
PRIVATIZATION AND CORPORATE GOVERNANCE IN BRAZIL

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1. Introduction

The reform of state-owned enterprises (SOEs) has become an integral part of most macroeconomic stabilisation programmes implemented worldwide in recent years. The main instruments used to reform these enterprises have been divestiture and workforce downsizing. In Latin America, in particular, the pursuit of fiscal consolidation has added another important dimension to public enterprise reform.¹ Nevertheless, one aspect of SOE reform which is still needs closer scrutiny by policy makers and practitioners is the impact of divestiture on corporate governance.

There are many different definitions of corporate governance. Overall, it can be broadly defined as the economic and institutional mechanisms that guarantee “fair” remuneration to the suppliers of finance to corporations [Zingales (1997) and La Porta *et al.* (1996 and 1997)].² Public enterprise reform, and divestiture in particular, are instrumental in reshaping corporate governance systems. This is because divestiture fosters institutional and structural changes in product and labour markets, as well as changing the ownership structure of the economy in favour of the private sector. In turn, improved corporate governance boosts private sector development and facilitates corporations’ access to new sources of finance.

Because corporate governance is a broad and multifaceted topic,³ this paper will focus on the relationships between public enterprise reform, with emphasis on divestiture, and the improvement of corporate governance in Brazil. Before 1994, macroeconomic disarray, chronic inflation, and interest rate volatility discouraged equity and debt market development, thus biasing the capital structure of Brazilian corporations towards self-financing. More recently, despite progress in the consolidation of macroeconomic stability and the rapid development of equity markets after 1994, the Brazilian corporate sector is still characterised by low leverage and excessive reliance on self-financing. An “equity-

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1 A lot has been said about the macroeconomic repercussions of these reform programmes. See Castelar and Giambiagi (1999) and Carneiro and Rocha (1999), in this volume, for further details.

2 In more formal terms, corporate governance theory studies a corporation’s access to sources of finance. It also includes the composition of corporations’ capital structure between self-financing and external financing (debt and/or equity).

3 For a recent survey of the literature, see Schleifer and Vishny (1997) and Zingales (1997).

holder culture” still needs to be fostered in the country, since only a relatively small share of private wealth is invested in equity. Against this background, the main question this paper addresses is whether divestiture is likely to improve access to equity and debt markets and hence alter the capital structure of Brazilian corporations in favour of external financing in the years to come.

The remainder of the paper is organised as follows. Section 2 briefly reviews the theory of corporate governance, by comparing and contrasting private and public sector governance models. Emphasis is placed on the corporate finance aspects of governance. Section 3 presents on the stylised facts about corporations’ access to finance in Brazil, in particular debt, equity, and foreign financing in recent years. The section also places the Brazilian experience in an international scenario. Section 4 focuses on the relationships between divestiture and public sector governance and Section 5 concludes.

2. The General Argument: The Theory of Corporate Governance

2.1. The Private Sector

There are two basic ways to describe corporate governance theory. First, based on the theory of contracts, corporate governance can be examined from the point of view of the dissociation of ownership from managerial control in an environment of imperfect/incomplete information. In particular, the contract theory approach to corporate governance is as follows.⁴ In the private sector, corporations borrow to finance operations and investment. The suppliers of capital, named financiers, expect firm managers to extract the best rates of return by allocating those funds to different uses. Because financiers do not have full information over how these funds are used by managers, they lose (at least partially) control over their capital. Complete contracts are often hard to write, information is costly, and free-riding may occur among investors.⁵ If lenders were to monitor directly how managers invest their funds, transaction and information costs would rise and rates of return would fall, thereby discouraging lending in the first place – the “hold-up” problem. Suboptimal lending in the corporate sector subsequently leads to underinvestment and inefficient allocation of resources in the economy

4 See Aghion and Bolton (1992), Hart (1995) and Meza and Lockwood (1998), for further details.

5 Free-riding occurs because information is costly. If a potential stakeholder invests resources to find out about a corporation’s financial health and creditworthiness, his/her decision to invest (or not to invest) in that corporation will convey the information to other market participants. The risk of free-riding precludes this type of investment in the first place.

at large. In more formal terms, the distribution of non-contractible property rights over investible funds affects the bargaining power of managers and financiers over asset returns, and ultimately affects the productivity of these assets and the economy-wide allocation of resources.

The second strand of corporate governance literature focuses on minimising financing costs. Because of the dissociation of ownership from control, self-financing – the use of own resources, such as retained earnings and cash flow – may be less risky, and hence less costly, than external financing, such as bond and equity issuance. This is because there is no separation of ownership from control in the case of internal financing, given that financier and manager are the same person, and financing occurs without loss of control over how funds are invested. Self-financing tends to predominate when lending is risky and property rights are not fully protected. Weak corporate governance institutions discourage investors from giving up control over their funds for fear of expropriation or “unfair” remuneration. External financing becomes cost-inefficient and corporations rely primarily on internal financing.

However, self-financing is inefficient from the point of view of the economy-wide allocation of resources, because it discourages financial intermediation. Financial intermediation creates opportunities for capital-rich investors to maximise rates of return in finance-constrained firms, encourages portfolio diversification in the corporate sector, and promotes more efficient risk-sharing in the economy at large. The development of financial intermediation consequently facilitates access to external financing. In this case, debt market development is likely to precede equity market development, given that property rights are more easily protected in debt, rather than equity, financing.⁶ In mature, developed financial markets, equity financing is likely to dominate corporations’ capital structure. The choice between equity and debt also depends, among other things, on the macroeconomic environment, legal institutions, the structure of product and labour markets, and capital market development.⁷

International experience with external financing offers a number of stylised facts. Low leverage is the hallmark of the Anglo-Saxon model of corporate governance. One of the reasons why equity predominates as the main source of finance in Anglo-Saxon countries is better legal protection of shareholder rights, particularly minority shareholders [La Porta *et al.* (1996)], which reduces the costs and risks associated with equity financing. At the other extreme of the finance spectrum are the German and

6 See, for instance, Schleifer and Vishny (1997).

7 The equity-debt mix is further affected by the country’s tax system: different taxation of capital gains, dividends, and interest payments affect a firm’s tax liability structure for given assets, thereby making one type of finance more attractive than the other [Glen and Pinto (1994)].

