ARGUMENTA OECONOMICA
No 2(13) 2002
PL ISSN 1233-5835

*Krzysztof Zalega**

LAW AS A DETERMINANT OF CORPORATE FINANCE DEVELOPMENT. A SURVEY OF 1996–2002 SELECTED RESEARCH RESULTS

This paper offers a comprehensive survey of research results on the link between law and corporate finance. The quality of law and its enforcement determine the way corporations are financed and governed. Recent research has documented large differences between countries in capital markets developments, ownership concentration in public companies and the access of firms to external finance. These variations are considered to be due to the differences in laws and the effectiveness of their enforcement across countries. Principal conclusions of major 1996–2002 empirical studies are presented here. We concentrate on such issues like the effects of investor protection on the development of capital markets and on the valuation of firms as well as the main constraints on private sector investment. The legal approach may be a helpful way to understand corporate finance and its necessary reform in transitional economies.

INTRODUCTION

The economic literature demonstrates a relatively long debate on the relevance of law for corporate finance. In the early 90's legal scholars suggested that in comparison with competitive capital product and managerial labour markets, the role of law is at best secondary (Easterbrook and Fischel 1991) or even trivial (Black 1990). However, it has been economists rather than lawyers who have promoted the relevance of law for corporate finance. They have found that law is a key determinant of stock market development (La Porta et al. 1997) and the banking sector (Levine 1998). Empirical analyses suggest that the quality of law and its enforcement has a high explanatory power for corporate finance development (La Porta et al. 1997, 1998, Levine 1997). Research results show that weak property rights discourage firms from reinvesting their profits (Johnson et al. 2002). Ownership concentration in publicly traded firms is strongly affected by the quality of law enforcement. Shareholder protection determines the concentration of ownership of shares in the largest public companies (La Porta et al. 1999). Moreover, this is correlated with corporate valuation (La Porta et al.

* Member of the Scientific Society for Organization and Management

1999a). Countries with poorer investor protection have smaller and narrower capital markets – both equity and debt markets (La Porta et al. 1997).

The study in corporate finance development stimulates the debate on the economic transformation of Eastern Europe. Empirical evidence proves that weak property rights in transitional economies limit the reinvestment of profits in start-up manufacturing firms (Johnson et al. 2002). It has been proved that legal change in investors' rights protection has an impact on the propensity of firms to raise external finance in transitional economies. External financing there is still very underdeveloped despite legal change that has substantially improved shareholder and creditor rights. However, legal transplants and extensive legal reforms are not sufficient for the evolution of effective legal and market institutions in Eastern Europe (Berkowitz et al. 1999).

1. INVESTOR PROTECTION AS THE CORE OF LAW AND FINANCE

The question why some countries have vastly bigger, more vibrant capital markets than others has been for some years the central point of economists' debate on financial systems development. A research trend called "law and finance", which originated in 1996 (La Porta et al. 1996), tries to answer this question.

It has been found that capital markets are broader and firms tend to be larger in countries with a better investor protection. Overall research results show that legal protection for shareholders and creditors varies across countries. The analysis of laws governing investor protection, the quality of enforcement of these laws, and ownership concentration in 49 countries around the world have allowed researchers to formulate three broad conclusions (La Porta et al. 1996).

First, laws differ markedly around the world, though in most places they tend to give investors a rather limited bundle of rights. In particular, countries whose legal rules originate in the common law tradition tend to protect investors considerably better than do the countries whose laws originate in the civil law tradition. The analysis proves that the strongest protection has been found in English common law countries, the weakest in countries with French-style laws. The German and Scandinavian systems have been placed in between. The very origins of the legal systems in those countries play an essential role. The French, German, and Scandinavian traditions all are variations on Roman law, dominated by legislator-drawn legal codes, while in English common law, legal precedents are set by judges deciding specific cases, and only later incorporated into legislation. The study has provided no clear evidence that different countries favour different types of investors. The evidence rather points to a relatively stronger stance favouring all investors in common law countries. It confirms the researchers' basic hypothesis that being a shareholder, or a creditor, in different legal jurisdictions entitles an investor to very different bundles of rights. These rights are determined by laws which are not inherent in securities themselves.

