Enforcement and Good Corporate Governance in Developing Countries and Transition Economies

Erik Berglöf • Stijn Claessens

More than regulations, laws on the books, or voluntary codes, enforcement is key to creating an effective business environment and good corporate governance, at least in developing countries and transition economies. A framework is presented to help explain enforcement, the impact on corporate governance when rules are not enforced, and what can be done to improve corporate governance in weak enforcement environments. The limited empirical evidence suggests that private enforcement tools are often more effective than public tools. However, some public enforcement is necessary, and private enforcement mechanisms often require public laws to function. Private initiatives are often also taken under the threat of legislation or regulation, although in some countries bottom-up, private-led initiatives preceded and even shaped public laws. Concentrated ownership aligns incentives and encourages monitoring, but it weakens other corporate governance mechanisms and can impose significant costs. Various steps can be taken to reduce these costs and reinforce other corporate governance mechanisms. But political economy constraints, resulting from the intermingling of business and politics, often prevent improvements in the enforcement environment and the adoption and implementation of public laws.

The problem of enforcing agreements has been a long-standing part of the development agenda. Nobel laureate Douglass North (1991) argues that “how effectively agreements are enforced is the single most important determinant of economic performance.” Recent research supports this assertion, suggesting that enforcement of the rule of law is perhaps the central functional difference between developed market economies and developing economies. Indeed, according to some analyses, the degree to which private property rights are respected explains the development of countries (Acemoglu, Johnson, and Robinson 2001). Comparisons between developed market economies and transition economies also show much larger differences.
in enforcement (law effectiveness) than in laws on the books (law extensiveness) (Pistor, Raiser, and Gelfer 2000). Simple correlations suggest that an index of the efficiency of a country’s judicial systems is more strongly associated with GDP per capita than are laws protecting minority rights.

While enforcement is a general problem of development, it particularly affects firms seeking external financing. Financial contracts, after all, involve the commitment of the firm to adhere to certain obligations, in particular to pay an appropriate rate of return to the providers of external financing. A weak enforcement environment makes it more difficult for firms to make such commitments. Empirical evidence shows that actions taken against insider trading, rather than the mere presence of insider trading laws, help explain the development of securities markets (Bhattacharya and Daouk 2002). A large international study finds that the level of enforcement is more important than the quality of laws in explaining the turnover of CEOs (see Gibbons 2002; Defond and Hung 2003). This is not to say that laws are unimportant but rather to note that they need to be written so that they can be enforced and that there must be institutions to enforce them.

A weak enforcement environment also influences ownership and control patterns and the functioning of different corporate governance mechanisms. Ownership concentration and insider control are responses to the absence of other instruments by which firms can commit to lenders to repay and ensure investors of the quality of firm management. But while they can improve monitoring and align incentives, they also have many potential costs. At the firm level, these costs include entrenchment of the manager and owner; limited risk diversification; liquidity costs, as majority owners cannot easily sell their stakes; and the expropriation of minority rights. Concentrated ownership structures also undermine the effectiveness of other corporate governance mechanisms. At the country level, potential costs include undermining the development of capital markets (and the establishment of new firms), reducing access to external financing, and slowing growth. High ownership concentration also affects the development of corporate governance rules. Many, if not most, corporate governance systems in developing countries and transition economies are heavily tilted in favor of controlling owners, potentially perpetuating any social costs.

This article develops a framework to help explain enforcement, the impact on corporate governance when rules are not enforced, and what can be done to improve corporate governance in weak enforcement environments. It begins by characterizing the lack of enforcement problem and providing a typology of different forms of enforcement mechanisms. It then introduces the corporate governance problem, focusing on the role of various corporate governance mechanisms in dealing with the commitment problem of a firm seeking external financing from individual investors. After analyzing which mechanisms may be the most effective in weak contracting environments and identifying which reform options are most likely to improve
corporate governance practices and mitigate social costs, the article identifies some areas for further research.

Enforcement

Although enforcement is generally agreed to be of critical importance to economic performance, and there is a vast literature on the subject, no simple framework for thinking about enforcement exists. One way of addressing the issues is to distinguish between private ordering, private enforcement of the law, public enforcement of the law, and state control (Djankov and others 2003). Private ordering initiatives are transactions that take place in the absence of laws and courts or other public enforcement institutions; they can be unilateral, bilateral, or multilateral. Private enforcement of the law occurs when private agents avail themselves of the framework defined by law or regulations to punish violations from contracts, using the courts to adjudicate and the state to enforce the final judgment. Public enforcement involves the enforcement and prosecution of the law by the government.

An aspect common to both private and public enforcement of the law is the extensiveness of the law. Law serves to standardize contracts and clarify liability, but it can be more or less extensive, affecting the nature of the enforcement problem. Government can internalize or avoid all disputes by maintaining full control and ownership over all activities.

Private Ordering


Unilateral enforcement mechanisms involve efforts by individual firms to improve their commitment power. Through its own actions, a firm can create valuable assets that would be lost in case of violations of earlier agreements or standards. The most common unilateral mechanism is reputation built, for example, through costly advertising.

In the absence of a well-functioning general enforcement environment, unilateral actions can be important. For example, the Russian oil company, Yukos, was generously...
rewarded by the stock market when it unilaterally reformed its management and corporate governance. The actions were presumably credible, because if the company, which had had a poor governance record, were to violate its professed principles, much of its investment would be lost (the investment did not, of course, protect the company and its valuation from actions by the government).

Other unilateral mechanisms include investment strategies that pay off only if the firm continues to have access to external financing. A natural resources extraction firm, for example, may undertake a large investment with a long gestation period and substantial sunk costs to signal its commitment to honoring current financial contracts, even though doing so makes it vulnerable to unanticipated future events.

If the gains from unilateral actions are so large, why do so few companies increase their commitment in this way? The greatest problem with reputation is that it relies on future interactions (such as returning to the stock market for more funding) taking place. Moreover, since the costs of building a reputation are sunk, they may not deter future violations if the gains are sufficiently large. An additional problem is that memory, particularly in stock markets, may be short. With losses to investors from previous violations already incurred and new investors coming into the market, considerations of new investments may not be affected by previous actions, thus weakening the commitment power of reputation in financial markets.

