

# Corporate Governance and Industrialization in Brazil: An Historical Approach<sup>†</sup>

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*The main goal of the paper is to analyze the history of modern Brazilian companies through the ownership and capital structure dimensions, with the goal of justifying the relatively quick process of transition of many Brazilian companies towards a dispersed ownership structure since the 1990s. The paper shows that the relevant features in the historical analysis of the shift towards the relevance of corporate governance in Brazil are: changes in industrialization policies, retained profits and government funding as the major source for investments, and a culture of personalization of the figure of the controller/entrepreneur/founder.*

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## Introduction

The main objective of the paper is to analyze the history of modern Brazilian companies through the ownership and capital structure dimensions, with the goal of justifying the relatively quick process of many Brazilian companies towards a dispersed ownership structure since the 1990s. The development of corporate governance—the mechanisms that regulate the relationship between executives and shareholders (Zahra, 1996)—is recent enough that a historical perspective may be premature. However, the advances brought forward by the literature on corporate governance may be utilized to allow another look at the industrialization process and the formation of modern capitalism in developing countries.

A central question surrounding the industrialization process is the financial requirements necessary for it to blossom. The financial link to capital accumulation is heavily analyzed by authors such as Gerschenkron (1962), Zysman (1983), and Minsky (1986), but one aspect that has been mostly overlooked is firm-level analysis. Authors like Chandler (1962) have developed a history of the modern Anglo-Saxon firm, but there is really nothing similar to many other countries. In Chandler (1962), for instance, one can find an interesting account of the emergence of the modern capitalism firm, with economies of scale and transaction costs as the driving forces for the rise of the modern firm. Corporate governance would derive from the professionalization of this kind of modern corporation, with separation between ownership and

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control generating the issues dealt with in this strain of literature. Using corporate governance to analyze the development of the modern firm in developing countries implies, then, that one would have to look for the development of the capital structure of firms in developing countries. Most firms would begin, necessarily, as family-owned business. How these firms develop is then the central question in this paper. Moreover, with state financing, either directly or indirectly, being so relevant to the industrialization process, questions regarding separation between private and public capital are relevant to understand the dynamics of the capital accumulation process from the point of view of firms in a developing country.

The paper is structured as follows: it presents a primer of corporate governance with a focus on the issues relevant to later analysis. Then, it traces the development of the modern firm in Brazil, beginning after the Second World War and finishing in contemporary times, after all the reforms in the Brazilian capital markets. The paper specifically chooses Brazil because this country is a good representative of the industrialization processes in Latin America. A typical process in Latin America is divided into two major phases: one in which the government delves into industrialization with unrivaled gusto, and another in which the major focus shifts from industrialization to market reforms, which results in a similar structure as the Anglo-Saxon model. Subsequently, it arrives at the proposed analysis of the development of the modern firm in Brazil through the lens of corporate governance, and finally, offers a few final comments.

### **Corporate Governance, Ownership Structures and Developing Countries**

The current research on corporate governance is oriented towards the mitigation of the problems arising from the separation of ownership and control in corporations, a discussion with origins in Berle and Means (1932). In this classic paper, the authors identify the emergence of dispersed ownership as the dominant model of capital structure in the US. This dispersion of ownership implies a separation between control (in the hands of managers) and property. Many subsequent papers focus on ownership structures, analyzing the role of shareholders, and agency theory as the predominant reference to address the problems that arise from this separation between ownership and management (Shleifer and Vishny, 1986; Aguilera and Jackson, 2003; Daily *et al.*, 2003; and Lynall *et al.*, 2003).

However, as pointed out by La Porta *et al.* (1999), this context is only true for large firms in the richest common law countries, since in most of the other countries firms are typically controlled by families or the state, and the equity control by financial institutions is less common. Contrary to the findings of Berle and Means (1932), in most countries, the controlling shareholders usually have significant power over firms in relation to their cash flow rights.

These results lead to the identification of at least two basic contexts or paradigmatic models to classify international environments of corporate governance. First is the Anglo-Saxon model, where property is dispersed and the stock market has an important role in allowing liquidity and facilitating the exit of shareholders. Variations in stock prices reflect the amount of agreement by market players, with the strategies traced by the publicly-listed companies and

the evaluation of their performance. The control systems of corporate governance are strongly based on the pressures by capital markets through the sale of shares and takeovers.

In the second context, known as Japanese-German model, the ownership is concentrated in banks or economic groups, and there are cross-holdings, with frequent involvement of workers and representatives of society on the boards of directors. This concentration of ownership fosters the use of internal instruments of control exercised by shareholders. In this context free riders almost never happen.

