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WHAT DO FIRMS DISCLOSE AND WHY? ENFORCING CORPORATE GOVERNANCE AND TRANSPARENCY IN CENTRAL AND EASTERN EUROPE

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While specific corporate-governance rules are often controversial, most observers agree on the need to disclose who owns and controls a firm and what governance arrangements are in place. This paper examines such disclosure in a sample of 370 companies listed on stock exchanges in Central and Eastern Europe. The data show widespread non-disclosure of even the most basic elements of corporate-governance arrangements, despite existing regulation. The level of disclosure varies substantially across firms, and there is a strong country effect in what companies disclose. Overall, what is disclosed depends on the legal framework and practice in a given country, but it does not *correlate with firms' financial performance. On the other hand, financial performance is strongly related with how easily available the information is to the public. In particular, information is more available in larger firms, firms with lower leverage, higher market-to-book ratios, and more concentrated ownership.*

I. INTRODUCTION

The countries in Central and Eastern Europe began their transition from different starting points and then pursued remarkably different policies. Their economies also followed different trajectories of economic and financial development. Some countries developed fast early on, then slacked, even experiencing financial crises. Others were slow starters, but caught up later. Yet, today their eco-

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nomic systems are rapidly converging. The contours of a new European capitalism are emerging, combining features of Continental European capitalism with large controlling shareholders and elements of entrepreneurial or founder capitalism most associated with the United States. Essentially, this is the pattern of emerging capitalism around the world, and the core corporate-governance challenge is the same: how to balance the incentives of controlling owners to exercise governance against the protection of minority investors.

In parallel, large numbers of laws and regulation have been adopted over a very short time period, with courts and enforcing agencies struggling to keep pace with the speed of transformation in the laws-on-the-book. Some countries could rely in part on earlier legal traditions and even legal texts, but to a considerable extent the new laws have been imposed from the outside as part of the EU accession process or copied from the United Kingdom or the United States. Ensuring the implementation and sustained enforcement of these laws is another challenge facing the Central and Eastern European (CEE) countries, requiring backing from the political process. Given the recent history of most enforcing institutions and the narrow base of the shareholder constituency, building political support is not trivial. Consequently, as in many other emerging markets, the level of implementation and enforcement of key corporate-governance provisions are a source of concern.

The purpose of this paper is to document the extent to which rules and regulation relating to corporate-governance disclosure are being implemented and enforced in individual corporations in Central and Eastern Europe. What do firms disclose and why? If there are substantial gains from releasing information, why do not individual firms disclose more? Does disclosure depend on the ownership and control structure or the nature of the firm's activities? Does the level of disclosure differ across countries? What could explain such variations? When enforcement is lax we would like to understand why. In order to answer these questions we have collected all the relevant laws and regulation pertaining to information disclosure in the annual reports, as well as constructed two measures of firm-level disclosure.

Using a sample of 370 non-financial companies listed on ten CEE stock exchanges, we construct the following disclosure measures. First, we analyse and code the information availability on companies' websites (the *WebDisclosure* index), here considered as voluntary disclosure, as of mid-2004. Second, to evaluate enforcement of mandatory disclosure rules, we analyse 128 annual reports[2] from year 2003 in terms of information on remuneration and shareholdings by management and the board, as well as related and affiliated party transactions. We construct an aggregate measure called *ARDisclosure* index, based on how detailed the information a company provides is, and compare it with the legal requirements in a given country. The two disclosure measures are then related to firm-level financial indicators, as well as the structure of ownership and control.

The data show that the level of disclosure varies substantially across firms, and there is a strong country effect in the deviation between the actual and required disclosure. We find evidence that the voluntary information disclosure (*WebDisclosure* index) is positively associated with resource availability. In particular, larger firms and firms with less leverage, with higher cash balances, and with slower growth disclose more. The data show that the dependence on external capital does not encourage firms to disclose more. These results suggest that for firms in the CEE countries the direct costs of disclosure outweigh the benefits of attracting minority investors and reducing the cost of external capital.

The deviation from mandatory disclosure in annual reports exhibits a strong country effect. From the sample of reports examined here, Lithuanian and Polish companies disclose less in their annual reports, while Czech and Estonian companies disclose more than is legally required. We argue that this cross-country variation in disclosure enforcement can be to some extent *intentional*. Securities market

[2] The initial sample of 370 companies includes all the (non-financial) companies that were listed as of mid-2004. The sample of companies with annual reports is only 128 for the following reasons: (i) the company has no web-page, (ii) the annual report is neither available on-line nor provided by the company upon e-mail request, or (iii) only financial statements such as balance sheet and income statement are provided.

regulators or individual exchanges are faced with a trade-off between more stringent enforcement of disclosure rules and more firms leaving the stock exchange because of too high disclosure requirements. In some cases they may decide to loosen the enforcement to reduce the incentives of companies to delist.

The following section (section II) briefly discusses the main trade-offs of corporate governance with a particular emphasis on disclosure. Section III evaluates the enforcement of transparency of corporate-governance arrangements. We find substantial variations across countries in what individual companies disclose. While EU accession has been remarkably successful in transforming the laws-on-the-book in these countries, implementation at the level of the individual corporation is still lagging. Improvements in this regard must come from forces within the countries. Section IV looks at the options for achieving improved enforcement of existing laws and regulation. Section V concludes.

II. THE EMERGING CORPORATE-GOVERNANCE CHALLENGES

The corporate-governance challenges facing Central and Eastern Europe are similar to those of many other emerging markets. Despite the early dispersion following privatization programmes, in many countries shareholdings have become increasingly concentrated and financial markets remain weak. Given that owners are often still involved in management, and that, even in firms where they have withdrawn, in the few companies run by professional managers they cannot be expected to be independent in heavily concentrated ownership structures, the main conflict in these firms will be between controlling owner–managers and minority investors. It is in this perspective that we have to revisit some key trade-offs in the regulation of corporate governance: between managerial initiative and investor protection; between the interests of large blockholders and those of minority investors; and between minority investor protection and the market for corporate control. We discuss these trade-offs as they relate to disclosure by individual firms and the enforcement of disclosure regulation by regulators and exchanges; but first we need establish our basic view of corporate governance.

The universal challenge of corporate governance is the principal–agent problem faced by an entrepreneur or a manager approaching outside markets for finance: how can he or she commit to choosing the right projects, exerting sufficient effort, adequately disclosing relevant information, and ultimately repaying investors? In the absence of complete contracts, outside investors will assume that the entrepreneur/manager will use all opportunities to defraud investors or in other ways not live up to his promises. The problem of contractual incompleteness is amplified by the riskiness of projects in many weak institutional environments. The worse is the entrepreneur/manager's commitment power, the costlier will its outside financing be (and the more difficult it is to recruit good personnel and establish long-term supplier–customer relationships). Corporate governance is in great part about mitigating this commitment problem.

To mitigate the commitment problem, investors can reduce the likelihood of being defrauded or deceived by monitoring and potentially punishing management. When the costs of collecting information and enforcing contracts are high, as in many emerging markets, investors will find it more difficult to monitor and thus be more tempted to free-ride on monitoring by other investors.