Firms can strengthen their commitment ability in their interactions through bilateral mechanisms. Reputation can play an important role in sustaining such bilateral enforcement arrangements. Yukos, for example, hired the consulting firm McKinsey to help it reform. Presumably, McKinsey would not have agreed to associate itself with the company had it not been convinced that Yukos was committed to reform.

Firms can also create vertical and horizontal dependencies in which one party gives up control over important decisions to the other party or a third party. In weak contracting environments, firms are more likely to internalize transactions, create conglomerates, or form joint ventures. Like many other companies in the Russian oil industry, Yukos integrated vertically and began building a conglomerate. It also considered many foreign joint ventures, in part to increase the costs of government intervention (the anticipation of such ventures may have contributed to the actions by the Russian government).

Joint ventures, particularly 50/50 control splits, may appear ambiguous, providing much scope for conflicts among shareholders, especially in weak contracting environments. Yet, the specific assets each partner brings in allow for commitment and optimal bilateral private contracting (see Hauswald and Hege 2003 for a formal analysis of joint ventures).

A related form of bilateral commitment is the “hostage exchange,” in which one party leaves with the other assets that are more valuable to the provider than to the “hostage holder” (in medieval times princesses were used). It is difficult to find
concrete examples of hostage exchanges that improve the commitment of firms toward outside third-party investors. Such exchanges are difficult to arrange, since the specific assets needed are typically in short supply and often of less value to outside investors. Some private shareholder agreements, for example, include covenants requiring some assets to be held offshore, but these are not asymmetric in value. Compensating cash balances and prepayments are sometimes cited as examples, but they are highly symmetric in value and typically require some third party, such as a bank or a court, to determine whether the party can draw on the cash balance. Moreover, timing is critical, because preferably the exchanges should be simultaneous. Bilateral mechanisms in general require some duration and reputation, and both parties should earn above-market returns to sustain the mechanism.

For external financial commitments, by far the most important class of mechanisms is multilateral arrangements. Customs among multiple parties are established over time in repeated interactions or through learning across industries and jurisdictions, as in guilds or other associations. Private parties can take the next step and establish institutions for collecting and conveying information about adherence to these customs and erect credible punishments for deviations. Intermediaries may emerge to exploit economies of scale and profit opportunities and prevent free riding in enforcement.

Examples of such mechanisms abound, although their effectiveness varies greatly. Trade associations adopt their own codes of conduct and eventually their own institutions for resolving conflicts. In the financial sector, self-regulatory organizations include brokers associations providing licenses and overseeing the conduct of brokers, investment banks establishing standards for underwriting, clearing-houses and payments systems organizing settlement and payment services, and associations of banks and other financial institutions developing rules governing conflicts of interest, exchange of information, and so forth. Intermediaries such as business organizations sell information and develop rules and standards; rating agencies and other organizations that monitor quality collect data, establish standards, and disseminate information.

Stock exchanges develop listing requirements. They develop norms for interactions among members and mechanisms for punishment. Clearinghouses, for example, expel members if necessary to function properly. Commercial and investment banks can certify and monitor firms in the context of lending and underwriting activities. Since they engage in multiple relationships, they can act as multilateral enforcement mechanisms.

Private arbitration is another form of multilateral mechanism, in which parties sign on to a mechanism that has some commitment power, as it is involved in repeated interactions. Ultimately, though, some form of public intervention enforcement may be necessary to enforce private arbitration.

Perhaps, the most important form of multilateral enforcement is self-regulation or "soft law." Key stakeholders in particular areas of economic activity come together,
often with the consent or encouragement of the government, to set up and enforce rules. Self-regulatory agencies or authorities (commonly referred to as self-regulatory organizations) are created, often as complements to but sometimes as substitutes for public agencies and courts. As the jurisdiction of these agencies grows, the distinction between self-regulation and public regulation blurs. Often public regulators may surrender enforcement to self-regulatory organizations.

Private enforcement mechanisms, particularly multilateral arrangements, face many challenges. Actors should generally be expected to behave opportunistically whenever it pays. The more parties are involved, the harder it is to sustain such collaboration, unless it is supported by some form of public action. At the same time, a limited number of actors can lead to entrenchment and weaker (corporate governance and other) standards. This is particularly so in small markets, where self-regulatory associations and organizations often maintain low standards and engage in rent-seeking behavior. Reputation is also often difficult to build in developing countries and transition economies, where poor reputation makes it difficult to sustain transactions, creating fewer opportunities to build reputation. Moreover, the uncertainty that is so pervasive in these economies reduces the value of future rewards for good behavior today. When stakeholders have poor reputations and strong interests in regulatory outcomes, self-regulation may not be legitimate in the eyes of the public.

**Private Enforcement of the Law**

Private initiatives may require public law to be effective, and public laws and regulations may require private enforcement. The government creates the rules governing private conduct but leaves the initiation of enforcement to private parties. When a party feels cheated, it can initiate a private suit and take it to a court or other agency.

For private enforcement to be effective, agents must have incentives. Individual shareholders may not have sufficient incentives to litigate because of the free-riding problems. While procedures such as class action suits can overcome this problem, they can also lead to frivolous law suits. For many of the corporate governance issues related to securities markets, stock exchanges should have appropriate incentives to check whether firms adhere to listing standards. For many other corporate governance issues, this will not be the case.

What types of public laws lend themselves best to private enforcement of the law? In one influential view, private mechanisms are more likely to work and to be cheaper if the law mandates a certain standard. The existence of such a standard may make it easier to initiate and prove a case in court as the burden on the courts and the plaintiff of proving liability or lack of liability is reduced if statutes specify what facts need to be established. Well-defined statutes may also reduce the discretion of judges and undermine attempts to subvert the law. Some researchers have argued that private enforcement of the law may be particularly efficient in environments with weak
or inexperienced courts (Black and Kraakman 1996; Hay, Shleifer, and Vishny 1996). This view, of course, assumes that private mechanisms and the setting of standards are not captured by special interests.

For private enforcement of the law to work, functioning institutions—courts, judges, and other institutions—must be able to adjudicate and impose sanctions. Governments often delegate enforcement to lower levels of government or to self-regulatory organizations. Much of the implementation of rules for, say, obtaining a business license can be delegated to semi-government agencies. Many professions, such as medicine and law, are entrusted with licensing their own members. In financial markets, many self-regulatory organizations derive their status and ability to regulate transactions from public law. A stock exchange, for example, may be granted a natural monopoly, giving it the explicit and implicit power to regulate securities markets activities.