These two models can also be classified as the exit and voice (Buck *et al.*, 1998). In the Anglo-Saxon model, or exit, the behavior of managers is constrained by the threat of shareholders to sell their shares and leave the company. In the Japanese-German model, or voice, there is greater involvement of shareholders in the business decisions and controlling mechanisms, including the participation of non-shareholders, like employees, on the board.

The definition of these models helps to establish paradigmatic assumptions about the existence of links between economic, social, cultural and institutional development of a country and, in particular, the methods of financing companies and adoption of corporate governance practices.

There are important research questions regarding the identification of particular forms of ownership in a country or region. This identification problem can arise from two kinds of pressure—exogenous and endogenous.

In analyzing an endogenous perspective, Demsetz (1983) argues that ownership is the outcome of decisions made by shareholders in order to maximize their profits. It implies that the ownership structure is an endogenous outcome of share trading by profit maximizing shareholders (Kapopoulos and Lazaretou, 2007). In a later study, Demsetz and Villalonga (2001) argue that the ownership structure should be modeled simultaneously as an amalgam of shareholdings owned by persons with different interests, including managers. In their words, “persistent diffuseness of a firm’s ownership structure plausibly serves the firm’s shareholders better than would a concentrated ownership structure, even if more diffuseness of ownership would allow professional management to divert more of the firm’s resources to serve its own narrow interests” (Demsetz and Villalonga, 2001, p. 9).

However, the endogenous model is unable to answer the structure of family-owned firms in many countries. A business structure based on state-owned and family enterprises does not appear to be exactly the one that seeks to maximize profits. Thomsen and Pedersen (1996), following an exogenous perspective, place two hypotheses for investigation. First, called industry effect—corporate ownership patterns will vary across industries beyond what differences in company size can explain. Second, called the nation effect—political, institutional and cultural differences between nations will have an independent impact on corporate ownership patterns beyond what differences in industrial structure can explain. They found nation-specific differences in the ownership structures of companies in Europe, and also found that economic factors like industry and firm size influence those structures.

This exogenous perspective can also be associated to the issues of culture and institutional environment. La Porta *et al.* (1999) relate ownership dispersion and the system of law, and find that in countries where the judicial system does not present good protection for investors, there is a high concentration of ownership as a substitute for the weak protection. These firms “probably face difficulty raising equity finance, since minority investors fear expropriation by managers and concentrated owners” (La Porta *et al.*, 1999, p. 1151).

Gorga (2003), in relating culture and corporate governance and using his analysis on Brazil, argues that culture and ideology, in particular the ‘patrimonialist’ and ‘personalist’ aspects, are crucial factors to explain the restraints for the development of capital markets. In this sense, the first industrial firm in Brazil was built by Barão de Mauá, in 1846, who turned out to be one of the richest men in the country and its biggest entrepreneur at the time. Nevertheless, he suffered under the antagonism of political and economic forces, including the emperor (Caldeira, 1995). Culture can hinder or foster not only entrepreneurship, but it is also relevant to determine ownership structures in many countries.

Adopting a more exogenous perspective, the following sections look into Brazilian industrial development, theorizing on how this development is associated with weak institutional environment and cultural forces that influence ownership structure and corporate governance practices in Brazil. As these conditions are similar to every Latin American country, we intend to contribute to understanding why, as pointed out by Sanz and Holán (2004), in a typical Latin American firm, the five biggest shareholders own 80% of the firms’ equity.

## **Evolution of the Private Brazilian Firms**

Many papers have been written about the industrial development of Brazil after the Second World War. Historical approaches, finance through public institutions, import substitution, and the role of foreign capital have been extensively covered. However, precious little has been written about the capital structure and the history of the Brazilian firms.<sup>1</sup> There isn’t a Brazilian version of Chandler’s history of the development of the modern American firm. The goal of this section is to provide a preliminary description of the development of the modern Brazilian firm. The structure of this description is a simple one: it begins as a general framework with some stylized facts about the Brazilian development and converges to the changes in the capital structure of the Brazilian firms from the late 1940s to the present day. Since the data on Brazilian firms does not go back that far in time, the evidence for these changes is indirect, but we strive to show that the existing evidence forms a compelling set that allows for a good analysis of the changes that happened to the Brazilian firms over the analyzed period.

## **Origins of the Industrial Development: Entrepreneurs and Industrial Growth**

The Brazilian industrial development process has three major actors: the private firm, the state and foreign capital. The state was a direct producer of goods, forming or taking over such

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<sup>1</sup> The only major vehicle for business history in Brazil is the *Conferência Internacional de História de Empresas* (International Conference on Business History). The first such conference was held in São Paulo in 1993 and the eighth version was in Aracaju in 2007.

companies as Petrobras (oil), Companhia Siderúrgica Nacional (steel), Vale do Rio Doce (iron ore), among others. Particularly from the 1950s onwards, foreign companies also provided industrial growth to the Brazilian economy in such sectors as automobiles, energy, and many others.

