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# LEGAL RULES, GOVERNANCE STRUCTURES AND FINANCIAL SYSTEMS

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Abstract

This paper intends to reexamine commonly accepted view on association of legal rules with corporate governance and financial markets. It summarizes findings of a number of empirical studies and gives view of current thinking on association between legal rules and financial systems characterized by ownership patterns, nature of equity, governance structure, finance behavior and capital structure. Nature and effectiveness of financial systems across countries can be partly traced to the differences in legal structures. On the other hand, legal systems are products of different governance and financial systems that place different "demands" on legal institutions. Thus, on the issue of causality, we argue that legal systems evolve as a reflection, as well as a cause, of different governance and financial systems. The practical implication is that few strong conclusions can be deduced about the policy reform. Thus, the policy reform should rely on basic principles.

Acknowledgement

This paper is an excerpt from larger study that will be the final product of research on the impact of legal rules on corporate ownership, governance and financial markets. The topic is of great practical importance for reforms that are currently on agenda of the FRY. I am very grateful to ICER to enable me to make this research, particularly to become acquainted with the Italian corporate governance and financial system.

**LEGAL RULES, GOVERNANCE STRUCTURES AND FINANCIAL SYSTEMS**

The paper summarizes findings of a number of empirical studies[1] and gives view of current thinking on association between legal rules and financial systems characterized by ownership patterns, nature of equity, governance structure, finance behavior and capital structure.

Studies suggest that nature and effectiveness of financial systems across countries can be partly explained by differences in legal structure. Thus, causality goes from legal structures to governance patterns and financial systems. On the other hand, our view is that legal systems evolve as products of different governance and financial systems. Therefore, in the analytical framework that relates the theory of corporate governance and corporate finance with legal rules, we argue that legal structure is a reflection, as well as a cause, of different governance and financial systems. Interconnectedness[2] of the theory of corporate governance, corporate finance and financial systems with legal rules is analyzed in the contractual - transaction cost framework analysis.

The topic is of great practical importance for reforms that have been on agenda of both, developed market economies and transition economies. The globalization of capital markets and emerging markets in transition economies raises the issue whether some characteristics of corporate ownership and governance structures by affecting the liquidity of capital markets, affect the firm's access to capital. We assume that different governance structures and corresponding capital markets perform better in some sectors. Thus, smaller and narrower capital markets do not necessarily mean that firms are constrained to grow because the access to external finance is reduced. Other forms (retained earnings) of financing could always be used, depending on sector to which firms belong.

Interconnectedness of economic and legal devices for reducing informational asymmetry (agency problems) is discussed in the first section of the paper. Exogenous character of legal rules is adopted in studies that are reviewed in this paper. Therefore, the second section briefly comments on methodological concept of legal rules as exogenous variables. The third section summarizes findings of a number of empirical studies about the association between legal rules and corporate ownership, corporate governance and development of financial markets. Also, findings are analyzed in the light of whether the country's particular legal structure and/or legal origin affect corporate

[1]These studies trace legal determinants of ownership patterns /See for example: La Porta,R., Lopez-De-Silanes, F. and Shleifer,A (1999)/ or governance systems /Shleifer,A. and Vishny,R., (1997)/ or legal determinants of external finance /La Porta,R., Lopez-De-Silanes, F.,Shleifer,A. and Vishny,R., (1997)/ or impact of the development of financial systems on investment and growth of firms /Rajan,R. and Zingales,L., (1995), Rajan,R. and Zingales,L.,(1998)/, etc.

[2]Recent literature relates the theory of governance structures with the theory of corporate finance. Explicitly or implicitly legal rules and their enforcement are taken into account as determinants of governance structures, methods of corporate financing and financial markets. For example: Williamson, O.E., (1988), Aghion, P. and Bolton, P., (1989), Miller, G.,(1996), Israel, R., (1991).

financing and firm's access to capital. Within the broader perspective of the variety of governance structures and financial systems, we sometimes refer to the Italian model because most of the systems around the world seem to be closer to the Italian model than to the models that are in economic theory thought to be the best. It means that large firms tend to be family controlled and to rely predominantly on internal financing. The fourth section is focused on policy recommendations for reforming corporate governance and financial markets. Transition economies, their institutional and legal reforms regarding financial markets are the subject matter of the fifth section.

**1. Economic and Legal Institutions as Devices for Reducing Informational Asymmetry**

Complex institutional structures – economic and legal - work to constrain contractual parties in their opportunistic behavior, thus to reduce informational asymmetry and minimize agency costs. Various theoretical strands of the new institutional economics[3], emphasize different problems arising from incomplete contracting, all of them just being the aspects of the same transaction costs problem[4].

Institutions – economic and legal are transaction cost economizing devices. Their function is to reduce costs of global contractual governance[5] - across markets and within the firm. Modern theory of the firm is based on the concept of the firm as a set of contracts[6] and many phenomena related to the firm (ownership structure, governance, finance and financial markets, the choice of capital structure, corporate law) can be explained by considerations of incomplete contracting. Contractual approach to theory of the firm and to the theory of corporate finance focuses on the relation between ownership structure and control rights assignment[7]. Ownership and control over firm need not to coincide. The separation between the two may create governance structures (control) that are not based on ownership (like fiduciary duties, trust, coalitions). Contracts (and/or legal rules) are supposed to assign control over firm in a way that aligns the interests of different parties within the firm. Informational asymmetry and opportunism of contractual parties create agency costs that affect the firm's value. Economic and legal institutions deal with two major and often overlapping forms of agency costs based on informational asymmetry. One form is the