Japanese systems, where debt-financing predominates. The average debt-equity ratio in the 1980-91 period was over 3 in Japan, South Korea, continental Europe (France, and Italy), and Scandinavia (Finland, Norway, Sweden). Australia, Canada, New Zealand, United Kingdom and the USA, are low-leverage countries, with debt-equity ratios of less than two.⁸

In most developing countries, the choice between internal/external financing and between debt and equity, in the case of external financing, is affected by macroeconomic instability and capital market volatility, on the one hand, and weak corporate governance and inadequate financial intermediation and legal institutions, on the other. Macroeconomic volatility discourages external financing by increasing investment risks and undermining confidence. A vicious circle can then be identified in these countries, whereby weak corporate governance discourages external financing and financial deepening, and the latter reduces the incentives for upgrading governance systems and institutions.

2.2. The Public Sector

By analogy with the ownership-control approach to corporate governance, in the public sector, taxpayers transfer funds to the government in exchange for the provision of public goods and services. However, public governance is more complex than corporate governance because of the existence of a third agent: politicians. Bureaucrats, as public sector managers are named in the literature,⁹ are concerned primarily with maximising their budget, rather than reducing operating and delivery costs. The bigger their budget, the greater their political prestige, and the brighter the prospects of career advancement. Politicians are motivated by the political payoff of public sector spending, given that spending pleases the electorate. As a result, they transfer taxpayers' money to government agencies regardless of the cost-effectiveness of bureaucrats' actions. Control rights are totally dissociated from cash flow or ownership rights, given that ownership is dispersed among taxpayers.

In addition to limited cost effectiveness, such factors as job tenure, limited accountability, and generous labour rights provide weak incentives for efficiency in the public sector and encourage shirking in public sector employment. Poor performance in the case of SOEs tends to result in losses which are often financed by taxpayers. Lack of bankruptcy provisions and market-based profit-maximisation constraints reduce the incentive for financial prudence and managerial probity in the public sector. SOEs also often rely on subsidised credit from the govern-

8 See Demirgüç-Kunt and Maksimovic (1996), for further details.

9 For a standard reference, see Niskanen (1975).

ment, which leads to inefficient allocation of credit in the economy, and crowds out private sector financing. These enterprises also tend to rely on external financing by issuing debt, which is often publicly guaranteed. This creates contingent liabilities for the government, which often have a negative impact on the budget. Equity financing may also occur in the case of publicly-traded SOEs, but soft budgets and opaque accounting tends to obscure the mechanisms under which SOEs choose their optimal capital structure. These factors explain differences in public and private sector productivity, which have been object of intense scrutiny in the literature.¹⁰

Public governance also has a federal dimension, which is examined in greater detail elsewhere in this volume. In multilevel governments, the delegation of spending powers to lower levels of government, as in the case of federations and decentralised administrations, may create additional incentives for mismanagement. This is because, in an environment of imperfect/incomplete information, the centre loses control over how lower levels of government or decentralised agencies make use of the resources transferred to them. Residual control can be exploited by these agencies, leading to inefficient allocation of public funds.¹¹

3. Corporate Governance in Brazil

3.1. The Sources of Finance

In Brazil, the capital structure of the corporate sector has been shaped primarily by macroeconomic factors. During most of the 1980s, the absence of a well-functioning debt market limited the scope for debt financing in the corporate sector, despite low, often negative, interest rates, and the predominance of credit creation, particularly long-term credit, by government-owned banks.¹² In the early 1990s, debt financing was discouraged by tighter monetary policy and higher real interest rates. As a result, corporations relied on internal financing to minimise borrowing costs. The creation of financial and/or banking divisions/affiliates in large corporations/holdings reduced the cost of internal financing and allowed for more efficient inflation hedging, particularly in the short run. Equity financing was discouraged by high issue costs due to lack of competition among investment banks, and a ban on foreign access to domestic equity markets (until 1991).

10 For surveys, see Kikeri *et al.* (1992), and Boycko *et al.* (1996).

11 The fiscal federalism literature highlights the risk of a deficit bias in decentralised governments [Mello (1999)].

12 The average debt-equity ratio in the 1980-91 period in Brazil was less than 1, as in, for instance, Mexico and Malaysia [Demirgüç-Kunt and Maksimovic (1996)].

In the post-1994 period, progress in the consolidation of macroeconomic stability, increased competition in capital markets, and renewed access to foreign capital provided Brazilian corporations with a richer and less constrained array of financial instruments. Divestiture is expected to be a catalyst in this rationalisation process, as will be discussed below, not only by promoting private sector development, but also by reshaping the country's corporate governance system, and altering the ownership structure of the economy in favour of the private sector. In what follows, a more detailed analysis of different financing instruments will be provided for the Brazilian case.

3.1.1. External Financing: Equity

Equity is less preferred to debt as a source of external financing in the absence of well-functioning domestic capital markets. Small and/or illiquid markets render risk-pooling and portfolio diversification costly, and discourage information gathering and monitoring by market participants. In Brazil, macroeconomic volatility and chronic inflation in the 1980s and early 1990s acted to limit the issuance of equity, as suggested above. Nevertheless, Brazilian stock exchanges are by far the largest and most liquid among leading Latin American bourses in terms of number of companies listed, annual turnover and market capitalisation (Table 1).

The main characteristics of Brazilian equity markets are as follows:

- Brazilian equity is underpriced compared to the Latin American countries in Table 1, with low price-equity ratios. Price-to-book value ratios are often less than one, which discourages equity financing.
- Equity ownership is highly concentrated, as in other Latin American countries, as shown in Table 2.
- The stock of publicly traded divestible assets in since 1997 has been concentrated in the telecommunications, utilities, and transport sectors, which dominate the country's stock exchanges (Table 2).¹³
- SOEs predominate among listed companies. Table 3, using 1996 balance sheets, shows that although government-owned firms are only a 40 per cent minority of the 50 largest companies listed in Brazilian bourses, their total assets (roughly R\$ 240 billion in 1996 prices) are over 70 per cent of the total assets of the 50 largest

13 This coincides with the OECD scenario, where proceeds of privatisations in the manufacturing sector peaked in 1994 [OECD (1998a)].