Although there is no consensus on the origins of the Brazilian industrial development,<sup>2</sup> this evolution does not present a complicated history: it is an amalgam of response to external changes—the Great Depression, a necessity of foreign capital that provided opportunities to export industries such as textiles, and the historical arrival of the capitalist way of production. Opposing views rely on the major role that each factor played in the emergence of industry in Brazil, but in this paper we are less interested in discussing the major variable that is responsible for jumpstarting industrial development than describing which kind of private firm emerged from it.

The only policy that is constant throughout the industrialization period that goes from 1930 until 1980 is import substitution. Initially, it was a response to lack of external capital, but after the Second World War, import substitution was probably the most important strategy in the search for industrialization in Latin America. Early development economists like Furtado (1954), Prebisch (1959) and Tavares (1972) advocated it and in Brazil it was the main pillar of industrial policy from the late 1940s until late 1980s. The effect of import substitution on private firms was the absence of external competition. This, in turn, allowed private firms to break new grounds, unfettered, and reap high profits from their efforts.

Industrial growth in Brazil was high for a long period of time. Starting in 1930, it averaged almost 8% per year until 1980. Table 1 compiles some data from Versiani and Suzigan (1990), showing average annual growth plus change in industrial patterns.

Table 1: Relative Share in Industrial Production, 1919-1980 and Annual Average Growth in Each Period					
		1919	1939	1959	1980
Heavy Industry	Steel	3.80	7.60	11.80	11.50
	Mechanical Machinery	0.10	1.30	3.50	10.20
	Chemical Industry	5.00	10.70	13.50	19.60
	Other Heavy Industries	2.80	5.70	14.60	17.00
Agricultural, Beverages, etc.	Textiles	24.40	22.00	12.00	6.40
	Food Industry	32.90	23.60	16.40	10.00
	Other Agro-Business	16.70	11.50	8.40	5.10
Other	Other Manufacturing Industries	14.40	17.60	23.20	22.90
	Total Annual Growth	–	5.97	8.70	8.07
Source: Versiani and Suzigan (1990), elaborated by the authors.					

<sup>2</sup> Suzigan (2000) presents a nice summary of the arguments of different authors.

Table 1 shows how the industrial pattern in Brazil developed, led by heavy industries, which comprised a little more than 10% in 1919, 24% in 1939 and 58% in 1980. Industrial growth accelerated from around 6% from 1919 to 1939 to more than 8% for the period 1939-1980.

There are two major interpretations as to the nature of the private firms that helped trigger the Brazilian industrial development. Prado Jr. (1966) argues that the modern Brazilian firm has its roots in the coffee oligarchic structure—industrial firms that emerged from coffee producers who used profits from coffee to build industrial businesses. This is the dominant view, and has ample support in textbooks on the history of Brazil. However, an interesting interpretation is due to an early work on Brazilian business history by Bresser-Pereira (1964). In it, the author conducts a survey of entrepreneurs from São Paulo<sup>3</sup> to determine their ethnic and social background. The survey was conducted in 1962 on 204 firms with more than 100 employees. The main results of the research are: 82.8% of respondents are the founders of the industrial firms, and an astounding 49.5% of the total respondents are immigrants, while only 15.7% did not have an immigrant father or grandfather (being thus defined as Brazilian). In fact, 34.8% of all 204 industrial founders are Italians.

With regard to social background, Bresser-Pereira (1964) divides the possible social backgrounds in categories, with the high upper class representing the traditional Brazilian families, mainly either coffee or other agricultural exporters. The author finds that only 3.8% of entrepreneurs have a background in said families, and that 66.7% have a middle-class or lower background.

The results from Bresser-Pereira (1964) seem robust and the implication is that the modern Brazilian firm has its origin in a wave of entrepreneurship led by multi-classed and ethnically diverse entrepreneurs, and not by the coffee producers' elite. In many regards, the modern industrial Brazilian firm is of Italian origin. The main question remaining is then how this process was financed? To answer that question, we now turn to the structure of Brazilian capital markets.

### **The Absence of Capital Markets**

Brazilian capital market was almost non-existent before the 1960s. From the 1920 to the early 1960s there were many changes in the Brazilian financial markets, but only after the major reform of 1964 we can safely state that there was an embryonic capital market in place. A coupling of high inflation in some periods and interest rate ceiling (12% a year, due to the usury law) led to many restrictions to the expansion of banking credit in the economy. The banking system could not offer long-term credit or even short-term credit, in the amounts required to finance the new industrial activity (Baer, 1996).

