

Corporate Governance in listed Brazilian Companies, 1882-1890

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Introduction

Almost at the dawn of the Imperial Brazil (1822-1889), and at the beginning of the Republic (1889-present), three important pieces of legislation were enacted: the 1882 Corporation Law, the 1882 Decree regulating the Law, and the 1890 Decree modifying the Corporation Law. In the two decades 1870 and 1880, there was a period of outstanding development of capital markets and company investments in Brazil, ending in the financial crisis called “Encilhamento”. There was a sentiment at the time that “bad” enforcement of these laws was partially responsible for the crisis. On the other hand, the new laws were praised as progressive and important for the industrial and financial development of the country. This paper intends to explore the contents and practices of corporation legislation, and also, more important, the enforcement of the three pieces of legislation from the view point of corporate governance. In order to proceed with the evaluation, a theoretical framework was developed. In it, five topics were discussed: the making of new laws; the trade-offs between the new “modern” laws and Enforcement; the marginal costs of enforcement; the optimal level of enforcement; and the role of financial innovation and of society preferences for improvements in moral capital. Based on this theoretical framework, the 1882 and 1890 pieces of legislation are evaluated. In this presentation, I want to examine the subject from the standpoint of the Conference theme: varieties of capitalist development and corporate governance. I believe this paper can bring a comparative perspective with Australia and New Zealand developments in corporate governance.

Corporate Governance

Corporate governance, in modern times, has become not only an important new field of inquiry in corporate finance, but is also considered a factor for economic growth at the national level. In the past, however, the concept of corporate governance was not spread, although the practice of some of its tenets was followed in corporation life.

Using a modern concept, we can define the system of corporate governance as establishing the rules and regulations that guide the behavior of controlling shareholders, board members and the professional managers of corporations. Good governance can have a positive impact on profitability and overall economic performance, and attract investments in the capital markets for the company. Given the importance of corporations for economy at large, good governance ends up creating more jobs and income for the country.

Corporate governance is based in a mix of corporation laws and enforcement of the respective rules and regulations. In general, the legal framework sets two main objectives: (i) to provide a system of economic incentives for managers, in order to align their actions with the objective of wealth creation for the shareholders; (ii) to define and establish rules and responsibilities and other accountability measures in order to provide a fair distribution of company profits among the main stakeholders (corporate managers, shareholders and creditors) and avoid that majority shareholders and others insiders use their power to extract value from minority shareholders, non voting shareholders, creditors and others outsiders.

Corporate governance is a continuous set of actions and attitudes with the leadership of the CEOs and overseeing by the Board of Administrators. The Corporations Laws set the legal framework and define the rights and duties of the stakeholders, but corporate government in a sense is the on going enforcement of the norms and regulations under this law. Therefore, when a new corporate law is enacted, like the 1882 and 1890 pieces of legislation, it was implicit that with proper enforcement they would receive practical content and become an engine for the creation of profitable companies and attraction of large number of shareholders.

The Making of New Laws in Brazil

When one examines the economic history of Brazil in the last two centuries, one aspect that calls attention is the claimed low level of enforcement of regulations and laws, and an associated high level of corruption.

In countries like Brazil, we say that some laws “catch”, while others exist, but are ignored. In others words, the enforcement of laws is uneven. The coexistence of laws that are enforced, or partially enforced, or not enforced at all is a typical aspect of the history of Brazil, and I suspect of other less developed countries too.

Sometimes, it is claimed the country has a “low moral capital”, or that the “culture” of the inhabitants is intrinsically tolerant - more than it should - for law breaking and corruption. I am using the expression “moral capital” to indicate the set of cultural and behavioral social attitudes translated into a honest conduct in the ordinary business of life. It is a new concept, and has the same nature as “human capital” or “social capital”: it can be measured and treated as a stock, it can suffer depletion and depreciation, and can be built-up or replenished with new investment.

As economists and economic historians, we should be suspicious of such generalizations about presumed intrinsic dishonest behavior of the population of Brazil. After all, the Brazilian population is a melting pot of different ethnic groups and varied cultural backgrounds. Perhaps, if we examine the macro and microeconomics of the decision process related to law creation and law enforcement, we can offer another explanation.

In this section we attempt a broad economic explanation of why laws are “good” and enforcement is “bad” in countries like Brazil, in order to use this theoretical framework for an analysis of the Brazilian corporation laws of 1882 and 1890. We want to raise the hypothesis that there is a conscious trade-off, in which the country adopts a “modern” law knowing beforehand that this new law can not be totally enforced immediately, but only gradually.

We are using here a very broad definition of enforcement. Enforcement in a narrow sense is defined as to compel, sometimes getting obedience by threat. Enforcement is also defined as to execute the law with vigor. In this paper, we mean by “enforcement” the set of actions and devices allowing the rules and regulations to reach their goals. In this sense, it includes: (i) the building-up of the necessary prerequisites for a proper enforcement; (ii) the actions needed to overcome the petty institutional bottlenecks which create obstacles; (iii) to change the existing micro-culture sometimes foreign to the new law, as it was the case when introducing a corporation law in the coffee plantation society of Brazil; (iv) to undertake the small investments needed to put in order the enforcement; (v) to create the ancillary means in order to get a credible response to the objectives of the “modern” law.

We want first to examine the issue of why developing countries choose more advanced laws as “role models”. Economic historians have done an outstanding work of studying the importance of technological progress for the economic development of regions and countries. In this context, transfer among nations of new technologies can foster economic growth in backward countries, as argued by Gerschenkron.

In my view, the same reasoning applies for the transfer of laws, rules and regulations from industrialized countries to less developed countries. Like in the case of technology, the developing countries can profit from the experience of more developed countries, adopting their institutions and “burning” stages for the creation of their own institutions. The major difference is that technology transfers occurs mostly at the company level of business decisions, while transfer of laws, rules and regulations are made at the institutional and political level, involving society as a whole.

