Corporate Governance in Listed Brazilian Companies, 1882-1890:

A Theoretical Framework

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Resumo

Um tema recorrente na história econômica e social do Brasil diz respeito a dificuldade de fazer cumprir as leis aprovadas. Isso cria uma sensação de impunidade e fraqueza moral, tanto para os estrangeiros quanto para os próprios brasileiros. Esse artigo busca construir um quadro de referência teórica, no qual as leis no Brasil são propositadamente muito ambiciosas, buscando um progresso social e econômico. Ao fazer isso, no entanto, existe um entendimento que a estrutura social e política é incapaz de fazer cumprir na sua plenitude a nova lei. Só com o tempo. Desse modo, existe um "trade off" entre um projeto social ambicioso (que traz um "beneficio social"), e o descompasso com a efetiva possibilidade de se conseguir cumprir a lei (o que acarreta um custo "moral"). O quadro teórico mostra o equilíbrio entre benefício e custo social, que dita "o grau de enforcement" atingido, e mudanças que possam alterar esse quadro. O modelo é aplicado para examinar a governança corporativa no Brasil durante as`três últimas décadas do século XIX, e examina a crise do "Encilhamento" nesse período

Abstract

The difficulty of making laws stick is a recurring theme in Brazilian economic and social history. Both foreigners and Brazilians feel this difficulty creates a sense of impunity and moral weakness. This articles seeks to establish a theoretical reference model wherein Brazilian laws are purposely ambitious in the direction of social and political progress. There is an understanding that the social and political structure is incapable of enforcing these new laws in their entirety. Only with time. Thus there exists a trade-off between an ambitious social project (which provides a social good) and the delay in the effective enforcement of these laws (which bears a moral cost). This theory reveals the balance between social goods and costs that determines the degree of enforcement attained as well as the changes that alter this model. This model is used to examine corporate governance in Brazil during the last three decades of the nineteenth century and examines the crisis of the "Encilhamento" of this period..

Introduction

The main purpose of this article is to develop a theoretical framework to examine historical examples in which progressive laws are enacted, but the enforcement of such laws takes time to consolidate.

In it, five topics are discussed: the making of new laws; the trade-offs between the new "modern" laws and enforcement; the marginal costs of enforcement; the optimal level of enforcement; and the role of financial innovation and of society preferences for improvements in moral capital.

In order to apply this framework to historical events in Brazil, we intend, as an example, to examine the issue of corporate governance in listed Brazilian companies during the period 1882-1890. Our intention is only to sketch some aspects of the financial history of this period, as a way to provoke the development of deeper studies.

At the end of the Empire (1822-1889), and at the beginning of the Republic (1889-present), three important pieces of legislation were enacted: the 1882 Corporation Law, the 1882 Decree regulating the Law, and the 1890 Decree modifying the Corporation Law.

In the two decades 1870 and 1880, there was a period of outstanding development of capital markets and company investments in Brazil, ending in the financial crisis called "Encilhamento". There was a sentiment at the time that "bad" enforcement of these laws was partially responsible for the crisis. On the other hand, the new laws were praised as progressive and important for the industrial and financial development of the country. In order to evaluate the trade-offs involved, we apply the theoretical framework developed in the first part of the article.

Corporate Governance

Corporate governance, in modern times, has become not only an important new field of inquiry in corporate finance, but is also considered a factor for economic growth at the national level. In the past, however, the concept of corporate governance was not widespread, although the practice of some of its tenets was followed in corporate life.

Using a modern concept, we can define the system of corporate governance as establishing the rules and regulations that guide the behavior of controlling shareholders, board members, and the professional managers of corporations. Good governance can have a positive impact on profitability and overall economic performance, and attract investments in the capital markets for the company. Given the importance of corporations for the economy at large, good governance ends up creating more jobs and income for the country.

Corporate governance is based on a combination of the corporation laws themselves and enforcement of the respective rules and regulations. In general, the legal framework sets two main objectives: (i) to provide a system of economic incentives for managers, in order to align their actions with the objective of wealth creation for the shareholders; (ii) to define and establish rules and responsibilities and other accountability measures in order to provide a fair distribution of company profits among the main stakeholders (corporate managers, shareholders and creditors) and avoid that majority shareholders and other insiders use their power to extract value from minority shareholders, non voting shareholders, creditors, and others outsiders.

Corporate governance is a continuous set of actions and attitudes with the leadership of the

CEOs and oversight by the Board of Directors. The Corporation Laws set the legal framework and define the rights and duties of the stakeholders, but corporate government in a sense is the on-going enforcement of the norms and regulations under this law. Therefore, when a new corporate law is enacted, like the 1882 and 1890 pieces of legislation, it was implicit that with proper enforcement they would receive practical content and become an engine for the creation of profitable companies and for the attraction of large numbers of shareholders.

The Making of New Laws in Brazil

When one examines the economic history of Brazil in the last two centuries, one aspect that calls attention is the alleged low level of enforcement of regulations and laws, and an associated high level of corruption.

