Eastern European Economics, vol. 37, no. 5, September–October 1999, pp. 6–35.

ISSN 0012–8775/2000 $9.50 + 0.00.

EVŽEN KOČENDA

Residual State Property in the Czech Republic

1. Rationales for 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 percent of the labor force and producing a negligible fraction of 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 percent of productive capacity being transferred to the private sector by the first quarter of 1995 after the mass privatization program was completed (see Aghion, Blanchard, and Burgess 1994 and Blanchard et al. 1991). This is comprehensively captured in Table 1.

Privatization in the Czech Republic was carried out under three programs: restitution, small-scale privatization, and large-scale (or

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Table 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
Municipally 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 of the Czech Republic.

mass) privatization. This comprehensive privatization program resulted in a remarkably high share of gross domestic product (GDP) eventually being produced by the private sector. Prior to the split of the former Czechoslovakia, which took place on January 1, 1993, privatization was carried out jointly in the Czech and Slovak Republics. Generally, however, data are available for each republic separately, which makes analysis easier. For other references related to macro aspects of privatization see Frydman, Rapaczynski, and Earle (1994) and Kotrba (1995) among others. As a summary of the official macro outcome of the privatization process, Table 2 compares the role of the private sector as a percentage share of GDP in various Central European countries from 1990 to 1997.

1.2 Privatization Methods

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

Table 2

Contribution of Private Sector to the GDP (as 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: International Monetary Fund.

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 to transfer 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 10,000 additional 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. Initially, 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 vested 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 through tenders; medium businesses were sold through tenders or to a predetermined buyer (direct sales). The largest firms were transformed into joint-stock companies, the shares of which were distributed through voucher privatization. Almost one-half of the total number of all shares of all joint-stock companies were privatized. Finally, some companies were 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 3.

Table 3

Large Scale Privatization in the Czech Republic

	Property June 1993, million CZK	Units June 1993	Property June 1994, million CZK	Units, June 1994	Property June 1995, million CZK	Units, June 1995	Property June 1996, million CZK	Units, June 1996
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 company	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 of the Czech Republic.

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 1989–91.

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 percent 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

Table 4

Brief Overview of Voucher Privatization

Subject	Wave 1	Wave 2
Number of state enterprises entering the voucher scheme	988.00	861.0
Book value of shares allocated for voucher in particular wave (billions of crowns)	212.50	155.0
Participating citizens (in millions)	5.98	6.16
Average accounting value of assets per participating citizen (crowns)	35,535.00	25,160.0
Percent of voucher points with investment privatization funds	72.20	63.5

Sources: Ministry of Finance and Ministry of Privatization of the Czech Republic.

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 percent of capital being placed in the voucher scheme. The second largest share (23.3 percent) 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[1] (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 percent of the country's capital assets. The second, somewhat smaller wave, was completed by the end of 1994.

Table 4 shows as a summary the two-wave process of voucher privatization translated into major numbers. However, these numbers give only a rough sketch of the situation.

2. Controlling Institutional Structures of Residual State Property

2.1 Large Privatization and Investment Privatization Funds: Indirect Residual Property

The investment privatization funds were a popular way for citizens to use their points to get shares in the large privatization. The funds pooled the points they received and used them to acquire shares in numerous companies, where the state also kept its share. At the same time, it must be noted that a number of these funds were formed by banks in which the state has kept a controlling interest. Thus, the funds involuntarily became, to a certain extent, institutional managers of the residual state property. The following helps to explain the situation.

All Czech citizens over the age of eighteen who resided in the Czech Republic or the Slovak Republic 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 funds (IPF). These IPFs had to provide basic information regarding their ownership and investment strategy. In addition, information regarding profitability, sales, growth rates, and the 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 the form of a database designed to make analyses easy. A great number of citizens opted to put their points into the funds. Tables 5 and 6 show the most important fund groups that managed to gain more than 2 percent market share and their relative position on the market.