These forms of delegated enforcement may work better if the subsidiary body has more specific information, better resources, and a broader range of sanctions. Local agencies may be better able to judge the quality of the application for a business license. Self-regulatory organizations may have better insights into what constitutes market manipulation and better information systems to detect such behavior. Self-regulatory organizations may also be able to delicense, issue reprimands ("name and shame"), and impose financial sanctions, actions that may be more difficult for a government agency.

In most cases, failure to comply with sanctions imposed by the delegated enforcers triggers actions by the public sector. These agencies therefore need some backing up from higher levels of government or the judicial system.

**Public Enforcement of the Law**

A large body of literature examines public enforcement of the law (see, Polinsky and Shavell 2000, for a review). This section focuses on three of the issues it addresses: the interrelationship between the extensiveness and the effectiveness of law, the positive theory of enforcement and the efficiency and effectiveness of enforcement institutions, and the relationships between laws, corruption, and enforcement.

Many laws are unwritten, so the first question that arises is what needs to be codified, how codification varies across countries, and how codification interacts with the various enforcement mechanisms. Very homogenous and close-knit societies may still be able to rely on social means to enforce norms of behavior. As they develop more market-based economies, with arm’s length contracts, they require more formality and codification in the forms of laws.

In the simplest possible characterization, written laws (and regulations) have no independent function; the only thing that matters is that part of the laws and regulations that is actually enforced. Some argue that this dichotomy is too simple: the
written law can be more or less extensive, enforcement can be more or less effective, and the extensiveness of the law can affect the nature of the enforcement problem. Under this view, one can think of a two-by-two matrix with rudimentary versus extensive rules and weak versus strong enforcement, with costs and benefits in each of the four cells. A large literature has documented differences between the extensiveness of the law (that is, the scope and detail of the law) and its effectiveness (that is, the extent to which the law is actually enforced). Since each law and regulation has its own optimal balance, the distinction between written rules and their enforcement becomes blurred.

A related view distinguishes between low and high legal standards, where the distinction relates to the threshold set for violating the law. This body of work examines the choice between very detailed, highly nuanced rules and simple, easily understood and interpreted rules (so-called “bright-line” rules). Some laws are more easily enforced than others, suggesting that the enforcement environment may shape what laws are desirable and that how the law is written may in turn influence the scope for enforcement. With imprecise laws, for example, private ordering and private enforcement may be costly or uncertain, and the benefits for parties to deviate may be too great.

For this reason, Glaeser and Shleifer (2001) argue in favor of bright-line rules in securities markets. At the same time, broader laws allow for more evolution. The tradeoff between the strictness of the laws and the incentives to comply has been used in the debate on accounting principles, where the choice has been between international accounting standards, which are more principle based, and the U.S. Financial Accounting Standards Board norms, which are more detailed and rule based.

The tradeoff has also been at the center of the general economic literature on (public) enforcement, inspired by Gary Becker’s (1968) provocative article suggesting that maximizing punishment would ensure optimal enforcement. Later contributions have emphasized the constraints imposed on fines by the wealth of those punished. Others have pointed to the (exogenous) limits to enforcement technology. These analyses have provided some insights into the factors affecting enforcement technology and the choice among enforcement technologies.

The efficiency and effectiveness of technologies and enforcement institutions such as courts (but also regulators, stock exchanges, self-regulatory organizations, and the like) are hard to study empirically. Efficiency normally refers to outputs relative to inputs, but both outputs and inputs are difficult to measure. In evaluating the efficiency of courts, the speed with which cases are processed cannot be the only criterion. Access (by the poor, for example); fairness; and predictability are also important. In some cases, effectiveness may also be the overriding objective, and very large sums may be justified to ensure that an outcome is just or right. The Microsoft antitrust cases in the United States and European Union, for example, cost
taxpayers millions of dollars, but the expenditures may have been worthwhile given the enormous implications of the case.

How cases are managed—that is, what input (judicial systems, legal assistance) is entered when—also matters. Input efficiency involves assessing the type of funding and incentives provided. Ultimately, court output must take into account overall customer satisfaction, that is, the degree to which people trust the legal system. Analysis of court efficiency needs to extend beyond the courts to understand their role in the larger legal system. Much more conceptual and empirical work is needed on how to evaluate courts.

A body of literature exists on the importance for enforcement of regulators and supervisors that are independent, have adequate powers, are well staffed, and have operational and financial functional independence. Evidence of its importance has been found for central banks and other agencies, such as competition policy agencies and regulatory agencies. Financial and operational independence can be particularly important but dependent on subtle rules. In many countries, securities exchange regulators have their own sources of income (fees from new issues or trading), but they have to transfer some part to the general budget or have their budget approved by the parliament or other government agencies, thus reducing their de facto independence.

At the same time, there can be limits to the benefits of stronger regulators and supervisors in the weak institutional environments of many developing countries. Greater legal powers in environments with relatively low pay for regulators and supervisors and weak checks and balances may create perverse effects, as Barth, Caprio, and Levine (2004) note. In such environments, giving more powers to public enforcers may simply invite more corruption.

The Choice of Enforcement Technologies

All enforcement mechanisms have costs and benefits, and both complementary and tradeoff relationships exist. Private and public initiatives are often complements rather than substitutes. For example, the effectiveness of private enforcement mechanisms often depends on the effectiveness of public enforcement mechanisms. Public enforcement can also reduce the costs of private enforcement. But while more public intervention may mitigate market failure, it is more vulnerable to government failure, and it may not be most efficient when private agents have better information, resources, and incentives. Tradeoffs can arise. Private agents are particularly important for enforcement when the general institutional environment is weak. A system of social control of business is necessary where both markets and government fail or cannot be expected to operate.

