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Government and Market Failures in Emerging Market Economies:
Implications for Corporate Governance and Bankruptcy

by

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Abstract

Corporate governance and bankruptcy are about ensuring that market signals are channeled into corporate decisions, and corporations do not abscond with resources entrusted them by investors. The purpose of this paper is to discuss how market and government failures influence the design of institutions supporting corporate finance in emerging market economies. Weaknesses in these institutions are an important part of the explanation for why more capital is not flowing from the capital-rich to the capital-poor economies. Even in countries that now enjoy large inflows of direct investment may find weak corporate governance and poorly functioning bankruptcy procedures to be critical if these flows were to cease for exogenous reasons. Moreover, while well-functioning corporate governance and bankruptcy laws are generally believed to be critical to investment and growth, they are particularly important in emerging market economies where corporations often are hugely influential in the economy-at-large and in politics. We propose a general framework for thinking about the challenges of designing these institutions in emerging market economies and draw some policy implications. In particular, we emphasize the importance of enforcement and the impact of weak enforcement on corporate governance and bankruptcy design.
1. Introduction

Corporate governance and bankruptcy are about ensuring that market signals are channeled into corporate decisions, and corporations do not abscond with resources entrusted them by investors. Well-functioning corporate governance and bankruptcy systems have in place checks-and-balances that ensures that these resources are used in the appropriate way. After some glaring governance failures over the last decade the importance of the subject hardly need to be stressed. There is now consensus that corporate governance is critical to corporate investment and growth. But it is particularly important in emerging market economies (EMEs) where corporations often are important actors in the economy and in politics. Good corporate governance contributes to good political governance and, as we will discuss extensively, good political governance is essential for the enforcement of corporate governance standards. In this sense corporate governance reform is part of broader governance reform.

The purpose of this paper is to discuss the issues relating to corporate governance and bankruptcy that are most pertinent for EMEs. While in principle all major corporate governance and bankruptcy questions in advanced economies are relevant for EMEs, many core debates in the US and other advanced countries, which mainly deal with public corporations are of less immediate concern to EMEs. Thus, for example issues relating to independent directors and the functioning of boards, executive compensation, hostile takeovers or shareholder activism, which pervade the financial pages of the Wall Street Journal or the Financial Times are not burning issues for most EMEs. Similarly, issues on whether there the debtor should be allowed to remain in possession of the firm
after having declared bankruptcy, or whether there should be stricter limits on courts’ authority to grant new priority financing, as interesting and pertinent as they are for mature market economies, may not be priority bankruptcy reform issues for EMEs. Unfortunately but understandably, most of the existing academic literature on corporate governance and bankruptcy deals mostly with such issues.

In contrast, corporate governance and bankruptcy issues in EMEs are mostly related to small or medium-sized, bank-financed, and privately held firms. The main corporate governance and bankruptcy concern in EMEs is more with credit rationing caused by poor enforceability of debt contracts and asymmetric information than with self-dealing by managers of publicly traded corporations. Banks and the State play a more dominant economic role in EMEs and the issues that are of concern for large widely held corporations in developed economies mainly show up at the level of bank governance and state intervention. There is also a relatively bigger shortage of capital, whether physical or human, in EMEs and governance issues inevitably are mainly concerned with the problem of lowering the cost of capital and fostering business investment.

While corporate governance and bankruptcy in advanced economies normally are treated separately, in EMEs it makes more sense to merge the two topics into a general discussion of corporate finance. In this paper, we attempt to offer a framework of analysis of corporate finance in EMEs and identify tradeoffs that can help frame the debate on corporate governance and bankruptcy policy in these countries. We also provide a more
in depth analysis of corporate governance and bankruptcy institutions and their evolution for specific countries, in particular China, Indonesia, South Korea and Russia.

1.1 Corporate governance, Bankruptcy and economic development

We shall take as our starting point the common observation that the typical EME country has an abundant cheap labor supply but lacks physical and human capital. The main economic reason why per-capita income is low in most developing countries by standard if somewhat simplistic neoclassical economic reasoning is that hourly productivity of the average worker is low. And, hourly productivity is low because physical and human capital is low. In addition, the technology of production and basic infrastructure in place in most EMEs may be significantly lagging behind the more advanced industrial economies. This reasoning has led many economists to the conclusion that the transition out of underdevelopment can be accelerated by easing the inflow of capital from capital-rich countries, where the marginal return on capital is relatively low, to the capital deprived EMEs.

It is remarkable that, even as global financial markets have become increasingly integrated, the capital per worker differentials between rich and poor countries remain large. Indeed, as Gourinchas and Jeanne (2004) and others have documented, non-OECD countries, with the striking exception of China, and other South-East Asian Tigers before the crisis of 1997, have so far benefited very little from financial integration. This general observation has led more theoretically inclined economists to puzzle over why capital flows between rich and poor countries are so low? Why aren’t capitalists grabbing what
appear to be free arbitrage gains by moving their investments from rich to poor countries?¹

There may be several important obstacles to the flow of capital to EMEs. Hausman et al. (2005) propose a distinction between factors contributing to a low return to economic activity and those leading to high costs of finance. Returns can be low either because economic returns are indeed low, e.g., because human capital is weak or infrastructure is poor, or because only a fraction of returns can be appropriated by those engaging in economic activity. Low appropriability, in turn, could stem from government failures, resulting in lack of property rights protection, corruption, and expropriating taxes but also in macro instability, or from market failures reflecting poor information or lack of coordination between private actors. High costs of finance, in this framework, is due to weaknesses in the international financial system or the local financial system with low domestic saving or high intermediation costs.

While it may be hard in reality to identify the most important obstacles, what appears to be generally true is that differences in capital concentration across countries are larger than regional differences within countries. This latter observation suggests that institutional obstacles – the way countries are run, their political and legal systems and how they affect the appropriability of returns -- are likely to be among the significant

¹ Eaton and Kortum (2001) have shown that most of the world’s capital is produced in a small number of R&D-intensive countries, while the rest of the world generally imports its equipment. In his influential paper “Why Doesn't Capital Flow from Rich to Poor Countries?”, Lucas (1990) emphasizes the role of human capital, and that of private incentives to accumulate human capital as a quantitatively important answer. His other explanations include expropriation and monopoly rents.
factors hindring the flow of capital to emerging market economies. The aforementioned study by Gourinchas and Jeanne also sheds light on this observation. They attempt to estimate what is sometimes referred to as a country capital wedge (an implicit or explicit country “tax” on capital income) and they find that it is indeed higher in poor countries, and lower in middle-income countries including, in particular the fast growing economies of China, South-East Asia and India.²

In order to increase private returns to new investment in physical and human capital in emerging market economies: (i) outside investors must be better protected from expropriation (hence incentives to provide capital); firms must be efficiently governed (hence efficient application of capital provided by investors); and human capital matched with physical assets must be efficiently used (hence incentives to accumulate human capital and to reverse brain drain). All of the above constitute the problem of corporate governance either defined as protection of investors (Shleifer and Vishny, 1997) or as protection of quasi-rents generated by firm-specific investments (Zingales, 1998). Indeed, capital income suffers not only from outright expropriations towards insiders or stakeholders, but also from waste due to inefficient governance and suboptimal incentives. These two issues are, however, often interrelated, particularly in less developed economies. As discussed in Jensen (2004) and Friebel and Guriev (2004), expropriation of outside investors may be costly for internal efficiency as well.