Yet, countries with very different legal systems and enforcement environments have developed well-functioning corporate governance. For example, studies show that the probability of a chief executive officer (CEO) being forced out following bad corporate performance is equally high for countries with very different corporate-governance regimes (Kaplan, 1994; Kang and Shivdasani, 1995). The same or similar results can apparently be achieved with different combinations of corporate-governance mechanisms. Figure 1 provides an overview of the various mechanisms that can be used (see Becht *et al*. (2003) for a general review of the literature on some of these mechanisms). The effectiveness of these mechanisms will depend on the nature of other institutions in a particular country.

The most common response to weaknesses in the general contracting environment is to give one shareholder a sufficiently large stake in the firm so as to provide him or her with incentives to monitor and intervene when necessary. In fact, highly

Figure 1
The Corporate-governance Mechanisms in Central and Eastern Europe

Corporate governance mechanism	Relative importance in Central and Eastern Europe	Scope for policy intervention
Large blockholders	Likely to be the most important governance mechanism; leads to concentrated ownership	Strengthen rules protecting minority investors while retaining incentives to hold controlling blocks
Market for corporate control	Unlikely to be important when ownership is strongly concentrated	Remove some managerial defences; disclosure of ownership and control; develop banking system
Proxy fights	Unlikely to be effective when ownership is strongly concentrated	Technology improvements for communicating with and among shareholders; disclosure of ownership and control
Board activity	Unlikely to be influential when controlling owner can hire and fire board members	Introduce elements of independence of directors; training of directors; disclosure of voting; use cumulative voting
Executive compensation	Less important when controlling owner can hire and fire and has private benefits	Disclosure of compensation schemes, conflicts-of-interest rules
Bank monitoring	Important, but depends on health of banking system and the regulatory environment	Strengthen banking regulation and institutions; develop credit bureaux and other information intermediaries;
Shareholder activism	Potentially important, particularly in large firms with dispersed shareholders	Encourage interaction among shareholders. Strengthen minority protection. Activate institutional investors
Employee monitoring	Potentially very important, particularly in smaller companies with mobile high-skilled human capital	Disclosure of information to employees; possibly require board representation; assure flexible labour markets
Litigation	Depends critically on quality of general enforcement environment, but can sometimes work	Facilitate communication among shareholders; encourage class-action suits (safeguards against excessive litigation)
Media and social control	Potentially important, but depends on competition among and independence of media	Encourage competition in and diverse control of media; active public campaigns can empower public
Reputation and self-enforcement	Important when general enforcement is weak, but more powerful when environment is stronger	Depend on growth opportunities and scope for rent-seeking; encourage competition in factor markets
Bilateral private enforcement mechanisms	Important, as they can be more specific, but do not benefit outsiders and can have downsides	Relies on well functioning civil and commercial courts; institution-building in this area helps
Arbitration, auditors, other lateral mechanisms	Potentially important, often multi- the origin of public law; but the enforcement problem often remains; audits sometimes abused; watch conflicts of interest	Facilitate the formation of private third-party mechanisms (sometimes avoid forming public alternatives); deal with conflicts of interest; ensure competition

concentrated shareholdings are the predominant pattern around the world (LaPorta *et al*., 1998). Some controlling shareholdings have their origins in (individual or family-owned) firms growing large and accessing public markets while maintaining close control. But investors also respond to weak contracting environments by building up controlling stakes sufficiently large to provide proper incentives to monitor management. Concentrated shareholdings are often further reinforced as ownership is separated from control, primarily through pyramiding (a firm owning another firm which owns a third firm, and so on) but in some countries also through cross-ownership and dual-class shares.

Large blockholders is a solution to some corporate-governance problems: concentrated ownership overcomes some of the principal–agent problems and mitigates some *ex post* conflicts between management and shareholders. At the same time, there are important costs to ownership concentration, as documented extensively (see Morck and Yeung (2003) for a review of these costs). Needless to say, delegation of authority gives rise to the problem of monitoring the large shareholder. Large shareholders may be entrenched and optimize their own benefits rather than shareholder value, and engage in expropriation of minority shareholders through tunnelling of assets and other mechanisms.

The presence of large blockholders will also undermine the other corporate-governance mechanisms. Both takeover bids and proxy fights against the desire of the controlling shareholder, with their potential benefits of correcting managerial failure and disciplining management *ex ante*, are less likely to succeed when shareholdings are concentrated. The market for corporate control will function poorly, as insiders cannot be challenged. Similarly, board activism is less likely to be successful in challenging the dominant owner, given that board members are appointed on his or her mandate. Executive compensation schemes are also less important as governance mechanisms, when controlling investors can easily intervene more directly and oust management. The middle column of Figure 1 summarizes the above discussion of the effectiveness of these corporate-governance mechanisms.

More fundamentally, large controlling owners also tend to get involved in politics influencing the legislative and regulatory processes as well as the enforcement of adopted laws and regulation. Concentrated shareholdings may thus undermine the political will to enforce existing rules and regulation or prevent corporate-governance reforms from being implemented.

In determining the amount and type of information to disclose, firms also face a number of specific trade-offs. Better disclosure can increase investor awareness of the firm and hence reduce the cost of capital and increase equity valuation. Firms that rely on outside equity capital should be particularly concerned about this issue and thus disclose more. Disclosure also carries direct financial costs. In times of financial difficulties and limited resource availability, effort and money spent on producing and releasing information may be reduced. Disclosure can also be selective if the firm discloses only when performance has been good.

But the incentives to disclose information may also differ across shareholders. Disclosure is essentially a form of minority protection that reduces the scope for extraction of private benefits by controlling shareholders (Ostberg, 2004). More disclosure results in one-time windfall profits for minority investors as they expect less future extraction of private benefits. But fewer private benefits also reduces the incentives for controlling shareholders to monitor managers and to invest in the first place. Moreover, an indirect cost of disclosure is the information given to rivals, which places the public firms at a disadvantage *vis-à-vis* private firms. In other words, the improved ability of a firm to attract minority investors should be weighed against the lowering of incentives for controlling owner/managers and the direct costs of disclosure. This trade-off may explain the reluctance of firms, even those taking into account all investors, to increase disclosure or to push regulators to enforce disclosure requirements.

III. ENFORCING TRANSPARENCY

Many regulators in Central and Eastern Europe have declared enforcement of transparency regulation as the number one priority of corporate-governance reform. In this section we focus on implementation of laws and regulation affecting disclosure of corporate-governance arrangements. While other aspects of corporate-governance rules are often highly controversial, reflecting different views of what constitutes good corporate governance and different interests in the corporation, there is broad unanimity regarding most rules relating to disclosure of corporate-governance arrangements. The European Union has also adopted a directive on transparency outlining minimum standards for what information has to be provided and how it should be provided. The individual member states have then more or less voluntarily taken on additional commitments. In this section we characterize the resulting transparency regulation and, based on the examination of annual reports from a large number of firms, we evaluate the extent to which it is being implemented in the individual corporations. However, before examining the data, we draw on existing studies to characterize the laws-on-the book and the general enforcement environment in the region.

(i) General Enforcement Environment

The institutional environment in the former socialist economies has improved tremendously over the last decade, and changes are still being implemented. Even relatively recent studies, therefore, risk being obsolete, and our comparison of enforcement of transparency regulation suggests that the relative ordering of countries can change within a few years.

