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# FOCUS

*Corporate  
Governance and  
Development*

Stijn Claessens

*Foreword by Sir Adrian Cadbury*

Global  
Corporate  
Governance  
Forum

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# *Corporate Governance and Development*

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*Global Corporate Governance Forum  
Focus 1*

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## FOREWORD

*by Sir Adrian Cadbury*

It is a privilege to be asked to write a foreword to this study, given the international importance of the issues with which it deals and the pointers it provides for the direction which corporate governance policy should take. The key question the study addresses is the degree of influence which standards of corporate governance have in promoting the efficient use of scarce resources to the benefit of society as a whole. Stijn Claessens has carried out a thorough and rigorous review of the available evidence on the relationship between corporate governance and development. His review confirms the generally accepted view that there is a positive link at the level of the firm between good governance and good performance. How widely the benefits of the value which good governance can add are distributed depends on the institutional and structural context within which firms carry out their activities.

Corporations work within a governance framework. That framework is set by law, by regulations, by the corporation's own constitution, by those who own and fund them, and by the expectations of those they serve. The framework will differ country by country, since it owes much to history and culture and it involves both rules and institutions. Its effectiveness depends on its coherence and on the degree of reliance which can be placed on its constituent parts. The governance framework also changes shape and develops through time. Stijn Claessens rightly draws attention to how little we know about the nature of these changes and how their direction might be influenced.

Standards of corporate governance are determined by the measures which companies take for themselves, whether voluntarily or otherwise, to improve the way they are directed and controlled, and by the legal, financial, and ethical environment in which they work. However, the actions which corporations take to improve their internal governance cannot make up for deficiencies in the external framework, notably if an appropriate and enforceable legal system is lacking. This provides useful guidance for where the priorities for reform lie, especially as the study makes the point that poor corporate governance is a particular handicap for small firms. It is the growth potential of such firms which is crucial to improving the economic prospects of countries in the course of development.

The review clearly sets out the reasons why corporate governance has moved higher up the agenda of corporations and countries. Private capital has become the prime source of funds for investment. Investment is to an increasing extent in

the hands of institutions who act as intermediaries. In that role—a role, incidentally, which raises issues about their governance and accountability—they place the funds for which they are responsible wherever in the world they see them earning acceptable returns. They are looking for a spread of risk and reward and in coming to their judgments on this, standards of corporate governance have a measurable part to play. A further reason why corporate governance has become increasingly relevant is that, with advances in communications technology, detailed information about individual corporations and about their national governance frameworks is now readily available on screen and the public scrutiny of business is correspondingly more intense.

The importance of international institutional investors is that they apply the same tests of security and rate of return wherever in the world they place the funds of those for whom they are acting. They are, therefore, a force for governance convergence, a process which has its pluses and minuses. Convergence of this kind raises corporate governance standards generally, since these investors look for the same levels of board effectiveness, transparency, accountability, and financial probity wherever in the world they invest. The downside is that they may thereby overlook opportunities in countries where their investment could earn both an acceptable return and make a considerable contribution to that country's development; in effect, where their investment could be socially and economically most productive.

As the review points out, only a limited number of countries provide investment funds of this kind, important though they are in economic terms. Businesses throughout the world rely more on banks and on internally generated finance than they do on capital markets. Family businesses are after all the dominant corporate form. Nevertheless, the same issues arise for banks and for those who have the responsibility for allocating funds on behalf of others as they do for institutional investors. They have an equal responsibility for the effectiveness and integrity with which the enterprises they are financing are being directed and controlled. The upshot is that, whatever their source, funds will flow to businesses around the world which are seen to meet internationally accepted standards of corporate governance.

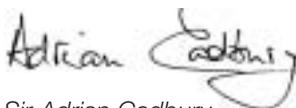
What practical policy lessons can be drawn from this review? First, they suggest caution over importing governance structures or systems from foreign jurisdictions. Countries and corporations are best advised to start from where they are and to build on their existing structures and systems. Convergence is taking place, but it is convergence on standards of corporate governance, not necessarily on their form. The OECD identified four principles against which governance practice can be assessed; they were those of *fairness, transparency, accountability, and responsibility*.

These principles are equally relevant whether businesses are privately, publicly, or state-owned, or are subject to a controlling shareholder.

The objective, therefore, of the agencies with responsibility for the way in which corporations are governed—whether businesses themselves, the states who regulate them, or those who provide them with funds—should be to encourage the firm application of these principles. The more widely the four principles are applied, the more equitably and effectively will resources be allocated. Transparency and disclosure are in many ways the key. Provided companies are open about their purposes and the way in which they go about achieving them, they will earn the trust of those on whom they depend for their success. Resources will flow to companies which inspire trust, through their approach to governance and through the integrity of those who manage them. Responsible governance is the basis on which trust is established and enterprise encouraged.

Corporate governance is a process, not a state. The field is continually evolving, as the review explains. Its initial focus was on the way in which individual corporations are directed and controlled. This led to the introduction of national codes of best practice. As the wider economic and social significance of corporate governance became apparent, international guidelines were published to advance its cause more broadly. These guidelines reflected the part which good governance can play in promoting economic growth and business integrity. The way ahead lies in ensuring that the fruits of good governance, its ability to add value, are widely and wisely shared, thus playing a positive part in the goal of the developed and developing world to alleviate poverty.

In its broadest sense, corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, of corporations, and of society. The incentive to corporations and to those who own and manage them to adopt internationally accepted governance standards is that these standards will assist them to achieve their aims and to attract investment. The incentive for their adoption by states is that these standards will strengthen their economies and encourage business probity.



Sir Adrian Cadbury



## CORPORATE GOVERNANCE AND DEVELOPMENT

### *Abstract*

This paper investigates the relationship between corporate governance and economic development and well-being. It finds that better corporate frameworks benefit firms through greater access to financing, lower cost of capital, better firm performance, and more favorable treatment of all stakeholders. Numerous studies agree that these channels operate not only at the level of the firms, but in sectors and countries as well—although causality is not always clear. There is also evidence that when a country's overall corporate governance and property rights system are weak, voluntary and market corporate governance mechanisms have limited effectiveness. Less evidence is available on the direct links between corporate governance and poverty. There are also some specific corporate governance issues in various regions and countries that have not yet been analyzed in detail. In particular, the special corporate governance issues of banks, family-owned firms, and state-owned firms are not well understood, nor are the nature and of determinants of enforcement. Importantly, the dynamic aspects of corporate governance—that is, how corporate governance regimes change over time—have only recently received attention. This paper concludes by identifying some main policy and research issues that require further study.

Corporate governance, a phrase that not long ago meant little to all but a handful of scholars and shareholders, has now become a mainstream concern—a staple of discussion in corporate boardrooms, academic meetings, and policy circles around the globe. Two events are responsible for the heightened interest in corporate governance. During the wave of financial crises in 1998 in Russia, Asia, and Brazil, the behavior of the corporate sector affected entire economies, and

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deficiencies in corporate governance endangered the stability of the global financial system. Just three years later confidence in the corporate sector was sapped by corporate governance scandals in the United States and Europe that triggered some of the largest insolvencies in history. In the aftermath, not only has the phrase corporate governance become nearly a household term, but economists, the corporate world, and policymakers everywhere began to recognize the potential macroeconomic consequences of weak corporate governance systems. The scandals and crises, however, are just manifestations of a number of structural reasons why corporate governance has become more important for economic development and well-being (Becht, Bolton, and Röell 2003). The private, market-based investment process is now much more important for most economies than it used to be, and that process is underpinned by better corporate governance. With the size of firms increasing and the role of financial intermediaries and institutional investors growing, the mobilization of capital has increasingly become one step removed from the principal-owner. At the same time, the allocation of capital has become more complex as investment choices have widened with the opening up and liberalization of financial and real markets, and as structural reforms, including price deregulation and increased competition, have increased companies' exposure to market forces risks. These developments have made the monitoring of the use of capital more complex in certain ways, enhancing the need for good corporate governance.

