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Elizabeth Gardner Bruml April 15, 2014

Investor Protection and Stock Market Growth: The Effect of Coalition Governments on Enforcement of Shareholder Rights in Central and Eastern European Countries

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Abstract

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Since the fall of the Soviet Union, countries in Central and Eastern Europe have experienced wide variation in the development of their financial markets. This paper aims to provide a domestic political institutions approach to explaining variation in stock market growth across thirteen countries in the region. I study the relationship between the number of veto players – collective actors necessary to produce policy change – and the size of a country's stock market. I hypothesize that a high number of veto players reduces investor confidence. Using case studies from Latvia, Estonia, Romania, and Slovakia, my research provides qualitative evidence that more veto players correlates with low stock market capitalization as a percent of a country's GDP.

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Introduction

Generating investor confidence is key to the development of a robust financial market. Investor confidence is the belief that managers will put invested money to good use – or increase the profitability of the firm and ultimate return to shareholders – rather than expropriating shareholder wealth and diverting profits for personal benefit. Forms of expropriation can include managers stealing profits; selling assets or securities in the firm they control to another firm they own at below market prices; or positioning an unqualified family member in a managerial position (La Porta et. al 2000, 1). Confidence increases when managers are held accountable for their behavior. On the other hand, when poor practices take place and are not punished, investors will not be confident that investing in a publicly traded firm is a wise decision, as it is either unlikely that the company's stock will appreciate in value, and even if the price of the stock does increase, investors may not be able to reap the benefits. According to the agency theory of the firm, shareholders are the principals and firm managers are agents, and shareholders face problems in monitoring management of the firm. Low investor confidence reflects lack of managerial accountability to shareholders (Aguilera and Jackson 2003). I use a country's stock market capitalization as a percent of GDP – or the number of shares outstanding multiplied by the price of the shares – to measure investor confidence, but I acknowledge that this is a crude proxy.

The degree of investor confidence, as measured by a country's stock market capitalization, varies widely across countries in Central and Eastern Europe (CEE). As of 2012, CEE countries demonstrate interesting variation in stock market capitalization as a percentage of GDP, and, by implication, in investor confidence. In one year alone (2012),

values range from highs in Poland (36.3% of GDP) and Estonia (10.4%) to lows in Slovakia and Latvia of 5% and 3.9%, respectively. This variation is not just in recent years but has occurred over time as well. Figure 1 illustrates the variation in the average market capitalization from 2000 through 2012 across CEE countries. Countries as similar as Estonia and Latvia demonstrate very different stock market sizes over time; similarly, the sizes of the Czech and Slovak Republic markets have developed along very different paths. Over 2000-2012, the average stock market capitalization of Estonia is 24.5% of GDP, while Latvia's is 8%. The Czech Republic's average stock market capitalization is 23.8% of GDP, while Slovakia's is less than 6%. This variation is puzzling because each country's stock market launched at roughly the same time, and the postcommunist experience provided similar political and economic environments, as countries attempted to transition from communist to democratic rule and from centralized, planned economies to market structures. So, what explains this puzzling variation in stock market capitalization and, by implication, in investor confidence?

I argue that the answer lies in the nature of each country's domestic political institutions. Specifically, more veto players – defined by George Tsebelis as collective actors necessary to produce policy change, or for my research the number of parties in the governing coalition – negatively affect investor confidence and stock market capitalization. The causal mechanism is that a high number of parties in the coalition can result in more bribery to produce policy change. All parties in the governing coalition must approve a policy to produce change, so it is thus more difficult to produce change when the coalition consists of a high number of parties. Higher levels of bribery due to a large number of parties in the governing coalition makes businesspeople accustomed to

using bribes to achieve desired ends, increasing the likelihood that they also use bribery to affect enforcement of rules and regulations. In addition, when many parties are in the governing coalition – which can also mean greater ideological differences among parties – businesspeople have more opportunities to take advantage of competing parties and give large sums of money to these parties in return for favors. Parties rely on private funds to remain in the governing coalition and hold on to power, so prominent firm managers giving the funds in turn act unfairly with invested money because they know that they can bribe party leaders to influence implementation of the rules. The resultant political system is one in which politicians and businesspeople are mutually reliant on one another: parties in the governing coalition need oligarchs' monetary contributions, and oligarchs are then able to have politicians intervene on their behalf when violating shareholder rights. Businesspeople bribe party leaders in the governing coalition who then exercise influence on their behalf. In sum, bribing officials who influence rule enforcement – including prosecutors, securities regulators, anticorruption officials, or judges – can reduce investor confidence as businesspeople escape crimes, and a high number of parties in the governing coalition makes this bribery more likely. Figure 2 shows variation in the average number of veto players across CEE countries.

> Hypothesis: a high number of veto players reduces stock market capitalization.

To test my hypothesis, I examine four cases over the 2000-2012 time period. The cases are Latvia, Estonia, Romania, and Slovakia. I chose Estonia as a "success" case, as the market is much larger than Latvia, a very similar country. I then wanted to test whether a similar dynamic that has correlated with low stock market capitalization in

Latvia – a high number of veto players – is also present in Slovakia and Romania. These countries are also all EU members, which helps control for international pressure to adopt better enforcement of shareholder rights. After using the World Bank's Database of Political Institutions' Checks variable as a starting point for determining the number of veto players, I qualitatively examined country reports, country-specific scholarly articles, and local newspaper articles available online. This approach allowed me to see whether outcomes correlate with veto players and to yield qualitative evidence to validate the causal processes at work. I find that the number of parties in the governing coalition does correlate with the size of a country's stock market, but other factors also matter.

I found that parties in Latvia, Romania, and Slovakia have very close ties with prominent businesspeople, and qualitative evidence shows that party leaders in these countries have consistently interfered in prosecutions and court cases on behalf of the oligarchs in return for their party donations. I argue that this political interference has reduced investor confidence in these countries, as stock market capitalization is low. Estonia, on the other hand, has successfully punished businesspeople who violate investor rights and has to a large extent combated corruption. The country has, on average, a higher stock market capitalization than the other countries. Governing coalitions in Latvia, Slovakia, and Romania have consisted of a higher number of parties than is the case in Estonia, a country that has moved from three to two parties in the governing coalition.

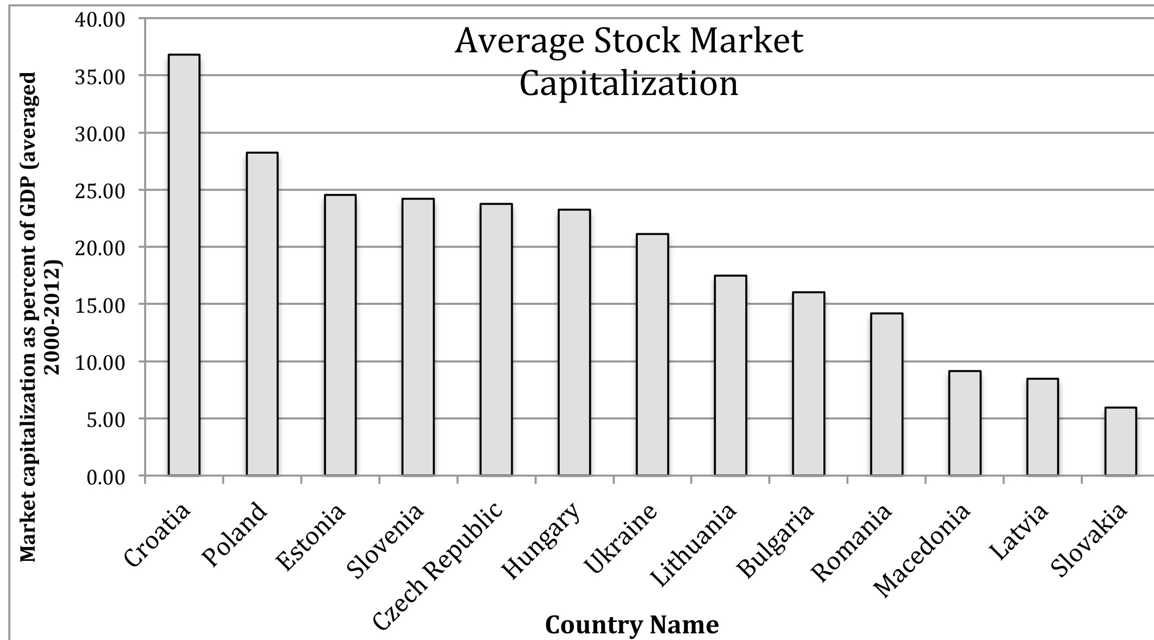

Figure 1

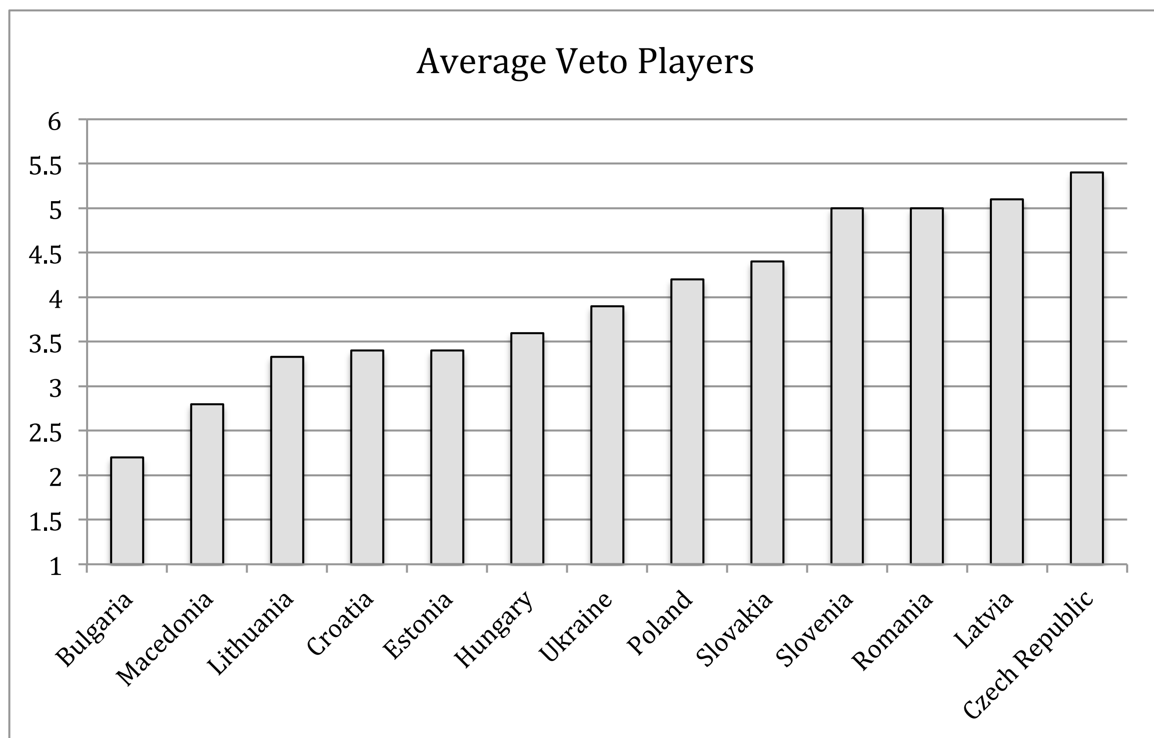

Figure 2

Background and Theory

Dependent Variable

My dependent variable aims to capture investor confidence in publicly traded firms, or confidence in managers acting in investors' best interests rather than diverting company profits for personal benefit. Ideal measures of limiting managerial discretion would include indicators of actual enforcement undertaken, such as the number of prosecuted cases, fines levied against managers and conviction rates, but it is not practical to obtain such data, and I use stock market capitalization as a percent of GDP to represent investor confidence (Jackson and Roe 2009, 33). Several scholars support the notion that financial market statistics are good indicators of the practices occurring because enforcement of shareholder rights encourages the development of equity markets. On the other hand, expropriation of shareholder wealth reduces confidence and results in security price declines and low market capitalization (LLSV 1999, 16).