The most remarkable transformation is regarding the 'laws-on-the-books', where the countries of Central and Eastern Europe have, in a little over a decade, adopted a very broad set of laws and regulation comparable to those developed over centuries by their Western neighbours. In many cases, they could draw on previous legal frameworks and traditions, but the achievement is still remarkable. Table 1 provides a standardized comparison using an aggregated variable, stock-market integrity, covering the conflict of interest rules, the independence of shareholder registers, insider trading rules, mandatory disclosure threshold, state control of capital market supervision agency, and the independence of capital-market supervision. For comparison, the cumulative shareholder rights index (called anti-directors index in La Porta *et al*., 1997) is provided for our sample countries, as well as four legal origin groups and the world average for 49 countries in the La Porta *et al*. (1997) sample.

These two variables do not show how these laws are actually implemented, supervised, and enforced. The European Bank of Reconstruction and Development (EBRD) evaluation of commercial law and financial regulations' extensiveness and effectiveness (or enforcement) attempts to capture these aspects. Table 2, for years 1998 and 2002, shows that, while commercial law extensiveness and effectiveness are aligned and have stabilized around the 3.6 mark, the enforcement of financial regulations is lagging behind law on books. Enforcement of financial regulations was particularly slow in coming, but at the same time it also improved the most in the period from 1998 to 2002. Recent indicators show that most improvements in law on books had been implemented by 2000 and further improvements can be expected in financial regulations enforcement.

The countries have made significant progress in establishing functioning legal institutions, but the courts still face important challenges in establishing their authority. Procedures are often slow, and corruption is a serious problem in many countries. Kaufmann *et al*. (2003) aggregate the governance indicators constructed by different international institutions, databases, and consulting firms, and compile country measures for regulatory quality, rule of law, and control of corruption (Table 3). The average measures for our sample countries have doubled from 1996 to 2002, but are still well behind the average scores in 15 pre-enlargement EU member states. Control of corruption is particularly demanding for further improvements.

Judging from the institutional indicators, the ten CEE countries can roughly be classified into four groups in terms of their approach to enforcement of investor protection and securities markets regulations (Berglöf and Pajuste, 2003). The first group, Poland and Hungary, has chosen strict regulatory mechanisms aimed at investor protection from management and large blockholder fraud. These two countries have also put considerable effort into enforcement, often the most deficient part of the legal framework in transition economies. The three Baltic States and Romania early on implemented rather strict security-market regulations. But the capacity of the capital-market regulators fully to exercise their regulatory function has been limited, largely owing to the lack of clear, legal responsibilities,

Table 1
Investor Protection

	Stock-market integrity (Pistor, 2000)				Cumulative shareholder rights ('anti-director index' in La Porta *et al.*, 1997)			
	1992	1994	1996	1998	1992	1994	1996	1998
Bulgaria	1	1	5	5	4	4	4	4
Czech Republic	3	3	4	5	2	2	3	3
Estonia	0	2	4	4	2	2	3.75	3.75
Hungary	3	3	3	5	2.5	2.5	2.5	3
Latvia	1	1	1	1	3.5	3.5	3.5	3.5
Lithuania	2	1	1	1	2.5	3.75	3.75	3.75
Poland	4	4	4	4	3	3	3	3
Romania	1	1	1	1	3	3	3	3
Slovak Republic	0	2	2	2	2.5	2.5	2.5	2.5
Slovenia	0	3	3	3	0	2.5	2.5	2.5
Average	1.50	2.10	2.80	3.10	2.50	2.88	3.15	3.20
Common law							4	
French civil law							2.33	
German civil law							2.33	
Scandinavian civil law							3	
World average (49)							3	

Sources: Pistor (2000); La Porta *et al.* (1997).

Table 2
Law on Books versus Enforcement

	Commercial law extensiveness *(Law on books)*			Commercial law effectiveness *(Enforcement)*			Financial regulations extensiveness *(Law on books)*			Financial regulations effectiveness *(Enforcement)*		
	1998	2000	2002	1998	2000	2002	1998	2000	2002	1998	2000	2002
Bulgaria	4	4	3.7	4	3.7	4	4	3	3	3	2.3	3
Czech Republic	4	3	3.7	4	3.3	3.7	3.3	4	3.3	2.7	2.7	3
Estonia	3	3.7	3.7	4	3.3	4	3.3	4	4	2.7	2.7	3.3
Hungary	4	4	3.7	4	3.7	3.7	4	4	3.3	4	4	3.7
Latvia	3.3	4	3.7	2	3.7	3.3	3.3	3	4	2.3	3	3.7
Lithuania	4	4	3.7	3	3.3	3.7	2.7	4	3.7	2	3.7	3
Poland	4	3.7	3.3	4	4	3.7	4	4	3.7	3	4	3.3
Romania	4	3.3	3.7	4	3.7	4	3	4	3.7	2.7	3	3
Slovak Republic	3	3	3	2	3	3.3	3	3	3	2	2.7	2.3
Slovenia	3	4	3.3	3	3.7	3.7	3.3	4	3.3	2.7	4	3
Average	3.63	3.67	3.55	3.40	3.54	3.71	3.39	3.70	3.50	2.71	3.21	3.13

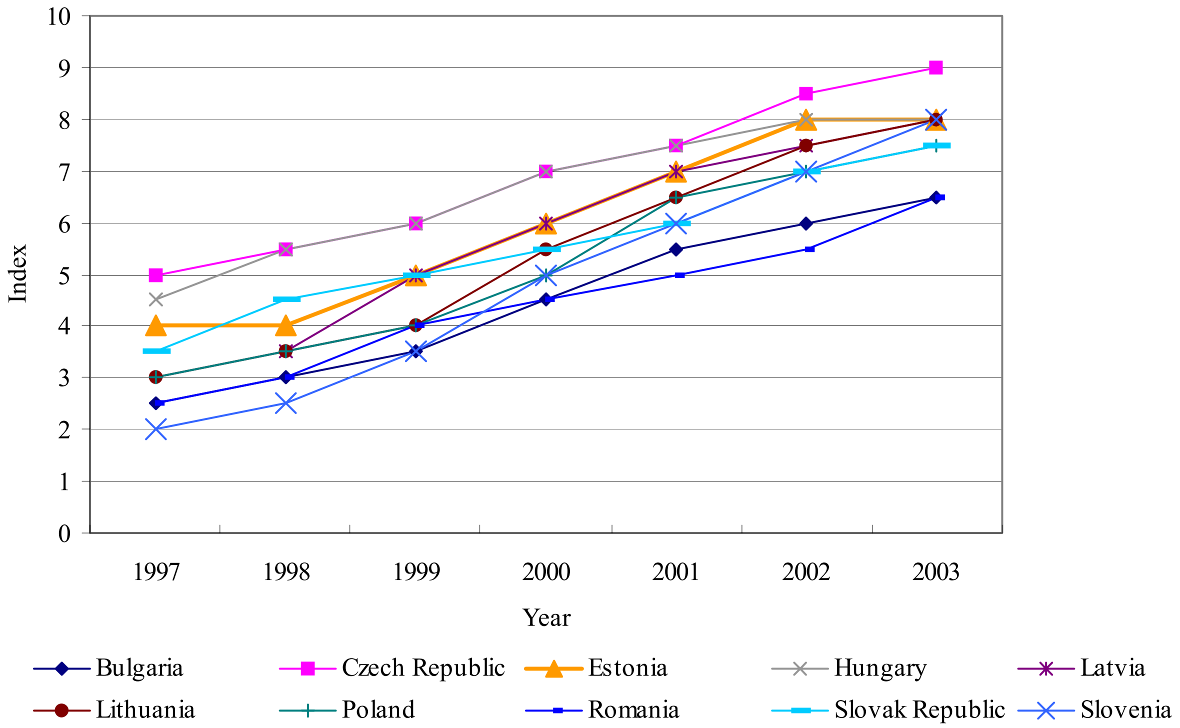
Source: EBRD (2000, 2002). The variable ranges from 1, 1+, 2–… to 4–, 4, 4+. The numbers in this table are constructed as follows: e.g., 3+ is 3.3, 4– is 3.7, and round numbers remain intact.

