

## How Public Governance may Foster Private Corporate Governance?

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## Plan

1. Policies Improving Corporate Governance
2. Theory: ownership concentration
3. Empirical evidence
4. Conclusion: Tax, then Law

## 1. Motivation

Tax **and** Law  
or  
Tax, **then** Law

## Improving Corporate Governance

reduces:

- Required insiders ownership concentration (by outside investors)
- capital rationing
- expands the number of official projects and economic activity.

## Policies

A) Improving investors protection:  
security laws  
the efficiency of the judiciary  
(Schleifer and Wolfenzon (2002)).

B) Fighting against corruption  
within the tax system  
(Desai, Dyck and Zingales (2007))

## Is this true?

Legal System Reform  
Protecting Investors  
Efficient,  
Anywhere,  
Anytime.

## Tax, then Law

Spending in legal system reform  
**including judiciary** system  
inefficient  
(does not increase output)  
in emerging countries  
with weak tax system.

## Tax, then Law

- Investors do not spend monitoring resources.
- Do not need to use the legal system at this stage (but later on)
- Changing the written financial law costless but not credible.
- Tax system efficiency necessary condition for FUNDING the judiciary system reducing Investors monitoring costs.

## 2. Theory

Ownership concentration,  
the decision to monitor or not,  
tax system, legal system quality.

## Costs of corporate Governance

Envelope of the costs of monitoring of all types of monitors:

- banks
- rating agencies
- independent members of boards
- private equity...

Monitoring costs need to be offset by a premium on returns.

## Tax fraud and unofficial economy

Insiders divert funds: twin benefits at the expense of:

- Tax administration
- Outside investors.

Tax fraud means less public funding for public goods:

- Judiciary (with efficiency  $e(J)$ )
- Tax inspection (with efficiency  $e(T)$ ).

## Weak Tax System: No corporate governance

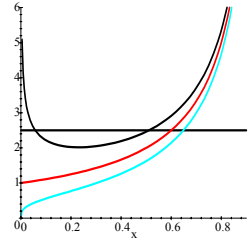
- Incentive Compatibility constraint (diversion in the unofficial economy).
- Minimal co-investment (ownership concentration) by wealthy informed shareholders/family increases when
  - High Tax Fraud
  - High Return from unofficial economy

## Efficient Tax System: Corporate governance

- Second incentive compatibility constraint: so that some uninformed investors DO monitor.
- Costly monitoring increases the weighted average cost of capital for entrepreneurs.
- Only entrepreneurs rationed in the first regime interested in this contract.

## Private decision to monitor firms

- HIGH tax rate threshold function of different efficiency level of public funding
  - in the tax system
  - in the legal system.
- Particular case for low tax rate with private monitoring (cf. tax havens).



## Ownership concentration =

$$a - b (\text{tax system quality}) - c (\text{legal system quality})$$

Two New Tests:

- for weak tax systems:  $c = 0$  (test 1)
- for efficient tax systems:  $b' (=0) < b$  (test 2)

## 3. Empirical evidence

Ownership Concentration,  
Corruption, Law,  
Tax system threshold

## Cross country indicators

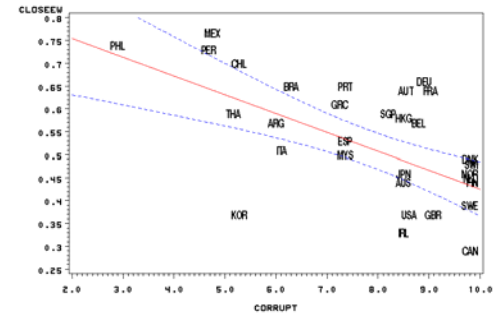
- Ownership concentration (Worldscope 2002) (Stulz (2005))
- Anti director rights (La Porta et al.)
- Expropriation risk (La Porta et al.)
- Public governance indicators (Friedman et al. (2000)): tax, law, corruption, goods market.
- N=31 countries

