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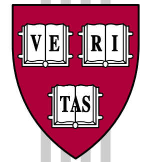

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G-24 Discussion Paper Series

The Politics of Legal Reform

Florencio López-de-Silanes

No. 17, April 2002

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

THE POLITICS OF LEGAL REFORM

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Yale University and NBER

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Abstract

As a result of the emerging market crises of the last decade and a large body of academic research on the influence of investor protection in the development of capital markets and economic growth, there is a growing consensus that reforming the legal infrastructure supporting business should be an important component of reforms in many developing countries. But the consensus is unwieldy, as there are still many forces against reform and little agreement about what constitutes feasible legal reforms. This paper has two parts. In the first, we identify the forces for and against legal reform and review the role these forces play in episodes of reform. In the second, we seek to further our understanding of what constitutes good laws and regulatory mechanisms, and more importantly how to make them enforceable in different countries. If legal reform is to succeed, the commonly advocated principles of corporate governance in the international community must be brought down to the local political and judicial realities. Translating international corporate governance initiatives into clear and enforceable rights for creditors and shareholders that incorporate these constraints will be difficult but necessary. Bankruptcy law and corporate law reform need to be politically feasible and enforceable. Legal reforms should be complemented with carefully drafted judicial reforms, as well as market-based mechanisms that foster a culture of corporate governance.

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The Politics of Legal Reform

Florencio López-de-Silanes[*]

I. Introduction

As more countries make a transition to market economies, the focus of the public policy debate has broadened from macroeconomic stability to the design of institutions that sustain growth. Acknowledging that institutional reform is a vast topic, this paper focuses on the development of financial institutions such as banks and stock exchanges, the construction of the legal infrastructure supporting business, and the creation of regulatory mechanisms in line with best world practice. The ever increasing interconnections among financial markets and the waves of international turmoil in the last decade, such as the Tequila crisis, the Asian crisis and the Russian crisis, are creating a consensus among policy-makers that the reform of financial institutions is an essential component of reform. This belief has been backed up by continuing academic research showing that the institutions of corporate governance, in particular law and the quality of its enforcement, matter for the development of financial markets and economic growth.

Although some consensus has been reached and several international institutions and bodies have begun promoting legal reform, the consensus is unwieldy as there are still many forces against reform and little agreement about what constitutes feasible legal reforms. This paper first identifies the forces for and against legal reform and reviews their role in episodes of reform. Forces against reform include managers and families in control of firms, labour, and sometimes politicians themselves. On the other side, one of the main allies of reform is the opening up of economies and the increased interconnectedness of financial markets that allows investors from all over the world to "vote with their feet" when investor protection is not part of the agenda. The main lesson of this analysis is that the design of reforms needs to consider the reality of local forces that may oppose reform and work on mechanisms to appease those interests.

Secondly, we attempt to identify what constitutes feasible legal reforms. There is no "one-size-fits-all" set of good laws and regulatory mechanisms. More importantly, rules that work in developed countries might not succeed in developing countries struggling with poor judicial systems and inadequate rule of law. This paper makes clear that the divide between developed and developing economies is more pronounced in the level of enforcement than on the laws themselves. Bankruptcy

[*] I would like to thank Prof. Dani Rodrik and participants at the UNCTAD's G-24 Technical Group Meeting in Washington D.C. for their comments. Parts of this paper draw on various research papers and publications with several of my co-authors including Juan Carlos Botero, Simon Johnson, Rafael La Porta, Andrei Shleifer and Robert W. Vishny.

and corporate law reform need to be considered in the local enforcement context. Complementary market-based mechanisms and judicial reforms that build further consensus on reform and enforcement are needed for long-term success.

If legal reform is to succeed, the commonly advocated principles of corporate governance in the international community need to be brought down to the local political and judicial realities of each country. There is a lot of work that needs to be done to translate international corporate governance initiatives and principles into clear and enforceable rights for creditors and shareholders.

The organization of the paper is as follows. Section II briefly reviews the importance of investor protection and corporate governance for the development of capital markets and economic growth. This section also evaluates whether developing countries and emerging economies have systematically weaker investor protection embedded in their laws and enforcement, i.e. whether there exists a legal trap for developing nations. While the results show little evidence of a legal trap, they do confirm that disclosure standards and legal enforcement is systematically lower in less developed countries. These facts have two implications for legal reform. First, blindly copying the laws from developed countries and providing rights to creditors and shareholders will not necessarily work in developing countries. Second, reform needs to be in accordance with the local legal system. Section III of the paper reviews what we have learned about the politics of legal reform, describing the forces for and against such reform.

Section IV attempts to translate the challenges imposed by the political and judicial local realities into feasible creditor rights and shareholder rights reforms respectively. The first part of this section analyzes the avenues open for bankruptcy law reform and emphasizes the need to create venues that allow market forces to play a larger role. The second part studies current proposals for corporate law reform and argues for their translation into feasible reforms. It also urges complementary market-based mechanisms that tie higher valuations to higher investor protections to foster a corporate culture of legal protection to shareholders. Each subsection provides some lessons and suggestions for reform.

Since one of the main challenges for successful legal reform is the judicial system, section VI undertakes a comprehensive analysis of the available evidence on judicial reform itself and makes some recommendations for the structure of future reforms in developing countries. Section VII concludes with some general comments.

II. Investor protection

A. ***Does investor protection matter?***

The development of stable capital markets and financial institutions helps firms gain access to the external funding needed to undertake investments. Securing access to external funds is essential for local firms, particularly in countries that have opened up to international trade. Without these funds, local firms may not be able to undertake the appropriate investments and reach the scale needed to compete internationally. The development of capital markets that help entrepreneurs access external funds crucially depends on the legal institutions that support these markets. These

institutions, mainly laws and their enforcement, are intimately linked to corporate governance. Corporate governance is the set of mechanisms, including laws and their enforcement, that ensure a firm's suppliers of finance get a return on their investments. The main concern of corporate governance is that the returns owed to security holders (shareholders and creditors) are not stolen or expropriated.

The legal approach of corporate governance argues that agency relationships in the firm are the main source of the expropriation by managers and controlling shareholders. This approach helps explain why some countries have much larger capital markets than others and why legal protection for investors and legal enforcement differ enormously from country to country. Recent research (La Porta, López-de-Silanes, Shleifer and Vishny 1997, 1998) has shown that laws and their enforcement do matter: countries with higher investor protection offer entrepreneurs better terms of external finance and thus have both higher valued and broader capital markets.

Extensive expropriation severely undermines the effectiveness of a financial system. Potential investors, fearful of expropriation, are unlikely to finance even the most attractive investment when they know their return is likely to be expropriated. Clearly, weak legal institutions lead to few projects being financed. The projects most likely to be financed are those of firms with sufficient internal funds to make the investment. Overall, too few projects are financed and not necessarily those that result the most beneficial to society, from a welfare perspective. Thus, when investment is insufficient and misallocated, productivity and economic growth suffer.

Through its effect on financial markets, investor protection also influences the real economy. Extensive literature has provided a wealth of evidence on the link between financial development and economic growth (Demirguc-Kunt and Maksimovic, 1998, King and Levine, 1993, Levine and Zervos, 1998, Rajan and Zingales, 1998, Ross Levine, 1999, and Carlin and Mayer, 1999). Some of these papers show that the association between external finance and growth holds even at the industry level. Other authors show that an exogenous component of financial market development, obtained by using legal origin as an instrument, predicts economic growth. In particular, financial development can accelerate economic growth in three ways. First, by raising opportunities, financial development can enhance savings. Second, it can channel these savings into real investment and thereby foster capital accumulation. Third, to the extent that the financiers exercise control over the investment decisions of the entrepreneurs, financial development improves the efficiency of resource allocation, as capital flows toward the more productive uses. All three channels can in principle have important effects on development.

Another body of research suggests that improved resource allocation is an important consequence of financial development, and that through this channel, investor protection contributes to the growth of productivity and output (Beck, Levine and Loayza (2000) and Wurgler (2000).[1]

[1] Beck, Levine, and Loayza (2000) find that banking sector development exerts a large impact on total factor productivity growth, and a less obvious impact on private savings and capital accumulation. Wurgler (2000) finds that financially developed countries allocate investment across industries more in line with industry-related growth opportunities than do the financially undeveloped countries.

Conversely, weak legal institutions make recovery from economic crises more difficult. Weak protection of investor rights does not make shocks more likely, but it does enlarge the negative effect shocks have on the overall economy. For this reason, institutions matter for a particular aspect of volatility after collapses as the evidence from the 1997–1998 Asian crisis shows (Johnson et al, 2000).[2]

B. <u>Investor protection and per capita income: is there a legal trap</u>?

As explained in the previous section, an increasing number of academic papers are exploring the ramifications of investor protection, leading to widespread concern that different degrees of investor protection are explained mostly by levels of income. Do developing countries have systematically worse legal protections than developed countries? If this is true, then it could be the case that poor countries are stuck in a bad equilibrium of inadequate legal protection and scarce external finance, which stunts their growth and therefore keeps them poor and with inadequate legal protection. On the other hand, if per capita income is not a critical determinant of effective legal protection countries can still grow out of the trap, even if weak laws slow down financing and investment. This section attempts to shed some light on these issues.

In table 1 (at the end of this paper), countries are sorted by per capita income into the bottom 50 per cent and the top 50 per cent. Appendix A describes the variables shown in this table. A means comparison is performed of some investor protections, judiciary system, and size, activity and concentration of the financial market variables across per capita income groups. The data shows indices of key legal rules on the rights of investors and creditors, on the quality of enforcement of laws, and the breath and depth of financial markets for 49 countries with publicly-traded companies. The sample comes from La Porta, López-de-Silanes, Shleifer and Vishny (1997 and 1998). Rules protecting investors come from different sources, some of the most important being company laws and bankruptcy laws. Though there are many potentially measurable differences among countries in their company and bankruptcy laws, La Porta et al. (1998) focus exclusively on the basic rules that scholars believe are essential to corporate governance, especially those that can be interpreted as pro-investor. Variables on the enforcement in the judiciary come from various sources including Business International Corporation and International Country Risk Guide. Variables on the size of financial markets were constructed by the authors with data from Moodys, WorldScope and various country sources.