² There is no consensus in development accounting on the nature of the capital “tax” and similar frictions, especially given the difficulties in measuring the quality of physical and human capital and non-factor-neutrality of the distortions, see Caselli (2004).
Effective corporate governance can also improve allocation of risks and reduce transactions costs of bargaining over rents (Zingales, 1998). Both are very important in EMEs where insurance markets are not developed and legal adjudication is usually costly. As a result, the risk premium is higher for investments in both physical capital and human skills. They also face larger risks due to macroeconomic imbalances and political disruptions. As recent experience as well as evidence from centuries of development suggest, there are strong links between macroeconomic instability and weak institutions. Improvements in protection of outside investors, governance inside firms, and incentives to accumulate human capital are likely to contribute to more stable economic and political conditions. At the same time more stability in the broader macro environment is in itself an important determinant of investment.

1.2 Our approach

Not only are there different reasons for the low approbriability in many emerging market economies, different solutions may also be needed. Even in mature market economies, there is no first-best solution to the problems of corporate governance and bankruptcy. In reality there is considerable variation in legal rules and institutions across countries and over time. Optimal corporate governance and bankruptcy institutions are necessarily second-best solutions to multiple collective action, and moral-hazard-in-teams problems. Given that the nature and extent of the collective action and moral-hazard problems is likely to vary considerably across firms and countries, it is unlikely that the same corporate governance institutions are appropriate for all firms and countries. There is no one-size-fits-all solution.
Recognizing that diverse policy solutions are called for that fit the cultural, political and economic environment of each country our paper focuses more on the common economic principles and mechanisms of corporate governance across EMEs and attempts to identify the costs and benefits of various policy options, to help foster a more informed debate on corporate governance and bankruptcy in EMEs. It is crucial to recognize that not only do different environments need different corporate law (Kraakman et al. 2004 and its review by Skeel) but the enforcement of the same law may be very different in different countries (Berkowitz et al 2003).

2  General Principles

2.1  What is specific about Corporate Finance in Emerging Market Economies?

In understanding the challenges facing emerging market economies it is important to remember that they suffer from shortages of both physical and human capital. As noted, these shortages are closely interrelated, and alleviating one may also require alleviating the other. For example, investments in physical capital often imply training of personnel, and increases in the level of education raises the returns to investments in physical assets. Investments in both physical and human capital are held back by access to financial capital.
The most important source of credit rationing in EMEs is, in our view, weak contractual enforcement, stemming from corrupt and malfunctioning courts, police, and law enforcement. Corruption, in turn, can take the form of petty corruption stemming from, for example, weaknesses in the incentives offered to government employees, excessive regulation of business activities, and lack of transparency. Another form of corruption is capture where special interests manages to influence the rules of business transactions in their favor, e.g., by bribing legislators and regulators or investing in media. Capture arises from weaknesses in the political institutions. Consequently, improving contractual enforcement requires policy intervention at many different levels, including fundamental constitutional changes as well as administrative and regulatory reform.

The second major source of credit rationing is lack of institutions for information communication, such as credit bureaus, credit histories and accounting standards. Viewed in isolation investments in these institutions are unlikely to yield large returns, but when combined with improvements in contractual enforcement they could help reinforce the enforcement environment.

An important aspect of emerging market economies is their greater macroeconomic volatility. Such volatility directly influences corporate governance and particularly bankruptcy. The moral hazard problems of government guarantees must weighed against the need for intervention in crises.
3 Implications for Corporate Governance

Our framework implies that the corporate governance problem and how to address this problem crucially depends on the particular institutional environment. The impact of specific policy interventions is heavily influenced by the prevailing ownership structure, costs and benefits of specific corporate governance mechanisms, market structure, political economy etc. In particular, an important feature of the analysis of corporate governance in EMEs is the role of the state. On the one hand, there is a greater scope for government intervention in these economies as there are many more market failures. On the other hand, the lower quality of governments and more widespread corruption results in higher costs of intervention. Often interventions reinforce rather than mitigates market failures. As discussed in Stulz (2005), the “twin agency” problem of investor expropriation by both insiders and government may undermine the investment climate. The potential failure of regulation and the risk of rent-seeking by a predatory bureaucracy frustrates privatization efforts. This creates yet another role for the government. In many EMEs, governments remain important owners in the industries that in the advanced countries are predominantly privately owned.

Below we first analyze these mechanisms in the contexts of EMEs and then discuss the costs and benefits of specific CG reforms.
3.1 Corporate governance mechanisms

3.1.1 Controlling shareholder.
Having a controlling shareholder is the major tool to overcome the corporate governance problem in EMEs. Ownership concentration outperforms other mechanisms whenever monitoring is costly, and courts and regulators fail to protect investors. Shareholders with large stakes have strong incentives to monitor management and are less inclined to dilute firm value given that they bear a substantial share of the cost. Consequently, to raise finance and to cash in they should be expected to introduce better corporate governance voluntarily at the firm level, even if regulation and enforcement lag behind (Durnev and Kim, 2005). As large owners can only divest gradually, and may want to return to the capital market later, they care about a reputation for the protection of minority investors. But the mechanism also has its problems.

In all the concern for small shareholders and creditors in EMEs we may actually lose a very fundamental point, the protection of property rights of majority shareholders. After all, in many of these countries, particularly in the less developed economies, the main problem is to get investors to commit to holding controlling blocks necessary to monitor management and provide guarantees other investors. Without protection of their property rights majority shareholders large blockholders may not be interested in maximizing firm value and would probably not invest in the first place in anticipation of expropriation. The protection of the large owners’ property rights may or may not be equivalent to the basic property rights protection in the economy. For example, if inequality of income and
wealth is high, large owners may be especially vulnerable to the risks of expropriation. The Yukos case in Russia exemplifies how inequality and illegitimacy of privatization can undermine property rights of majority owners (Goriaev and Sonin, 2005). In India, in some states more than others, large owners are under strong pressure from labor market regulation (Besley and Burgess, 2004).

Another problem with the concentrated ownership is exit. At some point the firm should either raise outside funds to grow, or the owner should sell a stake to cash in and/or to diversify. The problem is that if the home stock market – precisely due to the prevalence of concentrated ownership – may be too thin. Hence, access to the global capital market is vital; in fact it may be the only way to credibly commit to a higher governance standard (Doidge, Carolyi, and Stulz, 2004). In many cases, however, foreign investment is discouraged by the government’s ideology (e.g. India in 1980-90s and Russia since 2004). Also, foreign listing involves large fixed costs and is therefore available only to the largest firms.

Yet another issue is that controlling shareholders enjoy benefits that other shareholders do not. Some of these so-called private benefits, like a reputation or social status, strengthens the large shareholders’ incentives and impose no costs on minority shareholders, while others dilute the value of their stock (e.g., through consumption-on-the-job or transfers to related companies). The more important the latter type of benefits are in a particular firm, the greater are the risks that a controlling shareholder will make
decisions that will undermine the value of the firm. Corporate governance policy should aim to reinforce the non-diluting private benefits and delimit the scope for dilution. Concentrated ownership often relies on reputation to commit not to exploit minority shareholders. Reputation, in turn, is easier to build in a well-functioning regulatory environment with enforcement of transparency and disclosure. If regulators fail to enforce disclosure, an independent business press could play an important role in reporting the treatment of outside shareholders (Dyck, Zingales, and Volchkova, 2004). As the Hermitage Fund investment strategy (Dyck, 2002) shows, majority investors do care about their reputation in smoothing their exit strategies. This in turn translates into better protection of minority investors. Similarly, enforced regulation that clearly defines, not necessarily minimizes, the scope for dilution helps controlling shareholders raise outside funds.