From the savers' perspective, the preferred asset was real estate because commercial banks were unable to properly compete in acquiring sizable savings due to the usury laws. Many

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<sup>3</sup> São Paulo was and still is the industrial center of Brazil. Although maybe not representative of the whole of industrial entrepreneurs in Brazil, the survey is particularly interesting because most coffee producers were in São Paulo; so in a survey of ethnic and social backgrounds, there would be evidence against or in favor of Prado Jr.'s argument.

authors point out that the credit system at that time was unable to cope with the demand for funding of the industrial firms (e.g., Tavares, 1972; Goldsmith, 1986; and Baer, 1996).

Goldsmith (1969 and 1986) and Baer (1996) are prominent sources in tracing the evolution of the Brazilian financial system before 1964. Among other reforms, the period prior to 1964 presented the creation of: Credit Fund of Agriculture and Industry (CREAI), the only public fund to foster development in Brazil until new public banks were funded in the 1950s; Superintendence of Money and Credit (SUMOC) (1945)—its purpose was to control the monetary base and to function as a preliminary central bank, which was finally created in 1965; and finally the Brazilian Development Bank (BNDE) (1952)—its purpose was to explicitly develop Brazilian industries, although at first because of restriction of funds, the bank was mainly loaning to steel and energy industries. The CREAI was created by Banco do Brasil (Bank of Brazil) and never had enough depth to be able to really foster development since “the resources of the Bank of Brazil are derived primarily from sight and short-term deposits” (Basch and Kybal, 1970, p. 114). Even though the Bank of Brazil was at the time by far “the most important lending institution in the Brazilian banking system” (Basch and Kybal, 1970, p. 114), it was still incapable of providing the long-term credit necessary for industrialization. SUMOC was created to stabilize the financial system, and worked as a *de facto* central bank, although not with all the prerogatives of a full central bank.

The BNDE was the first public bank that was a relevant actor in the Brazilian long-term credit market. It was created to act as the engine of industrialization in the tradition of Economic Commission for Latin America and the Caribbean (ECLAC) authors such as Prebisch and Furtado. BNDE's funding was done through a share of income tax, external loans, and treasury loans (Baer, 1983). However, as important as the BNDE became in funding long-term projects, until 1964, 90% of its loans were directed to public-owned companies (Cruz, 1994).

### **The Early Brazilian Industrial Firm**

From the preceding subsections, the main implications are: due to the fact that the industrial process was jumpstarted by immigrants and other middle-class or lower entrepreneurs without access to capital markets or simple bank financing, the resulting Brazilian private company is a family-owned company controlled and centralized around the founder. Moreover, the capital structure of the firm is a simple one, with almost no long-term debt. Investments were funded by profits due to the protection from external competition throughout the period, first by the Great Depression and the steep decrease in imports, and then by an active Import Substitution Industrialization (ISI) policy. The resulting typical Brazilian industrial firm is then one that is middle-sized, with only short-term debt and that is not controlled by many partners, with the controlling power centered around one person or one family. The typical ways of acquiring finance for investments, new partners through equity or internationalization, banking system, credit markets, or public funds were all outside the range of possible choices for private firms.

In this environment, corporate governance is not an issue. Control and management not only are not separated, but also are tightly tied together in the figure of the company founder.

### Capital Market Reforms and Industrialization Deepening

President Kubitschek was responsible for the acceleration of the industrialization process in Brazil. The main strategy was, instead of allowing imports by heavy industries, Brazil would give incentives for the relocation or creation of industrial plants by foreign firms. The 'Plano de Metas' began in 1956 and public credit was directed to foreign and government-owned firms. Beginning with the 'Plano de Metas', Brazil finally entered the phase described in Chandler (1962), where increasing returns allow the emergence of companies that exploit economies of scale and become so big as to present diminishing returns in terms of managerial capacity. At first, the necessity of growth in scale was answered by the arrival of foreign firms, but after the reforms of the 1960s and the opening of public credit to family-owned companies, the Brazilian private firm entered the second phase of their development: the transition from founder to second-generation owners and access to public and private funds to increased growth. It was the phase of the consolidation of the modern Brazilian firm, in a pattern similar to what is described in Chandler (1962), albeit with a significant lag in time.