Investor protection laws are also important in determining stock market capitalization, but looking at rules on the books fails to capture developments that occur outside of the legislative realm. Furthermore, investor protection laws are persistent over time – once the laws are in place that outline acceptable practices, policy rarely changes. The World Bank's strength of investor protection index, part of the Bank's Doing Business project, reflects the unchanging nature of corporate governance policy on the books. This index reflects whether national laws address the extent of information companies must disclose, the ease of shareholder suits, and director liability. The score each country receives on an annual basis has rarely changed. Furthermore, I chose to study domestic political institutions rather than the laws on the books after noticing that

Latvia and Estonia have both scored 5.7 out of 10 on the index since it launched in 2006 but have very different stock market sizes. Similarly, the fact that Romania has stronger laws than Estonia, as it has scored a 6 since 2007, but its stock market is much smaller, means that something else besides laws is influencing investor confidence. The basis for my dependent variable is that the laws on the books do not necessarily reflect managerial practices actually occurring.

Independent Variable and Causal Mechanism

Many scholars have written about the impact that veto players have on the policy environment, but I look at how veto players affect enforcement of the rules. Past works note that more veto players results in policy stability, while few veto players can produce unpredictable policy change. With respect to the effect of veto players on investor confidence, one may expect to see strong investor confidence in a country that has a large number of veto players and strong investor protection rules. Expected stability in strong investor protection would result in high stock market capitalization. When there are many veto players and the rules are weak, investors would not expect rules to change in the near future, and stock market capitalization would be low. Few veto players can result in weak confidence in the policy environment, as the rules can easily change (Tsebelis 1995).

However, veto players can also affect investor confidence by increasing incentives for bribery. Tsebelis focuses on the policymaking effects of veto players and does not argue that veto players can increase bribery. However, I think understanding the ways that veto players affect implementation of the rules is important in understanding

the development of stock markets. While I agree that veto players might make a policy commitment more credible, maintaining strong investor protection laws is clearly not the only influential factor in determining stock market growth. For instance, while Romania, according to the World Bank, has stronger investor protection laws, its market capitalization is one of the smallest in the region. Perhaps Romania adopted strong laws in part to compensate for the high levels of bribery that result from many veto players in government. My theory is that since many veto players result in policy rigidity, bribery may be necessary in order to influence policy. As managers engage in corrupt relationships with politicians in government, they are also more likely to use bribery to get away with cheating shareholders out of firm profits. Managers can use bribery to get away with expropriating shareholder wealth, and implementation of the rules on the books then suffers, reducing stock market capitalization. As Gerard Roland discusses the corruption cycle that can become embedded in society, "managers use bribery to extract subsidies or favorable legislation...These influences will lead to more corruption within the state, weak tax enforcement, weak law enforcement, and so on" (Roland 2002). Investment in the stock market suffers when individuals are not confident of equal treatment by the judicial system because the courts are not reliable dispute resolution institutions; corruption and rent-seeking raises costs for producers and consumers by tunneling resources into the rent-seeking process; and corruption introduces distortions that impede long-run economic growth, such as restrictions on entry and expropriation of assets through managerial malfeasance (Haggard et. al 2008, 211).

<u>Literature Review</u>

When investors put their money in the stock market, they want credible enforcement of their rights. So, even when the laws exist on the books, the expectation of enforcement or lack of enforcement is crucial in determining stock market capitalization. Bribery is one type of corruption, or the abuse of public power for private benefit, which can influence enforcement (Amundsen 1999, 7). I specifically focus on bribery that affects ordinary citizens' confidence in investing in stock markets. According to the definition that Inge Amundsen provides, bribery is "the payment of a fixed sum, or any other favor in money paid to the state official in charge of making contracts...or otherwise distributing benefits to companies, individuals, and businessmen." Paying or receiving a bribe is engaging in corruption (Amundsen 1999, 11). Bribery is a widely used term, and scholars often examine bribery between firm managers and politicians as it pertains to companies unfairly shaping policy in their favor. For example, managers can successfully lobby for favorable tax, employee, and investment policies by providing secret campaign contributions to politicians. In return for the side payments, politicians cater to managers' needs (Hellman et. al 2000). "Bureaucratic corruption" refers to bribing public officials – including judges and prosecutors – to affect implementation of already existing rules (Bagashka 2013, 5). Multiple parties in the governing coalition, or a large supply of party leaders, makes it easier for oligarchs to find leaders who demand a low price to help escape punishment for seizing shareholders' invested money. Businesspeople bribe party leaders in the governing coalition who then exercise influence on their behalf by interfering with actions of judges, prosecutors, or securities regulators. In "Political institutions and corruption: the role of unitarism and parliamentarism," Gerring and

Thaker study the relationship between basic-level political institutions and corruption, and they note the surprising lack of studies that study this relationship in a cross-national setting (Gerring and Thacker 2004, 298). The general consensus among scholars is that more democracy, or a longer experience with competitive, multi-party elections, leads to lower levels of corruption. However, veto players are essentially access points through which businessmen can entrench bribery in the political system (Gerring and Thacker 2004, 313). More parties in parliament can make it easier for the “supply side” of corruption to take place. The supply side of corruption refers to those who offer the bribes and the advantages they gain, including individuals of non-governmental or corporate organizations (Amundsen 1999, 2).

Gerring and Thacker argue that obstacles to government action by themselves – which occurs with multiple veto players – has little positive effect on the quality of government. In fact, the presence of multiple veto points allows corrupt actors to block reform efforts. “The greater the number of effective vetoes, the more private regarding will be the policies enacted,” they write (Gerring and Thacker 2004, 322). Political systems with few veto players establish greater accountability between elected officials and bureaucrats, making governments more responsible. Leaders limit arbitrary behavior on the part of lower-level officials rather than encourage poor behavior. Consequently, “centralized systems are capable of creating a stable, predictable, and therefore credible regime for investors” (MacIntyre 2008, 213).

In “The Politics of Corruption in Latin America,” Kurt Weyland argues that during the process of democratization – which oftentimes increases the number of veto players through political competition – the fact that new veto players may arise can create

more opportunities for politicians to extract bribes from firm managers. In effect, veto players in a country new to democracy can create more avenues for corruption, as new government actors take advantage of their new positions of power to extract bribes (Weyland 1998, 108). There are then more opportunities for firm leaders to pay off politicians who have the power to interfere with enforcement of the rules.

Research Design

I used a qualitative approach to study the effect of the number of parties in the governing coalition on investor confidence and stock market capitalization. I chose this approach because my sample size of thirteen countries is fairly small, and I wanted to investigate the exact ways that government actors can intervene with enforcement of the rules. I read country reports – such as from Freedom House and the Bertelsmann Transformation Foundation – in addition to country-specific scholarly articles and local newspaper articles available online. This approach allowed me to gain a detailed understanding of the relationship between politicians and powerful businesspeople and research the ways these relationships can hinder the enforcement of shareholder rights and stunt stock market growth. I collected data on thirteen countries (Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Slovakia, Slovenia, and Ukraine) but focused on four countries in particular. The countries I chose for my case studies are Latvia, Estonia, Romania, and Slovakia. Estonia is the one success case, while the other three countries have not produced strong investor confidence and high stock market growth.

Dependent Variable Measurement

I use stock market capitalization as a percentage of GDP to operationalize investor confidence in protection from managerial expropriation of shareholder wealth. Stock market capitalization indicates the depth of a financial market; other types of financial market indicators include the number of listed domestic firms, and the number of IPOs relative to GDP. I acknowledge that stock market capitalization is a crude proxy to indicate managerial discretion, but to a certain extent it does reveal the amount of resources investors are willing to put forth to finance a firm (Shleifer and Vishny 1997, 743.

Independent Variable Measurement

A commonly used measure of veto players in government is the Checks variable from the World Bank's Database of Political Institutions. According to Beck et al, "a key element in the description of any political system is the number of decision makers whose agreement is necessary before policies can be changed...[Checks] counts the number of veto players in a political system, adjusting for whether these veto players are independent of each other, as determined by the level of electoral competitiveness in a system, their respective party affiliations, and the electoral rules" (Beck et. al 2001, 170). For presidential systems, Checks reflects whether different parties control the executive and legislative chambers. For parliamentary systems, Checks includes the number of parties in the government coalition. This variable reveals "the extent to which one political decision maker might act as a check on another" (Beck et. al 2001, 170).

Caper Dahl elaborates on the construction of the Checks variable in "Parties and institutions: empirical evidence on veto players and the growth of government." He states that Checks reflects changes in the number of parties in government, or "government fractionalization." Checks only counts a party in government as a veto player if it is needed to maintain the governing coalition. Furthermore, the Checks variable increases by one if a governing party holds a position on economic issues that is closer to the main opposition party than to the leading party of the governing coalition. Thus, Checks places greater emphasis on party preferences than Tsebelis's original index: according to Tsebelis, political parties always count as effective veto players whether they are ideologically similar or not (Dahl 2013, 9).

I use Freedom House's Nations in Transit reports to understand more about what the Checks variable represents, as these reports reveal details about governing coalitions, namely the number of parties in the coalition and policy stances. Checks does not strictly reveal the number of parties in the governing coalition, and I refer to Nations in Transit to count the number of parties in the coalition and understand whether these parties shared ideological stances or had conflicting policy preferences.