Step 1: Stulz Adjusted R2=0.45  
... to Step 4: Adjusted R2=0.63

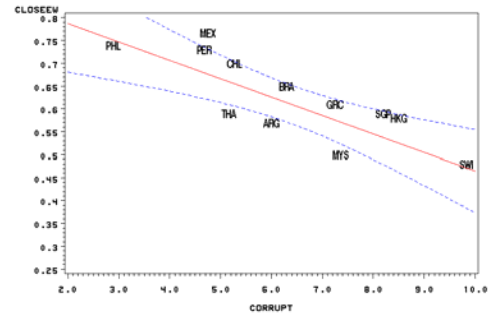
- Ownership Concentration = 1.1
- 0.056 [-0.60] **Less-Exp-Risk-By-Gov** (p=0.001)
  - 0.033 [-0.35] **Anti-Director-Rights** (p=0.016)

Both Policies Efficient in any Country  
No debate on priorities.

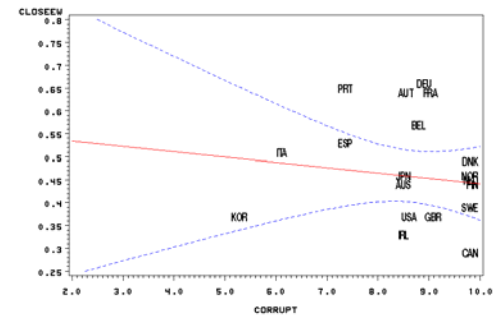
### Ownership Concentration and Corruption: 31 countries



### Ownership Concentration and Corruption: 12 Weak Tax System Countries



### Ownership Concentration and Corruption: 19 Efficient Tax System countries



Test 1: P-Value=0.56

Ownership Concentration = 0.97

- 0.041 LessExpRisk\*(tax<4/5)

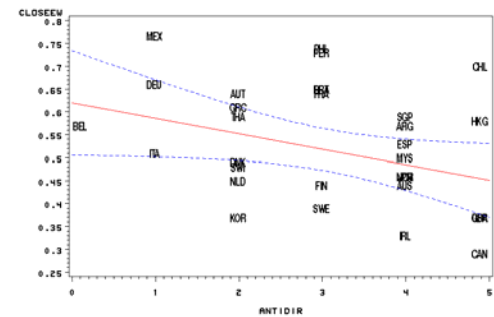
(p=0.041)

- 0.032 LessExpRisk\*(tax≥4/5)

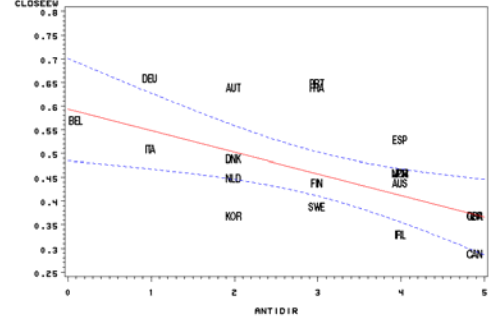
(p=0.56)

