Comment on "Corporate Governance and Restructuring: Lessons from Transition Economies," by Gérard Roland

John S. Earle

The dilemmas, policies, and outcomes of privatization in transition economies have fueled a growth industry in the analysis of corporate governance systems. The reasons for the interest in ownership and governance in transition are clear. Under socialism, dominant state ownership was complemented by tight bureaucratic control over large industrial firms—the "commanding heights" of the economy (Kornai 1992). After communism collapsed, questions immediately arose about what forms of ownership and control should follow and how the new system should be arranged.

The discussions of these issues have displayed a remarkable evolution in the 10-odd years since transition began. In the early transition years, the "Washington consensus" favoring rapid liberalization and privatization was dominant, while more recently a "new consensus" (Washington or not) has apparently emerged that advocates gradualism and cautious privatization.[1] Both viewpoints have had substantial effects on policymaking in the transition economies and on the advice provided by international organizations. But neither has ever been universally accepted, nor has the debate between them been informed by an amount of scientific analysis that would justify firm conclusions.

Limits of our Knowledge

What are the limits to our conceptual understanding and empirical knowledge of corporate governance and restructuring in the transition economies? To start, although theory has developed rapidly and in some exciting directions, it is still incapable of offering precise empirical predictions. Existing theory suggests few specific hypotheses, and it provides little guidance for empirical testing and quantification of the magnitude of effects.

Consider the problem of estimating the impact of privatization on firm restructuring and performance, one of the main topics in this literature and in the article by

John S. Earle is associate professor at the Stockholm School of Economics.

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Gérard Roland. Leaving aside how privatization, restructuring, and performance are measured—difficult enough questions about which theory has little to say—theory does not suggest a set of variables that should be controlled for in the analysis, nor does it imply a particular functional form for the relationship.

Such regressions, for instance as summarized in the review article of Djankov and Murrell (2000), routinely include control variables representing the initial quality of the firm and its retained earnings, an important issue developed in Roland's article. But the relationship between initial conditions and restructuring is complex. It includes the positive effect due to the availability of resources for restructuring and the negative one due to entrenchment, both of which are cited by Roland. But it also includes a negative effect due to reduced competitive pressure in firms with cash cushions and a positive effect due to avoiding the difficult restructuring associated with downsizing a firm. Thus the net effect is ambiguous, and no structural, behavioral model has accounted for these separate aspects of the relationship.

Empirical knowledge of the relationship between privatization and restructuring is limited by data and by the small number of studies that have been performed. One problem is the frequent use of data from early in the process. For example, Earle and Estrin (1997, 1998) analyze survey data from Russia collected in July 1994, just after the conclusion of voucher privatization. Many Russian firms were actually privatized earlier (in 1991–93), but it would certainly be desirable to collect more recent information to assess the impact of privatization. Until very recently, however, the data used in those analyses, collected through a World Bank research project, were the best available. To take another example, Frydman and others (1999) analyze data from 207 firms in the Czech Republic, Hungary, and Poland, measuring performance through 1993. Not only is the sample small, but again the data are far too dated to permit a confident evaluation of the effects of privatization.

Other problems involve sampling and questionnaire design. The Business Environment and Enterprise Performance Survey, a project by the World Bank and European Bank for Reconstruction and Development, gathered data on a large group of enterprises in 20 transition economies. But it employed quota rather than probability sampling, and it failed to collect information on previous ownership and other potential determinants of performance. As a result, analyses of the ownership-performance relationship using this database (appearing, for instance, in EBRD 1999) use contemporaneous ownership and past performance, calling into question the assumption maintained throughout the work that ownership may be taken as exogenous. Finally, a general problem in many studies is that data collection does not receive the careful attention to questionnaire design, interviewer training, and data entry and cleaning essential to ensuring reliable information.

Beyond the problems with data timing, sample sizes, sampling techniques, and data collection, a more fundamental issue in empirical work on the effects of privatization is establishing the appropriate counterfactual. Much of the "new consensus" contains strong assertions about the effects of privatization in various countries. But beyond the lack of empirical evidence to support most of those claims (which are not necessarily the fault of the authors, but rather a consequence of the state of

research in the area), a major problem is that we cannot observe what would have happened without privatization or with a different privatization policy.

Establishing the appropriate counterfactual is important both for estimation strategy (how to control for selection or simultaneity bias in the observed relationship) and for policy evaluation. Policies are sometimes infeasible for political reasons, and it makes little sense to compare an implemented policy with a Panglossian world where first-best policies can always be implemented (Shleifer and Treisman 2000). This is most obvious in Roland's discussion of privatization in East Germany, where all the "efficiency objectives of privatization were likely to be met." But it also holds in other circumstances.