The preferred mix of enforcement technologies varies by type of activity and country characteristics. In some areas, social norms serve as the first enforcement
technology, with the more formal system used as a second resort. The media can play an important role, both nationally and locally. Consumer actions can also be important, even for corporate governance. Threats of revolts by customers against a large pay package for the new CEO of the Dutch grocery chain Albert Heijn led the company to reduce his pay package and the chairman of the board of directors of the parent group (Ahold) to resign. In many ways, these social pressures are the most important corporate governance mechanisms. They require relatively free media and access to newspapers. Technology can also be important, as it has been in the Republic of Korea, where concerns about corporations’ activities have been shared over the Internet.

Although it is hard to generalize, the role various formal enforcement technologies play in a particular sector or activity depends in part on the relative costs and benefits of these technologies. The existence of cheaper outside options affects the use of courts versus other enforcement technologies, such as arbitration in commercial disputes. The choice of mechanism also depends on the extent to which one technology requires the backing of another to make it credible and ensure finality of decision. Activist movements, such as shareholder lobbying groups, require some legal backing (Milhaupt 2003). Regulatory intervention in the corporate governance area does not typically fully resolve the basic commitment problem and requires some backing by the court system for appeals and enforcement (insider trading pursued by the stock exchange requires the backing of sanctions by a securities and exchange commission, for example). An important corporate governance mechanism is monitoring by banks, but the development of bank lending and monitoring obviously relies on the effectiveness of the regulatory framework and supervision, in addition to other public enforcement institutions that allow collateral to be collected.

How effective are private mechanisms—unilateral, bilateral, or multilateral—in bringing about change in enforcement of good governance practices? Black (2001) provides some suggestive data from the Russian Federation indicating that even in a weak environment, individual firms can increase their value substantially by improving their corporate governance unilaterally. Firms in Central and Eastern Europe sometimes voluntarily disclose more information than is required (Berglöf and Pajuste 2005). Similar evidence exists for the Korea (Black, Jang, and Kim 2003) and other countries. Serious causality and other methodological problems weaken the power of these studies, however.

The entry of foreign firms, which normally adhere to higher governance standards, can also help. Cross-border mergers and acquisitions tend to originate in countries with higher corporate governance standards, potentially improving corporate governance in the partner countries (Rossi and Volpin 2003). There is also a tendency, however, for foreign investors to adjust to or even misuse the local corporate governance environment, as the takeover of firms in developing countries and transition economies by foreign investors at “unfair” values has shown. Even if incentives
are weak for individual firms, foreign (and domestic) entry and competition may nevertheless put pressure on local firms to improve their corporate governance.

The effectiveness of all of these private enforcement mechanisms in the area of corporate governance depends on the institutional environment. Private mechanisms are complements to public enforcement. Private arbitration, for example, is more likely to be effective when courts and enforcement agencies work well. In work on Korea Black, Jang, and Kim (2003) show that private mechanisms are often insufficient and need the support of government intervention. Durnev and Kim (2005) and Klapper and Love (2003) suggest that actions by individual firms cannot compensate fully for deficiencies in local governance practices.

Private enforcement mechanisms are nevertheless likely to be the main mechanisms in most markets, particularly in countries with severe weaknesses in public law and public enforcement. Evidence is still limited, but in the area of securities regulation, private enforcement of the law seems highly effective for capital market development, while public enforcement seems less important (La Porta, Lopez-de-Silanes, and Shleifer 2006). As many elements of securities regulation involve issues related to corporate governance, this may apply to enforcement of corporate governance more generally (Lopez-de-Silanes 2004). Furthermore, in one view, public law emerges out of private ordering, at least in common law systems; courts "find" well-functioning contractual arrangements and elevate them to law (Cooter 1991). The history of securities law in the United States seems to confirm this view, in that private parties adopted rules that later were adopted by individual market places and eventually became laws or regulations. Coffee (1999, 2002) reviews the effects of globalization of securities markets on corporate governance standards and the spread (or lack thereof) of international standards.

To some extent, cost-benefit considerations can explain the choices among enforcement technologies. Path dependence is also important, however, an enforcement technology may be introduced and then remain in use for a long time, even though other, more efficient paperless technologies have become available. For example, collateral (the registration of the title of the asset to ensure that rights are unequivocal) is a form of contract enforcement. Today, collateral can be registered electronically and perfected using registries rather than expensive courts or notary-based systems, but the transition to electronic systems often takes time, and institutional reluctance may have to be overcome. Technological progress can change enforcement tools. Securitization, the sale of many assets bundled together, became possible only as a result of progress in information technology that allowed secondary asset sales while ensuring that the underlying contracts remained identifiable and could be enforced.

The mix of technologies in many developing countries and transition economies differs from that observed in developed countries. Public enforcement can play only a limited role in weak institutional environments, as powerful insiders will most
likely find their way around the system. Private enforcement of public laws and the
down power of litigation and court intervention vary greatly across countries as well, in
large part depending on the functioning of the public enforcement institutions.
Russian investors, for example, almost never go to court, because the likelihood of
success there is miniscule and even if they win, the judgment is often not enforced
(Zhuravskaya and Zamulin 2003). Yet, even here relative costs are important. In
China, more and more investors are taking their grievances to court, even though
court decisions are not always predictable or necessarily enforced (Pistor and Xu
2003). The reason is that other mechanisms are absent or even more costly. Weak-
nesses in public enforcement are also likely to foster the growth of other mechanisms
including informal, mafia-type mechanisms.

Many of the choices between technologies depend less on the specific activity and
more on the overall economic environment. Several interrelated factors then come
into play. Slinko, Yakovlev, and Zhuravskaya (2002) show that the general envi-
ronment of courts and other enforcement institutions is affected by the incentives of
national and local authorities, political competition at various levels of government,
and the strength of civil society. These aspects vary not only across countries but
also across regions and municipalities within a country. Large differences exist in
enforcement among states or provinces not only in the Russian Federation but also
in countries like Brazil and Mexico (Broadman 1999; Pinheiro Castelar and Cabral
2001; Laeven and Woodruff 2003). Furthermore, where markets function poorly, it
is more difficult for the legal system to function, as the standard against which to
judge financial and economic aspects of transactions is unclear. Conversely,
increases in competition in product markets, which affect the scope for capture, and
the size of the small and medium-size enterprise sector, which affects the role of
insiders, can affect the functioning of courts. Policies promoting bank lending and
financial development may also help.