Shareholders have residual rights over the cash flows of the firm, and their right to vote is their main source of power. The shareholder rights index measures how strongly corporate law protects shareholders' voting rights and the rights that support voting mechanisms – and thus how strongly it protects minority shareholders against expropriation by controlling shareholders. The index covers shareholders' rights to receive advance notice of shareholder meetings and to vote by mail, to participate in the meetings, to elect directors that represent their views, to subscribe to new issues of securities on the same terms as controlling shareholders, to call extraordinary shareholder

[2] Johnson et al.(2000) analyze the depreciation of currencies and the decline of the stock markets in twenty-five emerging markets during the Asian crisis of 1997–1998. Their results show that investor protection indices, and especially the measures of the quality of law enforcement, are powerful predictors of the extent of stock market declines and exchange rate depreciations during a crisis.

meetings, and to sue directors for suspected wrongdoing, including expropriation. A country scores one point on the index for each pro-investor right its corporate law grants.

The more developed countries – with an average index of 3.17 – provide somewhat better shareholder protection than less developed countries (average index 2.84). But this is not the case for creditor rights. The index of creditor protection, based on bankruptcy law, measures the ability of creditors to use the law to force companies to meet their credit commitments. The index scores creditor rights in both reorganization and liquidation, in part because almost all countries rely to some extent on both procedures. The creditor rights assessed are those of senior secured creditors, in part because they account for much of the debt in the world. Creditor protections relate largely to bankruptcy procedures. These include creditors' rights to take possession of collateral, to protect their seniority, and to decide whether to fire management. They also include measures that make it harder for firms to seek court protection in reorganization without creditors' consent. Like the shareholder rights index, the creditor rights index includes one point for each pro-investor right granted by law. On average, there is no evidence that more developed countries offer creditors stronger legal protection than less developed countries do. The average creditor rights score for developed countries is 2.13, compared with a 2.48 for developing countries.

The results thus far show that although corporate and bankruptcy laws differ a great deal across countries at different development levels, there is no clear-cut evidence that developing countries are trapped by their laws. The laws in developed countries are more favourable to shareholders but there is no conclusive evidence that creditors are better protected in either group of countries. Still, shareholders fare better in some countries than in others. What explains these differences? Legal rules are only part of investor protection story. Enforcement of the law is just as important, if not more so. Good laws that are not enforced cannot be effective. However, strong enforcement can compensate for weak rules, and an efficient judiciary system can redress management expropriation, protecting investors despite bad laws.

An index measuring the efficiency of the judicial system serves as a proxy for the quality of enforcement. This index shows significant differences across groups of countries in different income levels. Table 1 shows that the mean score for the efficiency of the judicial system across developing countries is 6.26 compared with a 9.14 in developed countries. Similarly, the index that measures the prevalence of the rule of law and serves as a proxy for the tradition and respect of the law suggests that developing countries lag behind considerably in quality enforcement – the average for developing countries is a mere 4.68 versus a 9.10 in developed countries. This seems to indicate that even if investor protection might not be all that different across nations, quality of enforcement and tradition of the law differs significantly in poorer countries of the world. In contrast with legal rules, which do not appear to depend on a country's level of development, the quality of enforcement is markedly better in wealthier economies.

Another index measures the quality of accounting standards for publicly traded firms. Disclosure and accounting standards, usually imposed by securities exchanges, are central to corporate governance. They provide investors with the information they need to exercise their rights and allow courts to resolve disputes among investors. In this respect, developing countries once again

show lower levels of disclosure and accounting standards scoring 5.29 compared with a 6.72 in developed countries.

Overall, table 1 shows that shareholder and creditor rights do not systematically depend on the level of per capita income. Table 1 suggests that creditor rights are somewhat stronger in developing countries. It is possible that the relative anti-management stance of poor countries' bankruptcy laws is dictated by efficiency: unless creditors get their hands on the assets fast, these assets are likely to disappear. It is also possible that, in richer countries, management lobbying has succeeded in emasculating creditor rights. The aggressive pro-management stance of the United States bankruptcy law is consistent with both of these interpretations. In any case, there is no evidence that poor countries have *weaker* creditor rights.

The efficiency of the judicial system and rule of law both increase substantially with the level of income. In fact, per capita GNP alone explains over half of the variation in enforcement measures. The quality of accounting standards also rises sharply with per capita income, although we have fewer observations for the poorer countries. The picture is thus very different for law enforcement than it is for legal rules.

As for the size of capital markets, the evidence runs in favour of developed countries which broadly speaking have larger stock markets with considerably more domestic publicly-traded firms, more active capital markets with firms seeking funds more often, and broader debt markets. In particular, results are presented in table 1 for a list of variables on the ownership of the three largest shareholders in the average domestic firm, the number of IPOs, the number of listed domestic firms, and the size of the debt market for a sample of cross countries. First, ownership concentration in financial markets is negatively and significantly correlated with income levels. Measures on the ownership of the three largest shareholders in the average domestic listed firm is lower for developed countries (0.46) than for developing ones (0.52). The test for the difference in means is significant at standard levels (t-stat 3.43). Second, the number of initial public offerings or seasoned equity offerings in the local stock market is considerably lower in developing countries than in developed ones. On average, only 0.34 firms per million inhabitants go public in the developing world compared with 1.02 firms in the developed world. Third, the number of domestic publicly-traded firms per million inhabitants in an average developing country is merely 9 compared with an overwhelming 22 in the developed world. Finally, the size of debt markets – measured by the ratio of total bank debt of the private sector and outstanding non-financial bonds to GNP – shows that wealthier countries hold an edge in the level financial development. On average, the size of debt markets to the economy is 0.76 per cent in developed countries and 0.40 per cent in developing ones.

In summary, data does not present evidence of a legal trap in terms of laws on the books, although there are marked differences in terms of enforcement measures and accounting standards between developed and developing nations. Partly as a result of poor investor protection, developing countries have less smaller stock and debt markets. One interpretation of these findings is that the legal rules in developing countries are not "the right ones" because they are not designed for judicial systems of low efficiency. The implication of this view is that legal reform needs to make sure that rules are redesigned taking into account the low efficiency of the judicial system. Another interpretation of these findings is that low judicial efficiency renders "the right rule" unenforceable.

The implication of this view is that legal reform needs to be complemented with judicial reform itself. The rest of the paper adopts the view that both of these arguments are at play, and therefore, successful legal reform in developing countries needs to take both into account.

III. The forces of legal reform

For most developing countries, the improvement of investor protection would require rather radical changes in the legal system. Securities, company, and bankruptcy laws would generally need amending, and the regulatory and judicial mechanisms of enforcing shareholder and creditor rights would need radical improvement. There is no reason to think that a particular list of legal protections of investors, emerging from the international "codes of best" practice or from the list of rights included in the indices of creditor and shareholder rights described in table 1, is either necessary or sufficient for such reforms. The evidence presented in Section II suggests that the country's judicial system plays a key role in shaping investor rights.

There are tremendous political obstacles to effective legal reform. Perhaps the most important objections come from the controlling shareholders at the top of large corporations. The reason for this is straightforward. From the point of view of the controlling investors, an improvement in the rights of outside investors is first and foremost a reduction in the value of control, particularly as the opportunities to unlawfully seize the assets deteriorate. This is the case despite the fact that the total value of these firms increases as a result of legal reform, expropriation declines, and investors finance new projects under more attractive terms.

The impossibility to conduct self-dealing transactions and restrained competition are perhaps further reasons why the insiders of major firms oppose corporate governance reform and the expansion of capital markets. Under the status quo, the existing firms can finance their own investment projects through internal cash flows as well as relationships with captive or closely tied banks. In Mexico, for example, the lion's share of credit goes to the few largest firms: 18 per cent of all private claims in the Mexican economy go to the largest 20 private firms listed on the stock exchange. This number is twice as high as the world mean and almost three times as high as in the United States or Canada. Most of these types of loans in Mexico, as in many other developing countries, come in the form of related lending, e.g. loans to owners of the bank (La Porta, López-de-Silanes and Zamarripa, 2001). As a consequence, the large firms not only get the finance they need, but also the political influence that comes with access to such finance. In addition, they are protected from competition that would arise if smaller firms could raise external capital. When new entrepreneurs have good projects, they often have to come to the existing firms for finance. Poor corporate governance delivers the insiders not only secure finance, but also relatively secure politics and markets.

The opposition to reform may also come from labour interests. After all, these interests are also receiving some rents from the existing arrangements, for example when managers invest in large plants that are irrelevant and employ large numbers of people. The losers in the existing arrangements are the new entrepreneurs who cannot raise external funds to finance new investment, and the parts of the labour force that do not have access to the privileged jobs. Objections from labour groups make it more difficult to get reforms through Congress. Successful reforms have only occurred when the

special interests could be destroyed or appeased. In this respect, corporate governance reform is no different from most other reforms in developing or developed countries (Hirschman, 1963).

Although difficult, reform has taken place in several countries, such as the United States in 1933–1934, Japan after World War II, Chile in the 1980s, and more recently in Germany, Republic of Korea, and Poland. These examples illustrate the possibility of legal reform in the area of investor protection, but also point to the substantial political difficulties. Yet, there are some countervailing political interests as well, including foreign (institutional) shareholders and creditors who have recently begun insisting on some rights as investors. In some countries, these outside investors are beginning to have influence. Their influence becomes particularly great in the times of financial crisis, such as the emerging world experienced in 1997–1998 when companies and the insiders ran them desperately in need of funds. Indeed, Thailand has recently introduced a new bankruptcy law, and the Republic of Korea has allowed outside investors to successfully sue directors who act against their interests. It remains to be seen how far these efforts will go. Slow and difficult as it is, real legal reform also needs to take place in Mexico, although it is difficult to ascertain what parameters reform should follow?

What can policy-makers do to foster better investor protection? There are capital market reforms 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. Some mechanisms adopted in developed countries might be appropriate for developing countries, though others might not work, given the current enforcement environment of some nations. Unfortunately, our understanding of the principles of reform of investor protection remains limited. There is no checklist of what needs to be done. However, the available evidence indicates that to foster financial markets in developing countries reforms must meet three tentative principles:

- The enforcement of legal rules is deeply connected with the rules themselves;
- Potentially more controversial, Government regulation of financial markets may be useful when court enforcement of private contracts or even of Government laws cannot be relied on;
- As legal reform is slow and complicated complementary market-based mechanisms should be adopted, because they can help create the necessary pressures for reforms to take place.
- The next section applies these principles and the reality of the politics of legal reform to try to develop some ideas about feasible bankruptcy and corporate law reform.