Problems of Mass Privatization

A good example is the most forthright policy message in the "new consensus," the contention that mass privatization was a failure because it increased asset stripping and reduced restructuring. Before considering the alternatives to mass privatization, let us examine the elements of this proposition. In Roland's variant, mass privatization is defined as giveaways to dispersed outsiders and asserted to have the same effects as giveaways to insiders. But the definition of asset stripping is unclear. "Reducing the value of the assets" is not very persuasive as rational owners will always try to maximize the returns from their assets, so this does not differentiate asset stripping from restructuring. Moreover, there is an important difference between stripping assets and diverting cash flow, since the latter may maintain asset values while finding other uses for the returns to the assets.

The argument appears to assume that cash flow stripping and restructuring are substitutes in managerial effort, although this assumption is not supported by any empirical evidence. Indeed, the two actions may be positively correlated, as active owners try to improve the cash flow of their firms while doing their utmost to hide it from the tax authorities. A possible explanation is that "good" managers (in Roland's terminology) may be good not only at strategic restructuring but also at enriching themselves: thus the skills required for the two tasks are correlated.

Why is mass privatization alleged to increase asset or cash flow stripping? According to Black, Kraakman, and Tarassova (1999), granting control rights through the Russian privatization program increased the scope for theft. But this analysis neglects the problem that control rights were already de facto held by managers, and that privatization involved a transfer of legal cash flow rights. Roland argues that mass privatization tends to enhance the net benefit of asset stripping because managers or owners have received the asset nearly for free, thus they can reap immense gains from stripping it even when doing so is not optimal from an economic perspective. But the purchase price is a sunk cost from the new owner's perspective: because it is contracted before the owner has control rights it should not affect later behavior. Even an owner who has paid for an asset—or particularly, a partial share in an asset—may be able to gain more by reducing its value, say, by diverting cash flow (to avoid sharing rents with other shareholders or the state).

The usual selection arguments associated with well-organized auctions (that is, the new owner has the highest valuation) may also not apply. Such auctions may be difficult to organize in the poor informational and institutional environments of transition economies, and in fact very few countries have carried them out; more common for large and medium-size enterprises were tenders, where multiple criteria were employed in addition to price, and where corruption was rife. Furthermore, the usual efficiency proposition associated with ownership resulting from an auction may fail if ability to pay does not reflect valuation, and auctions may be politically infeasible where ability to pay is socially unacceptable as a criterion. This leads us to the question of counterfactuals.

Privatization Alternatives

What then is the realistic counterfactual to mass privatization? The new consensus does not make clear whether the claim of increased asset stripping under mass privatization is meant relative to continued state ownership or relative to some other form of privatization. Nor is any evidence cited on the amount of asset stripping actually observed under those alternatives. The discussion treats sales and giveaway privatizations as a dichotomy, but in reality privatization transactions involve a range of prices. Giveaways have seldom been completely free, and sales have rarely achieved what the assets might have fetched in a market setting—though we will never know because of valuation difficulties (see below).

A higher privatization price may reduce restructuring if it has a significant income effect on new owners with limited liquidity. Capital-constrained owners may be forced to liquidate assets to stay liquid. An example is the widespread unbundling of assets by Polish firms, partly to finance their privatization through leasing. Again though, it is unclear whether this should be classified as restructuring or asset stripping.

On the other hand, since the earliest discussions mass privatization has been criticized for not directly raising investment finance. But once again the counterfactual is not clear, for who had access to such finance? In the early 1990s most transition economies had little domestic savings (except Hungary). The possibilities that existed for financing privatization purchases were spread fairly evenly over the population except for some concentration in the nomenklatura (again, except in Hungary). Thus the only effective demand for large companies being privatized through sales came from the former communist elite and from foreigners.

Transferring loads of assets to the former elite would have resulted in incompetent owners and would have decreased the legitimacy of the process as much as any other program did (some of which did not differ much from such a direct transfer). And citizens of most countries feared foreigners because of nationalistic movements. For their part, foreigner investors were cautious given uncertainty about the reversibility of the process, the possibility of implicit or explicit renationalization, and the unknown usefulness of communist assets in a capitalist world.

Thus the general lack of demand for state assets in early transition was intertwined with two other problems: distributional conflicts and difficulty of valuation.

That the assets of state enterprises had been accumulated almost entirely during the socialist period—when costs, depreciation rates, and cash flow were almost meaningless—implied that standard accounting measures based on historical costs or projected cash flows were next to useless.