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 1992, official estimates were that only about 20 percent of eligible participants would pur-

Table 5

Position of the Major Funds on the Market: Wave 1

Founder	Number of points allocated	Market share	Cumulative market share	Number of IPFs
Česká státni spořitelna	950,918,800	15.494	15.494	1
První investi ční, a.s.	713,837,100	11.631	27.126	11
Harvard Capital and Consulting	565,170,000	9.209	36.334	6
V and B Invest, i.a.s.	500,668,100	8.158	44.492	1
IKS KB spol., s.r.o.	465,708,300	7.588	52.081	1
Kapitálová investiční společnost, a.s.	334,234,900	5.446	57.527	1
Slovenské investice , s.r.o.	188,041,300	3.064	60.591	1
Creditanstalt, a.s.	138,924,800	2.264	62.854	1
Prva Slovenska investi ční, a.s.	136,348,000	2.222	65.076	11

Source: Ministry of Finance of the Czech Republic and author's computation.

chase 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 percent in one year.[2] In the end, 75 percent of those eligible to participate did so. About 72 percent of the voucher points were placed for bidding with one of the 264 IPFs in the Czech Republic, while 28 percent were retained by individuals. There was substantial concentration among the IPFs, with over 56 percent 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 remain a substantial number of companies in which the state has

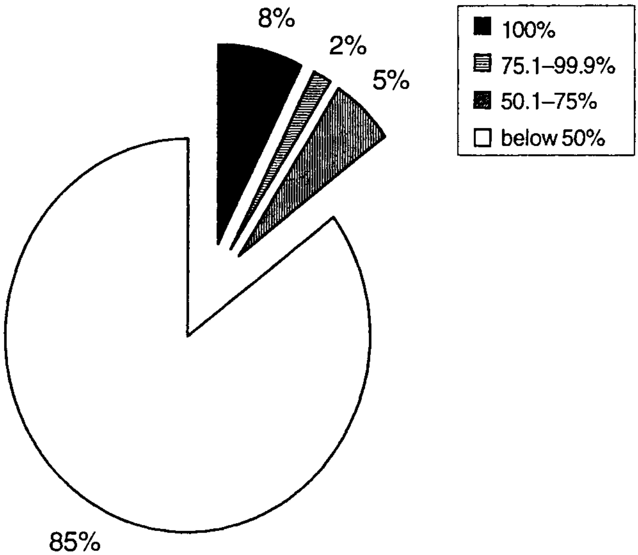
Table 6

Position of the Major Funds on the Market: Wave 2

Founder	Number of points allocated	Market share	Cumulative market share	Number of IPFs
A-Invest, investiční společnost, a.s.	309,243,300	7.896	7.896	2
Investiční společnost Expandia, a.s.	306,290,600	7.820	15.716	3
Harvard Capital and Consulting investiční společnost, a.s.	29,2170,900	7.460	23.176	23
O.B.Invest, investiční společnost, s.r.o.	198,351,200	5.064	28.240	3
KIS, a.s., Kapitálová investiční společnost české pojištovny	186,697,800	4.767	33.007	3
Investiční společnost podnikatelů, a.s.	159,263,500	4.066	37.073	2
Investiční společnost Linh Art, s.r.o.	156,432,100	3.994	41.067	3
Czech Investment Company investiční společnost, spol., s r.o.	151,666,300	3.872	44.939	1
Spořitelní investiční společnost, a.s.	124,161,800	3.170	48.110	1
Investiční kapitálová společnost KB, a.s.	124,063,500	3.168	51.277	1
PPF investiční společnost, a.s.	119,703,700	3.056	54.334	2
První investiční akciová společnost	97,629,000	2.493	56.826	5
C.S. Fond, a.s., investiční společnost	94,007,200	2.400	59.226	7
Moravská agrární potravinářská investiční společnost, akciová společnost	89,932,800	2.296	61.523	1

Source: Ministry of Finance of the Czech Republic and author's computation.

