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Privatization and Corporate Governance

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Abstract

Effective privatization requires enforceable investor protection. There is no evidence that strong investor protection emerges spontaneously from private contracts or political institutions. Attempts to "opt in" by listing privatized firms in high investor protection countries have only limited value. One way to protect investors is by instituting strong domestic regulation for privatized companies, mutual funds and financial intermediaries. For countries with relatively weak legal systems, Poland offers a good model.

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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 help speed the economic recovery and sustain growth.

The early appeal of 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 and providing adequate protection to consumers. 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 demonstrated weak performance and have frequently been "tunneled" by their management. In the Czech Republic, for example, 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 needs to 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 by simply relying on private contracts, in which case all the government needs to do is ensure such contracts can be 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 the 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 providing effective guarantees to investors, for example through mandating certain forms of government intervention or establishing a particular ownership structure and dividend policy. As a consequence, they argue bringing US-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 necessarily need US-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, 1999b) argues that while US firms derive important advantages from the US 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 US-type private contracts with their investors, for example by issuing American Depositary Receipts. 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, it will not improve firm performance and will likely be accompanied by worsening agency problems, including various forms of expropriation or "tunneling" by management.

There is now overwhelming evidence that legal rules matter. Protection for 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 being equal (La Porta, Lopez-de-Silanes, Shleifer, and Vishny LLSV 1997). Firms in countries with less investor protection use less outside finance (LLSV 1997) and have higher debt-equity ratios, making them more vulnerable to collapse (Friedman, Johnson and Mitton 2001b). Countries and companies with weak corporate governance can also suffer larger collapses when hit by adverse shocks (Johnson, Boone, Breach, and Friedman 2000, Mitton 2001, Lemmon and Lins 2001). Countries with weaker institutions have experienced greater output volatility over the past 40 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 "tunnelled" legally out of a company (Johnson, La Porta, Lopez-de-Silanes, and Shleifer 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 the countries with relatively strong legal systems, there is a move to establish stronger investor protection for important segments of the stock market. Germany leads the way in this regard, and the initial effects have been impressive (Goyer 2000, Johnson 2000); other European countries are following. 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 court-enforcement of contracts (Glaeser, Johnson, and Shleifer 2001). As Glaeser, Johnson, and Shleifer (2001) point out, there is a theoretical danger that a strong regulator will act in a capricious manner and undermine economic freedom. But 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 (1997) review the literature on corporate governance before the recent wave of findings from comparative research. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000a) describe the first wave of this research, which constitutes about 20 papers written through the early fall of 1999. However, the pace of activity in this area is accelerating. We cover about 30 new papers not included in either of these previous surveys.

Sections 2, 3, and 4 review the evidence against each of the Coasian positions, with particular emphasis on recent experience with privatization. Section 5 reports recent theoretical analysis based on this evidence. Section 6 concludes.

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.

Investor Protection

The new literature on the importance of law begins with La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV 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.

LLSV (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 boards decision. In the United States, this oppressed minority mechanism takes a 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. LLSV (1998) aggregate these 6 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 LLSV (1998) sample of 49 countries is 5. Investor protection is significantly higher in common law countries, with an average score of 4, compared with an French-origin civil law countries, with an average score of 2.33. There is significant variation within legal origin, however. In the LLSV (1998) 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 GNP.

LLSV (1998 and 1999a) 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 is on average 8.15 in English-origin countries (on a scale of 1-10, 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 LLSV (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) has extended the LLSV work to 21 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 LLSV 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 post-communist countries, privatization has proved much more effective where capital markets have also developed at least to some extent.

Recent research has focussed on some additional determinants of investor protection (Bebchuk and Roe 1999, Roe 2000, 2001, Stulz and Williamson 2001). Rajan and Zingales (2001) maintain that there is an important underlying political process. Berkowitz, Pistor, and Richard (1999) argue that the way in which legal systems were transplanted to other countries is more important than legal origin. However, Acemoglu, Robinson, and Johnson (1999) 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 GDP per capita today.

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 have developed less in French origin countries (LLSV 1997). 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, LLSV (1997) 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 1998). Wurgler (2000) finds there is a better allocation of capital to industries in countries with more financial development.

There is also evidence that countries with weaker investor protection suffer greater adverse effects when hit by a shock. Johnson, Boone, Breach, and Friedman (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 40 years (Pivovarsky and Thaicharoen 2001, Thaicharoen 2001.)

Firm-level evidence supports this view. Mitton (2001) looks at five Asian countries most

affected by the 1997-98 crisis, and finds that firms with larger inside ownership and less transparent accounting suffered larger falls in stock price. He also finds 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 (1998), 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 (2001) confirm Mitton's (2001) 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 (1999) also find a discount for diversified firms in seven emerging markets. Claessens *et al.* (1999) find a diversification discount for East Asian firms and worse performance for conglomerates during the East Asian crisis

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 can produce investor protection or it may be the outcome of reasonable private negotiation between firms and investors. 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 (LLSV 2001).

This approach requires an honest and effective government, but this is itself an endogenous outcome partially affected by legal institutions. LLSV (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 recently in some Asian countries, for example Malaysia (Johnson and Mitton 2001).