Cash auctions were feasible in principle, but they made it difficult to advance other social goals (ensuring investment, preserving employment, cleaning the environment). And foreigners and the former nomenklatura usually would won the auctions—giving rise to a highly skewed distribution favoring the two least popular groups in society. The importance of social goals led instead to sales through tender and direct negotiation in East Germany and Hungary. Given the nontransparency of these deals and the impossibility of reaching an objective valuation for each company, such privatizations were open to charges that the decisions reached on buyers and prices had been corrupt. Opposition parties regularly leveled such charges against incumbent governments, politicizing the process and making the bureaucrats in charge of sales still more timid.

As a result every country that pursued sales moved slowly, with the exception of East Germany. Private capital must be accumulated before more concentrated control over firms can be achieved, and that takes time. Except among the nomenklatura, no private savings will initially be available for large buyouts. If one assumes that private savings is initially equal to 6 percent of the corporate capital stock and grows by 10 percent a year, then it will take almost 30 years to privatize the stock.

The citizens of most transition economies did not want to wait that long. For one thing there were serious concerns about reverting to communism in the first few years after its collapse. In addition, citizens of transition economies wanted to deliver a functioning capitalist system if not to their children then at least to their grandchildren. And there was recognition that slow privatization would likely lead to steady depletion of the capital stock in state enterprises, given the breakdown in the state's ability to monitor them. Could the state have prevented this asset-stripping by continued socialist-style active administration of its enterprises while gradually privatizing and permitting new enterprises to enter, as suggested by Kornai (1990) and Murrell (1992)? To some extent this is what has been happening in China, although continued state control of the economy has also been associated with political control by the Communist Party (consistent with Kornai's 1992 analysis of the interdependence of the political, ownership, and coordination elements of classical socialism).

But the interesting counterfactual question is whether this setup was possible in Eastern Europe and the former Soviet Union. As with any counterfactual, we will never know the answer with certainty. But it is clear that no country managed to achieve this.

The possibility for the sales approach was greatest where the demand constraint was most relaxed due to greater private savings and availability of foreign capital, namely in Hungary. Moreover, Hungarian managers had more autonomy and experience in decisionmaking as a result of progressive liberalization in the 1970s and 1980s. Finally, Hungarian managers and consumers had acquired experience and

openness through small entrepreneurial activity permitted under the "New Economic Mechanism" and subsequent reforms, and from contact with foreigners, leading to foreign direct investment in the early 1990s that (even excluding privatization deals) dwarfed that of neighboring countries.

Thus Hungary had special advantages in pursuing sales (Earle, Frydman, and Rapaczynski 1993; Stark and Bruszt 1997). But these very advantages made sales more urgent by increasing the problem of asset stripping. Indeed, discussions of privatization in Hungary were dominated throughout the 1990s by the fear that the residual state sector was gradually leaching away under the influence of various forms of spontaneous privatization and asset diversion.

Related to the appropriate pace and method of privatization is the question of whether the state should restructure firms before releasing them to the private sector. One consideration concerns the situation when firms have market power, and privatization somehow permits that power to be exercised more freely. Roland takes a strong view, arguing that Russia made the mistake of privatizing before demonopolizing and now suffers the consequences. The argument appears to assume that Russian authorities were capable of carrying out an active, appropriately targeted, and uncorrupt competition policy. But were they? By all accounts, Russia's antimonopoly commissions were effective only at maintaining price controls over many firms, not at forcing splitups, and there have been charges of corruption in their choice of firms to regulate (Joskow, Schmalensee, and Tsukanova 1994).

Conclusion

So what lessons does transition teach about corporate governance and restructuring? First, notwithstanding all the controversy, most studies (including those cited in Roland's review of the empirical literature) do support the proposition that private ownership matters; despite data problems and the limitations of short time span, few studies find no effect of privatization. Second, it is critical to distinguish different methods of privatization, with their associated ownership structures and corporate governance outcomes. Third, privatization is not a panacea: the enormous restructuring problems in transforming enterprises will not be overcome easily or quickly, and ownership change is insufficient to keep the state from interfering with firms' decisions. Rather, privatization is only one of several important policies whose joint effects are complex (Brown and Earle 2001).

Fourth, privatization is not easily separated from new firm development. There have been few attempts to quantify the size of the new private sector, but much evidence points to antecedents in old state enterprises. While the relationship between privatization and new entry is frequently posed as a trade-off (see, for example, Murrell 1992), it might rather be complementary, as privatization policies set the basic conditions for startup entry. Finally, transition appears to show that ownership concentration has ambiguous effects—due not to excessive monitoring (Burkart, Gromb, and Pannunzi 1997) but to entrenched managers and suboptimal owners and to controlling owners that expropriate minority investors.

