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Volume Title: Governance, Regulation, and Privatization in the Asia-Pacific Region, NBER East Asia Seminar on Economics, Volume 12

Volume Author/Editor: Takatoshi Ito and Anne O. Krueger, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38679-1

Volume URL: http://www.nber.org/books/ito_04-1

Conference Date: June 28-30, 2001

Publication Date: January 2004

Title: Privatization and Corporate Governance

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URL: http://www.nber.org/chapters/c10182

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Privatization and Corporate Governance

Simon Johnson and Andrei Shleifer

1.1 Introduction

Privatization is at the top of the political agenda in Asia. In China, the state sector has failed to wither and continues to consume a large amount of state resources (Steinfeld 1998, 2000). In Korea, the state has acquired substantial banking assets through bailout programs and now faces the serious issue of how to dispose of these assets (Chopra et al. 2001). In Malaysia, there is the beginning of a real discussion about how best to manage the relationship between the state and previously state-owned enterprises (Gomez and Jomo 1998). Throughout Asia, strong interest is developing in whether further privatization will speed up the economic recovery and sustain growth.

The early enthusiasm for privatization, however, has worn off since the 1980s and there is a general feeling of caution. Recent experience, particularly in Eastern Europe and the former Soviet Union, has demonstrated that simply privatizing is often not enough. As a result, there is a new emphasis on various complementary measures, such as stimulating competition. These complementary measures are often quite distinct from privatization itself and require separate political initiatives. In this paper we focus on one important issue that has emerged over the past decade: corporate governance of privatized firms.

Privatized firms with weak corporate governance have repeatedly

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demonstrated weak performance and have frequently been "tunneled" by their management. In the Czech Republic, management of newly privatized firms conspired with the managers of investment funds to strip assets and siphon off cash flow (Coffee 1999b). Belated attempts by the Czech authorities to control this process have proved difficult. The lesson from post-communist countries is that effective investor protection must accompany privatization.

But how exactly should corporate governance be implemented? In particular, is it necessary or even helpful for the government to pass and enforce laws or legal regulations? Or can the private sector achieve all its desired outcomes simply by relying on private contracts, in which case all the government needs to do is to ensure that such contracts are enforced?

Ronald Coase (1960) explained the conditions under which individuals and private firms should be able to make contracts as they please. As long as the enforcement costs of these contracts are nil, individuals do not need statutory law or can find ways to contract around the law. There remains strong support in both law and economics for three important Coasian positions: law does not matter; law matters, but other institutions adapt to allow efficient private contracts; and finally, while law matters and domestic institutions cannot adapt enough, firms and individuals can write international contracts that achieve efficiency.

Coasian arguments have had great influence on discussions about corporate finance, and in this paper we focus on this literature, emphasizing points that seem particularly relevant for thinking about privatization. In the spirit of this general position, Easterbrook and Fischel (1991) argue that firms wishing to raise external finance can commit themselves to treat investors properly through a variety of mechanisms. Law may restrict the scope of these mechanisms, but firms and investors can always reach efficient arrangements. If this view is taken to the extreme, all countries that have a good judicial system should be able to achieve similar and efficient financial arrangements for firms. In this view, all privatization needs to do is to transfer property rights to private investors and the market will take care of the rest.

Also in the Coasian spirit, Berglof and von Thadden (1999) argue that civil-law countries in Europe have developed institutions that allow companies to enter enforceable contracts with investors. In their view, law may matter and have shortcomings, but the political process and firm-specific actions can generate other ways of offering effective guarantees to investors—for example, by mandating certain forms of government intervention or establishing a particular ownership structure and dividend policy. As a consequence, bringing U.S.-type institutions into Europe would not be helpful and could even be disruptive. In this view, the arrangements may differ across countries, but in many cases firms should be able to access external finance. The implication is that while privatization should be

accompanied by institution building of some form, it does not need U.S.-style investor protection in order to be effective.

Even among the scholars who are convinced that legal rules matter, there is a Coasian skepticism about whether changing rules can have large effects. Coffee (1999a, b) argues that while U.S. firms derive important advantages from the U.S. legal system, other countries are not converging through changing their rules, presumably because this is politically difficult. Instead, there is a process of "functional" convergence, through which firms choose to adopt U.S.-type private contracts with their investors—for example, by issuing American Depositary Receipts (ADRs). In this view, corporate governance of privatized firms can be assured through the issue of ADRs or through otherwise listing in a stock market with a high level of investor protection.

These Coasian arguments are extremely powerful. However, they are rejected by the data. Recent research shows that the legal rules protecting investors matter in many ways, that other institutions cannot adapt sufficiently, and that changing domestic legal rules can have a big impact. We are also moving closer to a theoretical understanding of why exactly these Coasian positions are not correct and what this implies for standard models of economics and finance. The implication is that unless privatization is accompanied by enforceable investor protection, its benefits for firm performance will be limited because of severe agency problems, including various forms of expropriation or "tunneling" by management.