IV. Feasible legal reform

The implications of the first two sections are very important for the design of feasible legal reform. In the last decade, the reform of corporate governance has preoccupied policymakers all over the world, from Western to Eastern Europe, Latin America and Asia. Proposals to improve governance are wide-ranging. The Cadbury Committee focuses on boards of directors. The European Corporate Governance Network stresses improved disclosure. In the aftermath of the emerging-markets crises, several Latin American and Asian countries are reforming regulations covering

bankruptcy, disclosure, and several other aspects of governance, yet their progress has fallen short of expectations. Many times, the reasons behind the failure of legal reform is due to underestimating the politics behind it and the strong opposition that these changes may encounter through the process of approval, as this section will illustrate.

In the last five years, several international organizations and groups of countries have established codes of "best corporate governance" practices to protect shareholders and creditors (e.g. OECD Corporate Governance Principles, World Bank initiatives on Corporate Governance and Insolvency, etc.). What table 1 shows is not that developing countries need to copy laws from developed countries but that, although its governance systems might be similar across groups, they may not work in the same way. One reason for these differences in effectiveness may be the various degrees of judicial efficiency across groups. If so, a great deal of work is required to design laws that are actually enforceable in most developing countries, particularly those with a history of poor enforcement of rules and laws. Blindly copying principles or inserting some investors' rights into the laws of developing countries is not likely to lead to effective legal reform.

The rest of this section details some examples of failed reform in corporate and bankruptcy laws, illustrating the difficulty of implementing successful corporate governance. They evidence lessons about basic elements that should be incorporated in the design of legal reform in developing countries.

A. ***Feasible bankruptcy law reform***

In the absence of a bankruptcy law, creditors may engage in a socially wasteful race to be the first to seize their collateral or to obtain judgement against a debtor. This may lead to disbursing the debtor's assets and to a loss of value to all creditors when the assets are worth more as a whole rather than in parts. For this reason, it is in the collective interest of creditors that the disposition of a debtor's assets be carried out in an orderly manner.

Several international organizations, such as the OECD, World Bank and other regional development banks, have started to develop an insolvency initiative to be used as reference for countries undertaking reform in their bankruptcy laws. This initiative tries to develop efficient legal and regulatory mechanisms, and aims to deal with unusual cases such as bankruptcies of State-owned enterprises and banks. However, it will very likely take quite sometime to understand the particularities of the many different insolvency procedures in place around the world.

Regardless of the existing techniques, a strong bankruptcy procedure not only assures the orderly disposition of a debtor's assets, but by protecting creditor rights, it could also meet the following four conditions:

1. *It should try to achieve an outcome that maximizes the total value of the proceeds received by the existing claimants.* Clearly, all creditors would benefit if the bankruptcy procedure could be modified so as to deliver a higher expected ex-post value of the firm;

2. *It should neither be too soft on "bad" companies nor too hard on "good" firms.* Debt can serve an important role in disciplining management by, for example, limiting their discretion to engage in wasteful projects. Accordingly, a good bankruptcy procedure should preserve the ex-ante bonding role of debt by penalizing managers adequately in situations of bankruptcy. However, even economically viable firms run into financial distress and bankruptcy law should provide a way to preserve them;

3. *It should maintain the absolute priority of claims.* That is, the most senior creditors should be paid off before anything is given to the next most senior creditors and so on. There are two basic reasons for this. First, senior creditors would be reluctant to lend if the previously contracted structure of debt priority was violated within the framework of the bankruptcy procedure. Second, having different rules for dealing with creditors inside and outside of bankruptcy can result in perverse incentives with some creditors wasting resources trying to induce management to either forestall or precipitate bankruptcy;

4. *A strong bankruptcy procedure should try to minimize the amount of discretion that the judiciary is able to exercise.* For example, allowing a judge to make business decisions may not be desirable if this person does not have the qualifications or the appropriate incentives. In addition, there is a concern that discretion may facilitate corruption.

There are two basic procedures to address problems of financial distress: (1) cash auctions; and (2) structured bargaining. Cash auction or liquidation procedures are most widespread. Virtually every country in the world has this type of procedure. A cash-auction involves closing down the firm's operations and appointing a trustee or receiver in charge of organizing a cash auction for the firm's assets. The firm may be sold as a going concern or piecemeal. The receipts from the auction are distributed among claimants according to absolute priority.

Structured bargaining or reorganization encourages creditors and shareholders to bargain over the future of the company. Under the judge's supervision, claimants develop a plan to liquidate or reorganize the firm and to divide its value among them. Such a plan is implemented if it receives approval by a suitable majority of each claimant class.

In practice, both types of procedures have serious problems. Under perfect and complete capital markets, cash auction or liquidation procedures sell the firm to its highest bidder and guarantee an efficient outcome. However, if capital markets are not efficient, the best managers may not be able to raise the cash necessary to buy the firm. Capital market imperfections may have dire consequences if firms are inefficiently dismantled and their assets sold-off cheaply at fire sale prices. A well functioning structured bargaining procedure requires a sophisticated legal system. In practice, bargaining procedures have been criticized for being time-consuming, involving significant legal and administrative costs, causing considerable loss in company value, being relatively soft on management and allowing a judge abusive powers. Although these difficulties could be addressed through legal reform, there are two inherent problems with any structured bargaining process.

First, it is difficult to know what fraction of the firm should be allocated to each class of claimants because there is no objective valuation for the restructured firm. Second, and more

importantly, structured bargaining processes address two questions simultaneously: (1) Who should get what? and (2) What should be done with the firm? The coupling of these issues introduces conflicts of interest and may cause assets not to be put to their most productive use. For example, senior creditors may press for a speedy liquidation, to ensure they will be paid off, whereas junior claimants may encourage protracted bargaining, as they enjoy the upside of any changes in the firm's value, but not the downside.

In general, improving bankruptcy procedures is more difficult than improving shareholder rights because different types of creditors, unlike the different non-controlling shareholders, have different objectives. Senior creditors, especially the secured senior creditors, prefer rapid liquidation of bankrupt firms. Junior creditors and shareholders, whose claims are less secure, may prefer more orderly liquidation or even reorganization. These conflicts have pushed most countries to opt for slow, reorganization-focused bankruptcy schemes rather than liquidations (Hart, 1993).

Unfortunately, this is not all that can go wrong when applying a bankruptcy procedure in a developing country. In such nations further problems may arise. Since capital markets in emerging economies are less developed, the deficiencies outlined for liquidation procedures may be more severe. It should also be noted that the effectiveness of court procedures is impaired by the low efficiency of the judicial system and widespread corruption common in emerging markets (Keefer and Knack, 1993). Court procedures in some of these nations are slow not only as a result of less efficient courts, but also because the law is underdeveloped and vague. Many of these countries have poor systems for registering property, causing long and uncertain bankruptcy procedures because title to property is difficult to ascertain. Finally, deficient accounting standards which characterize financial reporting of companies in emerging economies (see Center for International Financial Analysis and Research, 1994) makes it harder to sort out the claims and determine if bond covenants have been breached.

The practical consequences of the deficiencies outlined above is that creditors in countries such as Indonesia, Thailand, Mexico and the Russian Federation, are able to recoup a very small fraction of their claims at the end of a very long procedure, and in turn, those countries have very small debt markets.[3] Given the high costs of the present procedures, there are very few court-sanctioned reorganizations as firms typically prefer informal solutions to their financial problems. In some countries, personal property, which can be seized more easily because it is not subject to the provisions of a bankruptcy law, is commonly used as collateral in commercial transactions. Unfortunately, personal property can back only so much debt. In addition, although out-of-court settlements can be an effective means of coping with financial distress, the bargaining position of creditors is compromised by the lack of an effective collective procedure. Moreover, in some cases the parties may not achieve an out-of-court settlement, particularly if there are many creditors.[4]

[3] The resolution of a bankruptcy procedure may take anywhere from 3 to 7 years in countries such as Peru or Mexico and even decades as has occurred in Thailand.

[4] Gilson et al. (1990), in a study of the companies listed on the New York and American Stock Exchanges that were in severe financial distress during 1978–1987, found that workouts fail more than 50 per cent of the time and are more likely to fail the larger the number of creditors (see also John, 1993).

This scenario becomes more evident during a corporate debt crisis such as those which recently occurred in East Asia, Mexico, and the Russian Federation. In their aftermath, investors sought better creditor rights which caused some countries to modify procedural features of their existing court-run bankruptcy and reorganization laws. Unfortunately, these reforms did little to change the situation for investors. Courts in many countries are reluctant to play too active a role in matters as political and complicated as closure or liquidation of companies. In the aftermath of the Asian crisis, several East Asian countries reformed their bankruptcy laws. Yet few companies have been taken through the bankruptcy process so far, largely because courts are politicized and not ready to adopt the new procedures. They tend to throw out most creditor applications – especially those against powerful borrowers – on technicalities.

Mexico's recent bankruptcy law reform illustrates how politics oppose reform. As in the case of Indonesia, Mexico's reform was judicial-based, so it raised many issues involving politics in Congress. Most experts in the country felt that the bankruptcy law was outdated, inefficient, and very costly. In the words of Domínguez del Río, one of the most respected corporate lawyers in Mexico: "As a legal process, Mexico's bankruptcy law has proved to be full of defects, confusing, and inept, ... it is unable to deal in an orderly fashion with a kind of litigation that needs speed and clarity in order to prevent irreversibly wasting the assets of the firm". Or, according to a Mexican Supreme Court Judge: "Mexico's bankruptcy law has the result of 'breaking the head' ("quebrar la cabeza") of anybody related to the bankruptcy process. It 'breaks the head' of judges, lawyers, debtors, creditors, and of all of those that have the misfortune of having to read, trying to understand, or trying to interpret the complex, tortuous, and poorly written text of the law". In these circumstances and as a result of the Tequila crisis in 1994, the Government stepped up efforts to change bankruptcy law.