Second, law enforcement differs a great deal around the world. German civil law and Scandinavian countries have the best quality of law enforcement, although this reflects to some extent their higher average income levels. Law enforcement is strong in common law countries as well, whereas it is the weakest in the French civil law countries.

Third, it has been shown that ownership concentration in publicly traded companies is extremely high around the world. The concentration of ownership of shares in the largest public companies is negatively related to investor protections. Highly concentrated ownership is an adaptive response to poor investor protection in a corporate governance system. Good accounting standards, rule of law, and shareholder protection measures are highly negatively correlated with the concentration of ownership. These results suggest that inadequate protection of investors may be costly. This is consistent with the hypothesis that small, diversified shareholders are unlikely to be important in countries that fail to protect their rights. Specifically, if small investors are not protected, companies would not be able to raise capital from them and entrepreneurs would not be able to diversify their holdings. High ownership concentration, then, has been interpreted as a symptom of a poorly functioning capital market.

Overall, these findings oppose the arguments made by Easterbrook and Fischel (1991) that the legal system does not matter very much, and that investors can generally contract around the limitations of the legal system.

Another research findings (La Porta et al. 1997) have linked investor protections and legal traditions to the health of capital markets. It has found strong links between capital market conditions in different countries and the legal traditions followed by those countries. The measure to evaluate the "strength" of capital markets have been the ratio of stock market capitalization to gross domestic product, the ratio of debt-to-GDP, the number of publicly traded domestic corporations per million inhabitants and the number of initial public offerings per million inhabitants. By all of these measures, English common law countries as a whole vastly outscore their

French law counterparts. The countries with German- and Scandinavian-style laws have been generally placed in the middle, although in one scale - the debt-to-GDP ratio – the bank-dominated German-style countries lead the way. That means that the strongest capital markets are in common law countries. Countries where English-style common law holds sway (the United Kingdom and former colonies such as the United States, Australia, India, and Singapore) have the most developed capital markets. The weakest capital markets are in countries with legal systems based on France's Napoleonic Code (France, Italy, Spain, and most of Latin America). In between are countries with laws based on the German model (Germany, Japan, and a handful of others) and the Scandinavian countries, which have their own legal tradition.

The study also aimed to measure the ability of individual companies to get external financing. The results show a much less pronounced difference between countries with different legal traditions. This could be explained by the limited scope of data available to analyze obtained from only large, well-established companies. It has allowed the researchers to conclude that the largest companies can get access to external finance no matter where they are based, while smaller companies' ability to raise money is much more dependent on a country's legal system.

Some empirical studies prove that investor protection also affects corporate valuation. A lot of research evidence link healthy financial markets with the presence of laws, regulations and courts that protect shareholders and creditors from insider expropriation of profits. It has been observed that better investor protection raises company share values. Statutory limits on the behaviour of those in control of publicly traded companies appears to be good for share prices (La Porta et al. 1999a). In situations where there are clear and strong legal limits on what is known as "expropriation" of earnings, investors are willing to pay a premium for securities. That means that investor protections actually make companies worth a lot more than they would be without such restraints. This analysis of data on 371 large firms located in 27 high income countries has shown that better shareholder protection is associated with higher valuation of corporate assets. On the other hand, poor shareholder protection is penalized with lower valuations. The authors note that when investors are aware that the law is not on their side, they are not willing to split the price. That deprives companies of capital and limits "the set of projects that can be financed". When an individual entrepreneur or small groups of shareholders control publicly traded companies they have the authority to "divert a share of the profits" to themselves and then distribute what is left as dividends. According to the authors, a key determinant of whether those dividends are meagre is whether there are laws that at least make it difficult for controlling shareholders to seize the profits. Such laws have clear benefits. They are a plus for minority shareholders and for the stability of financial markets. Moreover, it turns out that when investors feel their rights are secure, they reward companies by paying "more for financial assets such as equity and debt". Better legal protection lets investors pay more because they recognize that more of the firm's profits would come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm. This way, by limiting expropriation the law helps companies acquire the capital they need to take advantage of opportunities for expansion.