Most important, we still have a lot to learn, and we need a lot more evidence before we "rush to judgment," as suggested by Stiglitz (2000). For an initiative that has attracted so much attention and controversy, privatization has benefited from relatively little systematic research. An evaluation requires better and more recent data than have generally been available, as well as careful attention to econometric problems that arise in estimating the relationship between enterprise ownership and performance. It also requires an analysis of ownership evolution and takeovers, which may render moot the initial postprivatization ownership structure. At a more basic level, we should distinguish between different privatization policies and components (for example, loans for shares and voucher privatization in Russia, or tunneling and the voucher scheme in the Czech Republic) and determine the appropriate counterfactual for the evaluation. While paying close attention to existing evidence, efforts to expand evidence remain essential—as does retaining scientific open-mindedness as new evidence emerges. The most important (and reliable) lessons from transition are yet to come.

Note

1. The early consensus in favor of rapid privatization is summarized by Lipton and Sachs (1990), Balcerowicz (1995), Blanchard and Layard (1992), Frydman and Rapaczynski (1991), and Boycko, Shleifer, and Vishny (1993). Critics of rapid privatization include Kornai (1990 and 2000); Murrell (1992); Stiglitz (1994, 2000); Black, Kraakman, and Tarassova (1999); and Spicer, McDermott, and Kogut (2000).

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Comment on "Ownership Structure, Legal Protections, and Corporate Governance," by I. J. Alexander Dyck

Rafael La Porta

I. J. Alexander Dyck argues that investor protection is essential for the development of capital markets. He emphasizes that investor protection includes not only the letter of the law but also its enforcement. Enforcement requires both an efficient judiciary and the availability of good financial information that can be used to monitor insiders. La Porta and others (1997, 1998) make a similar argument and show that both legal rules and their enforcement (as measured by the efficiency of the judiciary and the quality of accounting) are important determinants of the level of investor protection and the development of capital markets. Dyck presents new evidence that suggests that firms with widely held ownership structures may simply not be viable in countries with weak investor protection. He argues that setting up ownership structures (through privatization, for example) that are inconsistent with the existing level of investor protection can be enormously wasteful. He concludes by making the case for a broad program of corporate governance reform that includes writing better laws as well as creating the institutions that will facilitate their enforcement.

Dyck's article is a difficult one to review because I agree with so much of what is in it. Rather than disagree on minor issues, I focus on an important aspect of investor protection that Dyck does not cover at length: legal origin and its implications for legal reform. My comments are organized in three sections. I first examine the source of the differences in investor protection across countries and argue that these differences are intimately tied to the legal origin of countries. I then discuss the implications of the legal approach to corporate governance for policy reform. In the last section I present my conclusions.

Legal Origin

There are significant differences across countries in how well legal rules protect outside investors. Common law countries provide the strongest protection of outside investors, both shareholders and creditors; French civil law countries provide the

Rafael La Porta is associate professor of economics at Harvard University. These comments borrow heavily from Johnson and others (2000) and La Porta and others (2000).

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weakest protection (La Porta and others 1998). German civil law countries are in between, although they provide stronger protection of creditors, especially secured creditors than French legal origin countries do. Countries with laws of Scandinavian origin are similar to German law countries. In general, differences between legal origins are best described by the proposition that some countries protect all outside investors better than others, not by the proposition that some countries protect shareholders and others protect creditors.

Countries differ systematically in how they enforce legal protections for outside shareholders. The quality of enforcement also has several elements, from the efficiency of the judiciary to the quality of accounting standards. The quality of enforcement is higher in richer countries, although legal rules themselves do not appear to depend on the level of economic development. But here as well legal origin matters: with the level of per capita income constant, countries with French legal origin have the lowest quality law enforcement of the four legal traditions, and countries with Scandinavian legal origin the highest.

It is unlikely that laws were written primarily in response to market pressures, since legal origins, which long preceded the development of financial markets, are highly correlated with the content of the law. Instead, legal origins appear to shape legal rules, which in turn influence financial markets. But what is special about legal origins? Why, in particular, is common law more protective of investors than civil law?