Figure 1. **Relative Numbers of Enterprises in Each Category of State Ownership**

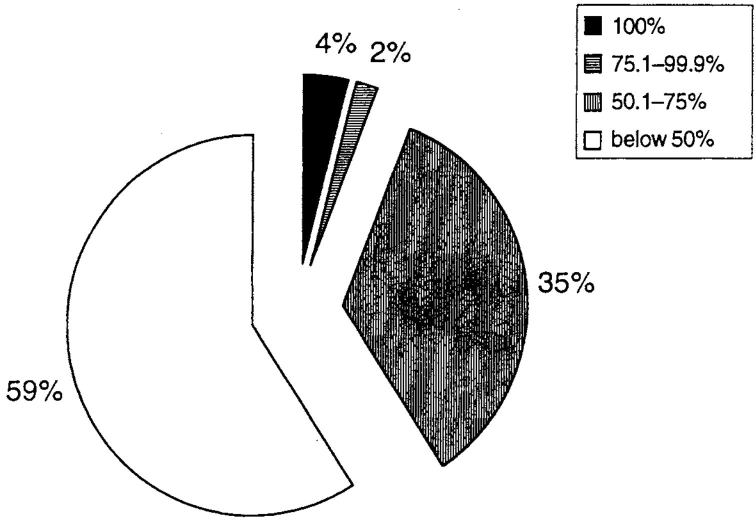


been involved. From Table 4 we know that 1,849 companies with a book value of 367.5 billion crowns entered both waves of voucher privatization. In 1998 the state retained its involvement in 369 companies with an overall book value of more than 440 billion crowns. The book value of the state share in these companies amounted to almost 177 billion crowns. A great number of these companies were "privatized" through voucher privatization but the state did not privatize them entirely.

The FNP, as a legal owner, is involved to different degrees in a vast number of companies. The extent of its involvement is based on the number of shares the state holds in each company that belongs to the portfolio of the FNP. An illustrative example of such an arrangement can be extracted from Figure 1, which 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.

Thus, Figure 1 depicts the *relative number* of enterprises falling

Figure 2. **Relative Book Value of Enterprises in Each Category of State Ownership**



into each of four categories of state ownership. These are: (1) enterprises where the FNP holds 100 percent of shares; (2) enterprises where the proportion of shares in the FNP's ownership ranges from 75 percent to 99.9 percent; (3) enterprises where the FNP holds more than 50 percent but less than 75 percent of shares; and finally (4) enterprises in which the FNP's share amounts to less than 50 percent. One can observe that the enterprises in which the state keeps more than fifty percent of shares represent only a relatively small part of all firms, namely, 15 percent.

However, such an assessment would be too simple for a matter as complicated as the ownership structure of the state. Therefore, Figure 2 takes into account a book value of each firm. This us to derive a perception of the economic power of the companies and consequently the extent of wealth that is controlled by the state.

As revealed by Figure 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 that belong entirely to the FNP is no more than 4 percent and a relative number of these is about 8 percent. However, the relative book value of all enterprises where the FNP has a share over 50 percent reaches a spectacular 41 percent. It has to be noted that the control over 41 percent of companies is effected solely through the voting rights associated with the number of shares above 50 percent. Thus, even though the state literally controls only a seemingly unimportant proportion of Czech companies, as far as the number of firms is concerned, the book value of this portion is no longer unimportant. One cannot help but conclude that, despite the voucher privatization, the state sustained its influence over a significant portion of the Czech economy.

2.3 Residual Cross-Ownership

We have already noted that state control is associated with 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 percent of shares of company A is owned by company B, while the rest is the property of company C. But 60 percent of company C is owned by company B. Clearly, the real influence of company B over company A is much greater 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 a new methodological approach that can provide some insight into 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 scenes in 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 to the case of the major Czech banks.

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

$$S^0 = (s^0_{ji})_{\substack{i=1,\ldots,m \\ j=1,\ldots,n}}$$

as the primary property distribution matrix and matrix

$$T^0 = (t^0_{ji})_{\substack{i=1,\ldots,m \\ j=1,\ldots,n}}$$

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

$$\sum_{i=1}^{m} s^0_{ji} + \sum_{k=1}^{n} t^0_{jk} = 1$$

Expressing the same in matrix form yields

$$S^0 e_m + T^0 e_n = e_n$$

where e_n denotes the n-dimensional vector composed of 1s.