Table 3
Aggregate Governance Indicators

	Regulatory quality				Rule of law				Control of corruption			
	1996	1998	2000	2002	1996	1998	2000	2002	1996	1998	2000	2002
Bulgaria	–0.12	0.47	0.21	0.62	–0.09	–0.22	–0.11	0.05	–0.62	–0.50	–0.15	–0.17
Czech Republic	0.98	0.78	0.66	1.12	0.61	0.62	0.60	0.74	0.55	0.35	0.38	0.38
Estonia	1.18	1.06	1.30	1.35	0.33	0.54	0.73	0.80	0.05	0.49	0.76	0.66
Hungary	0.47	1.15	1.09	1.21	0.62	0.78	0.85	0.90	0.59	0.69	0.76	0.60
Latvia	0.41	0.72	0.52	0.86	0.18	0.08	0.25	0.46	–0.52	–0.10	0.01	0.09
Lithuania	0.27	0.21	0.51	0.98	–0.14	0.19	0.27	0.48	–0.12	0.07	0.27	0.25
Poland	0.34	0.83	0.60	0.67	0.44	0.57	0.64	0.65	0.38	0.49	0.47	0.39
Romania	–0.43	0.30	–0.27	0.04	–0.27	–0.25	–0.21	–0.12	–0.17	–0.38	–0.48	–0.34
Slovak Republic	0.18	0.29	0.36	0.76	0.11	0.13	0.32	0.40	0.39	–0.08	0.25	0.28
Slovenia	0.38	0.74	0.64	0.81	0.49	0.91	0.89	1.09	0.98	0.83	1.08	0.89
Average for TE	0.37	0.66	0.56	0.84	0.23	0.34	0.42	0.55	0.15	0.19	0.34	0.30
Average for 15 pre-enlargement EU members	1.18	1.23	1.33	1.57	1.58	1.66	1.69	1.58	1.44	1.93	1.78	1.70
USA	1.31	1.51	1.50	1.51	1.70	1.77	1.92	1.70	1.60	1.95	1.77	1.77

Source: Kaufmann *et al*. (2003); aggregated governance indicators.

Figure 2
Implementation of the *Acquis Communautaires* (company law)



resources, and experience. The Czech and Slovak Republics initially did not pay proper attention to the regulatory framework, and have seen fraud, tunnelling of resources and significant stagnation in the local stock markets. As we will see, the situation in the Czech Republic has been improved remarkably with the adoption of once again revised Commercial Code. Figure 2, depicting the implementation of the *acquis communautaires* in the area of corporate law, also shows the high level of ambition in the country.

Bulgaria started with a completely unregulated securities market. The situation was slightly improved with the 1995 Law on Securities, Stock Exchanges, and Investment Companies, though the law was ambiguous in terms of 'related party' definition, as we well as did not impose any mandatory bid thresholds (Tchipev, 2001). Slovenia stands out as a separate case. The Slovenian method of privatization granted large numbers of shares to employees, former employees, and state-controlled public funds. Besides, Slovenian law provides employees with substantial corporate-governance rights, including representation on boards.

(ii) Transparency in Individual Companies: Some Hypotheses

The CEE countries have all adopted the EU Transparency Directive, and most of them have taken on additional commitments. To determine the extent to which this regulation is implemented and enforced, we examine firm-level data to see what firms are actually disclosing, and what determines how much they disclose. There are, of course, many corporate-governance tools available to a firm besides disclosure (see Figure 1). One could hire a reputable auditor, do a listing in a high-quality (foreign) environment, have more independent directors, apply for voluntary corporate governance or credit rating, etc. The data used in this study do not allow us to judge whether disclosure is a substitute for or complement to other firm-level corporate-governance tools.[3] Our claims, therefore, pertain solely to the relation between firm-specific characteristics and disclosure, and not the overall firm-level corporate governance.

What are the pros and cons of increased transparency from the firm's perspective? The answer to this question is not always straightforward, and the causation could go in both directions and any observed correlation may be explained by some omitted variable. Despite these problems we formulate four hypotheses.[4] First, better disclosure should matter more to firms that rely on equity capital:

H1: *Firms with higher external capital dependence disclose more.*

Relating disclosure to financial performance is complicated. Disclosure is a direct financial cost. In times of financial difficulties and limited resource availability, effort and money spent on disclosure can be reduced to save costs. Firms in dire straits may also prefer not to disclose so as not to worry markets. Both these explanations suggest that we should find that:

H2: *Financially constrained firms disclose less.*

In line with the latter explanation better-performing firms firm discloses only when performance has been good. In other words,

H3: *Better performing firms disclose more.*

Firms with large controlling owners are likely to be less dependent on transparency, since information can be transferred directly through informal channels, or simply because incentives are better aligned, reducing the need for corporate governance on behalf of minority investors. In any case,

H4: *Firms with concentrated shareholdings should disclose less.*

Our first measure of disclosure addresses the information availability on the company's web-page. We ask seven questions and code the answers as follows. *Website*: 0 if the company does not have a

[3] Two other corporate-governance characteristics we obtained, namely big four auditor and cross-listing in foreign exchanges, did not have any significant relation to disclosure.

[4] A more thorough theoretical background can be found in Doidge *et al.* (2004), which presents a model on the relation between firm characteristics, firm-level corporate-governance mechanisms, and country-level investor protection and financial development.

website, 0.5 if the website is only in the local language, and 1 if the website is available also in English. *AR2003*: 0 if the latest annual report (year 2003) is not available online, 0.5 if the latest annual report is provided only in the local language, and 1 if the latest annual report is available also in English. *CGSection*: 1 if the website includes a separate section on corporate governance; and 0 otherwise. *MgrNames*: 1 if the website includes the names of key managers; and 0 otherwise. *BoardNames*: 1 if the website includes the names of board members; and 0 otherwise. *Owners*: 1 if the website discloses ownership structure of the firm; and 0 otherwise. *Bylaws*: 1 if company's bylaws are available online; and 0 otherwise. Finally, we sum these seven measures into the *WebDisclosure* index that ranges from 0 to 7. Table 4 shows the average scores on individual measures and the aggregate *WebDisclosure* index by country. A higher score implies more disclosure provided in the company's website. The average *WebDisclosure* index is the highest in the Czech Republic (3.53), Slovak Republic (3.40), and Slovenia (3.05), and the lowest in Bulgaria (0.86), Romania (1.37), and Lithuania (1.53).