There is no consensus on the answer to these questions. It may be useful to distinguish between two broad kinds of answers: "judicial" explanations, which account for differences in legal philosophies using the organization of the legal system, and "political" explanations, which account for the differences using political history. The "judicial" explanation of why common law protects investors better runs as follows.[1] In all major legal systems courts assess the legality of transactions on the basis of two broad principles. The first is duty of care, which in this context refers to the responsibilities of corporate directors (and of controlling shareholders insofar as they also serve as directors). The duty of care, derived from the Roman concept of mandatum, requires directors to act the way a reasonable, prudent, rational person would act in their position. In most countries courts have implemented the duty of care using the "business judgment rule," which gives directors the benefit of the doubt unless plaintiffs demonstrate gross negligence. In the United States, for example, case law on executive compensation and takeover resistance is typically governed by the business judgment rule. Not surprisingly, these are the areas in which perceived abuse of minority shareholders is most significant in the United States.

The second general principle is the duty of loyalty, which addresses situations in which a conflict of interest arises. This duty requires that an agent not take improper advantage of the principal. In corporations this means that directors must not take advantage of shareholders or of anyone else to whom they owe the duty of loyalty (employees, "the corporation," or even "the business group"). The duty of loyalty goes beyond "rational and prudent" conduct of directors and, depending on the legal system, is governed by statutes prohibiting particular conduct or by more gen-

eral notions of fairness. In situations involving a conflict of interest, the duty of care may allow directors to take actions that favor themselves as long as they can argue that the shareholders also benefited or were not hurt too badly, at least in the long run. In contrast, the duty of loyalty may rule out such self-serving conduct.

The Belgian court case of Flambo and Barro illustrates the difference between the two duties (Wymeersch 1993). Flambo, a French firm, was the controlling shareholder in Barro, a Belgian company. Arguing that Flambo had stripped Barro of its assets, several significant minority shareholders of Barro sued Flambo, demanding judicial intervention and remedies. The plaintiffs argued that Flambo had tried to pledge Barro (the entire company) as collateral to guarantee Flambo's debt, forced Barro to acquire all the new shares issued by Flambo in a capital increase, withdrawn a substantial sum from Barro's accounts without subsequent repayment, diverted an important contract with Rank Xerox from Barro to Flambo, and used utilities belonging to Barro without paying for them.

The court barred Flambo from continuing to transfer resources from Barro without judicial review pending the election of a new board of directors for Flambo. But it did not propose any remedies for past expropriation or even a change in Barro's board. Relying on the business judgment rule, the court held that Flambo's conduct was consistent with the interest of the group as a whole. It found nothing inherently objectionable in a subsidiary supporting its parent as long as the subsidiary itself was not in danger of bankruptcy. Fairness to Barro's minority shareholders did not come up in the ruling. This and other cases illustrate that in civil law countries insiders face a very low standard of proof in cases of minority shareholder abuse; this results from the narrow application of the concept of fiduciary duty and the reliance on statutes (see Johnson and others 2000).

Civil law courts' greater reliance on statutes rather than general principles in judging conduct is not accidental. In fact, it was central to the design of the civil code by Napoleon and his jurists, who feared monarchist judges and felt that good laws should turn judges into automatons rather than interpreters of the law. This conscious choice may reflect an optimal balance between the goals of regulating the behavior of individuals through the law and controlling the behavior of those who enforce the law to ensure that its application is consistent with the goals of the social planner (Glaeser and Shleifer 2000).

Thus although the application of the law may be more predictable in civil law than in common law countries, courts in civil law countries cannot stop self-dealing transactions with a plausible business purpose, because motivated insiders can structure transactions to comply with the letter of the law. Judges in civil law countries are not allowed to apply a "smell test" to uncover unfair conduct. As a consequence, a corporate insider who finds a way to expropriate outside investors that is not explicitly forbidden by the law can proceed without fear of an adverse judicial ruling.

In contrast, legal rules in the common law system are usually made by judges based on precedents and inspired by general principles such as fiduciary duty. Judges are expected to rule on new situations by applying these general principles even when the statutes have not yet described or prohibited the specific conduct under

judicial review. Judges apply special scrutiny to transactions that "smell bad." The expansion of legal precedents to additional violations of fiduciary duty and the fear of such expansion limit expropriation by insiders in common law countries. From this perspective, the vague fiduciary duty principles of common law are more protective of investors than the "bright line" rules of civil law, which can often be circumvented by sufficiently imaginative insiders.

The judicial perspective on the differences between legal origins is incomplete. It requires a further assumption that judges have an inclination to protect outside investors rather than insiders. But it is easy to imagine that judges in common law countries would use their discretion to narrow the interpretation of fiduciary duty and to sanction rather than prohibit expropriation. In principle, common law judges could also use their discretion to serve political interests, especially when outside investors obstruct the government's goals. To explain investor protection, it is not enough to focus on judicial power; a political and historical analysis of judicial objectives is required. Important political and historical differences between mother countries shape their laws. This is not to say that laws never change but to suggest that history has persistent effects. How so?