This paper aims to trace the many dimensions through which corporate governance works in firms and countries. To do so, it reviews the extensive literature on the subject—and identifies areas where more study is needed. A well-established body of research has for some time acknowledged the increased importance of legal foundations, including the quality of the corporate governance framework, for economic development and well-being. Research has started to address the links between law and economics, highlighting the role of legal foundations and well-defined property rights for the functioning of market economies. This literature has also started to address the importance and impact of corporate governance.<sup>1</sup>

Some of this material is not easily accessible to the nonacademic. Importantly, much of it refers to situations in developed countries, in particular the United States, and less so to developing countries. Furthermore, this literature does not always have a focus of the relationship between corporate governance and economic development and well-being. The purpose of this paper is to fill these gaps.

The paper is structured as follows. It starts with a definition of corporate governance, as that determines the scope of the issues. It reviews how corporate governance can and has been defined. It describes why more attention is being paid to corporate governance in particular, and to protection of private property rights, more generally. The paper next explores why corporate governance may matter. It does so by reviewing the general evidence of the effects of property rights on financial development and growth. It also provides some background on the ownership patterns around the world that determine and affect the scope and nature of corporate governance problems. After analyzing what the literature has to say about the various channels through which corporate governance affects economic development and well-being, the paper reviews the empirical facts about some of these relationships. It explores recent research documenting how legal aspects can affect firm valuation, influence the degree of corporate governance problems, and more broadly affect firm performance and financial structure. The paper concludes by identifying some main policy and research issues that require further study.

## WHAT IS CORPORATE GOVERNANCE AND WHY IS IT RECEIVING MORE ATTENTION?

### *What is corporate governance?*

Definitions of corporate governance vary widely. They tend to fall into two categories. The first set of definitions concerns itself with a set of behavioral patterns: that is, the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second set concerns itself with the normative framework: that is, the rules under which firms are operating—with the rules coming from such sources as the legal system, the judicial system, financial markets, and factor (labor) markets.

For studies of single countries or firms within a country, the first type of definition is the most logical choice. It considers such matters as how boards of directors operate, the role of executive compensation in determining firm performance, the relationship between labor policies and firm performance, and the role of multiple shareholders. For comparative studies, the second type of definition is the more logical one. It investigates how differences in the normative framework affect the behavioral patterns of firms, investors, and others.

In a comparative review, the question arises how broadly to define the framework for corporate governance. Under a narrow definition, the focus would be only on the rules in capital markets governing equity investments in publicly listed firms. This would include listing requirements, insider dealing arrangements, disclosure and accounting rules, and protections of minority shareholder rights.

Under a definition more specific to the provision of finance, the focus would be on how outside investors protect themselves against expropriation by the insiders. This would include minority right protections and the strength of creditor rights, as reflected in collateral and bankruptcy laws. It could also include such issues as the composition and the rights of the executive directors and the ability to pursue class-action suits. This definition is close to the one advanced by economists Andrei Shleifer and Robert Vishny in their seminal 1997 review: “*Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment*” (1997, p. 737). This definition can be expanded to define corporate governance as being concerned with the

*resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders.*

A somewhat broader definition would be to define corporate governance as a set of mechanisms through which firms operate when ownership is separated from management. This is close to the definition used by Sir Adrian Cadbury, head of the Committee on the Financial Aspects of Corporate Governance in the United Kingdom: “*Corporate governance is the system by which companies are directed and controlled*” (Cadbury Committee, 1992, introduction).

An even broader definition is to define a governance system as “*the complex set of constraints that shape the ex post bargaining over the quasi rents generated by the firm*” (Zingales, 1998, p. 499). This definition focuses on the division of claims and can be somewhat expanded to define corporate governance as *the complex set of constraints that determine the quasi-rents (profits) generated by the firm in the course of relationships and shape the ex post bargaining over them*. This definition refers to both the determination of value-added by firms and the allocation of it among stakeholders that have relationships with the firm. It can be read to refer to a set of rules, as well as to institutions.

Corresponding to this broad definition, the objective of a good corporate governance framework would be to maximize the contribution of firms to the overall economy—that is, including all stakeholders. Under this definition, corporate governance would include *the relationship between shareholders, creditors, and corporations; between financial markets, institutions, and corporations; and between employees and corporations. Corporate governance would also encompass the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment.*

When analyzing corporate governance in a cross-country perspective, the question arises whether the framework extends to rules or institutions. Here, two views have been advanced. One is the view that the framework is determined by rules, and related to that, to markets and outsiders. This has been considered a view prevailing in or applying to Anglo-Saxon countries. In much of the rest of the world, institutions—specifically banks and insiders—are thought to determine the actual corporate governance framework.

In reality, both institutions and rules matter, and the distinction, while often used, can be misleading. Moreover, both institutions and rules evolve over time. Institutions do not arise in a vacuum and are affected by the rules in the country or the world. Similarly, laws and rules are affected by the country's institutional setup. In the end, both institutions and rules are endogenous to other factors and conditions in the country. Among these, ownership structures and the role of the state matter for the evolution of institutions and rules through the political economy process. Shleifer and Vishny (1997, p. 738) take a dynamic perspective by stating: "*Corporate governance mechanisms are economic and legal institutions that can be altered through political process.*" This dynamic aspect is very relevant in a cross-country review, but has received much less attention from researchers to date.

When considering both institutions and rules, it is easy to become bewildered by the scope of institutions and rules that can be thought to matter. An easier way to ask the question of what corporate governance means is to take the functional approach. This approach recognizes that financial services come in many forms, but that if the services are unbundled, most, if not all, key elements are similar (Bodie and Merton 1995). This line of analysis of the functions—rather than the specific products provided by financial institutions, and markets—has distinguished six types of functions: pooling resources and subdividing shares; transferring resources across time and space; managing risk; generating and providing information; dealing with incentive problems; and resolving competing claims on the wealth generated by the corporation. One can define corporate governance as *the range of institutions and policies that are involved in these functions as they relate to corporations*. Both markets and institutions will, for example, affect the way the corporate governance function of generating and providing high-quality and transparent information is performed.

### *Why has corporate governance received more attention lately?*

One reason, mentioned earlier, is the proliferation of scandals and crises. As also mentioned, the scandals and crises are just manifestations of a number of structural reasons why corporate governance has become more important for economic development and a more important policy issue in many countries.

First, the private, market-based investment process—underpinned by good corporate governance—is now much more important for most economies than it used to be. Privatization has raised corporate governance issues in sectors that

were previously in the hands of the state. Firms have gone to public markets to seek capital, and mutual societies and partnerships have converted themselves into listed corporations.

Second, due to technological progress, liberalization and opening up of financial markets, trade liberalization, and other structural reforms—notably, price deregulation and the removal of restrictions on products and ownership—the allocation within and across countries of capital among competing purposes has become more complex, as has monitoring of the use of capital. This makes good governance more important, but also more difficult.

Third, the mobilization of capital is increasingly one step removed from the principal- owner, given the increasing size of firms and the growing role of financial intermediaries. The role of institutional investors is growing in many countries, with many economies moving away from “pay as you go” retirement systems. This increased delegation of investment has raised the need for good corporate governance arrangements.

Fourth, programs of deregulation and reform have reshaped the local and global financial landscape. Long-standing institutional corporate governance arrangements are being replaced with new institutional arrangements, but in the meantime, inconsistencies and gaps have emerged.

Fifth, international financial integration has increased, and trade and investment flows are increasing. This has led to many cross-border issues in corporate governance. Cross-border investment has been increasing, for example, resulting in meetings of corporate governance cultures that are at times uneasy.