This discussion suggests that court-intensive bankruptcy procedures may impose substantial deadweight losses as assets are dissipated throughout the process and out-of-court settlements are expensive. Since the deadweight loss associated with bad bankruptcy procedures may be particularly significant in emerging markets, the search for alternative bankruptcy procedures to reduce reliance on the judiciary may be of particular appeal in developing countries.

In the absence of a well-functioning judicial process, as in most emerging markets, it may be worthwhile to consider the following two alternative reorganization procedures. First, allowing creditors, for example, secured creditors, the right to appoint an administrative receiver in charge of both running the firm in default and disposing of its assets piecemeal or as an ongoing operation. This method would parallel the United Kingdom's administration procedure. Once the assets of the firm have been disposed of, the receiver would distribute the proceeds in accordance with absolute priority marking the end of the process. The advantage of this mechanism is that it can be implemented quickly, therefore minimizing the firm's loss of value. In addition, the immediate transfer of control to creditors minimizes intervention from the court whose main role is to police the procedure to avoid fraud. Unfortunately, there is no reason to believe that a creditor-appointed receiver would be interested in maximizing the firm's value. Not only may he/she favour some creditors over others, but he/she may also fail to act in the interest of shareholders when the firm is still economically viable.

Second, another departure from court-intensive procedures is to leave the restructuring or liquidating decision to market forces. Introducing market forces in bankruptcy proceedings requires steps akin to those in a privatization. Hart, La Porta, López-de-Silanes and Moore (1997) develop such a bankruptcy procedure using auctions. Specifically, both firm insiders and outsiders are invited to place cash and non-cash offers for the *assets* of the firm. In other words, the assets of the bankrupt firm are auctioned off to the highest bidder and the proceedings are used toward cancelling the existing claims according to absolute priority. Although the firm is stripped of its assets, in preparation for the auction, claimants retain control and cash flow rights (*bankruptcy rights*) over the firm's assets. The holders of *bankruptcy rights* decide among the competing offers made by bidders and retain all the proceeds from the auction. To eliminate conflicts of interest among different classes of claimants, this procedure transforms the capital structure of the firm into an all-equity firm through a mechanism that preserves absolute priority of claims. The way to achieve this goal is to cancel all debts, allocate all *bankruptcy rights* to the most senior class of claimants, and allow more junior classes to acquire these rights if and only if they are willing to retire all senior claims to them.[5]

The introduction of market forces into bankruptcy through this procedure has several advantages. First, the ability for firm insiders and outsiders to make offers in cash and/or non-cash securities, for the firm as a whole or for parts of it, makes it more likely that the assets of the firm will be put to their most productive use.[6] Second, it eliminates conflicts between different classes of claimants regarding the future of the firm since all holders of *bankruptcy rights* are equal and have only one objective: to maximize the value of the firm. Third this procedure, while increasing creditor rights, allows for debtor protection by giving shareholders and management the opportunity to propose offers for the firm, which may include reorganization plans, and by allowing them first priority to exercise their right, acquire the *bankruptcy rights* from creditors.[7] Fourth, the procedure is simple and quick, reducing uncertainty and minimizing the loss of value created by financial distress and the depletion of assets which usually follows the declaration of bankruptcy and reorganization. The preservation of the firm's value increases the probability of a successful reorganization and is translated into higher cash flows for the claimants entitled to the assets. And finally, the procedure minimizes the reliance on and room for discretion of the judicial system, yet it achieves the "fair outcome" in terms of absolute priority.[8]

This paper suggests that improving creditor rights is a sound strategy in order to develop credit markets. Unfortunately, reforming creditors' rights can be politically treacherous. Extending

[5] A potential drawback of this mechanism is that capital market imperfections may preclude junior claimants to exercise their right to buy *bankruptcy rights* from senior creditors. In such cases, this procedure delivers allocative efficiency but not a fair outcome, as senior creditors benefit at the expense of other classes of claimants. But as shown in Hart et al (1997), the basic procedure can be enhanced to avoid liquidity constraints through the introduction of an outside market for *bankruptcy rights*. A public cash auction for *bankruptcy rights* may be organized to sell all *bankruptcy rights* that could not be assigned to claimants and to purchase *bankruptcy rights* held by claimants if outside investors are willing to offer a price such that the claims of its holders are paid in full.

[6] A related advantage of allowing outside bids for the firm is that it reduces the probability of strategic behavior of debtors by making it harder for them to declare bankruptcy and buy the firm cheap.

[7] This preferential treatment protects shareholders when the cause of financial difficulties is "bad luck" and not poor management performance.

[8] An additional advantage of this procedure over existing options is that contentious claims need not hold up the reorganization process. This feature makes the proposal particularly attractive for emerging markets with a poor registry of property and/or lengthy court proceedings.

improved creditor rights to pre-existing credits is likely to cause wealth transfers from debtors to creditors. In addition, banks may be uninterested in facilitating bankruptcy reform if it means having to write down the value of bad loans in their portfolio and, as a result, injecting fresh capital into their operations. Bankruptcy reform may be further complicated by the need to reach compromise between the conflicting interests of secured and unsecured creditors (Hart, 1999).

But the introduction of new ideas and departures from the unusual procedure is hard to conduct politically. Mexico is a good example of a country facing these difficulties. The authorities struggled for several years to introduce procedures that used market forces, like the ones described above. The passage of a bankruptcy law reform, for instance, through a very divided Congress which represented political interests of forces opposed to legal reforms such as those previously discussed, proved extremely hard. In fact, the Congress removed basic features designed to solve many of the problems that plagued bankruptcy law. The politics of legal reform may waste the very few chances a country has to substantially reform its legal institutions.

The same type of resistance in congress currently faces the new Philippine bankruptcy proposal. In some sense, the presence of a large negative economic shock might be a catalyst for deep legal reform, as in the case of Colombia's reform to bankruptcy law in 1998. Political expediency as well as fairness suggests that changes in creditor rights should apply only to new credits. In fact, one could take this idea further and allow firms to opt-into a more protective creditor regime by specifying irrevocably in their charters whether the new creditor-friendly rules apply in the event of financial distress. If the new set of rules for creditor protection are superior to the old ones, firms should voluntarily adhere to higher standards of creditor protection enticed by the prospect of lower interest rates.

B. *<u>Feasible corporate law reform</u>*

With the four principles in mind that were described above, there are several policy recommendations that may form part of the agenda for deepening developing countries' financial markets. These measures are thus classified into two groups: (1) legal reforms that create rules which reduce the room for discretion; and (2) mechanisms that allow market forces to create a culture of investor protection.

B.1. Legal reforms

The design of successful legal reforms for the protection of non-controlling shareholders must take into account the weaknesses of the legal system of each country. This illustrates the third principle mentioned above: the enforcement of legal rules is deeply connected with the rules themselves. The strategy for reform is not to create an ideal set of rules and then see how they can be enforced, but rather to enact the rules that can be enforced within the existing enforcement structure.

Again, as in the case of bankruptcy, the politics behind corporate law reform are very strong. Large private firms and the labour unions often try to derail reforms before they get to the Congress. Several Latin American countries are currently in this painful process. Although some of them have

been able to pass corporate laws, the exact regulation of these principles in the commercial code needs to be clearly established if the ideas are ever going to benefit minority shareholders.

Securities regulation

The recommendation here is to try to refocus regulation so that supervision is concentrated on intermediaries, rather than on issuers. This idea is sometimes credited to James Landis, a contributor to the 1933 and 1934 Securities Acts of the United States, who reasoned that regulators by themselves could hardly monitor the compliance with disclosure, reporting, and other rules by all listed firms, and 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.

A number of countries, including Germany and Poland, have introduced private intermediaries into the enforcement of securities regulations. Their success suggest that smarter regulations, particularly in countries with relatively weak legal systems can improve the protection of investors.

Corporate law

The successful regulation of the United States securities markets, the Polish financial markets, and the Neuer Markt in Germany share a common element, namely the regulatory insistence on extensive disclosure of financial information by the issuers. But this point illustrates why securities regulations alone, which basically focus on disclosure, may need to be complemented with changes in the corporations law of the country to give shareholders the rights to act on the information they receive. A right to act appears to be a key element of their protection.

In order for improved disclosure standards to have an effect, the corporate laws of many countries must be revamped. In some instances, this might require refining existing principles to make them more applicable. In other cases, it is necessary to create rights that are easily enforceable. The reform of corporation law may not need to follow mechanisms of Anglo-Saxon origin that rely heavily on the judicial system via derivative or class-action suits. Instead, once the state of the legal system is recognized, the application of more “automatic” principles, such as some of those in Chile, may be a better answer for many developing nations.

The OECD initiative on corporate governance, as well as initiatives from other international institutions, embrace some of the main principles that must be incorporated in the reform of company laws around the world. The following are four of the most useful recommendations.

(I) Protection of shareholder rights

a. Basic shareholder rights should include: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect members of the board; and 6) share in the profits of the corporation;

b. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes;

c. Shareholders should have the opportunity to participate effectively and vote in general shareholders' meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings;

d. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

(II) Equitable treatment of all shareholders

a. All shareholders of the same class should be treated equally;

b. Insider trading and abusive self-dealing should be prohibited;

c. Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

(III) Timely and accurate disclosure and transparency

a. Disclosure should include, but not be limited to, material information on: 1) financial and operating results of the company; 2) company objectives; 3) major share ownership and voting rights; 4) members of the board and key executives, and their remuneration; 5) material foreseeable risk factors; 6) material issues regarding employees and other stakeholders; and 7) governance structures and policies;

b. Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit;

c. An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented;

d. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

(IV) The responsibilities of the board: Monitoring and accountability

a. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders;

b. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly;

c. The board should ensure compliance with applicable law and take into account the interests of stakeholders;

d. The board should be able to exercise objective judgement on corporate affairs independent, in particular, from management;

e. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

Although it is difficult to argue that these principles are not important, upon close inspection there are some basic ideas or principles without which several of the principles outlined may be rendered useless or without the desired power. Most countries with poor shareholder protection are missing two basic principles that have long ramifications. First, the definition of relationship and interested or related-party is key and without it, some of the ideas about improved voting facilities or even disclosure are useless. It does not change much if the interested shareholders and/or directors can still vote and approve by majority transactions in their favour but at the disadvantage of the rest of the stakeholders, for example. Second, there needs to be carefully developed ideas about the responsibilities and penalties for directors who violate their duties.