During the process of law making and adoption, there is a “borrowing” of laws, rules and regulations from more advanced countries, which set standards far above the ones which would be set only by domestic considerations given the prevailing culture of the country. However, what is not generally perceived, or when it is, is treated as a trade-off, is that the law, rules and regulations can be borrowed, but not the other institutional features that mold and cement the framework of enforcement.

The pressure to adopt “modern” laws can be ignited either by domestic initiatives, as a sign of social progress, or by foreign initiatives from countries exerting cultural, political or economic influence in the country who adopt the laws.

In the choice of the “role model”, the developing country set high aspirations for social or economic change to be obtained by the adoption of the new law. The new law is seen as placing an ambitious target, a bench mark for progress. It is an agenda for social reform or modernization of the economy, establishing ambitious goals to be achieved. However, any “good” law needs “good” enforcement. It is not only a question of approving the new law. It has to be enforced. In other words, it is an ongoing process.

In addition of not meeting all the pre-requisites for a proper total enforcement, the “modern” law can create incentives for the affected individuals and companies to delay the enforcement. Some of the new laws can bring social improvements and foster the offer of merit goods, but can adversely affect production or consumption in the short run. For instance, new laws about child labor, environmental protection, food quality, etc. Other pieces of legislation may set equity goals that hurt efficiency goals. In some cases, non-economic (equity) considerations prevail over economic (efficiency) conditions in the “modern laws”, reflecting the social progress pursued by the developed countries responsible for making the laws. We could list other situations, but the point to be made is that the new laws can create externalities, and give incentives to disobey the laws by taking decisions and acting based on private costs (benefits) rather than social costs (benefits).

We could summarize by saying that in some situations the companies perceive that by not obeying the laws the private costs are smaller than the social costs, and thus they can reach high production levels. From a pure economic standpoint, it is possible that production can be higher by not following all the rules and regulations.

In the industrialized countries, the process of law creation, in general, evolves gradually, and has an organic character. Law creation and viable enforcement develop together. It is a harmonic process with the business activities or social

reforms affected by the legislation. It usually proceeds with incremental advances of legislation, and in tandem with marginal improvements in enforcement procedures.

Several of these laws, tested and proved in the developed countries, are seen as “role models” by developing countries. The laws are studied, and many times almost totally copied. As a result, the new law in the developing country is born as a “supply shock” in the domestic culture, and without firm foundations for an effective enforcement.

Suppose L_0 is the law (the “domestic” law) which would be consistent with the prevailing social, cultural and economic conditions of the developing country, and apt to be totally enforced at once (E_0). Suppose, instead, the country chooses a “modern” law, L^* , with goals much more ambitious than the ones envisioned by L_0 .

There is a concern for enforcement of the new law, and it is assumed the enforcement will be gradual. We can think of a kind of flexible accelerator hypothesis, in which the larger the gap between L^* and L_0 , the longer the time to attain total enforcement. The hypothesis is that, by consciously choosing the “modern” law, the country plans to close a fraction λ of the gap between the desired (E^*) and actual enforcement each period. Denote the enforcement level at the end of last period by E_{-1} . The gap between the desired and actual levels of enforcement is $(E^* - E_{-1})$. The country plans so that the enforcement level at the end of the current period E will be such that

$$E - E_{-1} = \lambda (E^* - E_{-1}) \quad (1)$$

Equation (1) states that the country plans to have the enforcement level at the end of the period be such that a fraction λ of the gap between the desired (E^*) and the enforcement level that existed at the end of last period is closed. Rewriting equation (1),

$$E = E_{-1} + \lambda (E^* - E_{-1}) \quad (2)$$

Equation (2) shows that to increase the enforcement level from E-1 to E, the country has to make an effort to achieve more enforcement. We can say it has either to invest in “moral capital” or adopt innovations (mainly financial innovations in the case of corporate governance). The more the country invests in “moral capital”, the more it closes the gap between desired enforcement and actual enforcement. Notice that, when choosing the “modern law”, the country has to be realistic about the needed investments in “moral capital” to enforce the new law.

Trade-offs between Law Abiding and Enforcing Costs

In what follows, a simple theoretical model is sketched to show the tradeoffs between the quality of the laws enacted and the respective degree of enforcement.

Let's assume the country adopts a “modern” law. As seen in the last section, there will be a time interval till the law will be totally enforced. In order for the new law to be enforced, we can assume there will be two components of costs for society.

The first component is formed by the direct costs (regulation, auditing, accounting, surveillance, etc) for enforcing the law. We can call it control costs.

The second component is formed by the negative impact on the moral capital (including self-esteem) of the country when laws are disrespected. This loss of moral capital is supposed to affect investments and decrease potential GDP. We can call it moral costs, translated in monetary terms as a depletion of the stock of moral capital.

Both cost components can be seen as monetary costs, the MCC with out-of-pocket costs and the MMC as opportunity costs expressed in monetary terms. Both curves are represented showing increasing marginal costs. They are increasing because enforcement costs rises more than proportionally when full enforcement is approaching, and moral costs have a contagious effect on risks and uncertainties of new investments.

We can represent the total marginal costs of enforcement (TMCE) as the sum of marginal control costs (MCC) and marginal moral costs (MMC):

$$TMCE = MCC + MMC \quad (1)$$

Figures 1(a) and 1(b) are graphical representations of the control costs (MCC). Figure 1(a) shows in the vertical axis the MCC in monetary terms, and in the horizontal axis the degree of law violation. From the left to the right the degree of law breaking increases, at to the point in which the law is totally disobeyed. Costs of enforcement are decreasing as we move to the right, till they are zero with zero degree of enforcement.