Concentrated ownership aligns incentives at the firm level but is very costly from the social welfare’s point of view. It limits diversification of owners’ portfolios and hampers development of liquid financial markets which in turn is very costly for the economy (Schiller, 2003). In many cases, large owners diversify their risks through building diversified business groups. This in turn results in substantial costs; the conglomerate discount literature (e.g., Scharfstein and Stein, 2000; Schoar, 2002) suggests that diversified groups destroy value in the developed markets. However, as Khanna and Yafeh (2005) show, their benefits seem at least to balance the costs in the EMEs.
As mentioned above, there is an important/related special case of concentrated ownership: often the majority owner is the government per se (China, decreasingly so India, and increasingly so – Russia). In principle, partial privatization of non-controlling blocks improves transparency and allows for stock market monitoring of managers in the state-owned firms as much as in the private companies (see e.g. Gupta, 2005, on India). Yet, the managers being government officials have weaker incentives and shorter horizons. So the case of state-owned firms is paradoxically similar to the case with private ownership concentration where the expropriation risk distorts incentives.

Also, due to the conflict of interest between ownership and regulation functions of the government, it is not clear how to establish a credible commitment to protect outside investors. This conflict of interest would be resolved if the government were perfectly benevolent and had an infinite horizon – like the large private owners the government would establish a reputation for protecting outside investors in order to maximize the market capitalization whatever the current political pressures. Yet, an EME government is unlikely to satisfy these conditions; this is the case even in China. As the influential Chinese economist Wu Jinglian has said “China’s stock market is worse than a casino. At least in a casino there are rules.” (Liu, 2005).

There is therefore an unpleasant trade-off between the market failure and the government failure: government can neither assure private property rights nor run the firms itself. There seems to be a way out. As literature on privatization shows (Meggison, 2002)
Even if governance is not perfect and privatization per se does not work well, privatization to foreign direct investors seems to improve performance. Evidence from the large-scale enterprise survey of transition countries, Business Environment Enterprise Perception Survey (BEEPS), finds that foreign-controlled firms even manage to improve their efficiency faster over time relative to other firms with other types of owners (EBRD Transition Report, 2005). Yet, FDI is often constrained by politics.

The effects of different ownership types on corporate performance may differ depending on the broader business environment and the level of competition in a particular industry. Interestingly, the same BEEPS survey show that while more inefficient from the start state-owner firms restructure as well as privatized firms and better than private firms. Competition as such does not seem to have a strong effect on performance, but being exposed to competitive pressures in export markets helps. As discussed above, the performance of state-owned enterprises should also helped by privatization through sales of minority stakes and possibly through sales of competitors. Most importantly, state-owned firms should benefit greatly from improved corporate governance, e.g., through greater transparency and professionalization of boards, in particular when these firms have to approach capital markets.

3.1.2 Corporate control market

The role of hostile takeovers in EMEs is similar to that of in the advanced countries. While hostile takeovers have played an important role in the US in 1980s, they have been
less common in 1990s and have only recently began to be used in Europe and Japan (Holmstrom and Kaplan, 2002). Takeovers are considered to be a rather blunt instrument for corporate governance (Berglof and Burkart, 2003) and need not to be socially efficient (Burkart, 1999). In particular, hostile takeover may involve disruptions of corporate activity and “breach of trust” (Shleifer and Summers, 1988) that undermines implicit or explicit contracts between shareholders and stakeholders. This is why in many countries (including the US) legislation includes many anti-takeover devises. Often, takeovers are prevented by managers even without the use of legal defenses. Managers can use labor as a shield (especially in proportional political systems, Pagano and Volpin, 2005) or pension overhang as a poison pill (Rauh, 2006).

In EMEs the takeovers may work even less well as the imperfections of the judiciary may result in takeovers by less efficient owners. More importantly, when firms are predominantly controlled by majority shareholders executing truly hostile takeovers is impossible. Yet, even when ownership is concentrated the accumulation of large blocks of equity (or debt) by outside investors can exert influence on controlling shareholders (Jenkinson and Ljungqvist, 2001). In some EMEs takeover market are also quite active and the threat of takeover does impose a limited discipline on the insiders (Guriev et al., 2003).

.3.1.3 Boards, executive compensation, fiduciary duty, managerial labor market.
All these mechanisms are “institutions-intensive” and require enhanced reputation mechanisms, liquid markets, and efficient courts. Yet, as mentioned above, these mechanisms may work inasmuch as the companies are integrated into the global capital markets (in particular, through cross-listing in the OECD markets). It is also important to note as most of EMEs have only recently started their integration into the global financial system, there may also be a lack of human capital for corporate boards. The most competent directors are still actively involved in their own corporations and are not yet ready to work as board members. Again, relying on foreign board members is a potential solutions.

3.1.4 Taxes
Desai, Dyck and Zingales (2005) emphasize the potential positive role of the tax collection for the corporate governance. As government is essentially a large shareholder in every company (through the tax claim on the corporate profits), the effect of taxes is similar to the effect of ownership concentration. If the government is benevolent and is interested in collecting all taxes due, the government will monitor the management and penalize asset stripping and tunneling.

However, in many EMEs the benevolent government assumption may not hold. There are two potential problems. First, the government is interested in tax income and monitors the management but may be willing to collude ex post with management or majority owners to expropriate outside shareholders. Second, government officials may not even be interested in tax income but rather settle for a bribe ex ante for not monitoring at all.
3.1.5 Bank monitoring

Many EMEs rely on banks as the major source of funding. It is not surprising as the stock market is more demanding in terms of regulating and law enforcement capacity. While protection of creditors is somewhat easier than that of shareholders, there are also substantial problems (see bankruptcy section). Creditors’ monitoring may nevertheless be an (imperfect) substitute in terms of impact on internal incentives.

Yet, the domestic banking system is not necessarily very strong. Even in Central and Eastern Europe where banks are predominantly foreign-owned, it is only in the last few years, after more than a decade of reforms, that banks begin to fund investment and therefore get involved in monitoring corporate management (Berglof and Bolton, 2002, Berglof and Pajuste, 2005). In many countries, banks are also either government owned or happy to support politically connected firms (Faccio, 2005; Mian and Khwaia, 2005). Such lending results in soft budget constraints and worsens corporate governance rather than disciplines the managers (Tian, 2005). Again, the largest companies that have access to the global credit market do benefit from lower cost of funding and from bank monitoring but this channel is too expensive for medium-size firms.
3.2 The tradeoffs in corporate governance

The mechanisms above are not independent of each other. Some are often based on conflicting goals but some reinforce each other. Below we discuss specific policies.

3.2.1 Developing a broad stock market or encouraging delisting?

Stock market development involves protection of minority shareholders which may reduce mobility in corporate control market and slow down ownership consolidation. On the contrary, policies promoting delisting, such as squeezeouts, freezeouts, breakthrough rules (Berglof and Burkart, 2003) encourage more efficient takeovers but undermine broad share ownership. Inasmuch as the benefits of concentrated ownership outweigh its costs, mobility in the corporate control market is more preferable. This tradeoff is especially salient in Central and Eastern Europe where after very different reform paths, ownership systems have converged to those of consolidate ownership and very shallow stock markets (Berglof and Bolton, 2003, Berglof and Pajuste, 2005). In any case, where possible, the trade-off should be resolved at the firm- rather at the country-level. The policies should lower the costs of self-selection into listed and non-listed companies. The limited enforcement capacity should then be focused on the public companies.

3.2.2 Transparency vs. business secrecy

Enforcing disclosure is one of the major tools for reducing costs of outside financing (LaPorta et al., 2005). Yet, disclosure may constrain managerial initiative and increase
the risks of expropriation by the government (Ostberg, 2005). This is why the optimal disclosure depends on firm-level characteristics such as investment opportunities, ownership structure, and political risk (that can be also firm-specific, Goriaev and Sonin, 2005). Hence, mandatory disclosure rules may be socially suboptimal. Too much transparency can also be costly for businesses whose comparative advantages are more efficient business processes or production technologies. In this case, the US firms approach special financial intermediaries (e.g. venture capitalists) whose reputational concerns prevent them from abusing access to information. Yet, venture capital market does rely substantially on developed legal system (Kaplan, Martel, Stromberg, 2004) and may not function well in most EMEs.