La Porta and others (2000) argue that an important historical factor shaping laws is the state's greater role in regulating business in civil law countries than in common law countries. One element of this view, suggested by Finer (1997) and other historians, is the difference across European states in the relative power of the king and property owners. In England from the 17th century on (and arguably before), the crown partially lost control of the courts, which came under the influence of Parliament and the property owners who dominated it. As a consequence, common law evolved to protect private property against the crown. Over time courts extended the protection of property to investors.

In France and Germany, in contrast, the parliaments never dominated the kings, and the state dominated the courts and property owners. Commercial codes were adopted only in the 19th century, by the two great state builders, Napoleon and Bismarck, to enable the state to better regulate economic activity. As the law evolved, the dominance of the state translated into the more political conception of the corporation and the more limited rights of investors in dealing with the politically connected families that control firms. After all, the state was not about to surrender its power over business to financiers.[2] Relative to courts in England, courts in civil law countries were more dependent on the government and less likely to take the side of investors in disputes with the government or with firms close to it. As a consequence of these divergent political histories, civil law developed to become less protective of investors than did common law.

Recent research supports the proposition that civil law is associated with greater government interference in economic activity and weaker protection of private property. La Porta and others (1999) examine the determinants of government performance in a large number of countries. To measure government interventionism, they consider proxies for the quality of regulation, the prevalence of corruption and red tape, and bureaucratic delays. They find that as a general rule, governments of

civil law countrises, particularly French civil law countries, are more interventionist than those of common law countries. The inferior protection of the rights of outside investors in civil law countries may be one manifestation of this general phenomenon. This evidence thus provides some support for interpreting the differences between legal origins in light of political history.

Possibilities for Reform

In the past decade the reform of corporate governance has attracted interest in Asia, Latin America, and Western and Eastern Europe. Not much appears to have been done, however, although interest remains high.

To discuss any reform, it is important to start with its goals. In most countries the objective of corporate governance reform is to protect the rights of outside investors, both shareholders and creditors. As the evidence surveyed by Dyck shows, such reform would expand financial markets, facilitate external financing of new firms, reduce the concentration of ownership, and improve the efficiency of investment allocation.

What can be done to achieve this goal, and what are the obstacles to doing so? To organize this discussion, it is useful to follow Coffee (1999b) in distinguishing between legal and functional convergence. Legal convergence refers to the changes in rules and enforcement mechanisms toward some desirable standard. To achieve legal convergence to effective investor protection, most countries need extensive legal, regulatory, and judicial reform. Functional convergence refers to more decentralized, market-based changes; these do not require legal reform but still bring more firms and assets under the umbrella of effective legal protection of investors.

For most countries, improving investor protection requires rather radical changes in the legal system. Security, company, and bankruptcy laws generally need to be amended. As Dyck points out, there is no reason to think that the list of legal protections of investors studied by La Porta and others (1998) is either necessary or sufficient for such reforms. Moreover, the regulatory and judicial mechanisms of enforcing shareholder and creditor rights need to be radically improved. The evidence on the importance of the historically determined legal origin in shaping investor rights—which could be thought of as a proxy for the law's general stance toward outside investors—suggests that many rules and institutions need to be changed simultaneously in a country with poor investor protection to bring them up to best practice.

The politics of such change have proved brutal. Effective legal reform runs into tremendous political obstacles. Interventionist governments may not be interested in ceding to financiers the control they currently have over large corporations. In addition, families that control large corporations strongly resist improvements in investor protection. From their point of view, an improvement in the rights of outside investors is first and foremost a reduction in the value of control, because it reduces opportunities for expropriation. Legal reform may increase the total value of these firms as expropriation declines and investors finance new projects on more attractive terms.

Still, the first-order effect on insiders is a massive redistribution of wealth from them to outside investors. No wonder then that controlling shareholders—from Latin America to Western and Eastern Europe to Asia—oppose legal reform. As Hellwig (1999) describes the attitude of German industrialists to corporate governance reform, "You can wipe my face but do not get it wet." The German government has opposed transparency and other governance reforms in the European Union.

There is another reason why insiders in major firms oppose corporate governance reform and the expansion of capital markets. Under the status quo, existing firms can finance their investment projects internally (Mayer 1988) or through captive or closely connected banks. In fact, La Porta and others (1997) show that the lion's share of credit in countries with poor investor protection goes to the largest firms. As a consequence, large firms obtain not only the finance they need but also the political influence that comes with access to such finance as well as protection from the competition that could develop if smaller firms could also raise external capital. When new entrepreneurs have good projects, they often have to come to existing firms for capital. For the insiders, poor corporate governance delivers not only secure finance but also secure politics and markets. They thus have an interest in keeping the system as it is.