Table 1
Privatisation and Stock Market Development – 1993-97

<i>Indicators</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997*</i>
Number of Companies Listed					
Rio de Janeiro	570	576	570	577	
São Paulo	550	544	543	551	557
Buenos Aires (Argentina)	180	156	149	147	148
Santiago (Chile)	263	279	284	291	287
Mexico (Mexico)	190	206	185	193	189
Annual Turnover (US\$ Billion)					
Rio de Janeiro	7.5	16.9	10.0	14.1	
São Paulo	49.9	92.5	69.2	98.0	95.0
Buenos Aires (Argentina)	10.3	11.4	4.6	4.4	12.2
Santiago (Chile)	2.8	5.3	11.1	8.5	4.0
Mexico (Mexico)	62.4	83.0	34.4	43.0	20.9
Market Capitalisation (US\$ Billion)					
São Paulo and Rio de Janeiro	99.4	189.3	147.6	217.0	283.2
Buenos Aires (Argentina)	44.0	36.9	37.8	44.7	54.7
Santiago (Chile)	44.6	68.2	73.9	65.9	81.2
Mexico (Mexico)	200.7	130.2	90.7	106.5	131.8
Market P/E Ratio					
São Paulo and Rio de Janeiro	12.6	13.1	36.3	14.5	17.4
Buenos Aires (Argentina)	41.9	17.7	15.0	38.2	29.5
Santiago (Chile)	20.0	21.4	17.1	14.6	19.5
Mexico (Mexico)	19.4	17.1	28.4	16.8	20.7
Dividend Yield (%)					
São Paulo and Rio de Janeiro	0.4	0.7	3.4	2.3	2.5
Buenos Aires (Argentina)	2.3	2.9	3.5	2.9	2.5
Santiago (Chile)	2.7	2.4	3.5	3.9	4.0
Mexico (Mexico)	1.6	1.8	1.1	1.5	1.5
Market Price-to-Book Value					
São Paulo and Rio de Janeiro	0.5	0.6	0.5	0.7	1.1
Buenos Aires (Argentina)	1.9	1.4	1.3	1.6	2.0
Santiago (Chile)	2.1	2.5	2.1	1.6	1.9
Mexico (Mexico)	2.6	2.2	1.7	1.7	2.1
Privatisation Proceeds ** (US\$ Million)					
Brazil	2,718 (8)	1,697 (14)	992 (8)	4,099 (8)	4,373 (4)
Argentina	4,732 (35)	890 (24)	1,208 (9)	552 (6)	0 (0)
Chile		128 (5)	13 (3)	519 (2)	0 (0)
Mexico	2,131 (22)	766 (12)	167 (8)	1,400 (1)	0 (0)

**End June/July 1997.*

***Number of sales/flotations/issues in parentheses.*

Source: Emerging Markets Investor Fact Book 97/98, *BankBoston*.

Table 2
Composition and Ownership Concentration in Stock Markets

<i>Listed Companies per Sector</i>	<i>Argentina</i>	<i>Brazil</i>	<i>Chile</i>	<i>Mexico</i>
1. Sectoral Composition (%), 1997				
Manufacturing	19.7	28.9	42.1	40.0
Transport/Telecom/Utility	19.6	50.8	47.3	25.2
Financial	13.3	9.4	5.4	4.3
Others	47.4	10.9	5.2	30.5
2. Ownership Concentration				
Concentration Ratio*				
Includes Government	0.7	0.5	0.5	0.6
Excludes Government	0.3	0.5	0.4	0.6
Market Cap. of 10 Largest Firms**				
Government-Owned	7,378	2,908	2,415	2,984
Privately Owned	1,237	2,185	2,330	2,984

*Defined as the average per centage of common shares owned by 3 largest shareholders in the 10 largest domestic non-financial firms.

**US\$ million.

Sources: Ownership concentration is available in La Porta et al. (1996), and sectoral composition is available in Emerging Markets Investor Fact Book 97/98, BankBoston.

companies. Given the country's federal structure, virtually 80 per cent of the open-capital SOEs, and 65 per cent of their combined assets are owned by subnational governments.

Against this background, divestiture is expected to affect capital market development and corporate governance by:

- Boosting market valuation, and increasing transaction volumes. Although caution should be exercised as shock waves of the Mexican 1994/95 meltdown are visible in the data, P/B values and dividend yields have increased since 1995, simultaneously with privatisation proceeds. In Argentina and Mexico, P/B values increased sharply when privatisation proceeds peaked in 1993. In Chile, dividend yields peaked when privatisation proceeds were highest (1996). Nevertheless, turnover and market capitalisation does not seem to be boosted by divestiture in these countries, which can be attributed to turbulence in international markets and/or the development of alternative, divestiture-related sources of finance.
- Changing equity ownership in favour of the private sector. In the sample of 50 largest companies listed in Brazilian bourses, Table 3 shows that roughly 40 per cent of non-government, publicly traded companies are former SOEs, and their combined assets amount to 62 per cent of the total assets of open-capital, privately owned companies. In the sample, only 14 per cent of privately owned firms are not publicly held (closed-capital firms), with combined assets of only 5 per cent of the total assets of the 50 largest companies. These firms are,

Table 3
Stock Market Indicators: Ownership Composition

<i>Ownership Type</i>	<i>Number of Companies Listed</i>	<i>%</i>	<i>Total Assets (R\$ million)</i>	<i>%</i>	<i>Net Revenue (R\$ million)</i>	<i>%</i>
State-Owned	20	40	238,611	73	53,838	50
Open Capital	14	28	151,369	46	45,567	43
Of which Subnat.	11	79	98,950	65	20,565	45
Closed Capital	6	12	87,242	27	8,271	8
Of which Subnat.	1	17	10,081	12	488	6
Privately Owned	30	60	88,072	27	52,831	50
Open Capital	23	46	72,395	22	37,808	35
Of which former SOE	9	39	44,658	62	13,299	35
Closed Capital	7	14	15,677	5	15,023	14
Of which former SOE	0	0	0	0	0	0

Notes: *Sample: 50 largest companies listed in Brazilian stock exchanges using information available in their 1996 balance sheets. The data exclude holding companies (such as Telebrás).*

Source: *Conjuntura Econômica, Fundação Getúlio Vargas, Aug. 1997.*

in most cases, family-owned,¹⁴ which are often insulated from external monitoring, and rely almost exclusively on self-financing and debt instruments to fund expansion and modernisation.

