP is no more than 4% and a relative number of these is about 8%. However, the relative book value of all enterprises where the FNP has a share over 50% reaches spectacular 41%. It has to be noted that the control over 41% of companies is effected solely through the voting rights associated with the number of shares above 50%. Thus, even though the state literally controls only seemingly unimportant part of Czech companies, as far as number of firms is concerned, the book value of this part is no longer unimportant. One cannot but to conclude that, despite the voucher privatization, the state sustained its influence over the significant part of the Czech economy.

2.3 Residual Cross-ownership

We already noted that the state control is associated with the ownership in companies and banks that may involve a certain degree of cross-ownership. To understand the problem, let us consider the following example: 40% of shares of company A is owned by company B, while the rest is the property of company C.

Company C is, however, owned from 60% by company B. Clearly, the real influence of company B over company A is much bigger than the primary ownership indicates.

The question of how to evaluate the extent of such influence that stems from cross-ownership is not easy to address. Turnovec (1999) suggested new methodological approach, which can provide some insight in the real property rights in an enterprise with cross-ownership involvement. The matrix algebra based technique was designed to unveil the indirect ownership that is usually hidden behind the scene, on which the 'actors'—seemingly unrelated owners—perform. In the following section we briefly outline the matrix-algebra technique proposed by Turnovec (1999), and present the results by applying the methodology on the case of the major Czech banks.

Suppose there is *m* primary owners and *n* secondary owners. Primary owners can be citizens, the state, municipalities, etc. and they can own, but cannot be owned. Secondary owners are companies that can be owned. Let s_{ji}^0 denote the direct share that the primary owner *i* (*i*=1, …,*m*) has in the secondary owner *j* (*j*=1,…,*n*), expressed as the proportion of the total number of *j*'s shares. Similarly, let t_{jk}^0, *j*,*k*0{1,…*n*}, denote the direct share of the secondary owner *k* in another secondary owner *j*. Let us label the matrix

$$\mathbf{S}^0 = (s_{ji}^0)_{\substack{i=1,\dots,m \\ j=1,\dots,n}}$$

as *the primary property distribution matrix* and matrix

$$\mathbf{T}^0 = (t_{ji}^0)_{\substack{i=1,\dots,m \\ j=1,\dots,n}}$$

as *the secondary property distribution matrix*. The couple $\{\mathbf{S}^0, \mathbf{T}^0\}$ then represents an primary property distribution in the economy. If follows from the definition of $\mathbf{S}^0$ and $\mathbf{T}^0$ that for any *j*=1,…,*n* it must be that

$$\sum_{i=1}^{m} s_{ji}^0 + \sum_{k=1}^{n} t_{jk}^0 = 1.$$

Expressing the same in matrix form yields

$$\mathbf{S}^0\mathbf{e}_m + \mathbf{T}^0\mathbf{e}_n = \mathbf{e}_n,$$

where $\mathbf{e_n}$ denotes the *n*-dimensional vector of composed of 1's.

Let us assume that $\mathbf{T}^0 \neq \mathbf{0}_{nn}$, where by $\mathbf{0}_{nn}$ we mean $n \times n$ zero matrix (if $\mathbf{T}^0 = \mathbf{0}_{nn}$ we have a transparent ownership structure that deserves little theoretical interest). Then the real share of i's primary owner in company j is given not only by i's direct ownership (s_{ji}^{0}), but also by the shares i holds in the other owners of j, namely, in other companies $k0\{1,\ldots n\},\ k \neq j$. Thus the "first degree" ownership of the primary owner i in the secondary owner j can be defined in the following manner

$$s_{ij}^{1} = s_{ji}^{0} + \sum_{k=1}^{n} t_{jk}^{0} s_{ki}^{0} .$$

Analogously, one can express the "first degree" ownership of secondary owner k in another secondary owner j

$$t_{jk}^{1} = \sum_{l=1}^{n} t_{jl}^{0} t_{lk}^{0} .$$

In matrix form this can be expressed as $\mathbf{S}^{1} = \mathbf{S}^{0} + \mathbf{T}^{0}\mathbf{S}^{0}$ and $\mathbf{T}^{1} = \mathbf{T}^{0}\mathbf{T}^{0}$. Exploiting further the suggested notion of "gradual" ownership, the following is definition of the "r-th degree" ownership

$\mathbf{S}^{r} = \mathbf{S}^{r-1} + \mathbf{T}^{r-1}\mathbf{S}^{r-1}$, and

$\mathbf{T}^{r} = \mathbf{T}^{r-1}\mathbf{T}^{r-1}$.

