

Performance of IPFs after mass privatization process. Evidence from Russian and Czech mass privatization programs

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Abstract – IPFs were created to facilitate the ownership concentration. Extensive literature points out that effective corporate governance needs ownership concentration. Vishny and Shleifer (1986), Mc Connell and Servaes (1990), Vishny, Shleifer (1997) find a positive relation between ownership concentration and corporate performance in US. They all argue that diffuse ownership yields significant power to managers, whose interests do not coincide with shareholder's interests. Consequently, managers could pursue non-value maximizing activities such as self dealing, quiet life or empire building. This paper examines evidence on IPFs in transitional economies of Czech Republic and Russia.

Keywords: investment privatization funds, corporate governance, business performance

I. INTRODUCTION

Czech mass privatization took place in two waves. The first started in October 1992 and ended in June 1993; the second started in January 1994 and ended in October the same year. In total 988 enterprises have participated in the first wave and 861 in the second one (Classens, Djankov, 1999). The firms privatized in the first wave mainly consisted of manufacturing firms and excluded large, vertically integrated firms. They were given more time to restructure and split in small business units. The second wave included those newly created firms and utilities companies. Firms had to submit privatization proposals to the founding ministry. At the same time outside investors were entitled to submit privatization proposals. Within a short period, 60% of Czech economy was transferred into private hands. If an investor had been identified prior to voucher privatization, those shares were not offered in the voucher rounds. As a result 442 sales happened outside mass privatization, although they involved largely small firms (Classens, Djankov, 1999).

A large number of IPFs emerged on a voluntary basis. More than 430 funds were created in the first wave and an additional 120 in the second one. In the first wave IPFs were organized as joint stock companies, while in the second some were established as unit funds. As a result of marketing campaigns, IPFs attracted 72% of all points in the first wave and 64% in the second one.

Mass privatization in Czech Republic was dominated by large state-owned at that time banks. They sponsored the establishment of IPFs. The result was a hybrid between German bank oriented system and Anglo-Saxon system. The main difference between Czech system and German Model is that German Banks are the owners of the stakes in private companies while in Czech Model, Banks only control the IPFs whose shareholders own stakes in the privatized companies.

Specific to the Czech Model is the phenomenon of cross-ownership that has resulted after the mass privatization. As explained earlier, banks sponsored IPFs which invested voucher capital in privatized companies. But afterwards banks were privatized and the existing IPFs had the possibility to buy stakes in competing banks. The legislation in place concerning IPF specifically precluded this phenomenon. However, Banks found ways to elude the regulation. One way to do that was to establish subsidiaries, which in turn established IPFs. Cross-ownership phenomenon implied a potentially collusive system where disputes in companies' boards could lead to a stalemate. The potential winner of such a situation was the management and ultimately the state provided that the latter still maintained stakes in privatized companies. One hypothesis is that the government, although at first was taken by surprise by the cross-ownership problem, it finally tacitly approved it.

Cross-ownership phenomenon has an additional meaning. It also refers to the possibility that the Investment Fund (the bank for example) could own in its turn shares in its affiliated IPFs. This could further amplify the agent – principal problem, already in place in the case of IPFs. In short, it is possible that IPFs

would act as agent of their mother Investment Fund, rather than agents of their shareholders. By their appointed Boards' directors they could obtain inside information which they could use it later for trading.

Czech legislators thereby confronted an important policy option. Should regulation aim to move the system towards the German Model or should they embrace the Anglo-Saxon Model. They favored the later for two reasons. First it appears that the benefits of the German Model are being lately questioned. Second, it is possible that German Model would function properly only under conditions specific to German economy. Circumstances being different in Czech Republic, it is thereby possible that the German approach would not be the best approach. Thereby Czech legislators opted for an Anglo-Saxon model. Specific to this model is the erection of "fire-walls". Their role is to force Investment Funds to act in the benefits of their shareholders and not of the bank which has sponsored the creation of the IPF as it happened in Czech experience.

Russian mass privatization resulted in massive insider's ownership. On average insiders (management and workers) controlled 70% of the stakes of privatized companies. This is in sharp contrast with the situation in Czech Republic where employee owned only 4.4% of the shares. Outsiders held on average 21.5% the rest remaining in State's ownership. IPFs played an insignificant role. They manage to control only approximately 6% oh he shares in privatized companies (Katharina Pistor and Andrew Spicer, 1996).

In an extensive study of Russian experience of mass privatization, Pistor, Spicer and Frydman conclude that the insiders' control phenomenon was a necessary compromise the privatization's planners had to make in order to dislodge the existing state-controlled structures. In other words, it was a profound hostility towards the communist structures which drove the design of mass privatization scheme in Russia. Ironically, the same argument is invoked by their Czech counterparts. A more plausible answer for the insider's control problem in Russia resides in specific socio-political realities in place in Russia at that time. We also have to mention that Czech Republic had the chance to be governed by competent people. Vaclav Havel, president at that time was considered a national hero for his opposition to communists before the Velvet Revolution. And he was wise enough to listen to competent economic advisors like Vaclav Klaus and Dusan Triska.