[3]The new institutional economics has different ramifications (property rights approach, contractual approach, transaction costs and social norms approach) that are all just different dimensions of the same methodological approach.
[4]Transaction costs are costs of exchanging property rights. Different authors focus on different sources and aspects of transaction costs - informational asymmetry, principal-agent problem, bounded rationality and opportunism, expropriation, moral hazard, performance measurement or costs of resource coordination. See: Williamson, O., (1985), Alchian, A. and Woodward, S., (1988), Jensen, M. and Meckling, W., (1976), Alchian, A. and Demsetz, H., (1972).
[5]Guelpa, F., (1997).
[6]Coase, R., (1937), Alchian, A. and Demsetz, H., (1972), Jensen, M. and Meckling, W.H., (1976), Fama, E. and Jensen, M., (1983) Hart, O., (1995), Williamson, O., (1985).
[7]Grossman, S., and Hart, O., (1986).

shareholders-manager relation and the other form is the relationship between controlling and non-controlling shareholders.

So, parties within firm face the problem of finding out economic methods and devices for aligning the interests of managers and shareholders, and/or controlling and non-controlling shareholders in order to discourage managers and/or controlling shareholders to divert too much of the firm's net income to themselves. Those methods range from making the managerial compensation dependent on the performance of the firm, firing managers, leveraged buyouts, paying dividends, takeovers, risk of bankruptcy, etc.

The role of legal protection is to reduce informational asymmetry by implying in corporate charters those rights that shareholders would insist upon in order to invest in the corporation. Besides voting rights and dividend entitlement, they insist upon the membership in the board of directors and some other rights. But the shareholders are not homogenous group. So, their rights and their stake in the corporation determine the level of protection they expect to be provided in the corporate charter. It is not the same level of protection required for controlling shareholders and for minority shareholders.

Legal systems are equipped to deal with agency problems in different ways and each has different costs and benefits. Legal devices provide safeguard for investors, particularly non-controlling. Excessive protection of non-controlling investors allows their interference in control and reduces incentives of the controller to behave efficiently. On the other side, poor protection of investors, particularly non-controlling shareholders reduces their incentives to offer capital because it hinders the efficient transfer of control[8].

## 2. Reviewed Empirical Studies and the Problem of Causality

A great body of the empirical literature on the firm's governance, finance and financial systems confirms that differences in legal protection of investors explain much of the differences in governance and financial systems in the world. Thus, legal rules are exogenous variable. Legal rules are measured by quality of legal protection of investors and level of their enforcement. In some of the studies, countries are classified according to their legal origin[9] and not according to actual legal rules (commercial codes) in order to avoid endogeneity of legal rules. According to authors, endogenous rules may be imposed as a result of lobbying of powerful political and economic groups. A variable in economic model will be endogenous or exogenous depending on what is chosen as an object of investigation. By assuming that legal rules are exogenous, legal rules are

[8]Barka, F., (1997) argues that excessive control hinders the efficient transfer of control. The Italian economic literature is concerned that the excessive control-enhancing devices seen in family, coalition control and in pyramidal group structures endanger the need for well-balanced relation between the protection devices and control-enhancing devices.

understood as given variables within an economic model. Legal rules are, thus, taken as key explanatory variables for understanding economic devices (such as ownership patterns, governance structures, corporate finance and financial markets) that reduce informational asymmetry. It means that one direction causation is ascribed to the association of legal rules with ownership patterns, governance structures and financial systems. Causation goes from legal rules/legal origins to corporate governance patterns, financial markets, firms' access to external finance and to costs of capital. This explanation of the association of legal rules and economic variables have strong policy implications regarding the possible designing of legal systems.

Other possible approach to the causation issue is the neo-institutional approach. The neo-institutional concepts of informational asymmetry and transaction costs reduction within the firm and across the markets are essential to understand a variety of corporate ownership structures, governance structures, financial market systems and the capital structures.

In the theoretical framework of neo-institutional economics legal rules (institutions in general) are endogenous variables that are chosen by economic agents. Legal rules are endogenous and choice variables. Economic agents chose legal rules the same way they chose governance structures, financial systems or whether to sell and buy goods. Within the neo-institutional framework association of legal and economic devices is not one side causation[10]. Their endogenous character suggests possible future line of research in modeling the association of legal rules and corporate governance, ownership structure and financial markets as endogenous variables.

The neo-institutional economics approach explains why it is a good methodological choice to capture the quality of legal rules by legal origin of the country. Quality of legal rules comes from economic pressures within the system, from numerous contractual relationships and property rights arrangements and social norms and values in a society. On the other side quality of legal rules determine the quality of economic process. Thus, we can say that shareholder protection is determined by economic forces and some broader culture reflected in legal origin.

However, in spite of the endogenous methodological treatment of legal rules, the reviewed studies give an important and valuable insight in the association of legal rules and more general structure of financial markets and governance structures.

## 3. Legal Rules Governance Structures, Corporate Finance and Financial Markets

Governance structures are about how the suppliers of capital safeguard returns on their investment. In regard of governance structures and corresponding types of financial markets, there

[9]Legal origin is highly correlated with shareholder protection.
[10]If legal rules are choice variables, then company law and, even broader. the whole body of economic laws can be understood as standard contract. See: Easterbrook, F. and Fischel, D., (1991).

are huge institutional and legal differences among countries across the world. In spite of these differences, some countries demonstrate similar level of economic development. They demonstrate that access to external finance depends on the level of legal protection of investors, and not contrary to expectations, whether they belong to bank oriented or market oriented financial system as theoretically extreme variants of financial systems.