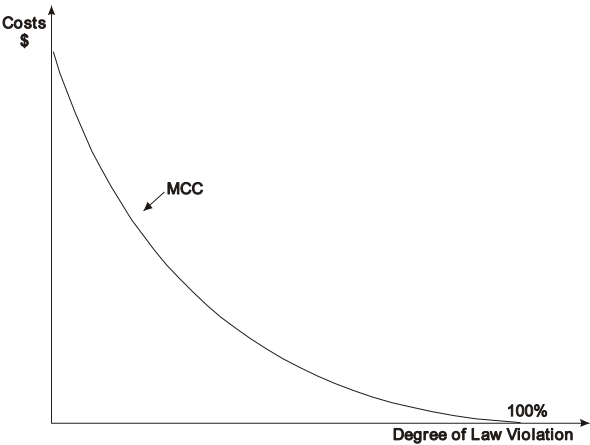


Figure 1a - MCC

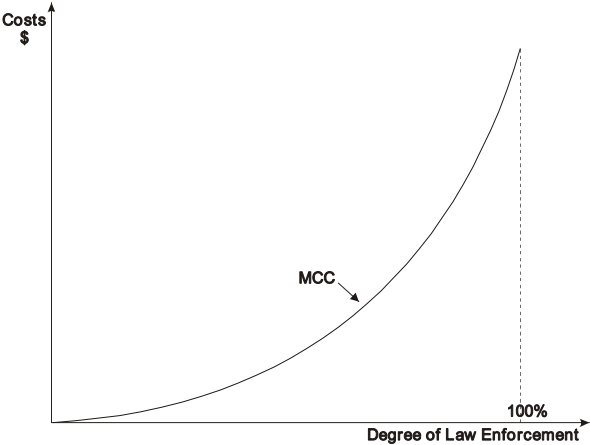


Figure 1b - MCC

Figure 1(b) is the mirror image of Figure 1(a). In Figure 1(b) the vertical axis is the same, but now the horizontal axis shows the degree of law enforcement. As we move from the left to the right, the degree of law enforcement increases, up to the point when we reach total enforcement. Marginal control costs increase more than proportionally with the deepness of enforcement.

Figures 2(a) and 2(b) show the marginal moral costs (MMC). Figure 2(a) shows in the vertical axis the MMC in monetary terms, and in the horizontal axis the degree of law violation. From the left to the right the degree of law breaking increases, at to the point in which the law is totally disobeyed. Moral damage costs

are increasing as we move to the right, till they are at a maximum with zero degree of law enforcement.

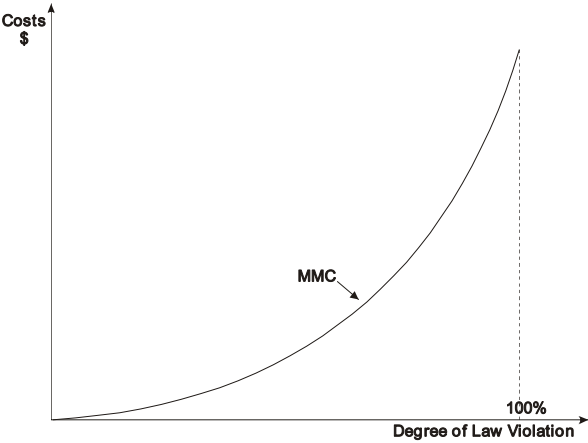


Figure 2a - MMC

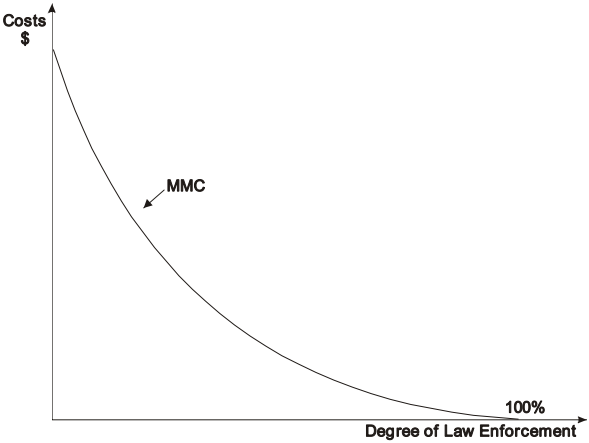


Figure 2b - MMC

Figure 2(b) is the mirror image of Figure 2(a). In Figure 2(b) the vertical axis is the same, but now the horizontal axis shows the degree of law enforcement. As we move from the left to the right, the degree of law enforcement increases, up to the point when we reach total enforcement. Marginal costs decrease more than proportionally with the progressive increase of enforcement.

Optimal Level of Enforcement

Based on the considerations about the MCC and MMC curves, it is possible to determine the “optimal” level of enforcement. We can interpret it as showing the expected degree of enforcement at the time the “modern” law is enacted.

Figure 3 shows a graph with both curves (MCC and MMC). In the vertical axis we have the cost in monetary terms, and in the horizontal axis we have the degree of law enforcement. However, we can give a different interpretation for the MMC curve. We can see it as a demand curve. The curve can be seen as showing the benefits for society of law enforcement, and, indirectly, of the strengthening of moral capital. In fact, we can interpret the MMC as revealing how much society would be willing to pay for not suffering the losses imposed by the demoralization of law. To have zero

tolerance, it would be willing to pay the maximum price. As the degree of law observance increases, the willingness to pay decreases more than proportionally. Thus, in that sense, MMC can be interpreted as the Marginal Benefit Curve of law enforcement.