Having defined the methodology for examining the indirect ownership, we present some results of its application in the Czech banking sector. The following Table 2.3 shows how the position of the Fund of National Property in the five leading banks changes, when one considers the "higher degree" ownership.[4] Not only the percentage share increases but in one case exceeds the 50% threshold that is so important in case of voting (KB). In other case (CSOB) no change occurs simply because the rest of the shares is already owned also by the state, however, through other legal bodies that are not considered by the above technique. We did not include the other case where no change occurred (IPB) due to the fact that this bank (IPB) was in 1997 fully privatized through the sale to a foreign strategic investor. Such "real" privatization is subject of a section 4.2.

[4] We reproduce only a part of the table. We intentionally omit the display of secondary owners' rights (secondary owners are represented mainly by investment funds) to simplify the exposition.

Table 2.3
Indirect ownership among the major Czech banks

Bank	property of FNM			
	primary	the first degree	the second degree	the third degree
CS	52.80	57.22	59.19	59.23
CP	30.25	38.40	38.40	38.40
KB	48.74	50.27	50.89	50.90
CSOB	65.69	65.69	65.69	65.69

Degree is represented by percentages. CS—Česká spořitelna, CP—Česká pojišťovna, KB—Komerční banka, CSOB—Československá obchodní banka. Source: Turnovec (1998).

3. Corporate Governance Implications of Residual State Property

3.1 State Management

State keeps the control of its property through the presence of its deputies in the statutory bodies of the companies. Each joint-stock company is, according to the Commercial Code, obliged to maintain Board of Directors and Supervisory Board. The Board of Directors is either executive or non-executive, or in certain cases a mixed one. In case of executive Board of Directors the position of director corresponds to that of executive officer. State nominates its deputies mainly to non-executive Board of Directors, while positions of executive officers are filled with professional managers. This way the state exercises control over the company.

In cases where the Board of Directors is an executive one, the state puts great accent at the function of Supervisory Board. The board is usually staffed with the deputies of state with exception of those members that are elected by the employees of the company. Since management has to ask Supervisory Board for approval in most important matters connected with operation, strategy, and expansion of the company, the Supervisory Board is an important body and medium for the state to exercise its control. The members of the boards are recruited from the top officials at the ministries under which jurisdiction the company operates and from the experts approved by the ministries and the Fund of National Property.

The influence of the state is exercised by various means. The simplest extent of control is through the number of shares or the percentage portion of the state property that is represented by voting rights. Other mean is embodied in a “golden” share. Such an instrument, in a form of a single share with a special status, allows the state to prevent any major changes in a company where the state holds such a share. Utility companies are a typical example of the state control through the golden share. Many other companies has been declared strategic and enjoy a special status that is embedded in related legal provisions.

The overall influence of the state over 369 companies belonging to the portfolio of the Fund of National Property is documented in Figures 3.1.

Figure 3.1
Relative number of enterprises by categories of the state's strategic influence