### 3.1. Legal Rules and Governance Structures

Brief description of the two extreme theoretical models of financial systems is as follows:

Economic theory usually associates dispersed ownership (widely held corporations) with market-oriented Anglo-American model[11] of financial system in which most of the financial institutions are precluded or unwilling to play a major role in corporate governance. Dispersed ownership gives rise to stock markets as devices against opportunistic behavior of managers and takeovers are synonym for corporate governance. On the other side concentrated ownership is associated with bank-oriented German model[12] of financial system. Banks and financial institutions play a major role in corporate governance by holding their own equity or by voting on behalf of other investors. However, in the most of the world, corporations typically have controlling owners. Even in the US corporate ownership is not completely dispersed and concentrated holdings can be seen more often than expected.

Regarding ownership patterns, the empirical evidence[13] suggests that the large publicly held corporations have large shareholders with ultimate control and that they are active in corporate governance. The evidence confirms that on average 36% of largest firms are widely held. On the other side, on average 30% of the largest firms are family[14] controlled and 18% are state controlled. It is interesting that Japan classified as bank-controlled system has widely held 18 out of 20 largest firms. There are countries like Argentina, Greece, Austria, Hong-Kong, Portugal, Israel and Belgium that could hardly be said to have any widely held firm. The same conclusion applies for Italy[15].

This result is in contrast to the widespread belief that large corporation are widely held. Evidence confirms that there is a negligent number of widely held large corporations in a countries

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[11]It is depicted as outsider system of the UK and the US where ownership is dispersed among large number of individuals and institutional investors, where cross-shareholdings are rare and where takeover activity is lively.
[12]It is depicted as insider system of Continental Europe and Japan where ownership of an individual firm is in hands of small number of families, banks and other firms and where cross-shareholdings are common place.
[13]La Porta, R., Lopez-De-Silanes, F. and Shleifer, A. (1999) tested whether usual image of corporation as widely held by small shareholders correspond to reality. For data and explanation of variables see La Porta, R., Lopez-De-Silanes, F. and Shleifer, A. (1999), p.474-477.
[14]Family control solves agency problem of separation of ownership and control but raises a problem of dynamic and static efficiency in distribution of skills and ownership. See: Barka, F., (1995).
[15]See: Caprio, L. and Floreani, A.,(1996).

with poor shareholder protection. Equity markets of continental Europe play limited role with exceptions of Netherlands and Sweden[16]. In countries with good shareholder protection as in common law countries, the incidence of widely held corporation is more often and, as a consequence, they have bigger and more liquid equity markets. Irrespectively of the type of financial system, the largest firms tend to have controlling shareholders with the exception of the US. Nevertheless, modest concentration of ownership is reported[17] in the US largest corporations, contrary to their usual image as widely held.

Significant concentration of ownership is reported for Germany, Japan and Italy[18] and heavily concentrated ownership for developing countries[19]. Concentration of ownership and corresponding governance arrangement which provides the separation of cash flow from control rights can be achieved through different economic and/or legal instruments: multiple classes of stock (deviation from one-share-vote-one), cross-shareholdings[20], pyramidal ownership structures, takeovers and participation of owners in management[21]. The most important mechanisms, as evidence demonstrates, is pyramidal scheme[22].

The empirical evidence confirms that most common categories of controlling shareholders are family and state, while bank control through equity ownership is not common. Only 5% of large firms are controlled by banks mostly and other financial institutions[23]. Bank control is much higher in countries with poor shareholder protection compared to countries with good shareholder protection. Equity ownership by banks is small outside Germany, Belgium and Japan. Thus, ownership of financial institutions does not play major role in corporate governance, but in Germany and Japan banks influence governance using mechanisms other then ownership – lending and board representation. In Germany and Japan banks gain significant powers through seats in the board of directors or through voting equity of other investors.

Countries with good shareholder protection have 48% of widely held firms as opposed to 27% in countries with poor shareholder protection. In countries with poor shareholder protection there are 34% of family controlled firms and 22% of state controlled as opposed to 25% family

[16]Stock markets in Netherlands are relatively highly liquid and have high value due to a small number of very large multinational firms. Sweden also has large and liquid equity market despite high concentration of ownership. According to, Berglòf, E., (1997), takeovers in continental Europe are devices for withdrawal of firms from stock exchanges rather than to replace managers and change control.
[17]Demsetz, H. and Lehn, K., (1985), Shleifer, A. and Vishny, R., (1986).
[18]See: Barka, F., (1996) and Bianco, M., Gola, C. and Signiorini, L.F., (1996).
[19]La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R., (1999).
[20]Cross-shareholdings is legally limited or restricted in Belgium, France, Germany, Italy, Korea and Spain. According to the study of La Porta, R., Lopez-De-Silanes, F. and Shleifer, A. (1999), this mechanism is more used in countries where it is restricted.
[21]Participation of shareholders in management reduces agency problems of separation between owners and managers but enhances the problem of separation cash flow rights from private benefits.
[22]Results of La Porta, R., Lopez-De-Silanes, F. and Shleifer, A., (1999) are consistent with Barka, F.,(1995).
[23]La Porta, R., Lopez-De-Silanes, F. and Shleifer, A. (1999), p. 502.

controlled and 14% of state controlled in countries with good shareholder protection. It seems that in the countries with poor shareholder protection, family controlled large firms and state controlled[24] large firms are the rule.