Control Variable

My research also discusses the effect of joining the EU on the quality of minority shareholder rights. Many former communist nations that transitioned to a market economy after the fall of the Soviet Union applied for and eventually joined the EU. For instance, on May 1, 2004, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia joined; in January 2007, Romania and Bulgaria joined.

Croatia is the newest member and joined on July 1 2013. One purpose of the EU is to foster greater financial market integration, and a way to do this is to offer investors options of where to invest their money. According to the European Commission, dynamic securities markets are vital to Europe's economic future, and "this requires giving both issuers and investors the opportunity to be far more active on other EU capital markets and to have confidence that the companies they invest in have equivalent corporate governance frameworks" (Global Corporate Governance Forum 2008). The Commission notes that the EU plays an active role in promoting sound corporate governance and in easing the transition of new member countries to becoming competitive, modern market economies. According to the Commission, common investor safeguards and enforcement of these safeguards should be present in all EU countries.

The aim to establish "European" corporate governance is evident in the creation of the European Corporate Governance Forum in 2004, an institution that issues recommendations to the Commission, and in the various Directives the EU has issued related to corporate governance since 2003. The Directives contain provisions for the transposition of investor protection rules and characteristics of compliance. EU members that fail to comply with corporate governance Directives after joining may suffer sanctions and reputational damage that can increase firms' cost of capital and hamper stock market development. However, some scholars note the weak prospects for convergence in corporate governance practices. As Douglas Branson notes in "The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance," "EU efforts have...exceeded any mandate the Council and the Commission may have had...That overzealousness has produced a backlash, making legitimate harmonization more

difficult to achieve" (Branson 2001, 336). Branson posits that domestic institutions will prevent attempted harmonization in corporate governance from actually occurring. He states that advocating for such convergence is "insensitive" to cultural and economic norms (Branson 2001, 362). It is therefore not guaranteed that countries comply with EU criteria.

Case Studies

Latvia

Dependent Variable

Market capitalization in Latvia has struggled to consistently remain above 5% of GDP in recent years. Although Latvia and Estonia receive the same score of 5.7 on the investor protection index, the performance of the stock market has widely differed in the countries. For instance, recovering from the economic crisis in 2010, Estonia's stock market capitalization as a percent of GDP was 11.95%, which was more than twice as large as Latvia's, at 5.2%. As a result, publicly traded firms face difficulty in financing investment by issuing stock. For instance, since 2009, capitalization has fallen from 7% of GDP to 3.9% in 2012. According to the World Bank's investor protection index, the laws on the books have remained stable, and Latvia has received a score of 5.7 out of 10 since the index launched in 2006. However, despite stability in the laws, it appears that investor confidence lags.

Independent Variable

According to the Checks variable, Latvia has consistently had five veto players. After the October 2002 elections, four parties came together to form a coalition government: New Era, Latvia's First Party (LPP), the Union of Greens and Farmers (ZZS), and For Fatherland and Freedom (TB/LNNK). The fact that the Checks variable is five, one greater than the number of parties in the governing coalition, reflects divergent preferences. As Freedom House notes, these parties all represented different business interests and views on privatization (Freedom House 2003).

The parliamentary elections that took place on October 7, 2006 also resulted in a governing coalition consisting of four parties: the People's Party, the Union of Greens and Farmers, the Union of First Party and Latvia's Way, and Fatherland and Freedom. Together, the four parties held fifty-nine out of the one hundred seats in the Saeima, or Latvian parliament. In total, seven parties were represented in the Saeima after elections.

After the scheduled October 2010 elections, public discontent with the dominance of oligarchs in government triggered the first dissolution of parliament – called for by President Valdis Zatlers – in May 2011. Snap elections for the 11th Saeima took place on September 17, 2011, resulting in a new ruling coalition of the Reform Party (ZRP), Unity Party, and National Alliance. The three center-right parties won a total of fifty-six deputies in the one hundred-member chamber; Valdis Dombrovskis became the new Prime Minister. Despite the three party coalition government, the Checks variable remains at five. It therefore appears that two of the parties hold positions on economic issues that are closer to the main opposition party than to the leading part of the coalition (Dahl 2013). The following section illustrates the way in which the number of parties has

increased incentives for bribery and reduced investor confidence. Figure 1 shows the number of veto players in Latvia and stock market growth over time.

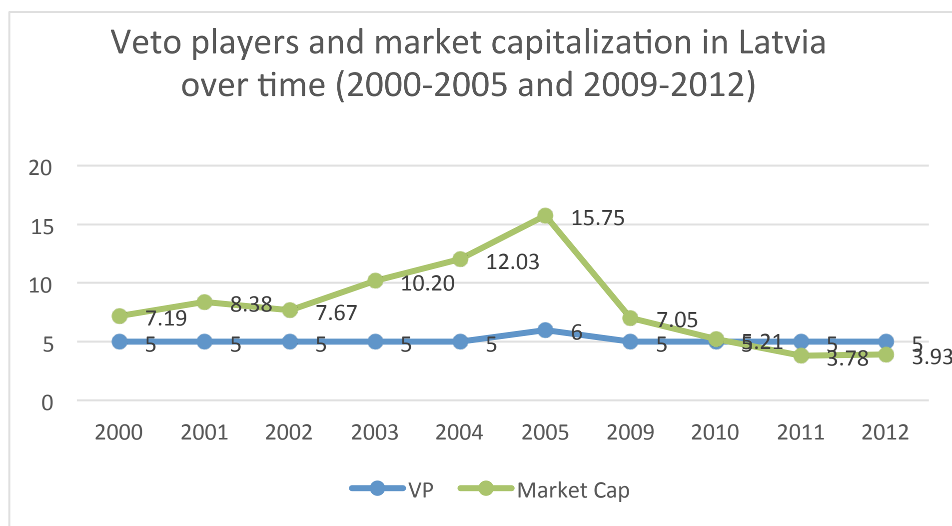

Figure 3

Source: The World Bank's Database of Political Institutions and the world development indicators

Year	Number of parties in governing coalition	Checks	Market capitalization (% GDP) at year end
2002: election year	4	5	7.67
2003	4	5	10.20
2004	4	5	12.03
2005	4	6	15.75
2006: election year	4	6	13.57
2007	4	5	10.82
2008	4	5	4.78
2009	4	5	7.05
2010	4	5	5.21
2011: election	3	5	3.78
2012	3	5	3.93

Table 1

Process

Weak growth in Latvia's stock market, which reflects poor investor confidence in managerial accountability, stems from the number of parties in the governing coalition in Latvia's parliament. To begin, in 2003 the World Bank noted the prevalence of state

capture – or the practice of companies or individuals illegally paying members of parliament to influence government policies or circumvent laws or decrees – despite the passage of several anticorruption laws and creation of Bureau of Anticorruption in 2002. The number of parties in parliament at the time, four, plus the additional veto point due to ideological differences to make the Checks variable five, prompted the prevalence of state capture, as businesses had to pay bribes to more parties in order to influence all of the parties in the coalition. Overall supply of bribes was high, as demonstrated by Latvia's low score of 3.8 in 2003 on TI's corruption perception index.

The 2006 election results of another four party coalition government provided further reason for supply of bribes in order to achieve desired policy. Furthermore, three of the four parties were connected to oligarchs – powerful businessmen with direct influence on Latvian politics – who had fought each other for years in pursuit of power. The People's Party is connected to oligarch Andris Skele, the Union of Greens and Farmers to Aivars Lembergs, and the Latvian First Party to Ainars Slesers. There was reason for the oligarchs to bribe politicians responsible for drafting and passing policy, as each businessman wanted to achieve his desired ends. The strong influence of these three individuals on Latvian politics and business resulted in ordinary citizens feeling as if the coalition was not looking out for the interests of the entire nation but for the narrow group of oligarchs (Freedom House 2008).

One fact to note when studying corruption in Latvia is that MPs in Latvia receive parliamentary immunity, meaning that once a member of the Saeima, actors are above the law and cannot be convicted for corruption. As a result, although some deputies have

been investigated for corruption, they have escaped prosecution because of their immunity (Drupa October 2013).

It is possible that parliamentary immunity has further lowered the price that MPs demand from businesspeople who request manipulating enforcement of rules that protect investors, as MPs face an almost nonexistent risk of punishment for bribing officials who oversee rule implementation. It is less costly for MPs to bend enforcement of the rules on a CEO's behalf than for CEOs to engage in the bribery because CEOs are not immune to punishment. Given parliamentary immunity, it is less risky for MPs to intervene with enforcement of the rules on behalf of businesspeople for than for businesspeople to affect enforcement. Corruption has become entrenched between businessmen and MPs, and powerful businesspeople had further reason to use bribery when getting away with expropriating shareholder wealth.

The ease with which Latvian oligarchs extend their political party influence to other officials responsible for enforcing the rules is evident in the poor functioning of anticorruption institutions. Weak anticorruption institutions facilitated irresponsible managerial behavior and worsened investor confidence in the country. Specifically, despite creating the Corruption Prevention and Combating Bureau (KNAB) in 2002 as part of Latvia's 2004 accession into the EU, the public continues to suffer from entrepreneurs' use of bribes to carry out business (Global Integrity 2007). Latvia therefore exemplifies what Tanya Bagashka calls "bureaucratic corruption," or bribing public officials to affect implementation of already existing rules (Bagashka 2013, 5). KNAB is a single agency with the power to handle corruption investigation, prevention,

and education. KNAB also sought to influence campaign finance and prevent the flow of money to parties that prompted state capture.

However, according to a 2013 article in Foreign Policy magazine, reform advocates were skeptical of KNAB, seeing it as “paper tiger designed to impress the international community rather than achieve real progress” (Kuris July 2013). KNAB must report semiannually to parliament; however, if the MPs responsible for monitoring KNAB are the ones who break the rules in the first place, the likelihood of KNAB’s success is doubtful (Kuris July 2013). Similarly, the government cabinet has the ability to appoint and upon legal cause remove the head of KNAB, with parliamentary confirmation.

Oligarchs have in many instances acted in ways that increased their wealth at the expense of minority shareholders in publicly traded companies and have managed to escape punishment. Several cases involving Staburadze, Latvia’s largest pastry maker, illustrate the overlap of politics and business in the country. This overlap reduces investor confidence because of the unfair treatment that prominent businessmen can receive due to political connections. In November 2000, Staburadze purchased a large stake of 73.2% in Laima, the country’s biggest chocolate maker, through a hostile takeover, or a deal that the target company’s management opposes. The purpose of the deal was to increase Staburadze’s ability to compete in the confectionary market at the European level; however, according to a November 30, 2000 article in *The Baltic Times*, Laima’s management was very skeptical about the deal. As the article quotes Laima’s board chairman, “in order to create a strong company...it takes investment and a detailed strategy plan, [and] investments in Laima are unlikely” (The Baltic Times Nov 30 2000).