- Reducing ownership concentration and diluting control rights.¹⁵ Ownership concentration reduces pressure from shareholders to improve corporate governance.

The dilution of control rights can be discouraged by the limited issuance of voting shares by Brazilian publicly traded corporations. These arrangements, in addition to vertical and horizontal cross-shareholdings, allow majority shareholders to control assets with the least amount of capital and dissociate control rights from cash flow rights.¹⁶ Because their investment is sunk, financiers are forced to relinquish more control rights than in the case where a higher proportion of voting shares is required. Shares with voting rights trade at a premium, given the significant benefits of control, and hence increase the revenue accruing to the equity-issuing firm. Expropriation of minority shareholders, or holders of shares with no voting rights, is more likely in these circumstances, which also reduces the scope for external financing and leaves minority investors unwilling to invest. It is also likely that divestiture will encourage equity financing through the issuance of voting, rather than non-voting, shares. In this case, equity financing can be boosted by divesti-

14 Important empirical questions in corporate finance are, first, whether owner-controlled, and particularly family-controlled, firms are likely to outperform manager-controlled firms and, second, in which macroeconomic or institutional environment one type of control is likely to boost corporate performance. Among other things, the performance-control link depends on industrial organisation and ownership concentration.

15 In Argentina, by Table 2, the ownership concentration ratio halves when the government is excluded.

16 Brazilian legislation allows for a one-third/two-thirds split of shares between voting and non-voting. Therefore, control may be ensured with ownership of as little as one-sixth of a firm's capital.

ture to the extent that the bias towards non-voting shares is reduced and minority shareholder rights can be protected more effectively.

The dilution of control rights is also affected by the type of divestiture. Public offerings tend to dilute control rights over management and broaden the country's shareholder base. Trade sales, on the other hand, tend to preserve new investor's control rights. As a result, the infusion of managerial and technical know-how is encouraged and a premium for control ensures the maximisation of privatisation proceeds, particularly when foreign investors are active players in privatisation programmes. In Brazil, public offerings have been limited and most divestitures have taken place through control auctions. In the absence of significant market disruptions, the emergence and consolidation of a "shareholder" or "equity-holder" culture' is expected with the growing participation of domestic institutional investors, such as pension and mutual funds and insurance companies, in trade sales, in addition to retail investors in public offerings. The dominance of institutional investors in Brazilian privatisation placements has not only absorbed a share of retail demand but also facilitated the participation of foreign investors.

A final consideration is that institutional investors (banks, pension funds, mutual funds, life insurance companies) have emerged as important suppliers of equity capital in the Brazilian privatisation programme, as shown in Table 4. In terms of corporate governance, the trade-offs to be considered for each type of investor are summarised in Box 1.¹⁷ Two important points can be made in this respect:

- Small investors are discouraged by the size of the Brazilian divestiture programme, but the predominance of

Table 4
Ownership Composition of Privatised Companies (until December, 1997)

	% of Total	By Sector (%)							By Size (%)	
		Steel	Petroch.	Elect.	Util.	Manuf.	Mining	Banking	Large Priv.	Small Priv.
Same Sector	62.7	60.4	81.6	61.4	43.7	65.0	80.0	100.0	48.1	82.2
Banks	14.1	30.3	24.2	17.6	26.0	34.5	77.1		37.6	29.4
Pension Funds	3.5	24.9	11.2		35.0	12.5	5.0		14.5	15.0
Employees	4.0	13.2	7.9	8.8	10.0	7.5	20.0		10.5	9.1
Foreign Capital	0.2	1.8	1.8			2.0				2.0
Others	15.5	14.7	8.0	12.1	47.6	17.4	8.9		19.6	9.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
No. of Companies	56	8	30	2	8	5	2	1	4	37

Notes: Banks includes trading houses, merchant banks and investment funds. Foreign Capital excludes foreign stakeholders prior to privatisation. Large Privatisations are those in which the selling price was above US\$ 1 billion. Small Privatisations are those in which the selling price was below US\$ 200 million.

Source: BNDES (1997).