3.2.3 Protection of creditors vs protection of owners.

As argued above, the protection of property rights of private owners is key to good corporate governance. Yet, as stock markets are underdeveloped, and the companies have to rely on bank credit and bonds, the protection of creditors is also important for external finance and corporate growth. This trade-off is discussed in the bankruptcy section.

3.2.4 Courts vs regulators

Glaeser et al. (2001) argue that aggressive regulation of securities markets may outperform reliance on courts in transition economies. They explicitly model the
incentives of judges and regulators and show that in some cases the politically motivated regulators may be better suited for the weakly institutionalized environment. In particular, they argue strong regulation did help Polish stock market overtake the Czech one in 1990s. Yet, their analysis also implies that the optimal solution is therefore very different in different EMEs.

It is important to discuss the “China outlier” where all listed companies are government-owned and both judges and regulators are government-controlled. One would expect pro-government bias of both courts and regulators. Yet, China has managed to provide political incentives through yardstick competition. As the central government has set regional listing quotas, the securities regulator CRSC has engaged the support of provincial governments to select and regulate listed companies (Du and Xu, 2005). Such federalism-based incentive structure is, however, not costless. Boyreau-Debray and Wei (2005) show that capital mobility across Chinese provinces is actually surprisingly low.

3.2.5 Corporate law and regulation vs corporate chapters and codes

As argued above, in EMEs corporate governance may be voluntarily improved by the individual firms (Durnev and Kim, 2005). Yet, even as the uniform regulation is too blunt, the decentralized charters impose a substantial burden on courts (Burkart, 1999). The intermediate solutions are codes that are more flexible as companies can sort according to their preferences and needs for stricter or softer CG rules. Evidence also
shows that country-level regulation and government factors dominate anything firms themselves can do, unless they manage to list themselves on a foreign exchange (Doidge, Carolyi, and Stulz, 2004).

3.2.6 The role of stakeholders

The policies above discuss the tradeoffs with regard to the maximization of shareholder value. However, the firm’s objective function may also include the payoffs of stakeholders including labor, national and regional government, suppliers, and customers (we discuss creditors separately in the bankruptcy section). In EMEs, stakeholders are important from both positive and normative points of view. First, in virtually all EMEs stakeholders do actually play important roles in the firm. Second, stakeholder intervention may be socially optimal. Indeed, if redistribution through government is rather costly (e.g. taxes, pension system, public education do not function properly), the corporations may be a more efficient channel for solving social issues. Also, if labor and product markets are segmented, corporate decisions impose substantial externalities on employees, suppliers and customers, and therefore pure profit maximization may be socially suboptimal.

On the other hand, stakeholder society involves substantial costs (Tirole, 2001): Government or other stakeholder intervention weakens the controlling owner/manager’s incentives, hence lower internal efficiency. These costs are especially high in EMEs where stakeholders are not well-organized, and governments are often inefficient and corrupt. For example, if trade unions are not functioning well, labor’s interests are
protected by other stakeholders, e.g. national or regional governments which exacerbates the costs as stakeholders themselves suffer from the multi-tasking problem.

4 Implications for Bankruptcy

4.1 Functions of the bankruptcy law

The proposed framework also has implications for how to think about bankruptcy reform in emerging market economies. Generally speaking, bankruptcy law, or more broadly debtor-creditor law, deals with conflicts between a debtor and its creditors, and among creditors. The basic functions of this body of law are to mitigate the common pool problems associated with multiple creditors (when the interests of individual creditors may conflict with those of the creditors as a collective), to specify seniority among creditors, and to prevent asset substitution and diversion by management or a subset of creditors. Bankruptcy law should also provide insurance to individual firms when factors beyond their control negatively impact their results. As with any law, provisions for what happens in a given contingency have ramifications for contracting ex ante.

4.2 What is different about EMEs compared to developed countries?

4.2.1 Information

A large part of what a bankruptcy court does in a country like the United States is to determine the structure of claims, i.e., who has legitimate claims on firms and how large these claims are. In emerging markets this task is particularly cumbersome given the lack of reliable information. Indeed, most emerging markets are characterized by a combination of poor information sharing and extremely low de-facto accounting
standards. They often lack reliable well-functioning credit bureaus with histories of individuals, and registries for claims and collateral.

A number of country studies show that the introduction of information sharing institutions significantly improves credit markets in poor countries. For example, Fuentes and Maquieira (2001) document that the establishment of a credit registry increased lending in Chile; Cristini et al (2001) associate the relatively high private lending rates in Argentina with the existence of a credit registry operated by the Argentine Central Bank. Overall, private credit bureaus are significantly less frequent in EMs compared to financially developed countries; whereas, public credit registries are just as common. Cross-country regressions show that in the sample poor and middle-income countries both the private bureaus and the public registries are associated with higher private credit; even though, the effect of private bureaus is much larger. (World Bank, 2005)

Private credit bureaus face a lot of legal obstacles in EMEs. For example, a major impediment to formation of private bureaus in many former SU countries is a secrecy provision in the banking laws; for example, these secrecy provisions precluded formation of private bureaus in Armenia, Georgia, Kazakhstan, and Russia. In places where legal obstacles are not binding, private credit registries have to overcome the inherent lack of experience and technical difficulties. International experience shows that it could be done more easily if entry of international credit agencies is permitted. Private credit registries in the Czech Republic, Guatemala, India, and Mexico first formed as joint ventures with the established foreign firms. (World Bank, 2004)

In the few poor countries where private information sharing agencies do operate, they usually concentrate only (or primarily) on negative information about debtors, i.e., defaults and late repayments. Even the simplest information about debt exposure is often missing. A single record of a default virtually eliminates the possibility for an entrepreneur to obtain formal credit as long as the records are kept. (The time of keeping
records varies from country to country; the information, however, is rarely kept for good.) Beck (2000) and Pinheiro et al (2001) provide evidence of severe sparcity of credit rating information in Brazil; Straub and Sosa (2001) describe similar problems in Paraguay. Yet, sharing of positive information is extremely important for financial development. Both cross-country evidence (see Djankov, McLiesh and Shleifer 2004) and case studies support this claim. Fuentes and Maquieira (2001) show that introduction of “white” information was an important factor behind a significant improvement in loan repayments in Chile.

Poor interpretability and comparability of firms’ financial records (i.e., balance sheets and income statements) is another important aspect of the overall problem with information flows in the credit markets in EMEs. For example, a survey of financial intermediaries suggests that project characteristics do not play a significant role in the decisions to grant a loan, primarily due to high evaluation costs and inadequate information (Monge-Naranjo et al., 2001). In contrast, borrower characteristics like credit references and previous experience with the intermediary are of great importance to them. In transition countries the legacy of socialist accounting exacerbate problems with transparency of business operations (Bailey 1995; Pistor and Xu 2005).

Various informal mechanisms arise in the absence of formal institutions for information sharing. Reputation arising in the long-term relationships between specific banks and borrowers is by far the most common mechanism to discipline debtors in developing countries. Financial intermediaries keep records of their own experiences with the borrower and extend credit only to borrowers with impeccable histories. When information-sharing institutions are not feasible, banks could join informal networks and share records under “gentlemen’s agreements.” Such cooperation requires very high levels of trust among (competing) banks. Even though we occasionally observe such cooperation, it is not common. Monge-Naranjo et al. (2001) provide examples of both successes and failures in creating informal communication networks among banks in Costa Rican provinces.
Generally, when contracts are rudimentary and information about assets is scant, the work of the bankruptcy court is made much more difficult and the scope for conflicts is greater.