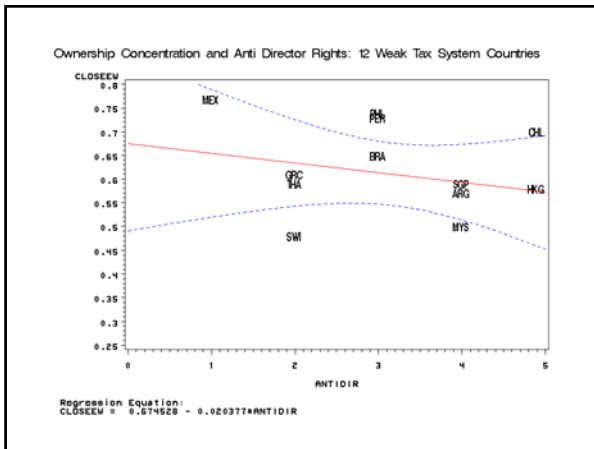
- See next slides

### Ownership Concentration and Anti Director Rights: 31 countries



### Ownership Concentration and Anti Director Rights: 19 Efficient Tax System Countries





Test 2: P-Value=0.41

Ownership Concentration = 0.97

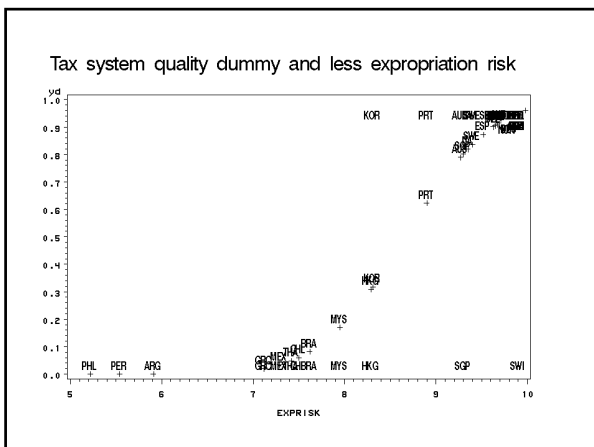
- 0.018 **Anti-Dir\*(tax<4/5)**  
(p=0.41)
- 0.047 **Anti-Dir\*(tax≥4/5)**  
(p=0.005)
- 0.687 (tax≥4/5)  
(p=0.22)
- See former slide

Gains from tax regimes	Ownership Concentration =	
Intercept	1.1	0.86
Less exp. risk by government	-0.056 P=0.001	
<b>Less corrupt * (tax &lt; 4/5)</b>		-0.039 P=0.001
Anti director rights	-0.033 P= <b>0.016</b>	
<b>Anti director rights * (tax ≥ 4/5)</b>		-0.055 P<0.0001
<b>Rule Law Judiciary * (tax ≥ 4/5)</b>		-0.029 P=0.0015
N=31 countries	Adj. R2 = 0.45	Adj. R2 = 0.63

Endogenous selection, Step 1  
 Tax threshold probit

Proba(tax≥4/5) =  
 $F(-1.25 + 0.2 \text{ Less Expropriation Risk})$   
 (p=0.001)

F=Normal cumulative distribution.  
 Beware! Better Quality of Tax System Index **NEGATIVELY** correlated with More Expropriation Risk Index.



Endogenous Selection, Step 2A:  
 inverse Mills ratio for weak tax countries

Ownership Concentration = 0.996

- 0.053 **Less Corruption**  
(p=0.016)
- 0.02 **Inverse Mills Ratio**  
(p=0.41)
- Weak tax system countries N=12
- Adjusted R2=0.57

Endogenous Selection, Step 2B:  
inverse Mills ratio for Efficient Tax Countries

Ownership Concentration = 0.620

- 0.048 Anti Director Rights

( $p=0.016$ )

- 0.08 **Inverse Mills Ratio**

( $p=0.43$ )

Efficient tax system countries  $N=19$

Adjusted  $R^2=0.28$

#### 4. Conclusion

# Tax, then Law

Thank you for your attention!

Step 2C: remove  $p<0.05$  variables  
Adjusted  $R^2=0.51$

Ownership Concentration = 0.97

- 0.041 LessExpRisk\*(**tax<4/5**)

( $p=0.041$ )

- 0.045 Anti-Dir\*(**tax $\geq$ 4/5**)

( $p=0.005$ )

- 0.329 (**tax $\geq$ 4/5**)

( $p=0.045$ )

Step 3: Corruption instead of LessExpR  
Adjusted  $R^2=0.57$

Ownership Concentration = 0.87

- 0.040 **LessCorrupt\***(**tax<4/5**)

( $p=0.004$ )

- 0.045 Anti-Dir\*(**tax $\geq$ 4/5**)

( $p=0.003$ )

- 0.275 (**tax $\geq$ 4/5**)

( $p=0.009$ )

Step 4: Add Judiciary in efficient tax  
system countries. Adjusted  $R^2=0.63$

Ownership Concentration = 0.86

- 0.039 LessCorrupt\*(**tax<4/5**)

( $p=0.001$ )

- 0.055 Anti-Dir\*(**tax $\geq$ 4/5**)

( $p<0.0001$ )

- 0.029 **RuleLaw\***(**tax $\geq$ 4/5**)

( $p=0.0015$ )