Our second measure of disclosure addresses the information availability in annual reports. We inspected the 128 available annual reports in terms of whether they had a separate section on corporate governance and whether they provided information on shareholdings by individual board members; shareholdings by the board as a whole; salaries paid to the management including the board; ownership structure; and related-party (owners, controlling parties, managers) transactions. Since we are evaluating enforcement against the lower bounds provided by the Transparency Directive, any lack of enforcement that we report is likely to be underestimated.

The observations were coded as follows. *InsideShares*: 1 if information is provided on shares held by each board member and manager, 0.5 if information is provided on aggregate shareholdings by the managerial and supervisory board, and 0 otherwise. *Income*: 1 if information is provided on remuneration of each board member and manager, 0.5 if information is provided on aggregate remuneration of the managerial and supervisory board, and 0 otherwise. *RelatedTrans*: 1 if detailed description of related-party transactions is provided, 0.5 if limited information on related-party transactions is given, and 0 otherwise. *Owners*: 1 if ownership stakes and names of all shareholders above a 10 per cent threshold are provided, 0.5 if only aggregate ownership stakes by shareholder category are provide, and 0 otherwise. *CGSection*: 1 if the annual report has a separate section on corporate governance; and 0 otherwise. Finally, we sum these five measures into the *ARDisclosure* index that ranges from 0 to 5.

Table 5 shows the average scores on individual measures and the aggregate *ARDisclosure* index by country. A higher score implies more disclosure provided in the annual report. The average *ARDisclosure* index is the highest in Estonia (2.86) and the Czech Republic (2.81), and the lowest in Romania (1.38), Latvia (1.44), Bulgaria (1.50), and Slovak Republic (1.50).

In the 128 companies studied, the level of disclosure varied substantially. The highest average score (0.86) was registered for information on direct ownership.[5] This is not surprising, given the enormous emphasis on both extensiveness and enforcement of disclosure of mandatory large block holdings in recent years. Other disclosure items exhibit much higher variability and are far from being disclosed in every company. On the whole, very few firms provided separate sections on corporate governance. Similarly, if the annual reports contained information on shares held by board members, this number was provided for the board as a whole and not for individual board members. The high cross-country variation in information disclosure in annual reports can be related to the legal requirements in each country. If the extensiveness of information disclosure on a company's website is voluntary, then the annual report disclosure has to follow certain requirements. Therefore, we have to construct a more precise measure of 'disclosure beyond legal requirements'.

Table 6 shows the *required* annual report disclosure by country. The information about the shareholdings of management and the board is typically required only in the issuing prospectus and

[5] The disclosure of ultimate ownership is still not available nor required in most of the sample countries.

Table 4
Website Disclosure by Country

Country	Website	AR2003	CG-section	Mgr-names	Board-names	Owners	Bylaws	Web-disclosure	N
Bulgaria	0.36	0.17	0.17	0.42	0.25	0.25	0.08	0.86	32
Czech Republic	0.91	0.63	0.03	0.74	0.68	0.65	0.00	3.53	32
Estonia	0.77	0.50	0.00	0.40	0.10	0.50	0.10	2.23	11
Hungary	0.75	0.57	0.29	0.72	0.61	0.50	0.29	2.71	26
Latvia	0.91	0.40	0.00	0.20	0.20	0.20	0.00	1.82	11
Lithuania	0.89	0.21	0.03	0.33	0.06	0.06	0.00	1.53	36
Poland	0.80	0.30	0.07	0.66	0.54	0.41	0.20	2.51	153
Romania	0.73	0.08	0.03	0.35	0.06	0.34	0.03	1.37	43
Slovak Republic	0.80	0.75	0.00	1.00	1.00	0.50	0.00	3.40	5
Slovenia	0.93	0.69	0.06	0.70	0.47	0.61	0.00	3.05	21
Total	0.78	0.36	0.07	0.58	0.42	0.40	0.11	2.26	370

Table 5
Annual Report Disclosure by Country (actual)

Country	Inside-shares	Income	Related-trans	Owners	CGSection	AR-disclosure	N
Bulgaria	0.00	0.00	0.00	1.00	0.50	1.50	2
Czech Republic	0.35	0.44	0.75	0.94	0.33	2.81	24
Estonia	0.64	0.55	0.82	0.86	0.00	2.86	11
Hungary	0.33	0.13	0.25	0.67	0.25	1.63	12
Latvia	0.17	0.22	0.44	0.61	0.00	1.44	9
Lithuania	0.73	0.42	0.19	0.98	0.00	2.31	24
Poland	0.28	0.17	0.29	0.81	0.07	1.62	29
Romania	0.25	0.00	0.13	1.00	0.00	1.38	4
Slovak Republic	0.00	0.00	0.50	1.00	0.00	1.50	2
Slovenia	0.55	0.36	0.09	0.86	0.00	1.86	11
Total	0.42	0.30	0.39	0.86	0.11	2.08	128

then further regular updates have to be made, which, in practice, makes it difficult to track the actual current inside shareholdings. The requirement for disclosure of income by management and board, even on aggregate, is non-existent in quite a few countries. Finally, the requirements for related-party transaction disclosure are still very controversial. None of the countries requires full disclosure of all transactions, either usual or unusual to the issuer's activity, entered with the related parties. Typically, only certain types of related-party transactions have to be disclosed, e.g. loans, advance payments, or purchase of assets above a certain size threshold.

Comparing Tables 5 and 6, we observe that the average required *ARDisclosure* index (2.22) is higher than the actual one (2.08). This discrepancy arises because firms avoid reporting the managerial shareholdings, and related-party transactions, and still not all firms disclose the ownership structure. We can also observe substantial cross-country variation in actual versus required disclosure. *ARDisclosure_dif* is constructed as actual minus required *ARDisclosure* index. Lithuania imposes the highest disclosure standards, but the enforcement is lagging; the average discrepancy between actual and required *ARDisclosure* is as low as –0.69. Actual disclosure in Polish companies is also

Table 6
Annual Report Disclosure by Country (required by law)

Country	Inside-shares	Income	Related-trans	Owners	CG Section	AR-disclosure	AR-Disclosure_dif
Bulgaria	1.00	0.00	0.50	1.00	0.00	2.50	–1.00
Czech Republic	0.50	0.50	0.50	1.00	0.00	2.50	0.31
Estonia	1.00	0.00	0.50	1.00	0.00	2.50	0.36
Hungary	0.00	0.50	0.00	1.00	0.00	1.50	0.13
Latvia	0.00	0.00	0.50	1.00	0.00	1.50	–0.06
Lithuania	1.00	0.50	0.50	1.00	0.00	3.00	–0.69
Poland	0.50	0.00	0.50	1.00	0.00	2.00	–0.38
Romania	0.00	0.00	0.50	1.00	0.00	1.50	–0.13
Slovak Republic	0.00	0.00	0.00	1.00	0.00	1.00	0.50
Slovenia	0.00	0.50	0.50	1.00	0.00	2.00	–0.14
Total	0.50	0.28	0.45	1.00	0.00	2.22	–0.14

Table 7
Descriptive Statistics of Financial Indicators

	Mean	Median	Std deviation	Min.	Max.	N
Size	11.03	10.86	1.41	7.13	15.81	343
Leverage	0.50	0.49	0.25	0.00	1.65	339
Market-to-book	0.86	0.61	0.83	0.09	6.85	249
ROA	0.02	0.03	0.10	–0.49	0.34	338
Sales growth	0.16	0.11	0.32	–0.82	2.29	334
Cash/assets	0.05	0.03	0.06	0.00	0.57	302
Capital_1	0.47	0.48	0.25	0.05	1.00	308

lagging behind the required; the average discrepancy is –0.38. The Czech Republic and Estonia have relatively high disclosure standards, and the firms disclose even more than is required; the discrepancy is 0.31 and 0.36, respectively.