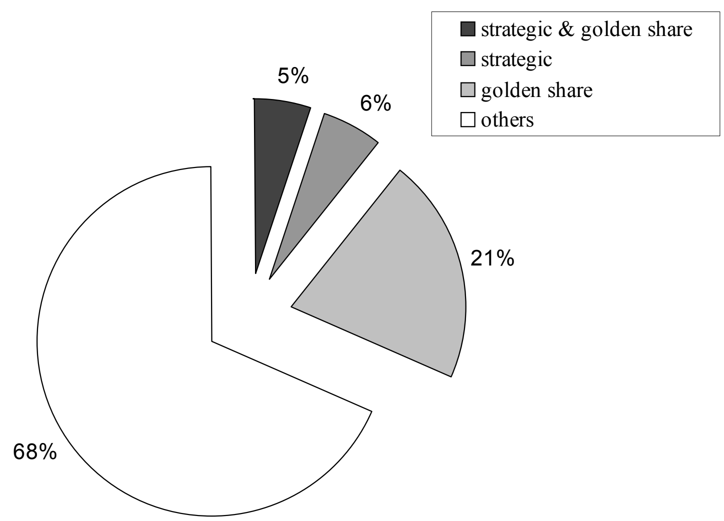
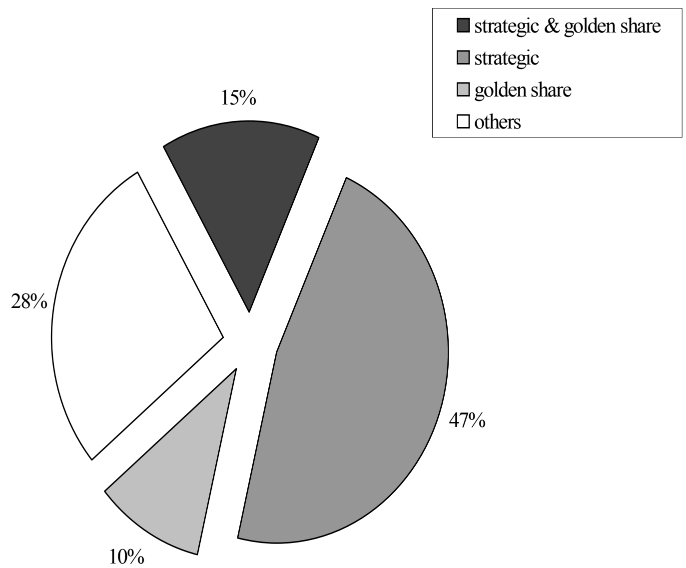


Figure 3.1 shows the relative number of enterprises in four categories that illustrate the influence of state. Fund of National Property holds golden share in 21% of companies of its portfolio. Enterprises labeled as 'strategic' amount to 6% of such companies. Further, the FNP keeps golden share in 5% companies that were already declared strategic. The first three categories together, i.e. all the enterprises in which the state can effectively influence decision-making, contain 117 companies. The number accounts for 32% out of the total of 369 companies.

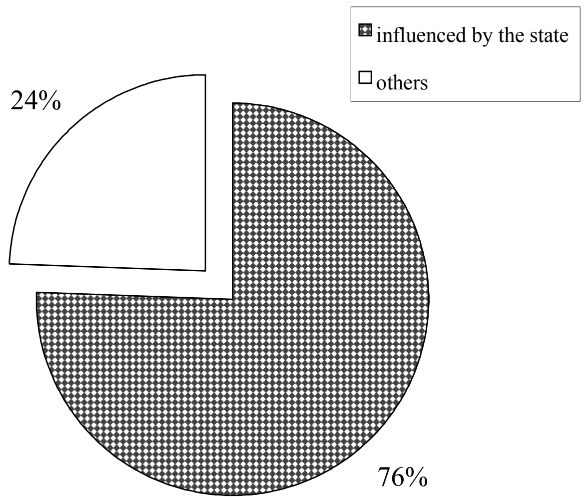
Despite the fact that the aggregate book value of these three categories, however, as documented by Figure 3.2, sums up to the incredible 72%.

Figure 3.2
Relative book value of enterprises by categories of the state's strategic influence



In order to evaluate an effective control power of the state over the companies we have to combine all feasible means of control together. Figure 3.3 therefore combines the previous approaches in that it shows the relative book value of all enterprises in which FNP either holds the control package of shares (over 50%), or it maintains the strategic position otherwise (via golden share, etc.).

Figure 3.3
Relative book value of enterprises controlled effectively by the state



If we translate the Figure 3.3 in to absolute numbers we conclude that 76% of the relative book value of the companies influenced by the state represents 332.7 billions crowns out of the total number of 369 companies in the portfolio of the Fund of National Property that amounts to the book value of more than 440 billions of Czech crowns. This means that the state is able to control enormous part of the Czech economy.