In countries like Brazil, we say that some laws "stick", while others exist, but are ignored. In others words, the enforcement of laws is uneven. The coexistence of laws that are enforced, or partially enforced, or not enforced at all is a typical aspect of the history of Brazil, and I suspect of other less developed countries as well.

Sometimes, it is claimed the country has a "low moral capital", or that the "culture" of the inhabitants is intrinsically tolerant - more than is desirable - for law breaking and corruption. I am using the expression "moral capital" to indicate the set of cultural and behavioral social attitudes translated into an honest conduct in the ordinary business of life. It is a new concept, and has the same nature as "human capital" or "social capital": it can be measured and treated as a stock, it can suffer depletion and depreciation, and can be built-up or replenished with new investment.

As economists and economic historians, we should be suspicious of such generalizations about the presumed intrinsic dishonest behavior of the population of Brazil. After all, the Brazilian population is a melting pot of different ethnic groups and varied cultural backgrounds. Perhaps, if we examine the macro and microeconomics of the decision process related to law creation and law enforcement, we can offer another explanation.

In this section we attempt a broad economic explanation of why laws are "good" and enforcement is "bad" in countries like Brazil, in order to use this theoretical framework for an analysis of the Brazilian corporation laws of 1882 and 1890. We want to propose the hypothesis that there is a conscious trade-off, in which the country adopts a "modern" law knowing beforehand that this new law cannot be totally enforced immediately, but only gradually.

We are using here a very broad definition of enforcement. Enforcement in a narrow sense is defined as to compel, sometimes obtaining obedience by threat. Enforcement is also defined as to execute the law with vigor. In this paper, we mean by "enforcement" the set of actions and devices allowing the rules and regulations to reach their goals. In this sense, it includes: (i) the building-up of the necessary pre-requisites for a proper enforcement; (ii) the actions needed to overcome the petty institutional bottlenecks which create obstacles; (iii) to change the existing micro-culture sometimes foreign to the new law, as it was the case when introducing a corporation law in the coffee plantation society of Brazil; (iv) to undertake the small investments needed to put the enforcement in order; (v) to create the ancillary means in order to get a credible response to the objectives of the "modern" law.

We want first to examine the issue of why developing countries choose more advan-

ced laws as "role models". Economic historians have done an outstanding work of studying the importance of technological progress for the economic development of regions and countries. In this context, transfer among nations of new technologies can foster economic growth in backward countries, as argued by Gerschenkron.

In my view, the same reasoning applies for the transfer of laws, rules and regulations from industrialized countries to less developed countries. As in the case of technology, the developing countries can profit from the experience of more developed countries, adopting their institutions and "skipping" stages for the creation of their own institutions. The major difference is that technology transfer occurs mostly at the company level of business decisions, while transfer of laws, rules, and regulations are made at the institutional and political level, involving society as a whole.

During the process of law making and adoption, there is a "borrowing" of laws, rules and regulations from more advanced countries, which set standards far above the ones which would be set only by domestic considerations given the prevailing culture of the country. However, what is not generally perceived, or when it is, is treated as a trade-off, is that the laws, rules, and regulations can be borrowed, but not the other institutional features that mold and cement the framework of enforcement.

The pressure to adopt "modern" laws can be induced either by domestic forces, as a sign of social progress, or by foreign initiatives from countries exerting cultural, political, or economic influence on the country that adopts the laws.

In the choice of the "role model", the developing country sets high aspirations for social or economic change to be obtained by the adoption of the new law. The new law is seen as placing an ambitious target, a bench mark for progress. It is an agenda for social reform or the modernization of the economy, establishing ambitious goals to be achieved. However, any "good" law needs "good" enforcement. It is not only a question of approving the new law. It has to be enforced. In other words, it is an ongoing process.

In addition to not meeting all the pre-requisites for a proper total enforcement, the "modern" law can create incentives for the individuals and companies affected to delay the enforcement. Some of the new laws can bring social improvements and foster the offer of merit goods, but can adversely affect production or consumption in the short run. For instance, new laws about child labor, environmental protection, food quality, etc. Other pieces of legislation may set equity goals that hurt efficiency goals. In some cases, non-economic (equity) considerations prevail over economic (efficiency) conditions in the "modern laws", reflecting the social progress pursued by the developed countries responsible for making the laws. We could list other situations, but the point to be made is that the new laws can create externalities, and give incentives to disobey the laws by taking decisions and actions based on private costs (benefits) rather than social costs (benefits).

We could summarize by saying that in some situations the companies perceive that by not obeying the laws the private costs are smaller than the social costs, and thus they can reach high production levels. From a pure economic standpoint, it is possible that production can be higher by not following all the rules and regulations.