In order better to understand the variability of disclosure across firms and countries, as well as to test our four hypotheses, we analyse the financial performance and ownership of companies. In particular, we explore the relationship between disclosure and six firm-level financial indicators: firm size (natural logarithm of firm's sales in thousands of US dollars), leverage (total liabilities to total assets), return on assets (ROA), market-to-book ratio of equity, average sales growth over 2000–3, and cash balance to total assets. We also estimate the ownership stake held by the largest shareholder (Capital 1) and the type of the largest shareholder. The descriptive statistics of financial indicators are provided in Table 7.

External capital dependence (H1) at firm-level can be proxied by leverage, cash balance, ROA, growth, and market-to-book ratio. According to H1, higher external capital dependence, and hence higher disclosure, should be associated with higher leverage, lower cash balance, lower profitability (return on assets), and higher growth (sales growth and market-to-book ratio). We can also use an industry-based measure of external finance dependence provided in Rajan and Zingales (1998) and defined as capital expenditures minus cash flows from operations divided by capital expenditures. This variable is computed using data on capital expenditures and cash flows for firms from the same industry in the USA. Following Rajan and Zingales, we assume that there are technological reasons

Hypothesis	Financial variables (expected sign)
Need for capital (H1)	Leverage (+), ROA (–), Market-to-book (+), Sales growth (+), Cash/assets (–), External finance dependence (+)
Resource availability (H2)	Size (+), Leverage (–), ROA (+), Sales growth (–), Cash/assets (+)
Performance (H3)	ROA (+), Market-to-book (+), Sales growth (+)
Ownership concentration (H4)	Capital 1 (–)

why some industries need more external finance than others. Assuming that these technological differences persist across countries, one can use the external dependence of industries in the United States to rank industries in every country along this dimension. A higher external finance dependence score (the average between 1970s and 1980s) should have a positive relation to firm disclosure, according to H1.

According to H2, higher resource availability, i.e. higher size, ROA, cash balance, and lower sales growth and leverage, should be associated with higher disclosure level. Firm performance (H3) can be proxied by return on assets, market-to-book ratio, and sales growth. According to H3, better performing firms, i.e. the ones with higher ROA, MTB ratio, and sales growth, should disclose more. Finally, H4 suggests that more concentrated ownership, higher Capital 1, should be associated with lower disclosure level. We use cash-flow rights as the measure of ownership, because it allows for a more consistent use of this variable across sample countries. The use of cash-flow rights instead of voting rights should not cause a problem, because voting and cash-flow rights differ only in very few companies in our sample (particularly in Poland and Hungary), and the wedge between the two is typically very small.

The above mentioned financial variables are the closest available measures for testing our hypotheses. Other useful measures, such as bank debt or capital expenditures, are not available in a large number of sample companies. The expected signs for financial indicators according to the four hypotheses can be summarized as above.

To estimate the effect of financial indicators on firm disclosure we use an ordered logit model, because of the ordinal nature of the dependent variables (*WebDisclosure* and *ARDisclosure_dif*). Both dependent variables can take 15 different values: *WebDisclosure* from 0 to 7 with an 0.5 step, and *ARDisclosure_dif* from –3 to 4 with an 0.5 step. Tables 8 and 9 report the regression results. Table 8 shows the model specifications with *ARDisclosure_dif*, i.e. the difference between the actual and required disclosure in the company's annual report, as the dependent variable. Table 9 shows the model specifications with the *WebDisclosure* index, i.e. voluntary disclosure, as the dependent variable. In all specifications, we report the χ^2-statistic for a test of the joint significance of all firm and/or country variables.

From Table 8 we observe that firm-level financial variables do *not* explain much which firms deviate, either positively or negatively, from mandatory disclosure in annual reports (*ARDisclosure_dif*). None of the financial variables or the industry-based external finance dependence variable is significant (Regression (1)). The χ^2-statistics for firm-level variables are insignificant in all specifications. We also do not find any significant difference in disclosure level by industry (not reported).[6] The deviation from mandatory disclosure, however, exhibits a strong country effect. To control for differences in country legal systems, we add a country-level variable *Rule of Law* in 2002 from Kaufmann *et al.* (2003).[7] Rule-of-law scores for each sample country are given in Table 3. From Regression (2) in Table 8 we see that the rule of law variable has a positive and significant effect on annual report disclosure. In Regression (3), we include six coun-

[6] Industry dummies added to the current specification are not significant. Moreover, Hausman tests indicate that a model using industry random effects is not appropriate.

[7] 'In 'Rule of Law' we include several indicators which measure the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts. Together, these indicators measure the success of a society in developing an environment in which fair and predictable rules form the basis for economic and social interactions, and importantly, the extent to which property rights are protected.' (Kaufmann *et al.*, 2003)

Table 8
Regression Results (*ARDisclosure_dif*)

	(1)	(2)	(3)
Size	0.044	0.074	–0.015
	(0.12)	(0.47)	(0.07)
Cash/assets	4.674	2.395	1.722
	(1.25)	(1.21)	(0.69)
Market-to-book	–0.028	–0.07	0.035
	(0.16)	(0.48)	(0.17)
Sales growth	–0.287	–0.172	–1.10
	(0.20)	(0.15)	(0.96)
Capital_1	–0.309	0.06	–0.666
	(0.30)	(0.07)	(0.65)
External finance dependence	–0.483		
	(0.30)		
Rule of law		2.387	
		(2.42)**	
CZECH_dum			1.668
			(2.38)**
EST_dum			1.652
			(2.23)**
HUNG_dum			1.535
			(1.56)
LATV_dum			0.887
			(0.86)
LITH_dum			0.015
			(0.02)
Observations	56	105	100
χ^2: firm-level	2.00	2.38	2.41
χ^2: country-level	.	.	21.17***
Pseudo R^2	0.006	0.023	0.045

Notes: Robust z statistics in parentheses, * significant at 10 per cent; ** significant at 5 per cent; *** significant at 1 per cent.

tries with more than five observations per country, and add country dummies with Poland as a reference country. We observe that firms in the Czech Republic and Estonia have significantly better disclosure if compared to Poland. By adding country dummies, the explanatory power of the model increases further, and country dummies are jointly significant. The significant country effect implies that the enforcement of disclosure requirements varies substantially across countries. Interestingly, the enforcement seems to be more lax in countries with higher number of listed securities (Poland, Lithuania), and more stringent in countries with a low number of listed securities and high delisting activity (the Czech Republic, Estonia). The securities market regulator clearly faces a trade-off between higher enforcement of disclosure rules and increasing number of firms leaving the stock exchange. In this context, lax enforcement can be seen as intentional.

