BSM906
Economic Environment of Business

Lecture 3
Laws, rules and regulations

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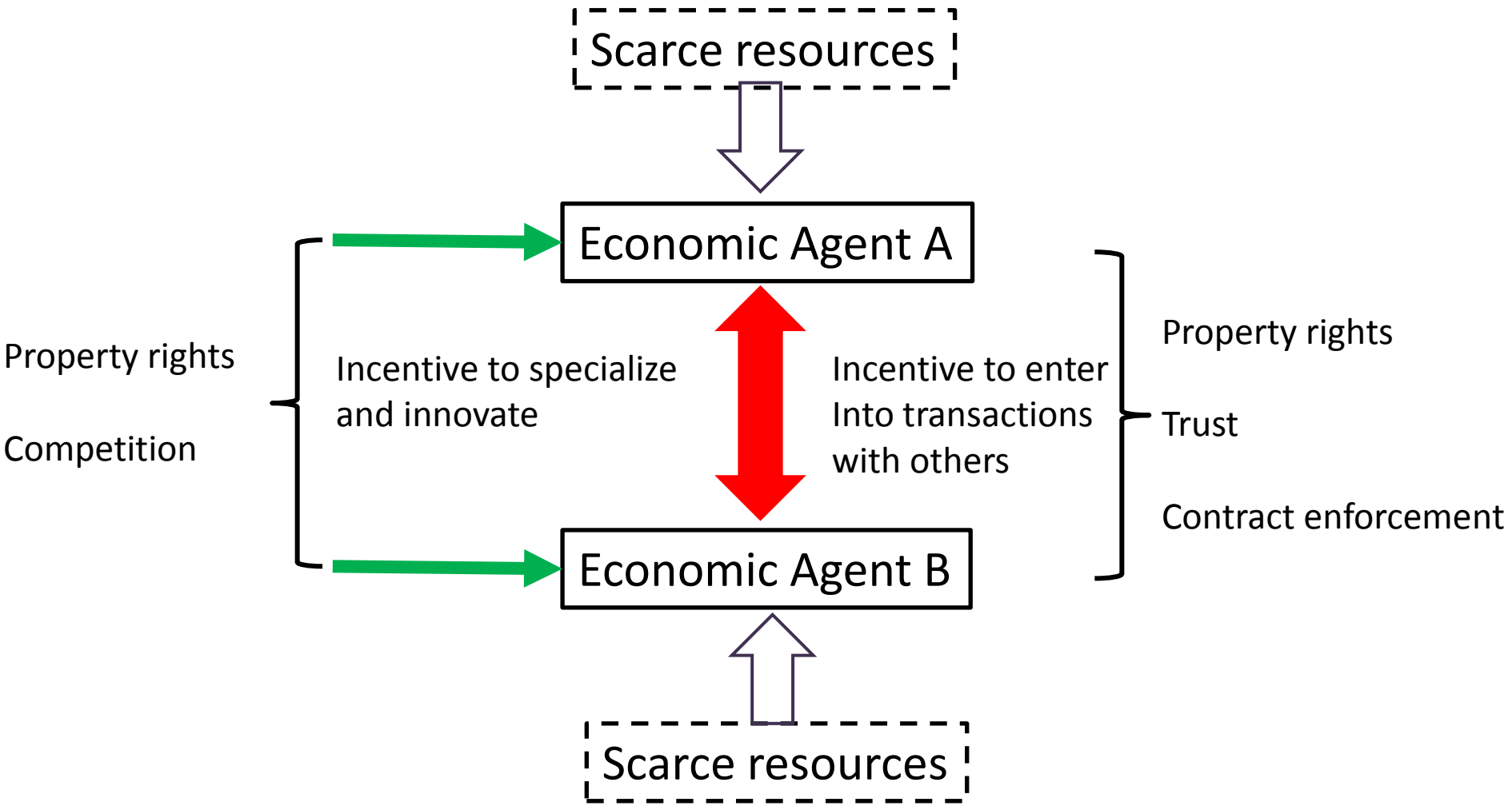
Transactions
The need for laws, rules and regulations



Rule of law
Key elements of a legal structure

Coase theorem:

"[I]f rights are transferable and if transactions costs are not too large, then the exact definition of property rights is not important because parties can trade rights and they will move to their highest value uses."