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

$$s^1_{ij} = s^0_{ji} + \sum_{k=1}^{n} t^0_{jk} s^0_{ki}$$

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

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

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

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

and

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

Having defined the methodology for examining indirect ownership, we present some results of its application in the Czech banking sector. Table 7 shows how the position of the Fund of National Property in the five leading banks changes, when one considers "higher degree" ownership.[3] Not only does the percentage share increase but in one case it exceeds the 50 percent threshold that is so important in the case of voting (KB). In another case (ČSOB), no change occurs simply because the rest of the shares are also owned by the state already, albeit 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 in 1997 this bank (IPB) was fully privatized through its sale to a foreign strategic investor. Such "real" privatization is the subject of section 4.2.

3. Corporate Governance Implications of Residual State Property

3.1 State Management

The state keeps control of its property through the presence of its representatives in the statutory bodies of the companies. According to the Commercial Code, each joint-stock company is obliged to have a Board of Directors and a Supervisory Board. The Board

Table 7

Indirect Ownership Among the Major Czech Banks

Bank	Property of of FNM	Primary first degree	Second degree	Third degree
ČS	52.80	57.22	59.19	59.23
ČP	30.25	38.40	38.40	38.40
KB	48.74	50.27	50.89	50.90
ČSOB	65.69	65.69	65.69	65.69

Source: F. Turnovec, "Privatization, Ownership Structure, and Transparency: How to Measure a Real Involvement of the State," *European Journal of Political Economy*, forthcoming 1999.
Notes: Degree is represented by percentages. ČS—Česká spořitelna; ČP—Česká pojišťovna; KB—Komerční banka; and ČSOB—Československá obchodní banka.

of Directors is either executive or nonexecutive, or, in certain cases, mixed. In the case of an executive Board of Directors, the position of director corresponds to that of executive officer. The state nominates its representatives mainly to the nonexecutive Board of Directors, while the positions of executive officers are filled by professional managers. In this way the state exercises control over the company.

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

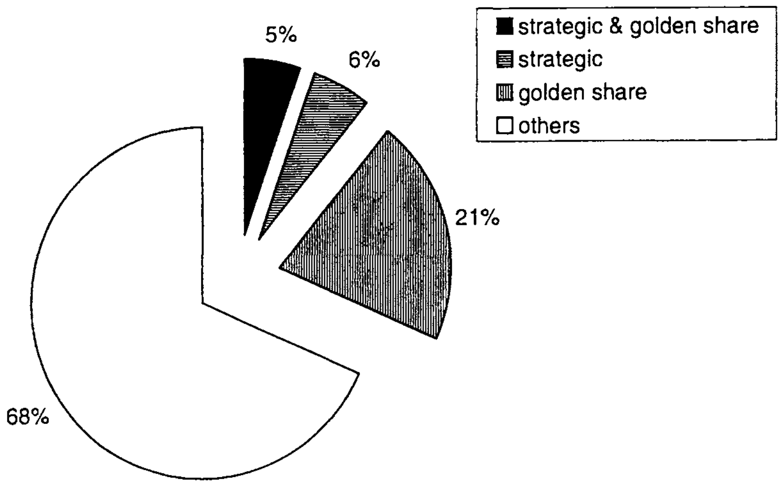
State influence is exercised by various means. The simplest form of control is through the number of shares or the percentage of the state property that is represented by voting rights. Another mechanism is embodied in a "golden" share. This instrument, in the form of a single share with special status, allows the state to prevent any major changes in a company in which it holds such a share. Utility companies are a typical example of state control through a golden share. Many other companies has been declared strategic and enjoy a special status that is embedded in similar legal provisions.

Overall state influence over 369 companies belonging to the portfolio of the Fund of National Property is documented in Figure 3. The figure shows the relative number of enterprises in four categories that illustrate the influence of the state. The Fund of National Property holds a golden share in 21 percent of companies in its portfolio. Enterprises labeled as "strategic" amount to 6 percent of such companies. Furthermore, the FNP keeps a golden share in 5 percent of companies that were already declared strategic. The first three categories together, that is, all the enterprises in which the state can effectively influence decision making, contain 117 companies. The number accounts for 32 percent out of the total of 369 companies. More important, the aggregate book value of these three categories, as documented by Figure 4, totals an incredible 72 percent.