Initial conditions, endowments, and the distribution of natural resources and
technology also matter for the institutional development of countries including the
degree of public enforcement. The historical origin of the legal and general institu-
tional system (English, French, German, or Scandinavian) and the corresponding
basic legal mechanism (common law or civil law) seem to matter for enforcement
(Glaeser and Shleifer 2002). Relationships have been found between institutional
features and countries’ more permanent characteristics, including culture, history,
and physical endowments. Institutional characteristics, such as the risk of expropri-
ation of private property, can be long lasting and relate to a country’s physical
endowments (Acemoglu, Johnson, and Robinson 2001). Both a country’s initial
endowments and the origin of its legal systems are important determinants of the
degree of private property rights protection (Beck, Demirgüç-Kunt, and Levine
2003). Wholesale legal transplants are largely ineffective in diffusing enforcement
practices (Berkowitz, Pistor, and Richard 2003).
The general enforcement environment is the product not only of many different market, endowment, and legal factors but also of social and cultural factors. Enforcement depends on basic social norms and trust (Djankov and others 2003, refer to this as “civic capital”). When societies are socially and culturally heterogeneous, the base for natural forms of enforcement is typically weaker. This is clearly true at the micro level: the ability to operate well-functioning rotating saving schemes, for example, greatly depends on the presence of close relationships and homogenous groups (see Berglöf, Burkart, and Friebel 2003). But it also seems true at the country level, where the roles of culture and openness have been found to be important for financial sector development including for corporate governance (Stulz and Williamson 2003). As societies develop, though, and undergo both economic and social transformation, the nature and forms of enforcement are likely to change toward more formal modes.

Political institutions are part of the general enforcement environment. They may not function well, and they can be dominated by an absolute ruler or captured by special interests. In both cases, serious enforcement problems can result. Countries with absolute rulers face many public governance issues including the protection of property rights against interference by the dictator. These countries may have fewer enforcement issues, however, as there are few genuine “market” transactions (Acemoglu and Johnson 2003). The other set of countries includes those, such as many emerging markets, in which business and politics tend to merge. When the rich influence the path of justice, litigation does not work (Glaeser, Sheinkman, and Shleifer 2003). When enforcement institutions are corrupt, the level of enforcement may be endogenous (Acemoglu and Verdier 2000). Corruption lowers the effectiveness of enforcement by increasing the costs of motivating and monitoring bureaucrats. When large controlling owners become politicians, an important countervailing force to government is lost and the interests of minority shareholders are less likely to be protected.

Legal standards and the level of enforcement can interact. Governments may respond to weak enforcement by establishing codes to reduce discretion and opportunities for subverting the law, but this can have its own costs. Stricter laws and regulations offer more incentives to evade and thus are more costly to enforce. Corruption may affect how laws are written (Immordino and Pagano 2003). In this view, legal standards and enforcement are complements; as countries develop, both can increase.

Laws and regulations can be adopted not only to correct market failures, reduce transactions costs, and achieve social objectives but also to extract bribes. Djankov and others (2002) find some support for this “tollbooth view,” especially in developing countries, suggesting that policymakers should err on the side of less strict or extensive laws in weaker environments. Barth, Caprio, and Levine (2004) find that giving more powers to bank supervisors leads to less efficient and
more unstable financial systems in environments with limited checks and balances. Immordino and Pagano (2003) provide evidence that governments in developing countries adopt lower standards to avoid the higher enforcement costs of stricter standards.

**Enforcement and Corporate Governance**

Private ordering, private law enforcement, and public law enforcement all play a role in determining the overall effectiveness of the business environment. The different sets of mechanisms overlap and can both substitute for and reinforce one another. To evaluate how the various options interact, the main corporate governance problem in developing countries and transition economies needs to be defined.³ This section focuses on how a weak general enforcement environment influences the basic corporate governance mechanisms. (For reviews of the corporate governance literature, see Shleifer and Vishny 1997 and Becht, Bolton, and Roell 2003; for a review that focuses on developing countries and transition economies, see the article by Claessens in this volume.)

An entrepreneur or manager approaching outside markets for finance faces a serious commitment problem: how can investors be assured that he will choose the right projects, exert sufficient effort, adequately disclose relevant information, and ultimately repay investors? In the complete absence of credible commitment, outside investors assume the worst case scenario, that is, that the entrepreneur/manager will use all opportunities to defraud investors or in other ways not live up to his promises. The weaker the entrepreneur/manager’s commitment power, the costlier outside financing (and the more difficult it will be to recruit good personnel and establish long-term relationships with suppliers and customers). Corporate governance is in great part about mitigating this commitment problem. In fact, this is the definition of *corporate governance* Shleifer and Vishny advance in their 1997 review: “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (1997, p. 737).

Investors can reduce the likelihood of being defrauded or deceived by monitoring and potentially punishing management. Firms can try to employ a variety of commitment mechanisms to overcome investors’ concerns. But problems arise for two reasons. The first is that an individual investor may not face the proper incentives to pay the costs involved in ensuring that the entrepreneur/manager lives up to his promises and may attempt to free ride on monitoring and enforcement by other investors. The second is that the mechanisms to commit and punish may be missing or incomplete, possibly due to poor enforcement of property rights in the country. Typically, the two problems go together.
The most common response to the free rider and poor contracting problems is to give one shareholder a sufficiently large stake in the firm so as to provide him with incentives to monitor and intervene when necessary. Concentration is often further reinforced as control is increased beyond direct ownership, primarily through pyramiding but in some countries also through cross-ownership and dual class shares. In fact, the overwhelming majority of companies in developing countries and transition economies have highly concentrated control (La Porta, Lopez-de-Silanes, and Shleifer 1999). Some controlling shareholdings have their origins in (individual or family-owned) firms that grew and accessed public markets while leaving the original owners with close control. But investors also respond to weak contracting environments by building up controlling stakes that are sufficiently large as to provide proper incentives to monitor management. In Central and Eastern Europe, for example, where shareholdings were initially deliberately widely dispersed, shareholdings have consolidated to concentration levels exceeding those in Western Europe and comparable to those in many developing countries (Berglöf and Pajuste 2003).