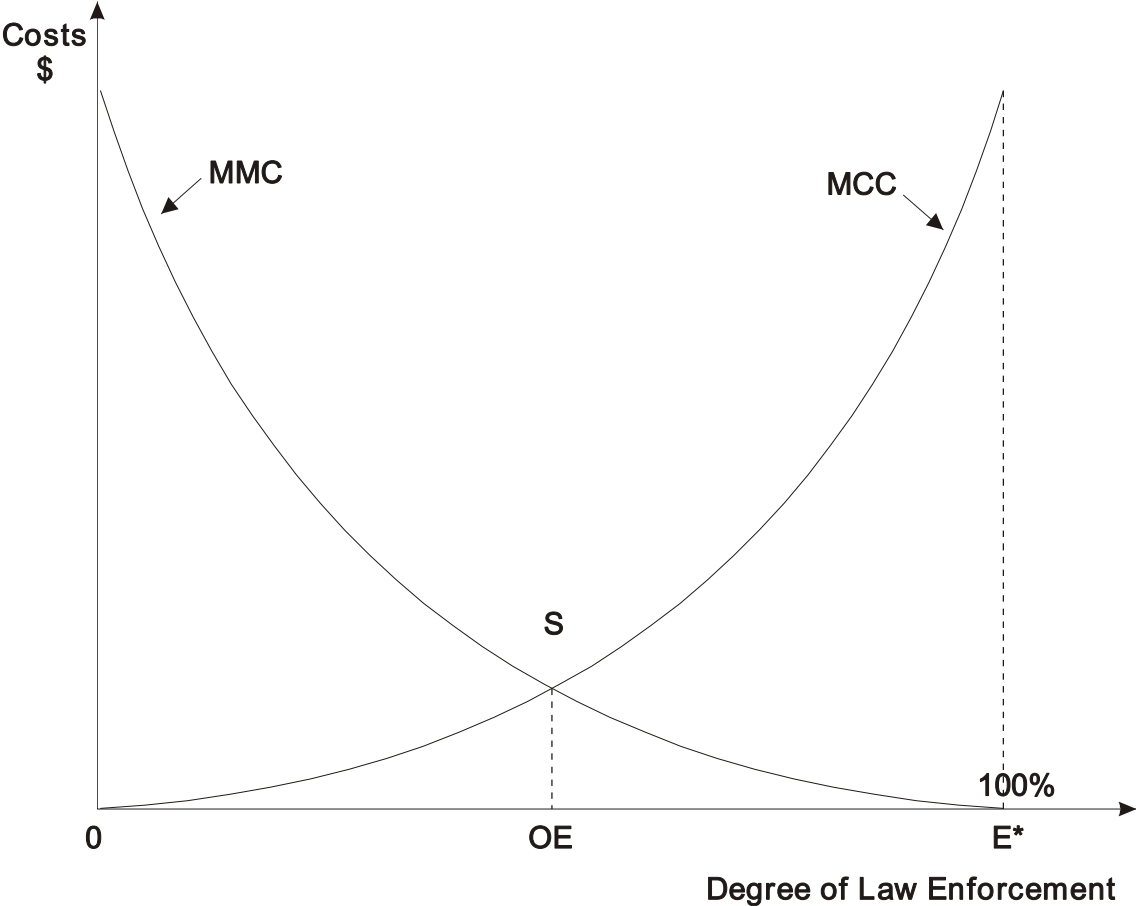


Figure 3 – Optimal Level of Law Enforcement

At the point S, where both curves cross, OE marks the “optimal” degree of law enforcement expected when launching the “modern” law. Total costs are minimized, as shown by the area OSE*. The point OE is a Pareto optimum, since any other point in the horizontal axis would imply an increase in total costs of enforcement.

Innovation and Changes in Preferences of Society

We can think of two main ways for having “modern” laws with better enforcement. In the first situation, the adoption of innovative instruments can reduce

the control costs of enforcement. In other words, financial innovation in corporate finance may cause a shift of the MCC curve to the lower right. For instance, some new instrument that facilitate compliance or reduce agency problems, allowing the same level of corporate governance using less resources than before the use of such instrument.

In Figure 4 we present the effect of innovation on the optimal enforcement level.