Second, ownership may develop in a different way from in the US and the UK. 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 (LLS 1999) show that groups of connected firms are much more usual than stand-alone firms in most countries. These groups typically control at least one company that is publicly traded or otherwise used to raise funds from outside investors, and a number of other companies that are privately held without any outside investors. 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 (LLSV 1998). With the exception of Chile, the other 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 (1999) find that firms are more highly valued when large shareholders own more shares in Germany. In 18 emerging markets, Lins (1999) 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 LLSV 1997. 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 (1999) 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. 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, LLSV (2000b) show that companies in common law countries pay higher dividends.

4. Legal Reform

Coffee (1999) argues that there is an important movement towards “functional convergence,” through which firms around the world are adopting US-type mechanisms to protect investors. There is certainly a move towards issuing American Depositary Receipts, and these seem to improve access to external capital markets. Lins, Strickland, and Zenner (1999) 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 LLSV 1997). Reece and Weisbach (1999) show that companies in civil law countries are more likely to list ADRs on an organized exchange in the US, 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 irrelevant.

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.

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. We can divide the reforms into two parts, those in countries with strong legal systems and those in countries with weak legal systems. In both cases, legal reform has proved strongly complementary to privatization.

Strong Legal Systems

The stock markets in many European countries do not attract initial public offerings. This may slow the development of new high technology firms. Despite a debate about how to address this issue, the main problem is that established firms like the status quo (Hellwig 1999). It enables them to raise capital on favorable terms, in part because they do not have to compete with new firms. Established firms also have strong relationships with some financial institutions, such as banks. Germany, however, has experimented successfully since 1997 with a new segment of the stock market designed for start-ups. This is part of a broader process of corporate governance reform that was prompted, in part, by the desire to privatize assets such as Deutsche Telecom.

The Neuer Markt represents a significant change in the rules protecting minority shareholders in Germany. The two most important changes are greater disclosure (in English) and requiring US GAAP or IAS for company accounts. Management of the exchange emphasizes the importance of clear and regular disclosure, including briefings for analysts. They enforce a system of disclosure, i.e., companies that list on this market know that they have to disclose a good deal and investors know that this will actually happen. It also helps that investment banks play the role of friendly enforcer by being "Designated Sponsors."

The established markets, on the other hand, retain German accounting principles and the old culture of non-disclosure and non-transparency, which is considered more favorable to creditors than shareholders. All German stock markets are governed by the same law (i.e., primarily the Commercial Code, securities law, and insider trading prohibitions.) But the Neuer

Markt offers new legal rules, in the form of a private contract, to those who agree to participate. Establishing these rules has had a significant effect on the ability of young technology-based companies to raise capital through public offerings in Germany. The success of the Neuer Markt in promoting IPOs of technology companies is helping encourage broader changes in the legal protection of shareholders in Germany (Balz 1999).

Changes are also underway in France and it appears that newly privatized companies generally have better corporate governance than well-established family-run firms (Goyer 1999). Japan is lagging but there is definite pressure for change, particularly from international investors (Matsui 1999). Other industrialized countries with strong legal systems are adopting measures similar to those in Germany.

Weak Legal Systems

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, 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 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, etc., who would in turn attempt to assure compliance with regulatory requirements by the issuers and the traders. Moreover, by maintaining substantial power over the intermediaries 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.

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?

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 interested in public welfare than in catering to incumbent firms. Glaeser, Johnson and Shleifer (2001) and Glaeser and Shleifer (2000) 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 very difficult to privatize without creating widespread possibilities for tunneling.

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, for example because it involves legal maneuvers. LLSV (1999b) show how to think about the cost of stealing across countries in a simple static framework. This approach has been developed further by Johnson et al (2000) and more recently by Friedman, Johnson and Mitton (2001).

Johnson et al (2000) presents 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 will lead to increased theft and to lower capital inflow and greater attempted capital outflow for a country. These, in turn, will translate into lower stock prices and a depreciated exchange rate.

The model in Friedman, Johnson and Mitton (2001) puts ideas from Jensen (1986),

Myers (1977) and LLSV (1999b) into a dynamic setting. The key assumption is that entrepreneurs can not only 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).

Friedman, Johnson and Mitton (2001) find that the presence of some debt 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 features analyzed by Myers (1977). When the legal system is weaker, Friedman, Johnson and Mitton (2001) 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, entrepreneur will 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 fewer projects being financed. But weak legal institutions can also contribute to economic crises. Having 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. Reasonable capital structures in a weak legal environment can lead to a bimodal distribution of outcomes.

The data is broadly supportive. Friedman, Johnson and Mitton (2001) show that Asian firms with weaker corporate governance were more highly indebted before the financial crisis of

1997-98. Kim and Stone (1999) find that countries with more corporate debt suffered larger falls in output during the Asian crisis of 1997-98. 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 (1999), 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 (1999) argues that labor market institutions in Western Europe were appropriate, but could not handle the shocks they received in the 1970s and 1980s. In his view a functional set of institutions became dysfunctional because of a particular set of shocks. More generally, Blanchard (2000) 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" (p.1404).

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 more 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. 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 these institutions develop always and everywhere.

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 US 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 US-type innovations can work even in countries with quite different legal origins, such as Germany and Poland.

By giving us a clear framework to think about contracts, Ronald Coase shed a great deal of light on many issues, including international corporate governance and privatization. It is an indication of the power of his approach, that research is now advancing by trying to reject 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 only be achieved through changing the broader legal rules that underpin capital and other markets.

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