The evidence that legal rules matter is overwhelming. Protection of minority shareholders is weaker in countries with a civil law tradition. In many countries, the judiciary cannot be counted on to enforce contracts between investors and firms. Countries with less protection for minority shareholders have smaller equity markets, other things equal (La Porta et al. 1997a). Firms in countries with less investor protection use less outside finance (La Porta et al. 1997a) and have higher debt-equity ratios, making them more vulnerable to collapse (Friedman, Johnson, and Mitton 2003). Countries and companies with weak corporate governance can also suffer larger collapses when hit by adverse shocks (Johnson, Boone, et al. 2000; Mitton 2002; Lemmon and Lins 2003). Countries with weaker institutions have experienced greater output volatility over the past forty years (Thaicharoen 2001) and have suffered larger exchange rate crises (Pivovarsky and Thaicharoen 2001).

Other domestic institutions can adapt to some extent, but not enough to offset weak legal protection. The government has only limited ability to act directly to compensate for weak investor protection. Private companies in civil-law countries have developed various mechanisms to improve their investor relations, but these mechanisms are far from perfect. In many civil-law countries there are significant loopholes through which value can be tunneled legally out of a company (Johnson, La Porta, et al. 2000). An

important complement of effective privatization is the effective legal protection of investors.

Laws and other institutions providing investor protection are persistent and hard to change. But this does not mean that legal reform is ineffective. Among countries with relatively weak legal systems, the evidence indicates that strong stock market regulation can to a large degree act as an effective substitute for judicial enforcement of contracts (Glaeser, Johnson, and Shleifer 2001). Poland provides a clear example of conditions under which a strong, independent stock-market regulator can create a well-functioning stock market, despite a weak judiciary. In all the success cases of capital market development and privatization through public sale of shares, good legal rules are of paramount importance.

Shleifer and Vishny (1997b) review the literature on corporate governance before the recent wave of findings from comparative research. La Porta et al. (2000b) describe the first wave of this research, which constitutes about twenty papers written through the early fall of 1999. However, the pace of activity in this area is accelerating. We cover about thirty new papers not included in either of these previous surveys.

Sections 1.2, 1.3, and 1.4 review the evidence against each of the Coasian positions, with particular emphasis on recent experience with privatization. Section 1.5 reports recent theoretical analysis based on this evidence. Section 1.6 concludes.

1.2 Law Matters

The strongest Coasian position is that law does not matter. If this were true, we should expect to see no significant correlation between legal rules and economic outcomes around the world. The evidence decisively rejects this hypothesis.

1.2.1 Investor Protection

The new literature on the importance of law begins with La Porta et al. (1998), who show there are systematic differences in the legal rights of investors across countries. An important explanatory factor of these differences is the origin of the legal system.

La Porta et al. (1998) propose six dimensions to evaluate the extent of protection of minority shareholders against expropriation by the insiders, as captured by a commercial code (or company law). First, the rules in some countries allow proxy voting by mail, which makes it easier for minority shareholders to exercise their voting rights. Second, the law in some countries blocks the shares for a period prior to a general meeting of shareholders, which makes it harder for shareholders to vote. Third, the law in some countries allows some type of cumulative voting, which makes it easier for a group of minority shareholders to elect at least one director of

their choice. Fourth, the law in some countries incorporates a mechanism which gives the minority shareholders who feel oppressed by the board the right to sue or otherwise get relief from the board's decision. In the United States, this oppressed minority mechanism takes the very effective form of a class action suit, but in other countries there are other ways to petition the company or the courts with a complaint. Fifth, in some countries, the law gives minority shareholders a preemptive right to new issues, which protects them from dilution by the controlling shareholders who could otherwise issue new shares to themselves or to friendly parties. Sixth, the law in some countries requires relatively few shares to call an extraordinary shareholder meeting, at which the board can presumably be challenged or even replaced, whereas in other cases a large equity stake is needed for that purpose. La Porta et al. (1998) aggregate these six dimensions of shareholder protection into an anti–director rights index by simply adding a 1 when the law is protective along one of the dimensions and a 0 when it is not.

The highest shareholder-rights score in the La Porta et al. (1998) sample of forty-nine countries is 5. Investor protection is significantly higher in common-law countries, with an average score of 4, compared with French-origin civil-law countries, with an average score of 2.33. There is significant variation within legal origin, however. In the La Porta et al. data, there is no association between a country's level of economic development and its anti–director rights score, but a strong association between the score and the size of its stock market relative to gross national product (GNP).

La Porta et al. (1998, 1999) also find that the legal enforcement of contracts is weaker in countries with a civil-law tradition. For example, the efficiency of the judicial system on average is 8.15 in English-origin countries (on a scale of 1 to 10, where 10 means more efficient), but only 6.56 in French-origin countries. Legal origin therefore affects investor protection both through the rights available in the laws and the ease of enforcement of these rights.