Concentrated control is a solution to some corporate governance problems. It reduces the precommitment problem in one dimension, by reducing the demand for external financing. Combined with control and a direct role in management, it also overcomes some of the principal agent and ex post resolution problems. Management, for example, becomes easier to oversee with a single controlling shareholder, and oversight is not a problem if management and the controlling owners are identical. At the same time, there are important costs associated with ownership concentration (Morck and Yeung 2003). Such delegation of authority gives rise to the problem of monitoring the large shareholder. The large shareholder may be entrenched and optimize private benefits rather than shareholder value, and he may expropriate minority shareholders by channeling the firm’s resources to his own account and using other mechanisms.

In weak contracting environments, controlling shareholders are most often the inevitable outcome. Unlike some developed countries, notably the United Kingdom and the United States, where the overriding corporate governance conflicts are between powerful managers and widely dispersed investors, the main corporate governance conflict in most countries pits controlling shareholders against minority shareholders. Corporate governance policy has to strike a balance between providing benefits to the controlling shareholders and protecting minority investors. To the extent that ownership and management have been separated, there are also potential conflicts between controlling shareholders and management and between minority shareholders and management. While many if not most corporate governance systems in developing countries and transition economies are heavily tilted in favor of controlling owners, wholesale transfer of governance standards from developed market economies may discourage investors from taking controlling positions.
and thus possibly undermine the most potent corporate governance mechanism in developing economies.

The presence of large blockholders, while inevitable in weak contracting environments, undermines some corporate governance mechanisms (for a review of various corporate governance mechanisms, see Becht, Bolton, and Roell 2003). Both takeover bids and proxy fights with the controlling shareholder are less likely to succeed when shareholdings are concentrated. The market for corporate control never materializes as insiders cannot be challenged. Similarly, board activism is less likely to be successful in challenging the dominant owner, given that the owner appoints the board. Executive compensation schemes are also less important as governance mechanisms when controlling investors can easily intervene more directly and oust management or controlling owners are themselves managers.

The relative importance of a particular corporate governance mechanism also depends on the enforcement environment in a country. Many firms in developed countries are closely held, but minority investors have some means to challenge insiders and ensure a reasonable rate of return on their investment. As a result, they are willing to provide external financing. In environments in which the court system functions satisfactorily, formal protection of minority shareholders enforced through private litigation is an option for improving the functioning of the key mechanisms of large shareholder monitoring. In weaker enforcement environments, policy may have to focus on promoting private mechanisms and empowering shareholders by disseminating information. The priorities for corporate governance reform and the scope for impact of policy intervention must thus take into account the environment, as the effectiveness of these other mechanisms hinges on the general and specific enforcement environment.

The effectiveness of various corporate governance mechanisms varies, and each has different scope for policy intervention (table 1). Different forms of private and public enforcement reinforce different corporate governance mechanisms. Some of these mechanisms are discussed below.

**Large Shareholders**

When the general enforcement environment is weak, external finance is costly, resulting in ownership concentration. Controlling shareholders are thus a feature of weak environments, a fact that any attempt to improve corporate governance has to take into account. Large shareholders act in their own interests and may pursue private benefits rather than increase overall firm value or the rates of return to minority shareholders. State ownership or covenants giving the state-specific (veto) rights (so-called golden shares) can, in some circumstances, be a means of dealing with the social costs of weak enforcement settings.
<table>
<thead>
<tr>
<th>Corporate governance mechanism</th>
<th>Private ordering</th>
<th>Private law enforcement</th>
<th>Public law enforcement</th>
<th>Importance in developing countries and transition economies</th>
<th>Possible policy interventions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Blockholders</td>
<td>Natural consequence of weak enforcement</td>
<td>(Minority) shareholder suits</td>
<td>Governance codes evolving into corporate and securities law</td>
<td>Likely to be most important governance mechanism</td>
<td>Strengthen rules protecting minority investors without removing incentives to hold controlling blocks</td>
</tr>
<tr>
<td>Market for corporate control</td>
<td>Corporate law (defenses, procedural rules); transparency of ownership and control</td>
<td></td>
<td></td>
<td></td>
<td>Remove some managerial defenses, require disclosure of ownership and control, develop banking system</td>
</tr>
<tr>
<td>Proxy fights</td>
<td>Improved communication technology; voting by mail</td>
<td></td>
<td></td>
<td></td>
<td>Improve technology for communicating with and among shareholders, require disclosure of ownership and control</td>
</tr>
<tr>
<td>Board activity</td>
<td>Interaction among board members, training of independent directors</td>
<td></td>
<td></td>
<td></td>
<td>Introduce elements of independence of directors, training of directors, require disclosure of voting, allow cumulative voting</td>
</tr>
<tr>
<td>Executive compensation</td>
<td>Transparency rules of stock exchanges</td>
<td>Transparency rules</td>
<td></td>
<td></td>
<td>Require disclosure of compensation schemes, conflicts of interest rules</td>
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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Monitoring by banks</td>
<td>Credit bureaus, registries, reputation</td>
<td>Protection of collateral; bankruptcy reform</td>
<td>Important but depends on health of banking system and regulatory environment</td>
<td></td>
<td>Strengthen banking regulation and institutions, encourage accumulation of information on credit histories, develop supporting credit bureaus and other information intermediaries</td>
</tr>
<tr>
<td>Shareholder activism</td>
<td>No ownership limits</td>
<td>Requirement to disclose voting and positions of institutional investors</td>
<td>Potentially important, particularly in large firms with dispersed shareholders</td>
<td></td>
<td>Encourage interaction among shareholders, strengthen minority protection, enhance governance of institutional investors</td>
</tr>
<tr>
<td>Monitoring by employees</td>
<td>Labor flexibility</td>
<td>Potentialy very important, particularly in smaller companies with high-skilled human capital, where threat of leaving is high</td>
<td></td>
<td>Require disclosure of information to employees, consider requiring board representation, ensure flexible labor markets</td>
<td></td>
</tr>
<tr>
<td>Litigation</td>
<td>Key mechanism for private enforcement</td>
<td>Governance codes adopted by exchanges and others that have a “charter” provided by law</td>
<td>Depends critically on quality of general enforcement environment but can sometimes work</td>
<td>Facilitate communication among shareholders, encourage class action suits, with safeguards against excessive litigation</td>
<td></td>
</tr>
<tr>
<td>Corporate governance mechanism</td>
<td>Private ordering</td>
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<tr>
<td>Reputation and self-enforcement</td>
<td>Depending on growth opportunities and degree of rents</td>
<td>Important when general enforcement is weak, stronger when environment is stronger</td>
<td>Encourage competition in factor markets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Media and social control</td>
<td>Deregulation of media to allow freer competition</td>
<td>Potentially important but depends on competition among and independence of media</td>
<td>Encourage competition and diverse control of media (active public campaigns can empower public)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bilateral private enforcement mechanisms</td>
<td>Hostage and shareholders agreements. Require firm-specific assets.</td>
<td>Establishment of specific control rights under contract law</td>
<td>Important, as they can be more specific generic corporate governance rules, but mechanisms do not benefit outsiders and can have downsides.</td>
<td>Develop functioning civil/commercial courts.</td>
<td></td>
</tr>
<tr>
<td>Arbitration, auditing, and other multilateral mechanisms</td>
<td>Arbitration to resolve conflicts; other third parties (auditors, rating agencies); stock exchange listing requirements; foreign listings; trade organizations; and corporate governance codes for reputation, signaling, standardization of norms</td>
<td>Potentially important—often the origin of public law—but enforcement problem often remains; audits sometimes abused; conflicts of interest a potential problem</td>
<td>Facilitate formation of private third-party mechanisms (to mitigate the need to form public alternatives where possible), deal with conflicts of interest, ensure competition</td>
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</tr>
</tbody>
</table>
Market for Corporate Control