In the industrialized countries, the process of law creation, in general, evolves gradually, and has an organic character. Law creation

and viable enforcement develop together. It is a harmonic process with the business activities or social reforms affected by the legislation. It usually proceeds with incremental advances of legislation, in tandem with marginal improvements in enforcement procedures.

Several of these laws, that have been tested and proven in the developed countries, are seen as "role models" by developing countries. The laws are studied, and often almost copied in their entirety. As a result, the new law in the developing country is born as a "supply shock" in the domestic culture, and without firm foundations for effective enforcement.

Theoretical Framework

Suppose L0 is the law (the "domestic" law) which would be consistent with the prevailing social, cultural, and economic conditions of the developing country, and apt to be totally enforced at once (E0). Suppose, instead, the country chooses a "modern" law, L*, with goals much more ambitious than the ones envisioned by L0.

There is a concern for enforcement of the new law, and it is assumed the enforcement will be gradual. We can think of a kind of flexible accelerator hypothesis, in which the larger the gap between L* and L0, the longer the time it will require to attain total enforcement.

The hypothesis is that, by consciously choosing the "modern" law, the country plans to close a fraction λ of the gap between the desired (E*) and actual enforcement each period. Denote the enforcement level at the end of last period by E-1. The gap between the desired and actual levels of enforcement is (E* - E-1). The country plans so that the enforcement level at the end of the current period E will be such that

$$E - E\text{-}1 = \lambda (E^* - E\text{-}1) \quad (1)$$

Equation (1) states that the country plans to have the enforcement level at the end of the period be such that a fraction λ of the gap between the desired (E*) and the enforcement level that existed at the end of last period is closed. Rewriting equation (1),

$$E = E\text{-}1 + \lambda (E^* - E\text{-}1) \quad (2)$$

Equation (2) shows that to increase the enforcement level from E-1 to E, the country has to make an effort to achieve more enforcement. We can say it has either to invest in "moral capital" or adopt innovations (mainly financial innovations in the case of corporate governance). The more the country invests in "moral capital", the more it closes the gap between desired enforcement and actual enforcement. Notice that, when choosing the "modern law", the country has to be realistic about the needed investments in "moral capital" to enforce the new law.

Trade-offs between Law Abiding and Enforcing Costs

In what follows, a simple theoretical model is sketched to show the tradeoffs between the quality of the laws enacted and the respective degree of enforcement.

Let us assume the country adopts a "modern" law. As seen in the last section, there will be a time interval until the law will be totally enforced. In order for the new law to be enforced, we can assume there will be two components of costs for society.

The first component is formed by the direct costs (regulation, auditing, accounting, surveillance, etc) for enforcing the law. We can call it control costs.

The second component is formed by the negative impact on the moral capital (including

self-esteem) of the country when laws are disrespected. This loss of moral capital is supposed to affect investments and decrease potential GDP. We can call it moral costs, translated in monetary terms as a depletion of the stock of moral capital.

Both cost components can be seen as monetary costs, the MCC with out-of-pocket costs and the MMC as opportunity costs expressed in monetary terms. Both curves are represented showing increasing marginal costs. They are increasing because enforcement costs rises more than proportionally when full enforcement is approaching, and moral costs have a contagious effect on risks and uncertainties of new investments.

We can represent the total marginal costs of enforcement (TMCE) as the sum of marginal control costs (MCC) and marginal moral costs (MMC):

$$TMCE = MCC + MMC \quad (1)$$

Figures 1(a) and 1(b) are graphical representations of the control costs (MCC). Figure 1(a) shows in the vertical axis the MCC in monetary terms, and in the horizontal axis the degree of law violation. From the left to the right the degree of law breaking increases, at to the point in which the law is totally disobeyed. Costs of enforcement are decreasing as we move to the right, till they are zero with zero degree of enforcement.

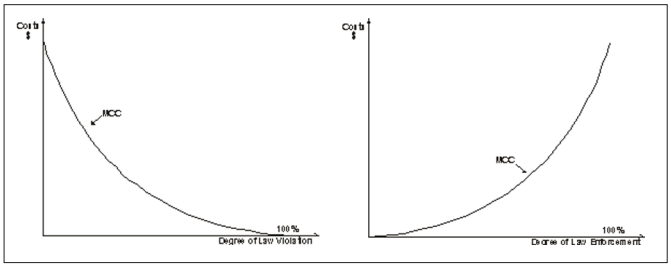


Figure 1a - MCC Figure 1b - MCC

Figure 1(b) is the mirror image of Figure 1(a). In Figure 1(b) the vertical axis is the same, but now the horizontal axis shows the degree of law enforcement. As we move from the left to the right, the degree of law enforcement increases, up to the point when we reach total enforcement. Marginal control costs increase more than proportionally with the strength of enforcement.

Figures 2(a) and 2(b) show the marginal moral costs (MMC). Figure 2(a) shows in the vertical axis the MMC in monetary terms, and in the horizontal axis the degree of law violation. From the left to the right the degree of law breaking increases, at to the point in which the law is totally disobeyed. Moral damage costs are increasing as we move to the right, till they are at a maximum with zero degree of law enforcement.