B.2. Market-based mechanisms

As explained above, legal reform may be slow and complicated, particularly if it involves the amendment of national laws or drastic changes in legislation. Therefore, market-based mechanisms should be designed to temporarily substitute or complement the reform of laws and regulations. These should be public measures that facilitate competition and ratings, making it possible for firms that adhere to these measures to access capital at lower cost. At the same time, these mechanisms also have the objective of extending/publicizing the concept of better corporate governance practices. The adoption of such measures could constitute a useful first step as they will foster the culture of respect for investor protection and set the basis for the coming legal reform.

Local committee on best corporate governance practices

Several developing nations such as Colombia, Mexico, and the Russian Federation have followed the example of Australia, New Zealand, and England, which established commissions formed by members of the private sector and Government to review corporate practices and investor protection in the country. In each of these countries, the committee in charge of the analysis produced a document called “Code of Best Practices,” detailing rules of good corporate governance

mechanisms and investor protections important to the country. These codes are mainly concerned with the organization of the board and special committees, but in some cases (probably as a result of the current lack of investor protection), the code also details several shareholder protections.

The philosophical principle underlying these codes is that the disclosure of information about each firm's corporate governance practices and investor protection by the firm allows the market to perceive the differences among the policies of various companies. Information should allow shareholders to distinguish those firms that adhere to investor protection, thus making the shareholders more willing to provide the companies with funds. Those firms with better practices should find it easier and less expensive to access capital, as they provide a more certain environment for the investor. This code is a substantial step forward in the creation of a culture of investor protection, as it allows investors: (1) to distinguish firms that do have effective corporate governance mechanisms in place; and (2) to reward firms that offer better protection with higher valuation multiples or lower costs of capital.

The adoption of the principles of the code of best practice is usually voluntary, but the disclosure is compulsory for all firms. The experience of several countries shows that adopting the code starts movement toward modernizing investor protection because it is equivalent to an agenda of reforms shareholders could submit to the board or at the shareholders' meeting.

Prudential measures for institutional investors

Enhanced disclosure requirements may not be sufficient in countries with weak legal institutions or where investors have very few rights and cannot demand changes. In such instances, it may be desirable to restrict institutional investors to investments in companies that meet minimum corporate-governance standards. These standards may be determined in relation to the code of best practices or by independent best-practice commissions.

This recommendation is based on prudential reasons as well as on the need to create an incentive for firms to agree on better investor protection. A similar idea has been implemented in Chile, also a civil law country, where a commission detailed a large list of minimum requirements that issuers of securities must meet in order to be the object of investment by institutional investors (Decree. No. 3.500 in Chile).

State-controlled enterprises

Finally, among those decentralized measures it is recommended that the State improve the corporate governance practices for those firms that still have participation. Despite widespread privatization, there are countries with many State-controlled enterprises. These firms could set the example for private firms by adopting better investor protections.

Generally, most of the state-run firms are large public utilities or companies dedicated to exploiting natural resources. For these firms, external funding is just as important, if not more important, than for private firms, because of substantially reduced Government expenditures. They need higher levels of investment to meet the demand from the growing private sector. Therefore, it

becomes imperative for them to find mechanisms to fund their projects from capital markets. Reform of corporate charters and improved board practices would also alleviate the Government budget constraint. The adoption of the code of best practices by firms in the stock exchange can provide a quick and easy way for these State-controlled firms to substantially transform themselves and secure access to funds at better rates.

Although the market-based mechanisms outlined above may help foster the growth of external funding, they have limitations for they only reach a small group of firms that are either already in the stock market or that belong to the State. There are also limits to what can be obtained by improved disclosure and voluntary adoption of higher investor protection standards. Even in the best case scenario, firms might adopt improved protections with non-standard contracts, but when violations occur, enforcement of those contracts may be difficult in weak legal systems. For these reasons, market-based mechanisms need deep legal reforms whose effects can reach all firms and can be easily enforced as the standard in the country.

V. What do we know about judicial reform?

Legal rules are only one element of investor protection – the enforcement of these rules may be equally or even more important. If good laws are not enforced, they cannot be effective. Likewise, investors may enjoy high levels of protection despite bad laws if an efficient judiciary system can redress expropriations by management. In this way, strong legal enforcement may serve as a substitute for weak rules.

Judicial systems in most developing countries are perceived to be in crisis: cases take too long, cost too much, and are littered with dishonest judges. Litigants are dissatisfied with the process, creditors never use bankruptcy laws and shareholders feel it would be impossible to win a case against the controlling investor in a local court. Even though there is little consensus on exactly what judicial efficiency means or how to measure it, people seem to agree that it is low. As a result, several countries have opted to implement judicial reform in the hope of improving the protection of investors and the efficiency of the judicial system. Judicial reform efforts, both in developed and in developing countries, have been varied and have met with mixed success.

Although judicial reform has taken many shapes, it can be divided into: (1) reforms based on enhancement of the managerial capabilities of the judiciary; (2) reforms based on incentives to judges; (3) reforms based on incentives to the parties and other actors of the judicial process; (4) reforms based on structural modification of the judicial system; (5) reforms based on modification of rules of procedures; (6) reforms based on simplification of substantive rules. There are four common threads that link these legal reforms.

A. ***Reforms that increase resources need to address incentives***

Reforms that tinker around the edges without addressing the incentives of judicial actors – such as indiscriminately increasing judicial budgets or salaries, or instituting a one-time "crash" programme to reduce backlogs – are unlikely to succeed. Judicial officials commonly complain that they have too few resources and are understaffed, but the evidence of the effectiveness of increased

resources is mixed. Data from the Caribbean, Latin America, and the United States shows no correlation between the overall level of resources and times to disposition (Church et al., 1978).[9] Many reform efforts lump other initiatives together with funding increases.[10] These packages may work more because of the other initiatives than because of the initiatives other than funding, as in the United Republic of Tanzania and Paraguay.[11]

Similarly, introducing computer systems or other mechanization apparently helps reduce delays, according to studies from Latin America and Singapore, and reduces corruption (Buscaglia and Ulen, 1997, Buscaglia and Dakolias, 1996 and 1999, Dakolias, 1999, and Hong, 1995). This is probably not a success story of resource increases; computer systems seem to work because they increase accountability. Funding increases themselves may help alleviate temporary backlogs in systems that have made serious effort to work better, but may be useless when inefficiencies are large – or, in fact, worse than useless, to the extent they draw resources away from fixing systemic problems. "Crash programmes" to reduce backlogs – presumably by a large infusion of resources – have shown good results in the short-term, but, similar to crash diets, without deeper change courts revert to their old, bad habits (Neubauer et al., 1981).

In extreme cases, when resource shortages are particularly acute (if the court has no paper, as in Uganda) or allocations of workload are particularly perverse (if the judge cannot delegate check signing and office-supplies ordering to a clerk), purely managerial reforms can work, but this is not the norm. Managerial reforms can help judges who already want to change, but often these are the judicial actors who need the least prodding. A major inefficiency in many judicial systems is judges' responsibility for administrative work, such as signing paychecks and ordering office supplies. Centralizing administrative work in a single office, where the employees possessed administrative training, increased efficiency in Colombian and Peruvian pilot courts and in the Guatemalan Public Ministry (Dakolias and Said, 1999 and Hendrix, 2000). It may also decrease judicial independence, however, since it may subject judges' paychecks to the Government's mercy.

Some studies in the United States, Singapore, and Latin America suggest that case management reduces time (Church et al., 1978, Neubauer et al., 1981, Hong, 1995, and Buscaglia and Ulen, 1997), particularly when it stresses pre-trial conferences, strict scheduling, and shortened discovery time cut-offs. However, case management can seriously backfire if poorly designed, as it did with pre-trial hearings in Japan (Hasebe, 1999). A safe conclusion seems to be that in the hands of judges who already take judicial efficiency seriously, case management can bring effective pressure on litigants to get their act together. But that because there is no easy way to test whether cases are being managed well or badly, case management may not make recalcitrant judges reform (Feeley, 1983).

[9] See Buscaglia and Ulen (1997) and Dakolias (1996 and 1999). See also Buscaglia and Dakolias (1996) where "resources allocated for court personnel" emerged as an important factor.

[10] See, for example, Hendrix (2000) for Guatemala; Tarigo (1995) for Uruguay; Hong (1995) for Singapore; and Dakolias and Said (1999) for Peru.

[11] In the United Republic of Tanzania, the Commercial Court is well funded because it gets its operating budget from filing fees, and, because it does not have exclusive jurisdiction, its ability to collect fees depends on its ability to offer a better product for the filing party (mainly for the party who is interested in resolving the issue most quickly). In Paraguay, the number of judges was increased at the same time as oral proceedings were introduced.

B. *Reforms should increase accountability*

Accountability increases judicial efficiency. In traditionally corrupt or repressive countries, judges may find juries a check on their behavior, since overruling a jury is a visible and seemingly heavy-handed act. Implementing judicial databases that make cases easy to track and hard to manipulate or "lose," whether by accident or on purpose, helps guard against sloppy procedures and corrupt officials. Individual calendars make explicit the link between a judge's case management habits and his reputation among the public or the political decision-makers whose opinions he cares about.[12] Some studies have found that the individual calendar is associated with reductions in times to disposition, not only because the judge in charge is more familiar with his own cases but also because judges feel more accountable (Church et al., 1978, Neubauer et al., 1981, Dakolias, 1996). One advantage of the individual calendar is that it allows measurement of judicial performance. The mere ability to generate accurate statistics, even without any enforcement mechanism, reduces delay, since judges care about their own numbers. Such an effect has been reported in the United States (though some judges rebel about perceived threats to their independence), Colombia, and Guatemala (Neubauer et al., 1981, Dakolias and Said, 1999, and Hendrix, 2000).

Not everything that *looks like* an accountability reform will succeed or will be beneficial if it does succeed. For instance, legislated time limits, while seeming like obvious incentive-based schemes, are largely unenforceable. There is no objective way to tell when a case drags on because it has legitimate difficulties or because someone falls down on the job. Every legislated time limit has had exceptions and loopholes so broad that they can fit any case (Feeley, 1983). In Argentina and Bolivia, judges are given mandatory time limits, but these are rarely enforced (Dakolias, 1996). Additionally, step-by-step regulation of the litigation seems to merely add rigidity to the procedure, limiting the space for case management techniques, reducing judges' accountability for the overall efficiency of the procedure, and leaving ample room for corruption.