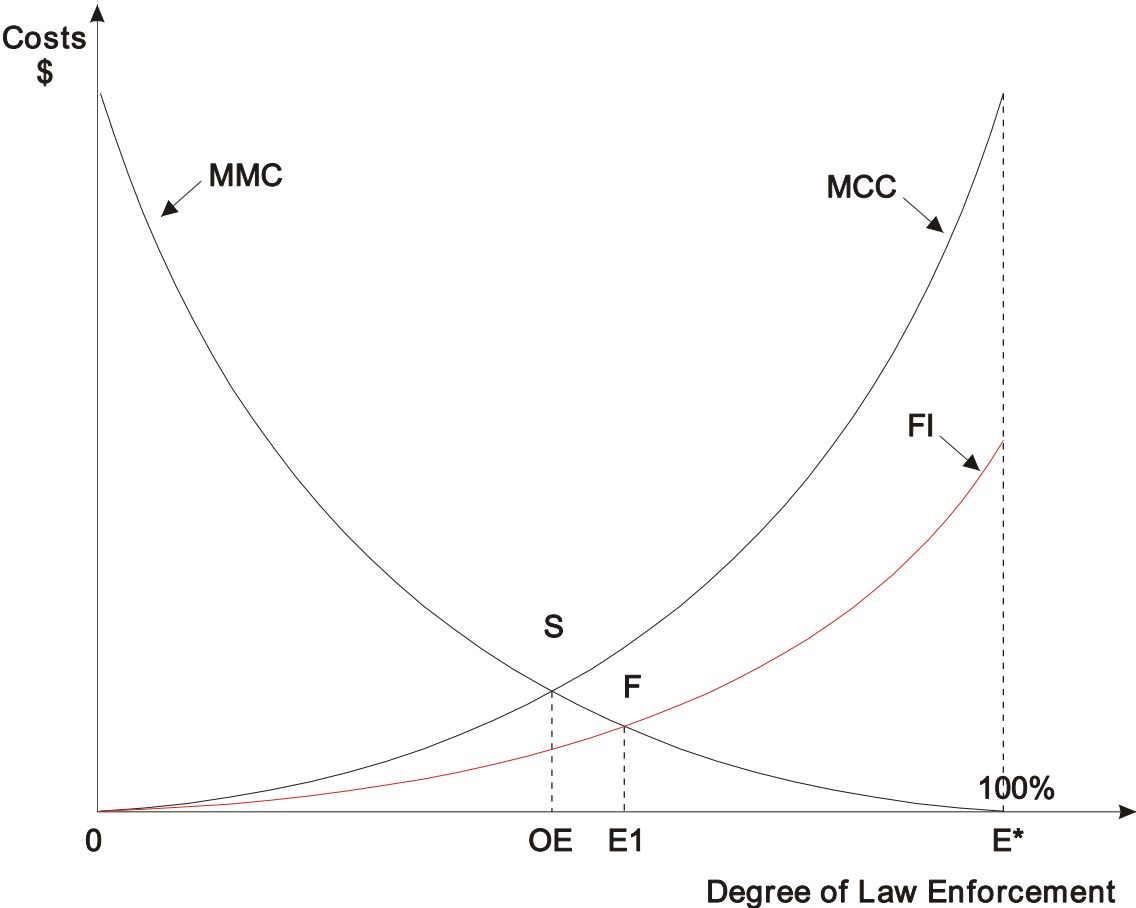


Figure 4 – Effects of Innovation

The decrease of costs, caused by innovation, is represented by a shift of the MCC curve to the lower right (From MCC to F1). The new equilibrium point (optimal enforcement) now moves from S to F. The degree of law enforcement increases from OE to E1. Notice that with the innovation the total costs of enforcement decrease by

the area OSF. It is a double achievement: decrease in costs and increase in the degree of law enforcement.

The second situation is a result of a change in preferences of society regarding the importance of improving moral capital. Suppose society decides to invest more real resources in order to achieve a positive increment in the stock of moral capital. In Figure 5, we represent the increase in demand for moral capital as the shifting to the upper left of the MMC curve. The new equilibrium point (optimal enforcement) moves from OE to E2. In this situation, however, the increase in enforcement comes together with an increase in total costs of enforcement.

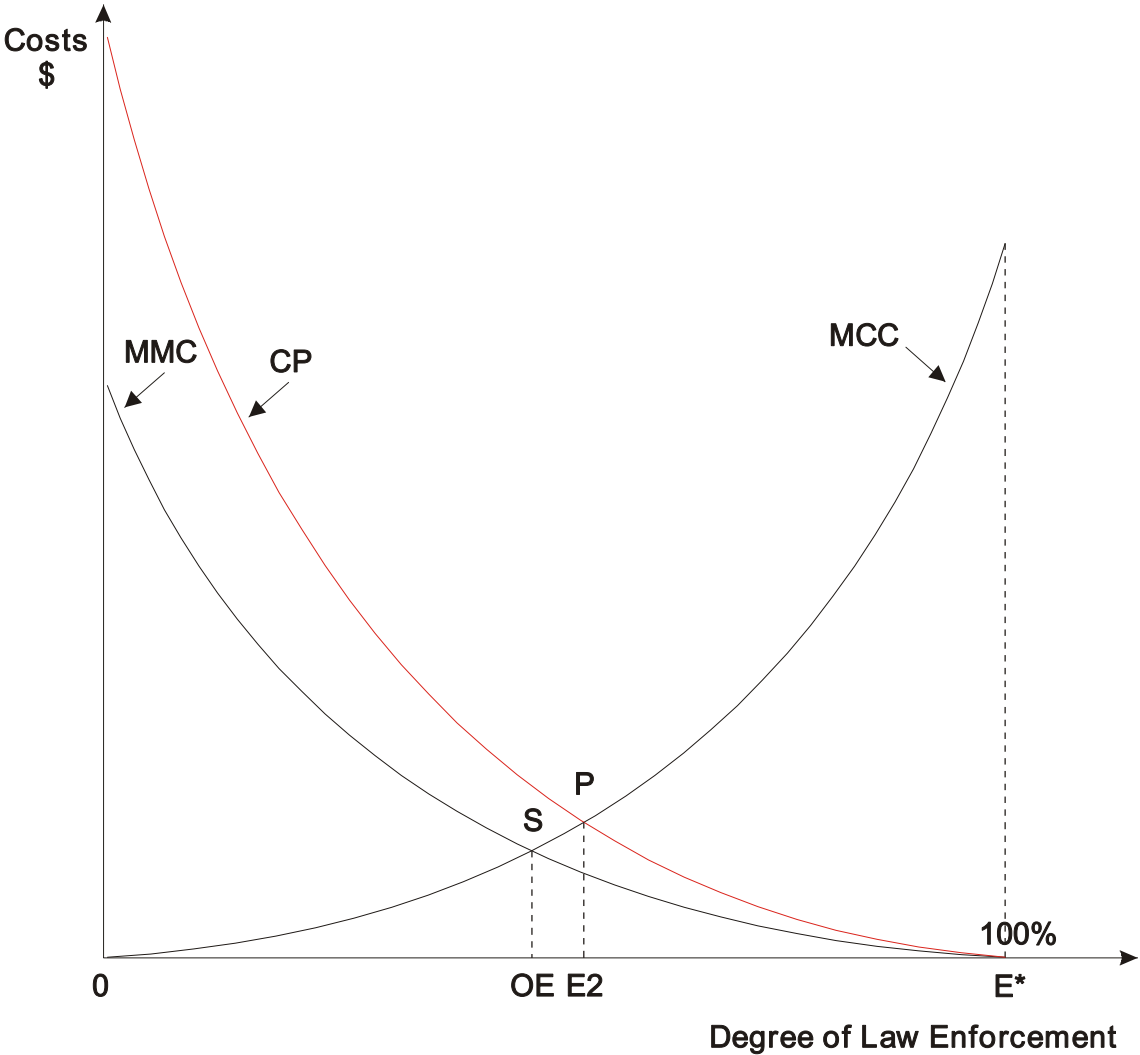


Figure 5 - Effects of Changes in the Preferences of Society

Social, Political and Economic Transformation of Brazil in the 1880s: Changes in preferences and Financial Innovation

The main purpose of this article is to study the Corporation Laws of 1882 and 1890. I consider very important to call attention about the turning point of economic, political and social of Brazil during that period, and the interrelationship with its financial development.