Glaeser, Johnson, and Shleifer (2001) look in more detail at Poland and the Czech Republic, which were not included in the original La Porta et al. (1998) sample. They find that the Polish commercial code protected investors more than did the Czech code, but the most important difference was in the design and implementation of securities law. As Pistor (1995), Coffee (1999a), and Black (2000) also argue, protection under the commercial code is complementary to protection under securities law.

Slavova (1999) extends the La Porta et al. (1998) work to twenty-one formerly communist countries of Eastern Europe and the former Soviet Union. Rather than looking directly at the laws, she uses a survey to ask local legal professionals what specific rules are in place and how they are enforced. Her work confirms the analysis of La Porta et al. on the general relationship between shareholder protection and stock market development

and the detailed assessment of Glaeser, Johnson, and Shleifer (2001) on Poland and the Czech Republic. For postcommunist countries, privatization has proved much more effective where capital markets have also developed at least to some extent.

Recent research has focused on some additional determinants of investor protection (Bebchuk and Roe 1999; Roe 2000, 2003; Stulz and Williamson 2003). Rajan and Zingales (2003) maintain that there is an important underlying political process. Berkowitz, Pistor, and Richard (2003) argue that the way in which legal systems were transplanted to other countries is more important than legal origin. However, Acemoglu, Johnson, and Robinson (2001) confirm that legal origin has explanatory power with respect to current institutions. They find that additional explanatory power lies with the way in which countries were colonized, and particularly whether the disease environment favored early settlers, but legal origin remains important. Using the pattern of colonization to generate a set of plausible instrumental variables, they show that institutions have a major impact on gross domestic product (GDP) per capita today (see also Acemoglu, Johnson, and Robinson 2002).

1.2.2 Outcomes

Measures of investor protection matter for economic outcomes. There is a direct effect of investor protection on the development of external capital markets. Both stock markets and debt markets are less developed in French origin countries (La Porta et al. 1997a). This is evident both in outside capitalization (measured as market capitalization owned by outsiders relative to GNP), domestic listed firms per capita, and initial public offerings per capita. For a sample of the largest firms in each country in 1996, La Porta et al. (1997a) find that French legal origin countries have significantly lower market capitalization relative to sales and to cash flow.

Subsequent work has found that lower stock market development can reduce growth (Levine and Zervos 1998), that financial development is correlated with growth (Beck, Levine, and Loayza 2000), and that the availability of external finance determines whether a country can develop capital-intensive sectors (Rajan and Zingales 1998a). Wurgler (2000) finds there is a better allocation of capital to industries in countries with more financial development.

Countries with weaker investor protection suffer more adverse consequences when hit by a shock. Johnson, Boone, et al. (2000) present evidence that the weakness of legal institutions for corporate governance had an adverse effect on the extent of depreciations and stock market declines in the Asian crisis. Corporate governance provides at least as convincing an explanation for the extent of exchange rate depreciation and stock market decline as any or all of the usual macroeconomic arguments. These results hold more generally for exchange rate crises and output volatility

over the past forty years (Pivovarsky and Thaicharoen 2001; Thaicharoen 2001).

Firm-level evidence supports this view. Mitton (2002) looks at five Asian countries most affected by the 1997–1998 crisis, and finds that firms with larger inside ownership and less transparent accounting suffered larger falls in stock price. He also finds that more diversified firms suffer a greater fall, particularly if they have more uneven investment opportunities (measured in terms of Tobin's *Q*). This is consistent with, although it does not prove, the view that firms with weaker corporate governance faced a larger loss of investor confidence. It may also be the case that more diversified firms are less able to allocate investment properly due to internal politics, as suggested by Scharfstein and Stein (2000), and that these political problems become worse in a downturn.

Nalbantoglu and Savasoglu (2000) find similar results for Turkey in the late 1990s. Lemmon and Lins (2003) confirm Mitton's (2002) findings using the separation of control and cash-flow rights to measure the extent of agency problems. Firms in which controlling shareholders had less cash-flow rights suffered larger stock price declines in the Asian crisis. Over longer periods of time, Lins and Servaes (2002) also find a discount for diversified firms in seven emerging markets. Claessens et al. (2003) find a diversification discount for East Asian firms and worse performance for conglomerates during the East Asian crisis.

1.3 Other Institutions

The second Coasian view is that even if legal rules matter and are weak in some countries, other governmental or private institutions should adapt to protect investors. The political process or even private negotiation between firms and investors can deliver investor protection. Three main mechanisms have been suggested.

First, the government may put pressure on firms to treat investors properly, even though the law does not require it. If firms expropriate investors, they can lose other rights, such as favorable tax treatment or even the right to operate. This is the argument made by Berglof and von Thadden (1999) for many European countries. The government could try to ensure that firms behave by directly owning and running banks. In fact, government ownership of banks is significantly higher in French-origin legal systems (La Porta, Lopez-de-Silanes, and Shleifer 2002).

