

COPYRIGHT NOTICE:

**Edited by Merritt B. Fox & Michael A. Heller:**

**Corporate Governance Lessons from Transition Economy Reforms**

is published by Princeton University Press and copyrighted, © 2006, by Princeton University Press. All rights reserved. No part of this book may be reproduced in any form by any electronic or mechanical means (including photocopying, recording, or information storage and retrieval) without permission in writing from the publisher, except for reading and browsing via the World Wide Web. Users are not permitted to mount this file on any network servers.

Follow links Class Use and other Permissions. For more information, send email to: [permissions@pupress.princeton.edu](mailto:permissions@pupress.princeton.edu)

## What Is Good Corporate Governance?

*Merritt B. Fox and Michael A. Heller*

THIS BOOK draws on a rich array of deviant corporate behavior from economies in transition to craft lessons for corporate governance theory. The very first lesson from transition is that standard corporate law theory needs a better definition of good corporate governance. Theorists have long used the term freely, but rarely explained just what they mean. We define corporate governance by looking to the economic functions of the firm. On the basis of this definition, we develop a typology that comprehensively shows all the channels through which bad corporate governance can inflict damage on a country's real economy. Many of these channels are far more visible when approached from the transition angle, but they are present in rich economies, just harder to spot. This definition helps unify such seemingly diverse experiences as Miwa and Ramseyer's nineteenth-century Japanese case in chapter 6 and Coffee's modern Czech example in chapter 7.

In developing our definition, we use the Russian experience in the first post-Soviet decade for our primary case, in part because it exhibits such a rich array of deviant corporate behavior. Overall, Russian industry performed poorly after privatization. The voluminous literature on transition economies explains this poor performance primarily in terms of continued bureaucratic meddling, poor macroeconomic and tax policy, and low human capital; problems in corporate governance often are mentioned as well but little analyzed.<sup>1</sup>

After the fall of Russian communism, state enterprises were privatized rapidly, stock markets created, and a corporate legal code adopted. However, even at its peak, before the 1998 collapse, the total stock market capitalization of Russia's two hundred largest companies only reached about \$130 billion<sup>2</sup>—less than that of Intel Corporation. In early 1999 the numbers were “phenomenally abysmal; if they could sink any further, shares would literally have a value of zero. As it is, the entire market is made up of penny stocks.”<sup>3</sup> These numbers represent a trivial fraction of the apparent value of the underlying corporate assets controlled by Russian corporations.<sup>4</sup> The low prices reflect severe corporate governance problems, including the high probability that the

firms' underlying assets will be mismanaged grossly and that whatever cash flow is produced will be diverted to benefit insiders or reinvested in unproductive projects, as Black, Kraakman, and Tarassova discuss in chapter 4.<sup>5</sup> What were the consequences of these corporate governance problems for the real economy in Russia?

To answer this question, we define corporate governance in a way that looks to the economic functions of the firm rather than to any particular set of national corporate laws. Firms exhibit good corporate governance when they both maximize the firm's residuals<sup>6</sup>—the wealth generated by real operations of the firm—and, in the case of investor-owned firms, distribute the wealth so generated to shareholders in a pro rata fashion. Bad corporate governance is just the failure of a firm to meet one or both of these conditions. Whether managers operate their firms in ways that meet these conditions depends on the structure of constraints and incentives in which they operate, a structure that depends in part, but only in part, on the prevailing legal system—a point that Rapaczynski develops further in chapter 5. In this chapter, we give more precision to the idea of “bad” corporate governance by developing a novel typology of the kinds of damage to the real economy that loosely constrained and poorly incentivized managers can inflict. By canvassing a rich array of deviant behavior, we identify why this damage has been particularly severe in Russia.

Our analysis is not confined to the Russian experience alone; rather, it provokes rethinking of corporate governance theory more generally. For the first time and in a comprehensive way, we link poor corporate governance to real economy effects. We create an analytic tool that identifies the complete set of vulnerabilities to corporate governance problems that may arise in any economy and that helps to generate more tailored policy responses than previously possible. To skip ahead, the chapter works toward table 1.1, which summarizes the complete framework of corporate governance pathologies. We will arrive there by defining what counts as good corporate governance, and then by drilling down to each of the ways that governance can go wrong.