The first question is why the country decided to have a “modern” corporation law. E. Bradford Burns, a historian who wrote an important book about the history of Brazil, states that:

“In 1888, a decade of significant changes exploded. The abolition of slavery marked the opening of that decade; the cataclysmic destruction of the folk society at Canudos closed it. The years between witnessed the overthrow of the monarchy, the establishment of a federal republic, the separation of church and state, the entry of the cities and the middle class into politics, the embrace of industrialization as an economic panacea, and an official shift of economic and political power to the southeastern states, in particular the recognition of the importance of São Paulo within that triumvirate...the changes between 1888 and 1897 shared a common denominator: modernization. Their conglomerate recognized the end to the centuries ambiguously combining neo-capitalism and neo-feudalism. Their conglomerate celebrated the triumph of capitalism and modernity...In some ways concluding three and one-half centuries of history and in other ways initiating trends that would characterize the twentieth century, this single ten-year period of change stands out as unusually significant for any interpretation of the history of Brazil” (Burns, 1993, p.197/198).

Thus, we can see the urge for having a modern law was present in the domestic scenario. Brazil in the 1880s was experiencing important changes. The coffee economy was very strong, in spite of the world crisis of 1873. Coffee exports rose from 286.8 million tons in 1880 to 313.1 million tons in 1990, and revenues in sterling pounds grew from 11.6 million in 1880 to 17.8 million in 1990 (Mello, 1977, p.39). From an 1819 population around 4.6 million, Brazil had grown to 9.9 million in 1872 and to 14.3 million in 1890 (Mello, 1977, ch.2). The main political issues were

slavery and monarchy, and in both fronts the country was able to promote peaceful transitions. Large numbers of immigrants from Europe, over 2.3 million in the two decades of 1880s and 1890s, made possible a huge increase in the labor supply. As a consequence, the abolition of slavery was conducted with partial replacement of slaves by immigrants, not causing loss of production in the coffee cultivation and exports, and cities and markets grew steadily during these years. The growth in the number and importance of big companies will be seen shortly, but the point to emphasize is that the corporate form of business, and the channels it provides for attract outside capital for investments, were strong factors to pressure for “modern” laws.

The other source of pressure for a “modern” law came from abroad, basically from Great Britain. During that time, companies from different segments were listed and traded in the Rio de Janeiro Stock Exchange, and later in other stock exchanges, particularly São Paulo. Those segments comprised railroads, ports, tramways and other transportation investments; electricity production and distribution; commercial banks; textiles companies; sugar manufacturing companies, and others. Several historians consider that Brazil, as well other Latin American countries like Uruguay and Argentina, were, during that time, for economic matters, part of the “informal” British Empire. Thus, the capital markets of Brazil had a close relationship with British investments and investors. Several Brazilian companies had even dual listing and trading in the London and Rio de Janeiro stock exchanges.

Corporation governance, in a modern sense, started and developed in Brazil during the last 20 years. One of the main reasons for that was the participation of Brazilian corporations in the emerging markets, in which international (mainly institutional) investors play a major role. By analogy, since our period of studies marks a phase of intense foreign investment (mainly British) in shares of Brazilian companies, corporate governance – even named by different words – must have been an important subject. The main hypothesis to be dealt with is that it is in the enforcement of the laws, and not in the laws themselves, that there were huge differences in corporate governance between Brazil and Great Britain. We can conclude that the financial innovation occurring in Europe could be used by Brazil for enacting “modern” laws.

Brazilian Joint Stock Companies in the late 1880s

Although economic activities in Brazil in the 19th century were primarily agricultural, by the 1870s and 1880s an important host of industrial and service activities had already emerged. A government survey in 1866 found 43,585 commercial and industrial businesses in Brazil. A further survey in the same year on 20,930 industrial and commercial establishments found that 17,503 of them were owned by single individuals, and 3,427 (or 16.4 percent) were companies with a social capital (Mello, 1977, p.131).

In the following year (1867) another government survey was made about the number of companies with social capital, and stocks and shares issued and floated in the capital market. A total of 69 companies was found (railroads, insurance, navigation, gas lighting, mining, water supply, turnpike roads, market plazas and others), with total nominal capital of 10 million sterling pounds equivalency. Of this total, 20 were foreign owned companies, with an average capital of 303,459 sterling pounds and 49 were Brazilian owned companies, with an average capital of 83,165 sterling pounds (Mello, 1977, p.132).

In 1887, 5 years after the corporation laws of 1882, the government published another survey of the joint stock companies. By that time, or during the two decades after the 1867 survey, their number had increased to 135 companies, with a total capital of 25 million sterling pounds equivalency. They had also diversified, as can be seen in Table 1.

There was an active market for the bonds, stocks and shares of a number of joint stock companies in the Stock Exchange Market of Rio de Janeiro. The *Retrospecto Commercial do Jornal do Commercio* published for some years the capital stock, the number, par (nominal) and market value of shares and bonds, and the nominal dividend rate. In a previous published article, I examined the capital markets of Brazil during that time from the view point of calculation of financial rates of return (Mello, 1984). Based in that article, we present in Table 2 the Invested Capital of the 65 companies, with a total capital of 176 million milréis or 17 million

sterling pounds, and the average yearly rates of return on investment on various economic activities with shares traded in the Rio de Janeiro Stock Exchange in the years 1877, 1878 and 1882.