In order to complete the deal, Staburadze purchased the shares in Laima from a company – the New Technology and Business Development Corporation – owned largely by Andris Skele, Latvia's former Prime Minister. The shares were purchased for an undisclosed sum but estimated as over twelve million U.S. dollars.

The whole deal was "shrouded in secrecy," the article states, as Staburadze company management failed to inform the Riga stock exchange of the deal. Riga then temporarily suspended trading in the company's shares because failing to disclose the terms of the deal could harm the interests of small investors in Laima; Laima's chairman was very much against the deal and went so far as to expect Laima's future "demise" (The Baltic Times Nov 30 2000). However, no company management in Staburadze was punished, and the RSE allowed share trading to recommence in December 2000 (The World Bank 2002).

Staburadze was able to get away with the hostile takeover and violating shareholder rights because of Skele's role in the deal. Despite the fact that the terms of the Staburadze-Laima deal – specifically that Skele was selling his shares in Laima to Staburadze – should have been public, application of rules intended to protect minority investors did not take place. Company leaders of Staburadze failed to disclose the terms of the purchase, potentially harming shareholders in Laima, but they managed to carry out the transaction because of Skele's involvement.

Skele, founder of Latvia's People's Party and Prime Minister from December 1995 to August 1997 and from July 1999 to May 2000, is an example of one of the many "oligarchs," or wealthy patrons in Latvia who influence major business and political decisions in Latvia. He is a major party donor, and the People's Party is more reflective

of his charismatic personality than of distinct political ideology (BTI 2012). At the time when he prepared to sell his shares in Laima, he led the People's Party. The People's Party depends on his financial influence, and his essential role in the party made party leaders willing to act on his behalf. Furthermore, four parties in the governing coalition is relatively high and means that each party in the coalition received a smaller share of votes than if there were fewer parties. The governing parties were thus eager to maintain oligarchs' votes and financial support and had strong motivation to defend the oligarchs in cases of violating shareholder rights.

By making parties reliant on their funding, oligarchs can bribe MPs to in turn bribe officials who enforce the rules. It is very likely that MPs of the People's Party took advantage of their immunity to bribe securities regulators in the Staburadze case to resume trading of the shares and not harshly punish Staburadze management or Skele. Skele's financial contributions to the People's Party gave him the upper hand in this case, while ordinary shareholders suffered. In addition, by both serving as an MP and having business interests, deputies can protect their economic empires by having parliamentary immunity. Investor confidence can plummet as both MPs and businesspeople who bribe MPs with immunity to act on their behalf get away with seizing shareholder wealth.

After serving as Prime Minister, Skele became a business tycoon able to use his connections to avoid playing by the rules (Global Integrity 2007). He used his financial influence in the People's Party to get away with business crimes. On May 11, 2000, months before Skele's involvement in the Staburadze deal and right after Skele resigned as Prime Minister, *The Economist* wrote that private and business interests have "too strong a grip on Latvian politics," and that voters were accustomed to watching

politicians make bargains and share power among themselves (The Economist, May 11 2000). The immunity that MPs receive in Latvia provides businessmen with a strong incentive to use their financial influence to have MPs act on their behalf. With a large number of parties in the governing coalition – and MPs therefore representing different interests – businessmen have many opportunities take advantage of MPs' immunity.

In Latvia, because of the parliamentary immunity rule, it is cheaper to bribe party leaders who rely on oligarchs' support and who receive immunity than for oligarchs to personally bribe officials who enforce the rules. Each MP in the governing coalition who is of a different party is an opportunity for businessmen to get away with cheating shareholders out of money. Oligarchs have used their wealth to build extensive networks of influence within the government that have intimidated officials and journalists into turning blind eye towards their dealings (Kuris July 2013).

Another case concerning Staburadze exemplifies violating minority shareholder rights in Latvia. In 2002 the Financial and Capital Market Commission (FKTK) brought a case to court that violated the Latvia's buy-out or mandatory bid rule (Olsson and Rafferty 2004). This rule is that any owner reaching fifty percent of the votes in a company must offer to buy out remaining shareholders at a fair price. According to the European Company Law Experts, a mandatory offer rule can protect minority shareholders from controlling shareholders who extract private benefits from the company. The "exit" rationale for buy-out rules is the following: buy-out rules aim to ensure that no shareholder can extract private benefits without first offering minority shareholders an exit opportunity from the firm (European Company Law Experts 2013). Despite the buy-out rule in place, a foreign investor in Staburadze split his holding into

three parties, and splitting up his ownership stakes to below fifty percent was a tactic used to avoid making the mandatory takeover bid, which could benefit other minority investors. According to Olsson and Rafferty, there is a large number of cases where both foreign and domestic owners of Latvian companies hid the true extent of their holdings by dividing their ownership into stakes below fifty percent.

The World Bank's 2002 Report on the Observance of Standards and Codes: Corporate Governance Assessment calls for greater enforcement of existing disclosure rules in Latvia. The Report states that although shareholdings of more than ten percent must be disclosed, this does not happen in practice, as informal relationships among shareholders may occur in order to conceal their arrangements. According to the Report, the misuse of shares to obtain a disproportionate degree of control compared to cash flow rights may discourage potential investors (The World Bank 2002).

Another oligarch, Aivars Lembergs, member of the Union of Greens and Farmers and mayor of the port city of Ventspils, has also used political connections to get away with fraud. Lembergs defrauded LASCO, a major shipping company with shares traded on the Riga Stock Exchange, of $100 million by siphoning off the money from the company to increase his own wealth. A press release in June 2010 describes that the UK's High Court of Justice established the ruling, which was the "first visible step on the way to actual sentencing of those responsible for defrauding LASCO" (JSC Latvian Shipping Company). The High Court froze Lembergs' assets, valued at $135 million, and the Latvian court approved the freeze in 2011. However, while the asset freeze is a positive development, the case is still pending and has been postponed multiple times (BTI Latvia 2014). The 2012 Bertelsmann Transformation Index Report on Latvia notes

that Latvians distrust politicians and political institutions precisely because of the influence of wealthy oligarchs, and the postponement of the LASCO case demonstrates failure of courts to adequately address violations of shareholder rights.

The inability to hold Lembergs accountable for his behavior traces back to the number of parties in the government coalition at the time and the reliance of the Union of Greens and Farmers on Lemberg's financial contributions. Because Latvian parties are characterized by their reliance on oligarchs' money, the Union of Greens and Farmers – considered Lemberg's "pocket party" – could not afford to lose Lembergs' support. As a result, MPs who represented the Union of Greens and Farmers were able to use their immunity to bribe court officials to delay the LASCO case. In addition, the fact that parliament elected Andris Berzins, a member of the Union of Greens and Farmers, as president in June 2011 provides an avenue for Lembergs to continue to influence implementation of the rules and have his case postponed.

In fact, KNAB has persistently struggled to combat judicial corruption, and Latvia has not yet resolved multiple corruption cases against judges for alleged receipt of bribes (Freedom House 2013). Judges have often been too lenient in corruption cases which involve oligarchs or their associates. Judges regularly granted suspended or conditional sentences to powerful defendants, such as with Lembergs' defrauding of LASCO. KNAB has uncovered cases of judicial bribery that reached high-level judges and prosecutors. Members of Parliament have bribed judges and interfered with the judicial system because they have direct links with businessmen and also receive immunity.

There is also conflict within the present three-party ruling coalition that stems from issues of ethnic polarization. Latvian ethnonationalists in the coalition, from the

National Alliance party, wanted to establish Latvian as the only language of instruction in 2011, a demand which conflicted with Russians in the country. Conflict is evident in the fact that six MPs from ZRP created a new party, the Free Democrats, that has threatened to leave the ruling coalition. Conflict within the coalition created more incentives for businesspeople to use bribery to escape punishment, and Latvia has been called the EU country where the dividing line between business and politics is the most blurred (Olsson and Rafferty 2004, 27).

Corrupt business-government relations in Latvia are clearly an issue, and the preceding cases demonstrate that shareholders in publicly listed companies have suffered as a result. In recent years, the public has grown increasingly frustrated with the influence of oligarchs in parliament and business. As Freedom House reports, “frustration with corruption and the influence of oligarchs in parliament was a major theme in public discourse in 2011” (Freedom House 2012). The 2011 snap elections ousted both Ainars Slesers and Andris Skele from parliament and reduced the representation of the Union of Greens and Farmers, the party controlled by Lembergs. Failure of the oligarchs to win seats was clearly a positive development in combating corruption. In addition, in June 2011, the unpopular head of KNAB, Normunds Vilnitis, who held his role since March 2009 and faced accusations of hindering KNAB’s effectiveness, was replaced. It is possible that ousting Slesers and Skele and reducing Lembergs’ influence have had positive effects on Latvia’s stock market, as it has experienced growth in recent years. From 2012 to 2013, the market more than doubled in size from 3.9% to 8.5% of GDP. While this shows reason to be optimistic, continuing to reduce oligarchs’ influence over

politicians will be critical, given the country's history of the tight ties between businesspeople and political leaders.

Estonia

Dependent Variable

I present Estonia as a success case because for a country similar in size and geographically close to Latvia, its stock market is much larger. Throughout the early 2000s, the stock market grew considerably. For instance, from 1999 to 2003, stock market capitalization as a percent of GDP consistently increased each year, growing from 31.3% to 38.5%. Furthermore, the country has recovered more so than other countries from the economic crisis: from 2008 to 2009, the market increased from 8.2% to 13.7%, and after a slight fall the next two years, the stock market is growing again. This recovery demonstrates a higher level of confidence in enforcement of shareholder rights than in Latvia's case.

Independent Variable

Parliamentary elections in 1999 resulted in the formation of a government by a center-right coalition of the Reform Party, Pro Patria, and Moderates. The three parties together held fifty-three seats in the 101-seat legislature (Freedom House 2003). Throughout the early 2000s, there was a trend to reduce the number of political parties in Estonia. For example, between mid-1998 and August 2002, the number of parties registered in Estonia fell from twenty-eight to twenty. The Parliament Election Act encouraged the reduction in parties by requiring a five-percent threshold – or minimum vote share – a political party must obtain for representation (Freedom House 2003).