## A TYPOLOGY OF CORPORATE GOVERNANCE FAILURES

### *A. A Simple Definition*

Commentators on transition economies invariably discuss the consequences of “poor corporate governance” but without specifying what that means. What little commentary does exist tends to focus on some idealized set of corporate law rules.<sup>7</sup> In contrast, we measure the quality of corporate governance in terms of the social welfare impact of firm

TABLE 1.1  
 Framework of Corporate Governance Pathologies

<i>I. Nonmaximization of residuals</i>	
<i>Pathology 1:</i> Unreformable value-destroying firms fail to close	Arises when an unreformable value-destroying firm can dissipate cash reserves or salvageable assets. Corporate governance is not the key issue when firm has no reserves or salvageable assets, or when subsidies or unsuitable credits are present.
<i>Pathology 2:</i> Viable firms fail to use existing capacity efficiently	Arises when continued firm operation, if undertaken as efficiently as possible and without new investment, would be a positive net present value (NPV) decision, but costs are not minimized, the best price is not obtained for given output, or a non-profit-maximizing output level is chosen.
<i>Pathology 3:</i> Firms misinvest internally generated cash flows	Arises when a firm uses internally generated cash flow to invest in new negative NPV projects instead of paying out this cash flow to shareholders who could invest the funds better elsewhere in the economy.
<i>Pathology 4:</i> Firms fail to implement positive NPV projects	Arises when a firm identifies but then fails to act on positive NPV projects. Managers tend to be risk averse because they can't diversify away unsystematic risk of a firm's project. If others do not pick up the opportunity, the firm's failure also reduces social welfare.
<i>Pathology 5:</i> Firms fail to identify positive NPV projects	Arises when a firm's managers fail to identify positive NPV projects that the firm is particularly well positioned to find. The possibility of venture financing and spinoffs can reduce the prevalence and social costs of this pathology.
<i>II. Non-pro rata distributions</i>	
<i>Pathology 6:</i> Firms fail to prevent diversion of claims	Arises when some residual owners of a firm manipulate corporate, bankruptcy, and other laws to shift ownership away from other residual owners—often by diluting shares held by outside minority shareholders.
<i>Pathology 7:</i> Firms fail to prevent diversion of assets	Arises when some residual owners privately appropriate assets and opportunities belonging to the firm, but leave the firm's formal ownership structure intact.

decision making. We make no prejudgments about which institutional arrangements work best in any particular country. Indeed, Pistor's and Mahoney's work, in chapters 2 and 3, suggests the challenges of such an enterprise. Under our definition, good corporate governance requires two things: (1) managers must maximize their firm's residuals; and (2) firms, at least investor-owned firms, must distribute those residuals on a pro rata basis to shareholders. Let us consider each element in turn.

The first key feature of a well-governed firm is that its managers make decisions that seek to maximize the residuals that the firm generates over time, discounted to present value. Residuals are defined as the difference between what a firm pays at contractually predetermined prices to obtain its inputs and what it receives for its output.<sup>8</sup> We define this criterion in terms of residual maximization rather than share value maximization to avoid foreclosing the possibility that labor- or consumer-owned firms may be optimal in certain situations.<sup>9</sup> In an ordinary investor-owned corporation, however, the residuals go to shareholders who provide the firm's equity-based capital, which is the only input not obtained at contractually predetermined prices. Thus, for such a firm, maximizing share value is equivalent to maximizing residuals.<sup>10</sup>

The conclusion that it is socially desirable for a firm to maximize its residuals flows from two assumptions, both of which are standard in simple models of the corporation: (1) that the firm purchases its inputs and sells its outputs in competitive markets, and (2) that there are no important externalities or subsidies. Thus, the contractually predetermined prices the firm pays for its inputs (other than its equity-based capital) are equal to the value of what the firm takes from society; similarly, the firm's selling prices for its output equals the value of what it gives to society. Maximizing the difference in value between inputs and outputs maximizes the firm's contribution to society and hence constitutes efficient behavior.<sup>11</sup>

In the case of an ordinary investor-owned firm, the second feature of good governance is that the residuals are distributed to shareholders and in a pro rata fashion.<sup>12</sup> Meeting this second condition is not strictly necessary for one-period, static efficiency. For a single period, all that is necessary is that the residuals be maximized, regardless of who receives them. The pro rata distribution condition is helpful, however, in achieving the efficient allocation of resources over time because pro rata distribution greatly increases the ability of firms to raise capital by issuing new equity.