.4.2.2 Structure of debt and the nature of conflicts

The emerging market context also shapes the nature of conflicts of bankruptcy law. In poor contracting environments inside finance raised among family, friends and acquaintances often dominates, and financial contracts tend to be more rudimentary. For example, based on a survey of entrepreneurs, Djankov et al. (2004 and 2006) report that over 90% of start-ups and 80% of business expansions in China and Russia are financed from personal savings of entrepreneurs and funds of their close friends and relatives. Ownership is often concentrated, either with the original entrepreneur still at the helm or with close ties between the controlling family and management. For example, Claessens, Djankov, and Lang (2000) analyze the concentration of ownership in East Asian companies and find that 1) more than two-thirds of companies are controlled by a single shareholder and 2) in most of these firms there is no separation of ownership and control.

The main concern of investors is typically the risk of asset substitution, particularly fraudulent conveyances by owner/management to itself or from one set of creditors to another. For example, Johnson et al. (2000) present many colorful cases of the transfer of cash and assets out of companies which expropriated majority creditors in Thailand, Hong Kong, Korea, Malaysia, Indonesia, and Russia in the aftermath of the Asian Crisis. Since markets for asset sales in developing countries are often distressed with low liquidation values as a result, external investors are reluctant to extend credit against collateral. External finance, thus, primarily comes as monitored bank debt provided by a small number of investors, usually dominated by a main bank. For example, a survey of
2,063 manufacturing firms in Chile shows that a half of all firms are associated with no more than two banks (Garcia and Rodriguez, 2003). The number of banks increases with the size of firms measured by the number of employees. The smallest 20 per cent of firms in the sample had fewer than two lenders on average (the median is one bank); the largest 20 per cent of firms borrowed on average from 5 banks (the median is four).

The rudimentary debt structures makes the conflict among external creditors and, particularly, mitigates the common pool problem. The rationale for the use of bankruptcy law to enforce debt repayments is therefore substantially weaker in EMEs compared to financially more developed countries. Cross-country evidence also shows that in poor and lower-middle-income countries (with ill-functioning judiciaries) debt enforcement outside of bankruptcy procedures works better on average compared to using complex bankruptcy procedures. Bankruptcy laws in developing countries significantly increases delays in resolution and legal uncertainly and therefore undermines ex-post and ex-ante efficiency. In countries, where firms have only a few creditors, better recovery rates and higher private lending are achieved when 1) contract law is used as the basis for private negotiation of debt restructuring between lenders and borrowers and 2) secured-transactions law is used to regulate simple foreclosure rules for secured-debt contracts outside insolvency (World Bank, 2005).

Poor countries often rely of private informal mechanisms substituting for judicial enforcement of any kind (not just the use of bankruptcy courts). Such mechanisms include private orderings of contracts and reliance on peer pressure to ensure debt repayment (Kranton 1996; Pinheiro et al. 2001). Townsend (1995) describes how these institutions work in Thai villages. Particularly, he shows that these mechanisms are effective only in relatively closed communities.

Because establishing an unambiguous and enforceable priority structure is so difficult, additional creditors are reluctant to contribute. In a number of developing countries, the
largest claim on firms is held by the government in the form of accumulated tax arrears. Generally, backlog of tax arrears (which often has higher priority to private claims) reduces ex-ante incentives to lend and creates private creditor passivity in relation to debt collection. Politicians are tempted use this claim as an instrument for exerting political pressure on firms and arrears often do not get written off even though they preclude raising outside finance. For example, Brazil in 2000 (according to the presentation of Aloisio Pessoa de Araújo at the IPD meeting) and Russia in 1997 (Ponomareva and Zhuravskaya 2004 and Lambert-Mogiliansky et al. 2004) were facing these problems.

In interpreting these results it is important to remember that the simple debt structures in emerging market economies are themselves the result of the weak institutions. Over time the development of more sophisticated credit markets go hand in hand with a greater role for bankruptcy law. As external funds become more important to individual firms the role of minority interests also increases.

4.2.3 Quality of judiciary and the cost of its use

In EMEs, courts generally are inefficient, slow, and costly. Moreover, judges in some developing countries are incompetent and need training. High administrative costs and delays in bankruptcy procedures usually represent a net loss for both borrowers and lenders. According to an estimate by Pinheiro and Cabral (1999), a judicial decision to recover a creditor claim in Brazil can take up to 10 years. Straub and Sosa (2001) report that in Paraguay, creditors usually pay one quarter of the value of the claim to attorneys for collecting debts. The “Doing Business” report (World Bank, 2005) gives estimates of length and administrative costs (i.e., court costs and fees of insolvency practitioners, independent assessors, lawyers, accountants, etc.) of bankruptcy procedures for 141 countries. Table 1 lists fifteen countries with the longest time needed to complete the procedure and the highest costs of the procedure measured as a share of the value of estate (World Bank 2005).
The characteristics of developing countries that we discuss above, namely, prevalence of firms with simple debt structure, close monitoring of debtors by the main bank, and inherent inefficiency of judiciary explains why the use of bankruptcy is rather low. 96.4% of all bankruptcy filings in the world take place in rich countries, 3.1% of bankruptcy filings take place in the middle-income countries, and only 0.5% - in poor countries. For example, the number of bankruptcies as a share of all limited liability companies is 83 times larger in Finland than in Peru (source of data: DB 2005). Yet, the differences in exit rates between developing and developed countries are much closer (see Figure 1). Monge-Naranjo et al (2001) estimate that only 3% of nonperforming loans reach courts in Costa Rica. In Chile, this number is 20% (Fuentes et al. 2001).

4.3 Designing bankruptcy laws in EMEs

In trying to mitigate conflicts within insolvent firms (which change with different stages of financial development), bankruptcy laws anywhere tend to be extremely detailed with many specific provisions, but any law would have to determine a few key rights: Who has the right to trigger a bankruptcy proceeding? Who controls the assets during the proceeding (debtor or creditors-in-possession)? Can new debt with higher seniority than existing debt (super-priority finance) be issued in bankruptcy? How do creditors vote in bankruptcy (majority or unanimity)? Who has the right to propose the reorganization plan, i.e., the plan for the reorganized unit to be voted on by the creditors? Based on how these key rights are allocated we can identify at least four key dimensions distinguishing existing bankruptcy systems from each other: degree of friendliness towards debtors (or creditors); orientation towards liquidation or reorganization of firms; bias among creditors (e.g., secured vs. unsecured creditors; banks vs. bondholders); and extent of court involvement.

Bankruptcy systems around the world vary a great deal in how they allocate these rights. Even developed market economies differ considerably in bankruptcy design. In the United Kingdom, the law is viewed as creditor-friendly with a strong bias towards
liquidation and one key creditor, the holder of the floating charge, normally a bank. In the U.K., the law delegates conflict resolution to this creditor as opposed to bankruptcy courts. The U.S. system on the other hand is considered as debtor-friendly with strong incentives against banks to get deeply involved in restructuring firms (or else their claims would be subordinated). The courts are given a major role in bankruptcy. Given these differences it is hard to claim that there is a “one-size-fits-all” system. As most bankruptcy lawyers now recognize different contexts requires different rules and procedures.