3.2 Ownership Environment of the IPFs and Management Regulations

Large-scale privatization brought companies out of *direct* state ownership, but left them without proper management. This was due to the fact that shares in legally and newly created companies belonged to the state, investment funds or banks, or were spread among numerous small shareholders. The interest of investment funds in increasing the net asset value of the shares on one side and the lack of power of small shareholders on the other created an extremely soft-management environment. Such a situation was not a suitable environment for the active management and necessary restructuralization of non-competitive industries.

Over time, however, the situation changed considerably. The investment funds started to trim their portfolios to weed out non-productive companies or to create positions for eventual transformation into holding companies. Sales for the sake of sheer profit were also not uncommon. Of particular importance is that such a process enabled firms to affect a corporate governance since the majority shareholders in each company started to transform their firms while pursuing active management. Despite the fact that the issue of corporate governance was addressed by Aghion, Blanchard, and Carlin (1994), and Coffee (1996), among others, literature on the corporate governance of companies in transition economies is still insufficient.

IPFs were subject to a number of regulations that made them resemble closed-end mutual funds in the West. Technically, funds for the first wave of voucher privatization were organized as "Legally Independent Joint Stock Companies" since the law that allowed more conventional mutual funds (including open-ended funds) did not come into effect until after the deadline for registering funds for the first round. Funds had to be approved by the Ministry of Privatization and had to have at least Kcs 1 million in initial capital. The structure of Joint Stock Companies that emerged out of privatization is conveniently presented in Table 3.1.

Table 3.1
Structure of Joint Stock Companies Privatized Through Voucher Scheme

	No of Units into which Privatized SOE Were Divided				
	1	2-4	5-9	10-	Total
Czech JSC	600	248	99	41	988
Slovak JSC	320	108	70	5	503
Total CSFR	920	356	169	46	1,491
Second Wave	324	160	74	118	676

Source: Database of the Center of Voucher Privatization

For a fund to be approved, the founder had to submit a plan including the contract between the founder of the fund and the fund itself (which was required to be a separate legal entity). This plan was required to document:

1) the management conditions of the fund,

2) the number and qualifications of the administrators of the fund,

3) information regarding the board of directors and supervisory board of the fund, and

4) the fund's investment policy regarding risk taking and sector specialization.

Czech corporate governance is a melding of American and German models. As we mentioned earlier in section 3.1 each firm has two governing boards, a Board of Directors and a Supervisory Board. The Board of Directors is elected by the general shareholders to actively manage the company. The Supervisory Board is elected 30% by employees and 70% by shareholders. It tends to have limited powers, best characterized as the ability to harass the Board of Directors.

Compensation to a fund's founder (operator) for managing the fund was limited to 2% of the nominal value of shares gained through voucher privatization plus up to 3% of assets and 20% of the fund's profits each year following privatization. Government officials were excluded from serving on the board of an IPF. Each IPF could not invest more than 10% of its points in a single company nor obtain more than 20% of any company.

Initially related funds from a single founder could own no more than 40% of a firm. This was later reduced to 20%. Funds could, in fact, exceed this limit if they agreed to sell the excess within six months of the opening of trading in the firm on the Prague Stock Exchange. In addition, mergers among funds could mean that this limit was violated and firms would have to sell shares to come into compliance.

Since the most common situation was for the founder of a fund to be an already established financial institution, regulations also forbade funds founded by financial institutions from purchasing shares in financial institutions. The potential for financial concentration is evident from the fact that the six large financial institutions included in the first wave of voucher privatization controlled 5 out of the 6 largest groups of IPFs. Together these six financial institutions obtained the right to bid over 36% of all the points in the first wave of voucher privatization. Such outcome was naturally translated into an ownership structure.

4. Residual Privatization

4.1 Direct State Share

Apart from the residual state property that is in reality managed by privatization funds the state still keeps important share in numerous joint stock companies. As a summary Table 4.1 shows in a brief but highly illustrative way current situation regarding direct involvement of the state in the companies that are contained in the portfolio of the FNP.