The authors note that aside from legal deterrents, the nature of people's financial stake in a company plays a role. It could give them a sort of self-interest incentive to distribute profits fairly. For example, entrepreneurs who depend on company stock to finance expansion – corporate acquisitions routinely substitute stock for cash – would not want to do something that would damage the share price. But while such dynamics might also produce fair treatment for minority shareholders and high valuations, the authors say that evidence of this more market-driven benefit is not as compelling as is proof of the positive effect of investor protection laws. Overall, the authors believe that demonstrating a clear link between investor protection and corporate health "expands our understanding of the role of investor protection in shaping corporate finance, by clarifying the roles which both the incentives and the law play in delivering value to outside shareholders".

The findings also show that comprehensive safeguards to protect shareholders and creditors from insider expropriation of profits seem to foster responsible corporate behaviour (corporate governance). It gives investors the confidence to acquire shares and to extend credit, which in turn increases corporate valuations and provides capital for lucrative expansion opportunities. But investor protections varies from country to country, despite their clear association with "effective corporate governance". There are a number of factors determining the quality of investor protection in well-managed financial markets, e.g. resistance to change by special interests or complex divergences in legal practices rooted in country's legal, economic and political system.

It is the country's law that is the consideration to explain international differences in investor protection – namely the legal structure of each country and the origin of its laws. It determines the nature of investor protection and consequently the regulation of the financial market (La Porta et al. 1999). Countries whose legal systems are based on English common law have "the strongest protection of outside investors", while French civil law countries have the weakest. The authors note that the common law system allows judges to apply general principles and legal precedents to alleged investor abuse "even when specific conduct has not been described or prohibited in the statutes". Civil law, by contrast, requires judges to base their rulings on the exact letter of the law. "From this perspective, the vague fiduciary duty principles of the common law are more protective of investors than the bright line rules of the civil law, which can often be circumvented by sufficiently imaginative insiders".

As noted these differences are deeply rooted in historical tensions between property owners and monarchs. Strong investor protections found in English common law evolved from a successful move in the 17th century by Parliament to legally protect property owners from the taxing impulses of the crown. Meanwhile, relatively weak safeguards in French civil law go back to the fact that Napoleon maintained power over a centralized state, creating a body of law that made it hard for financiers to exercise power over corporations.

The authors point out that reform to at least lessen, if not close, the gaps between the countries seems to be a difficult task. Such a reform cannot be accomplished by simply advising civil law countries to adopt a common law approach to investor protection. Because law is the chief factor, the improvement of investor protection for most countries requires radical changes in the legal system, and that invites intense opposition from families that control large corporations. Each attempt to reform is seen by these families not only as limiting their ability to take or expropriate company assets, but also as making it easier for potential competitors to raise cash and challenge their dominance. The authors stress that events such as the Great Depression and, more recently, the East Asian financial crisis and Poland's successful transition to a market economy show that opportunities for sweeping reforms "do arise, but under special circumstances" and that they "should not be wasted". Successful reforms should be supported by due regulatory regimes that share some common themes, such as extensive and mandatory disclosure of financial information by the issuers, the accuracy of which is enforced by tightly regulated financial intermediaries. In transitional economies companies might opt for more investor-friendly legal regimes e.g. by listing their securities on an exchange that protects minority shareholders. In addition, companies could be acquired by a foreign firm operating in a country where strong investor protection holds. Recently revealed cases of corporations' management misconduct (e.g. Tycon, Enron, Worldcom etc.) will make global financial markets provide a political and economic impetus for broad improvements in investor protection.

2. PROPERTY RIGHTS AND CORPORATE FINANCE

Much empirical evidence shows a significant link between property rights and investment. In general, property rights are possesory rights and rights to transfer these rights. A possesory right to a thing is the right to use it in a specified way at a named time and under a particular contingency. A right to transfer a possesory right is the right to give or sell a possesory right to another person. Thus, "ownership" of something entails both a large switch of possesory rights and associated rights to transfer them. Property rights provide incentives to maintain and improve things. Protecting the security of property rights promotes the transfer of property: without property rights protection, prospective buyers would not be inclined to buy things that might subsequently be stolen. Enforcement of property rights by the state protects people against risk and reduces serious disadvantages that would be incurred in the absence of property rights. With no property rights protection, individuals could face the possibility that their property would be taken from them (Shavell et al. 2001). It is important that a system of property rights allows for things to be transferred freely – if things can be traded, people will tend to allocate value in them.

