Corporate ownership may be a more important issue in developing countries than corporate governance.

Wall Street in the Third World?

By Robert E. Anderson

Experts from developed countries often give advice to developing countries about the policies, laws, and institutions that are needed to promote economic development. A frequent problem with their advice, however, is that the experts only recommend what they know, namely, what exists in their own countries.

For example, experts from the United States or the European Union will usually recommend the laws and policies that exist in those countries. The experts often fail to take into account the weaker legal and political institutions in developing countries. That is true even for international institutions like the World Bank.

The advice on corporate governance presented in the previous article by Troy Paredes is a refreshing change from that offered by most other experts. He explicitly takes into account the weaknesses in the institutions needed to implement alternative models of corporate governance and the difficulty in strengthening those institutions. Consequently, he concludes that the U.S. market-oriented model is often inappropriate for developing countries, and he proposes alternatives.

Though Paredes takes into account institutional weaknesses in his discussion of corporate governance, he fails to do so in his brief discussion of corporate ownership. He does not automatically assume that the U.S. model of corporate governance is best for developing countries, but his analysis seems to assume that the U.S. model of corporate ownership is best or will soon be common in developing countries.

The U.S. model of corporate ownership creates a serious problem because the many small, dispersed shareholders have difficulty controlling company managers. It is rare for the largest shareholder in large U.S. firms to own more than a small percentage of the outstanding shares. Consequently, managers have less incentive to reduce costs and maximize profits, and they may divert profits to themselves in the form of higher salaries and fringe benefits. It is not surprising that top executives in U.S. firms are paid much more than in almost any other country.

Because the U.S. model of corporate ownership is much less common in other countries, the U.S. problem of corporate governance is not important in those countries. Firms outside the United States typically have large shareholders who have both the incentive and the ability to control the managers.

An unspoken assumption in much of the analysis of corporate governance, financial markets, and stock market regulation by U.S. experts seems to be that the model of corporate ownership in the United States is a natural result of, or even a requirement to achieve, economic development. Because this model exists in the most developed economy, it must be superior to that in less developed economies. As the economies of other countries develop, it is assumed that they too will naturally adopt the superior U.S. model of corporate ownership.

The U.S. model, however, is not a natural outgrowth of economic development, but instead was largely determined by politics, law, and regulation. For example, Mark J. Roe of Columbia University argues that it is the result of populist fears of concentrated economic power, pressure from various special interest groups, and the federalist political system.

It is not surprising that corporate governance has primarily been a problem in the United States. Concern about this dates back at least to 1932 when Adolf Berle and Gardiner Means observed that large companies are primarily controlled by a new class of professional managers because ownership is dispersed among thousands of shareholders, each of whom owns only a small fraction of the shares.

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The U.S. model of dispersed corporate ownership is not a requirement for economic development as evidenced by the fact that it is uncommon in many other developed countries. For example, in the 372 large, publicly traded companies in Germany as of 1999, the median size of the largest voting block of shares totaled more than 50 percent of all outstanding shares. In other words, in a typical large company listed on the stock exchange in Germany, a single shareholder or group of connected shareholders owns about half of all the shares. The percentage owned by the largest shareholder is probably much higher in smaller companies or those not listed on a stock exchange, though exact numbers are not available because such companies do not have to report their ownership publicly. Germany is noted for its "Mittlestand" of moderate-sized companies that are usually family-owned or closely held by a small number of investors.

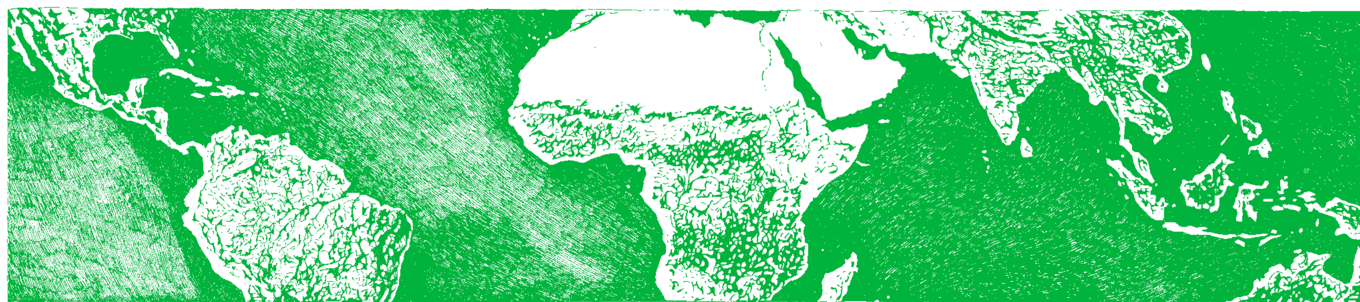
In Belgium, Italy, and Australia, company ownership is similar to that in Germany. The size of the largest shareholder is somewhat smaller in France or Spain but still the median size of the largest voting block is more than 20 percent for public companies. The United Kingdom is one of the few countries where company ownership is similar to that in the United States, resulting in what some have called the Anglo-Saxon model of company ownership.