Similarly, fee shifting, like "loser pays" rules, makes frivolous litigants responsible for the burdens they place on hapless defendants, but in cases where either party might win, they encourage excessive legal costs, since the parties think that if they spend enough, they will win and thereby not have to pay. Judges are not the only cause of delay since cases are often desired and pursued by at least one of the parties (Feeley, 1983 and Church et al., 1978). Lawyers and attorneys have vigorously opposed reforms in several countries (e.g. Uruguay and Peru).

High legal costs reduce the legal system's subsidy of litigation, but at the cost of restricting access. One way of discouraging long litigation is by increasing the direct costs to one or both of the parties. In Singapore where the first day of trial is free and court fees increase progressively for the subsequent days, 80 per cent of cases take a single day for trial (Buscaglia and Dakolias, 1996). In

[12] Individual calendars are different from systems with master calendars where the court can assign different parts of a case to different judges. The master calendar has some advantages – a case can go on if a judge is sick or has a congested docket; judges can specialize in the procedural tasks they are good at – and some jurisdictions use it without too many problems. But there are drawbacks as well – no judge becomes very familiar with the case; judge shopping by attorneys becomes more important; different judges can rule inconsistently in the same case; and, if a case takes a long time in a master calendar jurisdiction, it is hard to know on whom to pin the blame.

Latin America, higher direct costs also decrease the duration of cases (Buscaglia and Ulen, 1997). But the effects of such a system on efficiency are unclear, since what is gained in speed may sacrifice in access for poor people with cases too complex to solve in one day.

Fee-shifting mechanisms can also increase the direct cost to at least one party by using "loser pays" rules. This probably cuts down on frivolous litigation. But in cases where each litigant stands a fair chance of winning, each litigant may be encouraged to outspend his opponent in the hope of producing a marginally more persuasive case, thereby winning and paying nothing. So the effect of litigant's cost on judicial efficiency is unclear.

Because attorneys' fees comprise a large part of the costs of the justice, it seems natural to apply incentives on the attorneys themselves. Direct fee regulation may reduce efficiency, since it restricts the supply of lawyers, whom people often believe they need.[13] But the effect of low fees on efficiency is unclear, as low fees may lead claimants to hire an attorney even for minor controversies that could have been resolved by an arbitrator.

Part of the success of the Japanese judicial system is attributed to the absence of lawyers in 90 per cent of summary court cases, which account for over 60 per cent of all civil litigation in Japan.[14] Similarly, high levels of efficiency and litigant satisfaction at lower-level courts in England are associated with a low rate of lawyer's involvement – more than 80 per cent of unrepresented English small claims litigants surveyed in a recent study said they would not have preferred representation (Baldwin, 1997a). Finally, reduced costs increase litigation – both good claims and bad. In 1997, the United States had a filings per population rate of 34 per cent, compared to 4 per cent in Japan.[15]

C. ***Reforms should institute competition and choice***

Competition and choice, and generally, alternatives to the standard system, tend to increase judicial efficiency. Creating specialized courts generally improves efficiency. Creating or extending small claims courts are among the most praised of all judicial reforms.[16] In many countries, small claims courts have substantially reduced times to disposition and expanded access to justice.[17] The increase in the small claims limit in Great Britain is vastly popular among old and new litigants, though some of the enthusiasm may be driven by the decreased risk of small claims litigants who neither have to pay their opponents' legal fees nor have to go up against defendants bankrolled by the

[13] The Dutch and Japanese experiences suggest that deregulating the legal services market will increase the supply of legal aid and decrease costs – and studies of legal advocacy by lawyers and non-lawyers in the United States suggest that the decrease in costs is not necessarily associated with a decline in quality.

[14] See Ogishi (1999). See also Japan Statistical Yearbook 762 (1999), where out of the 456,000 civil and administrative litigation cases disposed of yearly, 277,000 were disposed of in Summary Courts.

[15] There were 91 million cases filed in the US State courts, according to Kauder and Ostrom (1998). Total filings in Japan were 5,128,000, according to the Japan Statistical Yearbook, 2000. The United States population is 270.3 million while the Japanese is 126.4 million, according to the World Bank Development Indicators (World Bank, 2000).

[16] Varela and Mayani (2000) argue that the 75 per cent of civil cases in the Dominican Republic where the claims are below RD $900 (US$56) should be tried at the Justice of the Peace level.

[17] Bermudes (1999) argues that the introduction of small claims courts in Brazil in 1995 "succeeded in bringing justice closer to the Brazilian people [by allowing them to] litigate at a very low cost, in an informal manner, and see immediate results for their judicial initiative".

Government's generous legal-aid system (unlike in regular British courts) (Baldwin, 1997a). Small claims courts are also popular in many other countries, such as the United States and Japan (Kojima, 1990). The main criticisms of small claims courts are that they do not provide enough legal advice to *pro se* litigants and that they sometimes, as in Italy and Germany, remain too formal in their procedures and thus do not fulfill their promise of reducing cost and delay (Baldwin, 1997b, Varano, 1997, and Rohl, 1990).

Specialized courts with a particular subject-matter jurisdiction can also increase efficiency. Such courts have been set up for streamlined debt collection in several countries, including the Netherlands, Germany, and Japan (Blakenburg, 1999, Rohl, 1990, and Kojima, 1990). Labour tribunals in Ecuador and the commercial court in the United Republic of Tanzania have been associated with reduced times to disposition (Dakolias, 1996 and Finnegan, 2001). The Netherlands also have specialized courts for divorce cases, which is considered inexpensive and easy to use; in the United States judges who specialize in contested divorce trials tend to resolve cases faster (Blankenburg, 1999, and Buscaglia and Dakolias, 1996). Many of these specialized courts emphasize arbitration and conciliation, so some of the positive results on specialized courts may be due to the effect of alternative dispute resolution and not specialized courts as such. Specialization is not only good for courts; the Guatemalan experience indicates that setting up specialized prosecution teams in the Prosecutor's Office can also lead to better-quality prosecutions (Hendrix, 2000).[18]

Alternative dispute resolution is also generally positive. As noted above, many successful small claims courts, specialized courts, and native justice courts incorporate a strong element of arbitration and conciliation – including the Dutch *kort geding*; Ecuadoran labour mediation; justices of the peace in the United States, Peru, and elsewhere; mediation centers in Latin America; and Indian *lok adalats* (Blankenburg, 1999, Dakolias, 1996, Brandt, 1995, Hendrix, 2000, Cranston, 1986). Moreover, the presence of alternative dispute resolution reduces opportunities for corruption (in Chile and Ecuador), as a judicial system in competition with other institutions is less able to extract rents from litigants (Buscaglia and Dakolias, 1999).

But while no one questions the value of voluntary alternative dispute resolution, mandatory dispute resolution is another story. While one study suggests that whether mediation is voluntary or mandatory has no effect, others suggest the opposite. In the United States, the courts with the most intensive civil settlement efforts tend to have the slowest disposition times; neither processing time nor judicial productivity is improved by extensive settlement programmes (Buscaglia and Dakolias, 1996 and Church et al., 1978). Referring cases to mandatory arbitration has no major effect on time to disposition, lawyer work hours, or lawyer satisfaction, and has an inconclusive effect on attorneys' views of fairness (Kakalik, 1997). Furthermore, in some mediation programmes in Japan and Latin

[18] However, a note of caution is in order. Courts that specialize in native or "peasant" justice have often been criticized for not respecting human rights, as in Peru. Other courts, like the *nyaya panchayats* in India, have been considered corrupt and driven by factionalism, though the experience with *lok adalats* has been more positive. The resistance committees in Uganda have had fewer problems. Even specialized, informal courts are still agents of the State, and procedures are in place partly to guarantee fairness and equal treatment for all litigants. An excessive emphasis on procedure may undermine fairness, but so may excessive informality – even as cost and delay numbers go down – since an informal forum may be an unaccountable forum. At the margin, however, formal judicial systems in developing countries seem to suffer more from an excess of formality than from its opposite.

America, the mediator is also the judge, which may be procedurally unfair, as the judge may railroad the parties into a settlement, and the parties will fear being frank before the same official who will pass judgment on them later (Hasebe, 1999 and Dakolias, 1996).

Competition and choice seem to work at all levels – sophisticated international commercial arbitration provides an expensive yet cost-effective alternative to court litigation for complex international transactions. Deregulation of legal services lets people prepare a case without relying on the expensive services of the legal monopoly. And, of course, the best alternative to the standard legal system is the opportunity not to have a dispute arise in the first place; simplification of substantive rules lets people structure their behavior to reduce their chances of ever having to use the legal system.

When the substantive rules are unclear, there may be a limit to how much judicial efficiency can be improved through procedural reform. For instance, when most land is untitled, land tenure is insecure because no one is sure how courts will rule on a contested claim. A land titling programme, like the one in Peru, may increase judicial efficiency and also substantially increase economic activity and land values (De Soto, 1998). In the Dominican Republic, one may argue that substantive changes in family and commercial law – reducing gender bias in custody cases, modernizing commercial code, and implementing more effective sanctions against fraudulent check writers – are a necessary condition for successful judicial reform (Varela and Mayani, 2000).

Substantive complexity is generally associated with increased time to disposition.[19] Studies in the United States have found the type and complexity of cases to be major contributing factors to civil and criminal trial length.[20] Studies in civil law countries suggest that this association is particularly important during the sentencing stage, where judges play a more active role and can't delegate their work to a clerk (Buscaglia and Dakolias, 1996). Substantive simplicity may also be driving many of the results in the small claims court studies (Baldwin, 1997b).

D. <u>Reforms should streamline procedure</u>

Streamlining procedures tends to increase judicial efficiency. Establishing simple procedures for simple cases improves the overall efficiency of the system by allowing the bulk of litigation to be resolved swiftly and inexpensively in one or two hearings, without further impact on upper judges' caseload. Reforms of this sort have improved efficiency and access in countries with diverse legal traditions, such as Brazil, Peru, England, the United States, Scotland, and Japan.