- Property law
  - Define property rights
- Contract law
  - Given the presence of transactions cost, well defined property rights may not be *sufficient* to redistribute assets to their highest value uses
  - Facilitate transfer of property
- Tort and criminal law
  - Protect property rights

Rule of law
The importance of property rights

- Less investment in wealth creation on account of uncertainty
- Greater investment in easily protected assets such as gold that are unproductive
- Greater investment in unproductive activities to become predators and/or to prevent predators from expropriating wealth

Bottom line:

Since capital and (skilled) labour are mobile internationally, differences in endowment of physical capital and human capital is not sufficient to explain persistent differences in growth across countries. The explanation therefore has to lie in differences in institutional quality, viz., definition and enforcement of property rights.

Rule of law
Enforcement of property rights

- Problem
  - "Hold ups" after contracts have been negotiated, especially if there is significant asset specificity

- Mechanisms to overcome hold up problem
  - Creation of reputation (unilateral; costly)
  - Self-enforcing mechanisms (e.g., collateral, bilateral "hostages")
  - Third-party arbitration (multilateral; based on formal laws as well as informal rules)

Enforcement of property rights
Norms or informal rules

Definition:

"A norm can be understood as a rule that distinguishes between desirable and undesirable behaviour and gives a third party the authority to punish a person who engages in the undesirable behaviour." (Posner 1995)

- Are norms created by closely-knit groups of efficient people efficient, so long as they do not produce negative externalities?

- Should courts of law enforce the norms of social groups that are apparently efficient, or should they insist on formal contracting?

Enforcement of property rights
Moving from norms to formal laws

- In principle, everyone in a small and cohesive group would internalise the cost of an inefficient norm, and hence such a norm would disappear. But norms, by definition, evolve over time and are not chosen

- Since norms evolve over time, they implicitly use the information content of past norms. This is an efficient or low cost basis for providing an environment for contracting. But we do not know whether the new norms created on the basis of evolution are efficient

- Problems:
  - Inability to identify costs associated with inefficient norms might lead to persistence of such norms even when the contracting needs change
  - Efficient norms require collective action that might have to be brought about by norm enforcers, but their cost of information might be high
  - Negative externalities (e.g., gang loyalty)

Moving from norms to formal laws
How do states eliminate inefficient norms?

- Identification
  - Extensive bargaining
  - Rapid economic or technological change
  - Highly unequal endowment of group members
  - Greater economies of scale of state in gathering information about potential inefficiencies

- Action
  - Providing incentives to break the norm
  - Norm transformation through education, rewards and penalties
  - Enforce property rights that enable individuals to enter into contracts that bypass the inefficient norms

Replacing norms with formalities
Are statutes embedded in *civil law* inefficient?

- Legislators create statutes that are supported by interest groups. These groups have the incentive to lobby because their gains from the statutes exceed the cost of lobbying. For individual voters, the cost of opposing the lobby is higher than the cost of the statutes. Statutes therefore represent a strong equilibrium but are inefficient

- Even if legislators start out with public interest at heart, given the incentive structures of the various parties, over time this inefficient equilibrium would necessarily occur

- Evidence suggests that statutes do not serve public policy interests. Instead, they often result in transfer of wealth and power to individuals and companies by protecting them from competition

Replacing norms with formalities
Are ***common law*** doctrines efficient?

- Since judges enjoy more freedom than legislators, they might well be moved more by efficiency considerations than by the distributive effect of their decisions. But is this consistent with maximisation of their own welfare?