Table 4.1

Direct Ownership of the State

Categories of FNP's share	**Number of enterprises**	**Book value of enterprises (in millions of Czech crowns)**
100%	28	16578.6
75.1-99.9%	6	8549.9
50.1%-75%	20	154804.5
below 50%	315	260147.9
Total	369	440080.9

Source: Fund of National Property

It is evident that the state still owns an enormous share of the economy through its ownership involvement in various companies. This fact should be contrasted especially with the number of companies that entered voucher privatization as well as with the scope of privatization in general. The state currently owns shares in 369 companies and this portion amounts to almost 155 billions crowns. The book value of these companies is next to three times greater though. The most valuable portion of assets falls into the category of 20 companies where the state holds more that half but less that three quarter share. Most of these 20 companies is considered as strategic ones and they account for more that a third of total book value of the companies in question. In view of the facts it seems legitimate to question the official success of the voucher privatization.

Nevertheless, the state felt its obligation to privatize further. The next two sections describe a case of bank privatization and the outline of future prospects to privatize the rest of the residual state property.

4.2 A Case of a Bank Privatization: Sale to a Foreign Investor

During the years following the formal end of the mass privatization nothing much changed as for the real privatization since the state has kept massive share in the voucher-privatized companies. The intention to privatize further has materialized in several cases though. As a case study we present the description of the privatization of the bank that has belonged to so called “Big Four” among the banks in the Czech republic.

The Czech government approved the plan of the privatization of the Investment and Post Bank (IPB) on November 27, 1996. The privatization of this bank was to be arranged through the sale of shares owed by the FNP (31.5%) and Czech Post (4.45%) to a strategic foreign investor. Set of criteria for a choice of a foreign partner was announced subsequently and renowned privatization advisory company, Salomon Brothers, was appointed to manage the tender. Fourteen candidates took part in the tender. Out of these candidates, four advanced to the second stage. The companies that were found eligible to bid were: Nomura, ING Bank, ABN AMRO, and Deutsche Bank. The Nomura came out as the most suitable candidate.

On July 23, 1997 the government of the Czech republic issued a decree about the sale of the state share in the IPB to the Nomura Europe PCL. In order to precise the sale price, an audit of the IPB was commenced. On March 8, 1998 the FNP and the Nomura Europe PCL signed the contract about the sale. Several binding conditions formed a part of the contract. Both parties involved agreed upon the price that amounted to nearly 3 billions of Czech crowns. One major condition was that Nomura would increase the total equity of the IPB by 6 billions crowns, and would be an exclusive issuer of this increase. Besides that, the Nomura had to commit itself to being an important issuer of the emission of bonds that took place on April 16, 1998.

During the extraordinary general assembly of shareholders that took place on March 8, 1998 the Nomura promised to the other shareholders of the IPB, that it would not take part in the second increase in the bank’s equity, so that the other shareholders could renew their positions. The second increase occurred in September 1998 without Nomura’s participation, and its volume reached 1.701 billions of crowns. As for the corporate structure it has to be mentioned that at the general assembly in March 1998 a major change in the bank’s statutory bodies occurred to reflect new ownership division. The governance structure of the bank was further altered later in 1998.

At the beginning of 1998 the IPB substantially increased its reserves and loan-loss provisions which has resulted in the total loss of 11 million crowns. Such an operation was to reflect troubled financial situation of the bank that reflected state of affaire within the Czech financial sector. The loss was naturally mirrored in the bank’s books and the IPB covered it mainly with an aid of reserve funds. Having taken the steps described, the bank was ready to increase its efficiency. It has set an ambitious goal for 1998 in a form of a net profit around 2 millions crowns. In the first half of the 1998 it declared the net profit of approximately 1 million crowns. By September 30, 1998 the net profit rose by other half million crowns. As for the year-to-year growth in revenues from financial activities the IPB exhibited 24.5% increase. Beside that the bank managed to stop the rise of operation costs, which lead to favorable values of cost/income index, as well as to high level of revenue, which increased by 42.4%. In addition, there was a significant increase in the volume of primary accounts (16.4% by September 1998). The uneasy process of transformation did not cost the IPB the trust of its customers and the total number of customers reached 2.5 millions by September 30, 1998.

It is obvious that only the future will show the complete picture about the privatization of the IPB. So far the bank did reasonably well. In any event its privatization was until now the only completed privatization of its kind within Czech banking sector.