The major reforms of the 1960s, with the goal of developing a strong capital market in Brazil, comprised a reform to institute monetary indexation—wages and contracts that would be periodically corrected to account for inflation; a reform of the monetary market, with the creation of the central bank and changes in the banking system; and a new law that strived to build proper capital markets in Brazil (mutual funds were regulated in 1970). This last reform had the goal of building a stock market with modern characteristics. With the purpose of giving incentives to the new stock exchange, the government passed a bill creating a mutual fund called Fundo 157 (Fund 157), in which individuals could invest 20% of the income tax in stocks instead of paying it to the government. It created a de facto subsidy of the stock market, trying to generate enough liquidity for the market to blossom. It was successful until 1971, when the market crashed after some years of hefty speculation.

The reforms of the 1960s were complemented in 1976 by a couple of laws that had the purpose of regulating the behavior of public companies and fostering Brazilian capital markets by adopting regulations similar to those of developed countries.

Although intended to change the structure of Brazilian capital markets, there were no major effects of these measures on the capital structure of private industrial firms. The necessity for growth was present, and net profits were insufficient to fund firms' growth, but capital markets, for all their reforms, were still not the answer for the financing needs of industrial firms, at least not in a way that implicated ownership sharing.

With the acceleration of the industrialization initiated by Kubitschek, the financing needs of industrial firms grew not only for the existing firms but for new firms as well. The characteristics of funding changed from the early periods, though. BNDE and other public banks started to fund private firms and the volume grew enough to have an impact on the capital structure of the firms. The main result was a growth in the debt-equity ratio, but public banks were not stakeholders in the modern sense, and shared no control with the families that owned private



companies. Public banks were interested in the creation of industrial projects, and so at times loaned money with negative real interest rates, while doing anything to prevent a default from the private firms, even to the point that debts could be renegotiated at ease.

Alongside public funds, the stock market was used to fund industrial projects. However, because of a peculiarity in the Brazilian market, firms were able to issue stock without sharing ownership, by issuing non-voting shares. Firms could issue two non-voting shares for each voting share issued. In practice, this allowed firms to use the stock market to issue bond-like stocks instead of proper stock. The result is that a lot of firms entered the market but the ownership structure did not change. In the end, firms issued stock that worked like bonds and were purchased by individuals that were funded by tax write-offs from income taxes not paid in full. It was a complicated mechanism to transfer government funds to private firms with the purpose of financing industrial projects.

The second stage of Brazilian development was then funded by retained profits from the absence of international competition due to ISI and government funds, either by public banks or by the subsidized stock market. Ownership was still concentrated in the founder's family, unless it was diluted by their own choice. However, this choice would not involve financing necessity since those were covered by other means. Capital concentration was a major part of the Brazilian landscape. Was the Brazilian industrialization path responsible for this kind of ownership structure? The evidence seems to indicate that it was indeed so. The kind of capital accumulation sought by the Brazilian government would only be possible through the existence of huge economies of scale, which in turn necessitated the existence of oligopolies in all major industrial sectors. The firms would then be financed, directly or indirectly, by public funds to achieve the kind of growth compatible with the pattern of capital accumulation. Since the development of heavy industries was the goal, big companies were the result, and due to historical reasons, those companies were owned by the founder or the founder's family, whose cultural heritage prevented them searching for new partners, thus sharing control.

The situation remained relatively the same throughout the 1970s and 1980s. The 1980s presented a scenario of recession, hyperinflation and bad economic policy, an adverse scenario for industrial growth.<sup>4</sup> Survival of industrial firms was possible due of the lack of international competition and negative real interest rates. In 1990, before the opening of the Brazilian market to trade and foreign capital, the ownership structure of Brazilian firms was still heavily skewed to family-owned companies (Table 2).

As can be seen from Table 2, only eight firms of the 100 biggest listed public companies did not have ownership in the hands of the state, foreigners or a single Brazilian family in 1990. In this scenario, there was no place for corporate governance or any other analysis that takes into account separation between ownership and managerial capacity. Even though beginning in the 1960s the Brazilian companies started to recruit professional managers

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<sup>4</sup> Brazil's GDP grew at 8.4% annually during the period 1966-1981, and only 2.4% annually during the period 1982-2002.

Table 2: Ownership of the 100 Largest Non-Financial Companies in Brazil						
	Dispersed Ownership	Dominant Minority Ownership	Family Ownership	State Ownership	Foreign Ownership	Cooperative Ownership
1990	1 (0.4)	5 (3.5)	27 (22.6)	38 (44.3)	27 (26.9)	2 (2.3)
1995	3 (2.1)	12 (7.9)	26 (17.1)	26 (32.8)	31 (37.9)	2 (2.1)
1997	3 (1.8)	19 (12.4)	23 (16.5)	21 (31.8)	33 (37.2)	1 (0.4)
<b>Note:</b> Percentages of cumulative revenues for the 100 largest companies are given in brackets.						
<i>Source: Siffert-Filho (1998)</i>						

(Bresser-Pereira, 1966), those professionals had to coexist with the figure of the founder/manager, hence there was no agency problems between managers and owners. The situation changed with the opening process of the Brazilian economy, a process that transformed the whole structure of Brazilian capital markets.