Table 9 shows that firm-level financial indicators are strongly related to how easily available the information is to investors (*WebDisclosure*), i.e. the voluntary disclosure. The χ^2-statistics for firm-level variables are significant in all specifications. Rule of law variable is significant only at the 10 per cent level, while country dummies are jointly insig-

Table 9
Regression Results (*WebDisclosure*)

webdisclosure	(1)	(2)	(3)	(4)	(5)	(6)
Size	0.599	0.638	0.671	0.477	0.61	0.591
	(5.15)***	(5.09)***	(6.51)***	(2.87)***	(4.86)***	(3.32)***
Leverage	–0.579					
	(1.07)					
Cash/ assets		2.378	2.813	2.548	2.078	2.262
		(1.45)	(1.82)*	(1.09)	(1.28)	(1.31)
Market-to-book	0.347	0.319		0.344	0.301	0.344
	(2.07)**	(1.90)*		(1.43)	(1.80)*	(1.78)*
ROA			0.095			
			(0.10)			
Sales growth	–0.991	–1.382	–1.043	–0.372	–1.278	–1.225
	(1.05)	(2.35)**	(2.90)***	(0.35)	(2.24)**	(1.89)*
Capital_1	–0.977	–0.676	–0.774	–0.828	–0.628	–0.479
	(2.05)**	(1.30)	(1.87)*	(1.19)	(1.20)	(0.89)
External finance dep.				0.902		
				(1.00)		
Rule of law					1.155	
					(1.78)*	
CZECH_dum						0.25
						(0.47)
EST_dum						–0.35
						(0.63)
HUNG_dum						–0.148
						(0.19)
LATV_dum						–0.731
						(1.72)*
LITH_dum						–0.646
						(1.81)*
Observations	229	202	272	111	202	190
χ^2: firm-level	31.64***	34.36***	53.05***	12.00***	30.18***	24.91***
χ^2: country-level	.	.	.	.	.	9.06
Pseudo R^2	0.048	0.056	0.057	0.035	0.059	0.064

Notes: Robust z statistics in parentheses, * significant at 10 per cent; ** significant at 5 per cent; *** significant at 1 per cent

nificant. From Table 9, we can see that the *need for capital hypothesis* (H1) is not supported, the *resource availability hypothesis* (H2) strongly supported, the *performance hypothesis* (H3) weakly supported, and the *ownership concentration hypothesis* (H4) supported. Larger firms tend to have higher voluntary disclosure. Firms with lower leverage and higher cash balances, i.e. financially less constrained firms, disclose more. Slower growing firms disclose more, which is strong support for resource availability rather than need for capital hypothesis. The industry-based external capital dependence variable has a positive but insignificant relation to voluntary disclosure. Overall, we cannot claim that external capital dependence encourages firms to disclose more.

Results in Table 9 show that firms with more concentrated ownership structures (higher *Capital_1* variable) disclose less (H4). If concentrated ownership comes with low number of external investors interested in company's performance, there is, indeed, no need to inform them through public means, like website. However, controlling shareholders may also disclose less in order to enjoy more private benefits. We do not find any significant difference between disclosure levels made by different types of controlling owners.

In sum, these results point to the problem that firms in the CEE countries perceive disclosure as a financial cost (that can be cut in 'bad times') rather than a tool to attract more investors and reduce the cost of capital. Financially constrained firms and firms with weaker operating performance most likely disclose the necessary information in their annual report, but do not put additional effort to make this information accessible for wider public, e.g. they only fill the information with the regulator, publish it only in the local language, etc. This evidence is also consistent with the observation that extensive disclosure requirements are one of the most often cited disadvantages of going public. Firms with controlling shareholders provide less information than those with dispersed shareholdings.

IV. HOW TO IMPROVE ENFORCEMENT

The examination of annual reports of listed companies shows clearly that current laws and regulation relating to disclosure of corporate-governance arrangements are not followed. The problem of enforcement of good corporate governance is not unique to Central and Eastern Europe, but is shared by many countries in Western Europe and by other emerging economies. In this section we examine the enforcement literature and the experience of other countries in order to suggest improvements.

A well-functioning enforcement system consists of numerous overlapping mechanisms ranging from private ordering via private law enforcement laws and government-enforced regulation to full government control (Djankov *et al*., 2003). All mechanisms have their costs and benefits, and trade-offs exist. Private and public initiatives are often complements, rather than substitutes. The effectiveness of private enforcement mechanisms often depends on the effectiveness of public enforcement mechanisms, while public enforcement brings down the costs of private enforcement.

(i) Private Ordering

Lawmakers can rely on self-regulation among the concerned parties, instead of intervening themselves. In the financial sector, self-regulatory organizations are many: brokers associations providing licences and overseeing conduct of brokers; investment banks establishing standards for underwriting; clearing houses and payments systems organizing settlement and payment services; and associations of banks and other financial institutions developing rules for conflicts of interest, exchange of information, etc. Private arbitration arrangements also emerge in response to weaknesses in the legal system, but like other forms of private ordering, arbitration is more likely to be effective when courts and enforcing agencies work well. The recent flurry of voluntary corporate-governance codes, sometimes initiated by governments and sometimes by market participants, is another important example of private ordering. Moreover, the many corporate-governance codes, not least in Central and Eastern Europe, have also served other purposes, in particular promoting debate and thus fostering awareness of the underlying issues. Historically, codes were a first step towards binding regulation (cf., for example, the US experience (Coffee, 2001)).

A firm can unilaterally try to distinguish itself as having better corporate governance. How effective is this form in bringing about change in enforcement of good governance practices? Black (2001) provides some suggestive data from Russia indicating that individual firms, even in a poorly functioning environment, can increase their value substantially by improving their corporate governance unilaterally. Similar evidence exists for Korea (Black *et al*., 2003), but, as with the Russian study, serious methodological problems weaken the power of these tests. The effectiveness of all of these private enforcement mechanisms in the area of corporate governance depends on the general institutional environment. Black *et al*. (2003) show that private mechanisms often are not sufficient, but need the support of government intervention. Evidence from Durnev and Kim (2004) and Klapper and Love (2003), from Central and Eastern Europe, show that individual firms cannot, by improving their own corporate governance, compensate fully for deficiencies in local governance practices.

Despite its shortcomings, private ordering will be the main enforcement mechanism in Central and Eastern Europe as in most other markets. Private parties should be encouraged to adopt rules that can later be embraced by individual market places and eventually become laws or regulations.

(ii) Private Law Enforcement

In most societies, private initiatives also play a critical role in enforcing existing public laws and regulation. The government creates the rules governing private conduct but leaves the initiation of enforcement to private parties. When a party feels cheated, he or she could initiate a private suit and take it to the court or other agency. Private enforcement is often more effective when the law has mandated a certain standard, making it easier to initiate and prove a case than if courts have to rely on general principles. Well-defined statutes may also reduce the discretion of judges and undermine attempts to subvert the law.