4.3 Privatization Schedule

Political crisis at the end of 1997 resulted in a dissolution of the government by the president who appointed new government to consolidate state affairs. Selection of the cabinet was made with professional merits rather than political affiliation on mind. This government received a time-limited mandate until the elections that were held in July 1998. The government intended to privatize the share of state property first in the so-called strategic companies. In order to do so, the privatization schedule was set up. Table 4.2 list all important companies the government wanted to fully privatize in the nearest future. These companies are divided in to three categories that correspond to the time phase of their privatization.

Table 4.2

Proposal of Privatization Schedule: Strategic Joint-stock Companies

	Name of Company	Share of State (%)	Industry
First Category	Česká pojišťovna	30.25	Insurance industry
	Mostecká uhelná společnost	46.29	Mining
	Severočeské doly	54.00	Mining
	Sokolovská uhelná	48.69	Mining
	Aero Holding	61.83	Aircraft industry
	Paramo	70.87	Oil industry
Second Category	ČSOB	65.70	Banking
	Komerční banka	48.74	Banking
	Česká spořitelna	45.00	Banking
	16 energy distributing companies	46.70-59.10	Energy industry
	OKD	45.88	Mining
	Budějovický Budvar	100.00	Brewery
	Sevac	78.86	Pharmaceutical industry
Third Category	Čepro	100.00	Transport industry
	Unipetrol	62.99	Oil industry
	České aerolinie	56.92	Air transport
	Vítkovice	34.01	Steel industry
	České radiokomunikace	51.00	Telecomunications
	Mero	100.00	Oil industry
	Škoda Praha	54.77	Machinery industry
	ČEZ	67.57	Energy industry
	Nová Huť	34.00	Steel industry
	SPT Telecom	51.83	Telecomunications

Source: Ministry of Finance

The first category contains companies that were selected to be privatized immediately and the strategic investor was to be selected entirely throughout the public auction. Firms operating in the mining industry dominate this section. The second category contains companies that would be prepared for privatization but the details would be clarified later. Three out of four largest banks belong to this cohort and steps towards their privatization were already being taken. Companies falling in to the third category were subject to further objectives of the government but the objectives were not clearly specified.

General elections held in July 1998 were won by the Social Democratic Party that after lengthy deliberation formed a majority government and signed so called “opposition agreement” with its political competitor, Civic Democratic Party, to avoid eventual clashes of power. The political change brought also the different perspective towards the blueprint of residual state property privatization. Table 4.3 lists the most important strategic companies where the state holds substantial share and provides a brief outline of the intended privatization schedule.

Table 4.3
Proposal of Privatization Schedule: Strategic Joint-stock Companies

Name of Company	**To be privatized**	**Share of State (%)**	**Industry**
Aero Holding	1999-2000	61.83	Aircraft industry
Budějovický Budvar	1999[2]	100.00	Brewery
Čepro	After 2000	100.00	Oil industry
Česká spořitelna	1999–first half of 2000[1]	45.00	Banking
Česká pojišťovna	After 1998[1]	30.25	Insurance industry
České aerolinie	After 1998[1]	56.92	Air transport
České radiokomunikace	2001[1]	51.00	Telecommunications
ČEZ	2002[2]	67.57	Energy industry
ČSOB	In the process	65.70	Banking
Komerční banka	1999–first half of 2000[1]	48.74	Banking
Mostecká uhelná společnost	1999[2]	46.29	Mining
Mero	After 2002[2]	100.00	Oil industry
Nová Huť	1999[2]	34.00	Steel industry
OKD	1999[1]	45.88	Mining
Paramo	1999[2]	70.87	Oil industry
Sevac	After 1998[2]	78.86	Pharmaceutical industry
Severočeské doly	1999[2]	54.00	Mining
Sokolovská uhelná	1999[2]	48.69	Mining
SPT Telecom	2001[1]	51.83	Telecommunications
Škoda Praha	After Nuclear Plant Temelín is finished	54.77	Machinery industry
Unipetrol	2001[1]	62.99	Oil industry
Vítkovice	1999[2]	34.01	Steel industry
16 energy distributing companies	2000-2002[1]	46.00–59.00	Energy industry

Notes: [1] sale, [2] preparation for privatization, decision on how to privatize

The government approved only a privatization framework without outlining details concerning privatization of different strategic companies. When compared to the time schedule of the consolidation government (Table 4.2) it is evident that the privatization of strategic companies tends to be delayed within the range from one to three years. In certain cases the timing proposal is entirely missing. The banks are the only exception because the government wants to privatize them as quickly as possible. Such a strategy might be contra-productive, though. Since many of the strategic manufacturing companies are heavily indebted with the strategic banks, the privatization of both categories of firms should be effected more or less simultaneously.