17 See Cho (1998), for an empirical analysis of the relationship between ownership structure and corporate performance.

Box 1 Divestiture and New Ownership Composition

<i>New Owners</i>	<i>Preferred Sectors/Activities</i>	<i>Advantages</i>	<i>Disadvantages</i>
Same-sector Firms (suppliers, competitors, major customers)	<ul style="list-style-type: none"> - Manufacturing and capital-intensive sectors. - Sectors with complex supplier/purchaser arrangements. 	<ul style="list-style-type: none"> - Creation of cost-saving economies of scale. - Strengthen backward linkages in the economy. - Active involvement in management. 	<ul style="list-style-type: none"> - Reduced competition and managerial transparency via ownership concentration. - Wealth-transfer risks from non-controlling investors in holding companies. - Proliferation of cross-holdings.
Institutional Investors (pension funds, mutual funds, insurance companies)	<ul style="list-style-type: none"> - High-return activities, fast-growing sectors. 	<ul style="list-style-type: none"> - Sizeable investible portfolios. - Pressure for timely disclosure of information, direct shareholder monitoring, and improved accounting standards. - Greater incentive for foreign investment. - Reduce the scope for managerial discretion (reduction of agency problems). 	<ul style="list-style-type: none"> - Little incentive to vote because active participation/monitoring is costly (passive investment) Remedy: use of proxy delegation, custodians voting, compulsory voting, and/or tax incentives for voting. Alternatively, an equity cap on institutional investors may be imposed. - Large share of SOE pension funds in divestiture operations. - Proliferation of cross-holdings (aggravation of control-ownership problems) and insider system of corporate governance. - Conflict between large controlling shareholder and outside minority shareholders (aggravation of agency problems, management entrenchment).
Employees	<ul style="list-style-type: none"> - Highly-unionised sectors. 	<ul style="list-style-type: none"> - Alignment of interests (management-employees-shareholders) in restructuring. - Improved human capital practices (training, employee relations, incentive-compensation schemes: employee stock or option plans, performance-related remuneration schemes). 	<ul style="list-style-type: none"> - Little incentive for productivity/performance enhancement via labour retrenchment. Remedy: generous severance package. - Little incentive for restructuring after privatisation. - Conflict between controlling shareholder and minority shareholders (aggravation of insider ownership problems).

institutional investors may encourage the use of divestiture to dilute control rights, which is expected to have an important impact on corporate governance.

- Divestiture may fail to improve corporate governance if the new ownership structure and organisation of the firm worsen conflicts of interest among stakeholders.¹⁸ This is likely to occur when employees, equipment suppliers and/or competitors become important shareholders in divested enterprises (Box 1). These conflicts of interest provide little incentive for managerial

¹⁸ According to BNDES (1997), until December 1997, when shares were offered to employees, their actual subscription varied from 3 per cent to 20 per cent of total shares, against roughly 20 per cent, in the case of foreign investors, and 25 per cent, in the case of pension funds.

prudence and productivity enhancement through workforce restructuring and downsizing. Indeed, recent research [Rajan and Zingales (1998)] has shown that, in addition to the ownership-control issue, corporate governance is affected by the internal organisation of firms.

3.1.2. External Financing: Debt

In the early 1990s, a tight monetary policy, high real interest rates and chronic inflation imposed severe limitations on external financing, in general, and debt financing, in particular.¹⁹ A closer look at the Brazilian banking system provides two basic reasons why the volume of debt financing has been modest in the Brazilian corporate sector. First, years of persistent high inflation and macroeconomic volatility created a divided banking sector. Inflation-related gains and regulation reduced price competition in the banking sector and perpetuated operational inefficiency, particularly in the credit-granting process. Slow growth in credit and overemployment reduced productivity. Chronic inflation shifted emphasis from traditional credit-granting and deposit-taking activities to rapid transaction clearing, payment processing, and cash management as the main source of income in the sector. Regulation in the form of price caps in certain activities (particularly savings and housing credit), on the one hand, and subsidised lending by public banks, on the other, created barriers to productivity improvement in the private banking system.

Second, in addition to the low-high efficiency divide in the private banking sector, the large share of government lending in total credit creation produced another dichotomy in the banking sector. Public banks tend to be less efficient than their private counterparts due to overstaffing and overbranching, bureaucracy and political interference in lending criteria, creditworthiness evaluation and loan portfolio management. Guaranteed market shares, through automatic deposit of civil servant wages and management of government assets, also weaken the incentives for price competition and cost trimming through productivity gains.

As a result, low-productivity banks – characterised by inefficient organisation of functions and tasks, and low capital/technology intensity in the payment mix – have coexisted profitably with high-productivity banks of comparable size and customer profile. As shown in Table 5, using 1996 balance sheets, of the 50 largest banks operating in Brazil, government-owned banks account for 46 per cent of the total assets, 54 per cent of credit creation and 57 per cent of total deposits in these 50 largest

19 Using aggregated firm-level data for a sample of 30 developing and developing countries in the 1980-91 period, Demirgüç-Kunt and Maksimovic (1995) find that debt financing is inversely related to inflation.

Table 5
Banking Sector Indicators

	<i>Indicator</i>	<i>Value (US\$ Million)</i>	<i>Share (%)</i>
All Banks	Total Assets	455,378	100
	Net Value	37,292	100
	Credit Operations	155,777	100
	Deposits	203,131	100
State-owned Banks	Total Assets	208,700	46
	Net Value	12,128	33
	Credit Operations	82,634	54
	Deposits	116,367	57
Foreign Banks	Total Assets	33,274	7
	Net Value	2,508	7
	Credit Operations	7,881	5
	Deposits	7,703	4

Note: The sample comprise the 50 largest banks registered in Brazil using information available in their 1996 balance sheets.

Source: Conjuntura Econômica, Fundação Getúlio Vargas, Aug. 1997.

banks. The share of foreign banks in total assets, credit and deposits is in the neighbourhood of 5 to 7 per cent. Since 1997, however, the banking sector has been opened to foreign participation and the share of foreign banks in total assets has risen to around 20-25 per cent, a ratio comparable to that in Argentina, and the USA.

In the banking/financial sector, divestiture is expected to:

- Reduce concentration in ownership and credit creation, and hence create new sources of finance. Productivity gains in retailing are expected to be accompanied by increased exposure in non-retail activities, thus promoting financial deepening.
- Promote financial deepening with the entry of foreign banks and non-bank product specialists (insurance, mortgage, mutual funds), which tends to accelerate the dissemination of best-practice norms and operations, as well as increase liquidity and promote technological upgrading.
- Encourage consolidation in the banking sector. Higher-productivity domestic and foreign banks are expected to buy state banks to be privatised and low-productivity domestic institutions, thereby improving corporate governance.
- Shift emphasis in the activity of government-owned banks to retailing in the case of low-income customers at the expense of investment banking. A more efficient, equitable use of public funds is expected in this case. This is particularly true at the subnational level, as a

significant share of state banks is expected to be privatised in the near future. Withdrawal from the investment banking sector, particularly at the subnational level, is expected to curtail credit to subnational governments, accelerate the consolidation of their fiscal positions, and discipline subnational debt management.