For a firm to raise capital by selling equity at a price worthwhile to its owners, a firm needs credibly to promise to abide by both principles of good corporate governance—striving to maximize its future residuals and guaranteeing shareholders some determinable proportion of these

residuals as dividends or other distributions. The expectation of eventually receiving such distributions is what makes worthwhile holding a share as a financial instrument and what induces outsiders to provide cash in return for shares. A firm gains credibility in several ways: by developing a record of abiding by its promises, by being subject to a binding legal system, and by structuring incentives so that managers gain if they fulfill their promises and suffer if they do not. If a firm acts contrary to its promises, it undermines its own record and becomes less able to acquire new equity financing.<sup>13</sup> Note, also, that when a legal system fails to punish such a firm, an individual firm's decision to break its promises imposes externalities: investors become generally less willing to buy equity of other firms governed by the same legal system. In other words, weak corporate governance in existing firms poisons the well for new firms that hope to use equity markets.<sup>14</sup>

Defective corporate governance means that a firm does not meet one or both elements of our definition. Most attention in reports on transition economies has focused on problems relating to non-pro rata distributions: for example, when insiders dilute shares of outsiders, loot companies, fail to pay dividends, or engage in other tactics that deprive outside shareholders of their pro rata share of the wealth generated by the firm.<sup>15</sup> Black, Kraakman, and Tarassova, later in this volume, develop a rich portrait of such non-pro rata behaviors. Non-pro rata distributions indeed do help explain low stock prices and the poor performance of the corporate sector. But failure to maximize residuals has the same effect, indeed even more directly. The vast transition economy literature never makes clear which failure dominates in any particular enterprise fiasco. Instead, bad corporate governance becomes a catchall explanation for problems that should be understood as being quite distinct.<sup>16</sup> Pinning down and separating out these distinctions should prove helpful when it comes time to prescribe policy cures.

A cautionary methodological note is in order at the outset, however. The study of corporate governance in Russia is hampered by two problems. First, serious firm-level econometric study of corporate governance changes in Russia is difficult, if not impossible, because meaningful hard data on enterprise behavior are hard to come by. Firms did not publish credible accounts of their own performance, because managers hid their ongoing thefts of firm assets from outside shareholders and from others, including labor and the mafia, who likewise sought to steal those assets themselves.<sup>17</sup> Back-tax debts, which pervaded the corporate sector, meant that any reported income might be seized, making the effective tax rate 100 percent.<sup>18</sup> Thus, most income statements and balance sheets were fictional. Perhaps surprisingly, Miwa and Ramseier, in chapter 6, are able to collect more robust corporate data on

nineteenth-century Japan than seems available for twenty-first-century Russia. Second, econometric work testing propositions about corporate governance based on country-level comparisons of economic performance is similarly difficult, as evidenced by Pistor's and Mahoney's work. Good corporate governance is neither a necessary nor a sufficient condition for achieving a developed capitalist economy—it simply helps. Italy, for example, has a vibrant economy even though the governance of its corporations generally would fall far short of the standards set out here.<sup>19</sup> Russia, in contrast, likely would have continued to languish economically absent a solution for some of its other pressing problems even if its firms all fully met these standards. The sample size of countries is small relative to all the other factors that affect national economic performance.

These two problems mean that we are left with anecdotal accounts and surveys as our main sources of empirical information. These sources involve their own biases; nevertheless, they present a reasonably coherent picture of the landscape of corporate governance failures. Imposing a theoretical framework on this picture yields a plausible and informative account of the relationship between corporate governance and national economic performance.

### *B. The Failure to Maximize Residuals*

In this section, we identify five distinct pathologies that loosely constrained and poorly incentivized managers may inflict on firms and that may result in the firms' failure to maximize residuals.<sup>20</sup> We focus first on this prong of bad corporate governance because it is crucial to explaining why insiders sometimes do not operate their firm even to maximize their own joint benefit, a puzzle we take up in part III. As we shall see, the initial structure of ownership makes Russian firms particularly vulnerable to these five corporate governance pathologies. When the initial ownership structures intersect with untenable firm boundaries, the pathologies we identify here become self-reinforcing and even more intractable.