After parliamentary elections that took place on March 2, 2003, Res Publica formed a coalition government with two other parties, the Reform Party and People's Union. Res Publica won 25.4 percent of total votes, and the left-leaning Center Party, which received 24.6 percent, was the opposition party. The coalition formed in 2003 also consisted of three parties; however, the Checks variable shows a fall in the number of veto players, from four to three, indicating greater ideological similarity among the three coalition parties elected in 2003 compared to the parties that governed since 1999. Specifically, the Moderates in the previous government proved to hold too different of a position on economic issues than Pro Patria, the party that led the coalition, resulting in an additional veto point (Dahl 2013, 9). Prime Minister Mart Laar ruled Pro Patria according to a broad economic liberalization program with which the Moderates were not entirely aligned. However, infighting among the governing coalition eventually caused Laar to announce his resignation on December 19, 2001.

After elections in March 2007, the ruling coalition became much more cohesive, as it had a clear center-right orientation. Prime Minister Andrus Ansip was elected Prime Minister and led the Reform Party (RP); the coalition consisted of his party along with the Pro Patria and Res Publica Union (PPRPU) and the Social Democratic Party (SDP). The coalition thus consisted of three parties (considering PPRPU as one party). According to a 2008 Freedom House report, this government had a much clearer direction and was on "much more solid governing ground than before."

The 2011 election results reflect the strength of Ansip's center-right coalition, as the coalition won an even larger parliamentary majority. As of 2011, the coalition consisted of only two parties, Ansip's Reform Party and PPRPU. Together, the two

parties took fifty-six seats out of the 101-member parliament. Freedom House notes that this election marked the first time that a coalition survived parliamentary elections, and given that there were only two parties in the coalition, it seemed likely to remain intact for the term rather than break up due to ideological differences and inability to reach consensus.

The structure of the governing coalition in Estonia's parliament shows interesting progression to reach few veto players. Governments evolved from the 1999 coalition consisting of three parties with conflicting policy stances to the 2003 and 2007 three party coalitions with greater ideological similarities. Then in 2011 the coalition consisted of only two parties that held common goals.

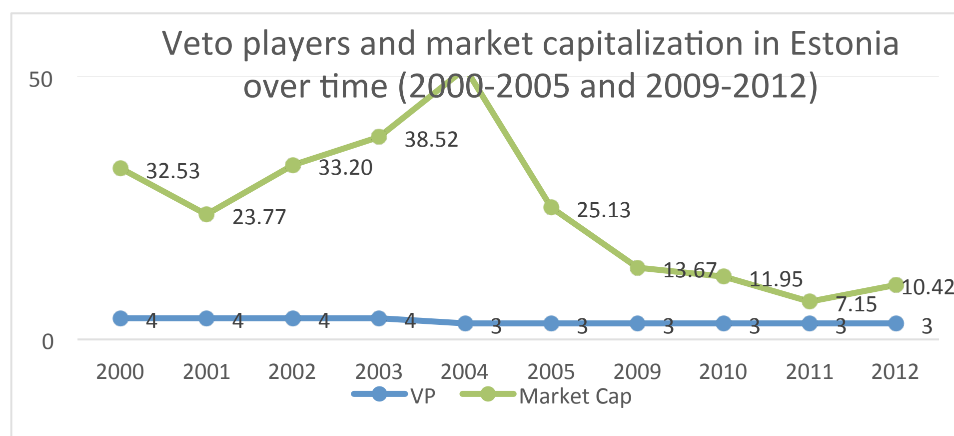

Figure 4

Year	Number of parties in governing coalition	Checks	Market capitalization (% GDP) at year end
1999: election year	3	4	31.34
2000	3	4	32.53
2001	3	4	23.77
2002	3	4	33.20
2003: election year	3	4	38.52
2004	3	3	51.58
2005	3	3	25.13
2006	3	3	35.50

2007: election year	3	3	27.45
2008	3	3	8.20
2009	3	3	13.67
2010	3	3	11.95
2011: election year	2	3	7.15
2012	2	3	10.42

Table 2

Process

The number of parties in the governing coalition in Estonia, looking at the years 1999-2012, has progressively fallen, and the parties have also grown more cooperative. I argue that these developments have boosted investor confidence and positively affected the stock market. As parties in the coalition had closer ideological orientations, and as the number of parties in the coalition fell from three to two, public perception of the need to bribe parties in order to produce policy change fell. Because parties were less conflicting, bribes were not viewed as necessary to convince MPs to agree on policy measures. As fewer bribes were supplied, efforts at combating corruption grew more successful, ultimately discouraging firm managers from expropriating shareholder wealth.

The country's commitment to combating corruption is evident in the Anti-Corruption Act parliament passed as early as January 1995. The Act provides a legal basis for prosecuting officials involved in corruption; the first version passed in Parliament in January 1995 and went into effect on March 1, 1999, and Parliament amended the Act on June 7, 2001. Various parts of the Act address potential conflicts of interest between companies and politicians. According to the Act, elected representatives and public officials must declare their economic interests about "immovable property [and] holding shares and other securities...[and] additional sources of income that exceed 10 percent of the previous six months salary should be declared. Bank accounts, taxable

income, and dividends belong under declaration" (Anti-Corruption Network for Transition Economies 2002).

Furthermore, as Freedom House describes, public officials including MPs, judges, and other government ministers declare their economic interests on an annual basis, and the Parliamentary Anticorruption Committee reviews the declarations which are then published in the State Gazatte (Freedom House 2003). The 2001 amendment improved the regulation of collecting, controlling, and depositing of declarations of economic interests (The Anti-Corruption Network for Transition Economies 2002). In addition, the Act establishes various restrictions on employment and activities: under the Act, government officials are not allowed to join directing or supervisory bodies of commercial enterprises unless they are state-owned (The Anti-Corruption Network for Transition Economies 2002, 7).

Not only did Estonia pass and amend the Act, but it has been enforced. For example, the 1998 failure of Eesti Maapank – which was the sixth largest bank in the country – sparked investigation into reason for the bank's failure and the ultimate conviction of its former CEO, Malle Eenmaa. In fact, Eenmaa was the first person convicted under the Anti-Corruption Act. She was sentenced to eighteen months prison, fined $1.7 million, and prohibited from serving in any future managerial position. She was sentenced for using money from the state's Rural Life Loan Guarantee Fund to increase the equity capital of Maapank and sustain her high salary. With money from the Fund, she took excessive risk and invested heavily in the securities market and acted according to an "unrealistic enlargement strategy" (Donald June 1 2000). She concealed essential information about the bank's operations and was ultimately held accountable for

failing to disclose that she was using excessive amounts of state money to invest in the stock market, actions which eventually hurt Maapank's shareholders. Her punishment demonstrates Estonia's commitment to enforcing managerial accountability, and the Maapank ruling perhaps set a precedent for holding managers to a high standard of behavior. The mechanisms were in place – namely an unbiased court system in which officials enforce the rules – to punish Eenmaa's actions that ultimately hurt the 3,000 shareholders of Maapank (Donald June 1 2000).

The level of corruption in Estonia is relatively lower than other former communist countries, having a positive impact on the investment climate (Freedom House 2003). Partly due to the culture against corruption, investors have greater confidence that investing in the stock market will yield returns; stock prices will, in the long run, increase because managers will act responsibly with invested money rather than bribing officials to escape crimes. Furthermore, greater ideological consensus among the coalition that rose to power in 2003 resulted in more anticorruption efforts. Bribery was unnecessary to prompt parties to cooperate on policy issues, and the reduced need for bribery resulted in more effective overall anticorruption efforts. Businesspeople were then held more accountable due to the successful enforcement of anticorruption initiatives. After the 2003 elections, one of the first actions the ruling coalition took was to strengthen the Anticorruption Committee in Parliament, which focuses on collecting and publishing information about the assets of government officials (Freedom House 2004). From 2003 to 2006, Transparency International consistently gave Estonia improved corruption scores. In 2003, Estonia received 5.5, in 2004 the score increased to 6, in 2005 it improved to 6.4, and in 2006 the score peaked at 6.7.

After the 2007 elections, the clear center-right orientation of the coalition further reduced public perception of need for bribery to achieve consensus among parliamentary parties. Then, with only two parties in governing coalition after the 2011 elections, government was able "to concentrate on assembling a robust package of policy goals for the next four years" (Freedom House 2012). In fact, the 2011 election results allowed Estonia to recover from the economic crisis, as the two governing parties built an economic program around boosting the investment climate.

Andrus Ansip, leader of the free-market Reform party and the 2007 and 2011 coalition governments, has generated reforms intended to fulfill his goal of making Estonia one of the least corrupt and richest countries in Europe. Ansip has developed close ties with Estonia's Nordic neighbors and has formed organizations to develop civil society and promote regional development. Enterprise Estonia is one such organization. The organization is one implementing unit of the EU's structural funds and demonstrates the country's commitment to reform and the free market.

Of course, other factors besides cooperative coalition governments encourage stock market development. For instance, in 2004, the year of Estonia's accession to the EU, stock market capitalization as a percent of GDP increased from 38.5% in 2003 to 51.6% in 2004. 2003 was also the election year in which the governing coalition was more ideologically aligned than in previous years after because it did not include the Moderates, but the EU also clearly plays an important role. Parties in the coalition may have cooperated and passed impressive anticorruption legislation in order to satisfy EU membership requirements, as "the EU considers the fight against corruption in new member states to be 'a vital element in building administrative capacity [and]

strengthening the judiciary" (Freedom House 2004). Evidence that conflict was present among the coalition parties is in the fall of government in 2005, which reflected the inability of Parliament to reach agreement on many key issues.

Romania

Dependent variable

Over the past few years, Romania has struggled to recover from the financial crisis, as evident in the country's low stock market capitalization. Besides the years leading up to the crisis, specifically 2006-2007, when market capitalization was roughly 26% of GDP, Romania's market capitalization has not consistently grown. Most recently, from 2010 to 2012, market capitalization decreased from 19.7% to a mere 8.3%. This drastic fall reflects weak investors' hesitancy towards placing their money in publicly traded companies. They do not trust enforcement of shareholder rights and view the possibility of managers getting away with expropriating their wealth as very likely.

Independent variable

From the period 2000 to 2012, the Checks variable for Romania ranges from four to eight. After the November 2000 elections, the Party of Social Democracy (PSD) led the governing coalition with the Humanist Party (PUR). However, the two parties together did not capture a majority in the Chamber of Deputies. They therefore were able to secure parliamentary majorities by working with other parties, particularly with the Democratic Union of Hungarians in Romania (UDMR). After these elections the Checks variable was four; it is unclear precisely how this number was reached, since the minority

coalition consisted of two parties. Nevertheless, cooperation among at least three parties was necessary to achieve a majority in parliament.

