QUO VADIS SERBIA

INTRODUCTION

The new government of Serbia has a formidable task of rebuilding the country after sixty years of socialist rule. Property rights in business firms, the choice of business organizations, and the way in which they are to be governed is certainly among the most critical decisions the new government has to make. The critical distinction is between business organizations that have to prove themselves in competitive markets and those that the government protects from competition. In this paper, I would like to make a contribution to discussion about business firms in post-socialist Serbia. I will concentrate on the importance of governance structures, the remarkable success of the corporate firm, and the dangers of industrial democracy.

THE CHOICE OF GOVERNANCE STRUCTURES

I conjecture that the choice of the governance of business firms is quite important for the future performance of the economy.

The rules imposed by *fiat*, regardless of how well they might be designed, freeze governance structures into a rigid system. In effect, they substitute preferences of rule makers, that is the individuals who bear no costs of their decisions about the rules, for internal contractual agreements among the holders of property rights in the enterprise, that is the individuals who bear the costs of organizational choices.

Alternatively, the government could provide stable property rights in resources and the freedom of contract. Stable property rights and credible contracts, in turn, give the holders of property rights the freedom (a) to choose what kind of firm they want to have (e.g., corporation, partnership); (b) to decide whether they want a centralized or decentralized firm, inside or outside directors, a strong director or a strong board; (c) to determine the method of rewarding performance (stock options, cash bonuses, premium over market wages, non-cash benefits such as long holidays, etc.); and (d) to specify trade-offs between profit and other objectives (as the York Times and the Wall Street Journal have done).

We observe many different governing structures in the United States. In some firms, boards of directors specialize in handling crises, others appoint top managers from among their members, some boards are involved in day-by-day operations, while others prefer to remain more detached. All those different governance structures have emerged through voluntary contractual agreements and passed the market (survival) test. The survival of alternative governance structures is the best evidence that no two firms are alike. That is, no single model can specify the best governance structure.

The American Law Institute, a Philadelphia based non-profit legal research center made the most comprehensive attempt in 1983 to promote a single model of corporate governance under the title: ***Principles of Corporate Governance and Structure: Restatement and Recommendations.*** The proposal was quickly rejected. The board of directors of the New York Stock Exchange refused to vote on the proposal. A leading American Executive said that lawyers could not tell business executives how to run corporations. And Professor Stigler, a Nobel Laureate, argued that the American Law Institute has no right to decide how American business is to be managed.[1]

It is also plain wrong to argue that the state could help business enterprises by enacting a set of rules reflecting the evolving trend in the governance of business firms. Given credible property rights and contractual freedom, no firm needs the law in order to adapt to emerging practices. In fact, many firms need to be free to deviate from the trend in order to perform better in competitive markets. Analysis and empirical observations suggest that the best way to develop governance structures for business firms is to let the holders of property rights act in accordance with *their* judgment of *their* firm's survival needs.

[1] See Pejovich, S. **Corporate Democracy: An Economist's Critique of Proposals for Corporate Governance and Structure,** Washington Legal Foundation: Washington D.C., 1983.

For example, in a large manufacturing firm in Dallas, four out of thirteen members of the board are former employees ("inside" directors). Two members of the board are current employees (chairman of the board and the president) of the Company. Remaining seven members of the board are "outside" directors selected for their accomplishments in finance, business and academics. As a condition of their tenure on the board, "inside" directors must seek membership on the board of other firms.

THE CHOICE OF BUSINESS FIRM

Labor Participatory Firm

Industrial democracy is an umbrella for all the different forms of labor participation in the governance of business firms. Evidence shows that industrial democracy has not emerged voluntarily on any significant scale and has failed to perform successfully whenever and wherever imposed by *fiat*. Yet, some members of new government, such as Miroslav Labus, have been suggesting that labor participation in the governance of business firms is a viable alternative for Serbia. The reason for their behavior is quite simple: industrial democracy offers many rent-seeking opportunities for those in power, and satisfies many ideological preferences among socialists and left-wing intellectuals to be discarded for such a trivial reason as the lack of economic performance. One of the best economist of our era, late Karl Brunner, wrote:

> The sacrifice of cognition is particularly easy to detect in the objections to the market system induced by discrepancies between one's desires, glorified as social values, and the result of market processes. However, our ability to visualize better organizational arrangements, more closely reflecting our preferences, yields no evidence that those arrangements can be realized.[2]

The fact that labor participation in governance has to be mandated by the government and protected from competition is the convincing evidence of its inefficiency. A major source of this inefficiency lays in the fact that by weakening the right of ownership, all

[2] Brunner, K., Knowledge, (1970): **Values and the Choice of Economic Organization**, Kyklos, 23.

the different forms of industrial democracy create a gap between private and social costs of using scarce goods. If labor participation had positive effects on the firm's productivity, why don't we observe the labor participatory firm on a significant scale? Why don't shareholders negotiate with employees a contract that would make both groups better off? If labor participation has to be mandated by law, on what scientific (non-normative) ground can we assert that it is a superior method for organizing production? There is no law in the United States that says that there shall be no labor participation. Indeed, there are cases in which labor participation has emerged voluntarily, but it has not happened on any significant scale.

Germany is a good case for analysis of the consequences of involuntary labor participation in the governance of business enterprises. The Codetermination Act of 1976 in Germany—a capitalist version of the labor-managed firm--applies to all business firms that have more than 2,000 employees. The supervisory council (i.e., the board of directors) for such firms has twelve members, of whom six are representatives of the shareholders and six are representatives of the employees. The chairman of the supervisory council is elected by the shareholders and holds the deciding vote in case of a deadlock.

Empirical evidence is simply not consistent with the claim that codetermination bestows benefits on workers without any detrimental effects on other members of the team. Immediately after the passage of the Codetermination Act of 1976, many business firms tried to escape the parity representation on the supervisory board through mergers, reorganizations, moving their headquarters abroad, and other structural changes. In the late 1970s, codetermination applied to about 650 firms. By the early 1980s codetermination covered only about 480 firms. About 120 firms had reduced their labor force below the 2,000 limit, while about 50 firms had changed their corporate charters. Assuming that both the size and contractual forms of those 170 firms reflected efficient business decisions, the post-1976 adjustments are a social cost of codetermination.

Jensen and Meckling summarized the economic effects of involuntary constraints on the freedom of contract in the following passage:

> Indeed, labor can start, and in rare cases has started firms of its own. Moreover, firms are free to write any kind of contracts they wish with their employees. If they choose to, they can offer no-dismissal no lay-off contracts (tenure at universities). If they choose to, they can establish worker councils and agree not to change production methods without worker approval. Moreover, employers would [encourage] such practices if the benefits exceeded the costs. Furthermore, if laborers value the security and "self-realization" which such participatory arrangements afford them at more than their costs to the employer, they are in a position to offer voluntary changes, which it will pay the employer to take. ...Since those arrangements are [rarely] observed, we infer that workers do not value the security, management participation, etc. at more than the cost of providing them [emphasis mine]. [3]

The Corporate Firm

In the United States, we observe a large number of different types of business firms such as single proprietorships, partnerships, corporations, mutuals, not-for-profit firms, cooperatives, etc. All those firms have emerged through voluntary contractual agreements and survived competition from other types of firms; that is, law mandated none of those types of business firms. They reflect the freedom of individuals to write any kind of contract they wish with each other and bear the costs (risk) of their choice. The corporate firm, by far the most successful type of wealth-producing business organization, is a product of this competitive environment. The issue is why has the corporate firm done so well? I conjecture that the advantages of the corporate firm over other types of private ownership firms arise from three critical factors: the rule of limited liability, the dispersion of shareholding, and the market for corporate control. Let me briefly describe the meaning and consequences of each of them.

The Law of Limited Liability. Mass production of goods, production of durable goods, production of heavy machinery, the implementation of new technologies, innovations, and many other investments and commercial activities require pulling together large amounts of capital. Banks could not satisfy this huge demand for capital without driving interest rates to a level at which many opportunities for economic growth would fail to be exploited. We have enough research and empirical evidence to know that the state can neither raise *voluntarily* large amounts of capital nor be trusted with the use of investable funds. Except in frictionless blackboard models, state ownership provides strong incentives for the allocation of resources to by-pass the market test.