In order to evaluate the power of the state to exercise control over these companies, we have to combine all feasible means of control together. Therefore, Figure 5 combines the previous approaches in that it shows the relative book value of all enterprises in which the FNP either holds the control package of shares (over 50 percent), or it maintains the strategic position otherwise, for example, through a golden share.

If we translate Figure 5 into absolute numbers, we conclude that 76 percent of the relative book value of the companies influenced by the state represents 332.7 billion crowns. The total number of companies in the portfolio of the Fund of National Property is 369, which amounts to a book value of more than 440 billion Czech crowns. This means that the state controls an enormous part of the Czech economy.

Figure 3. **Relative Number of Enterprises by Categories of the State's Strategic Influence**



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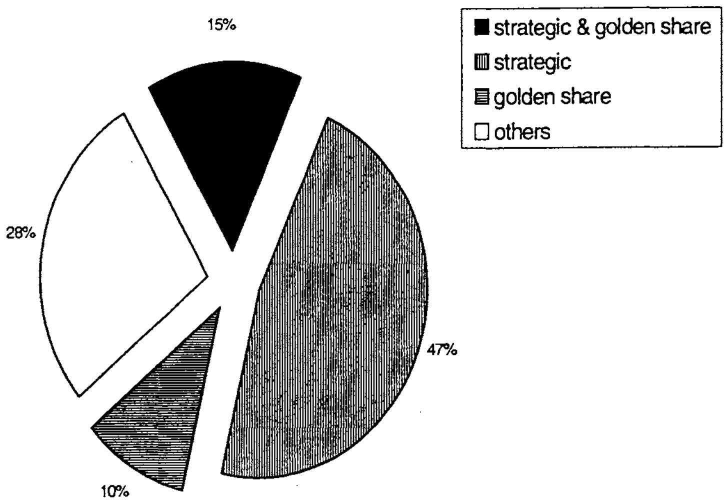
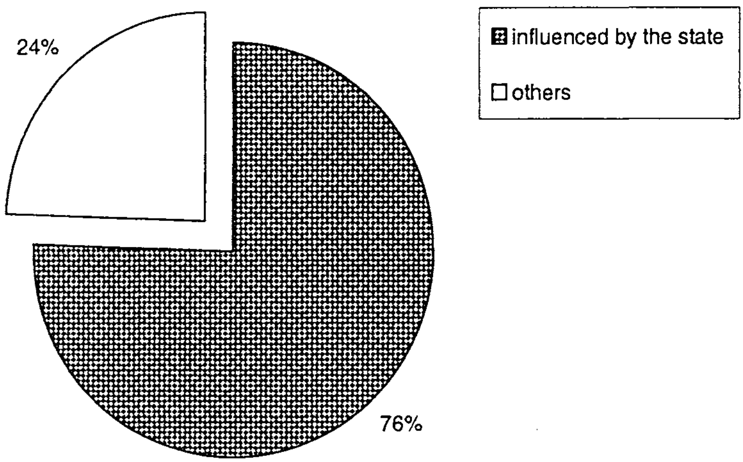


Figure 5. **Relative Book Value of Enterprises Controlled Effectively by the State**



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 is 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 restructuring of noncompetitive industries.

Over time, however, the situation changed considerably. The investment funds started to trim their portfolios to weed out nonproductive 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 create corporate governance because the majority shareholders in each company started to transform their

Table 8

Structure of Joint-Stock Companies (JSC) Privatized Through Voucher Scheme

	Number of units into which privatized state-owned enterprises 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.

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 undeveloped.

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 8.

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 percent by employees and 70 percent 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 or operator for managing the fund was limited to 2 percent of the nominal value of shares gained through voucher privatization plus up to 3 percent of assets and 20 percent of the fund's profits each year following privatization. Government officials were excluded from serving on the board of an IPF. Each IPF could invest no more than 10 percent of its points in a single company nor obtain more than 20 percent of the shares of any company.