Table 1 – Joint Stock Companies in Brazil, end of 1886

Total Number and Capital According to Economic Activities (value thousand milréis)

Economic Activities	Number	Capital
Railroads	14	51,356
Banks and saving institutions	13	87,400
Insurance (maritime and others)	13	32,500
Street cars	13	25,600
Textiles	15	12,310
Navigation	5	11,300
Mining	6	6,900
Central Sugar factories	9	6,300
Docks	2	6,000
Immigration and Colonization	5	5,000
Water supply	2	3,700
Electricity and Telephones	4	3,350
Industrial manufacturing	6	2,878
Building construction	6	2,675
Carriages and Coaches for rental	1	800
Amusement parks	4	254
Metal and Ceramic artifacts	4	338
Dynamite	1	180
Mutual assistance insurance	2	105
Laundry	1	100
Knife manufacturing	1	45
Agricultural and Husbandry	1	8,000
Brokerage house	1	1,000
Commerce and agriculture	1	800
Market plaza	1	500
Zoological garden	1	263
Commerce of lotteries	1	200
Educational institutions	1	50
Real State	1	25
TOTAL	135	269,929

Source: Relatório do Ministério da Agricultura, 1887

Table 2 – Average Yearly Rates of Return on the stocks of various economic activities, transacted in the Rio de Janeiro Stock Exchange, in the years of 1877, 1878 and 1882

Economic Activities	Realized Capital 1878 (thousand milréis)	Rate of Return 1877	Rate of Return 1878	Rate of Return 1882
Banks	72,132	16.98	15.46	6.47
Railroads	24,676	-3.46	10.32	-4.25
Street Cars	11,200	8.43	11.78	10.19
Navigation	7,432	35.84	30.25	12.48
Insurance	25,800	16.18	25.36	29.94
Private Turnpikes	1,980	10.65	13.34	2.95
Market Plazas	1,000	2.64	-1.30	0.26
Gas Lighting	8,100	20.02	-20.12	-5.20
Others	23,601	-3.61	27.56	-1.72
TOTAL	175,921			
Simple Average of Rates of Return		11.52	12.52	5.12
Weighted Average (by capital) of Rates of Return		11.47	16.45	6.45

Source: Mello, 1984

Mello used another source, the information contained in the London Stock Exchange Year Book, to produce a sample of the joint stock companies listed in London, some of which had their legal domicile in England, but with sole operation in Brazil. Some of the shares had dual listing, in the stock exchanges of London and Rio de Janeiro. With this information, Mello listed the number and capital of British investments in joint stock companies in Brazil in 1888, presented in Table 3.

Mello, in his Ph.D. dissertation, estimated that the grand total of Brazilian owned capital invested in Brazilian joint stock companies in 1888 was around 39 million sterling pounds. When comparing this value with the almost 47 million pounds of British investments in Brazilian joint stock corporations, it shows the importance of British investments in Brazil (Mello, 1977, p.139/140).

Table 3 – British Investments in Joint Stock Companies in Brazil, 1888

ECONOMIC ACTIVITIES	NUMBER OF COMPANIES	Capital Thousands of Sterling Pounds
Railroads	21	30,047
Shipping and Ports	17	3,398
Gas, Water Drainage and Tramways	20	4,804
Telegraph	3	2,805
Banks	3	3,446
Mining	7	988
Miscellaneous	9	1,103
TOTAL	80	46,591

Source: Mello, 1984

Evaluation of the Enforcement of the Corporation Laws of 1882 and 1890

Comparing the corporate governance provisions existent in the Brazilian Corporation Laws of the 1880s with what is conventional corporate governance today, there are striking differences in focus. Although the rudiments of provisions for information disclosure, accountability (“conselho fiscal”, or accounts board), CEO rules of conduct in managing the company, and others, were there, I would assess that the major worry revealed by the laws was with prevention of a systemic risk for the economy created by low capital and excessive leverage.

In other to understand the preoccupation of 19th century legal and policy makers with the corporate form of business organization, we need to have a historical perspective. We need to know more about the debate about corporation and joint stock companies in the second half of the 19th century, the marching of industrialization and the need for large investments made possible by the capital markets.

According to Cameron, already in the 16th century England and Netherlands had started joint stock companies (Cameron and Neal, p. 125). In the 17th century,

Colbert government codified commercial law, with the Ordinance of Trade (1673), and created monopolistic joint-stock companies (Cameron and Neal, p.150). During the initial years of the 18th century, two major financial crisis hit France (the Mississippi Bubble) and England (the South Sea Bubble). One of the reactions after the crises was to create legal barriers against the joint-stock or corporate form of business organization. The legal barriers in England would only be lifted in the third decade of the 19th century (Cameron and Neal, p.169). In 1807 Napoleon Bonaparte promulgated the Code of Commerce, regulating business enterprises. One of the forms of business organization was the *société anonyme*. In 1867 France abolished the need for authorization to grant corporation charts, and adopted free incorporation (Cameron and Neal, p.209). Brazil adopted similar laws, with the Commercial Law of 1850 creating the same figure of *société anonyme*, and in 1882 and 1890 with the improvement of the concept of *société anonyme* and the creation of joint stock companies with extended freedom for incorporation. The next important innovation was to extend the concept of corporation to commercial banks. This was also followed in Brazil in 1890, and it was one of the main factors for the financial crisis of the Encilhamento.

There were three important pieces of legislation, and Table 3 presents them, and their major features. The Law N. 3150, of November 4th of 1882, had the stated objective of regulating the establishment of companies and *société anonyms*. The law has 42 articles, and was approved by the General Assembly of the Empire of Brazil, the maximum decision making body including Representative and Senate Chambers. The Decree N. 8321, of December 30th of 1882, has 168 articles, establishing the details for the operation and enforcement of the Law N. 3150. It was promulgated by the Emperor of Brazil (Dom Pedro II), based on the constitutional delegation given by article 102, paragraph 12 of the Political Constitution of the Empire. The final piece of legislation was the Decree N. 164, of January 17th of 1890. The objective of the Decree was to reform the Law N. 3150. The Decree has 43 articles, and was produced about three months after the Proclamation of the Republic of Brazil. The Decree was headed with the following preamble: “The Marshal Deodoro da Fonseca, Chief of the Provisional Government of the Republic of the United States of Brazil, constituted by the Army and other Military Forces, in the name of the Nation”. This head of this Decree, in a sense, signalizes that the role

model for Brazil (now the “United States of Brazil”) switched from Great Britain to the United States of America.