## THE LINK BETWEEN CORPORATE GOVERNANCE AND OTHER FOUNDATIONS OF DEVELOPMENT

The research on the role of corporate governance for economic development and well-being is best understood from the broader perspective of other foundations for development, notably the importance of finance, the elements of a financial system, property rights, and competition. Four elements of this broad literature are worth highlighting.

### *The link between finance and growth*

First, over the past decade, the importance of the financial system for growth and poverty reduction has been clearly established (Levine 1997; World Bank 2001). One demonstration is the link between finance and growth. Almost regardless of how financial development is measured, there is a cross-country association between it and the level of GDP per capita growth. Numerous pieces of evidence have been assembled over the past few years to indicate the relation is a causal one: that is, it is not only the result of better countries having both larger financial systems and growing faster (although that plays an important role). The relationship has been established at the level of countries, industrial sectors, and firms and has consistently survived a rigorous series of econometric probes (as documented in World Bank 2001).

The development of a country's private credit system has a substantial impact on growth.

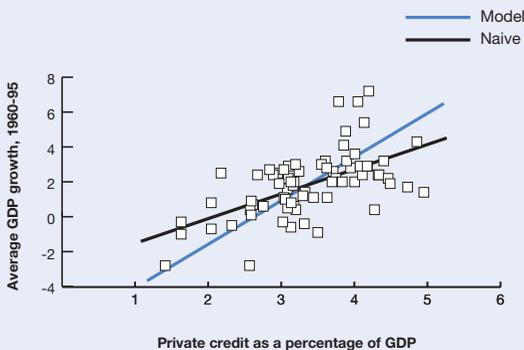


Figure 1. The relationship between the development of a country's banking system and per capita growth

Source: World Bank (2001).

Figure 1 illustrates this link. It shows the relationship between the development of the banking system (private credit as a share of GDP) and per capita growth. A simple relationship is plotted, as well as one that controls for some other variables affecting growth. The size of the estimated effect is substantial (and actually larger than would be predicted by a naïve simple regression of growth rates on financial development). A doubling of the ratio of private

credit (for example, from 19 percent of GDP to the sample average of 38 percent) is associated with an increase in the average long-term growth rate of almost 2 percentage points.

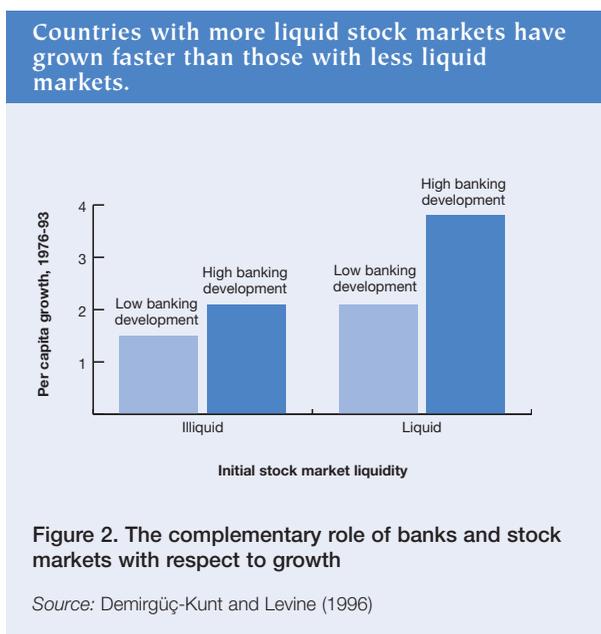
### *The link between the development of banking systems and market finance and growth*

Second, and importantly for the analysis of corporate governance, the development both of banking systems and of market finance helps economic growth. Banks and securities markets are complementary in their functions, although markets will naturally play a greater role for listed firms.

Figure 2 makes clear the importance of stock markets. It shows that countries that had more liquid stock markets in 1960 have grown faster than those that had less liquid markets from 1976 to 1993.<sup>2</sup> For both types of economies, growth per capita is higher if the banking system is more developed. This shows the complementarity between the two.

More generally, the findings provide support for the functional view of finance. That is, it is not financial institutions or financial markets that matter; it is the functions

that they perform that matter. In particular, for *any* regression model of growth that is selected and adapted by adding various measures of stock market development relative to banking system development, the results are consistent. None of these measures of financial sector structure has any statistically significant impact on growth (see Demirgüç-Kunt and Levine 2001).<sup>3</sup> To function well, financial institutions and financial markets, in turn, require certain foundations, including good governance.



### *The link between legal foundations and growth*

Third, the role of legal foundations is now better understood and documented. Legal foundations matter crucially for a variety of factors that lead to higher growth, including financial market development, external financing, and the quality of investment. Legal foundations include property rights that are clearly defined and enforced and other key regulations (disclosure, accounting, and financial sector regulation and supervision).

Comparative corporate governance research took off following the works of economists Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (La Porta and others 1997, 1998). These two pivotal papers emphasized the importance of law and legal enforcement on the governance of firms, the development of markets, and economic growth. Following these papers, numerous studies have documented institutional differences relevant for financial markets and other aspects.<sup>4</sup> These papers have established that the development of a country's financial markets relates to these institutional characteristics and furthermore that institutional characteristics can have direct effects on growth. Thorsten Beck and colleagues (Beck, Levine, and Loayza 2000), for example, document how the quality of a country's legal system not only influences its financial sector development but also has a separate, additional effect on economic growth. In a cross-country study at a sectoral level, Stijn Claessens and Luc Laeven (2003) report that in weaker legal environments, firms not only obtain less financing but also invest less in intangible assets. Both the less-than-optimal financing and investment patterns in turn affect the economic growth of a sector.

### *The role of competition and of output and input markets in disciplining firms*

Fourth, besides financial and capital markets, other factor markets need to function well to prevent corporate governance problems. These real factor markets include all output and input markets, including labor, raw materials, intermediate products, energy, and distribution services. Firms subject to more discipline in the real factor markets are more likely to adjust their operations and management to maximize value added. Corporate governance problems are therefore less severe when competition is already high in real factor markets.

The importance of competition for good corporate governance is true in financial markets, as well. The ability of insiders, for example, to mistreat minority shareholders consistently can depend on the degree of competition and protection. If small shareholders have little alternative but to invest in low-earning assets, for example, controlling shareholders may be more able to provide a below-market return on minority equity. Surprisingly, while well accepted and generally acknowledged (see Khemani and Leechor 2001), there is little empirical evidence that such a complementary relationship exists between corporate governance and competition.<sup>5</sup>

### *The role of ownership structures and group affiliation*

The nature of the corporate governance problems that countries face varies over time and between countries. One factor of importance is ownership structure, as it defines the nature of principal-agent issues. Another factor is group-affiliation, which is especially important in emerging markets. Of course, ownership and group-affiliation structures can vary over time and can be endogenous to country circumstances, including legal and other foundations (see Shleifer and Vishny 1997). As such, ownership and group-affiliation structures both *affect* the legal and regulatory infrastructure necessary for good corporate governance and *are affected* by the existing legal and regulatory infrastructure.

Much of the corporate governance literature has focused on conflicts between managers and owners. But around the world, except for the United States and to some degree the United Kingdom, insider-controlled or closely held firms are the norm (La Porta and others 1998). These can be family-owned firms or firms controlled by financial institutions. Families like the Peugeots in France, the Quandts in Germany, and the Agnellis in Italy hold large blocks of shares in even the largest firms and effectively control them (Barca and Becht 2001; Faccio and Lang 2002). Wealthy, powerful families dominate the ownership of most corporations in emerging markets (Claessens, Djankov, and Lang 2000; Lins 2003). In other countries, such as Japan and to some extent Germany, financial institutions control large parts of the corporate sector (La Porta and others 1998; Claessens, Djankov, and Lang 2000; Faccio and Lang 2002). This control is frequently reinforced through pyramids and webs of shareholdings that allow families or financial institutions to use ownership of one firm to control many more. Even in the United States, family-owned firms are not uncommon (Gadhoun, Lang, and Young 2003; Anderson and Reeb 2003).