The evidence suggests that, at least in the area of securities regulation, private law enforcement, unlike public enforcement, is highly effective in promoting capital markets development (La Porta *et al*., 2004). It is often argued that private law enforcement is particularly efficient in situations with weak or ill-experienced courts (Black and Kraakman, 1996; Hay *et al*., 1996).

Private enforcement of public law is still underdeveloped in Central and Eastern Europe. Interviews with regulators and supervisory agencies suggest that there are very few cases of private litigation to enforce public law. We are convinced that efforts to stimulate such enforcement would be worthwhile.

(iii) Public Enforcement

The effectiveness of public enforcement depends on both the extensiveness of public law and the efficiency and effectiveness of enforcing institutions, including the extent of corruption (the current situation in Central and Eastern Europe is summarized in section III(i)). In the simplest possible characterization the written law has no independent function; the only thing that matters is what part of laws and regulation are actually enforced. Others argue that this dichotomy is too simple. Some laws are also more easily enforced than others, suggesting that the enforcement environment may shape what laws are desirable. There is also a choice between very detailed, highly nuanced rules, and simple, easily understood and interpreted, rules (so-called bright-line rules) (Glaeser and Shleifer, 2002).

Enforcement depends on regulators and supervisors being (operationally and financially) independent and well-staffed, and having adequate powers. In many countries, securities exchange regulators have their own sources of income (by collecting fees from new issues or trading), yet they have to transfer some part to the general budget or otherwise have to get their budget approved by the parliament or other government agencies, thus reducing their *de facto* independence. At the same time, there can be limits to the benefits from stronger regulators and supervisors in weak institutional environments, such as in many developing countries. Perverse effects may arise from more legal powers in environments with relatively low pay for regulators and supervisors, and weak checks-and-balances (as highlighted by Barth *et al*., 2003). In such environments, more powers may simply invite more corruption.

In our estimation, there is still room for institutional development in the court systems and public enforcement agencies in Central and Eastern Europe, but the main problem is not lack of competence or experience. Rather the challenges are about lack of resources and, ultimately, lack of political will to back up key institutions. Corruption is also a serious concern in several countries.

(iv) Political Will to Enforce

Ultimately, the effectiveness of many enforcement mechanisms hinges on the commitment from the political sphere to enforce existing laws and regulations. Even in countries with the institutional capacity to built better enforcement, the political will is often not present. Poland, for example, has a strong regulatory framework and ample competence in the Securities and Exchange Commission and the Warsaw Stock Exchange, but corporate governance and its enforcement has not been very high on the political agenda, leaving the bodies without the necessary political backing. Many attempts to reform investor rights have failed because of powerful opposition. In Thailand, for example, senators blocked bankruptcy reform, as they were also major owners of distressed corporations. Nevertheless, changes to investor rights do occur, often following financial and other crises. Changes in enforcement appear much more difficult over short periods of time.

Investment in enforcement of corporate governance, and more generally in building institutions supporting market functioning, compete with other uses of government funds. Furthermore, capacity building is a longer-term effort that is less visible and less politically rewarding. Overcoming the constraints is typically also difficult, since the gains from improvements in the functioning of these institutions are not distributed evenly among all citizens; in particular, large parts of the electorate may not get any direct benefits at all from increased enforcement.

Thus, the level of enforcement is ultimately a matter of political priorities. How to build political constituencies for reform is always hard, especially when the benefits are not evenly distributed. The problem in enforcement, as in some other areas, is that there are bad equilibria. Investments in enforcing rule of law may exceed the benefits they generate. Moreover, given the costs involved and the difficult priorities, the 'political will' to invest in rule of law may not be present, even when sufficient resources are available and the returns to investment in enforcement are high. To get out of these traps is hard.

V. CONCLUDING REMARKS

As the features of the emerging capitalism in Central and Eastern Europe are becoming more distinct, it is clear that controlling shareholders will play a key role in corporate restructuring and governance for the foreseeable future. We have discussed the implications for other governance mechanisms, in particular for the market for corporate control and boards of directors. Any attempt at corporate-governance reform would have to take into account both the relative importance of the different mechanisms and the prospect for policy improvements of a particular mechanism (Figure 1). By these standards, perhaps the single most important objective is to increase transparency, not only about ownership and control structures, but also about what managers and controlling owners do, in particular how they reward each other. In this regard, the countries of Central and Eastern Europe have an opportunity to leapfrog other markets on the European continent where transparency is still lagging (Becht *et al.*, 1999). Yet, our study shows that the record so far in Central and Eastern Europe is not encouraging.

In our attempt to measure transparency, the most striking finding is that the rules relating to disclosure of corporate-governance arrangements are not sufficiently enforced. In all countries, a large number of firms failed to report ownership by management and boards of directors, total levels of executive compensation, and transactions with related parties. The study also unveiled interesting variations across countries. Particularly striking was the apparent marked improvement in the reporting by Czech companies. Previous studies have found many shortcomings in both the regulatory framework and corporate governance in individual firms in the Czech Republic, but our, admittedly limited, sample of firms suggests that governance has improved, at least when it comes to disclosure. Perhaps equally striking is the poor reporting of Polish companies. Poland's supervisory structure and management of the Warsaw stock exchange are often viewed as exemplary.

Our examination suggests certain priorities in Central and Eastern Europe. Given the resource constraints, the regulator has to weigh the costs and benefits of enforcing disclosure. The regulator should monitor, and sanction for non-disclosure of, those issues that are important to investors and continue to ignore non-disclosure of unimportant issues; sanctioning the latter violations would actually harm investors. So, the key question here is: which are the important issues that need to be disclosed and the disclosure enforced? So far, definitive answers to this question have been discovered only after a scandal has surfaced. But we suggest that more attention should be paid to related and affiliated party transactions.

Strengthening the legal recourse of minority investors could eventually help promote more disclosure. In the countries with a weak court system marred by corruption, it is easier to go to court (and win) with a case that is either 'black' or 'white', i.e. where breach of law can be easily established. One contention is that in 'grey' cases, where it may require considerable resources to prove that a particular regulation has been violated, wealth rather than right will prevail. Therefore, one way to improve enforcement, and particularly private enforcement of corporate-governance laws and regulation, is to make the rules less ambiguous, e.g. setting clear standards and blueprints ('bright-line rules') on what has to be disclosed and how (the disclosure standard on related-party transactions in the Czech Republic is a good example). We propose that this could be the key role of the regulator—to define more explicitly what is 'black' and what is 'white'. Once this is done, private enforcement of public laws and regulation becomes easier.

We argue that self-definition and introspection is, in fact, part of the solution to the problem of enforcement. Extensive evidence shows that wholesale transplants are largely ineffective in the diffusion of governance practices. When legislators and enforcing agencies have been part of the genesis of the rules they are more likely to continue to develop and enforce the rules. Just as in the individual firm, imported codes can serve as a useful reference point in the national regulatory process; any deviations would have to be explicitly motivated by local conditions. There is no substitute for a healthy debate on corporate governance, and increased transparency of existing arrangements will help sustain such a debate.

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