In response to economic pressures from within the system, numerous contractual agreements were tried in order to resolve the need for pulling together large amounts of capital. Eventually a new legal concept evolved the rule of limited liability.[4] By limiting each owner's (i.e., equity investor's) liability to the market value of his investment in the firm, the law created incentives for equity investments to be divided into small shares and traded in financial markets. That is, breaking up equity interests into relatively small shares, corporate firms were able to attract funds from small savers. The advantage derives from the anonymous alienability of shares, which enables shareholders to sell their shares without requiring the approval of other shareholders. By contributing to a substantial reduction in the transaction costs of raising large amounts of investable funds, the rule of limited liability made the

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[3] Jensen, M; Meckling, W. (1979): **Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination**, Journal of Business, 52: pp. 472-3.

[4] An excellent source is Easterbrook, F; Fischel, D. (1991): ***The Economic Structure of Corporate Law***, Harvard University Press, Cambridge, MA. For a different analysis of the rule of limited liability see R. Ekelund, R.; Tollison, R. (1981): ***Mercantilism as a Rent-Seeking Society***, Texas A&M University Press, College Station, TX.

corporate firm *the most effective method of* <u>*voluntarily*</u> *gathering large amounts of capital for long-lived ventures.* [5]

The Dispersion of Shareholding. Starting with the dispersion of shareholding, which is a fact of life, A. Berle and G. Means[6] developed the separation of ownership and control thesis. The separation thesis quickly acquired a strong following among the critics of capitalism, who routinely ignore the difference between one's desires and the reality of market processes. For many years, Branko Horvat from Croatia and Mihailo Markovich from Serbia blamed private ownership for transforming humanity into a horde of profit-seeking beasts. Today, they argue that the dispersion of shareholding has already socialized private property rights in business firms. Nothing could be further from the truth.

The separation thesis basically says the following: The dispersion of shareholding insulates the management from the owners. Thus, the right of ownership is empty because the shareholders have no control over the use of their resources. Managers control resources, make decisions affecting shareholders' wealth, and can easily protect themselves by soliciting proxies at the company's expense. If all of the above were true the observable consequences of the dispersion of shareholding would have to be (1) withering away of private property rights in the corporate firm; (2) the transfer of a part of the residual (i.e. shareholders' wealth) to managers; and, by implication (because of lower rates of return), (3) reduced flow of capital into business firms with dispersed ownership.

Empirical observations are consistent with none of these three outcomes. The fact is that millions of individuals continue to invest in common stock. Why do they not choose other investment opportunities that exist in the United States? Why is equity financing not being driven out by investments in fixed claims? Why do we not observe

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[5] See Easterbrook, F.; Fischel, *D.* (1991): ***The Economic Structure of Corporate Law***, chapter 2.

[6] Berle, A; Means, G. (1933): ***The Modern Corporation and Private Property***, Macmillan, New York.

a lower bid price for stocks of corporations with dispersed ownership relative to those firms that have less dispersed ownership? Why do dispersed ownership corporations not have lower rates of growth of shareholders' wealth?

The Benefits of the Dispersion of Shareholding. The dispersion of shareholding is, in fact, an important source of the efficiency of corporate firms.

1. There is no law in the United States that says that people have to buy shares in corporate firms. It is their reversible choice (and they themselves bear the costs of making a bad one). And they have many other alternatives for their savings. It means that people who buy shares *voluntarily* separate themselves from controlling their property. And they do that for a good reason. They voluntarily transfer their resources to those who, in their judgment, are good in making money. That is, shareholders choose to specialize in bearing the risks. Managers are individuals who specialize in managing the risk. *The dispersion of shareholding is then fully consistent with the law of comparative advantage.*

2. In the United States, even small savers can diversify their investment portfolios and avoid the firm-specific risks. The separation thesis then “leads to *lower capital costs for firms in the economy*, and to greeter innovation, as shareholders are capable of investing in riskier ventures due to their ability to mitigate such risk through diversification.”[7]

3. The fact that shareholders have incentives to include innovative ventures into their portfolios means that the dispersion of shareholding is *a source of capital for small start-up companies.*

4. The diffusion of ownership provides the funds required for economic growth *without a concentration of economic power* within a society. An alternative is a

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[7] Macey, J. (1998): **Gli Stati Uniti: Un Paese Senza Legge**, ***International Centre for Economic Research Working Papers***, Torino, Italy. 17/98, p. 2.

concentration of share ownership in the hands of the state or state protected rent seeking coalitions.[8]

5. The separation thesis contributes to the *development of a large middle class with significant and diversifiable stakes in the economy*. Highly competitive money managers who quickly punish non-performing firms by selling their shares in financial markets represent this group, which includes millions of retirees.