A corporation's ownership structure affects the nature of the agency problems between managers and outside shareholders, and among shareholders. When ownership is diffuse, as is typical for U.S. and UK corporations, agency problems stem from the conflicts of interests between outside shareholders and managers who own an insignificant amount of equity in the firm (Jensen and Meckling 1976). On the other hand, when ownership is concentrated to a degree that one owner (or a few owners acting in concert) has effective control of the firm, the nature of the agency problem shifts away from manager-shareholder conflicts. The controlling owner is often also the manager or can otherwise be assumed to be able and willing to closely monitor and discipline management. Information asymmetries can also be assumed to be less, as a controlling owner can invest the resources necessary to acquire necessary information.

Correspondingly, the principal-agent problems will be less management-versus-owner and more minority-versus-controlling shareholder. In these countries, the protection of minority rights is more often key. Countries in which insider-held firms dominate will have different requirements in terms of corporate governance framework than those where widely held firms dominate.

A related aspect is that many countries have large financial and industrial conglomerates and groups. In some groups, a bank or another financial institution lies at the apex of the group, as insurance companies do in Japan (Prowse 1990) and banks do in Germany (Gorton and Schmidt 2000b). In others, and often in emerging markets, a financial institution lies within the group.

Such groups can have many benefits for the firm and its investors, such as the use of internal factor markets, which can be valuable in case of missing or incomplete external (financial) markets. Particularly in emerging markets, group-affiliation can be valuable for firms. Groups or conglomerates can also have costs, however. They often come with worse transparency and less clear management structures. This opens up the possibility of worse corporate governance, including expropriation of minority rights.

The existence of such problems and related corporate governance issues also depends on the overall competitive structure of the economy and the role of the state. In more developed, more market-based economies that are also more

competitive, group affiliation is less common. Again, as with ownership structures, the line of causality is unclear. The prevalence of groups can undermine the drive to develop external (financial) markets. Alternatively, poorly developed external markets increase the benefits of internal markets.

## HOW DOES CORPORATE GOVERNANCE MATTER FOR GROWTH AND DEVELOPMENT?

The literature has identified several channels through which corporate governance affects growth and development:

- The first is the increased access to external financing by firms. This in turn can lead to larger investment, higher growth, and greater employment creation.
- The second channel is a lowering of the cost of capital and associated higher firm valuation. This makes more investments attractive to investors, also leading to growth and more employment.
- The third channel is better operational performance through better allocation of resources and better management. This creates wealth more generally.
- Fourth, good corporate governance can be associated with a reduced risk of financial crises. This is particularly important, as financial crises can have large economic and social costs.
- Fifth, good corporate governance can mean generally better relationships with all stakeholders. This helps improve social and labor relationships and aspects such as environmental protection.

All these channels matter for growth, employment, poverty, and well-being more generally. Empirical evidence using various techniques has documented these relationships at the level of the country, the sector, and the individual firm and from the investor perspectives.<sup>6</sup> A review follows.

### *Increased access to financing*

As mentioned, financial and capital markets are better developed in countries with strong protection of property rights, as demonstrated by the law and finance literature. In particular, better creditor rights and shareholder rights have been shown to be associated with deeper and more developed banking and capital markets. Figure 3 depicts the relationship between an index of creditor rights (adjusted for the extent to which the rule of law is being enforced in the country) and the depth of the financial system (as measured by the ratio of private credit to GDP).<sup>7</sup> The figure shows that the better creditor rights are defined and enforced, the more willing lenders are to extend financing.

The stronger the creditor rights, the greater the depth of the financial system.

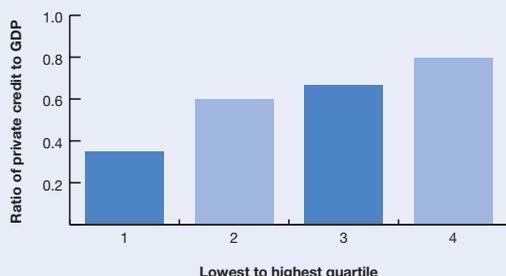


Figure 3. The relationship between creditor rights and rule of law and the depth of the financial system

Source: La Porta and others (1997).

the highest quartile country. As for the comparison between creditor rights and the development of private credit, this comparison does not correct for other factors that affect financial sector development, such as inflation and macroeconomic performance. Yet almost all studies find that these results are robust to including a wide variety of control variables in the analysis (see Levine 2004).

The better the quality of shareholder protection, the larger the country's stock markets.

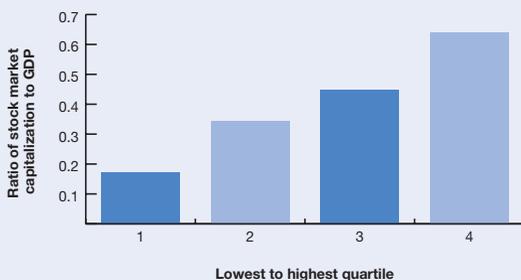


Figure 4. The relationship between shareholder rights and the size of stock markets

Source: La Porta and others (1997).

A similar relationship exists between the quality of shareholder protection and the development of countries' capital markets. Figure 4 depicts the relationship between an index of shareholder rights (the index of La Porta and others 1997, again adjusted for the efficiency of the judicial system) and the size of the stock markets (as a ratio of GDP).<sup>8</sup> The figure shows a strong relationship, with the market capitalization almost quadrupling between the lowest quartile country and

In countries with better property rights, firms thus have greater access to financing. As a consequence, firms can be expected to invest more and grow faster. The effects of better property rights leading to greater access to financing on growth can be large. For example, countries in the third quartile of financial development enjoy between 1 and 1.5 extra percentage points of GDP growth per year, compared with countries in the first quartile.

There is also evidence that under conditions of poor corporate governance (and underdeveloped financial and legal systems and higher corruption), the growth rate of the smallest firms is the most adversely affected, and fewer new firms start up—particularly small firms (Beck, Demirgüç-Kunt, and Maksimovic 2002; Rajan and Zingales 1998).

### *Higher firm valuation*

The quality of the corporate governance framework affects not only the access to and amount of external financing, but also the cost of capital and firm valuation. Outsiders are less willing to provide financing and are more likely to charge higher rates if they are less assured that they will get an adequate rate of return. Conflicts between small and large controlling shareholders are greater in weaker corporate governance settings, implying that smaller investors are receiving lower rates of return.

There is clear empirical evidence for these effects. The cost of capital has been shown to be higher and valuation lower in weaker property rights countries (La Porta and others 2000). Investors also seem to apply a discount in their valuation for firms and countries with relatively worse corporate governance (McKinsey and Company 2002). Furthermore, in countries with weaker property rights, controlling shareholders also obtain a fraction of the value of the firm that exceeds their direct ownership stake, at the expense of minority shareholders.

#### **Weak corporate governance translates into higher costs of capital.**



**Figure 5. The relationship between weak corporate governance and the cost of capital**

Source: Dyck and Zingales (forthcoming).