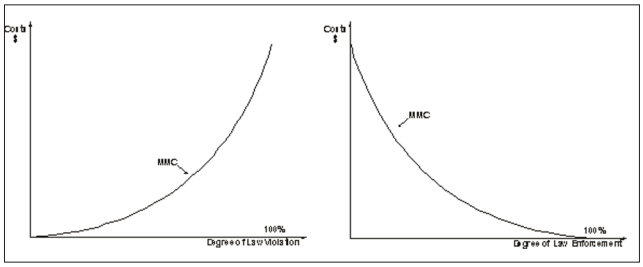


Figure 2a - MMC Figure 2b - MMC

Figure 2(b) is the mirror image of Figure 2(a). In Figure 2(b) the vertical axis is the same, but now the horizontal axis shows the degree of law enforcement. As we move from the left to the right, the degree of law enforcement increases, up to the point when we reach total enforcement. Marginal costs decrease more than proportionally with the progressive increase of enforcement.

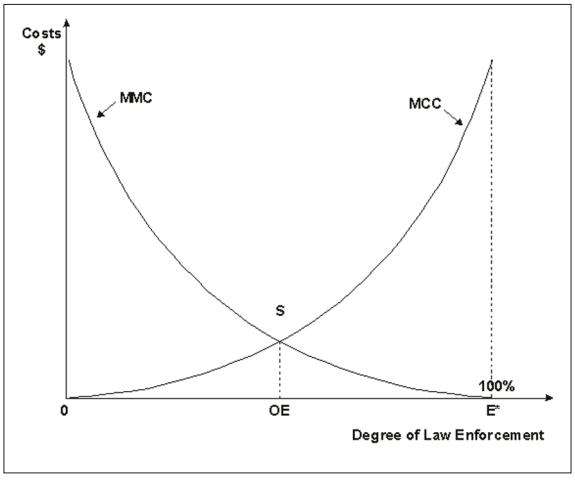
Optimal Level of Enforcement

Based on the considerations about the MCC and MMC curves, it

is possible to determine the "optimal" level of enforcement. We can interpret it as showing the expected degree of enforcement at the time the "modern" law is enacted.

Figure 3 shows a graph with both curves (MCC and MMC). In the vertical axis we have the cost in monetary terms, and in the horizontal axis we have the degree of law enforcement. However, we can give a different interpretation for the MMC curve. We can see it as a demand curve. The curve can be seen as showing the benefits to society of law enforcement, and, indirectly, of the strengthening of moral capital. In fact, we can interpret the MMC as revealing how much society would be willing to pay for not suffering the losses imposed by the demoralization of law. To have zero tolerance, it would be willing to pay the maximum price. As the degree of law observance increases, the willingness to pay decreases more than proportionally. Thus, in that sense, MMC can be interpreted as the Marginal Benefit Curve of law enforcement.

Figure 3 – Optimal Level of Law Enforcement



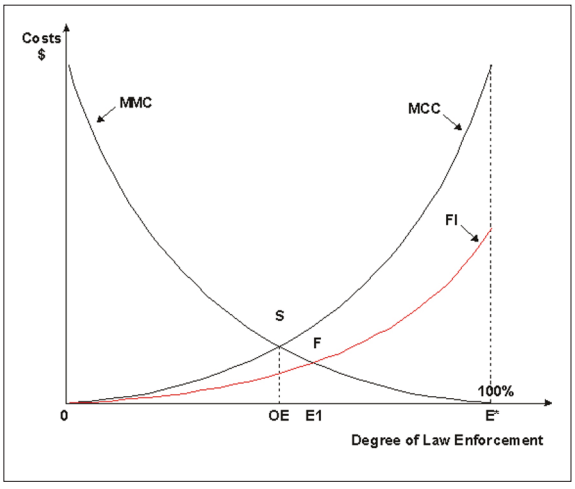
At the point S, where both curves cross, OE marks the "optimal" degree of law enforcement expected when launching the "modern" law. Total costs are minimized, as shown by the area OSE*. The point OE is a Pareto optimum, since any other point in the horizontal axis would imply an increase in total costs of enforcement.

Innovation and Changes in Preferences of Society

We can think of two main ways for having "modern" laws with better enforcement. In the first situation, the adoption of innovative instruments can reduce the control costs of enforcement. In other words, innovation in corporate finance may cause a shift of the MCC curve to the lower right. For instance, some new instrument that facilitates compliance or reduces agency problems, allowing the same level of corporate governance using fewer resources than before the use of such instrument.

In Figure 4 we present the effect of innovation on the optimal enforcement level.