A factor commonly associated with inefficiency in civil-law countries, especially in Latin America but also elsewhere, is the predominance of written over oral elements (Vescovi, 1996 and Varano, 1997). Oral hearings are unimportant, and judges do not have direct contact with witnesses and other sources of evidence. This tends to go along with a piecemeal trial, rather than one that is

[19] Buscaglia and Ulen (1997) make this point but Church et al. (1978) argue that substantive complexity was not found to be as important as "local legal culture".

[20] Dale Anne Sipes et al. (1988) argue that "[t]rial length for both civil and criminal trials varies greatly among States and within States. Factors contributing significantly to these variations are the types and complexity of cases and methods used to select juries".

continuous in time. A move toward oral litigation has produced positive results in Paraguay, Uruguay, 18th-century Prussia, and possibly Italy (Dakolias, 1996, Tarigo, 1995, Weill, 1961, and Varano, 1997). Oral litigation is, of course, a dominant characteristic of small claims courts and specialized tribunals, which are widely popular for this and other reasons (Baldwin, 1997a and Blankenburg, 1999).

Greater procedural complexity reduces transparency and accountability, increasing corrupt officials' ability to sell progress on the case (Buscaglia and Dakolias, 1999). Procedural simplification tends to decrease time and costs (for instance, a shortened time cutoff for discovery in the United States) and increase litigant satisfaction (for instance, the streamlined procedure of British small claims courts or justices of the peace in the United States, Peru, and elsewhere). The efficiency of small claims courts seems to be driven not so much by any structural difference between small claims courts and regular courts as by the simplicity of procedures. Indeed, English small claims courts are not a separate institution at all – county court procedures have merely been modified over the years to accommodate small claims (Baldwin, 1997a). The same is true in Scotland and several US States (Kelvie, 1994 and Mays, 1995).

However, not all streamlining efforts work; in the Dominican Republic, for instance, forms intended to simplify case filing procedures actually complicated the process (Varela and Mayani, 2000). Additionally, time and cost don't tell the whole story. Most procedures were adopted because they were believed to serve accuracy, protect the accused, improve access, or otherwise further justice. In the United States, for instance, the Federal Rules of Civil Procedure seem to have increased costs without reducing delay, but may have increased accuracy, which may or may not be a net gain (Leubsdorf, 1999). To the extent we focus on speed and cheapness, we risk losing some of the less measurable goals of procedure.

Simplification of lower court procedures has improved efficiency and access in countries with diverse legal traditions, such as Peru, Japan and Scotland; but the overall impact of procedural simplification depends on how burdensome the procedures were before. Reforms in completely clogged systems may bring about a large increase in filings in the short run, and in the long run will be associated with improved service, greater litigant satisfaction, and improvements in access. But reforms to already simple procedures may have little impact or result in frivolous litigation. Many procedures exist for a reason – and to the extent that streamlining undermines valuable procedural rights, caution is required – but in most countries there is a likelihood of too many procedures as opposed to too few.

In summary, there is no one measure of judicial efficiency; some aspects of judicial efficiency are unmeasurable; and the whole exercise is affected by value judgments about the nature of justice. So the conclusions of this paper can only be taken as tentative. Moreover, reformers should always ask themselves whether reforms from one country or legal system should be transplanted into another. Most importantly, the accuracy-speed-cost tradeoff is quite different in the developing world than it is in developed countries. It is unlikely that complicated legal systems that work in rich countries, where the resources and expertise necessary to handle complexity exist, can be transplanted without significant modification into poor countries. Poor countries, or countries without a developed judicial tradition, should probably concentrate on instituting simple rules that are easy to enforce; the quest for

a legal system that will do perfect substantive justice in infinite time and at infinite cost is a luxury that the poor can ill afford.

If the goal is accurate, cheap, and swift justice, infusions of money are probably not the answer, except in cases of egregious resource shortages or perverse allocations of workload. Nor is limiting access – a judicial system that denies people the right to sue – leave many wrongs unrighted; rather it will create perverse incentives for people to take justice into their own hands. Limiting access to the judicial system in order to solve structural inefficiencies is analogous to fighting cancer with morphine. The pain of congestion diminishes, but it will inevitably come back and precious time will have been lost.

Reforms that increase accountability, institute competition and choice, and streamlined procedures show promise. Accountability deters sloppy or corrupt judicial actors *ex ante*, or allows the public or the legislature to punish them *ex post*. Countries with a repressive history or present credibility problems with the administration of justice may do well to set up: (i) juries; (ii) good information systems; (iii) individual calendars for judges; (iv) individualized statistics on clearance rates and times to disposition are good first steps; and, (v) competition and choice to reduce the ability of the judicial system to work inefficiently or extract rents from litigants. In addition, countries should also: (i) promote voluntary alternative dispute resolution and criminal plea bargaining; (ii) set up specialized courts with nonexclusive jurisdiction, such as small claims courts or commercial courts in many countries;[21] (iii) deregulate their legal services, for instance by allowing mediators and others to compete with lawyers;[22] and (iv) simplify their substantive legal rules to reduce the need to use the legal system in the first place.

Finally, judicial procedures should be streamlined, provided that fundamental procedural rights are not violated. Evidence suggests that simplification and streamlining of procedures – especially at lower level courts – allocates resources better, increases access, and improves overall efficiency. In summary, (i) simple cases may be solved quickly and cheaply in one or two hearings with direct examination of the evidence, while complex litigation is handled at higher levels within a reasonable time and at a reasonable cost;[23] (ii) judicial sectors should have more leeway to innovative and experiment with different procedural requirements; (iii) countries with a heavy emphasis on writing should move toward oral hearings; (iv) specialized courts and small claims courts should be used more often; (v) and, generally, the number of procedural steps should be reduced.

VI. Conclusions

The legal environment – as described by both legal rules and their enforcement – matters for the size and extent of a country's capital markets. Some countries offer investors a rather unattractive legal environment in terms of shareholder and creditor rights, as well as the quality of enforcement. As a result, credit markets in these countries are exceedingly small, and stock markets are both small

[21] For interesting case studies involving small claims courts, see the discussion of Baldwin (1997), of Kojima (1990), of Rohl (1990), and others. For an interesting case study involving a commercial court, see the discussion of Finnegan (2001).

[22] For interesting case studies involving the deregulation of legal services see Kritzer (1997) and the discussions of Blankenburg (1999) and of Kojima (1990).

[23] For interesting case studies involving procedural simplification, see the discussion of Baldwin (1997), of Hendrix (2000), of Leubsdorf (1999), and many others.

and very narrow. The immediate reaction to the evidence here is to call for an overhaul of the judiciary system and undertake legal reform. However, the politics of legal reform are difficult.

Although there appears to be international support for legal reform, it is seldom fully completed on time or achieved at optimal terms. The overall benefits of reform might be sizeable for society but there are numerous political forces that tie-up and limit the efforts to conduct radical overhauls of corporate governance and laws. Opponents of reform have many faces and varied interests, including entrenched politicians, insiders from large corporations, distressed financial institutions, workers, and political parties representing them and the interests in Congress. Corporate governance reform is likely to cause wealth transfers from controlling investors and rent-seeking third parties in favour of creditors and minority shareholders. Against these forces, the increased interconnectedness of financial markets and the larger role of international investors have started to push for reform to reach convergence in governance practices across markets as firms compete for the funds they need to meet the challenges brought by a more open economy with increased competition. The politics of legal reform are difficult, but not impossible. Those countries that have successfully engaged in legal reform have taken account of the local political reality and designed the changes to appease the opposing forces.

Unfortunately, the challenges for successful legal reform do not end there. As some of the examples reviewed here show, getting reforms through the political process might not give positive results if those reforms do not take account of the judicial reality of the country. Because improving the efficiency of the judicial system and asserting the rule of law are slow processes, it is important to incorporate those constraints into the policy design. The general, and sometimes vague, principles of corporate governance need to be translated into feasible reforms that can be implemented, and most importantly, that can be enforced by the current judicial system of each country. As this paper argues, our understanding of the reform of the judicial systems is still very narrow and successful reforms take time to permeate through courts. Under this scenario, it is crucial that the design of bankruptcy and corporate law reform finds creative avenues to try to avoid existing enforcement problems.

In bankruptcy law, the reform of creditor rights needs to be grounded on those rights that can be enforced. Even if reorganization procedures were optimal, they probably would not work well in countries with slow and ineffective judicial systems. Mechanisms that allow the interplay of market forces, such as those described in this paper, may be particularly appropriate in countries with weak judicial systems. The success of the escrow systems in several developing countries illustrates the practical importance of creating out-of-court mechanisms for dealing with financial distress. However, these mechanisms are only a partial solution. More extensive legal reform is likely to be necessary to allow for broad access to credit.

Measures that allow the interplay of market forces as incentives to those in charge are essential for corporate and securities laws reform. In principle, some mechanisms – such as giving shareholders the right to a quick redress mechanism, allowing them to make their views known to other investors, and increasing facilities for voting – could work powerfully even in an environment where other shareholder rights are missing or where courts do not function well. Regarding securities exchanges, it is important to recognize that it is easier to supervise the financial intermediaries that bring securities to the markets than each individual issuer, therefore one should try to design mechanisms that make agents responsible for the actions of their clients. Again, all reforms should be

complemented with market-based mechanisms that allow market participants to award higher valuations to those companies that improve investor protection. Successful efforts in this area include local codes of best practices that force firms to reveal their corporate governance mechanisms and prudential measures that restrict institutional investors to investments in companies that meet minimum investor protection standards.

Improving corporate governance should be at the top of the policy agenda if developing countries are to embark on a self-sustainable path of long-term development. Institution-building is a critical part of the success of a market economy. Reforming institutions to allow for a deepening of financial markets is a key to ensuring business growth. However, it is essential to recognize the perils of blindly transplanting rules or applying a list of investor rights without regard for the legal realities and the financial structure of the country. The design of feasible legal reform must incorporate judicial reform as well as rules that take into account the status of the local legal enforcement.

The benefits of improved investor protection on the overall economy, as well as on facilitating monitoring by capital markets and lending institutions, justify taking steps toward improving corporate governance. The available empirical evidence suggests that enhancing corporate governance will likely result in larger capital markets, reduced output volatility, and faster growth. Macroeconomic management will need to pay increasing attention to the development of the institutional infrastructure that will support large and stable private capital inflows.