Figure 5 depicts this using the prices paid in a number of actual transactions for a block of shares that implies transferring control over the firm relative to the price of normal shares, plotted against the equity rights index. The higher cost of capital, and the corresponding lower firm valuation, translates into economic costs for lower corporate governance countries, as less attractive investments are bypassed.<sup>9</sup>

## Better operational performance

In the end, the way better corporate governance can add value is by improving the performance of firms, whether through more efficient management, better asset allocation, better labor policies, and similar efficiency improvements. Evidence for the United States (Gompers, Ishii, and Metrick 2003), Korea (Joh 2003), and elsewhere strongly suggests that at the firm level, better corporate governance leads not only to improved rates of return on equity and higher valuation, but also to higher profits and sales growth. This evidence is maintained when controlling for the fact that “better” firms may adopt better corporate governance and perform better due to other reasons. These and other firm-specific tests can nevertheless be criticized as suffering from homogeneity (see further, Himmelberg 2002). Across countries, there is also evidence that operational performance is higher in better corporate governance countries, although the evidence is less strong.

Figure 6 depicts the accounting rates of assets for a sample of publicly listed firms using data from *Worldscope*, plotted against the equity rights index. It shows a much less strong relationship between a measure of the quality of the governance framework and firm performance than for the relationship between the quality of the governance framework and access to financing and valuation. Other factors evidently affect operational performance to mute this relationship. As noted, many

**Better corporate governance translates into somewhat higher returns on assets.**



**Figure 6. The relationship between governance and firm operational performance**

*Note:* Data on returns are from Claessens and others 2000 and cover the 1996–99 period. The index on equity rights is from La Porta and others 1998. The figure excludes Mexico and Venezuela, where rates of return were heavily influenced by inflation and/or currency movements. *Source:* Claessens and others (2000); La Porta and others (1998).

institutions and factors influence a firm’s management and performance. Firms in developing countries may face better growth opportunities, thus reporting higher profits, although they may have worse corporate governance. There may also be a reporting bias. Firms in worse corporate governance environments may more likely overstate their accounting profits.

The limited relationship between operational performance and corporate governance measures at the country level may also

reflect the fact that corporate governance in most countries does not concern a conflict between management and owners, leading to inefficient firm operation and low rates on assets. Rather, as most firms are closely held or controlled by insiders, corporate governance concerns conflicts between controlling shareholders and minority shareholders, leading to lower valuation and reduced access to external financing.

This interpretation is supported by a comparison of the rate of return on investment relative to the cost of capital for different strengths of corporate governance framework. Figure 7 depicts firms' rate of return on investment for a sample of some 19,000 publicly listed firms from a variety of countries, plotted against a strength-of-equity-rights index. It shows that firms in many countries do not earn the cost of capital required by shareholders; only in the best corporate governance countries does the rate of return on investment exceed the cost of capital. The relationship derives, however, largely from the higher cost of capital—that is, the lower valuation of firms in weak corporate governance countries.

### *Reduced risk of financial crises*

The quality of corporate governance can also affect firms' behavior in times of economic shocks and actually contribute to the occurrence of financial distress,

with economywide impacts. During the East Asian financial crisis, cumulative stock returns of firms in which managers had high levels of control rights, but little direct ownership, were 10 to 20 percentage points lower than those of other firms (Lemmon and Lins 2003).

This shows that corporate governance can play an important role in determining individual firms' behavior, in particular the incentives of insiders to expropriate minority shareholders during times of distress. Similarly, a study of the

**Greater equity rights translate into higher returns on investment relative to the cost of capital.**



**Figure 7. The relationship between the strength of equity rights and the firm's rate of return on investment**

*Note:* The data on returns come from Gugler, Mueller, and Yurtoglu (2003), who in turn use data from *Worldscope*. The figure depicts the marginal rates of return on new investment adjusted for the cost of capital calculated using the Tobin's Q model. The index on equity rights is again from La Porta and others (1998).  
*Source:* Gugler, Mueller, and Yurtoglu (2003); La Porta and others (1998).

stock performance of listed companies from Indonesia, Korea, Malaysia, the Philippines, and Thailand found that performance is better in firms with higher accounting disclosure quality (proxied by the use of Big Six auditors) and higher outside ownership concentration (Mitton 2002). This provides firm-level evidence consistent with the view that corporate governance helps explain firm performance during a financial crisis.

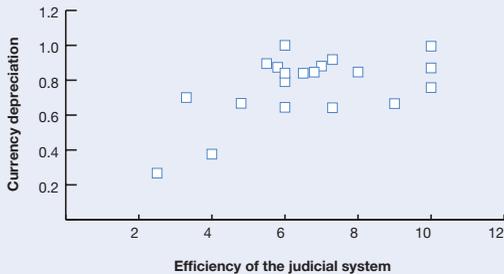
Related work shows that hedging by firms is less common in countries with weak corporate governance frameworks (Lel 2003), and to the extent that it happens, it adds very little value (Alayannis, Lel, and Miller 2003). The latter evidence suggests that in these environments, hedging is not necessarily for the benefit of outsiders, but more for the insiders. There is also evidence that stock returns in emerging markets tend to be more positively skewed than in industrial countries (Bae, Lim, and Wei 2003). This can be attributed to managers having more discretion in emerging markets to withhold bad information, or that firms share risks in these markets among each other, rather than through financial markets.

There is also country-level evidence that weak legal institutions for corporate governance were key factors in exacerbating the stock market declines during the 1997 East Asian financial crisis (Johnson and others 2000). In countries with weaker investor protection, net capital inflows were more sensitive to negative events that adversely affect investors' confidence. In such countries, the risk of expropriation increases during bad times, as the expected return of investment is lower, and the country is therefore more likely to witness collapses in currency and stock prices.

Figure 8 depicts a relationship between the efficiency of the judicial system and currency depreciation between the end of 1996 and the beginning of 1999. It shows that countries with less efficient judicial systems, which often also have weaker corporate governance systems, experienced much higher currency depreciation during the East Asian and global financial crises.<sup>10</sup> More generally, a well-functioning financial and legal system can help reduce financial volatility.

The view that poor corporate governance of individual firms can have economy-wide effects is not limited to developing countries. Recently, the argument has been made that in industrial countries corporate collapses (like Enron), undue profit boosting (by Worldcom), managerial corporate looting (by Tyco), audit fraud (by Arthur Andersen), and inflated reports of stock performance (by supposedly independent investment analysts) have led to crises of confidence among

Currency depreciation can be much higher in weak corporate governance countries.



**Figure 8. The relationship between the degree of currency depreciation and the efficiency of the judicial system**

*Note:* The degree of currency depreciation is relative to the U.S. dollar and refers to the percentage depreciation between December 3, 1996, and January 31, 1999. It is depicted against an index of the efficiency of the judicial systems as reported by La Porta and others (1998).

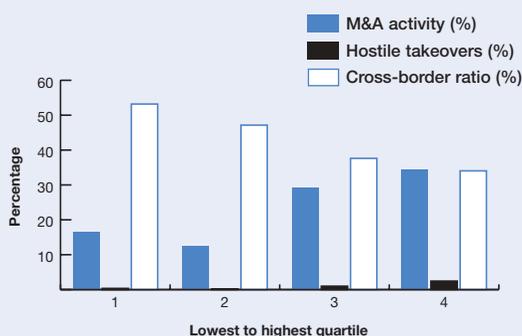
*Source:* Johnson and others (2000).

investors, leading to the declines in stock market valuation and other economywide effects, including some slowdowns in economic growth. While this is anecdotal evidence, and weaker corporate governance has not triggered financial crises in these countries, it is clear that corporate governance deficiencies have started to carry a discount, either specific to particular firms or for markets as whole, even in developed countries. As such, poor corporate governance practices can pose a negative externality on the economy as a whole for any country.