Consistent with the dominance of interest group politics, successful reforms have occurred only when special interests have been destroyed or appeased. In this respect, corporate governance reform is no different from most other kinds of reform in developing or industrial countries (Hirschman 1963). One example of significant legal reform of corporate governance occurred in Japan after World War II, where General Douglas MacArthur, aided by attorneys from Chicago and an occupying army, introduced a company law based on Illinois law (Ramseyer and Nakazato 1999). Another example is the introduction of regulations for securities markets in the United States in 1933–34, immediately after President Franklin D. Roosevelt's election, in the middle of the Great Depression. Although these regulations have been criticized as ineffective (Stigler 1964), there is little doubt that they have substantially increased corporate disclosure in the United States. Still another example, though one in which success has been more limited, is bankruptcy reform in East Asia following the 1997 crisis. These examples suggest that opportunities for corporate governance reform do arise, but under special circumstances, which should not be wasted.

Unfortunately, opportunities have often been wasted, because our understanding of the principles of reform of investor protection remains limited. There is no checklist of what needs to be done. However, recent research suggests some tentative principles.

Perhaps the first such principle is that legal rules do matter; it is not just the stance of the law or the political sentiment that shapes financial markets. One illustration of this principle is the Neuer Markt in Germany, a subexchange that the Frankfurt Stock Exchange created especially for new firms wishing to go public (Johnson 1999). Because the Neuer Markt operates in Germany, the corporate law, securities law, and other basic laws and regulations applied to the companies listed there are German rules. The politics are German as well. The Deutsche Bourse has ordered that companies wishing to list on the Neuer Markt must comply with international accounting standards, including more stringent disclosure requirements than those

applicable to firms already listed on the main exchange. The new listing venue—with its greater restrictions on entrepreneurs—has sharply accelerated the pace of initial public offerings in Germany. The captains of German industry have accepted it because it has not affected their firms. This example thus points to one possible strategy for overcoming political opposition to reform.

A second principle is that the enforcement of legal rules is deeply connected with the rules themselves. The strategy for reform is not to create an ideal set of rules and then see how they can be enforced but to enact rules that can be enforced with the existing enforcement structure. A famous example of success with such a policy is the securities legislation enacted in the United States in 1933–34. The creator of these laws, James Landis, a professor of administrative law, was deeply focused on enforcement (McGraw 1984). His strategy for forcing corporate disclosure was to demand independent audits of firms' accounts and to make the accountants liable for their reports. Although accounting firms initially resisted these reforms, they soon appreciated the increase in demand for their services. The accounting profession thus became an independent, private force in ensuring compliance with disclosure regulations with fairly limited government involvement. At the time at least, it would have been impossible for the government to enforce disclosure regulations on its own without creating incentives for private self-regulation. The principle of bringing private intermediaries into the enforcement of securities regulations has since been followed by several countries, including Germany and Poland, in regulating their financial markets.

The importance of enforcement is also illustrated by the still unsuccessful reform of bankruptcy procedures in East Asia. In general, improving bankruptcy procedures is harder than improving shareholder rights, because different types of creditors, unlike different noncontrolling shareholders, have different objectives. Senior creditors, especially secured senior creditors, prefer rapid liquidation of bankrupt firms. Junior creditors and shareholders, whose claims are less secure, may prefer more orderly liquidation or even reorganization. As a result of this conflict, most countries have opted for rather slow, reorganization-focused bankruptcy schemes rather than liquidations (Hart 1999).

The trouble is, bankruptcy procedures almost inevitably rely on significant adjudication by the courts. Yet courts in many countries are reluctant to be too active in matters as political and complicated as closing or liquidating companies. In the aftermath of the Asian crisis several East Asian countries, including Indonesia, the Republic of Korea, and Thailand, reformed their bankruptcy laws. Few companies have been taken through the bankruptcy process, however, largely because the courts, which are politicized and unready to adopt the new procedures, throw out most creditor applications on technicalities.

A third—and potentially more controversial—principle of successful reform is that government regulation of financial markets may be useful when court enforcement of private contracts or even of government laws cannot be relied on. An example of how regulation can work when courts are far from perfect comes from securities law reform in Poland and the Czech Republic, two transition economies whose judiciaries were viewed as ineffective. In the early 1990s the Polish government introduced

a tough securities law focused on protecting shareholders. Like U.S. securities law, the Polish regulations focused on significant disclosure by issuers and listed firms and the legal accountability of intermediaries for the accuracy of this information. The law also provided for the creation of a powerful securities and exchange commission with significant enforcement powers that did not require reliance on the courts. This reform was followed by remarkable development of the Polish stock market, with both new and listed companies raising equity in the market.