II. OWNERSHIP CONCENTRATION AND THE POST PRIVATIZATION FIRM'S PERFORMANCE

As argued, Czech mass privatization' design alleviated the statistical problems (endogeneity) which can render any statistical inference between ownership and firm's performance spurious.

Classens and Djankov (1999) have estimated a regression using a pooled sample of 371 firms with 2860 observations and 3 years of data. They estimate both an

OLS model and a Random Effects model. They want to determine the causality between profitability and labor productivity on one hand and ownership concentration. They include sector's dummies to capture sector-specific characteristics and year dummies to control for annual shocks industry or economy wide. A quadratic term on ownership is included. This allows for the possibility of diminishing returns to scale of ownership. The main results are presented in Table 1.

Table 1. Ownership's impact on firms' productivity

Explanatory variable	OLS estimation		Random-effects estimation	
Ownership concentration (T5)	0.178 (2.998)	275.15 (3.098)	0.215 (4.045)	149.98 (1.967)
Ownership concentration squared (T5 ²)	-0.157 (3.664)	-162.17 (2.427)	-0.187 (5.354)	-114.21 (1.723)
Dummy first phase	0.017 (3.598)	47.762 (4.751)	0.014 (1.824)	49.356 (3.267)
Year dummies included	yes	yes	yes	yes
Adjusted R ²	0.103	0.176	0.412	0.604

Source: Classens and Djankov (1999);

Empirical results show that the lower the ownership dispersion, the higher the profitability and labor productivity. In both specifications, profitability and labor productivity are positively and statistically significant correlated with ownership concentration. The coefficient on the squared term is negative, as anticipated. It shows that consolidation of control yields decreasing returns beyond a certain level. The coefficient on the first phase dummy is also positive and significant, which indicates that time is needed for the privatization to affect firm's performance.

Following Aghion and Blanchard (1996), Classens and Djankov try to evaluate the importance of different types of owners. The results suggest that certain types of owners (foreign investors and non-bank-sponsored IPFs) are associated with improved performance in a positive and significant way. The effect of bank-sponsored investment funds is insignificantly different from the effect of state ownership. Local strategic investors do not have a statistically significant influence on labor productivity although they do have on profitability. These findings show the positive impact of ownership concentration on firm's performance after privatization. However, it seems that different types of owners impact firms' performance to a different degree.

Telegdy, Earle and Brown (2006) also support the idea of a different importance associates with different types of owners. In an extensive long times series analysis on a cross section of enterprises from 4 countries (Hungary, Romania, Ukraine and Russia), authors have documented the positive impact of privatization on form's performance. However, important differences

accrue across countries. While foreign investors do have in all cases a positive impact, the other types of investors do not have in all cases, as one could expect, a positive impact on firms' performance. Relevant to our analysis is that privatization to insiders in Russia is associated with a decreased in productivity which extends for a period of 5 years after the privatization (Telegdy, Earle and Brown, 2006).

III. NPFS AS CORPORATE GOVERNANCE AGENTS

As argued before, IPFs were insignificant in Russia (6% of the shares in privatized companies according to Katharina Pistor and Andrew Spicer, 1996). Given the documented importance of ownership concentration on firms' performance, this proves the failure of IPFs to act as active corporate governance agents. Moreover, Telegdy et al provide evidence for an overall failure of Russian mass privatization to bring about productivity gains, showing that performance of the Russian Firms decreased after privatization for 5 years.

These radical findings are in a sense mitigated by Pistor & all (1996). They argue that even given massive insider's control, IPFs managed to participate actively in the corporate governance. They conducted a survey in 1994. From the population of 516 funds registered in 1994, they selected a sample of 148 funds which in terms of the vouchers collected from the population represented 69% of the entire population. The results indicate that most of the IPFs (which had the possibility to do that) have opted for Board representation. The main benefits for Board participation, as perceived by the IPFs in the sample were influencing management strategies, obtaining inside information (that could be used for trading) and influencing dividend policies. Nevertheless, the authors acknowledge that the IPFs have only a marginal impact on corporate governance in Russia's firms.

In Czech Republic, IPFs managed to acquire the stakes necessary for active corporate governance (Mc Coffee, 1996). However, Mc Coffee shows that the ability of Czech IPFs to act so is limited by time constraints, qualification and incentives. After a careful consideration of the corporate governance activities of IPFs, Coffee's study points out that:

..."directories appointed by IPFs simply lacked the business acumen and experience to offer specific advice and alternatives... time constraints were the most important... they attempted to supervise a too large number of companies"...

(John C. Coffee 1995)

Another important conclusion of the study is that IPFs lacked the incentives to participate in corporate governance. 96% of the revenues of the management company of IPF come from trading on stock exchange and 4% from dividends. To the opposite, 90% of expenditures go to share companies and 10% on wages of financial analysts. This shows a disparity between

costly participation in corporate governance and cheap and lucrative trading is an argument for passive behavior as corporate agents. Moreover, the management company of the IPFs can choose between 2% of the average net value of the IPF's assets or 20% of the IPF's annual profit. The only benefit for Investment Fund from equity appreciation in a stock of an affiliated IPF is an insignificant increase in management fee (Mc Coffee, 1996).