This approach requires an honest and effective government, but this is itself an endogenous outcome. La Porta et al. (1999) show that countries with a civil-law tradition are likely to have higher corruption and less effective government administration. Governments may also say that they want to protect investors, but in a sharp downturn find that they would rather protect entrepreneurs. This is one interpretation of what happened re-

cently in some Asian countries, for example, Malaysia (Johnson and Mitton 2003).

Second, ownership may develop in a different way from the United States and the United Kingdom. In particular, concentrated outside ownership may allow more effective control over management. In fact, most civil-law countries have concentrated ownership. La Porta, Lopez-de-Silanes, and Shleifer (1999) show that groups of connected firms are much more usual than stand-alone firms in most countries. These groups typically include at least one company that is publicly traded or otherwise raises funds from outside investors, as well as a number of additional companies that are completely privately held. Some valuable assets are usually kept private.

This type of organization is particularly common in emerging markets where the legal protection of minority shareholder rights and creditors is weaker (La Porta et al. 1998). With the exception of Chile, the Latin American countries for which data are available have higher than average ownership concentration (La Porta and Lopez-de-Silanes 1998). Concentrated ownership also plays an important role in some European countries. For example, Gorton and Schmid (2000) find that firms are more highly valued when large shareholders own more shares in Germany. In eighteen emerging markets, Lins (2003) finds that large blockholders generally increase firm value.

The trouble with this approach is that there are still small minority shareholders in most countries with stock markets (see the data in table 2 from La Porta et al. 1997a). If large shareholders actually control management, small shareholders are not protected from expropriation. In fact, what happened in the Czech Republic over the past decade suggests that in an environment of weak legal protection, it is easy to gain control over a privatized firm and then strip it of value (Coffee 1999b; Glaeser, Johnson, and Shleifer 2001). Hellwig (2000) explains clearly the deficiencies of protection for small shareholders in Germany and Switzerland.

Third, there may be some reputation building by firms. For example, by paying higher dividends, companies in civil-law countries could establish a reputation for treating shareholders properly. In principle, repeated interaction between managers and shareholders could establish that management can be trusted, and this should increase their ability to raise more capital.

Theoretically, this argument has an important weakness. Managers may be happy to treat shareholders well when the economy is growing fast, but this does not imply anything about how they will be treated in a downturn (Johnson, Boone et al. 2000). It is very easy to expropriate shareholders for a few years and then return to the capital markets. Not surprisingly, the empirical evidence does not support the view that there is more reputation building through dividend policy in civil-law countries. In fact, La Porta et al. (2000a) show that companies in common-law countries pay higher dividends.

1.4 Legal Reform

Coffee (1999a) argues that there is an important movement toward "functional convergence," through which firms around the world are adopting U.S.-type mechanisms to protect investors. There is certainly a move toward issuing ADRs, and these seem to improve access to external capital markets. Lins, Strickland, and Zenner (2002) show that the sensitivity of investment to cash flow falls when an ADR is issued by a company from a country with a weak legal system and a less developed capital market (as defined by La Porta et al. 1997a). Reese and Weisbach (2002) show that companies in civil-law countries are more likely to list ADRs on an organized exchange in the United States, thus committing themselves to greater disclosure. All of this work supports the third Coasian view, that international contracts can get around some of the deficiencies of domestic investor protection. The implication is that while law may matter and domestic institutions cannot adapt, domestic legal reform is inessential.

The trouble is that ADRs may help companies opt into a regime of greater disclosure, but they do not stop expropriation as long as it is disclosed. The substitutes for the law thus do not work perfectly. For example, privatized Italian companies over the past decade have often issued ADRs, but there is an active debate about whether this has proved effective. ADRs have had at best limited positive effects for Mexican firms in the 1990s (Siegel 2002).

There are important processes of legal reform at work in many countries, and the evidence suggests that some of these efforts have important effects on investor protection and the financing of firms. In countries with weak legal systems, the expropriation of outside investors takes place through relatively open forms of outright theft, transfer pricing, related lending, failure to disclose relevant information when issuing securities, and failure to report earnings properly. What can prevent this when the courts are weak? Recent work suggests that in such financial markets a strong regulator can protect the property rights of outside investors and thereby improve welfare. This may be particularly important where privatization is being attempted.

The idea of focusing the regulation of securities markets on intermediaries is sometimes credited to James Landis, a contributor to the 1933 and 1934 Securities Acts in the United States (McCraw 1984). Landis reasoned that the U.S. Securities and Exchange Commission by itself could monitor neither the compliance with disclosure, reporting, and other rules by all listed firms; nor the trading practices of all market participants. Rather, the commission would regulate intermediaries, such as the brokers, the accounting firms, the investment advisors, and so on, who would in turn attempt to assure compliance with regulatory requirements by the issuers and the traders. Moreover, by maintaining substantial power over the in-

termediaries through its administrative relationships, including the power to issue and revoke licenses, the commission could force them to monitor market participants.