- Even though most disputes are settled rather than litigated, inefficient laws are more likely to be litigated because they create asymmetries whereby the gain of one party is <u>less</u> than the loss of the other party, such that the former can never fully compensate the latter

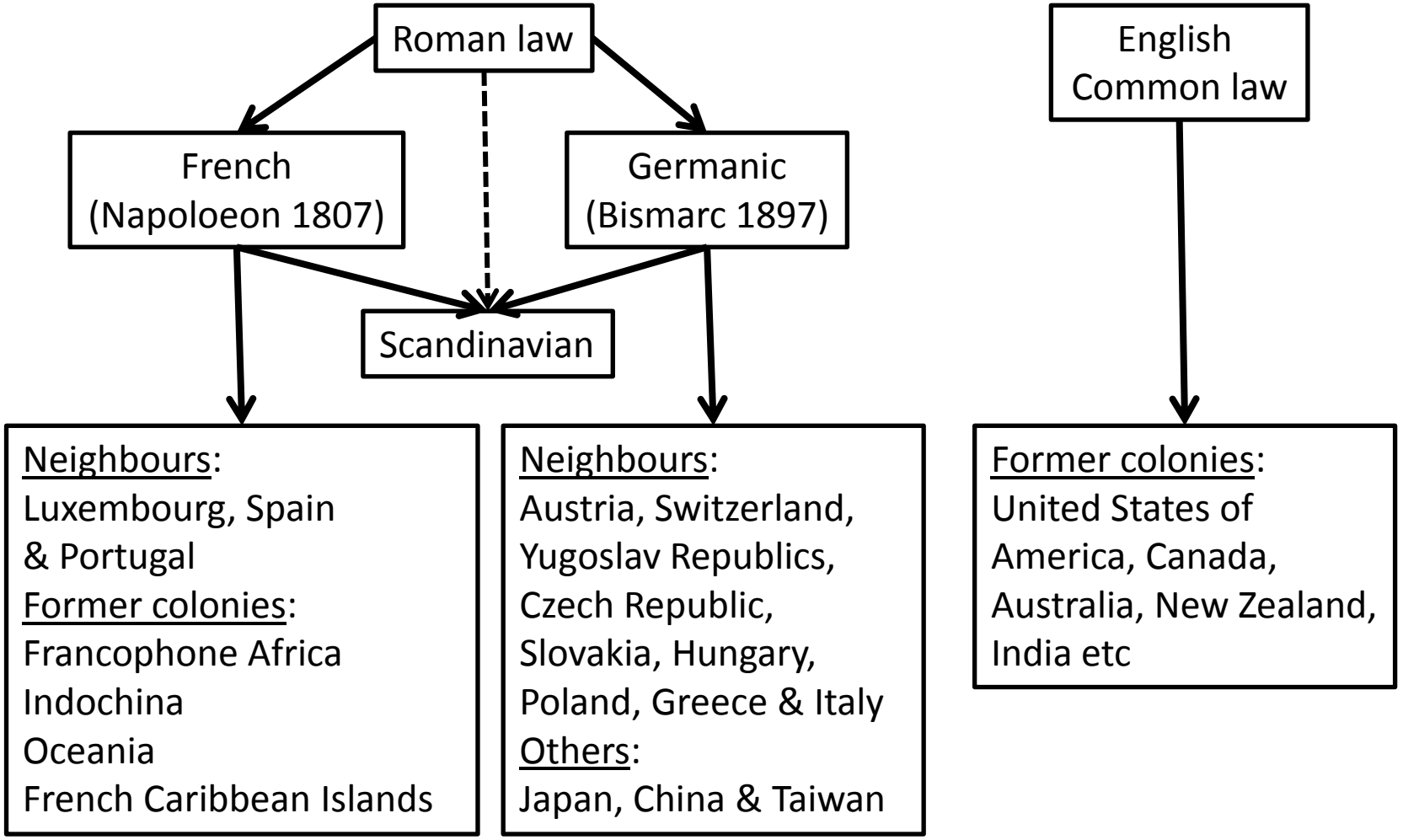
- Arguably, if a common law rule is inefficient, people will litigate against it, and over time such rules will be changed. Ultimately, therefore, the more efficient rules will survive. But since every rule creates winners and losers, why should the winners of inefficient rules not litigate to protect them?

- Apparently, common law doctrines protect property rights and enforce voluntary agreements among contracting parties. But is this an assumption as well?

Does legal origin matter?
Some questions

- Why does Germany have a relatively small stock market but large and powerful banks?
- Why do companies not go public in some countries?
- Why is ownership more concentrated in come countries than in others?
- Why is voting premium higher in some countries than in others?
- Why were post-privatisation shares of Russian companies not high valued, and why did these companies not get access to external finance?