More generally, poor corporate governance can affect the functioning of a country's financial markets. One channel is that poor corporate governance can increase financial volatility. When information is poorly protected—due to a lack of transparency and insiders having an edge on firms' doing and prospects—investors and analysts may have neither the ability to analyze firms (because it is very costly to collect information) nor the incentive (because insiders benefit regardless). In such a weak property rights environment, inside investors with private information, including analysts, may, for example, trade on information before it is disclosed to the public. There is evidence that the worse transparency associated with weaker corporate governance leads to more synchronous stock price movements, limiting the price discovery role of the stock markets (Morck, Young, and Yu 2000). A study of stock prices within a common trading mechanism and currency (the Hong Kong stock exchange) found that stocks from environments with less investor protection (China-based) trade at higher bid-ask spreads and exhibit thinner depths than more protected stocks (Hong Kong-based) (Brockman and Chung 2003). Evidence for Canada suggests that ownership structures indicating potential corporate governance problems also affect the size of the bid-ask spreads (Attig, Gadhoun, and Lang 2003).

Another area where corporate governance affects firms and their valuation is mergers and acquisitions (M&A). During the 1990s, the volume of M&A activity and the premium paid were significantly larger in countries with better investor protection (Rossi and Volpin 2003). This indicates that an active market for mergers and acquisitions—an important component of a corporate governance regime—arises only in countries with better investor protection (figure 9). The analysis also shows that in cross-border deals, the acquirers are typically from countries with better investor protection than the targets. This suggests that cross-border transactions play a governance role by improving the degree of investor protection within target firms. It further suggests that cross-border transactions aid in the convergence of corporate governance systems.

The M&A market is more active in stronger corporate governance countries, but cross-border M&A can help improve governance.



**Figure 9. The relationship between merger and acquisition activity and the strength of corporate governance**

*Note:* The chart depicts data on international mergers and acquisitions used in the paper by Rossi and Volpin (2003), sorted by the level of equity rights protection of La Porta and others (1998). M&A activity is the percentage of traded companies targeted in a completed deal. Hostile takeovers are the number of attempted hostile takeovers as a percentage of domestic traded firms. Cross-border ratio is the number of cross-border deals as a percentage of all completed deals. Source is SDC Platinum, provided by Thompson Financial Securities Data, and the World Development Indicators. The measure of the effective rights of minority shareholders is computed as the product of Rule of Law and Antidirector Rights divided by 10. Source: Rossi and Volpin (2003); La Porta and others (1998).

### *Better relations with other stakeholders*

Besides the principal owner and management, public and private corporations must deal with many other stakeholders, including banks, bondholders, labor, and local and national governments. Each of these monitor, discipline, motivate, and affect the management and the firm in various ways. They do so in exchange for some control and cash flow rights, which relate to each stakeholder's own comparative advantage, legal forms of influence, and form of contracts. Commercial banks, for example, have a greater amount of inside knowledge, as they typically have a continued relationship with the firm.

Formal influence of commercial banks may derive from the covenants banks impose on the firm: for example, in terms of dividend policies, or requirements for approval of large investments, mergers and acquisitions, and other large undertakings. Bondholders may also have such covenants or even specific collateral. Furthermore, lenders have legal rights of a state-contingent nature. In case of financial distress, they acquire control rights and even ownership rights in case of bankruptcy, as defined by the country's laws.<sup>11</sup> Debt and debt structure can be important disciplining factors, as they can limit free cash flow and thereby reduce private benefits. Trade finance can have a special role, as it will be a short-maturity claim, with perhaps some specific collateral. Suppliers can have particular insights into the operation of the firm, as they are more aware of the economic and financial prospects of the industry.

Labor has a number of rights and claims. As with other input factors, there is an outside market for employees, thus putting pressure on firms to provide not only financially attractive opportunities, but also socially attractive ones. Labor laws define many of the relationships between corporations and labor, which may have some corporate governance aspects. Rights of employees in firm affairs can be formally defined, as is the case in Germany, France, and the Netherlands where in larger companies it is mandatory for labor to have some seats on the board (the co-determination model).<sup>12</sup> Employees of course voice their opinion on firm management more generally. And then there is a market for senior management, where poorly performing CEOs and other senior managers get fired, that exerts some discipline on poor performance.

**Stakeholder management.** Two forms of behavior can be distinguished in corporate governance issues related to other stakeholders: stakeholder management and social issue participation. For the first category, the firm has no choice but to behave "responsibly" to stakeholders: they are input factors without which the firm cannot operate; and these stakeholders face alternative opportunities if the firm does not treat them well (typically, for example, labor can work elsewhere). Acting responsibly toward each of these stakeholders is thus necessary. Acting responsibly is also most likely to be beneficial to the firm, financially and otherwise.

Acting responsibly might in turn also be beneficial for the firm's shareholders and other stakeholders. A firm with a good relationship with its workers, for example, will probably find it easier to attract external financing. Collectively, a high degree of corporate responsibility can ensure good relationships with all the firm's stakeholders

and thereby improve the firm's overall financial performance. Of course, the effects depend importantly on information and reputation because knowing which firms are more responsible to stakeholders will not always be easy.

**Social issue participation.** Whether participation in social issues is also related to good firm performance is less clear. Involvement in some social issues carries costs. These can be direct, as when expenditures for charitable donations or environmental protection increase, and so lower profits. Costs can also be indirect, as when the firm becomes less flexible and operates at lower efficiency.

As such, socially responsible behavior could be considered “bad” corporate governance, as it negatively affects performance. (Of course, it can also be the case that government regulations require certain behavior, such as safeguarding the environment, such that the firm has no choice—although the country does.)

The general argument has been that these forms of social corporate responsibility can still pay: that is, they can be good business for all and go hand in hand with good corporate governance. So while there may be less direct business reasons to respect the environment or donate to social charity, for example, such actions can still create positive externalities in the form of better relationships with other stakeholders.

So far, there have been few empirical studies to document these effects. The general findings are of mixed evidence or no relationship between corporate social responsibility and financial performance. The willingness, for example, of many firms to adopt high international standards, such as ISO 9000, that clearly go beyond the narrow interest of production and sales, suggests that there is empirical support for positive effects at the firm level.

At the country level, clearly, more developed countries tend to have both better corporate governance and rules requiring more socially responsible behavior of corporations. There is also some evidence, however, that government-forced forms of stakeholderism may be less advantageous financially. In the case of Germany, one study found that workers' co-determination reduced market-to-book values and return on equity (Gordon and Schmidt 2000a).

As with many other corporate governance studies, the problem is in part the endogeneity of the relationships. At the firm level, does good corporate performance beget better social corporate responsibility, as the firm can afford it? Or does better social corporate responsibility lead to better performance? The firms that adopt ISO standards, for example, might well be the better performing firms even if they had not adopted such standards. At the country level, a higher level of development may well allow and create pressures for better social responsibility, while at the same time improving corporate governance.

## CORPORATE GOVERNANCE REFORM

The analysis so far suggests that better corporate governance generally pays for firms, markets, and countries. The question then arises why firms, markets, and countries do not adjust and adopt voluntarily better corporate governance measures. The answer is that firms, markets, and countries do adjust to some extent, but that these steps fail to provide the full impact, work only imperfectly, and involve considerable costs. The main reasons for lack of sufficient reform are entrenched owners and managers at the level of firms and political economy factors at the level of markets and countries. Both issues are considered below.

### *The role of entrenched owners and managers*

Evidence shows that firms adapt to weaker environments by adopting voluntary corporate governance measures. A firm may adjust its ownership structure, for example, by having more secondary, large blockholders, which can serve as effective monitors of the primary controlling shareholders. This may convince minority shareholders of the firm's willingness to respect their rights. Or a firm may adjust its dividend behavior if it has difficulty convincing shareholders that it will reinvest properly and for their benefit. These voluntary mechanisms can include hiring more reputable auditors. Since auditors have some reputation at stake as well, they may agree to conduct an audit only if the firm itself is making sufficient efforts to enhance its own corporate governance. The more reputable the auditor, the more the firm needs to adjust its own corporate governance. A firm can also issue capital abroad or list abroad, thereby subjecting itself to higher level of corporate governance and disclosure.