Glaeser, Johnson, and Shleifer (2001) find that the stringent—and stringently enforced—regulations in Poland, expressed in both company and securities laws, have stimulated rapid development of securities markets and enabled a large number of new firms to go public. It has also greatly facilitated the privatization of state-owned firms. The expropriation of investors has been relatively modest, and the qualitative evaluations of the Polish market have been very positive as well. In contrast, the lax—and laxly enforced—regulations in the Czech Republic have been associated with the stagnation of markets, the delisting of hundreds of privatized companies from the stock exchange, and no listing of new private companies. The expropriation of investors has apparently been rampant, and has acquired a new Czech-specific name: *tunneling*. Consistent with these concerns, the qualitative assessments of the Czech market have been poor. Starting in 1996, the Czech Republic has sharply tightened its regulations. These findings suggest that even countries with relatively weak legal systems can improve the protection of investors, and that this improvement will help firms to obtain external finance.

Poland also demonstrates the value of regulating intermediaries, particularly investment funds and brokers. When these organizations are tightly regulated, it is possible to suspend or revoke their licenses for inappropriate actions. These intermediaries then have a strong interest in ensuring both internal compliance and external vigilance. It is helpful that everyone involved with the securities market watch out for the misbehavior of others.

1.5 Theory

The Coasian argument seems extremely powerful. Why does it fail? How does this affect standard models of finance? What is the right way to model firms in countries with weak legal institutions?

1.5.1 Law and Regulation

The Coasian argument, in all three versions reviewed here, relies on the crucial assumption that the judiciary is able to enforce both existing property rights and the efficiency-enhancing contracts. But what if the courts are not efficient enough to perform this role, because they are underfinanced, unmotivated, unfamiliar with the economic issues, or even corrupt? At the least, it may then be necessary to provide a detailed legal framework to facilitate the work of the courts. In some cases, it may be necessary to go further and create a regulatory framework, which empowers a regulator to provide and enforce rules that promote more efficient outcomes. This case for regulation is stronger when the government is more in-

terested in public welfare than in catering to incumbent firms. Glaeser, Johnson, and Shleifer (2001) and Glaeser and Shleifer (2002) discuss the incentives to enforce alternative laws and regulations more generally.

It is quite possible for a country to get stuck in an equilibrium with weak law enforcement. For example, Johnson, Kaufmann, and Shleifer (1997) argue that many countries in the former Soviet Union drove firms underground with high taxation, corruption, and regulation. This undermined the tax base of the government and made it harder to provide reasonable rule of law. Without rule of law, there is much less incentive to become a registered firm and pay taxes. Thus most of the former Soviet Union, but not the better parts of Eastern Europe, is trapped with weak law enforcement, a large unofficial economy, and a low tax base. In this environment, it proved difficult to privatize without creating widespread possibilities for tunneling.

1.5.2 Tunneling, Propping, and Debt

While the evidence reviewed above suggests that expropriation of shareholders is endemic, it is not the case that there is a zero cost of stealing in most countries. In fact, we need to understand how standard finance results are modified as the cost of stealing varies.

The original model of expropriation by managers is Jensen and Meckling (1976). Burkhart, Gromb, and Panunzi (1998) introduce the assumption that most diversion by management is costly, because (for example) it involves legal maneuvers. La Porta et al. (2002) show how to think about the cost of stealing across countries in a simple static framework. This approach has been developed further by Johnson, Boone, et al. (2000) and more recently by Friedman, Johnson, and Mitton (2003) and Shleifer and Wolfenzon (2002).

Johnson, Boone, et al. (2000) present a new theoretical explanation for the effects of corporate governance on macroeconomic outcomes. If stealing by managers increases when the expected rate of return on investment falls, then an adverse shock to investor confidence leads to increased theft and to lower capital inflow and greater attempted capital outflow for a country. These, in turn, translate into lower stock prices and a depreciated exchange rate.

The model in Friedman, Johnson, and Mitton (2003) puts ideas from Jensen (1986), Myers (1977), and La Porta et al. (2002) into a dynamic setting. The key assumption is that entrepreneurs not only can take from the firm, but they can also give. There is substantial evidence that in moments of crisis, entrepreneurs in some legal systems prop up their firms in order to keep them going (Hoshi, Kashyap, and Scharfstein 1991; Kim 2003).