Does legal origin matter?
Legal families



Does legal origin matter?
Legal protection of shareholders' rights

- Dimensions of shareholder rights
  - Relationship between cash flow rights and voting rights (one share-one vote)
  - Ability to vote by mail
  - Requirement to deposit shares with company or financial intermediary before shareholder meeting
  - Mechanisms such as proportional representation on board that favour minority shareholders
  - Right to challenge decisions of directors in court
  - Pre-emptive right for existing shareholders to purchase new issues of shares
  - Percentage of share capital required to call an extraordinary shareholders' meeting

- Common law countries provide much greater shareholder rights than those governed by laws of French, German and Scandinavian origin; the remedial measure in French law countries is mandatory dividend

Does legal origin matter?
Legal protection of creditors' rights

- Dimensions of creditors' rights
  - Seniority of secured creditors
  - Automatic stay imposed on company's assets by the reorganisation procedure, such that secured creditors cannot possess loan collateral
  - Ability of management to pre-empt possession of loan collateral by initiating reorganisation (Chapter 11)
  - Replacement of incumbent management by third parties to manage reorganisation

- Common law countries provide strongest protection to creditors, providing managers limited court protection against creditors (USA is an anomaly)

- German and Scandinavian laws also provide a fair amount of protection, and French law provides the weakest protection for creditors' rights

Does legal origin matter?

What we know

- Shareholders' and creditors' rights are protected to different degrees across countries
- The nature and extent of protection is influenced by legal origin

Implications

- Can you now answer the questions posed in slide #11?

Rethinking rules and regulations
Role of politics

- Players
  - Controlling shareholders
  - Non-controlling shareholders
  - Employees

- Role of politics

  Case 1: *Political system favours coalitions* – coalition between controlling shareholders and employees leading to low shareholder protection and high employee protection (Continental Europe and Japan)

  Case 2: *Political system does not favour coalitions* – high shareholder protection and low employee protection (Anglo-Saxon countries)

- Observationally, the divide between corporatist and non-corporatist countries roughly match the divide between (French) civil law and common law countries

- Dynamics of political arrangements
  - Since low shareholder protection deters access to external finance, new start ups would lobby for better shareholder protection, unlike incumbent firms

Rethinking rules and regulations
Role of politics – examples

	Corporate finance	Banking	Security markets
Regulation	1. Protection of minority shareholders 2. Co-determination 3. Takeover restrictions	1. Branching restrictions 2. Bank supervision 3. Bankruptcy code 4. Deposit insurance	1. Insider trading code 2. Information disclosure for public companies 3. Opening to foreign competition
Specific interventions	1. Takeover prevention 2. Privatisation	1. Individual bank bailouts or closures 2. Individual company bailouts	1. Enforcement of securities market interventions

Source: Volpin and Pagano, Oxford Review of Economic Policy, 2001l; Table 1

Rethinking rules and regulations
Role of politics – specifics

- Mergers and acquisitions
  - Managers and employees natural coalition partners, with both opposed to takeovers; hence takeover code should be restrictive in corporatist countries
  - If control rights of managers exceed their cash flow right significantly, the “poison pill” used as defence against takeovers may be generous long-term labour contracts

- Bank branching
  - Branching deregulation in the USA: (a) permission to own multiple but separate banks; (b) permission to branch by M&A; (c) permission for state-wide branching
  - Since losers for deregulation are largely small banks, deregulation occurred earlier in states with large banks and small bank-dependent firms

- Insider trading
  - In the absence of regulations to prevent insider trading, equity has to be sold at a discount and cost of capital is high
  - Legal deterrents to insider trading might not be strong in many countries because incumbent firms that have already raised most of the capital they need and can rely on internal funds may not have an interest in promoting tough anti-insider trading laws

Where does that leave us?

- Norms may not be an efficient way to enforce contracts; formal laws or rules may be required
- Nature of these rules and laws may be historically determined; and there is significant path dependence
- In general, common law countries provides a more business-supporting legal environment (e.g., better shareholder and creditor protection) than civil law countries
- Legal origin may have significant impact on corporate finance, ownership structures , etc
- But politics – embodied in lobbying and coalition formation by groups with divergent interests – also has impact on the legal or regulatory environment