### 3.1.1. The Costs and Benefits of Governance Structures

Dispersed ownership gives to the owners less incentive to monitor because of the free-rider problem[25] Costs of monitoring are higher than expected benefits from the monitoring. Free rider problem may prevent the transfer of control over company to those who would be the most efficient managers[26]. Possible safeguards are: the exit by selling shares (including takeovers and management turnover) and the comprehensive system of fiduciary duties that require from the board and entrepreneur to act in the interest of non-controlling owners.

Concentrated ownership mitigates free-riders problems of corporate control and as a consequence, owners are more active in exercising control over managers. Finance literature attributes benefits to the role of large shareholders assuming that they have right incentives and skills to monitor managers. Different kinds of large and active shareholders exist and thus different is the working of corporate governance systems. As empirical evidence demonstrates regarding the relationship between ownership concentration and corporate performance, corporate performance initially rises with low levels of concentrated ownership and than falls with high levels[27]. A common implication of many models of corporate governance is that firms with more concentrated ownership structures, but otherwise identical, trade at higher prices as there is a higher incentive on the part of owners to monitor the firm and make the necessary changes in management.[28]

Concentrated ownership (large shareholdings) reduces diversification opportunities. Because of that investors want to extract private benefits[29] from the firm. So, control that is exercised by majority shareholders (insiders - like directors and families in Italy) is influenced by private benefits. Conflict of interest between majority and minority shareholders is inevitable. Majority and minority shareholders' interests are not likely to be aligned when decision about the reallocation of control is to be made (transfer[30] of control through sales, takeovers, etc.). The evidence from Italy confirms that majority shareholders enjoy large private benefits, not less than 18% of the total

[24]In Austria 70% of the largest firms, in Singapore 45% of the largest firms, in Israel 45% of the largest firms and Italy 45% of the largest firms are controlled by state. See: La Porta, R., Lopez-De-Silanes, F. and Shleifer, A., (1999), p. 496.
[25]Demsetz, H.,(1983).
[26]Grossman and Hart, O.,(1986).
[27]McConnel, J.J. and Servaes, H., (1990).
[28]Shleifer, A. and Vishny, R.W., (1997).
[29]See Demsety, H. and Lehn, K., (1985).
[30]For rules that protect minority shareholders in a process of acquisition see: Zingales, L.,(1994a).

market value of the median corporation[31] of the sample. Private benefits of the majority shareholders dissuade outside (non-controlling) investors to offer capital to the firm. So, costs of shareholders conflict may be incurred by the fall of the global value of the firm and thus the value of its shares.

The problem how to align cash flow rights with control rights is differently addressed by concentrated and dispersed ownership and corresponding governance structures and financial markets. Empirical evidence supports assumption that private benefits from control rights[32] are more important when shareholder protection is poor. Moreover, it is confirmed that ownership concentration is negatively correlated with shareholder legal protection. Weak protection of non-controlling investors reduces external finance and as a consequence equity markets are smaller and managers are less effectively controlled by the market for corporate control. So, development[33] of financial markets is positively correlated with shareholder legal protection. Italy, France and Germany have relatively small public equity markets.

The issue of control is extensively discussed in the light of ownership and governance structures and financial systems. Corporations do not usually deviate from one-share-one-vote principle[34], not even when it is legally allowed. Findings demonstrate that multiple classes of shares are not major methods for separating ownership from control. Cross-shareholding is not of significance in separating ownership from control except in Sweden and Germany. It looks like that cross-shareholding has more significance in countries where it is forbidden[35]. Separation of ownership and control is of practical relevance because control rights exercised by controlling shareholders may be significantly in disproportion of their cash flow rights. On average, it takes 18,6% of capital to control 20% of votes[36]. In poor shareholder protection countries, it takes on average 17,7% of capital to control 20% of votes and in good protection countries 19,7% of capital to control 20% of votes[37]. Large shareholders prefer to maximize private benefits of control as a substantial part of their wealth[38].

A great deal of evidence[39] about equity trade at a substantial premium confirms that control over firm is valued. The level of voting premium differs according to the managers' or controlling shareholders' opportunity to gain benefits. It ranges, as evidence indicates, from 6,5% reported for

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[31]See: Caprio, L. and Floreani, A.,(1996), p. 18.
[32]About the private benefits of control see: Jensen, M. and Meckling, W., (1976), Grossman, S. and Hart,O., (1988) and Haris, M. and Raviv, A., (1988).
[33]Development of financial market is indicated by stock market capitalization and liquidity.
[34]Scandinavian countries significantly deviate in this regard.
[35]It is forbidden in Italy, Germany, France, Korea, Spain and Belgium (out of the sample of 27 countries).
[36]See: La Porta, R., Lopez-De-Silanes, F. and Shleifer, A., (1999).
[37]See: La Porta, R., Lopez-De-Silanes, F. and Shleifer, A., (1999), p.498.
[38]Jensen, M., (1986).
[39]See: Shleifer, A. and Vishny, R., (1997), Zingales, L., (1995) and Zingales, L., (1994b).

Sweden to 82% that is reported premium on the Milan Stock Exchange[40]. And for example, as a consequence of a more dispersed ownership or modest concentration, superior voting rights in the US are traded at small premium. Prices of firms incorporate the effects of ownership and corporate governance on future firm performance[41].

Established ownership patterns and governance structures imply the liquidity of financial market. Reduced liquidity of financial markets, because financial instruments are held by small number of investors, is a cost of concentrated ownership. And vice versa, low liquidity of financial markets may preserve the existing ownership concentration. Moreover, it can preserve the existing poor legal protection of investors.