Dispersed corporate ownership is even less common in developing countries. If dispersed ownership is defined to mean that no shareholder owns more than 20 percent of the company, then the number of such companies is restricted to just a small fraction of the largest publicly traded companies in most developing countries. In Mexico and Argentina, none of the 20 largest public companies had dispersed ownership by this definition in 1999. In Indonesia, Thailand, and Malaysia, less than 10 percent of the publicly traded companies had dispersed ownership. In the Philippines, the number of public companies with dispersed ownership increases to 20 percent, perhaps because of past U.S. influence. The vast majority of other companies in those countries are not listed on a stock exchange, and thus their ownership, as in Germany, is closely held by a family or small group of investors. Though data do not seem to be available, I suspect that the proportion of companies with dispersed ownership is even less in most other developing countries.

Having a dominant or controlling shareholder, however, is not a panacea for corporate governance. A second type of corporate governance problem can result if a company has a large controlling shareholder combined with many small shareholders who may have little ability to control the large shareholder. The large shareholder will make certain that the managers maximize profits, but may divert those profits unfairly to himself (for example, through transactions with affiliated companies) at the expense of the small shareholders. This has become a problem in some developing countries for publicly traded companies with a dominant shareholder and many small shareholders.

Though the belief in the superiority of the U.S. model of corporate ownership seems to be widespread in the United States, there is little in the way of arguments or facts to support that belief. The usual argument is that the U.S. model encourages the development of capital markets—most importantly, a large liquid stock market that is believed to be an important source of capital for U.S. companies. In contrast, my view is that a large stock market is a cost—not a benefit—of dispersed company ownership and is not an important source of capital for companies in the aggregate.

It is true that dispersed corporate ownership requires the development of a stock market and its attendant costs. Small shareholders need a public stock market where they can buy and sell small blocks of shares quickly and efficiently to other investors located anywhere in the country or even in the world. Large shareholders, however, usually find such a market of little use. For example, if an investor wishes to sell his 50 percent stake in a company, he is most likely to sell it to another large investor who wishes to take over control of the company and is willing to pay a premium for that control. That will typically be done in a privately negotiated sale and not on the stock exchange. Consequently, in those countries where dispersed company ownership is rare, the size of their stock markets is small relative to the United States or the UK.



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Contrary to popular belief, the stock market is not a major source of capital in the United States and is probably even less important in most other countries. The U.S. stock market is a distant fourth in importance as a source of capital after internally generated funds (retained earnings and depreciation allowances), bank loans, and the sale of corporate bonds. In the United States and the UK (which have the largest stock markets), internally generated funds alone supply about 90 percent of the financing needs of companies.

In the aggregate, the stock market has actually been a net drain on the supply of capital for U.S. companies in recent years because of share buybacks. Though some companies do float additional shares on the market to raise capital, other companies for tax reasons use their internally generated funds to buy back their existing shares rather than pay dividends.

Among developing countries, India has one of the largest stock markets. Yet it is estimated that selling new shares accounts for only four to six percent of the funds raised by medium and large Indian firms.

The frantic trading on the New York Stock Exchange is often used to symbolize a capitalist, market economy, but it is only important in the United States because of the peculiar model of corporate ownership that exists here. Unfortunately, developing countries are led to believe that they too should have a large stock exchange in order to develop their economies. I do not object to countries establishing stock exchanges, though I think their importance is exaggerated.

I do object, however, to countries adopting policies that encourage the U.S. model of corporate ownership merely because such policies will result in a larger stock market. That is an example of the tail wagging the dog. The most common way that developing countries do this is through their privatization programs. Perhaps encouraged by investment bankers and stock brokers, countries often sell shares in state-owned companies to many small investors in a share flotation rather than to a large, strategic investor who has the expertise and capital to improve company performance. The government may even sell shares at reduced prices to encourage purchases by small investors. Not surprisingly, there is evidence that privatization through a share flotation results in less improvement in the performance of privatized companies.

The problem with corporate governance found in the United States is not important in most developing countries—and even many developed countries—because most firms are controlled by a few investors. Misguided attempts to encourage dispersed share ownership may result in large stock markets at the expense of poor corporate governance and reduced company performance. R

READINGS

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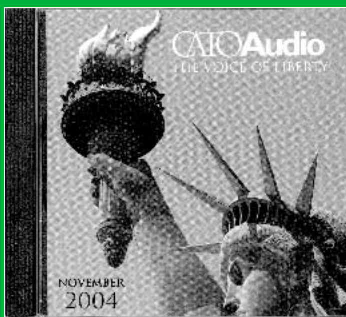

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