Empirical evidence shows that these mechanisms can add value and are appreciated by investors in a variety of countries. A study of a sample of U.S. firms found that the more firms adopt voluntary corporate governance mechanisms, the higher their valuation and the lower their cost of capital (Gompers, Ishii, and Metrick 2003). Similar evidence exists for Korea (Black, Jang, and Kim 2002), Russia (Black 2001), and the top 300 European firms (Bauer and Guenster 2003).<sup>13</sup> Gompers, Ishii, and Metrick (2003) also report that these firms have higher profitability and sales growth, and lower their capital expenditures and acquisitions to levels that are presumably more efficient.

There is also evidence that the voluntary corporate governance adopted by firms matter more in weak corporate governance environments. Two studies compared indexes of firm-specific corporate governance measures with countries' corporate governance indexes to analyze the effects on firm valuation and firm performance (Klapper and Love 2002; Durnev and Kim 2002). They found that firm-level corporate governance matters more to firm value in countries with weaker investor protection. Markets can adapt as well, partly in response to competition, as listing and trading migrate to competing exchanges, for example. While there can be races to the bottom, with firms and markets seeking lower standards, markets can and will set their own, higher corporate governance standards. One example is the Novo Mercado in Brazil, which has different levels of corporate governance standards, all higher than the main stock exchange. Firms can choose the level they want, and the system is backed by private arbitration measures to settle corporate governance disputes. Efforts like these can help corporations improve corporate governance at low(er) costs as they can list locally.

There is evidence, however, that these alternative corporate governance mechanisms, apart from being costly, have their limits. In a context of weak institutions and poor property rights, firm measures cannot and do not fully compensate for deficiencies. The work of Klapper and Love (2002) and Durnev and Kim (2002) shows that voluntary corporate governance adopted by firms only partially compensates for weak corporate governance environments.

There are also elements of self-selection, with worse firms choosing to list in worse environments. Competition between stock exchanges takes many forms, including not only listing standards, but also the direct cost of trading. This suggests that firms consider several dimensions in selecting where to list. One study, for example, has argued that family-owned firms prefer to choose to list in weak corporate governance environments (with perhaps higher trading costs). These markets would have little incentives to improve their corporate governance standards. By contrast, (large) firms with diversified ownership structures prefer to list in international markets (Coffee 1999 and 2001). Nevertheless, there are many other reasons why firms do not adjust their corporate governance or list in the environment optimal from a cost of capital point of view, including entrenched owners.

### *The role of political economy factors*

Importantly, countries do not always reform their corporate governance frameworks to achieve the best possible outcomes. In some sense, this is shown by the pervasive importance of the origin of the legal system in a particular country in many analyses and dimensions. Whether a country started with or acquired as a result of colonization a certain legal system some century or more ago still has systematic impact on the features of its legal system today, the performance of its judicial system, the regulation of labor markets, entry by new firms, the development of its financial sector, state ownership, and other important characteristics (Djankov and others 2003). Evidently, countries do not adjust that easily and move to some better standards to fit their own circumstances and meet their own needs.

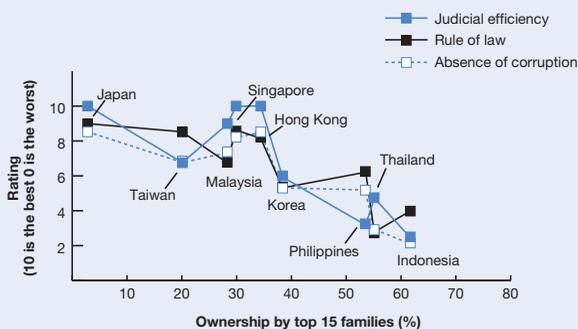
Partly this is because reforms are multifaceted and require a mixture of legal, regulatory, and market measures, making for difficult and slow progress. Efforts may have to be coordinated among many constituents, including foreign parties. Legal and regulatory changes must take into account enforcement capacity, often a binding constraint. While markets face competition and can adapt themselves, they must operate within the limits given by a country's legal framework. The Nova Mercado in Brazil is a notable exception where the local market has attempted to improve corporate governance standards using voluntary mechanisms. But it needs to rely on mechanisms such as arbitration to settle corporate governance disputes as an alternative to the poorly functioning judicial system in Brazil. Experiments with self-regulation in corporate governance, as in the Netherlands, have often not been successful.<sup>14</sup> The ability of corporations to borrow the framework from other jurisdictions by listing or raising capital abroad, or even incorporating, is limited to the extent that some local enforcement of rules is needed, particularly concerning minority rights protection (see Seigel 2002 for the case of Mexico).

Corporate governance reforms involve changes in control and power structures. As such, corporate governance reforms can depend on ownership structures. In parts of East Asia, for instance, where considerable corporate sector wealth is held by a small number of families, the degree to which corporate governance standards have been enhanced has been negatively correlated with the share of corporate sector wealth held by those families (Claessens, Djankov, and Lang 1999).

Figure 10 compares ownership concentration and institutional development across a sample of East Asian countries. Causality is unclear, as weak corporate governance standards could have led to more concentrated corporate sector wealth. Conversely, a higher concentration of wealth could have impeded improvements in corporate governance. For example, in Indonesia, there are direct relationships between the government and the corporate sector. The sample is too small to make any statistical inference. Nevertheless, it does suggest that wealth structures may need to change in order to bring about significant corporate governance reform. This can happen through legal changes (over time), and also as a result of direct interventions (such as privatizations and nationalizations, as during financial crises). Reforms can also be impeded by a lack of understanding. Partly this will be linked to political economy factors, perhaps directly related to ownership structures, as when the media is tightly controlled.

To date, the relationships between institutional features and countries' more permanent characteristics, including culture, history, and physical endowments, have not been widely researched. Institutional characteristics (such as the risk of expropriation of private property) can be long-lasting and relate to a country's physical endowments (Acemoglu and others 2003 show this for a cross-section of countries). Both the origin of its legal systems and a country's initial endowments are important determinants of the degree of private property rights protection (Beck, Demirgüç-Kunt, and Levine 2003). The role of culture and openness in finance, including in corporate governance, is also important (Stulz and Williamson 2003).

**Countries with higher concentrations of wealth show less progress in institutional reform.**



**Figure 10. Ownership concentration and institutional development**

Source: Claessens, Djankov, and Lang (1999).

More generally, the dynamic aspects of corporate governance reform are not yet well understood. The underlying political economy factors that may drive changes in the legal frameworks over time is the subject of a study by Raghuram Rajan and Luigi Zingales (2003a). They highlight the fact that many European countries had more developed capital markets in the early twentieth century (in 1913) than for a long period after the Second World War.

Importantly, many of these countries' capital markets in 1913 were more developed than the U.S. market at that time. A review of ownership structures at the end of the nineteenth century in the United Kingdom (Franks, Mayer, and Rosi 2003) shows that most UK firms had widely dispersed ownership before they were floated on the stock exchanges. And in 1940 in Italy, the ownership structures were more diffused than in the 1980s (Aganin and Volpin 2003). These three studies cast doubt on the view that stock market development and ownership concentration are monotonically related (positively and negatively, respectively) to investor protection.

These papers identify the issue but do not clarify the channels through which institutional features alter financial markets and corporate governance over time, and how institutional features change. As such, these papers represent the beginning of a research agenda (see also Rajan and Zingales 2003b). A more general review of the "new comparative economics" literature can be found in Djankov and others (2003), which also highlights the many unknown areas.

## CONCLUSIONS AND AREAS FOR FUTURE RESEARCH

At the level of the firm, the importance of corporate governance for access to financing, cost of capital, valuation, and performance has been documented in a number of countries. Better corporate governance leads to higher returns on equity and greater efficiency. Across countries, the important role of institutions aimed at contractual and legal enforcement, including corporate governance, has been underscored by the law and finance literature. At the country level, various papers have documented a number of differences in institutional features. Across countries, the relationships between institutional features and development of financial markets, relative corporate sector valuations, efficiency of investment allocation, and economic growth have been shown. Using firm-level data, relationships have been documented between countries' corporate governance frameworks, on the one hand, and performance, valuation, cost of capital, and access to external financing, on the other.