### 3.2. Legal Rules, Financial Systems and Corporate Finance: Access to External Finance

Differences in company laws (legal rules) around the world do not necessarily imply differences in protection of investors[42].

On the other side, there is strong evidence[43] that differences in legal rules that reflect different levels of investor protection affect the development of financial markets and the firms' access to external capital. In that case inefficiency of legal rules are more or less successfully substituted (compensated) by economic devices like more concentrated ownership. "The various rules and institutions may well substitute and complement each other in ways that produce the same outcome".[44] Fairly similar level of economic development of G-7 countries that belong to different legal origin could be the result of institutional substitution. The US and the UK belong to common law legal origin characterized by the best legally protected investor rights. Next four countries are civil law countries, with France and Italy belonging to French civil law subgroup that protects the least, and with Japan and Germany belonging to the German civil law subgroup that gives protection that is between common law and French civil law subgroup. Canada is characterized by bijuridism – common law and civil law legal origin in its different parts.

Strong correlation between poor investor protection and ownership concentration and smaller and less liquid capital markets stands contrary to the homogenous development of G-7 countries of which France and Italy and part of Canada belong to the poorest investor protection

[40]For Italy see Zingales, L., (1994b) and for some other countries see Shleifer, A. and Vishny, R., (1997).
[41]See evidence from the Czech Republic and the Slovak Republic in Classens, S., (1997).
[42]For example, rules protecting minority shareholders in the stage of control transfer differ across countries. Equal opportunity rule is accepted in the UK and (similar) at the EU level. Market rule is common in the US. It allows the transfer of controlling block at a premium without obligation for mandatory buyout but it is observed that it is almost usual for companies to regulate this issue by provision of so-called "fair price amendment" in their charters. Practices based on different rules have the same results and demonstrate that contractual parties protect their interests the best.
[43]La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R., (1997). The study compares legal rules using a sample of 49 countries. For data and variables see p. 1133-1137.
[44]Berglòf, E., (1997).

countries (French legal origin subgroup). Thus, research should be directed to answer broader question – does strong correlation between legal rules/origin and development of financial markets affect economic growth. There are empirical investigations about correlation between development of financial systems and economic growth[45], but study of specific properties of legal systems, corresponding financial markets and growth has yet to be undertaken.

Further part of this section presents the findings that confirm strong correlation between the investor protection, ownership concentration and the liquidity of financial markets. Differences in legal rules across countries are captured by quality of investor (shareholder and creditor) protection and by different legal origins. The common law countries protect investors the most and have the most developed financial markets[46]. Among civil law countries, French subgroup protects the least and German and Scandinavian subgroups are between common law and French civil law subgroup. Using three measures for the extent of equity financing[47], the study demonstrates that common law countries provide better access to equity finance than civil law countries, particularly French subgroup. The average ratio of outside held stock to GNP is 60%, 21%, 46% and 30% for common law, French subgroup, German subgroup and Scandinavian subgroup respectively. The average number of listed firms per million population is 35, 10, 5 and 27 for common law, French subgroup, German subgroup and Scandinavian subgroup. It is interesting that in France 8 listed firms are reported while in Germany 5 and in Italy only 4 per million of population. Reported number of IPOs per million of population in the period between mid. 1995 – mid. 1996 is 2.2, 0.2, 0.12 and 2.1 for common law origin, French, German and Scandinavian subgroups respectively. The reported IPOs in the US are 803, in Germany 7 and in France 10.

As far association between creditor rights and debt financing is concerned[48], results suggest that creditor protection influence[49] debt financing. Aggregate debt as a share of GNP is 68%, 45%, 97% and 57% in common law countries, French, German and Scandinavian subgroup respectively. Micro data on debt that covered large firms only, demonstrate that large firms get debt finance irrespectively of the legal rules and creditor protection.

[45]Financial sector development measured as the level of financial intermediation and share of private ownership in the financial sector is important to explain economic growth. See King, R. and Levine, R., (1993). The likelihood of the view that legal arrangements that shape financial markets affect growth is derived by Berglòf, E., (1997) following findings of La Porta, R., Lopez-De-Silanes, F.,Shleifer, A. and Vishny, R., (1997) and findings of King, R. and Levin, R., (1993). Also, see: Levine, R. and Zervos, S., (1998) and Rayan, R. and Zingales, L.,(1998).

[46]For the arguments that common law is more efficient than statutory law see Posner, R.A., (1992).

[47]Three measures of equity financing used in the study are capitalization of equity held by outsiders, number of listed firms per million population and number of IPOs per million population. See: La Porta, R., Lopez-De-Silanes, F.,Shleifer, A. and Vishny, R., (1997), p. 1137.

[48]See: La Porta, R., Lopez-De-Silanes, F.,Shleifer, A. and Vishny, R., (1997), p. 1145-1146.

[49]If legal origin is included, creditor rights are not significant. Unusually high debt levels, compared to aggregate ratio of liabilities to GNP, are reported for large firms in countries with heavy government regulation.

It is not confirmed that bank-oriented systems have greater reliance on debt[50]. Distinction between bank-oriented and market-oriented system is vague regarding the role of banks, so distinction between strong-bank countries and weak-bank countries might be more useful[51].

It is interesting that there is not significant difference in the incidence of widely held firms among strong and weak bank countries[52]. Contrary to expectations, greater reliance on bank finance is associated with the greater incidence of widely held firms. Empirical results demonstrates that well developed equity markets go hand in hand with well developed debt markets and that both are consequence of good legal investor protection. So, the results show systematic difference between countries belonging to different legal origin. Common law countries have more developed capital, as well as debt markets.