### Recent Evolution of Capital Markets in Brazil

As seen in the previous section, the process of industrialization of Brazil was funded, until the beginning of the 1990, primarily from retained profits and government funding, directly or indirectly. Only after privatization and the entry of domestic and international institutional investors did the capital market start to represent a significant instrument for the capitalization of private firms. However, this was possible only because the Brazilian firms which opted to open their capital were willing to share control with the market, especially improving the guarantees to small shareholders. In the case of state-owned enterprises, going public was a form used not only to get more funding, but also to support political changes in the management of the companies through the strength of corporate governance practices.

This section describes the recent developments of the Brazilian capital market, aiming to establish the relationship between the improvements of the institutional environment, security to minority shareholders, and changing the culture of the controllers of the companies with the participation of the market in financing the activity of the real economy.

As previously observed, few advances deserve to be recorded in the 1980s, a decade characterized by crises and bumps in the Brazilian economy, reflecting, in part, the low liquidity of international markets. The growth in monthly inflation to levels exceeding two digits per month required the introduction of the so-called economic 'packages' in the economy, represented by a set of heterodox economic actions aimed to contain inflation, which were unsuccessful and resulted in the default of 1987. With the resulting repeated recession and high interest rates obtained in public securities and banking, companies began to gain significant share of their profits from financial, instead of operational activities. Up to this point, both the ownership structures as the corporate governance practices were almost the same as that of the beginning of industrialization.

The great event that changed the Brazilian capital markets happened in the 1990s, the widespread privatization movement. This movement began with the privatization of Usiminas, a steel company, on October 24, 1991, marking the beginning of the implementation of the National Program for 'Desestatização' (Privatization), a movement that continued throughout the decade and changed the configuration of the structure of ownership of businesses in the country. This movement records the entry of institutional investors in the capital market, particularly of national pension funds, as well as international investors. Thirty-seven companies were privatized between October 1991 and November 2000, including large enterprises and economic groups such as Vale do Rio Doce, Embraer, Cia Siderurgica Nacional, Banespa, in addition to the system of telecommunications, centered at Telebras. Just as important as the entry of new owners was the active posture in the governance played by those new investors. Particularly important was the participation of pension funds in the Brazilian privatization process. For these organizations, the stability of inflation, reached in 1994, and the need to allocate large amounts of resources in long-term investment boosted purchases in shares of the privatized companies. The control rights gained by the main funds forced them to develop structures to work actively in the administration of companies. Subsequently, these structures enabled the development of skills to acquire and actively exercise control rights in other public companies. The performance of the funds in the construction of the best corporate governance practices, especially after 2000, reflects the perceived need for the funds to create an environment conducive to active management of this portfolio.

However, even this new context was not enough to boost Brazilian capital markets. Valadares and Leal (1999) analyzed the structure of ownership and control of 325 public Brazilian companies listed in the year 1997. They observed that the biggest shareholder had, on average, 41% of the equity capital, while the five biggest shareholders owned 61% of controlling rights. Table 3 presents the main findings of Valadares and Leal (1999).