The Costs of the Dispersion of Shareholding. Berle and Means were right in saying that the dispersion of shareholding has its costs. But, the fact that the corporate firm has continued to prosper could only mean that the benefits of the dispersion of shareholding exceed its costs. Let us now identify those costs and the circumstances upon which they depend.

Major costs of the dispersion of shareholding are the transaction costs of monitoring managerial decisions that affect shareholders' wealth, and the costs of hiring and firing corporate managers. Given their estimate of transaction costs, corporate managers should then be able to transfer some wealth from shareholders to themselves. They can do that in a variety of ways such as liberal expense accounts, plush offices, company planes, large number of beautiful (but not necessarily efficient) secretaries and receptionists, pleasant co-workers, opportunities to contribute to the causes they believe in, and so on. The consumption of those goods increases managers' total income over and above their contractual pay, and is conveniently reported as the cost of doing business.

An observable implication of the separation thesis should then be a negative relationship between the dispersion of shareholding and the shareholders' gains in wealth; or--the same thing--a lower bid price for stocks of corporation with dispersed ownership. However, academic research and empirical evidence have demonstrated that no statistically significant relationship exists between the dispersion of shareholding and the shareholders' gains in wealth. Clearly, the private-property free-

[8] *Ibid*. p. 3.

market economy creates incentives to reduce the transaction costs of monitoring managerial decisions. To understand those incentives, we must turn to the market for corporate control.

The Market for Corporate Control. The market for corporate control has an important consequence: it assures thousands of seemingly powerless shareholders that their wealth is well guarded. Three important ways in which that is done are:

1. In competitive (i.e., non-regulated) *financial markets,* market valuation of the expected future consequences of current decisions by corporate managers raises their costs of making decisions that are contrary to the interests of shareholders. With bounded rationality and positive transaction costs, market evaluations of the future consequences of current decisions are often wrong and are continuously modified. However, the critical factor protecting shareholders is that the (top) manager knows that his decisions are immediately scrutinized in financial markets, and that market (ex ante) valuations of the expected effects of those decisions on the profitability of his firms are quickly incorporated into stock prices. That is, financial markets raise the manager's costs of pursuing activities that deviate from the profit-seeking behavior or--the same thing--guard the shareholders' wealth.

2. *The opportunity costs* of corporate managers depend on the profitability of business firms they manage. That is, the present value of a manager's future earnings depends on the current profitability of his firm. An implication is that the pursuits of objectives other than the shareholders' wealth are costly to the manager in terms of his future marketability. The opportunity to pursue his preferences at the expense of potential profits has to appear to the manager as a choice between more utility now or more income tomorrow.

3. *Hostile takeovers* are the most effective mechanism by which the market for corporate control assures shareholders that their wealth is well guarded. By disciplining corporate managers, hostile takeovers have increased the operating efficiency of corporations, their employee productivity, and their shareholder value. Macey wrote: "The threat of a takeover creates a positive externality as managers of

all firms, even those that are not subject to an outside bid, have incentives to maximize share value in order to reduce the arbitrage possibility for outside bidders, and thereby retain their posts."[9]

4. CONCLUSION

My impressions are that new rulers in Serbia are most likely to end up making small marginal changes in the prevailing government dominated system. How else could one explain a recent statement by the prime minister of Serbia that the government needs to establish new dynamic agencies to replace slow moving ministries. That is an old socialist principle: Got a problem? Run to the state! Of course, we know from Milton Friedman, public choice scholars, socialist experiments in Nazi Germany and communist Eastern Europe, and costly welfare program in Western Europe that the cost of bureaucracy is not the money we pay them but the consequences of their policies. An alternative approach for economic reformers is to focus on the development of the rule of law (after decades of socialism it will take time for people to realize that the law could be credible), an independent judiciary (it will also take time to train new judges), and economic freedoms (credible and stable property rights. Freedom of contract, and a minimal state).

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[9] *Ibid*, pp. 6-7.