Taking into consideration the differences in common law and civil law legal origins, our opinion is that civil law weaknesses in legal investor protection and consequently less developed financial markets may be compensated by reduced informational costs due to the large shareholdings. Smaller and less liquid financial markets, and developed financial markets serve better different purposes. For example, countries with better developed financial systems, have superior growth in capital intensive sectors because these sectors naturally rely on external finance[53]. Also, the preliminary empirical evidence on performance of different governance models in Italy, confirms[54] that some models perform better in some sectors. Family and coalition control perform slightly better in traditional and specialization sector. Group control performs well in high technology sectors where large investments are needed. This is the evidence that firms organized in groups are less financially constrained. Also, it means that pyramidal group control substitutes financial institutions. Another question, regarding the relationship of legal rules, corporate finance and capital markets, is whether financial markets are developed according to investment needs of the economy sectors or economy sectors are developed according to the available access to financial markets.

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[50]Rayan, R. and Zingales, L., (1995) didn't find higher leverage in bank-oriented systems.

[51]Distinction between strong bank countries and weak bank countries is based on whether banks are allowed to own majority stakes in firms and to invest more than 60% of their capital portfolio in firms. The United Kingdom for example, belongs to strong bank countries. Italy, Japan and the United States, among others, belong to the weak bank countries. See: La Porta, R., Lopez-De-Silanes, F. and Shleifer, A (1999). There is not significant difference in the incidence of widely held firms in strong and weak bank countries, neither in market oriented and in bank oriented financial systems. Shareholder protection is crucial for the incidence of widely held firms.

[52]In testing the association of legal rules and ownership patterns, La Porta, R., Lopez-De-Silanes, F. and Shleifer, A., (1999) corroborate the results of La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R., (1997) that tested the association of legal rules with the access to external finance.

[53] See: Rayan, R. and Zingales, L., (1998).

[54]Cesari, R. and Salvo, G. (1996) regressed various performance variables (profits, growth of sales, growth of employment, sales per employee corrected for industry effects) on the firm's control model controlling for size, age, period of the last transfer of control and industry, p. 25. Regarding that ownership concentration influences control

Corporate financing according to all empirical data mostly relies on internally generated funds. Bank credits are the largest external source of finance regardless the differences in financial systems. The evidence that different financial systems are not associated with fundamentally different ways of financing firms supports our assumption that combinations of different legal and economic devices work as substitutes. In all financial systems (whatever the legal protection of investors), as confirmed by the empirical evidence, large firms have rather easy access to external finance.

Conclusion[55] that more investor protection (captured by legal origin) is always desired because it develops financial markets is simply incorrect. Excessive legal protection reduces entrepreneurial innovative activity, thus efficiency. So, our view is that optimal legal rules (protection) would be derived from practice as a complement to economic efficiency devices. The combination of certain types of economic and legal devices (like concentrated ownership, large shareholders control, smaller and narrower financial markets and weaker legal protection of investors) and their effectiveness is a substitute for some other combinations of economic and legal devices (like dispersed ownership, liquid financial markets and good legal protection of investors).

This paper tries to direct the future research of corporate governance and financial systems to understanding and explanations how countries "like Italy have managed to develop so strongly over the last 30 years despite apparent weaknesses in basic legal structure and investor protection?"[56] The Italian model[57]of corporate governance and financial market is based on the family and coalition control[58], state control and control derived from pyramidal group system. Another characteristic is that larger firms are more concentrated than small ones. It is to the highest degree favorable to majority shareholders. One of the Italian peculiarities is that privately held companies are the rule, even when the companies are the largest ones. The limited role of the Italian stock market and insignificant role of banks and other financial institutions is, therefore, the consequence. The Italian market for transfer of corporate control is segmented. It comprises of the intra-family transfers as one of the Italian peculiarities, and of non-family market transfers. The prevailing legal forms of corporations within pyramidal groups are privately held company and partnerships. These forms are chosen in order to keep the certainty of control within family and coalition groups.

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model and financial system as well, the obtained results confirm our assumption about the substitution between legal and economic devices.

[55]La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R., (1997).

[56]Berglòf; E., (1997), p. 114.

[57]See: Barka, F., (1996), Barka, F., (1997), Cesari, R. and Salvo, G., (1996), Bianco, M., Gola, S. and Signorini, L.F., (1996), Pagano, M., Panetta, F. and Zingales, L., (1998).

[58]Preservation of family control is possible explanation for preemptive clauses in company charters and it also explains why privately held corporation as legal form prevails among the Italian companies.

We argue that the model of Italian corporate governance and financial market has evolved in efforts to find substitutes for efficient governance devices. Family and coalition control substitutes fiduciary duties. Pyramidal groups is a device for concentrating ownership and substitute the role of financial institutions.

### 3.2.1. Legal Rules and Capital Structure as Specific Governance Arrangement

Capital structure could be understood as specific governance arrangement that is, as any governance structure, affected by the level of legal protection of investors. Incomplete contracting view and transaction costs approach provide a theoretical framework to analyze financial decisions. In deciding what capital structure to choose, a firm makes trade off between costs and benefits.

Any method of outside finance (different classes of debt or equity instruments) of the company is associated with agency costs because managers cannot be fully and costlessly controlled[59]. Moreover, different methods of outside finance involve different types of opportunistic behavior associated with different level of agency costs. Capital structure may be chosen to minimize the sum of agency costs. Financial institutions such as banks and non-bank intermediaries serve as efficient devices for reducing some types of opportunistic behavior.[60]

Capital structure mitigates managerial incentives to divert income from shareholders and to more closely align divergent interests of managers and shareholders. It is observed that various mixes of financial instruments (standard debt and equity contracts, as well as more complicated financial instruments) implicitly shape governance structures. The optimal debt level balances the probability of acquisition and bankruptcy and matters when investors make their decisions whether to invest.