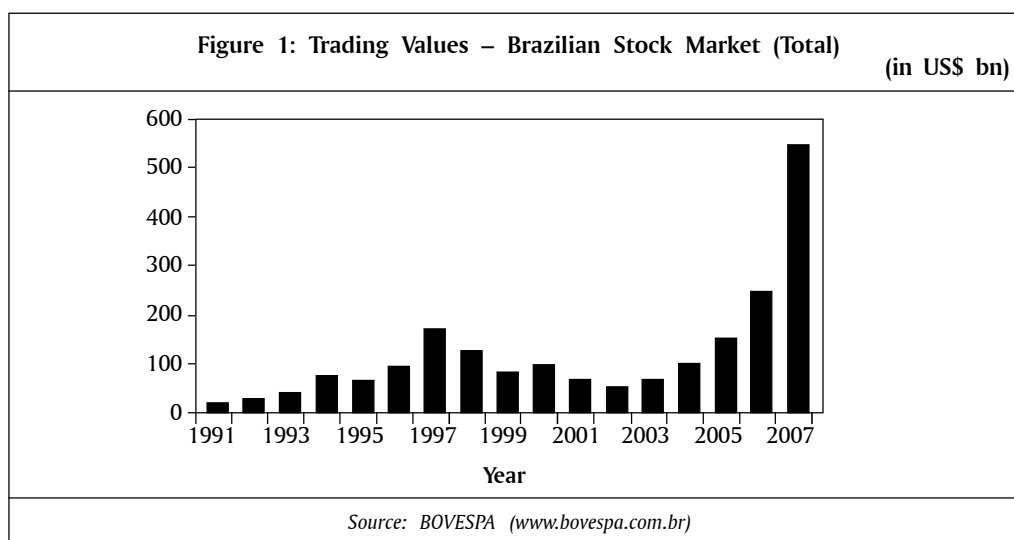
Table 3: Direct Shareholding Composition of Companies (in %)						
	Companies with a Majority Shareholder (203)		Companies Without Majority Shareholder (122)		Total Sample (325)	
	Voting Capital	Total Capital	Voting Capital	Total Capital	Voting Capital	Total Capital
Average Ownership of the Largest Shareholder (Median)	74 (73)	51 (50)	32 (29)	25 (18)	58 (58)	41 (36)
Average Ownership of the Three Largest Shareholders (Median)	89 (93)	63 (63)	67 (65)	49 (42)	78 (82)	58 (53)
Average Ownership of the Five Largest Shareholders (Median)	90 (94)	64 (64)	76 (73)	56 (48)	82 (87)	61 (56)
Source: Valadares and Leal (1999)						

It is important to note that, at that moment, the law permitted firms to issue shares without voting rights in an amount up to two-thirds of the total stock capital. This was changed to one-half in 2001. The authors noted that, in their sample, the violation of the one share-one vote rule with the use of non-voting shares was very common, insofar that only 11% of firms did not have non-voting shares and, on average, firms had only 54% of their equity capital as voting capital.

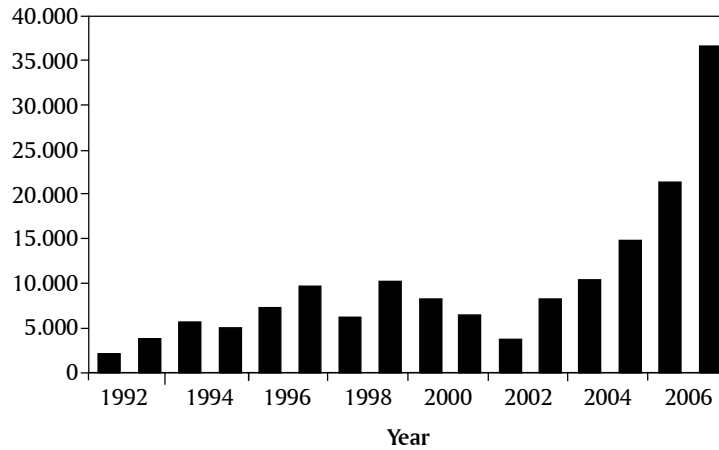
New changes were made in the legal framework in 2001. The main elements brought in by this legislation were the reintroduction of a tag along clause for 80% of the voting shares, approval for the resolution of disagreements between shareholders through arbitration if provided in the statute, and the requirement that the number of preferred shares without voting rights does not exceed 50% of the total issued shares.

Even with changes in the legislation, the growth of the capital market in terms of volumes traded, market capitalization and number of public companies only took off after 2003. Figures 1 and 2 show that growth.

One fact that may help explain this growth, related to the institutional environment, is the creation of the so-called new market BOVESPA. Based on the German Neur Markt, the 'Novo Mercado' is a listing segment designed for shares issued by companies that voluntarily undertake to abide by corporate governance practices and transparency requirements. The admission to 'Novo Mercado' implies the compliance with modern corporate regulation. Among those regulations are: the obligation to issue only shares with voting rights; the maintenance of a minimum free float equivalent to 25% of the total capital; a stringent tag along clause; disclosure of annual balance sheet according to standards of the US GAAP or IFRS; the establishment of a board of directors with a minimum of five members, with at least 20% of independent members; and the establishment of a board of arbitration for resolution of social conflicts.



**Figure 2: Dollar-Adjusted IBOVESPA Index**



Source: BOVESPA ([www.bovespa.com.br](http://www.bovespa.com.br))

At first, these rules would seem to represent disadvantages for the shares of companies traded on the 'Novo Mercado', mainly to controlling shareholders, because of the costs of introducing new practices of accountability, the free float, tag along and the increase in the number of board members. However, the recent findings indicate the success of this strategy. There was not only a stimulus to a number of Initial Public Offerings (IPO), but also a higher valuation of companies with these special practices of governance. Table 4 shows this development. In actual numbers, the market capitalization reached \$1,403,979 mn on April 10, 2008, almost double that of 2006.