Any designer or reformer of bankruptcy law would have to make decisions along these dimensions, but the various rules also have to be applied to specific cases. A number of factors influence how a particular legal text eventually is implemented. Bankruptcy procedures, particularly in less developed economies, are susceptible to capture by specific interests, sometimes combining tools provided them by bankruptcy law, wealth of resources, and political clout as large investors or employers. Actors in the economy learn how to use the system; those who use it more often and those with more resources are likely to learn the most. If large private creditor institutions exist, they are more likely to be in repeated proceedings, implying that there would be an inherent tendency towards more creditor-orientation in the implementation of laws. For example, some observers of the US bankruptcy system argue that it is much less debtor-friendly in practice because of the extensive learning of large creditors (Baird, 200X). In the UK, on the other hand, informal practices have developed, the so-called London Process, to introduce more debtor-friendly features.

An important consideration in designing bankruptcy law is how to strike the right balance between reorganization and liquidation. On the one hand, in emerging market economies labor markets tend to function less well and social safety nets are less developed suggesting that social costs of liquidation of firms are higher. Broader structural changes in industry are also likely to take place across different industries rather than within industries, implying larger costs of adjusting (Shleifer and Vishny 1992). On the other
hand, those EMEs that are growing rapidly can more easily absorb human capital made redundant. Many of not-so-fortunate developing countries (which do not grow rapidly) have no means apart from liquidation to transfer assets from the inefficient to more efficient uses and release workers to other parts of the economy because of disfunctionality of capital markets and the markets for corporate control and high politicization of the economy. This is particularly important in transition economies with strong insider control. In these economies, liquidations should be particularly harshly enforced for the old (formerly) state-owned firms; yet these firms are usually the ones that get bailed out. In addition, the strong reorganization bias of US bankruptcy law has its origin in the late 19th century and the large railroad bankruptcies with huge externalities and the emergence of the large modern corporation with complex capital structures. Such firms are not likely to dominate in emerging market economies.

On balance, bankruptcy law in emerging market economies should probably have a liquidation bias because reorganization procedures are much more complex than liquidation procedures. Reorganizations, to be effective, necessarily require more effective judiciary and more competent bankruptcy practitioners. One, however, cannot argue a priori that liquidation procedures are less susceptible to capture than reorganizations. Thus, the distributional consequences of the choice between reorganization and liquidation bias depend on the distribution of political power and wealth among the conflicting parties; yet, the overall losses associated with reorganization procedures on average are likely to be larger than those of the liquidation procedure.

Cross-country evidence presented in the “Doing Business” report (World Bank, 2005) supports this claim. It strongly suggests that the most efficient bankruptcy laws in the subsample of developing and transition countries prescribe very simple, fast, and cheap liquidation procedures. It is important to keep in mind, however, that possibilities for asset striping may actually make liquidations extremely debtor-friendly. Thus, a close
monitoring of all transactions in bankruptcies by the interested parties in the conflict should be allowed.

Another crucial issue in designing bankruptcy laws is how much discretionary power to give to the judge. Particularly, this relates to the questions of how much the judge can affect the decisions about the candidates and the actual choice of the bankruptcy practitioner, the fate of the firm (liquidation or reorganization), the choice of a reorganization plan under the reorganization procedure. Usually, the rationale behind giving discretionary power to the judge is to prevent socially inefficient liquidations (e.g., French and Indian bankruptcy laws concentrate most powers in the hands of the judge and leave little room for negotiations between the debtor and the creditors).

It would, however, be extremely naive to assume that bankruptcy judges maximize social welfare in developed countries, let alone in emerging markets. A very common feature of emerging market economies is judicial corruption, but there are also more subtle influences. In many systems judges are politically appointed or appointed by political appointees, and they are bound to serve political will which may also represent special interests (e.g., labor unions, the poor, etc.) and may substantially diverge from social welfare. When the political will is lacking, courts are more likely to be influenced by the actual bribes from actors involved in bankruptcy. When claimants know that judges do not stand up for them and enforcing agencies in any case are unlikely to implement decisions, they are less likely to use courts in the first place. This is the essence of the lack of rule of law. In some countries, e.g., in Russia, bankruptcy has even become a tool to undermine property rights. Large investors buy up debt claims, often at heavily discounted prices, and then use their influence on judges to take over firms

It is often argued that corrupt judges (or insolvency practitioners) ultimately act in the interest of the party most able and willing to pay – the party that is willing to bribe the most – and, thus, ex-post outcome of in-court procedures with corrupt judges are the same as they would be under the market-based structured bargaining a la Bebchuk (XXXX). Indeed, ex-post outcomes may be the same; but ex-ante efficiency may be severely undermined in the case with corrupt judge because the judge appropriates what, otherwise, would be divided between the debtor and the creditor. This, in turn, may reduce debt recovery rates, and therefore, reduce ex-ante incentives for lending.
(Volkov, 2004). In addition, in Russia’s regions, where governors are politically strong, they get effective control over insolvent firms by extending political influence on judges who appoint pro-government insolvency practitioners in reorganization procedures (Lambert-Mogiliansky et al. 2004).

An additional argument against heavy administrative involvement in decisions about the firm in bankruptcy is that judges are generally the least informed party. This is true in any country; but the informational gap between creditors and debtors, on the one hand, and judges, on the other hand, is substantially higher in poor countries due to low quality of information and poor qualifications of judges compared to rich countries. Thus, the most efficient procedures should be those that 1) facilitate negotiations of informed private parties and 2) limit the choice of the judge to the range of outcomes that are a result of these negotiations.4

Case studies of France, Italy, Spain, Czech Republic, Russia, and India vividly demonstrate that the only thing that may differ is the reason for why allocating a lot of discretionary power to the judge does not work well (source?). The actual outcome of functioning of bankruptcy law does not seem to differ across these countries; it is disappointing everywhere.

Empirically, there is a strong positive association between the levels of discretionary court power and corruption in developing countries. An increase in the power of courts substantially increases financial costs of bankruptcy as shown on Figure 3. Doing Business 2005 report shows that it is much better for the efficiency of the procedure to rely on stakeholders rather than on the court to make business decisions. The DB report

4 For example, if judicial decision about reorganization plan is constrained to the choice among several plans suggested by the groups of creditors and a plan suggested by the debtor, there are strong incentives for the informed private parties to negotiate and agree among each other.
estimates that countries where creditors have a say in appointment and replacement of bankruptcy practitioner have bankruptcy procedures that are cheaper by almost a third and twice as likely to achieve the efficient outcome (liquidation or rehabilitation). It also seems to be important to require the bankruptcy practitioner to report to stakeholders (and not only to the court) and to allocate decision power over the reorganization plan to stakeholders (rather than to the court).

Since one of the main concerns of investors in emerging markets is a possibility of assets stripping leading to expropriation by the controlling owners of firms, it is important to try to minimize these possibilities in the design of bankruptcy laws. Unfortunately, because of poor law enforcement, many creditor rights stipulated in the laws on the books (e.g., a la La Porta et al. 1997, 1998) do not affect the efficiency of bankruptcy practice in developing countries or even creditor proceeds. For example, mandatory removal of management in bankruptcy and restrictions on entering reorganization procedure (such as the need for creditor consent) do not have a significant effect on the creditor recovery rates (World Bank, 2005). For example, there is a lot of anecdotal evidence from Russia that debtor-friendly bankruptcy practitioners were appointed to oversee reorganizations when incumbent management was removed from insolvent firms in accordance to the law which stipulates manager’s dismissal (Volkov 2004; and Lambert-Mogiliansky et al., 2004).

There are two important exceptions to the rule that legal rights of investors do not generally matter under the conditions of poor law enforcement in developing countries. First, the provision in the law that secured creditors are able to seize collateral on their loan after a petition for reorganization is approved significantly increases the ex-post receipts of the creditors and, actually, of all claimants. Having no automatic stay on assets seems just as good for the efficiency of bankruptcy procedures as having a stay, but excluding collateral from the stay. Second, countries where, by law, secured creditors are paid first out of the liquidation proceeds, go through bankruptcy faster and, therefore,
also have lower costs and higher average recovery rates (Djankov, McLiesh and Shleifer, 2004; and World Bank, 2005). These results are illustrated by Figure 2.