So, the choice between retained earnings, financial intermediaries or public security offering on stock markets matters for the efficiency of corporation and its price. The role of capital structure is to reduce the costs of capital. Countries with better legal protection of investors have more external finance in the form of higher valued and broader capital markets.

Corporate financing mostly relies on internally generated funds. Bank credits are the largest external source of finance[61] regardless the differences in financial systems. Regarding capital structure[62], little difference is found in the relative importance between debt and equity finance in the bank-oriented and market-oriented G7 countries. Differences in their legal systems, particularly

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[59]Jensen, M.C. and Meckling, (1976).

[60]See: Diamond, D., (1991). A gency costs are cheaper because intermediaries are well devised and have knowledge for monitoring and because they have knowledge how to reduce them by well diversified portfolio.

[61]Franks, J. and Mayer, C., (1990). It is suggested that the UK and the US use more internal funds than France, Germany and Japan.

[62]Similar levels of leverage are found in G-7 countries in spite of considerable institutional differences. See: Rajan, R. and Zingales, L., (1995).

bankruptcy codes did not affect the level of leverage. It is surprising that debt finance is more important for the UK than for the German companies and that large German firms use little of bank loans[63].

**4. Economic and Legal Devices in the Light of Reforms and Policy Prescriptions**

The reviewed studies present fairly consistent results in assessing the importance of legal rules in shaping ownership patterns, governance structures, corporate finance and financial markets. If we reverse the causation line, the main conclusion that we derive from their findings is that ownership patterns, governance structures, corporate finance and financial markets place different "demands" on legal institutions.

Concentrated ownership (large shareholders) does not demand heavy legal intervention. Thus, large shareholders may rely on basic legal protection. In some countries it is easy to form a controlling block if minority shareholders are poorly protected. It is suggested, that in that case, focus of the corporate governance reform should be shifted to legal and regulatory setting of the capital markets. The real problem is in well balanced legal protection of minority because they do not have power (control) to protect themselves. So, laws should provide their protection that shareholders would provide for themselves in their corporate charters if they had opportunity to contract without transaction costs.

Legal protection across countries goes from substantive - mandatory rules and default (enabling rules that are choice variables in corporate charters), to procedural rules.[64]. The optimal level of protection, and generally the best structure of corporate law cannot be derived from theory. It evolves from practice[65]. Enabling and procedural rules better work against opportunism than mandatory rules.

In spite of the differences of corporate governance systems relying on different financial systems, it could not be said what is the best system. They have different costs and benefits and serve to different purposes. The differences between the US, the UK, Germany and Japan[66] are smaller compared to their differences to other countries. The common law origin and German civil law subgroup provide the best legal protection associated with corresponding governance and financial systems. Japan falls between the US and Germany regarding the degree of protection of both - shareholder and creditor rights. They work differently compared to systems of the French

[63]See: Edvards, J. and Nibler, M., (2000).
[64]For the problems in creating company law in transition economies see Black, B., Kraackman, R. and Hay, J., (1996).
[65]See: Easterbrook, F. and Fishel, D., (1991).
[66]Japan cannot be anymore characterized as one of the most successful financial systems because of huge amount of bad loans. In spite of significant power of banks through the seats in the board of directors and through voting of other investors' equity, the problems of bad loans require the revision of devices for investors' protection and their enforcement.

civil law subgroup with poor legal protection of investors but associated with more concentrated ownership (equipped with different economic device). Different legal rules and different economic institutions may complement or substitute each other and may produce similar outcomes. Most of the corporate governance and financial systems around the world are not like the most successful ones – the US, the UK and Germany. Most of the systems are more similar to the Italian financial system where legal protection of investors is poor. In most of the governance and financial systems, firms are controlled by family and state and have difficulties in accessing external finance[67]. It is hard for firms to obtain external financing and most of debt financing comes from state banks. As well established pattern, firms are predominantly internally financed.

Our opinion on the issue of causality[68] regarding the relationship between law and financial systems, is that one direction causation cannot be established. Most of the systems are based on less substantial legal protection and in these systems economic devices (for example, concentrated family ownership and control) are substitutes for poor legal devices. Or inversely, concentrated ownership "demands" just basic legal protection. Legal protection is just one dimension of protection against opportunistic behavior. Corporate ownership patterns, governance patterns, financial patterns and implied financial markets influence the creation of legal system. Evolution of legal system and its origin is the consequence of the workings of economic forces. Thus economic forces shape legal rules and vice versa.

Ownership patterns, governance structures and financial markets are relatively stable over time, legal systems as well. Thus, it is unlikely to impose one structure to dominate over another. The question is what purpose serve different governance structures and financial markets. Each system has its costs and benefits, comparative advantages and shortcomings. Each system provides a different means for reducing opportunistic behavior. Attempts to implement only one type of ownership pattern, governance structure and financial system contradict to understanding that institutions evolve as a spontaneous response to the problems of informational asymmetry. They are different because their differences make them better suited to solve different agency problems. The transition countries proved that legal reforms are not sufficient to impose desired ownership pattern, governance structure and financial system. "The system of corporate control is an integral part of the corporate culture landscape of any country".[69]

[67]Reported by Pagano, M., Panetta, F. and Zingales, L., (1998).
[68]The arguments for the same stand on the issue of causality see: Berglòf, E., (1997).
[69]Schneider-Lenne, E.R., (1992), p.22.