In contrast, the Czech government chose neither to introduce tough securities laws nor to create a powerful market regulator at the time of privatization. Perhaps as a consequence, the Czech markets have been plagued by massive expropriation of minority shareholders—the "tunneling" of assets from both firms and mutual funds. In contrast to the Polish market, the Czech market stagnated, with hundreds of companies delisted and virtually no public equity financing by firms (see Coffee 1999b; Pistor 1999; and Glaeser, Johnson, and Shleifer forthcoming). The comparison of Poland and the Czech Republic is an almost perfect experiment, because the two countries share roughly similar incomes, economic policies, and judiciary quality. In these circumstances regulation of the stock market and listed firms in Poland, with its focus on investor protection, appeared to play a beneficial role.

The successful regulation of the U.S. securities markets, the Polish financial markets, and the Neuer Markt in Germany shares a common element—the regulatory insistence on extensive disclosure of financial information by the issuers, the accuracy of which is enforced by the legally liable financial intermediaries. Although such disclosure is not sufficient by itself—without the right of shareholders to act on it—it appears to be a key element of shareholder protection.

Although legal reform has been slow and halting in most countries, functional convergence may play a role in improving investor protection. The liberalization of capital markets in many countries has increased not only the flow of foreign investment into them, as Henry (2000) and Stulz (1999) document, but also the economic and political pressure to create financial instruments acceptable to foreign investors. These pressures give rise to several forms of functional convergence. Most obviously, if contracts are enforced well, companies in unprotective legal regimes can offer their investors customized contracts, such as corporate charters, with greater rights than the law generally provides. This strategy relies on perhaps a greater faith in the contracting capacity of investors and courts than is warranted and ignores the empirically clear public good benefit of standard rules.

A more promising approach is for companies to opt into the more investor-friendly legal regimes. One way of doing so is to list a company's securities on an exchange that protects minority shareholders through disclosure or other means. This is done by the many companies that list their shares as American depositary receipts (ADRs) in New York. But such listing imposes only limited constraints on insiders: although it improves disclosure, it typically does not give minority shareholders any effective rights.

A related mechanism for opting into a more protective legal regime is acquisition by a company already operating in such a regime. When a British company acquires a Greek company, the possibilities for legal expropriation of investors diminish. In

a friendly deal such as this, the controlling shareholders of the Greek company can be compensated for the lost private benefits of control, making them more likely to go along. By replacing the wasteful expropriation with publicly shared profits and dividends, such acquisitions enhance efficiency.

It is important to recognize the limitations of functional convergence, particularly in creditor rights. Assets generally remain under the jurisdiction of the laws of the country in which they are located. Without bankruptcy reform, opt-in mechanisms are unlikely to address the legal problems faced by domestic, and especially foreign, creditors. Despite the benefits of opting into the more protective legal regime for external finance, then, this mechanism is unlikely to fully replace bona fide legal reform. Slow and difficult as it is, real legal reform needs to take place in many countries.

Conclusion

Leaving financial markets alone is not a good way to encourage them. Financial markets need some regulation protecting outside investors—whether by courts, government agencies, or market participants themselves. The evidence suggests that civil law countries are less protective of minority shareholders than are common law countries, in terms of both laws and their enforcement. Moreover, important differences in the ways in which countries from different legal traditions apply laws may facilitate minority shareholder expropriation in civil law countries. The link between investor protection and legal origin is probably not accidental. Strong investor protection may be a particularly important manifestation of the greater security of property rights against political interference in some countries.

Improving the regulation of financial markets is a difficult task for two reasons. First, the nature of investor protection, and of the regulation of financial markets more generally, is deeply rooted in the legal structure of each country and in the origin of its laws. Reform on the margin may not achieve the reformer's goals. Second, the existing corporate governance arrangements benefit both the politicians and the entrenched economic interests, such as the families that manage the largest firms in most countries. Corporate governance reform must circumvent opposition by these interests.

Despite these difficulties, investor protection reform can bring significant benefits, and it is politically feasible in some circumstances. It can take the form of opting into more protective legal regimes or introducing more radical change in the legal structure. The integration of world capital markets makes such reforms more likely today than they have been in decades.

Notes

1. This explanation is consistent with David and Brierley (1985) and Coffee (1999a)

2. According to Cameron (1961), France had a lively stock market in the 19th century. Nearly all firms listed on it, however, benefited from government concessions, investment, ownership, subsidies, and protection, as well as outright guarantees to investors in many cases.

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