An important aspect of the law which, generally, affects the possibilities for asset stripping is time which is required to go through the procedures. Overall, delays account for one half of the difference between the average recovery rates in rich and poor countries (World Bank, 2005). A part of this effect is due to the fact that the value of claims may simply erode in turbulent macroeconomic environments; but the most important reason behind this relationship is that delays are used to tunnel assets out of the insolvent debtors. For example, appeals in EMEs are often abused purposefully by the debtor to delay the resolution. Cross-country evidence shows that limiting appeals, both in the beginning and during the procedures, significantly increases recovery rates in middle-income and poor countries (World Bank, 2005). Since appeals are important for limiting violations of the law, it is important not to eliminate them. However, they are most effective, when the law sets an upper bound for the length of the appeals and allows the case to continue during the appeal.

Fuentes and Maquieira (2001) argue that a few simple provisions in the bankruptcy law against insider trading in Chile actually lead to an increase in lending. Yet, since asset substitution and insider trading is a widespread phenomenon in developing countries, one cannot take satisfactory level of enforcement of such provisions in EMEs for granted.

The emerging market environment also complicates the insurance function of bankruptcy law. On the one hand, economic fluctuations are often less predictable and have greater amplitude in emerging market economies, suggesting that exemptions and discharge of debt should be more substantial. On the other hand, the high costs of monitoring imply a need for more collateral and less exemptions. Given that shocks in institutionally less developed economies tend to be strongly correlated across firms, proposals have been made to allow for economy-wide stays or broad bailouts. While such “Super Chapter
11”-arrangements are attractive alternatives ex post when many firms simultaneously are facing bankruptcy, the ex ante effects are more difficult to estimate. There are some special conditions under which debt cancellations, moratoria, and bailouts during the major economic downturns improve ex-ante efficiency (i.e., prevent liquidation of viable firms). An important issue is the conditions under which such economy-wide moratoria could be declared and by whom (Bolton and Rosenthal, 2001 and 2002).

In the times of economy-wide crises, on the one hand, a pro-creditor bankruptcy law with a liquidation bias has negative externality on collateral value which may exacerbate the crisis because of impossibility to get additional collateralized lending into the system. On the other hand, harsh-on-the-debtor bankruptcy law could be better for keeping the banking sector alive which could improve the situation because of additional financing in the system. For example, having an automatic stay on bank credit could have a negative externality because banking system may down in a crisis and, therefore, would not be able to re-finance distressed but viable-in-the-long-term firms.

If a country that undertakes a drastic bankruptcy reform and at the same time attempts reforms aiming at tightening of formerly-soft budget constrains in state-owned banks or toughening formerly-poor tax enforcement (as happened in many transition countries), one should expect a sharp increase in the numbers of insolvent firms simply because the backlog of bad loans and tax arrears suddenly becomes a real liability. This may create a serious political pressure for a reversal of reforms and could actually have real consequences for the economy. For example, many observers of the introduction of an “automatic bankruptcy trigger” in Hungary argued that bankruptcy reform was the primary reason for the Hungarian credit crunch in the early 1990s (Mitchell 1998 and Bonin and Schaffer 2002).

Yet another feature of the EME environment is the coexistence of a modern, primarily urban, manufacturing sector, and a much less developed often rural agricultural sector
based on small and medium-sized enterprises. Naturally, firms in these two sectors are financed in very different ways, and this in turn has implications for what kind of bankruptcy law best corresponds to the needs of firms and investors. This dual nature of the economies raises the issue of the pro’s and con’s of having separate chapters corresponding to the different needs of the two sectors. Since entrepreneurship and small business growth are particularly important in developing countries, the benefits of “fresh start” policies that allow debtors-entrepreneurs to obtain relief from debt despite less-than-full creditor repayment (leaving some funds to the entrepreneur) arguably are greater than in developed economies. Thus, it might be beneficial to have special “soft” bankruptcies for small firms and individual entrepreneurs (it is worth noting that for the large firms, the benefits of fresh start are negligible). There are, however, important arguments against such a solution (Ayotte 2005). First, if small firms are treated preferentially ex-post, incentives to expand business and grow may be undermined (as often is the case in India and Brazil). Second, if the bankruptcy code is too soft on small firms ex-post, it should be difficult for them to get finance ex-ante which, in turn, may hurt their possibilities to grow.⁵

A related problem is the geographic fragmentation of finance, where individual financial institutions often dominate a particular region, and are favored by local political institutions and courts. Such local biases, once the driving force behind the establishment of a federal bankruptcy law in the United States, are a serious problem in many emerging market economies, particularly in the large countries with federative structures (e.g., Russia, Brazil, India, and Argentina). Regional special interests may use bankruptcy procedures as a bargaining chip in negotiations with the federal center (Lambert-Mogiliansky et al. 2004).

The government has a strong presence in many aspects of the economy in developing countries. In some transition economies, state ownership reflects the vanishing legacy of

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⁵ Ironically, in many countries large and not small firms have softer bankruptcy de-facto because of government bailouts and “social” clauses in the legislation.
socialism, but in many other developing and transition countries, the government still plays a key strategic role as an owner in industry. Needless to say, state ownership introduces particular conflicts into bankruptcy procedures, since the government finds itself on both sides of the table, as a debtor owner and as a creditor through its tax claims. At the same time the government also influences the rules of the game and often appoints judges.

Bankruptcy is a potential device for exercising political control over private firms or even nationalization or renationalization. When firms are unable to pay their claimants, and government often is the most senior claimant, the temptation to nationalize or use the threat of nationalization to pursue political objectives in private firms is great.

The strong stance of government in bankruptcy will have different implications depending on the tightness of its budget constraints. When budget constraints are soft, other investors may be tempted to join as they anticipate to be bailed out. However, when financial discipline is stronger, the strong stance of the government is likely to discourage other investors. Some observers argue that the revenue-maximizing government has interests aligned with those of small shareholders and could thus serve as a vanguard of minority interests (Desai, Dyck and Zingales, 2004). But as Pistor (2005) points out the government’s claim resembles “convertible equity” rather than straight equity because a default on tax obligation yields to the government the power to trigger bankruptcy proceedings against a firm and automatically converts government claims on this firm from an equity-like claim into a creditor-like claim. In any case, in trying to reform bankruptcy law in emerging market economies it is important to recognize the role of government as a claimant.

Other stakeholders, particularly labor unions but also various other citizen groups, also play an important role in bankruptcies in many emerging market economies. A designer of a bankruptcy law needs to take into account possible spillovers onto these stakeholders.
and the possibilities that these groups may be able to influence implementation of the procedures. For example, in countries, where trade unions are strong, companies may have an incentive to take on excessive debt to strengthen their bargaining position vis-à-vis the unions (ADD ON STAKEHOLDERS).

Bankruptcy reform has often focused on the need for a separate, specialized bankruptcy court system, or whether bankruptcies are best handled in regular courts. Prima facie, it is difficult to say whether specialized courts are more or less vulnerable to capture. Cross-country evidence, however, suggests that some kind of specialization in expertise of judges and bankruptcy practitioners does pay off. Presence of a specialized bankruptcy court (in middle-income countries) or a specialized commercial section in the general court (in poor countries) are associated with faster and cheaper procedures and, therefore, better recovery rates. Requirements that judges and bankruptcy practitioners are trained specifically in bankruptcy law and practice and that they have some prior business experience also leads to better outcomes (World Bank, 2005).