## 5. Transition Economies and Legal Tradition

Transition economy, for political reasons, relied on variety of models. Consequently, a variety of governance structures were created. In most of the transition economies capital markets are still underdeveloped. Insider privatization and consequently insider ownership structure (employee and managerial ownership[70]) were inefficient in enterprise restructuring. In Russia[71], for example, controlling owners were managers whose rights comprised of cash flow rights together with almost complete control rights. This is a consequence of the very poor protection of non-controlling shareholders. The Czech Republic[72] experience suggests that large shareholdings controlled by banks and mutual funds play a significant role in corporate governance. Direct sale of assets is the only method of privatization that unambiguously created efficient governance structures.

Transition indicator scores for 2000 have shown the largest improvement since 1997. Nevertheless, institutional development of market supporting institutions (banking and financial institutions, competition policy, corporate governance and enterprise restructuring) has lagged behind the progress in liberalization and privatization.

Three patterns are observed between progress in liberalization/privatization and institutional development. One pattern is balanced progress in liberalization/privatization and institutional development like in Hungary and in most of the central European countries. The second is rapid initial liberalization in the first half of decade, followed by strong institutional reform in the second half of decade like in Lithuania and the Baltic states. Third pattern is observed when rapid initial liberalization was not followed by subsequent institutional reforms like it was in Georgia and less advanced transition economies. In creating market economies, legal rules and their enforcement play crucial role in building market-supporting institutions, as vice versa, the development of market-supporting institutions develops legal rules and their enforcement.

Progress in institutional development in the area of financial institutions and financial markets required strengthening of legal protection of investors, particularly as reported, harmonization of banking regulations with international standards, strengthening bankruptcy laws, modernizing company and securities laws and strengthening enforcement of laws. The close association has been demonstrated between the improvements in financial market regulation, enterprise restructuring and corporate governance with the promotion of foreign equity investments

[70]About (in)efficiency of employees' and managerial ownership see Frydman, R., Gray, C.W. and Rapaczynski, A., (eds.), (1996).
[71]See: Boyko, M., Shleifer, A. and Vishny, R., (1995).
[72]Claessens, S., (1997).

and lending[73]. The problem, as evidence in transition economies demonstrates, is predominantly in the domain of enforcement[74] and not in quality of laws. Governments wanted to avoid shortcomings of the established governance structures by implementing different methods for remaining privatization - direct sales through tenders and auctions. Also, in order to improve ownership and governance structures resulting from previous voucher and management-employee buy-outs, they tried to promote firms restructuring through market for corporate control and external financing. These devices did not perform well in many countries[75]. Governments passed new modern laws, but their enforcement depended on deeply rooted legal tradition and acquired knowledge of business people and legal profession. Rapid legal changes are sometimes counterproductive. The quality of laws, thus, cannot be chosen according to the desired outcome but according to the economic pressures within the system and legal tradition.

In creating market economies, legal reform plays crucial role together with building supporting market institutions. It was expected that key commercial and financial codes approximate internationally achieved standards[76] and to achieve the internationally accepted degree of their enforcement. On the other side, legal framework of emerging market economies should be consistent with the legal tradition and level of economic development of each country. The need for consistency explains why enactment of new laws previously unfamiliar to the legal tradition of the country reduces the level of law enforcement[77]. Empirical results suggest that law enforcement is more important for financial market development than the quality of the laws[78]. Also, the choice of legal rules has to correspond to legal and broader cultural tradition of each country.

**Conclusion**

Practical conclusions derived from the summary of presented empirical studies and their findings regarding association of legal rules and corporate governance and financial systems are as follows: There is not a better system in general, but better for certain purposes. Ownership patterns, governance structures, corporate finance and financial markets place different “demands” on legal institutions. Recent empirical studies demonstrated that the cultural, historical and other differences

[73]See: EBRD Transition Report 2000, London.
[74]The evidence for transition economies is consistent with the findings of the numerous empirical studies about the significance of law enforcement (or rule of law) for the size, breath and liquidity of developed markets and for the establishing efficient ownership patterns and governance structures.
[75]See: EBRD Transition Report 2000,London.
[76]EBRD has developed measures to assess the extensiveness (content of laws which is adequate to international standards) and effectiveness (level of enforcement adequate to international standards). See: EBRD Transition Report 2000, p.33.
[77]The explanation is that judicial profession is not familiar with it and not willing to accept it. See: and Pistor, K., Raiser, M. and Gelfer, S., (2000). The problem is that courts and legal profession in transition economies do not understand business and do not have knowledge how to implement sophisticated rules.

would not allow the adoption of one single model of governance and financial system. A single model of financial market should not be imposed because different models serve different purposes and that is reflected in consequent costs and benefits. Most of the corporate governance and financial systems have less substantial legal protection than the most successful ones. Legal reforms that would enhance protection of investors are recommended in many studies. The idea is to change company laws by giving explicit rights to shareholders and/or to regulate financial markets. The recommendation are given in expectations that results will be directed toward the higher incidence of widely held firms and corresponding governance structures and toward broader and more liquid and valuable equity markets. However, a degree of freedom for policy makers is bounded by informal institutions – norms and social values as well, and legal rules are not sufficient to create (design) desired ownership patterns, governance structures, capital structures and financial markets.

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[78]See: Pistor, K., Raiser, M. and Gelfer, S. Market for corporate control and external financing predominantly works in countries with common law tradition and with fairly dispersed ownership.

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