Figure 4 – Effects of Innovation

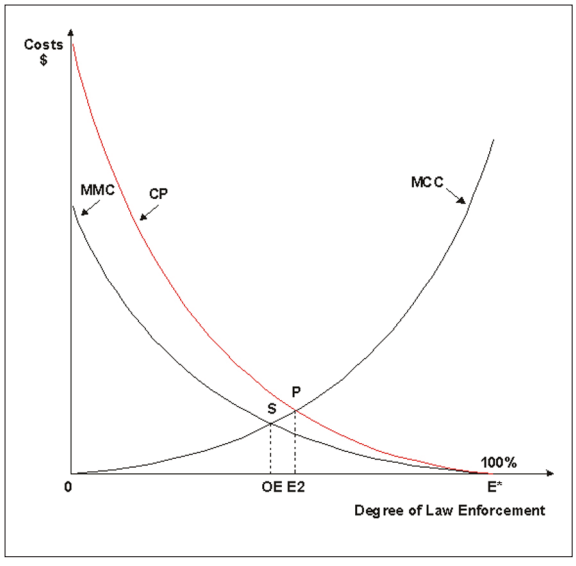


The decrease of costs, caused by innovation, is represented by a shift of the MCC curve to the lower right (From MCC to F1). The new equilibrium point (optimal enforcement) now

moves from S to F. The degree of law enforcement increases from OE to E1. Notice that with the innovation the total costs of enforcement decrease by the area OSF. It is a double achievement: a decrease in costs and an increase in the degree of law enforcement.

The second situation is a result of a change in the preferences of society regarding the importance of improving moral capital. Suppose society decides to invest more real resources in order to achieve a positive increment in the stock of moral capital. In Figure 5, we represent the increase in demand for moral capital as the shifting to the upper left of the MMC curve. The new equilibrium point (optimal enforcement) moves from OE to E2. In this situation, however, the increase in enforcement comes together with an increase in total costs of enforcement.

Figure 5 - Effects of Changes in the Preferences of Society



Social, Political, and Economic Transformation of Brazil in the 1880s: Changes in Preferences and Financial Innovation

As an example of the application of the above analysis to historical events, we examine the Corporation Laws of 1882 and 1890. I consider these laws an economic. political and social turning point for Brazil during this period, as well as a major event in financial development.

The first question is why the country decided to have a "modern" corporation law. E.Bradford Burns, a historian who wrote a standard reference book on Brazil, states that:

> In 1888, a decade of significant changes exploded. The abolition of slavery marked the opening of that decade; the cataclysmic destruction of the folk society at Canudos closed it. The years between witnessed the overthrow of the monarchy, the establishment of a federal republic, the separation of church and state, the entry of the cities and the middle class into politics, the embrace of industrialization as an economic panacea, and an official shift of economic and political power to the southeastern states, in particular the recognition of the importance of São Paulo within that triumvirate…the changes between 1888 and 1897 shared a common denominator: modernization. Their conglomerate recognized the end to the centuries ambiguously combining neo-capitalism and neo-feudalism. Their conglomerate celebrated the triumph of capitalism and modernity…In some ways concluding three and one-half centuries of history and in other ways initiating trends that would characterize the twentieth century, this single ten-year period of change stands out as unusually significant for any interpretation of the history of Brazil (BURNS, 1993, 197/198).

Thus, we can see the demand for having a modern law was present in the domestic scenario. Brazil in the 1880s was experiencing im-

portant changes. The coffee economy was very strong, in spite of the world crisis of 1873. Coffee exports rose from 286.8 million tons in 1880 to 313.1 million tons in 1890, and revenues in sterling grew from 11.6 million in 1880 to 17.8 million in 1890 (Mello, 1977, p.39). From an 1819 population around 4.6 million, Brazil had grown to 9.9 million in 1872 and to 14.3 million in 1890 (MELLO, 1977, ch.2).

The main political issues were slavery and monarchy, and in both fronts the country was able to promote peaceful transitions. Large numbers of immigrants from Europe, over 2.3 million in the two decades of the 1880s and the 1890s, made possible a huge increase in the labor supply. As a consequence, the abolition of slavery was accompanied by partial replacement of slaves by immigrants, without a decline in coffee cultivation and exports; cities and markets grew steadily during these years. The growth in the number and importance of large companies will be seen shortly, but the point to emphasize is that the corporate form of business, and the channels it provides for attracting outside capital for investments, were strong factors contributing to introduce "modern" laws.

The other source of pressure for a "modern" law came from abroad, basically from Great Britain. During this time, companies from diverse segments were listed and traded on the Rio de Janeiro Stock Exchange, and later on other stock exchanges, particularly São Paulo. These segments included railroads, ports, tramways and other transportation investments; electricity production and distribution; commercial banks; textile factories; sugar mills, and others. Several historians consider that Brazil, as well other Latin American countries like Uruguay and Argentina, were, during that time, in economic terms, part of the "informal" British Empire. Thus, the capital markets of Brazil had a close relationship with British investments and investors. Several Brazilian companies even had dual listing and traded both on the London and the Rio de Janeiro stock exchanges.