The problem of corruption has triggered discussions of randomized assignment and rotation of judges, and local biases have prompted proposals that bankruptcy cases, at least above a certain size, should be handled by higher courts. But as with corporate governance the causes of the problems in bankruptcy law in emerging market economies have deeper roots, and must also be addressed through more fundamental reform of the legal and political systems.

In the next section we discuss the political economy of corporate finance in these countries.

5 The Political Economy of Corporate Finance (to be written)
Concluding Remarks (PRELIMINARY)

Our premise in discussing corporate governance and bankruptcy design in emerging market economies was that they influenced the propensity of capital to move from capital-rich to capital-poor countries. Of course, we recognize that these countries differ greatly in their ability to attract foreign capital for reasons not necessarily related to corporate governance. Some countries, like China currently, are flooded with foreign direct investment, while others, like Russia, find it much more difficult to attract such investment. The combination of high social returns due to low labor costs, manufacturing skills, and high-quality infrastructure, and a reasonable appropriability of returns contribute to the inflow of capital into China. Poor appropriability of returns stemming from corporate governance definitely is part of the explanation for the lull of FDI into Russia, but other factors such a sizeable political risk, recent experience of macrovolatility, and a poor general investment climate are probably more important. But even though corporate governance and bankruptcy are not the most binding constraints in a particular market at a particular time this does not mean that they are not important. Often they interact with other institutional features; market failures are reinforced by government failures, and when government failures are mitigated, market failures may also affected.

Flows of direct investment, and much more so portfolio capital flow, shift over time, in both total volume and how they are allocated across markets. This volatility is likely to be amplified by weaknesses in the institutions supporting corporate finance. When foreign
capital for some reason is ample in a particular market these weaknesses may be concealed only to become all the more visible once the flow subsides. The Asian crises from the late 1990s provided many illustrations of such weaknesses; when times were good no one thought much about the potential institutional weaknesses, but when the crisis hit the contraction in investment was dramatic (Johnson et al., 200X). The same could be true for China, Russia and many other emerging market economies. Again, even though corporate governance and bankruptcy do not seem to be important constraints at the moment, they may very quickly become much tighter for reasons outside of these economies.

Our discussion of the tradeoffs of both corporate governance and bankruptcy design emphasizes the hazards of designing one-size-fits-all solutions. Still, the analysis does offer some insights that would ease most of the tradeoffs in every economy.

First, the general framework for enforcement is of overriding importance for corporate finance. Improving enforcement is not easy, but substantial progress is possible in a relatively short period of time. Most countries in Central and Eastern Europe, for example, have radically improved their general enforcement environment in a little over a decade. EU enlargement may be a unique historical event, but there is considerable variation among these economies and even backtracking in some, suggesting that improvements do not come automatically.
Second, with all the justified attention on the protection of minority investors it is important to keep in mind that the basic property rights of large controlling shareholders are critical. Once the property rights of major owners are protected, they should have stronger incentives to develop good corporate governance, at least if they want to raise external capital. Needless to say, this requires competent and non-corrupt bureaucracy and judiciary.

Third, integration into the global financial system helps solving – at least partially – some of the problems above and reduces the costs of second-best solutions. Access to global financial markets and insurance industry is particularly important. Third, for functioning reputational mechanisms an economy needs reputational intermediaries, including an independent business press.

Fourth, a central conclusion from our discussion is that banks do and should play an important role in corporate governance as well as bankruptcy in EMEs. Often in these economies the most effective way to improve corporate governance is through better bank governance.

Fifth, bank-based finance also has important shortcomings. It easily leads to crony lending and potential soft budget constraints. In many, but not all (notably the United
Kingdom) advanced economies bond markets serve as a useful on overlending and misdirected credit. Some emerging markets have also managed to develop active bond markets. These markets often developed in response to failures of the domestic banking systems, particularly in the wake of the Asian and Russian crises. As the banking systems have rebounded, the importance of these bond markets have again decreased. This is particularly troubling as bonds often are the only reasonably safe asset available to foreigners on a sufficiently large scale.

Sixth, in trying to develop bond markets the EMEs, again, face important tradeoffs. When, for example, the protection of bondholders in bankruptcy is strengthened, the incentives for banks to extend credit decreases. An important element in the development of debt markets could be pension reform as in, for example, Chile, but such reforms raise a number of other issues.

Seventh, an important feature of EMEs is their propensity to macroeconomic volatility. When shocks are strongly correlated across firms, the bankruptcy system, the banks, and ultimately the entire financial system comes under immense pressure. The real costs of the resulting credit crunches for manufacturing industry and real estate markets are often extremely high, easily outweighing any growth achievements from economic and political reforms. It is understandable that these countries try to incorporate the prospect of macrovolatility in their institutional arrangements, particularly in bankruptcy law. However, we believe that these shocks are best handled outside the court system, but they do need institutional responses.
Eighth, the conventional wisdom on the design of corporate governance are encapsulated in the so-called OECD Principles. These principles first launched in 199X and subsequently revised in 200X identify six areas and then elaborate for each area a number of specific recommendations. The core areas are: ensuring the basis for an effective corporate governance framework; the rights of shareholders and key ownership functions; the equitable treatment of shareholders; the role of stakeholders in corporate governance; disclosure and transparency; and the responsibilities of the board. While we are deeply skeptical regarding the usefulness of such general recommendations and attempts to produce one-size-fit-all solutions, the priorities suggested by the order of the list are consistent with our analysis.
Figure 1. Comparison of the exit rates in selected developed and developing countries in 1989-2000.

Notes for the figure:


b) Entry and exit rates are calculated as a share of total number of firms.
Figure 2. The only two legal creditor rights which matter for efficiency of bankruptcy procedures across countries in subsample of poor and middle income countries are the provision for secured creditors to be paid first in liquidation procedures (left plot) and the provision of no automatic stay on assets (right plot).

Note for the figure:


b) Graphs show residual correlation after controlling for per capita income, legal creditor rights, legal origin, level of the rule of law and the level judicial efficiency.

c) In the graph for time vs. secured creditor’s position in priority rule, there are two outliers: Mexico (with secured creditors after employees and government and fast bankruptcy resolution) and India (with secured creditors first in the queue and long bankruptcy). Even though, they are omitted, the relationship is statistically significant even when they are included.
Figure 3. Judicial discretion and the overall administrative cost of bankruptcy.

Subsample of rich countries:

Subsample of middle-income and poor countries:

Note:


b) Graphs show residual correlation after controlling for per capita income, legal creditor rights, legal origin, level of the rule of law and the level judicial efficiency. Difference in the slope of the regression line is always statistically significant; the effect in poor countries is robust and for a wide number of specifications significant.
Table 1 Time needed to go through insolvency and the cost of the procedure according to the Doing Business report

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<th>15 with slowest bankruptcy, 2004</th>
<th>15 countries with the most costly bankruptcy, 2004</th>
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<td><strong>Time</strong> (Years)</td>
<td><strong>Cost</strong> (% of estate)</td>
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<td>Marshall Islands</td>
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<td>Czech Republic</td>
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<td>Brazil</td>
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<td>Chad</td>
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Note for the table:


b) Total of 21 countries have cost of bankruptcy equal to 38% of estate. Among these countries, the table reports the ones that also have the lowest recovery rates. The actual differences in recovery rates as a result of reorganization procedures between rich and poor countries are large: on average recovery rates are 67 cents on the dollar in rich countries; 34 cents in middle income; and 21 cent in poor (World Bank, 2005).

Open questions
References


Holmstrom, B., and S. N. Kaplan “The State of U.S. Corporate Governance: What’s Right and What’s Wrong?”