The market for corporate control is less active, making hostile takeovers less effective and proxy fights more difficult to win. Hostile takeovers are not completely impossible, however. In the Russian Federation, for example, investors have found ways to exploit financial distress and use bankruptcy rules to topple incumbent owner-managers (Guriev and others 2003). Whether this is leading to efficient outcomes remains to be seen, but it shows that some elements of a market for control are working.

Board Activity

Since owners appoint boards, little independent corporate governance should be expected from the board in a firm with a controlling owner. Requiring independent directors has limited direct effect as the controlling shareholder will not allow any real influence on the firm’s board. Nevertheless, requiring some degree of independence from some directors could still be important. For example, independent directors can play an important role in transferring knowledge at the level of the individual firm and building constituencies for corporate governance reform at the country level.

Executive Compensation

Executive compensation schemes do not play the same role in decisionmaking as they do in firms with more dispersed ownership structures, given that the controlling owner can hire and fire managers at his discretion. Furthermore, the controlling shareholder typically has many other means to “reward” himself. Disclosure of executive compensation schemes is nevertheless a good thing, even when it is not the key motivating force in managerial decisionmaking, as public pressure may help restrain some forms of dilution. More generally, transparency promotes an informed discussion of corporate governance at both the firm and the country level.

Monitoring by Banks

Lending by banks is typically the most important source of external finance. As lenders, banks have a direct stake in the governance of corporations, requiring firm behavior that ensures that their loans will be repaid. As monitors, banks can compensate for some weaknesses in the general enforcement environment, as they have repeated dealings, have a reputation to maintain in lending, and can economize on monitoring and enforcement technology. The development of bank lending itself obviously relies on the effectiveness of the regulatory framework and supervision, in
addition to other institutions that allow collateral to be collected. Public enforcement is therefore still a necessity.

Shareholder groups, which exist in Japan, Korea, the United Kingdom, the United States, and many other countries, can also be important. The effectiveness of such groups varies, depending on their funding structures, whether awards are distributed to members or kept for future activities, and whether they seek to use and improve existing local enforcement institutions or abandon them, as Milhaupt (2003) shows in an analysis of shareholder groups organized as nonprofit organizations in Japan, Korea, and Taiwan (China).

**Monitoring by Employees**

Monitoring by employees can be an effective mechanism for enhancing corporate governance, as the interests of employees are largely aligned with good firm performance and fair treatment of all stakeholders. For this mechanism to be powerful, employees must be mobile, however, so that their threat to leave the firm is credible. More generally, effective competition in all factor markets improves firm’s corporate governance. Increased competition in output markets not only puts more pressure on the firm to enhance its performance, it also increases the premium on better corporate governance to be able to attract the necessary financing to invest and survive.

**Litigation**

Litigation cannot be expected to be a good governance mechanism in weak contracting environments. It is, however, less dependent on government actions than public enforcement, as it is a form of private enforcement of public laws. In securities markets, private enforcement works better than public enforcement, especially in developing countries (La Porta, Lopez-de-Silanes, and Shleifer 2005). Litigation can also help develop the standards against which corporations know they will be judged and which may eventually evolve into law.

**Media and Social Control**

Media and social control often play an important role in disciplining managers and controlling owners (Dyck and Zingales 2003). Such control improves access to information, reduces the costs of monitoring, and makes corporate governance an issue of public debate. In countries such as Korea, corporate governance became a household word thanks in part to wide media coverage of corporate sector abuses. In turn, regulation and other efforts promoting plurality in media can have a strong impact on the enforcement of good corporate governance.
Reputation

Even when ownership and control in individual firms are concentrated, because of weak enforcement, reputation mechanisms can be of value for large shareholders, because the firms need to raise outside funds. But minority shareholders should not expect too much from formal governance mechanisms.

Bilateral Private Enforcement Mechanism

Most private agreements are bilateral. To be renegotiated ex post when they are not enforced, they require firm-specific assets. Moreover, they need not benefit other shareholders. Nevertheless, bilateral agreements may be valuable (to blockholders) even in the absence of firm-specific assets. While they suffer from the weaknesses in the general contracting environment, agreements between blockholders and the controlling shareholder, which may cover board representation, access to information, permission for changes in control rights, and procedures for approving related party transactions, can add value. Because they include more specific covenants, they may overcome some incompleteness in the existing legal system and can more easily be judged by inexperienced courts. In addition, the general court system dealing with civil cases may be better than the specific court system dealing with capital market transactions. In many developing countries and transition economies, for example, civil courts function relatively well, but courts that deal with capital market transactions do not. In case of such “arbitrage” opportunities, shareholders’ agreements can add value to blockholders. They are of little value, however, to small shareholders.