Further, the privatization in energy sector was put on hold. Privatization schedule assumes that sales of energetic distribution networks will take place from 2000 to 2002. However, decision regarding further direction of privatization of the monopoly electricity producer (ČEZ) will wait till 2002. According to arguments in Kočenda and Čábelka (1999) such an approach might result in inept consequences.

As for the natural gas processing and distributing companies, the government intends to acquire back various portions of shares so that the state would again keep majority in such companies. Eventual sales would then be effected from a majority owner position. Relatively quick sales are expected in cases of one oil processing company and two coal mining companies where the state still holds sheer majority.

5. Concluding Remarks

Privatization in the Czech Republic was carried out under three programs: restitution, small-scale privatization and large-scale (or mass) privatization. The Czech government pursued three major programs of privatization: property restitutions, small-scale privatization and large-scale privatization. Restitution restored assets to those from whom they had been nationalized by the communist regime after 1948. Small-scale privatization dealt primarily with small economic units such as shops, restaurants or smaller industrial enterprises that were sold at public auction.

By far the most important privatization program in the Czech Republic was large-scale privatization that began in the spring of 1991. Large-scale privatization allowed combinations of several privatization techniques: small businesses were typically auctioned or sold in tender; medium businesses were sold in tender or to a predetermined buyer (direct sales). The largest firms were transformed into joint stock companies, the shares of which were distributed within voucher privatization (almost one half of the total number of all shares of all joint stock companies was privatized), sold for cash or transferred for free to municipalities.

This comprehensive privatization program resulted in a remarkably high share of the Gross Domestic Product (GDP) being eventually produced by the private sector. Often cited as one of the major success stories of the transition in Eastern Europe, the Czech privatization program resulted in almost 75% of productive capacity being transferred to the private sector by the first quarter of 1995 after the mass privatization program was completed.

The Investment Privatization Funds formed a popular form of how the citizens allocated their points from the large privatization. For these points the funds acquired shares in numerous companies, where the state also kept its share. At the same moment it has to be noted that a number of these funds was formed by financial institution where the state has kept its large share. Thus the funds involuntarily became to a certain extent institutional managers of the residual state property.

Despite the massive scale of the voucher privatization, there still remains a substantial number of companies where the state has been involved. The total number of 1849 companies of a book value of 367.5 billions entered both waves of voucher privatization. In 1998 the state has kept its involvement in 369 companies with the overall book value of more than 440 billions crowns. The book value of the state share in these companies amounted to almost 177 billions crowns. A great number of these companies was "privatized" through voucher privatization but the state did not privatize them entirely.

Even though the state literally controls only seemingly unimportant part of Czech companies, as far as number of firms is concerned, the book value of this part is no longer unimportant. One cannot but to conclude that, despite the voucher privatization, the state sustained its influence over the significant part of the Czech economy.

Translated from absolute numbers we concluded that 76% of the relative book value of the companies influenced by the state represents 332.7 billions crowns out of the total number of 369 companies in the portfolio of the Fund of National Property that amounts to the book value of more than 440 billions of Czech crowns. This means that the state is able to control enormous part of the Czech economy. In view of the facts it seems legitimate to question the official success of the voucher privatization.

The government recently approved a privatization framework without outlining details concerning privatization of different strategic companies. When compared to the time schedule of the previous government it is evident that the privatization of strategic companies tends to be delayed within the range from one to three years. The banks are the only exception because the government wants to privatize them as quickly as possible. Such a strategy might be contra-productive, though. Since many of the strategic manufacturing companies are heavily indebted with the strategic banks, the privatization of both categories of firms should be effected more or less simultaneously. Further, the privatization in energy sector was put on hold.

There exist a clear consensus that further privatization of the residual state property is both necessary and inevitable. We have described the origins and the current situation in this matter. We also outlined the scope and timetable of the official strategy in privatization. The future will tell the results.

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