Thus, the issue of property rights is directly linked with the problem of investor protection. The study in corporate finance development has consequently lead researchers' focus to the key constraints of private sector investment – weak property rights or limited access to external finance. In the private sector development, property rights are fundamental: entrepreneurs will not invest if they expect to be unable to keep the fruits of their investment. Secure property rights may be necessary for entrepreneurial investment.

A considerable variation in the extent to property rights protection and its effects on external finance in Eastern Europe has been found (Frye et al. 1997, Shleifer 1997) although many institutional weaknesses are present in transitional economies. Property rights have proven more secure in Poland than in other parts of Eastern Europe and the former Soviet Union. There has also been found a variation in access to bank credit – small firms are able in some degree to borrow only if they can provide adequate collateral. The evidence on a company level has allowed to determine whether secure property rights are (a) necessary, (b) sufficient, or (c) necessary and sufficient for investment by entrepreneurs.

A survey of new firms in post-communist countries has found that weak property rights discourage firms from reinvesting their profits, even when bank loans are available. Where property rights are relatively strong, firms reinvest their profits. Where they are relatively weak, entrepreneurs do not want to invest from retained earnings (Johnson et al. 2002). The perceived security of property rights and the use of bank credit vary considerably both across and within countries under research (Poland, Romania, Slovakia, Ukraine, and Russia). Firms' investment is affected by the perceived security of property rights. The entrepreneurs reinvest less of their retained earnings when they perceive their property rights to be insecure, irrespective of whether they own the collateral that is generally needed to obtain credit. Reinvestment rates are lowest in Russia and Ukraine, where bribes for government services and licenses are common, firms make payments for protection, and the courts are least effective, and highest in Poland and Romania, where property rights are the most secure. Within countries, there is also significant variation. The entrepreneurs, who perceive their property rights to be the least secure, reinvest percentage of their profits, while those with the most secure property reinvest 56 percent. The study shows that insecurity of property rights reduces firm's investment by over a third. Most of the firms say they were able to offer collateral to banks (more than three quarters of the firms in each of the countries). Lack of collateral, therefore, does not appear to have been a binding constraint on firms' investment. There are two reasons why, until now, external credit has not been essential for private-sector development. First, insecure property rights mean firms have a limited incentive to invest and therefore little demand for external finance (especially in Russia and the Ukraine). Second, the high profits of early entrants in all these transition economies meant that firms that wished to invest were able to do so. The potential for using retained earnings as a source of investment is seen from the fact that in all five countries unreinvested profits exceed the funds provided by banks. The research evidence indicates, then, that secure property rights have been both necessary and sufficient for investment. Although the firms had little demand for external finance at the time of the survey, they will begin to need access to credit as these economies develop their market supporting institutions. This is because legal and bureaucratic reforms increase the demand for investable funds by solidifying property rights. This is also because profits will be driven down to normal levels as transaction costs fall and market competition increases, so investment from internal funds will not be sustainable.

A comprehensive analysis of investors' rights protection in Eastern Europe (Pistor et al. 2000) shows that external finance is still very underdeveloped in transition economies, despite legal change that has substantially improved shareholder and creditor rights. The research has also focused on the analysis of the law on the books with an analysis of the effectiveness of legal institutions (legality).