Arbitration, Auditing, and Other Multilateral Mechanisms

For joint ventures or international investments, arbitration can help enforcement, as it can rely on tools such as the New York Convention, which makes international arbitration binding in the local context (although it still requires some degree of local enforcement). Arbitration is of less value, however, when the general enforcement environment is weak and backup and appeal procedures are missing. Only in markets with repeated dealings and a small number of participants can arbitration work well.

The listing requirements of stock exchanges are another multilateral tool. Brazil’s Novo Mercado combines higher corporate governance standards with an arbitrage system. Provision of voluntary standards can be useful, although they require some enforcement. Their effectiveness depends on the “franchise value” of the exchange: if the exchange is a (local) monopoly, it may have more enforcement power. (At the same time, the stock exchange may be less interested in corporate governance reform.) On other stock exchanges, listing rules are forcing corporations to reform or
risk delisting and seeing their access to public market financing disappear. Still, the effort needs to improve over other options for firms to signal higher corporate governance standards such as using international markets. Listing on a foreign stock exchange can be a bonding device as it involves some costs to adhere to higher standards. Some researchers note, however, that the securities and exchange commissions of host countries often do not take actions against minority rights violations committed at home (see Siegel 2005 for the case of Mexico; Licht 2003). As with the general findings for securities markets, listing abroad may help more through private enforcement of exchange listing requirements, particularly disclosure, and for only some aspects of public laws.

Other third parties can help by bonding. Accountants and auditors can signal the quality of a corporation and some of its corporate governance aspects if they have some reputation to lose. The scope for accounting and auditors to improve governance depends partly on the local standards used in accounting and auditing and the legal liabilities for misrepresentation. Accounting and auditing firms can suffer from conflicts of interest if they have other business, such as consulting contracts, with the same firm. Investment banks can signal the quality of firms in the process of underwriting public offerings, although here, too, conflicts of interest can lower the value of the signal.

Rating agencies assess firms for bond and loan ratings, which include some assessment of their corporate governance. Recently, traditional rating agencies and others have produced corporate governance ratings of firms. These ratings can coordinate information collection, establish standards, and be a source of bonding when rating agencies have reputations to protect. These ratings are new and have yet to prove their value, but they could be particularly useful for institutional investors that cannot incur the costs of assessing the corporate governance of each individual firm.

Like corporate governance ratings, corporate governance codes can coordinate information collection and establish standards. Stock exchanges can use them as part of their listing requirements (“comply or explain”), giving codes some enforcement power. Codes can also have an indirect value if they lead to the codification of laws. They do not enforce laws by themselves, however, and need to be used by investors and others to induce changes in the behavior of corporations.

Conclusions

Given the lack of research on enforcement and corporate governance, it is very difficult to draw strong conclusions. Some general lessons can be drawn, however, not all of them limited to enforcement.
One observation is that private sector efforts to enhance enforcement are often more effective than government-led efforts, but the two forms of enforcement tend to complement each other. Private ordering can precede and serve as a basis for public laws and a model for private and public enforcement of these laws. The balance between private ordering and private enforcement of public laws depends on the quality of public laws and the strength of enforcement institutions. When the general enforcement environment is very weak, private ordering may be the only hope. With a better contracting environment, the evidence, at least from securities regulation, suggests that private enforcement can be important.

Improvements in enforcement are more often the result of bottom-up approaches than top-down efforts. Capacity building is often important to support private initiatives (from rating agencies to banks), and it can help build constituencies for reform. Top-down efforts to improve the legal and enforcement environment are difficult and rarely successful. The record of transplanting elements of foreign legal systems has not been a good one, but the experience of EU accession suggests that outside anchors can play a positive role in enhancing reforms.

Enforcement greatly matters for corporate governance and for the ability of the corporate sector to attract external financing and improve its performance and growth. When designing strategies for improving enforcement of corporate governance, policymakers should consider both the likely impact of a governance mechanism and the scope for improving the mechanism. A particular mechanism may play a very important role in reducing agency costs, but it may have little room for improving enforcement or vice versa.

Knowledge about enforcement is limited; most issues need to be researched further. In particular, better understanding is needed of the balance between private and public enforcement of public standards. The empirical work on securities market laws shows the benefits of relying more on private means in enforcing some minority shareholder rights, disclosure, and other regulations to develop capital markets. But the conceptual basis for this observation remains weak. Investigation of the issue for other aspects of corporate governance is needed.

It would also be useful to better understand the effectiveness of self-regulatory agencies and organizations in encouraging better standards and stricter enforcement of these standards. When, for example, are stock exchanges effective in promoting good corporate governance? What does the move to a more for-profit status mean for the incentive structures of stock exchanges to adopt higher corporate governance standards? What other self-regulatory organizations can be effective and under what conditions?
Notes

Erik Berglöf is chief economist of the European Bank for Reconstruction and Development, a professor, and director of the Stockholm Institute for Transition Economies at the Stockholm School of Economics and a fellow of the Centre for Economic Policy Research; his e-mail address is erik.berglof@hhs.se. Stijn Claessens is a professor of international finance policy at the University of Amsterdam, senior adviser to the Financial Sector Vice-Presidency of the World Bank, and a fellow of the Centre for Economic Policy Research; his e-mail address is sclaessens@worldbank.org. This article was prepared for the Global Corporate Governance Forum. The authors owe Katharina Pistor many thanks for her extensive comments. They also thank the participants in the World Bank workshop on “Enforcement in Corporate Governance,” held in Washington, D.C., June 19, 2003; the participants in the workshop on enforcement held during the Global Corporate Governance Forum High-Level Working Meeting and Consultation on the OECD Corporate Governance Principles, held in Paris, November 2–4, 2003; and various seminar participants and three referees for very useful comments and suggestions.

1. For a general review of private ordering, see Dixit (2004).

2. In the model of Immordino and Pagano, a benevolent government trades off the benefits of stricter legal standards for the costs of their enforcement. With a benevolent government, standards should be set lower, because the costs of enforcing them are higher.

3. For simplicity, developing countries and transition economies are not distinguished here, even though the problems they face often differ in nature (for a discussion of the different corporate challenges facing developing countries and transition economies, see Berglöf and von Thadden 2000). Recently, there has been some convergence between the two types of economies, in terms of ownership concentration, for example (Berglöf and Pajuste 2003).

4. Many firms in developed countries are also closely controlled (Becht and Mayer, 2001; Faccio and Lang 2002).

References