Corporate governance, in a modern sense, started and developed in Brazil during the last 20 years. One of the main reasons for the rise of corporate governance was the participation of Brazilian corporations in the emerging markets, in which international (mainly institutional) investors play a major role. By analogy, since our period of studies marks a phase of intense foreign investment (mainly British) in shares of Brazilian companies, corporate governance – even by a different name – must have been an important subject.

The main hypothesis to be dealt with is that in the enforcement of the laws, and not in the laws themselves, there were huge differences in corporate governance between Brazil and Great Britain. We can conclude that the financial innovation occurring in Europe could be used by Brazil for enacting "modern" laws.

Brazilian Joint Stock Companies in the late 1880s

Although economic activities in Brazil in the 19th century were primarily agricultural, by the 1870s and 1880s an important host of industrial and service activities had already emerged. A government survey in 1866 found 43,585 commercial and industrial businesses in Brazil. A further survey in the same year on 20,930 industrial and commercial establishments found that 17,503 of them were owned by single individuals, and 3,427 (or 16.4 percent) were companies with a divided share capital (MELLO, 1977, 131).

In the following year (1867) another government survey was made regarding the

number of companies with shares floated and publicly traded on the capital market. A total of 69 companies was found (railroads, insurance, navigation, gas lighting, mining, water supply, turnpikes, market plazas and others), with total nominal capital equivalent to 10 million sterling. Of this total, 20 were foreign owned companies, with an average capital of 303,459 sterling and 49 were Brazilian owned companies, with an average capital of 83,165 sterling (MELLO, 1977, 132).

In 1887, 5 years after the corporation laws of 1882, the government published another survey of the joint stock companies. By that time, or during the two decades after the 1867 survey, their number had increased to 135 companies, with a total capital equivalent to 25 million sterling. They had also diversified, as can be seen in Table 1.

There was an active market for the bonds and shares of a number of joint stock companies on the Stock Exchange of Rio de Janeiro. The "Retrospecto Commercial" annual re-

Table 1 – Joint Stock Companies in Brazil, end of 1886 Total Number and Capital According to Economic Activities (value thousand mil réis)

Economic Activities	Number	Capital
Railroads	14	51,356
Banks and Saving Institutions	13	87,400
Insurance (maritime and others)	13	32,500
Street Cars	13	25,600
Textiles	15	12,310
Navigation	5	11,300
Mining	6	6,900
Central Sugar Factories	9	6,300
Docks	2	6,000
Immigration and Colonization	5	5,000
Water Supply	2	3,700
Electricity and Telephones	4	3,350
Industrial Manufacturing	6	2,878
Building Construction	6	2,675
Carriages and Coaches for Rental	1	800
Amusement Parks	4	254
Metal and Ceramic Artifacts	4	338
Dynamite	1	180
Mutual Assistance Insurance	2	105
Laundry	1	100
Knife Manufacturing	1	45
Agricultural and Husbandry	1	8,000
Brokerage	1	1,000
Commerce and agriculture	1	800
Market Plaza	1	500
Zoological Garden	1	263
Commerce of Lotteries	1	200
Educational Institutions	1	50
Real Estate	1	25
TOTAL	**135**	**269,929**

Source: Relatório do Ministério da Agricultura, 1887

Table 2 – Average Yearly Rates of Return on the stocks of various economic activities, transacted in the Rio de Janeiro Stock Exchange, in the years of 1877, 1878 and 1882

Economic Activities	Realized Capital 1878 (thousand milréis)	Rate of Return 1877	Rate of Return 1878	Rate of Return 1882
Banks	72,132	16.98	15.46	6.47
Railroads	24,676	-3.46	10.32	-4.25
Street Cars	11,200	8.43	11.78	10.19
Navigation	7,432	35.84	30.25	12.48
Insurance	25,800	16.18	25.36	29.94
Private Turnpikes	1,980	10.65	13.34	2.95
Market Plazas	1,000	2.64	-1.30	0.26
Gas Lighting	8,100	20.02	-20.12	-5.20
Others	23,601	-3.61	27.56	-1.72
TOTAL	**175,921**			
Simple Average of Rates of		**11.52**	**12.52**	**5.12**
Return				
Weighted Average (by capital) of Rates of Return		**11.47**	**16.45**	**6.45**

Source: MELLO, 1984

view of the Jornal do Commercio published for many years the capital stock, the number, par (nominal) and market value of shares and bonds, and the nominal dividend rate. In a previous published article, I examined the capital markets of Brazil during that time from the view point of the calculation of financial rates of return (Mello, 1984). Based on that article, we present in Table 2 the Invested Capital of the 65 companies, with a total capital of 176 million milréis or 17 million sterling, and the average yearly rates of return on investment in various economic activities with shares traded on the Rio de Janeiro Stock Exchange in the years 1877, 1878 and 1882.