Divestiture may also affect corporate governance in the following manner. In terms of external financing, equity and debt instruments are often considered to be substitutes. Evidence in the literature [Demirgüç-Kunt and Maksimovic (1995)] suggests that the substitution effect between equity and debt is only observed in well-established, mature capital markets. In emerging economies, however, capital market development is associated with an increase in both equity and debt financing, such that both options may well be complementary to each other. Subsequently, as capital markets develop, new opportunities may be created for more efficient risk-sharing and credit creation in the banking sector, which allow firms to increase leverage. Against this background, divestiture in Brazil is expected to boost both debt and equity financing, given the low leverage of the Brazilian corporate sector, and the rapid development of capital markets and the efficiency gains in the private banking sector in recent years.

3.1.3. New Sources of Finance: The Impact of Public Enterprise Reform

The divestiture-induced developments in equity and debt markets are expected to create new sources of finance, particularly easier access to foreign capital. The liberalisation of trade and investment is an integral part of structural reform in Brazil, and has so far played an instrumental role in the consolidation of macroeconomic stability. As a result, foreign investors are finding new opportunities in Brazil and corporations are being exposed to a broader, more comprehensive range of financing alternatives, as well as rewards for increased competition. Global portfolio diversification is likely to broaden international financing options, induce a more efficient allocation of capital, and increase pressure for corporate performance. When individual corporations seek capital from global equity investors, greater disclosure and transparency are demanded, thereby forcing local companies to adopt international standards and best practices.

Evidence of greater access of domestic firms to foreign capital is available in Latin America, despite the setbacks due to the 1994-95 Mexican meltdown, the 1997-98 crises in Asia and Russia. With regard to equity, Table 6 shows that the peak in privatisation proceeds in Argentina and Mexico coincided with massive fund-raising through depository receipts. In fact, allowing trade of former SOE equity in foreign markets has become standard in reforming economies in Latin America to boost

Table 6
Privatisation and Sources of Finance – 1993-97

<i>Indicators</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997*</i>
Privatisation Proceeds (US\$ Million)					
Brazil	2,718 (8)	1,697 (14)	992 (8)	4,099 (8)	4,373 (4)
Argentina	4,732 (35)	890 (24)	1,208 (9)	552 (6)	0 (0)
Chile		128 (5)	13 (3)	519 (2)	0 (0)
Mexico	2,131 (22)	766 (12)	167 (8)	1,400 (1)	0 (0)
Depository Receipts (US\$ Million)					
Brazil	132.5 (1)	1,039.6 (7)	282.8 (4)	440.1 (5)	0 (0)
Argentina	3,515.9 (11)	754.4 (7)	0 (0)	397.2 (4)	50 (1)
Chile	517.7 (7)	793.5 (11)	216.4 (3)	286.4 (4)	0 (0)
Mexico	8,576.0 (41)	1,584.0 (17)	0 (0)	346 (8)	28 (1)
International Bond Issues (US\$ Million)					
Brazil	5,501.1 (69)	3,317.8 (45)	5,222.7 (45)	9,919.9 (75)	9,048.2 (39)
Argentina		5,319.2 (43)	6,443.6 (28)	13,865.5 (63)	7,255.9 (25)
Chile		155.0 (2)	500.0 (6)	2,020.0 (12)	650.0 (3)
Mexico		6,601.9 (32)	7,551.0 (24)	17,960.9 (35)	9,527.5 (3)
Foreign Direct Investment (Net Inflows) (US\$ Billion)**					
Brazil	1.3	3.1	4.9	9.9	18.8
Argentina	2.5	3.1	4.2	4.3	6.3
Chile	0.8	1.8	1.7	4.1	5.4
Mexico	4.4	10.1	9.5	7.6	12.0

*End June/July 1997. Number of sales/flotations/issues in brackets.

**Source: World Bank.

Source: Emerging Markets Investor Fact Book 97/98, BankBoston.

privatisation proceeds, increase liquidity in domestic capital markets and facilitate equity injection in newly privatised firms. Divestiture also provides a major boost to foreign direct investment (FDI), although there does not seem to be a significant correlation between privatisation and international bond issues in the countries under examination. Moreover, FDI in the banking sector, which is rising in Brazil, is expected to unlock opportunities for foreign investors in the services sector.

3.2. Corporate Governance Institutions

Institutions play a prominent role in corporate governance, as suggested by North (1990), because they are important determinants of entrepreneurship. Good institutions – accounting standards, banking and financial regulation and property rights legislation – allow individuals to pursue productive objectives rather than protecting their interests from expropriation and opportunistic behaviour by managers and other stakeholders. Corporate governance systems differ mainly in terms of the regulatory and legal nature of contractual agreements, particularly with respect to settlement of disputes and law enforcement are concerned. Property rights of shareholders and foreign inves-

tors, labour and product market regulations, and consumer rights legislation are examples of broader institutional arrangements that shape governance practices.

Overall, as suggested in Section 2, corporate governance is expected to improve when creditor and shareholder rights are protected and their monitoring capabilities are enhanced. When the risk of expropriation perceived by shareholders and creditors decreases, corporations benefit from more diverse, less costly external sources of finance. Regulatory safeguards should emphasise fairness, transparency, and accountability [OECD (1998*b*)], without which access to capital is limited and costly and investment levels are depressed in the economy at large.

The choice between equity and debt financing depends on legal protection of shareholders [e.g. La Porta *et al.* (1996 and 1997)], as legal rules and their enforcement determine investors' readiness to finance firms. The choice between equity and debt is also determined by institutions, particularly company law; merger, take-over, banking/financial and stock exchange regulation; anti-trust legislation; and bankruptcy/reorganisation laws. Shareholders tend to demand stronger protection than other stakeholders because their investment is sunk. This includes voting rights and, in many cases, an affirmative duty of loyalty on the part of managers. In general, debt contracts depend essentially on appropriate collateralisation, and collateral assets are easier to value than the entire firm and its expected future earnings, as in the case of equity financing. On the other hand, when debt contracts are difficult to make, equity stands out as an option for external financing.²⁰ Debt contracts are also more easily enforceable and creditors benefit from the right of appropriation of the assets used as collateral for loans (asset repossession) in case of bankruptcy, liquidation of the company in the event of a default of outstanding debts, and removal of managers due to improper conduct and poor performance. Default on debt repayments and violation of contractual provisions trigger the transfer of control and asset repossession from the borrower to the lender.