Initially, related funds from a single founder could own no more than 40 percent of a firm. This was later reduced to 20 percent. 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's stock 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 prohibited 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 five out of the six largest groups of IPFs. Together these six financial institutions obtained the right to bid over 36 percent of all the points in the first wave of voucher

Table 9

Direct Ownership of the State

Categories of FNP's share	Number of enterprises	Book value of enterprises (in millions of Czech crowns)
100 percent	28	16,578.6
75.1–99.9 percent	6	8,549.9
50.1 percent–75 percent	20	154,804.5
Below 50 percent	315	260,147.9
Total	369	440,080.9

Source: Fund of National Property.

privatization. Such an outcome was naturally translated into the resulting 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 maintains an important share in numerous joint-stock companies. Table 9 summarizes in a brief but highly illustrative way the current situation regarding the direct involvement of the state in the companies that are contained in the portfolio of the FNP.

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 billion crowns. The book value of these companies is nearly three times greater. The biggest share of these assets derives from twenty companies in which the state holds more than one-half but less than three-fourths of the outstanding shares. Most of these companies are considered to be strategic, and they account for more that one-third of the total book value of the companies in question. In view of these facts, it seems legitimate to question the official success of voucher privatization.

Nevertheless, the state has felt its obligation to continue with privatization. The following two sections describe a case of bank privatization and outline future prospects for privatizing the rest of the residual state property.

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

During the years following the formal end of mass privatization, the situation of Czech firms changed much less than expected because the state maintained such an important ownership position in the voucher-privatized companies. However, the intention to privatize further has materialized in several cases. As a case study, we present a description of the privatization of the bank that has belonged to the "Big Four" banks in the Czech Republic.

The Czech government approved the plan for 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 owned by the FNP (31.5 percent) and by the Czech Post (4.45 percent) to a strategic foreign investor. The criteria for the choice of a foreign partner were announced subsequently, and the Salomon Brothers was appointed to manage the tender, in which fourteen candidates took part. 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. Nomura emerged as the most suitable candidate.

On July 23, 1997, the government of the Czech Republic issued a decree on the sale of the state share in IPB to the Nomura Europe PCL. In order to determine the sale price, an audit of IPB was commenced. On March 8, 1998, the FNP and the Nomura Europe PCL signed the sale contract. Several binding conditions formed part of the contract. Both parties involved agreed upon a price that amounted to nearly 3 billion Czech crowns. One major condition was that Nomura would increase the total equity of IPB by 6 billion crowns and would be the exclusive issuer of this increase. Besides that, 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, Nomura promised the other shareholders of 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. The capital increase was 1.701 billion crowns. As for the corporate structure, it must be mentioned that, at the general assembly in March 1998, a major change in the bank's statutory bodies occurred to reflect the new ownership structure. Later in 1998 the governance structure of the bank was further altered.

At the beginning of 1998, IPB substantially increased its reserves and loan-loss provisions, which resulted in a total loss of 11 million crowns. Such an operation reflected the troubled financial situation of the bank, which, in turn, reflected the state of affairs within the Czech financial sector. The loss was naturally mirrored in the bank's books and IPB covered it mainly through charges against its reserve funds. Having taken the steps described, the bank was ready to increase its efficiency. It has set an ambitious goal for 1998 in the form of a net profit of approximately 2 million crowns. In the first half of 1998 it declared a net profit of approximately 1 million crowns. By September 30, 1998, the net profit had risen by another 500,000 crowns. As for the year-to-year growth in revenues from financial activities, IPB exhibited a 24.5 percent increase. In addition, the bank managed to stop the rise of operating costs, which led to higher profit margins, as well as to a high level of revenue, which increased by 42.4 percent. Furthermore, there was a significant increase in the volume of primary accounts (16.4 percent by September 1998). The difficult process of transformation did not cost IPB the trust of its customers and the total number of customers reached 2.5 million by September 30, 1998.

It is obvious that only the future will show the complete results of the privatization of IPB. So far the bank has done reasonably well. In any event, until now, its privatization has been the only completed privatization of its kind within the Czech banking sector.