Friedman, Johnson, and Mitton (2003) find that some debt finance is generally optimal because it reduces theft and induces propping in some states of the world. Thus debt can serve the role proposed by Jensen (1986)

in reducing agency costs, even if there is no enforceable debt contract (i.e., effectively no collateral). However, in other states of the world, a debt overhang may induce entrepreneurs to loot the company. Thus there can develop an overhang of debt with the negative consequences analyzed by Myers (1977). When the legal system is weaker, Friedman, Johnson, and Mitton show that the debt-equity ratio will usually be higher, even though this increases the probability that the firm will collapse. In weaker legal systems, entrepreneurs also make investments that increase the cost of renegotiation, because this raises the cost of defaulting on a loan and thus increases the feasible amount of debt.

In this model, weaker legal institutions lead to the financing of fewer projects. But weak legal institutions can also contribute to economic crises. Weak protection of investor rights does not make shocks more likely, but it does mean that negative shocks have larger effects on the overall economy. Institutions matter for a particular aspect of volatility—whether countries can suffer large collapses (Acemoglu et al. 2003). Reasonable capital structures in a weak legal environment can lead to a bimodal distribution of outcomes.

The data are broadly supportive. Friedman, Johnson, and Mitton (2003) show that Asian firms with weaker corporate governance were more highly indebted before the financial crisis of 1997–1998. Kim and Stone (1999) find that countries with more corporate debt suffered larger falls in output during the Asian crisis of 1997–1998. Other work suggests both that aggregate corporate debt is higher in countries with weaker corporate governance (Demirguc-Kunt and Maksimovic 1999) and that it was higher within Asian countries for firms with weaker corporate governance. Lee, Lee, and Lee (2001), for example, demonstrate that corporate leverage was higher for *chaebol* companies than for non-*chaebol*, and highest for the top few *chaebol*.

More work is needed to link the debt findings more precisely to corporate governance and macroeconomic outcomes. Caballero and Krishnamurthy (1999) is one early attempt to formalize these ideas, emphasizing implications of underinvestment in appropriate collateral that occurs due to legal problems in some countries.

This research is part of a broader movement looking at the macroeconomic implications of institutions. Blanchard and Wolfers (2000) argue that labor market institutions in Western Europe were appropriate, but could not handle the shocks they received in the 1970s and 1980s. In this view a functional set of institutions became dysfunctional because of a particular set of shocks. More generally, Blanchard argues that macroeconomic dynamics may depend on institutional structures: "Institutions also matter for short-run fluctuations, with different mechanisms across countries. . . . Identifying the role of differences in institutions in generating

differences in macroeconomic short- and medium-run evolutions is likely to be an important topic of research in the future (2000, p. 1404).

1.6 Conclusions

A great deal of research suggests that privatization can be helpful for economic development. But the effectiveness of privatization is greater when corporate governance works well. This paper has reviewed recent evidence showing that effective laws are an important requirement for corporate governance. Without enforceable investor protection, privatization is less likely to succeed.

Law definitely matters. Countries with better investor protection have better developed financial markets and more growth. The determinants of law are complex, but the origin of the legal system is an important factor.

Legal origin is not destiny. Laws can be changed and other institutions can adapt to some extent. Civil-law European countries have become rich with more government ownership and more concentrated ownership than is seen in common-law countries. But it is a fallacy to infer that compensating institutions fully compensate for the shortcomings of the law.

Legal reform works. Countries as diverse as Chile, Germany, Poland, and South Korea have all made progress recently with changing the rules for investor protection. There are many different ways to change the rules, and the required changes vary by country. But investor protection is advancing in many countries, precisely because people have learned that it matters for economic development.

We are not arguing that all countries could or should become just like the United States. But in important dimensions we see countries around the world adopting investor protection measures that are modeled on U.S. law. The evidence suggests that when these measures are implemented in an enforceable way, they can change both the extent of investor protection and the ability of firms to obtain external finance. Properly designed U.S.-type innovations can work even in countries with quite different legal origins, such as Germany and Poland.

Of course, confidence in the United States has been shaken recently by corporate scandals, particularly concerning accounting issues. But, at least so far, there have been only four major scandals: Enron, WorldCom, Tyco, and Adelphia, and the U.S. regulatory system is responding (see Coffee 2003). It is important not to exaggerate the dimensions of the U.S. problems with corporate governance. At the same time, we do not think that the United States has ideal or even best practices on all dimensions of accounting, regulations, and corporate governance. There is clearly a need for the reforms now underway (and perhaps more).

By giving us a clear framework to think about contracts, Ronald Coase

shed a great deal of light on many issues, including comparative corporate governance and privatization. It is an indication of the power of his approach, that research is now advancing by trying to augment Coasian arguments about how firms are financed around the world. The Coasian idea that private contracts can attain efficient outcomes is powerful and in many instances correct. The right question is how to make it easier for the private sector to write its own efficient contracts. In many cases, this can be achieved only through changing the broader legal rules that underpin capital and other markets.