The absence of effective legal institutions (legality) has been then found an important constraint on financial market development. The only shareholder rights index that shows a positive and statistically significant correlation with stock market development, is the stock market integrity index (SMINTEGR). This index captures rules that are designed to protect the functioning of the market. Laws that establish an independent state agency to supervise capital markets and prohibit insider trading and self-dealing seem to be taken as a sign that the state is seriously committed to making these markets work against the odds of private predators and state intervention. Thus, SMINTEGR is the only legal index with a significant positive impact on capital market development. There is also some indication that credit market development benefited from improvements in the law on the books. Analysis shows that legality has overall a much higher explanatory power for the level of equity and credit market development than the quality of the law on the books. In a way, this result is a reflection of a more fundamental problem in the transition from central planning to the market. This transition requires at its core the transformation of the role of the state from a direct coordinator of economic activity to an impartial arbiter. The lack of confidence in the rule of law reflects the extent to which this transformation has remained partial, as governments continue to play to vested interests, often those that have benefited from asset redistribution during the initial transition. Improving the law on the books in such an environment is at best a partial solution, but will not be rewarded unless a commitment to rule-based governance of markets is made credible.

The other major conclusion of the examination is that the absence of external finance is a key aspect of weak corporate governance in transition economies. That problem cannot be solved only by improvements in the legal framework for the protection of shareholder and creditor rights. However, the extent of legal reform in these areas of the law has been impressive by any standard. In fact, many of the countries of the former Soviet Union which received legal technical assistance primarily from the United States can today boast higher levels of investor rights, protection on the books than some of the most developed market economies, such as France or Germany. Yet, it is unlikely that in the foreseeable future the development of the law will be matched by the development of financial markets.

This study findings imply that corporate governance is an integral part of state governance. In particular, an effective system of external private finance requires a credible commitment by the state that private rights will be honoured and enforced, and not undermined by state interventions. Where these conditions are present, the law on the books may indeed make a difference. Where they are absent, changes in the law on the books will have at best a marginal effect. Analysis of law and finance around the world (La Porta et al.1997, 1998) show that effective law enforcement is not a substitute for poor laws on the books. Thus, the effectiveness of legal institutions (legality) has a much stronger impact on external finance than the law on the books. This is true especially for debt, but also for equity finance. This finding contrasts with studies in market economies showing that the quantitative effect of the law on the books is greater than legality at least for capital market development (La Porta et al. 1997; Levine 1998). Instead, it supports the proposition that legal transplants and extensive legal reforms are not sufficient for the evolution of effective legal and market institutions (Berkowitz et al. 1999).

Country-level studies consistently show that less secure property rights are correlated with lower aggregate investment and slower economic growth (Knack et al. 1995; Mauro, 1995; Svensson 1998; Acemoglu et al. 2001). External finance also matters for investment and growth, for if bank credit is not available, it may be hard for entrepreneurs to take advantage of new opportunities. There is some evidence that a well-functioning financial system contributes to investment and growth (Levine, 1997; Rajan et al.1998).

The core problem in this issue is whether external finance alone or together with property-rights security are necessary factors for entrepreneurs to invest. Only some studies (La Porta et al.1997, 1998; Shleifer et al. 2000) show more external finance is available when there is a stronger legal system in general and more effective protection of investors in particular, while another evidence proves (Kunt et al. 1998) that firms invest more from external funds in countries with secure property rights.

CONCLUSIONS

The above presented research allows us to sum up with the following major conclusions. The quality of law and its enforcement affect the ownership concentration in publicly traded firms, corporate dividend policies, and the access of firms to external finance. In countries with strong shareholder protection, investors can afford to take minority positions rather than controlling stakes. As a result, firms tend to have dispersed shareholders as owners and capital markets are rather liquid. By contrast, where shareholder rights are not well protected, investors will compensate this deficiency by taking controlling stakes in a firm. The quality of investor protection determines the structure of firms and the level of stock market development. Moreover, it influences private sector investment – weak property rights make entrepreneurs not to want to invest from retained earnings which means that insecure ownership discourages firms from reinvesting their profits. Countries with poorer investor protection, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets.

The experience of transition economies suggests that good laws cannot substitute for weak institutions. As shown, legal transplants and extensive legal reforms are not sufficient for the evolution of effective legal and market institutions. The effectiveness of legal institutions (legality) strongly affects external financing.