It is known that there are numerous differences in the quality of institutions across countries.²¹ Tables 7 and 8 summarise important features of Brazilian institutions and present comparable indicators for other Latin American countries, as well as the USA, Japan, and Germany. In the case of equity, ownership

20 For instance, firms with intangible assets that are intrinsically inadequate for collateralisation tend to resort to equity financing, as well as young firms with insufficient cash flow to service debt repayments and those operating in fast-growing markets, such as information technology. Speculative bubbles and inadequate financial regulation in fast-growing economies, such as Southeast Asia until late 1997, also explain the rapid growth of equity financing in countries with shallow capital markets and weak institutions.

21 In particular, La Porta *et al.* (1996) analyse creditor and shareholder rights in a sample of 49 countries and show that legal protection for investors is best in common law countries and worst in civil law countries, particularly of the French type.

**Table 7
Financial Institutions**

<i>Indicators</i>	<i>Brazil</i>	<i>Argentina</i>	<i>Chile</i>	<i>Mexico</i>	<i>USA</i>	<i>Germany</i>	<i>Japan</i>
1. Shareholder Rights							
One Share One Vote	yes		yes				yes
Proxy by Mail		yes			yes		
Shares Blocked before Meeting		yes		yes		yes	
Cumulative Voting for Directors		yes			yes		
Oppressed Minority	yes	yes	yes		yes		yes
% of Share Capital to Call an ESM	0.05	0.05	0.01	0.33	0.01	0.05	0.03
Mandatory dividend	0.50	No	0.30	no	no	no	no
2. Creditor Rights							
Restrictions for Reorganisation	yes		yes			yes	
Automatic Stay on Assets	yes	yes	yes	yes	yes		yes
Secured Creditors First Paid		yes	yes		yes	yes	yes
Management Stays in Reorganisation	yes	yes	yes	yes	yes	yes	
Legal Reserve Required as % of Capital	0.20	0.20	0.20	0.20	no	0.10	0.25
3. Rule of Law							
Efficiency of Judicial System	5.75	6.00	7.25	6.00	10.00	9.00	10.00
Rule of Law	6.32	5.35	7.02	5.35	10.00	9.23	8.98
Corruption	6.32	6.02	5.30	4.77	8.63	8.93	8.52
Risk of Expropriation	7.62	5.91	7.50	7.29	9.98	9.90	9.67
Risk of Contract Repudiation	6.30	4.91	6.80	6.55	9.00	9.77	9.69
Accounting Standards Rating	54	45	52	60	71	62	65
CP Index*	4.0	3.0	6.8	3.3	7.5	7.9	5.8

Source: *La Porta et al. (1996). In Part 3 (Rule of Law), the scores vary in the 0-10 range. The higher the score, the more efficient the judicial system, the stronger the rule of law, the lower the corruption level, the lower the risk of expropriation, the lower the risk of contract repudiation. The accounting standard rating varies in the 0-90 range. The higher the score, the better the accounting standards. See La Porta et al. (1996) for further details.*

*CP (Corruption Perception) is an index constructed by Transparency International (1998). The maximum score is 10.

**Table 8
Market Institutional Characteristics**

	<i>Fixed Income Market Accessibility Restrictions</i>	<i>Equity Market Regulation</i>	<i>Taxation on Equity</i>	<i>Capital Controls</i>	<i>Currency Convertibility</i>
Brazil	Restricted	- Only approved institutional investors - Institutional investment portfolio (Annex IV)	15% corporate income tax, capital gains tax	Yes	- Not fully - Multiple exchange rates
Argentina	Free	No restriction on foreign ownership	No	No	Full
Chile	- 30% non-interest reserve requirement for one year - Extensive regulation	Minimum holding period	35% capital gains tax, dividends also subject to 35% tax	Yes	Not fully
Mexico	Free	Certain shares only through trust funds	No	No	Full

Source: Emerging Markets Investor Fact Book 97/98, *BankBoston*.

concentration reduces pressure from shareholders to improve corporate governance. One-share one-vote rules mean that ordinary shares carry one vote per share; that is, dividend rights are linked to voting rights. Cases such as a maximum number of votes per shareholder irrespective of his/her number of shares, and multiple-voting and non-voting ordinary shares are in breach of one-share one-vote rules.

In terms of creditor rights, Brazilian law tends to be pro-management, since it guarantees automatic stay on assets (secured creditors are not allowed to repossess collateral when a reorganisation petition is filed). In this respect, managers and unsecured creditors are protected *vis-à-vis* secured creditors, since the latter do not have the right to repossess collateral. Unlike in Mexico and Brazil, Argentine law protects the rights of secured creditors, at the expense of unsecured creditors and managers. Nevertheless, creditors participate actively in reorganisation by, for instance, appointing managers in the reorganisation period. With regard to more general, rule-of-law indicators, Brazil has relatively good scores in controlling corruption, property rights (risk of contract repudiation and expropriation), accounting standards and property rights legislation. The judicial system is nevertheless weaker than in the countries under examination.

In terms of protection for minority shareholders (such as rights to sue directors), given the indicators presented in Table 7, Brazilian legislation is comparable to that of Chile and superior to that of Argentina and Mexico. Brazilian law provides for equal treatment of shareholders, minority rights, mandatory dividends and the possibility of calling an extraordinary shareholders' meeting (ESM). These provisions are designed to protect shareholders' assets against "insider" trading and wrongdoing such as fraud and managerial or majority shareholder self-dealing.