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Comment

Cassey Lee Hong Kim

The early literature in privatization focused on the importance of private ownership for efficiency as well the role of competition in soliciting behavior that would benefit consumers. In the past few years, the emphasis in the privatization literature has shifted to the issue of corporate governance. What brought about this change? Were private ownership and competition themselves insufficient to ensure that the full benefits of privatization will materialize? The gap that corporate governance fills in the privatization literature can be seen from figure 1C.1.

Private ownership provides incentives for firms to operate efficiently

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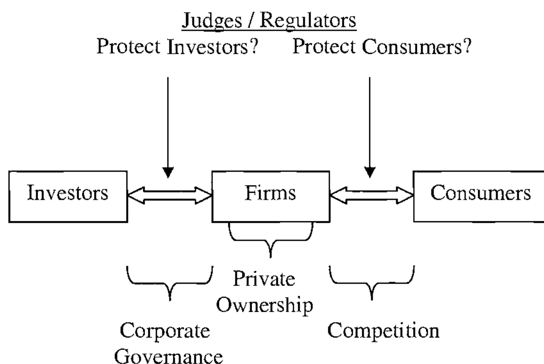

Fig. 1C.1 Agents and institutions in privatization

while competition ensures that such efficiency gains are passed on to the consumers. Corporate governance looks at the missing link between investors (suppliers of finance) and those who control the firms (management). More specifically, it addresses the question of how investors can get a return on their investments (Shleifer and Vishny 1997). Will this come about "naturally" (emerge spontaneously) or do we need to enact effective laws that protect investors?

Johnson and Shleifer attribute to Coase (1960) the idea that private contracts can be written between investors and managers such that the former's interests are safeguarded. In their paper, Johnson and Shleifer argue that, contrary to Coase, law matters. The authors also review the evidence against two weaker variants of the Coase argument. The first variant involves the emergence of spontaneous actions by governments or private institutions (e.g., concentrated shareholders) to protect the interests of investors in the presence of weak legal rules. The second variant goes one step further by postulating the emergence of capital markets outside the country with weak legal system to overcome this problem.

Coase I

Johnson and Shleifer marshal a wide range of empirical evidence involving many different levels of analysis to support their argument that law matters (fig. 1C.2). The strongest evidence comes from country case studies involving Poland and the Czech Republic (Glaeser, Johnson, and Shleifer 2001) that directly attempt to link stock market development to legal institutions that protect investors. The authors also cite numerous papers by La Porta et al. that found relationships between legal traditions and legal institutions for investor protection, and between legal institutions and economic performance. Compared to all these areas, the least developed area is the evolution of legal traditions (Glaeser and Shleifer 2000 is an example). It is not very clear from the literature why private contracts cannot be written to solve principal-agent problem under corporate gov-

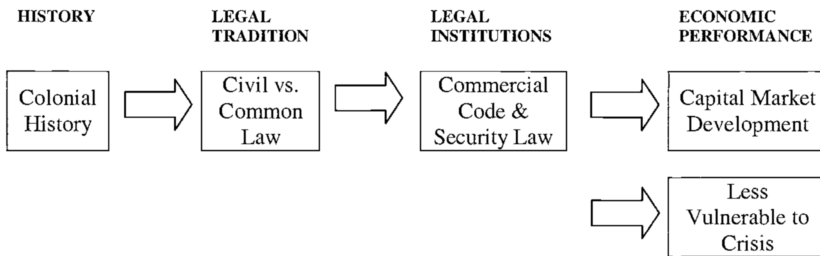

Fig. 1C.2 How law matters in corporate governance

ernance. Is it simply because the Coasian assumption about zero transactions cost does not exist? Or is something more fundamental happening here?

It is plausible that there are circumstances where the gains that a manager can obtain from an action that works against the owner's interest exceed any amount the latter can compensate the former. A private contract between such parties can of course involve some form of agreed-upon punishment. But there are limits to such punishment without infringing on a person's fundamental rights. Severe punishments such as imprisonment can only be enforced in the realm of the law and not private contracts. In this sense, it is not just that law matters, but rather that law complements private contracts. For matters of a smaller scale, such as a firm's quarterly performance, contracts are still effective.

Coase II

What if law matters, as Johnson and Shleifer argue, but is too weak in a given country? Can institutions—both public and private—overcome this by taking over the financing and management of corporations? The first option is tantamount to renationalization—an action that fundamentally transforms the objective of the firm from a profit-oriented to a public or politically oriented one. Once this is done, we are back where we started: namely, the preprivatization situation. Hence, the problem with this is not (as Johnson and Shleifer argue) that the state—the new owner—may not be honest or effective but rather that it has a different objective from private institutions. Very often, renationalization of privatized entities is undertaken to avoid political fallout. One way to look at this problem is to apply Coase's (1937) theory of the firm to the state. As long as private ownership best serves the state's objective, it is upheld. Otherwise, the boundary of the state is re-enlarged by renationalizing the firm, perhaps at least until the legal institutions pertaining to corporate governance are strengthened.[1] To

1. There are other problems when this occurs. When privatization exercises are accompanied by liberalization via market entry, renationalization of the incumbent poses considerable regulatory problems.

further complicate matters, the evolution of such institutions is, as Johnson and Shleifer put it, "an endogenous outcome" (albeit in a different context).