Similarly, in the November 2004 elections, no party captured a majority, and the Party of Social Democracy (PSD) initially formed a coalition with the Humanist Party (PUR) and the Democratic Union of Hungarians in Romania (UDMR). Yet after these elections, Checks increased to six. In general, the variable indicates that cooperation among a high number of parliamentary parties was necessary to achieve a majority in parliament (Freedom House 2007). After the 2008 elections, Checks decreased from six to five. As can be inferred from the Checks variable, Romania has generally required a high number of parties to form a majority in parliament.

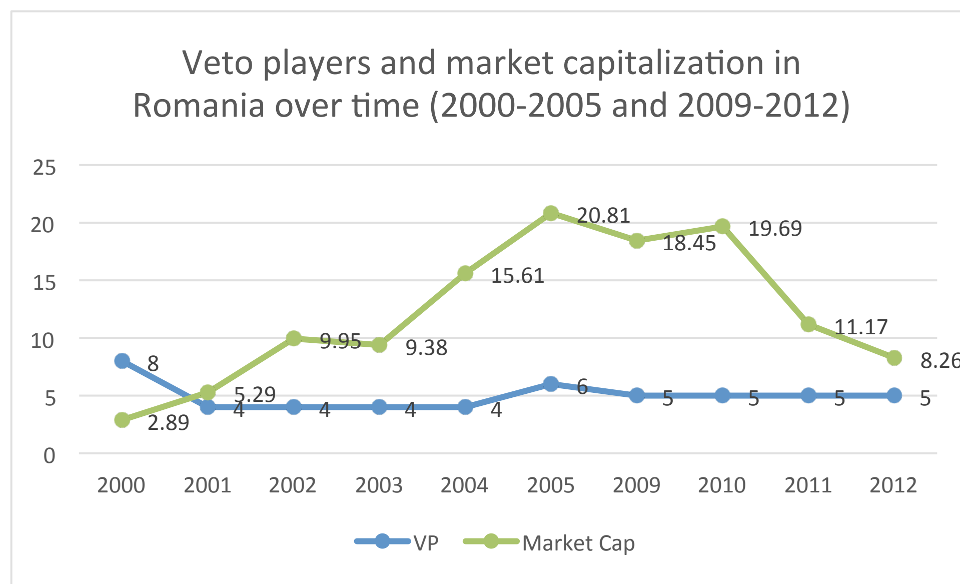

Figure 5

Year	Checks	Market capitalization (% GDP) at year end
1997	8	1.78
1998	8	2.41
1999	8	2.45
2000	8	2.89
2001	4	5.29
2002	4	9.95

2003	4	9.38
2004	4	15.61
2005	6	20.81
2006	6	26.73
2007	6	26.54
2008	6	9.75
2009	5	18.45
2010	5	19.69
2011	5	11.17
2012	5	8.26

Table 3

Process

According to my hypothesis, in order to encourage agreement among parties in parliament, businessmen established links with the parties by bribing them with money in order to achieve favorable policy. With more parties in a governing coalition, it is more difficult for the parties to reach a consensus, and bribes were supplied to each party with the ability to approve or disapprove policy. Freedom House notes that political battles among parties in Romanian coalitions have in fact hurt anticorruption efforts over the years. Consequently, using bribes to achieve desired ends became the norm throughout all of society, and businessmen were able to use bribes to get away with illegal activities that hurt shareholder wealth, ultimately reducing investor confidence and stock market capitalization. More parties in the government coalition increased the incentives that parties had to accept bribes, as they needed oligarchs' money for campaign contributions. With many parties eager for funds, businesspeople faced low costs of accessing officials who oversee implementation of the rules, and party leaders have acted on their behalf.

Dinu Patriciu is one Romanian businessman who has leveraged his political connections in order to increase personal wealth and undermine the investor protection rules on the books. From 1990-1996 and from 2000-2003, Patriciu served as a Member of Parliament in Romania; he is a founder and prominent member of the National Liberal

Party (PNL) in Romania and remains a major party financier (Atlantic Council Energy and Economic Summit). Patriciu is also a well-known Romanian businessman: he is the majority shareholder and chairman of the Rompetrol Group, a Romanian oil company that owns the nation's largest oil refinery, the Petromedia refinery. According to a January 2007 article in *The Wall Street Journal*, in 1998 Patriciu paid $2.1 million for an 80 percent stake in Rompetrol. In 2000, Rompetrol bought Petromedia, and since then, Patriciu has been accused multiple times of misconduct in his business endeavors. For example, in 2006 he was sent to court after being accused of insider trading, money laundering, and stock market manipulation. Specifically, as *The Wall Street Journal* describes, Patriciu faced allegations of undervaluing shares of Petromedia during the oil refinery's IPO. In April 2004, Rompetrol floated 8 percent of Petromedia on the Bucharest Stock Exchange for $5.5 million. The Petromedia shares were allegedly sold at an undervalued price, causing investors in Rompetrol to lose money. In addition, the state was still a major shareholder in Rompetrol, so underselling the shares caused the state to lose money. Furthermore, Patriciu then proceeded to successively buy back the undervalued shares and held on to them to eventually reap a personal profit (Miller January 2007).

The Rompetrol case unfolded very slowly and took many years to conclude. The timeline is the following: in May 2005, Patriciu was detained and questioned concerning allegations of market manipulation; in September 2006, Patriciu and eleven others were officially charged with various crimes; in July 2008, the trial was still pending; and in August 2012, the court finally acquitted Patriciu (Global Integrity 2007). Calin Popescu Tariceanu – Prime Minister of Romania from December 2004 to December 2008 –

assisted Patriciu with his eventual acquittal in the Rompetrol case. The report notes that business and political networks are near impossible to separate in Romania, and that Tariceanu called the prosecutor general for the Rompetrol case to ask about Patriciu's file. A February 2007 article in The Diplomat, a Bucharest magazine, elaborates that "Prime Minister Tariceanu sent President Basescu a note in 2005 asking the leader to 'have a word with the prosecutors investigating the affairs of the Prime Minister's friend and political ally, Dinu Patriciu." The article continues, "Romania's prosecutor general Laura Kovesi said she would check the information on the scandal sparked by the note Tariceanu sent to president Basescu" (The Diplomat, Feb 2007). In August 2012, Patriciu was finally acquitted, arguably because of the pressure Tariceanu placed on the prosecutors. Patriciu contributes large sums of money to the PNL party – in fact, according to official disclosure documents, in 2004 alone he gave $23,000 to the PNL (Wikileaks 2004). So, although Patriciu resigned from Parliament in 2003 to comply with an "incompatibilities law" that barred the blurring of public and private interests, his political connections continued to allow him to receive business favors. Tariceanu placed higher value on Patriciu's financial backing for PNL than on upholding rule of law, and he thus interfered with the case and pressured the prosecutors to release him. This is a clear case of Patriciu using his financial influence in PNL to bribe Tariceanu to act on his behalf and influence the potential prosecution. General Chief Prosecutor Ilie Botos was then forced to resign from his post because he supposedly "trashed" Patriciu's defense rights in an unnecessary detention. Botos claimed, however, that the investigation observed all legal procedures and that he would continue his fight against corruption. He

also noted that “such demands amounted to a gross interference with the judiciary and the ‘politicization of cases such as Rompetrol” (Wikileaks June 6 2005).

The Rompetrol case exemplifies the role that bribery can play in escaping punishment. It is also important to note that finding Patriciu guilty could have had a dire economic impact given Rompetrol’s size. In 2005, Rompetrol represented 2.5% of the nation’s total GDP, and arrest of management board members “would probably be regarded as such ‘material change’ which could then cause business operations to grind to a halt” (Wikileaks June 6 2005). The country thus faced a tradeoff between fair, effective oversight over the financial system and confidence in Rompetrol’s management and revenue stream; the fact that Romania sacrificed the former demonstrates that the country has struggled with addressing corruption in an effective way.

In fact, as a 2013 Freedom House Report on Romania discusses, there have been many problems with the court’s impartiality, specifically with the “politicized and opaque nature” of recent appointments of prosecutors. Romanian courts are generally regarded as not particularly effective, meaning that in many cases of high-level corruption, court proceedings are delayed, judges grant suspended penalties, and there is a general lack of closure (Freedom House 2013). Romania’s judiciary has clearly lacked substantial reform progress, and the judiciary is one of the most problematic institutions in Romania” (Freedom House 2007). The divisive conflict among parties in parliament has only perpetuated the problem of the ineffective judiciary.

The lack of impartiality in courts potentially makes it easier for businessmen and politicians to sway decisions, such as in the Patriciu case. When politicians or bribes from businessmen easily sway prosecutors, it is difficult to rightly convict crimes; in other

words, when the criminals themselves are easily able to influence the system, it is hard to trust enforcement of the rules. This lack of enforcement can occur when too many interests influence the "policy" environment by having the ability to bribe prosecutors. For instance, a majority government has been absent from Romania, and the Romanian government has been marked by conflict within coalitions and indecisive policymaking. Freedom House notes the weak policy formulation process in Romania that resulted from having to negotiate every bill with each Member of Parliament because of the lack of Parliamentary majority.

A large number of parties in a government coalition can lead to violating the "equality of arms" element of a fair trial. Equality of arms, according to the Untied Nations, is the procedural equality of parties and does not exist if the judicial system is corrupt. If one of the parties to a trial, such as a prominent businessperson, has bribed a judge or other court official who accepts the bribe, the judge cannot be impartial, independent, or fair. Indicators of judicial corruption include delay in the execution of court orders; delays in delivery of judgments; unusual variations in sentences; and frequent socializing of judges with members of the executive or legislature (The United Nations 2001).

Conflicting coalition governments continue to plague Romania. As Freedom House states in a 2013 Report, "tensions within the governing coalitions blocked the process of reform." With so much infighting in a coalition government, politicians and businessmen can form mutually beneficial yet corrupt ties, as businessmen lobby for favorable policy and politicians receive money, whether for personal wealth or for campaign purposes. When there is conflict in a coalition, parties accept more bribes from

businessmen; otherwise, competing parties cannot coordinate on drafting or enforcing policy, resulting in “deadlock in decision-making and reform strategies” (BTI 2012). The BTI Romania 2012 Report notes that “the grand coalition resulting from the November 2008 elections was characterized by endless infighting...All relevant political players occasionally resorted to the abuse of democratic instruments for party interests and to the use of strategies of doubtful democratic quality” (BTI 2012). This government, led by Prime Minister Emil Boc, collapsed in October 2009 after the Social Democratic Party (PSD) finally withdrew from Basescu’s conservative PDL. Bribery in parliament starts a pattern that seeps into the court system and hurts investor confidence while increasing oligarchs’ power.