This paper argues that effective legal reform may needs to include changes in several specific areas of investor protection laws (corporate law, securities laws, bankruptcy laws, etc.) as well as changes in the more general area of judicial reform. Undertaking such reforms is economically and politically costly and some priorities may need to be set according to the forces of the status quo in each of these areas in each country. Although a priority list is hard to come by, one could argue that judicial reform should be prominent in the list of reforms because of its impact in other areas beyond the functioning of capital markets and because those reforms take time to implement and permeate through the system. Additionally, facilitating the flow of dispute resolutions would also facilitate and provide more security for small financial transactions, such as the cashing of a supplier's check when the supplier defaults. This in turn, should be reflected in an increase in trade credit and inter-firm financing, complementing reforms that directly affect the development of capital markets.

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Table 1

INVESTOR PROTECTION IN ECONOMIES OF DIFFERENT LEVELS OF DEVELOPMENT

Panel A: Investor protection variables in developing and developed economies

Less developed economies	Share-holder rights	Creditor rights	Efficiency of judicial system	Rule of law	Rating on accounting standards	Ownership 3-largest shareholders	IPOs/Pop	Domestic firms/Pop	Debt/GNP
Kenya	3	4	5.75	5.42	na	na	na	2.24	na
India	5	4	8.00	4.17	5.70	0.40	na	1.69	na
Nigeria	3	4	7.25	2.73	5.90	0.40	1.24	7.80	0.29
Pakistan	5	4	5.00	3.03	na	0.37	na	5.89	0.27
Zimbabwe	3	4	7.50	3.68	na	0.55	na	5.82	na
Sri Lanka	3	3	7.00	1.90	na	0.60	0.11	11.94	0.25
Egypt	2	4	6.50	4.16	24.00	0.62	na	12.50	na
Indonesia	2	4	2.50	3.98	na	0.58	0.11	1.16	0.42
Philippines	3	0	4.75	2.73	6.50	0.57	0.28	2.91	0.27
Jordan	1	na	8.66	4.35	na	na	na	23.75	0.70
Ecuador	2	4	6.25	6.67	na	na	0.09	13.18	na
Colombia	3	0	7.25	2.08	5.00	0.63	0.06	3.14	0.19
Peru	3	0	6.75	2.50	3.80	0.56	0.13	9.48	0.10
Thailand	2	3	3.25	6.25	6.40	0.47	0.57	6.71	0.93
Venezuela	1	na	6.50	6.37	4.00	0.51	0.00	4.29	0.10
Brazil	3	1	5.75	6.32	5.40	0.57	0.00	3.49	0.39
Turkey	2	2	4.00	5.18	5.10	0.59	0.05	2.93	0.15
South Africa	5	3	6.00	4.42	7.00	0.52	0.05	16.00	0.60
Malaysia	4	4	9.00	6.78	7.60	0.54	2.89	25.16	0.84
Chile	5	2	7.25	7.02	5.20	0.45	0.36	19.93	0.63
Mexico	1	0	6.00	5.35	6.00	0.64	0.03	2.29	0.47
Uruguay	2	2	6.50	5.00	3.10	na	0.00	7.00	0.26
Argentina	4	1	6.00	5.35	4.50	0.53	0.21	4.59	0.19
Greece	2	1	7.00	6.18	5.50	0.67	0.30	21.60	0.23
Republic of Korea	2	3	6.00	5.35	6.20	0.23	0.02	15.89	0.74
Average	2.84	2.48	6.26	4.68	5.29	0.52	0.34	9.25	0.40
Median	3.00	3.00	6.50	5.00	5.45	0.55	0.11	6.71	0.28

Table 1 (continued)

Panel A: Investor protection variables in developing and developed economies

More developed economies	Share-holder rights	Creditor rights	Efficiency of judicial system	Rule of law	Rating on accounting standards	Ownership 3-largest shareholders	IPOs/Pop	Domestic firms/Pop	Debt/GNP
Portugal	3	1	5.50	8.68	3.60	0.52	0.50	19.50	0.64
Taiwan Province of China	3	2	6.75	8.51	6.50	0.18	0.00	14.23	
New Zealand	4	3	10.00	10.00	7.00	0.48	0.67	69.00	0.90
Ireland	4	1	8.75	7.80	na	0.39	0.75	20.00	0.38
Spain	4	2	6.25	7.80	6.40	0.51	0.08	9.72	0.75
Israel	3	4	10.00	4.82	6.40	0.51	1.80	127.60	0.66
Australia	4	1	10.00	10.00	7.50	0.28	na	63.56	0.76
Hong Kong, China	5	4	10.00	8.22	6.90	0.19	2.02	88.17	na
United Kingdom	5	4	10.00	8.57	7.80	0.54	5.17	35.69	1.13
Finland	3	1	10.00	10.00	7.70	0.37	0.60	13.00	0.75
Italy	1	2	6.75	8.33	6.20	0.58	0.32	3.91	0.55
Singapore	4	4	10.00	8.57	7.80	0.49	5.67	80.00	0.93
Canada	5	1	9.25	10.00	7.40	0.40	4.93	40.86	0.72
Netherlands	2	2	10.00	10.00	6.40	0.39	0.67	21.13	1.08
Belgium	0	2	9.50	10.00	6.10	0.54	0.30	15.50	0.38
France	3	0	8.00	8.98	6.90	0.34	0.18	8.05	0.96
Austria	2	3	9.50	10.00	5.40	0.58	0.25	13.88	0.79
Germany	1	3	9.00	9.23	6.20	0.48	0.09	5.15	1.12
Sweden	3	2	10.00	10.00	8.30	0.20	3.11	30.12	0.81
United States	5	1	10.00	10.00	7.10	0.28	1.67	12.67	0.55
Norway	4	2	10.00	10.00	7.40	0.36	4.50	33.00	0.64
Denmark	2	3	10.00	10.00	6.20	0.45	1.80	50.40	0.34
Japan	4	2	10.00	8.98	6.50	0.18	0.26	17.78	1.22
Switzerland	2	1	10.00	10.00	6.80	0.41	0.00	33.86	na
Average	3.17	2.13	9.14	9.10	6.72	0.40	1.60	34.45	0.76
Median	3	2	10.00	9.62	6.80	0.41	0.67	20.57	0.75
Total Average	3	2.3	7.67	6.85	6.09	0.46	1.02	21.59	0.59
Total Median	3	2	7.25	6.78	6.40	0.49	0.30	13.18	0.63
Panel B: Test of means (t-statistics) and medians (z-statistics)									
Less vs. more developed mean	-0.87	0.88	-6.89a	-11.07a	-3.94a	3.43a	-2.81a	-3.95a	-4.58a
Less vs. more developed median	-1.09	0.99	-4.93a	-5.78a	-3.58a	3.29a	-3.32a	-4.06a	-3.78a

na = not available; a = significant at 1% level; b = significant at 5% level; c = significant at 10% level

Note: The table shows the basic data of investor protection, efficiency of the judiciary, accounting standards and size of the financial markets across economies divided into two groups according to GNP levels. Economies are ordered by level of GNP per capita in 1999. Economies with a GNP per capita below the median of the sample are classified as “less developed", and those above the median are classified as "more developed".

Appendix A: The variables determining investor protection

This table describes the variables collected for the 49 economies included in table 1. The first column gives the name of the variable. The second column describes the variable and gives the range of possible values. The third column provides the sources from which the variable was collected.

Variable	Description	Sources
Shareholder rights	An index aggregating the shareholder rights which we labeled as "anti-director right". The index is formed by adding 1 when: (1) the country allows shareholders to mail their proxy vote to the firm; (2) shareholders are not required to deposit their shares prior to the General Shareholders' Meeting; (3) cumulative voting or proportional representation of minorities in the board of directors is allowed; (4) an oppressed minorities mechanism is in place; (5) the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting is less than or equal to 10 per cent (the sample median); or (6) shareholders have preemptive rights that can only be waved by shareholders' vote. The index ranges from 0 to 6.	Company Law or Commercial Code
Creditor rights	An index aggregating different creditor rights. The index is formed by adding 1 when: (1) the country imposes restrictions, such as creditors' consent or minimum dividends to file for reorganization; (2) secured creditors are able to gain possession of their security once the reorganization petition has been approved (no automatic stay); (3) secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm; and (4) the debtor does not retain the administration of its property pending the resolution of the reorganization. The index ranges from 0 to 4.	Bankruptcy and Reorganization Laws
Efficiency of judicial system	Assessment of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms" produced by the country-risk rating agency *Business Internaional Corporation* . It "may be taken to represent investors' assessments of conditions in the country in question". Average between 1980-1983. Scale from 0 to 10, with lower scores lower efficiency levels.	Business International Corporation
Rule of law	Assessment of the law and order tradition in the country produced by the country-risk rating agency *International Country Risk* (ICR). Average of the months of April and October of the montly index between 1982 and 1995. Scale from 0 to 10, with lower scores for less tradition for law and order. (We changed the scale from its original range going from 0 to 6).	International Country Risk Guide
Accounting standards	Index created by examining and rating companies' 1990 annual reports on their inclusion or omission of 90 items. These items fall into 7 categories (general information, income statements, balance sheets, funds flow statement, accounting standards, stock data and special items). A minimum of 3 companies in each country were studied. The companies represent a cross-section of various industry groups where industrial companies numbered 70 per cent while financial companies represented the remaining 30 per cent.	International Accounting and Auditing Trends, Center for International Financial Analysis & Research, Inc.

Appendix A *(continued)*

Variable	Description	Sources
Ownership, 3 largest private firms	The average percentage of common shares owned by the three largest shareholders in the 10 largest non financial, privately owned, domestic firms in a given country. A firm is considered privately owned if the State is not a known shareholder in it.	Moodys International, CIFAR, EXTEL, WorldScope, 20-Fs, and various country sources
IPOs/Pop	Ratio of the number of initial public offerings of equity in a given country to its population (in millions) for the period of 1995:7-1996:6	Securities Data Corporation, AsiaMoney, Latin Finance, FT Guide to World Equity Markets, and Word Development Report
Domestic firms/Pop	Ratio of the number of domestic firms listed in a given country to its population (in millions) in 1994.	Emerging Market Factbook and World Development Report 1996.
Debt/GNP	Ratio of the sum of bank debt of the private sector and outstanding non-financial bonds to GNP in 1994, or last available.	International Financial Statistics, World Bondmarket Factbook

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