4.3 Privatization Schedule

Political crisis at the end of 1997 resulted in the dissolution of the government by the president, who appointed a new government to consolidate state affairs. Selection of the cabinet was made based on professional merits rather than on political affiliation. 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, a privatization schedule was set up. Table 10 lists all the important companies that the government wanted to fully privatize in the nearest future. These companies are divided into three categories that correspond to the time phase of their privatization.

The first category contains companies that were selected to be privatized immediately, and the strategic investor was to be selected through a public auction. Firms operating in the mining industry dominate this category. The second category contains companies that would be prepared for privatization but with the details to be clarified later. Three out of four of the largest banks belong to this cohort and steps toward 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.

The general elections held in July 1998 were won by the Social Democratic Party, which, after lengthy deliberation, formed a majority government and signed an "opposition agreement" with its political competitor, the Civic Democratic Party, in order to avoid ensuing clashes of power. The political change also brought a dif-

Table 10

Proposal of Privatization Schedule: Strategic Joint-Stock Companies

Name of company	Share of state (percent)	Industry
First category		
Česká pojištovna	30.25	Insurance
Mostecká uhelná společnost	46.29	Mining
Severočeské doly	54.00	Mining
Sokolovská uhelná	48.69	Mining
Aero Holding	61.83	Aircraft
Paramo	70.87	Oil
Second category		
ČSOB	65.70	Banking
Komerční banka	48.74	Banking
Česká spořitelna	45.00	Banking
Sixteen energy distributing companies	46.70–59.10	Energy
OKD	45.88	Mining
Budějovický Budvar	100.00	Brewery
Sevac	78.86	Pharmaceutical
Third category		
Cepro	100.00	Transport
Unipetrol	62.99	Oil
České aerolinie	56.92	Air transport
Vítkovice	34.01	Steel
České radiokomunikace	51.00	Telecomunications
Mero	100.00	Oil
Škoda Praha	54.77	Machinery
ČEZ	67.57	Energy
Nová Hu•ta	34.00	Steel
SPT Telecom	51.83	Telecomunications

Source: Ministry of Finance of the Czech Republic.

ferent perspective with respect to the blueprint for residual state property privatization. Table 11 lists the most important strategic companies in which the state holds a substantial share and provides a brief outline of the intended privatization schedule.

Table 11

Proposal of Privatization Schedule: Strategic Joint-Stock Companies

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

[a]Sale.
[b]Preparation for privatization, decision on how to privatize.

The government approved only the framework of the privatization without outlining the details concerning the privatization of various strategic companies. When compared to the time schedule of the consolidation government (Table 10), it is evident that the privatization of strategic companies tends to be delayed for about one to three years. In certain cases, the timing horizon is entirely missing. The banks are the only exception, because the government wants to privatize them as quickly as possible. However, such a strategy might be counterproductive. Because many of the strategic manufacturing companies are heavily indebted to the strategic banks, the privatization of both categories of firms should be effected more or less simultaneously.

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

As for the natural gas processing and distributing companies, the government intends to reacquire various portions of shares so that the state would again hold a majority in such companies. Eventual sales would then be effected from a majority owner position. Relatively quick sales are expected in the cases of one oil processing company and two coal mining companies where the state still holds an absolute 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. By far the most important privatization program in the Czech Republic was large-scale privatization. The largest firms were transformed into joint-stock companies, the shares of which were distributed through voucher privatization, sold for cash, or transferred for free to municipalities. This comprehensive privatization program resulted in a remarkably high share of gross domestic product (GDP) eventually being produced by the private sector.

Investment privatization funds were a popular way for citizens to allocate their points, enabling the funds to acquire shares in numerous companies. Despite this massive privatization, the state has retained a major ownership role in Czech firms.

Even though the state controls a small number of Czech companies, their value is quite large. One cannot help but conclude that, despite voucher privatization, the state retained its influence over a significant part of the Czech economy.

The government recently approved a privatization framework without outlining its details. When compared to the time schedule of the previous government, it is evident that the privatization of strategic companies is to be delayed by one to three years. Banks are the only exception.

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

Notes

1. 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 Kc and placed after the numerals.

2. 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.

3. We reproduce only 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.

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