Mello used another source, the information contained in the London Stock Exchange Year Book, to produce a sample of the joint stock companies listed in London, some of which had their legal domicile in England, but which had operations only in Brazil. Several of the shares had dual listing, on the stock exchanges of London and Rio de Janeiro. With this information, Mello listed the number and capital of British investments in joint stock companies in Brazil in 1888, presented in Table 3.

Mello, in his Ph.D. dissertation, estimated that the grand total of Brazilian owned capital invested in Brazilian joint stock companies in 1888 was around 39 million sterling. When comparing this value with the almost 47 million sterling of British investments in Brazilian joint stock corporations, the importance of British investments in Brazil is placed in perspective. (MELLO, 1977, 139/140).

Table 3 – British Investments in Joint Stock Companies in Brazil, 1888

ECONOMIC ACTIVITIES	NUMBER OF COMPANIES	Capital I Thousands of Sterling
Railroads	21	30,047
Shipping and Ports	17	3,398
Gas, Water Drainage and Tramways	20	4,804
Telegraph	3	2,805
Banks	3	3,446
Mining	7	988
Miscellaneous	9	1,103
TOTAL	**80**	**46,591**

Source: MELLO, 1984

Evaluation of the Enforcement of the Corporation Laws of 1882 and 1890

Comparing the corporate governance provisions existent in the Brazilian Corporation Laws of the 1880s with what is conventional corporate governance today, there are striking differences in focus. Although the basics of provisions for information disclosure, accountability ("conselho fiscal", or board of auditors), CEO rules of conduct in managing the company, and others, were there, I would assess that the major concern revealed by the laws was with prevention of a systemic risk for the economy created by low capital and excessive leverage.

In order to understand the preoccupation of 19th century law and policy makers with the corporate form of business organization, we need to have a historical perspective. We need to know more about the debate about corporation and joint stock companies in the second half of the 19th century, the course of industrialization, and the need for large investments made possible by the capital markets.

According to Cameron, already in the 16th century England and Netherlands had started joint stock companies (CAMERON and NEAL, 125). In the 17th century, in France, Minister Colbert codified commercial law, with the Ordinance of Trade (1673), and created monopolistic joint-stock companies (CAMERON and NEAL,150). During the initial years of the 18th century, two major financial crisis hit France (the

Mississipi Bubble) and England (the South Sea Bubble). One of the reactions after the crises was to create legal barriers against the joint-stock or corporate form of business organization. The legal barriers in England would only be lifted in the sixth decade of the 19th century (CAMERON and NEAL,169). In 1807 Napoleon Bonaparte promulgated the Code of Commerce, regulating business enterprises. One of the forms of business organization was the "societé anonyme" (limited liability corporation). In 1867, France abolished the need for authorization to grant corporation charters, and adopted free incorporation (CAMERON and NEAL, 2003, 209). Brazil adopted similar laws, with the Commercial Law of 1850 creating the institution of "societé anonyme", and in 1882 and 1890 with the improvement of the concept of "societé anonyme" and the creation of joint stock companies with extended freedom for incorporation. The next

Table 4 – Corporation Laws of Brazil, 1872 and 1890

Corporation Laws of Brazil	Main Provisions	Comments about Corporate Governance
Law number 3150, November 4, 1882 (Empire of Brazil)	• Definition of need for authorization for establishing corporations • Number of 7 partners as the minimum • Defines prudential rules for completeness of capital • Establishes publicity rules for major corporation acts • Establishes rules and duties for managers • Defines conflicts of interest and honest rules for behavior by managers • Defines the rights of shareholders and convocation of General Assemblies • Defines profit distribution for shareholders • Establishes the role and duties of a Fiscal Board • Establishes rules for emission of shares and corporate bonds • Establishes rules for shareholders responsibilities in the case of company failure (bankruptcy)	• Most articles set standard rules for corporate governance • In comparison with the modern corporate governance, there is not a concern about possible agency conflicts • The concern is about the honesty of the manager, and not if the performance is aligned with the objective of maximizing the wealth of shareholders • In my view, what is evident is the concern for the corporation to act responsibly in the country, and that the shareholders have responsibility for the company acts • The major device to align shareholders with corporate responsible behavior was through capital completeness requirements • Shareholders were required to deposit in currency at least 10% of the nominal value of the share, and while the capital completeness of the share value was under 25% the share was nominal and had restrictions to be traded in the secondary market • In my view, it was the main piece of governance, and the target were not the minority shareholders, but the economic and financial soundness of the corporation vis a vis the rest of society • Enforcement of this requirement was poor
Decree number 8321, December 30, 1882 (Empire of Brazil)	• The Decree gives a detailed description of how to obey the articles in the Law N. 3150 • Defines what kind of business can be incorporated • Defines what corporations still need government approval • Explains the provision of reserved liability, by which in case of failure of the company the shareholders who had paid only one fifth, had to pay the remaining four fifths, or have their assets seized and auctioned	• Defines that "the companies, or societé anonymes, are distinguishable of other species of societies due to the division of the capital in shares, by the limited responsibility of shareholders, and by the need of having, at least, seven partners" • "All sectors of commerce or industry, or agricultural companies, and all services of commercial or civil nature can be organized as corporations, with the exception of business contrary to law, moral and good customs" • All corporations could be created without government approval. The exception was banks, religious associations, food retailers and foreign companies. In order to become companies they needed government approval.
Decree number 164, January 17, 1890 (Republic of Brazil)	• The Decree expanded the list of financial institutions requiring government authorization: banks of circulation, banks of real credit, saving companies, saving banks • Increased the responsibilities of company managers • Increased the rights of shareholders	• The major feature of this Decree, in my view, was to free the creation of banks of the existing contols • With the Decree, instead of approval by the Chambers, now they needed only executive government approval • As a hypothesis, we can view this lack of governance as conducive for abuses and excessive leverage of capital • In consequence, banks could leverage money creation. Inflation and financial crisis ("Encilhamento") was the result