The business activities of another Romanian “oligarch,” Dan Voiculescu, mirror the way in which Patriciu used his PNL connections to get away with fraud. Voiculescu is the founder of the Conservative Party (PC) and served as a Senator from 2004 to 2012. According to various news sources, Voiculescu engaged in fraudulent behavior during the privatization of the formerly state-owned Institute of Food Research (ICA). The case opened in 2007 when he was accused of using his influence as a party leader in order to obtain an advantage in the privatization by purchasing land controlled by the Institute at a price 75 times smaller than the market price. By buying the land at the low price, Voiculescu essentially cheated the Agriculture Ministry – and the country – of 60 million euro (HotNews.ro September 2013).

Voiculescu was able to get away with his theft for roughly five years because of his political connections, as his leadership in the PC gave him the power to delay his hearing. As a Romanian news website states, “the court proceedings were delayed and

postponed repeatedly, with Dan Voiculescu even resigning repeatedly as a Senator in order to change his status and thus force moving the case from one court to another" (HotNews.ro September 2013). In September 2013, he was eventually sentenced five years in jail, a considerable punishment, but the sentence came more than 1,700 days after his indictment.

Given his political donations, it appears that over the years, he paid off PC members of parliament to in turn sway the court system not to address his case by postponing the trial. A January 2005 article in *The Financial Times* provides support for this argument: "To many Romanians, Mr. Voiculescu represents everything that has gone wrong with business and politics in this Balkan country in the 15 years since the fall of the Ceausescu dictatorship...Mr. Voiculescu is compromised by his past involvement with the communist regime and wealth because of deals that relied on political connections" (Condon January 10 2005). Rather than directly bribing court officials himself, Voiculescu used his already heavy influence in the PC party to have party members act on his behalf.

Romanian businessman Sorin Ovidiu Vintu has taken advantage of the conflict among leading political parties in order to get away with fraud: his ties to many politicians have provided him with the avenues necessary to prolong and escape punishment. Rather than solely tying himself to one party, Vintu seeks to influence many parties by providing donations and developing relationships with politicians. The Economist Intelligence Unit (EIU) has documented his tactic of forming connections with multiple government leaders. Specifically, in January 2000, an email that provided insight into Vintu's political connections leaked into the press. The email "contained

allegations of links between one of Romania's largest business empires and senior figures in major political parties, the army, police, and intelligence services...[Vintu] has provided financial support to politicians of all parties," according to a 2002 EIU article (The Economist March 31 2002). Furthermore, the release of the 2000 email revealed close financial links with Prime Minster Adrian Nastase of the PSD party.

Vintu oversees a business empire that includes financial investment companies and banks. In fact, Vintu led one of Romania's largest mutual funds, the Fondul National de Investitii (FNI). He started FNI in the late 1990s; however, the fund went bankrupt in 2000, when thousands of people lost savings they had deposited (Romania Insider January 27 2014). Specifically, as a Bucharest newspaper noted in July 2006, Vintu attracted investors' money to be invested in the stock market. However, around 300,000 investors lost savings totaling approximately 394 million USD when the fund collapsed after not being able to offer full redemption (The Diplomat July 2006). Vintu remains a controversial business figure because he retained his wealth, and at the time the article was published he was the third richest businessman in the nation. Investors in FNI blamed the government for their losses and potentially grew hesitant to place future money in the hands of a fund or company manager (Freedom House 2001).

The email affair was generally acknowledged as the government's first major political setback since taking power in November 2000, and "raised fresh doubts about the abuse of executive power and the independence of the police and legal system." The 2001 Freedom House Report on Romania states that the scandal overshadowed any intended reform efforts, as many Romanians lost their life savings. At the time, there were various other reports in the Romanian press of other allegations linking senior

government officials and business organizations. Yet, despite the controversial revelations of close ties between Vintu and Nastase of PSD, the party PSD continued to dominate the political scene, and Vintu held on to his empire (The Economist April 5 2002). Vintu was never convicted in direct connection with the FNI case, and the collapse of the fund is still under investigation (Business Review January 23 2014).

Slovakia

Dependent Variable

Slovakia's stock market capitalization has failed to grow since it launched in 1995. In the years before the financial crisis, capitalization was at its highest of 8.2% of the country's GDP, but in recent years the market capitalization struggles to exceed 5% of GDP, indicating a lack of confidence that investors have in investing in the market. The EBRD notes in its 2012 report on the Slovak Republic that the equity market remains underdeveloped and small and shallow relative to its neighbors, namely the Czech Republic and Poland (European Bank for Reconstruction and Development 2012). Similarly, the World Bank's Corporate Governance Report on Standards and Codes for Slovakia in 2003 discusses the underdeveloped stock market, and the Report recommends improving protection of minority shareholder rights in order to increase the number of listed companies on the Bratislava Stock Exchange.

Independent Variable

Mikulas Dzurinda served as the first Slovakian Prime Minister after the fall of the Meciar government, leading the country from 1998 until 2006. After the 1998 elections, the ruling coalition formally consisted of four parties but was actually eight parties,

resulting in the government known as the “Coalition of Coalitions” (BTI 2003). These parties, a collaboration of center-right and leftist parties, suffered from different ideological foundations and divergent policy goals. The 2002 elections created additional veto points, as parties from the previous government split into new parties. The new 2002 coalition government consisted of the following four parties: the Slovak Democratic and Christian Union (SDKU, Dzurinda’s party), the Hungarian Coalition Party (SMK), the Christian Democratic Movement (KDH), and the new Citizen’s Alliance (ANO).

After the June 2006 elections, the governing coalition consisted of three parties: left-wing Smer-Social Democracy (Smer-SD), the Slovak National Party (SNS), and the People’s Party-Movement for Democratic Slovakia (LS-HZDS). These parties controlled 83 of the 150 seats in parliament (Freedom House 2010). The new Prime Minister Robert Fico led Smer-SD. Given the different viewpoints held by Smer-SD on the one hand and by SNS and LS-HZDS on the other hand, there was potential for conflict in the ruling coalition. Specifically, Smer-SD was a left-wing party and aimed to increase the role of the state in the economy; the party called for state regulation over market-based competition and was not in favor of entrepreneurship. On the other hand, the right-leaning LS-HZDS and SNS wanted a pure market economy rather than a socially-oriented model with state involvement. So, although the major political actors in the governing coalition agreed on establishing a market economy, there was disagreement over the specific type of market economy (BTI 2010). Furthermore, SNS is a strong nationalist party against Hungarians, creating further potential for conflict among government leaders due to ethnic polarization manifesting in party politics.

Prime Minister Iveta Radicova's government came to power in the June 2010 parliamentary elections and consisted of four parties: the Slovak Democratic and Christian Union-Democratic Party (SDKU-DS), the Freedom and Solidarity Party (SaS), the Christian Democratic Movement (KDH), and the Most-Hid ("Bridge") party.

Figure 6

Year	Number of parties in governing coalition	Checks	Market capitalization (% GDP) at year end
1998: election year	4	5	3.30
1999	4	3	3.54
2000	4	3	4.24
2001	4	3	5.14
2002: election year	4	3	5.50
2003	4	5	6.06
2004	4	5	7.87
2005	4	5	7.16
2006: election year	3	5	8.08
2007	3	4	8.29
2008	3	4	5.19

2009	3	4	5.36
2010: election year	4	4	4.77
2011	4	6	4.94
2012	4	6	5.06

Table 4

Process

Given the persistently low market capitalization levels of Slovakia, it seems that the government structure after independence – or multiple parties in the governing coalition – posed an initial challenge to successful privatization of state-owned enterprises, namely the listing of these companies on the stock exchange, and the country has yet to successfully grow the stock market.

The Report notes that corporate governance reforms in 2001 intended to reduce tunneling – defined as illegally taking assets or profits out of a firm by controlling shareholders or managers for personal gain – that was common throughout the 1990s (Johnson et. al 2000). Specifically, reforms focused on improving information and voting rights of shareholders, company disclosure requirements, and liability provisions for company directors. Furthermore, the Financial Market Authority (FMA), established in 2002, has authorization to supervise the securities market. However, the FMA not been particularly effective, as it lacks the authority to issue legally binding regulations. The organization therefore faces difficulty in responding to corporate governance violations.

Tensions within governing coalitions from 1998 onwards, after the fall of Prime Minister Vladimir Meciar's semi-autocratic rule, have encouraged corrupt business-political relationships, reduced investor confidence, and ultimately prevented stock market growth. Multiple parties and conflict among them had the potential to induce

bribery between the different party leaders and businessmen. A Bertelsmann Transformation Country Report on Slovakia notes that after the Fico government came to power in 2006, the business environment worsened. Specifically, problems hurting business activity, according to the Slovak Business Alliance (PAS), included opaque legislation, poor law enforcement, and high levels of corruption and bureaucracy (BTI 2010). Furthermore, after the elections, a number of top managers of private companies were appointed to various prominent state administration positions. Clientelistic relations between politicians and businesspeople became the primary way the ruling coalition, as well as individual ruling parties within the coalition, operated, according to Freedom House.

The difficulty that parties in the governing coalitions under Dzurinda's leadership had in collaborating resulted in problems implementing rules to take legal action; specifically, courts suffered from high levels of corruption. Unfortunately, the pressure the judiciary faced under the Meciar era was not relieved after his fall in 1998. An ineffective judiciary ultimately undermined the government's ability to boost investor confidence, as interest groups and individuals used political connections to influence the decision-making process (BTI 2003). For example, a scandal known as the "Gorilla file," which surfaced in 2012, demonstrates corrupt links between business and politicians that undermine investor confidence. The scandal involved Penta investments, was the biggest corruption scandal in Slovakia's history, and overshadowed any anticorruption efforts the country had attempted. Due to such close financial links between Penta and the governing coalition, the investment fund was dubbed "the fifth coalition partner" during Dzurinda's second term.

The scandal revealed that Penta paid bribes worth millions of euros to officials in order to win privatization contracts. Not only did Penta have close ties with Dzurinda's SDKU party, but the company allegedly paid bribes to all four parties in the coalition. According to a 2012 article in the Economist, "Penta is alleged to have bribed government politicians in 2005-2006 to win lucrative privatization deals" (The Economist January 27 2012). The parties in power were responsible for awarding the privatization contracts, and Penta bribed them all to produce consensus and win the deals. The file was an extensive written document that included leaked wiretapped conversations from an operation codenamed Gorilla between Slovak politicians, top public sector officials, and prominent businesspeople.

After the file leaked, "public confidence in equality of opportunity and rule of law [fell] close to zero." Though Slovakia has the legal framework in place to prosecute unfair business bribery, the country lacks the implementation skills necessary to improve the functioning of the judiciary. After the interaction between Penta and the government became clear, the public grew outraged at the "brazen way politicians and businessmen collude (Jacko March 8 2012).