In the second option, when the legal rules are weak, private institutions can take over the management of the firm, possibly via concentrated ownership. The empirical evidence that Johnson and Shleifer discuss is intriguing. For example, they allude to the importance of relationship-based (bank) financing. It is not clear, however, whether relationship-based financing is an adaptation to weak investor protection by legal institutions or whether this is inferior to the Anglo-Saxon, arm's-length type of equity financing. Finally, the authors highlight interesting evidence on the impact of large shareholding. Firms are more highly valued when large shareholders own more shares in Germany (and emerging markets), while large shareholders can lead to expropriation at the expense of small holders in the Czech Republic. Do these findings contradict each other, or does it mean large shareholding is beneficial only if some form of protection is accorded to minority shareholders?

Coase III

The problem of weak domestic-investor protection is overcome in the third Coasian argument through bypasses via sourcing funds in international markets. In other words, there is no need to improve domestic investor protection since firms can source funds from outside the domestic capital markets. Is this second-best, and is constrained efficiency achieved? Johnson and Shleifer give the impression that there is very little empirical work that addresses these questions. Instead, the authors argue that legal reforms are beneficial. One such reform—for countries with strong legal systems (the Neuer Markt)—involves the formation of a new segment of the capital market for start-ups with higher degrees of investor protection. This could be perceived as supporting the third Coasian argument if the argument is construed as involving external contracts rather than international contracts. After all, markets such as the Neuer Markt appear to have an "enclave" characteristic (i.e., a different set of rules seems to apply). For countries with weak legal systems, Johnson and Shleifer propose a different type of reform that focuses on regulating financial intermediaries. The effectiveness of this will, of course, depend on whether the political system is conducive to the establishment of an independent and effective regulator. In this regard, the political economy of corporate governance reform seems to be the next important research agenda.

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Comment Richard H. Snape

Many of us would agree with Johnson and Shleifer that the 1990s have shown that institutions do matter, as do transaction and agency costs; that vacuums are not necessarily filled by socially useful activities; that governments do not necessarily pursue the general good; and that they are often weak and captive. Legal systems matter.

A great deal of recent research work is drawn upon in this paper. Efficiently operating capital markets matter for development and even if efficient institutions may develop endogenously in the long term, a great deal may be wasted in the meantime. But, it is suggested, countries can be stuck in an equilibrium of weak law enforcement, a large unofficial (gray) economy, and a low tax base. Such an economy is very difficult to privatize without "tunneling," which does not just have distributional effects, but efficiency and development effects also.

If legal systems are weak, how does one move to give confidence to investors—particularly small investors? There is an endorsement of Poland compared with the Czech Republic, for example—a strong and independent regulator of the stock market, despite a weak judiciary. The stock market is not the only institution, of course. There is a case for regulation and prudential requirements on a whole range of financial intermediaries. These intermediaries can be large enough to monitor those in whom they invest, but they in turn need to be monitored and, if necessary, disciplined.

Of course, we quickly hit the problem of who regulates or monitors the regulators.

We can specify good principles of regulation, but how can they be legislated or enforced if the government is weak, populist, complicit, or even corrupt?

What perhaps could be developed further in the paper is an examination of how to move to better regulation. There are two questions:

1. What are good principles for regulation?
2. How do we introduce them?

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We have some examples of change provided—Chile, Germany, Poland, and South Korea—but there is more to be pursued here. We can hardly expect civil-law countries to change their legal systems without revolution (and, incidentally, Malaysia is not a civil-law country). Perhaps we can take some lessons from trade policy.

Why did countries move from inward-looking to outwardly oriented policies? Partly from empirical evidence, partly from change in development theory; partly from external pressures (from the International Monetary Fund or the World Bank); partly from crises. Governments were also required to stand up to protected interests, and this of course is the critical factor.

The important literature drawn upon in the paper is part of the empirical work that can facilitate the change. It can be compared with work by Anne Krueger and others in the 1970s and 1980s in the trade policy area. Crises can help, and the Asian financial crises have brought the lesson home to some. But as was mentioned by Mari Pangestu, we need the substance of good regulation and not just institutions with fine-sounding names. Moreover, we cannot develop appropriate institutions, including institutions to regulate, without developing a framework for acceptance of them. Knowing the right rules is one thing; knowing how to introduce them is another.

Public education is crucial in getting the framework to introduced good regulation for corporate governance as well as good trade policy.

Why did trade policy change in Australia?

There was education, measurement of costs of protection, a perceived crisis, and a government that took an economy-wide perspective—and a parliamentary opposition that did not oppose the changes. But populism is always present and education is an ongoing requirement.