Table 4 – Corporation Laws of Brazil, 1872 and 1890

Corporation Laws of Brazil	Main Provisions	Comments about Corporate Governance
<p>Law number 3150, November 4, 1882 (Empire of Brazil)</p>	<ul style="list-style-type: none"> • Definition of need for authorization for establishing corporations • Number of 7 partners as the minimum • Defines prudential rules for completeness of capital • Establishes publicity rules for major corporation acts • Establishes rules and duties for managers • Defines conflicts of interest and honest rules for behavior by managers • Defines the rights of shareholders and convocation of General Assemblies • Defines profit distribution for shareholders • Establishes the role and duties of a Fiscal Board • Establishes rules for emission of shares and corporate bonds • Establishes rules for shareholders responsibilities in the case of company failure (bankruptcy) 	<ul style="list-style-type: none"> • Most articles set standard rules for corporate governance • In comparison with the modern corporate governance, there is not a concern about possible agency conflicts • The concern is about the honesty of the manager, and not if the performance is aligned with the objective of maximizing the wealth of shareholders • In my view, what is evident is the concern for the corporation to act responsibly in the country, and that the shareholders have responsibility for the company acts • The major device to align shareholders with corporate responsible behavior was through capital completeness requirements • Shareholders were required to deposit in currency at least 10% of the nominal value of the share, and while the capital completeness of the share value was under 25% the share was nominal and had restrictions to be traded in the secondary market • In my view, it was the main piece of governance, and the target were not the minority shareholders, but the economic and financial soundness of the corporation vis a vis the rest of society • Enforcement of this requirement was poor

<p>Decree number 8321, December 30, 1882 (Empire of Brazil)</p>	<ul style="list-style-type: none"> • The Decree gives a detailed description of how to obey the articles in the Law N. 3150 • Defines what kind of business can be incorporated • Defines what corporations still need government approval • Explains the provision of reserved liability, by which in case of failure of the company the shareholders who had paid only one fifth, had to pay the remaining four fifths, or have their assets seized and auctioned 	<ul style="list-style-type: none"> • Defines that “the companies, or <i>société anonymes</i>, are distinguishable of other species of societies due to the division of the capital in shares, by the limited responsibility of shareholders, and by the need of having, at least, seven partners” • “All sectors of commerce or industry, or agricultural companies, and all services of commercial or civil nature can be organized as corporations, with the exception of business contrary to law, moral and good customs” • All corporations could be created without government approval. The exception was banks, religious associations, food retailers and foreign companies. In order to become companies they needed government approval.
<p>Decree number 164, January 17, 1890 (Republic of Brazil)</p>	<ul style="list-style-type: none"> • The Decree expanded the list of financial institutions requiring government authorization: banks of circulation, banks of real credit, saving companies, saving banks • Increased the responsibilities of company managers • Increased the rights of shareholders 	<ul style="list-style-type: none"> • The major feature of this Decree, in my view, was to free the creation of banks of the existing controls • With the Decree, instead of approval by the Chambers, now they needed only executive government approval • As a hypothesis, we can view this lack of governance as conducive for abuses and excessive leverage of capital • In consequence, banks could leverage money creation. Inflation and financial crisis (“Encilhamento”) was the result

Conclusions

To conclude this article, I would argue that the corporate governance of these Corporation Laws had as the priority goal to achieve responsible financial behavior of the companies. Since the shareholders had limited responsibility, up to the capital invested in the company, the Corporation Laws were concerned that the shareholders would complete the capital requirements. The permission to trade shares in the secondary market was dependent on the fulfillment of minimum trenches of capital to complete the nominal value of the share, calculated in relation to the “authorized capital”.

The evidence presented or mentioned by several commentators indicates poor enforcement (it seems fraudulent behavior was widespread on fully paying the shares) of the two major restrictions: to complete the capital and to have fully paid up the nominal value of the shares, and to trade the shares not yet fulfilling the minimum capital requirements.

As we claimed in the beginning of the article, perhaps it was a conscious decision to relax in the total enforcement of the new laws. By not fully paying the value, the capital of the shareholders could be leveraged, and they could acquire more shares or more stocks than their income would allow. This would create more public offers and trading in the capital markets.

As we saw, the country economy was changing fast, companies were founded, the domestic market was expanding with immigration and abolition of slavery, the coffee market was booming, and the economy needed large amounts of capital to finance the new ventures. The trade off was to enlarge the capitalization of companies and leverage of shareholders investments, by lenience on enforcement of capital requirements, and a blind eye for what was happening in the market.

The financial crisis of Encilhamento is claimed to be a result of this lack of control. There is a hot debate in Brazil about the causes of the Encilhamento (see Schulz, 1996 and Suzigan, 2000). As a contribution for this debate, I would argue the following:

1. the two pieces of corporation legislation of 1882 had a positive net impact on the boom of new ventures, and the investments in the primary markets of corporations;
2. the 1890 Decree, in what concerns more freedom for the creation of banks with the power to issue money, perhaps failed in the task of “macroeconomic governance”. The growth of the issuance banks probably fueled too much money in the economy in a short period, even considering that the economy was transforming from a slave “low money” economy to a “high money” market economy;
3. the lack of governance, in a sense, was partially responsible for the overshooting of the money supply, the inflationary pressures, and the financial bubble in the stock market;
4. if we return to the Equation (1), which states that “the country plans to have the enforcement level at the end of the period be such that a fraction λ of the gap between the desired (E^*) and the enforcement level that existed at the end of last period is closed”. Accepting the model, the problem of the 1890 Decree was not the lenience about enforcement, since it was expected and part of the “rationality” of the introduction of a “modern” law. My hypothesis is that λ was not properly managed or forecasted.

In my opinion, as a contribution to economic growth and development of the primary market of shares negotiated in the Stock Exchange, the 1880s and 1890s were more relevant for capital market development than the other decades that followed, till the present day.

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