However, as suggested above, Brazilian corporate governance suffers from a proportionally high percentage of non-voting shares. The one-third/two-thirds split between voting and non-voting shares plays an interesting role in divestiture operations. On the one hand, it allows for the extraction of considerable control premiums in divestitures, thereby maximising privatisation proceeds and encouraging further equity investment in the newly privatised SOEs. On the other hand, it prevents further strengthening of a "shareholder" culture since the dissociation between ownership and control discourages small investors. Ownership concentration remains high and divestiture may fail to dilute control in equity markets. Also, the possibility of control with limited ownership encourages the creation of joint ventures, mergers and acquisitions, facilitates the creation of large holding companies and strengthens the position of institutional investors, such as banking/financial corporations, in divestiture placements. Finally, if divestiture is to improve corporate governance in Brazil, reform is needed in the country's corporate and com-

mercial law, equity market regulations, and mergers and acquisitions legislation, and prudential regulation in the banking/financial sector will have to be upgraded.

4. Divestiture and Governance in the Public Sector

In large-scale privatisation programmes, a number of enterprises are expected to remain in public hands for institutional reasons (such as constitutional impediments to privatisation), due to the complexity of the privatisation process, or because of the optimal sequencing/timing of privatisations which may require a number of years for the stock of divestible assets to be depleted. This calls for a public governance policy for “residual” SOEs, which are expected to face stronger competition from privatised firms and new entrants. Stronger competition is often due to the loss of monopoly power and more stringent, consumer-oriented regulation in the sector/activities where SOEs operate.

In Brazil, residual SOEs are concentrated mainly in the following sectors:

- In the oil sector, Petrobrás is not expected to be privatised, at least in the foreseeable future, but has already lost its monopoly power over production and distribution.
- In the banking sector, a number of state banks are expected to remain under government control. Banco do Brasil and Caixa Econômica Federal are not expected to be privatised in the foreseeable future.
- In public utilities and transport, the timetable for privatisation and concessions varies enormously among subnational governments (states and municipalities), where commitment to reform is not universal.

The key question to be addressed in this case is how public sector reform can foster institutional changes that improve governance in residual SOEs. In other words, how can reform induce private sector-like governance in these public sector corporations? There are two, often complementary, main policy options to address this issue.

First, residual SOEs may be corporatised to ensure an arm’s-length relationship between the public corporate sector and the government. In the private sector, co-operative behaviour on the part of managers can be encouraged by the introduction of incentive contracts (share ownership, stock options, performance-related threat of dismissal, etc.). The introduction of similar contracts in the public sector would emulate private sector

constraints, and provide incentives for managerial prudence. Other ways of improving management in SOEs and the behaviour of the state as owner include: appointing management through open competition; introduction of independent auditing; labour force downsizing/restructuring; imposition of hard budgets; and elimination/reduction of subsidies and soft financing, price controls, transfers, tax exemptions, procurement preferences, and government-guaranteed loans.

The second option is to open the capital of residual SOEs, which is an integral part of the corporatisation process. Minority private shareholding in SOEs, which is rare in transition economies [Pannier (1996)] and in a number of reforming emerging economies, is common in Brazil, where the largest SOEs are mixed-ownership companies, as mentioned above. Although the mixed- or dispersed-ownership arrangement has been praised in recent research,²² there are important limitations to improving corporate governance by opening the capital of residual SOEs. The most important constraints are as follows.

1. Opening the capital of SOEs may fail to boost private sector performance when the state remains a major shareholder. In this case, rather than using the equity composition of the firm as a means of inducing private sector-like corporate governance in the public sector, lax public sector governance practices may be extended to companies of mixed ownership.

The state may remain as the major stockholder in publicly traded SOEs due to the unavailability of private-sector partners to create public-private joint ventures. This is particularly true if the equity stake is too large relative to the private sector's capability for mobilising resources. In shallow and illiquid capital markets, changes in the equity composition of SOEs may require access to vast amounts of capital on short notice, and opening the capital of SOEs may fail to create large investors. Large, low-return, long-maturity investment projects are illustrative of this possibility. If the domestic capital market is not large enough, foreign investors may become important shareholders in listed SOEs. In this case, legal provisions may ban sectors/activities from foreign ownership and investment, which is *per se* an important reason for the existence of residual SOEs, and preventing foreign investors from becoming majority shareholders in these corporations.²³

2. Divestiture may fail to improve corporate governance when it occurs prior to institutional reform and regulation. Divestiture may in this case create opportunities for rent-seeking

²² See Galal *et al.* (1996), for further details.

²³ In Brazil, a number of such restrictions have been abolished (e.g. mining, oil prospection, telecommunications, banking, etc.), which has unleashed new investment opportunities for foreign investors and provided alternative sources of finance for public funds-constrained SOEs.

size of its divestiture programme nonetheless pose additional challenges. Emphasis on sectors such as public utilities and the federal nature of Brazilian divestitures also create further complications in the ongoing programme.

In general, divestiture and public enterprise reform are expected to improve corporate governance in two ways. First, a change in the ownership structure of the economy in favour of the private sector encourages productivity-enhancing management practices based on profit-maximisation and market-driven allocation of resources. Second, increased competition in product markets and better design of institutions ensure that managers are exposed to pressure from owners, shareholders and creditors. In the case of public utilities, the need for designing and reforming institutions, particularly in the area of regulation, is expected to be a major task as far as corporate governance is concerned.

Because privatisation and public enterprise reform are an integral part of overall macroeconomic reform, it is sometimes difficult to disentangle the impact of divestiture on corporate governance and financial decision-making in the corporate sector, from that of the consolidation of macroeconomic stability. Nevertheless, the developments in Brazilian corporate financing in recent years already show a trend in favour of financial deepening and improved corporate governance. In a more stable macroeconomic environment, improvements in corporate governance are expected to take place at a faster pace. Access to foreign capital markets and further consolidation of the country's trade and investment liberalisation programmes will provide a further impetus to the rapid development of Brazilian financial and corporate institutions. It is nevertheless important to note that divestiture alone may be insufficient to improve corporate governance in Brazil. Better regulation in product markets, upgrading of capital market legislation, and protection of minority shareholder rights are additional important conditions for divestiture to improve Brazil's corporate governance system.

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