Professor C. Coffee has a series of proposals to improve IPF's to participate actively in corporate governance. First of all, he considers the issue of the existing 20% ceiling to IPF's participation with shares in the same company. After a careful consideration of theoretical arguments in favor of controlling stake as prerequisite for corporate governance, a number of policy options are proposed.

- Remove the 20% ceiling and forbid stock holdings in the range 30-50%
- Move the ceiling to 30% and then require that additional shares be acquired through a tender offer (GB, Spain, Australia, CEE recommendation)
- Counter recommendation by OECD 1972, on the basis that the management of the fund is not governed by the wishes of the shareholders.

Coffee also identifies other mechanism through which legislators can increase corporate activism. One of them involves the lifting of the 2% ceiling on management tax (which in fact the Investment fund which in most cases provides the management of the IPFs is entitled to get). By doing so, the author shows that IPFs would have more incentive to increase the value of their portfolio and would better serve the interest of their shareholders. Another possibility to improve IPFs' implication in corporate governance is to remedy the issue of managerial contracts. In Czech Republic, managers appointed by the Investment Companies to manage IPFs have long term contracts, usually for a 6 years period. The author shows that in US annual approval of managerial contracts of Investment funds is normal.

Thereby Czech experience provides mixed results. Although much had been accomplished, important things were in 96' still to be addressed. On overall, Czech experience can be considered a success story of mass privatization. According to Coffee it is the only successful story of mass privatization, but as shown, this depends on the perspective we choose to adopt.

IV. CONCLUSIONS

After the mass privatization process ended, IPFs had to survive with the acquired portfolio. Several trends were obvious in both countries. First of all, the number of IPFs decreased significantly. In Russia from the 650

licensed IPFs only 350 were active in 1995, according to a governmental estimate (Katharina Pistor, Andrew Spicer, 1996). There were 67 mergers among IPFs and 69 of them transformed into joint-stock companies. Overall the analysts consider that only 25-30 of them have played an important role on the stock market and managed to acquire an active portfolio with long-term perspectives of survival. Since many of the IPFs were relatively small this trend is not surprising. Many of them simply went out of business.

Many of the funds simply have not managed to earn sufficient profits to survive. One important reason for this is the illiquidity of the securities markets and of the market for the funds' shares. Although the mass privatization programs ended, state continued to maintain control over major economic players. In Czech Republic, Banks dominated the creation of the IPFs. But they were controlled by the state which postponed the privatization of the banking sector. This impacted negatively on the efficiency of banking sector, which was unable to support the restructuring of the newly privatized companies. As a result their efficiency did not improve significantly. They were unable to pay dividends which translated in illiquid financial markets and further on the profitability of the investment funds. Moreover, IPF were unable to generate a market for their shares. In Russia once the mass privatization ended, most IPFs traded the most lucrative shares. As a result they were left with a poor portfolio. The remaining shares were under-evaluated, being trade at a market value much lower than the nominal value of the funds' shares. The illiquidity of capital markets in both countries was further amplified by the lack of trust of population in IPFs. In Czech Republic the existing funds, made unreasonable promises to attract voucher capital. Being unable to fulfill their promises, people lost their trust in the funds as financial intermediaries. The very fact that people chose to invest their capital vouchers into newly created IPFs (in the second wave of mass privatization, in Czech republic were created 221 new IPFs) rather than in the existing ones make a compelling argument for the generalized lack of trust in IPFs as financial intermediaries. In Russia things were even worst. Thousands of unlicensed financial companies took advantage of loose regulations and attracted populations' savings (i.e. Pyramidal Schemes). 80 millions. Russians invested in such schemes and 50-70 trillions rubles were lost.

Another issue that impacted negatively on the overall IPF's profitability was the double taxation problem, which hindered IPFs attempt to attract new investment. Vouchers Funds faced a double taxation system. The fund itself paid taxes on its profits. Fund's investors also have to pay taxes for the dividends paid by the fund. Under these circumstances, a strategic investor paid fewer taxes if he chose to invest directly into a company rather than in an IPF.

However, few IPFs managed to overcome the cash-flow issue. They managed to gather a lucrative portfolio and to restrain from trading it immediately after the mass

privatization ended. They also managed to acquire large stakes which afforded them to actively participate as corporate agents' post-privatization. Another explanation for their success is that some of them were part of financial groups, especially in Czech experience of mass privatization. As a result they faced less severe financial constraints, having an easier access to loans when they needed them. Most importantly, the successful IPFs managed to diversify their portfolio of activities. They offered a large range of financial services, from investment and reengineering expertise to arranging credits for companies. This additional revenue complemented the revenues from management tax and afforded IPFs to gain profits.

Empirical studies document the failure of Russian IPFs as active corporate governance agents. It seems that the overall Russian mass privatization failed to result in an increase in firms' performance after privatization.

In Czech Republic the evidence of the IPF's funds is mixed. Many have disappeared due to the cash-flow problem. Few have managed to survive. They do have the potential to contribute to better corporate governance, provided they benefit from a coherent supportive legal framework to give them the right incentive to do so.

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