**Table 4: Figures of the Brazilian Stock Market**

Market (December 2006)	Number of Companies		Market Capitalization (US\$ bn)*		Daily Average Trading Value (US\$ mn)**	
Novo Mercado (New Market)	94	20.84%	213,846.55	16.46%	602.13	18.43%
Level 2	20	4.43%	35,686.92	2.75%	129.90	3.98%
Level 1	43	9.53%	484,657.82	37.30%	1,364.58	41.76%
Traditional & BDR	294	65.19%	565,173.52	43.50%	1,170.90	35.83%
<b>Total</b>	<b>451</b>		<b>1,299,364.82</b>		<b>3,267.51</b>	

**Note:** \* US\$ = R\$1.7491 (March 31, 2008); and \*\* US\$ = R\$1.708 (Average March 2008).

Source: BOVESPA, *Boletim Informativo*, Ano 7 – Número 121 – abril de 2008  
in <http://www.bovespa.com.br/pdf/BoletimInformativo121.pdf>

## Conclusion

In this paper, we tried to relate the evolution of the private Brazilian firm through changes in the capital structure and corporate governance issues to the industrialization process and other changes experienced by the Brazilian economy in the last 60 years. We initially concluded that the history of the Brazilian firm is the history of family-owned business, which maintained a relatively concentrated capital structure from the beginning of the industrialization process of Brazil through the end of the 1980s.

This relatively stable capital structure is due to two main reasons: cultural aspects and the goals of industrial policy. The typical entrepreneur that jumpstarted the industrialization process was an immigrant (Bresser-Pereira, 1964) and internalized ownership was the main variable in the return function of the firm, and hence had an inherent desire to maintain control throughout the growth process of the firm. At first, the family-owned Brazilian industrial firms were able to grow almost solely on past profits. Since there was no need for external funding, the owners of these firms did not feel compelled to share any kind of control, especially since there was no viable capital market to do so even if firms searched for it.

When industrialization became the main focus of government policy, public funding became available for the growing funding needs of these firms, either directly or indirectly (as we have shown, the Brazilian stock market was used as an indirect way by the state to finance private firms), but public funding did not come with caveats of control sharing. In a way, it can be argued that for rapid industrialization of the kind sought by Brazilian policy makers, a concentrated capital structure was in fact desired since it is easier to allocate resources through the hands of a few owners than to do it through a disperse ownership structure. In fact, it seems that there is a direct relation between concentrated capital structure and the kind of industrialization process experienced in Brazil. Since Brazil shares some characteristics of rapid industrialization with countries like Germany, Argentina and Japan, it is interesting to notice that in these countries the capital structure of the firms were similar to that of Brazil in terms of concentration (not necessarily in terms of the firms being owned by families). We can thus conclude that exogenous factors were mainly responsible for the capital structure of Brazilian firms as the industrialization process unfolded.

After Brazil abandoned the industrialization by import substitution policy, substituting it for market-driven policies, one important source of concentrated capital structure was also abandoned. However, the family-owned firm did not shift its capital structure towards the Anglo-Saxon model. The recent development of the Brazilian capital market is due mostly to the privatization of state companies, with only just recently some movements towards dispersion of ownership through capital markets.

Between the years 1995 and 2007, market capitalization increased five times, exceeding 74% of the Brazilian GDP, and IBOVESPA, the main stock exchange index in Brazil, increased by about 10 times. In 2006, the issuance of shares, debentures and other financial instruments made it possible for companies to raise more than twice the volume of loans from the National Bank of Economic and Social Development (BNDES). The result is a shift from an industrial policy

environment where the main driver is the government to a more market-led environment. This fits the Post-Washington Consensus view of economic development, and shows that Brazil has turned its policy towards an Anglo-Saxon model.

As generally happens in Latin America and shown in the present paper, the structure of ownership in Brazil is still very concentrated. This is justified by the historical absence of effective tools for resolving conflicts (La Porta *et al.*, 1998), greater transparency, and certainly cultural aspects. Consequently, firm control remains necessary to prevent the capture of the firm value by others. However, accelerated changes have been occurring in the last five years, with the ascension of the new market and Brazil's insertion into the global economy.

In any case, the macroeconomic changes of the decade of the 1990s added to the improvement of the institutional environment of the country and enabled consistent growth of the market capitalization, mainly during the last five years. Although many of the cultural aspects remain, it is interesting to see how globalization has affected the capital structure of firms. This change may lead to a modern Chandlerian version of the history of the Brazilian firms. This shift towards capital markets seems in line with the Anglo-Saxon model, for better and worse, and corporate governance issues are becoming increasingly important in this context. □

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