The absence or a much limited extent of external finance in transitional economies is a key aspect of weak corporate governance there. That problem cannot be solved only by improvements in the legal framework alone – that is in the quality of law for investor protection and of its enforcement. The transition requires a shift of the role of the state from an active player and direct coordinator to an impartial arbiter. The state must guarantee that private rights are honoured and effectively enforced. To some extent transformation in Eastern Europe has remained partial as governments continue to play to vested interests. In a partially privatized economy, like Poland, corporate governance is still an integral part of state governance. The state commitment to rule-based governance of markets is then welcome.

A comprehensive economic analysis of law (Shavell 2001) prompts another general conclusion that there is still a broad need for empirical work on the legal system to be undertaken – society needs estimates of the benefits and costs of legal activity in broad domains, including corporate finance.

REFERENCES

Acemoglu D., Johnson, S. and Robinson J. (2001), *The Colonial Origins of Comparative Development: An Empirical Investigation*, American Economic Review 91 (5), pp. 1369-1401.

Berkowitz D., Pistor K., Richard J.-F. (1999), *Economic Development, Legality, and the Transplant Effect*, mimeo.

Black B.S. (1990), *Is Corporate Law Trivial?: A Political and Economic Analysis*, Northwestern University Law Review, 84, pp.542-597.

Easterbrook F.H.,. Fischel D.R (1991) *The Economic Structure of Corporate Law*, Cambridge, Mass. Harvard University Press..

Frye T., Shleifer A. (1997), *The Invisible Hand and the Grabbing Hand*, American Economic Review, Papers and Proceedings 87 (2), pp. 354-358.

Johnson S., McMillan J., Woodruff C. (1999), *Property rights, finance and entrepreneurship*, EBRD Working paper No43,

Johnson S., McMillan J., Woodruff C. (2002), *Property Rights and Finance*, NBER Working Paper No.w 8852,

Kaplow L., Shavell S. (2001), *Economic analysis of law*, in: Auerbach and Feldstein eds., (2001), *Handbook of Public Economics*,

Knack S., Keefer P. (1995), *Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures*, Economics and Politics 7 (3), pp. 207-228.

La Porta R., Lopez-de-Silanes F., Shleifer A., Vishny R.W. (1996), *Law and Finance*, NBER Working Paper 5661 (published also as *Law and Finance*, Journal of Political Economy, 1998, 106 (6), pp.1113-1155).

La Porta R., Lopez-de-Silanes F., Shleifer A., Vishny R.W. (1997), *Legal Determinants of External Finance*, The Journal of Finance, LII (3), pp.1131-1150.

La Porta R., Lopez-de-Silanes F., Shleifer A., Vishny R.W. (1999), *Investor Protection: Origins, Consequences, and Reform*, NBER Working Paper No. w7428*, (published also as *Investor Protection and Corporate Governance*, Journal of Financial Economics, 2000).

La Porta R., Lopez-de-Silanes F., Shleifer A., Vishny R.W. (1999a), *Investor Protection and Corporate Valuation*, NBER Working Paper No.w7403,

Levine, R. (1997), *Financial Development and Economic Growth: Views and Agenda* Journal of Economic Literature 35 (2), pp. 688-726.

Levine R. (1998), *The Legal Environment, Banks, and Long-Run Economic Growth*, Journal of Money, Credit, and Banking, 30 (3), pp.596-613.

Mauro, P. (1995), *Corruption and Growth*, Quarterly Journal of Economics 110 (3), pp. 681-712.

Pistor K., Raiser M., Gelfer S. (2000), *Law and finance in transition economies*, EBRD, Working paper No.48,

Rajan, R., Zingales L. (1998), *Financial Dependence and Growth*, American Economic Review 88 (3), June, pp. 559-586.

Shleifer, A.. (1997), *Government in Transition*, European Economic Review 41 (3-5), pp. 385-410.

Shleifer A., Vishny R.W. (1997), *A Survey of Corporate Governance*, The Journal of Finance, LII (2), pp.737-783.

Shleifer A., Wolfenson D. (2000), *Investor Protection and Equity Markets*, NBER Working Paper nr W7974.

Svensson, J. (1998), *Investment, Property Rights and Political Instability: Theory and Evidence*, European Economic Review 42 (7), July, pp. 1317-1341.

received: August 2002; revised version: December 2002