#### 1. PATHOLOGY 1: CONTINUED OPERATION OF VALUE-DESTROYING FIRMS

Any economy has some unreformable value-destroying firms that should be shut down immediately.<sup>21</sup> Continued operation of these firms, even if undertaken as efficiently as possible, represents a negative net present value decision from a social point of view: The cost of operation in the current period results in a social loss too great to be offset by social gains, if there are any, from continued operation in subsequent periods.<sup>22</sup> Despite the social harm, institutional arrangements in

an economy nevertheless may permit such a firm to continue operating. For example, in Russia the Tutayev Engine Factory continued to operate despite the plant manager's estimate that "it costs the plant about 1.33 rubles to produce about 1 ruble in output."<sup>23</sup> In the case of many unreformable value-destroying firms, poor corporate governance is the main cause of their continued operation, and hence the reason for identifying this problem as the first type of potential corporate governance pathology. Firm managers wish to continue operations in order to hold on to their jobs and the associated perquisites.<sup>24</sup> Because they are not constrained by effective corporate governance mechanisms, the managers get their way. In other cases, however, good corporate governance is not necessary to shut down a firm that in fact should be closed. And in yet other cases, good corporate governance is a necessary but not a sufficient condition to close the firm. Making these distinctions is important for identifying effective policy responses.

*a. When Is Corporate Governance Relevant?* Retain the assumption for a moment that an unreformable value-destroying firm purchases inputs and sells outputs in competitive markets; that there are no important externalities; and that credit and other finance is extended to firms only on a reasonably informed, rational basis. Even with no new investment, such a firm's ordinary operations result, in the current period, in a negative cash flow (one that is sufficiently negative that expected future cash flow, discounted to present value, would, even if positive, be unable to offset it). The firm thus would lack enough current cash flow to purchase the inputs it needs to continue production and would lack cash flows in the future to use as a basis to obtain credit or other finance sufficient to cover this deficit.

The importance of corporate governance here depends entirely on whether the firm has any cash reserves or assets with significant salvage value. Without reserves or salvageable assets, the firm would be forced to close immediately, regardless of how much its managers wanted to continue operations, and regardless of how ineffective existing corporate governance mechanisms were in restraining the managers. Russia's generally outmoded factories suggest that many firms lacked assets with any significant salvage value.<sup>25</sup> There was also a general cash shortage.<sup>26</sup> Thus, absent subsidies and problems in the way credit is extended, many firms whose continued operation was value destroying would have shut down promptly even though the corporate governance regime was highly ineffective. Neither improved corporate governance nor an effective bankruptcy regime would have been necessary to eliminate such firms.<sup>27</sup>

For firms with reserves or salvageable assets, however, effective corporate governance is necessary to shut down the firm immediately. Even

if the legal regime reflects a sound model, there is still the problem of enforcement, as Pistor shows in chapter 2. With weak enforcement, managers can indulge their desires to continue operation. Where cash reserves are available, the cash can be used directly to buy the needed inputs. Where the firm has salvageable assets, cash can be raised by selling the assets or using them as a basis for gaining credit. Many value-destroying Russian firms did have assets with significant salvage value.<sup>28</sup> Manufacturing businesses, for example, often were located inside large cities on real estate with far more value in other uses. If a firm has a negative cash flow, its managers nevertheless may be able to keep operating by cashing out the salvage value of these assets to acquire needed inputs. Even with a positive cash flow, closing the firm may be socially desirable once the rental value of the land is counted properly as an opportunity cost.<sup>29</sup>

*b. The Role of Subsidies and Inappropriate Credit and Finance.* Now, drop the assumptions made above concerning subsidies, credit, and finance. Where there is a subsidy, or where credit or finance is extended on other than a reasonably informed and rational basis, a firm can have a positive cash flow even though the social benefit from the firm's output might be less than the social cost of its inputs. Under such circumstances, the firm's continued operation, even though involving a social loss, can be perfectly consistent with maximizing residuals. Corporate governance mechanisms that push a firm's managers to maximize residuals will not lead by themselves to the socially desirable result of closing down these firms. Indeed, for firms without reserves or salvageable assets, the quality of corporate governance is not even relevant. Such firms will be shut down, regardless of the quality of corporate governance, only if the subsidies or inappropriate credit provision is ended.<sup>30</sup>

Russia continued to provide many subsidies, particularly in the energy area.<sup>31</sup> The system by which input suppliers were paid, often involving barter, was highly chaotic, implying that credit was not extended in a rational, well-informed fashion.<sup>32</sup> Workers often became involuntary creditors when firms did not pay them.<sup>33</sup> All this suggests that, while many Russian firms that were continuing to operate should have been shut down immediately, improved corporate governance would not, or would not by itself, have solved the problem. Instead, elimination of subsidies and improvement of the credit process were necessary reforms.

In sum, Russian firms that should have been shut down immediately fall into three groups. The first consists of firms with no cash reserves or assets with significant salvage value that did not benefit from subsidies or unsuitable credit extensions. These firms were presumably closing on their own, no matter how bad their corporate governance mech-









