important innovation was to extend the concept of corporation to commercial banks. This was also followed in Brazil in 1890, and it was one of the main factors for the financial crisis of the "Encilhamento".

There were three important pieces of legislation, and Table 3 presents them, and their major features. Law 3150, of November 4 1882, had the stated objective of regulating the establishment of companies and "societé anonymes". The law has 42 articles, and was approved by the General Assembly of the Empire of Brazil, the supreme decision making body including the Senate and the Chamber of Deputies Decree 8321, of December 30 1882, has 168 articles, establishing the details for the operation and enforcement of Law 3150. It was promulgated by the Emperor of Brazil (Dom Pedro II), based on constitutional powers given by article 102, paragraph 12 of the Political Constitution of the Empire. The final piece of legislation was Decree 164, of January 17 1890. The objective of the Decree was to reform Law 3150. The Decree has 43 articles, and was produced about two months after the Proclamation of the Republic of Brazil. The Decree was headed with the following preamble: " Marshal Deodoro da Fonseca, Chief of the Provisional Government of the Republic of the United States of Brazil, constituted by the Army and other Military Forces, in the name of the Nation". This preamble of this Decree, in a sense, signalizes that the role model for Brazil (now the "United States of Brazil") switched from Great Britain to the United States of America.

Conclusions

To conclude this article, I would argue that the corporate governance of these Corporation Laws had as its first priority the achievement of liability financial behavior on the part of the companies. Since the shareholders had limited responsibility, up to the capital invested in the company, the Corporation Laws were concerned that the shareholders would effectively pay in the full amount of the capital. The permission to trade shares subscribed, but not paid in, on the secondary market was contingent on the payment of minimum tranches of capital to complete the nominal value of the share, calculated in relation to the "authorized capital".

The evidence presented or mentioned by several commentators indicates poor enforcement (it seems fraudulent behavior was widespread) of the two major restrictions: to not pay in the capital subscribed, and to trade the shares before meeting the minimum paid in capital requirements.

As we argued in the beginning of the article, perhaps there was a conscious decision to relax the enforcement of the new laws. By not fully paying in the capital subscribed, the capital of the shareholders could be leveraged, and they could acquire more shares than their income would allow. This would create more public offerings and trading on the capital markets.

As we saw, the country's economy was changing fast, companies were founded, the domestic market was expanding with immigration and abolition of slavery, the coffee market was booming, and the economy needed large amounts of capital to finance the new ventures. The trade off was to enlarge the capitalization of companies and the leverage of shareholders' investments, by lenience on enforcement of capital requirements, and a blind eye for what was happening in the market.

The financial crisis of Encilhamento is claimed to be a result of this lack of control. There is a hot debate in Brazil about the causes of the Encilhamento (see Schulz, 1996 and Suzigan, 2000). As a contribution for this debate, I would argue the following:

the two pieces of corporation legislation of 1882 had a positive net impact on the establishment of new ventures, and the investments in the primary issues of corporations;

the 1890 Decree, in that it encouraged the creation of banks with the power to issue money, perhaps failed in the task of "macroeconomic governance". The growth of the banks of issue probably provided too much money to the economy in a short period, even considering that the economy was transforming from a slave "low money" economy to a "high money" market economy;

the lack of governance, in a sense, was partially responsible for the overshooting of the money supply, the inflationary pressures, and the financial bubble in the stock market;

if we return to the Equation (1), which states that "the country plans to have the enforcement level at the end of the period be such that a fraction λ of the gap between the desired (E*) and the enforcement level that existed at the end of last period is closed". Accepting the model, the problem of the 1890 Decree was not the lenience about enforcement, since it was expected and part of the "rationality"

of the introduction of a "modern" law. My hypothesis is that λ was not properly managed or forecasted.

In my opinion, as a contribution to economic growth and development of the primary market of shares negotiated on the Stock Exchange, the 1880s and 1890s were more relevant for capital market development than the other decades that followed, up to the present day.

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