While the Penta scandal does not explicitly involve managers siphoning off shareholders' invested money for personal benefit, the case nevertheless illustrates that unfair business ties with government officials can impede stock market growth. Furthermore, according to the *Prague Post*, in early February 2012, the court decided not to publish a book written by an investigative journalist that documented the Gorilla file and revealed the high-level political corruption. The judge who ordered the injunction, Branislav Kral, stated that he judged "the right to protect defamation of [the fund]" as

more important than suffering from potential accusations of censorship. Penta won the injunction to stop the publication of the book most likely in the same manner it won privatization contracts – via bribery – but in response to Kral's decision, the public reacted very strongly and widespread protest occurred in the Slovak capital of Bratislava. In fact, judges noted that during Dzurinda's rule from 1998 to 2006, the judicial system operated in "an atmosphere of fear," as politicians in the ruling coalition had considerable influence over court cases. According to *The Wall Street Journal*, 3,000 protesters gathered in the main square of Bratislava and in a call "to root out corruption and improve law enforcement" (Rousek February 10 2012).

The Penta case made fighting widespread bribery a dominant political theme in Slovakia. Iveta Radicova, the Prime Minister at the time, met with the organizers of the protests to hear their demands, but it was difficult to banish beliefs suspicions of continued clientelism within her ruling coalition. The Radicova government came to power in the June 2010 parliamentary elections and consisted of four parties: the Slovak Democratic and Christian Union-Democratic Party (SDKU-DS), the Freedom and Solidarity Party (SaS), the Christian Democratic Movement (KDH), and the Most-Hid ("Bridge") party. Radicova led SDKU-DS and intended to reverse the former government's reputation for engaging in corruption with businesspeople. Although she defined combating corruption as a top priority, her efforts were not very successful, as the governing coalition's reputation for using clientelistic practices remained. For instance, in Freedom Houses' 2010 Nation's in Transit Report, Slovakia's corruption rating worsened from 3.25 to 3.75 (on a scale from 0 to 7, with 7 the worst).

Conclusion and Implications

Many scholars have demonstrated the link between the number of parties in a governing coalition and expectations concerning policy change, but few studies examine a direct relationship between the number of governing coalition parties and the enforcement of existing rules and regulations. My research provides qualitative evidence of political interference with enforcement of the rules; furthermore, past work has not completed a cross-national study of CEE countries' stock markets. These markets are young and provide interesting variation across countries. It is important to understand the underlying causes of the success and failure of the stock markets and to determine the role of political institutions in influencing investor confidence and market outcomes. I study the incentives that a high number of parties in the governing coalition provide for bribery to occur. In particular, the bribery that my study addresses concerns enforcement of shareholder rights.

To summarize my findings, I have attempted to draw a causal connection between the number of parties in the governing coalition and stock market capitalization. A high number of parties in the coalition provides various incentives for different types of bribery to occur, reducing investor confidence. Countries with a high number of parties in the governing coalition have lower stock market capitalizations because party leaders interfere with enforcement of the rules. Interfering with enforcement involves bribing or threatening judges, prosecutors, or securities regulators, and cases I studied often demonstrated delayed court proceedings or cancelled prosecutions. With a high number of parties in the governing coalition, party leaders are more reliant on their personal relationships with oligarchs to obtain both campaign financing and accumulate personal

wealth, and they are therefore more likely to complete favors for the oligarchs who break investor protection rules. Oligarchs bribe the politicians who in turn bribe public officials responsible for enforcement. Sometimes, oligarchs directly bribe the officials responsible for implementation, but more parties in the governing coalition lowers the cost that oligarchs must pay to get away with breaking the rules. Estonia – my "success" case – has a high level of accountability between managers and investors because politicians are less likely to affect rule implementation. In Estonia, businesspeople have been punished for acting irresponsibly with invested money. The governing coalition in Estonia has consisted of fewer parties, and two parties in the country's coalition has perhaps discouraged the tight links between politicians and oligarchs which can lower investor confidence.

Although I have demonstrated a causal relationship in a few instances – such as Dinu Patriciu's donations to the PNL party prompting PNL party leader Calin Popescu Tarcineau to interfere with the prosecution of Patriciu – it is difficult to obtain evidence of direct interference in court cases or prosecutions. Intervening in implementation of shareholder rights can more generally be seen in the postponement of oligarchs' court cases. For instance, the delayed hearing of Aviars Lembergs in Latvia for seizing money from LASCO to increase his personal empire has reduced investor confidence. It is difficult to pin down exactly who bribes those who enforce the rules, and I have tried to provide qualitative evidence of actions occurring. Both powerful firm managers and party leaders can interfere with enforcement of rules and regulations, but demonstrating that judges, prosecutors, or securities regulators received money from a particular person who wanted to escape punishment is difficult.

My case studies demonstrate that prominent oligarchs can take away shareholders' invested money and oftentimes escape without punishment, and a general conclusion is that public officials responsible for carrying out trials or punishments are oftentimes bribed by either party leaders or the businesspeople themselves. Sometimes, the party leaders are also the businesspeople. I found that the tight links between businesspeople and politicians have perpetuated corruption in CEE countries; if managers continue to escape punishment, stock markets will fall short of potential growth, and firms miss out on financing opportunities. However, investor confidence is certainly affected by other factors besides the number of veto players, such as EU membership. In addition, parliamentary immunity in Latvia has increased the ease with which MPs can act on managers' behalf, augmenting the effect that a high number of coalition parties can already have on reducing investor confidence.

My study looked at general trends in the average number of veto players and average stock market capitalizations over time, and I classified countries as successes or failures. While my argument was that a low number of veto players can increase stock market capitalization, there are certainly cases that do not fit this argument. For instance, Bulgaria and Macedonia both have a low number of veto players but have low stock market capitalization. Figure 7 illustrates that Macedonia and Bulgaria do not follow my argument. Perhaps the fact that Macedonia is not an EU member partially explains the country's low market capitalization, but this is not the case for Bulgaria, as the country joined in 2007. There is no ideal number of parties to have in a governing coalition, but there is some evidence to suggest that a low number of parties can reduce incentives for bribery to occur, which can raise investor confidence. In addition to my case studies, I

used the data I collected on the thirteen countries to graph the relationship between veto players and stock market capitalization. Figure 8, which excludes Bulgaria and Macedonia, shows a trend line that is in accordance with my hypothesis: more veto players reduces investor confidence and thus stock market capitalization. This eleven-country dataset supports the qualitative evidence I provided in my case studies. However, a larger statistical study would be necessary to draw more convincing conclusions.

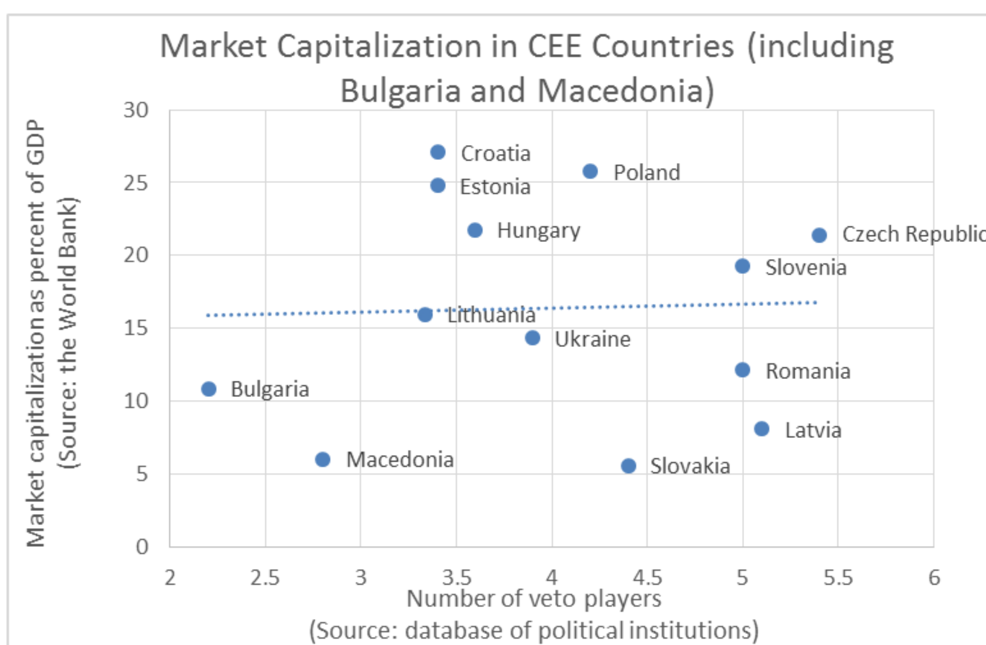

Figure 7

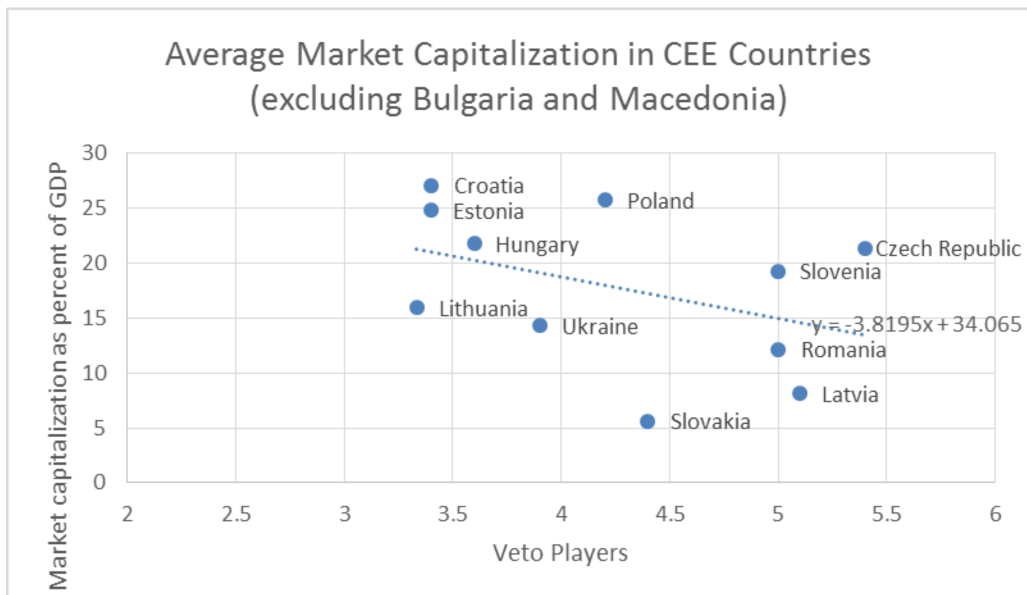

Figure 8

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