While the general importance of corporate governance has been established, knowledge on specific issues or channels is still weak in a number of areas. These include the following:

- ***The corporate governance of banks.*** This has been identified to be different than that of corporations, but in which ways is not yet clear—besides the important role of prudential regulations, given the special nature of banks. Clarifying this topic will be key, as banks are important providers of external financing, especially for small and medium-size firms. Separately, in many countries banks have important corporate governance roles, as they are direct investors themselves or act as agents for other investors. And creditors, including banks, can see their credit claim change into an ownership stake, as when a firm runs into bankruptcy or financial distress.
- ***The role of institutional investors.*** Institutional investors are increasing throughout the world, and their role in corporate governance of firms is consequently becoming more important. But the role of institutional investors in corporate governance is not obvious. In many countries, institutional investors have purposely been assigned little role in corporate governance, as more activism was considered to risk the company's fiduciary obligations. Furthermore, the governance of the institutional investors themselves is an issue, as they will not

exercise good corporate governance without being governed properly themselves. Moreover, the form through which more activism of institutional investors can be achieved is not clear. For example, institutional investors typically hold small stakes in any individual firm. Some form of coordination is thus necessary, on the one hand. On the other hand, too much coordination can be harmful, as the financial institutions start to collude and political economy factors start playing a role.

- **Enforcement.** How can enforcement be improved in weak environments? How can a better enforcement environment be engineered? More generally, what factors determine the degree to which the private sector can solve enforcement problems on its own, and what determines the need for public sector involvement in enforcement?
- **State-owned firms.** What is the role of commercialization in state-owned enterprises? Are there special corporate governance issues in cooperatively owned firms? How do privatization and corporate governance frameworks interact? Are there specific forms of privatization that are more attractive in weak corporate governance settings? What are the dynamic relationships between corporate governance changes and changes in degree of state-ownership of commercial enterprises?
- **Family-owned firms.** Such firms predominate in many sectors and economies. They raise a separate set of issues, related to liquidity, growth, and transition to a more widely held corporation, but also related to internal management, such as intrafamilial disagreements, disputes about succession, and exploitation of family members. Where family-owned firms dominate, as in many emerging markets, they raise systemwide corporate governance issues.
- **Best practice in relation to other stakeholders.** Little empirical research has been conducted on the relationships between corporate governance and social corporate responsibility. To the extent there is research, it refers to firms in developed countries.
- **The impact on poverty alleviation.** There are few studies on the direct relationship between better corporate governance and greater poverty alleviation. While the general importance of property rights for poverty alleviation has been established (De Soto 1989; North 1990), the specific channels through which improved

corporate governance can help the poor have so far not been documented. This is in part because much of the corporate governance research has been directed to the listed firms. However, much of the job creation in developing countries and emerging markets comes from small and medium-size enterprises. Different corporate governance issues arise for these firms. These require different approaches, which so far have not been researched very much.

- ***The dynamic aspects of institutional change.*** Finally, little is known about the dynamic aspects of institutional change, whether change occurs in a more evolutionary way during normal times or more abruptly during times of financial or political crises.

In this context, it is important to realize that enhancing corporate governance will remain very much a local effort. Country-specific circumstances and institutional features mean that global findings do not necessarily apply directly to each and every country and situation. Local data need to be used to make a convincing case for change. Local capacity is needed to identify the relevant issues and make use of political opportunities for legal, and regulatory reform. As such, the progress with corporate governance reform depends upon local capacity, in terms of data, people, and other resources.

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## NOTES

<sup>1</sup>The first broad survey of corporate governance was Shleifer and Vishny (1997). Several surveys have since followed, including Becht, Bolton, and Röell (2003), Claessens and Fan (2003), Denis and McConnell (2003), and Holmstrom and Kaplan (2001).

<sup>2</sup>Liquid stock markets have turnover ratios (turnover in value terms divided by market capitalization) greater than the median turnover.

<sup>3</sup>As reported in World Bank (2001). The report also states that there appears to be no effect either on the sectoral composition of growth or on the proportion of firms growing more rapidly than could be financed from internal resources; even bank profitability does not appear to be affected. This is the case regardless of whether the ratio employed relates to the volume of assets (bank deposits, stock market capitalization) or efficiency (net interest margin, stock turnover).

<sup>4</sup>All these applications are important, although not novel. Coase (1937, 1960), Alchian (1965), Demsetz (1964), Cheung (1970, 1983), North (1981, 1990), and subsequent institutional economic literature have long stressed the interaction between property rights and institutional arrangements shaping economic behavior. The work of La Porta and others (1997, 1998), however, provided the tools to compare institutional frameworks across countries and study the effects in a number of dimensions, including how a country's legal framework affects firms' external financing and investment.

<sup>5</sup>In a paper on Poland, Grosfeld and Tressel (2001) find that competition has a positive effect on firms with good corporate governance, but no significant effects on firms with bad corporate governance.

<sup>6</sup>Some of these studies suffer from endogeneity issues: that is, firms, markets, or countries may adopt better corporate governance and perform better. However, the relationship is not from better corporate governance to improved performance; rather it is either the other way around or because some other factors drive both better corporate governance and better performance. For discussions of the econometric problems raised by endogeneity, see Himmelberg (2002) and Coles, Lemmons, and Meschke (2003).

<sup>7</sup>The figure is based on the analysis of La Porta and others (1998). The creditor rights index is developed by La Porta and others (1998). It is the summation of four dummy variables, with four being the highest possible score. The rule of law is a measure of the (lack of) judicial efficiency. Countries are sorted into four quartiles, depending upon where they rank on a scale that is the product of their creditor rights and the efficiency of the judicial system, a measure of the index of the efficiency and integrity of the legal environment. The measure is reported for most countries by La Porta and others (1998) and for transition economies by Pistor (2000).

<sup>8</sup>The equity rights index is developed by La Porta and others (1998) and is the summation of five dummy variables, with five being the highest possible score. It includes the following dummy variables: the country allows shareholders to mail

their proxy vote; shareholders are not required to deposit their shares prior to the General Shareholders' Meeting; cumulative voting is allowed; an oppressed minorities mechanism is in place; the minimum percentage of share capital that entitles a shareholder to call an Extraordinary Shareholders' Meeting is less than or equal to 10 percent.

<sup>9</sup>The cross-country evidence on the costs of poor corporate governance is corroborated in a number of country studies. Johnson and others (2000), Bae, Kang, and Kim (2002), and Bertrand, Mehta, and Mullainathan (2002), for example, analyze the siphoning off of funds by controlling shareholders in the Czech Republic, Korea, and India, respectively. In turn, the misuse by controlling shareholders translates into higher cost of capital.

<sup>10</sup>This may have been a specific phenomenon experienced only in this time period, when many emerging markets were faced with financial stress. In other periods, this relationship is not observed. As such, the perverse effects of weak corporate governance may depend on the state of the economy.

<sup>11</sup>Note the large differences between countries in this respect. In the United States, for example, banks are limited in intervening in corporations operations, as they can be deemed to be acting in the role of a shareholder, and therefore assume the position of a junior claimholder in case of a bankruptcy (the doctrine of equitable subordination). This greatly limits the incentives of banks in the United States to get involved in corporate governance issues as it may lead to their claim being lowered in credit standing. Other countries allow banks a greater role in corporate governance.

<sup>12</sup>Employee ownership is of course the most direct form in which labor can have a stake in a firm. The empirical evidence on the effects of employee ownership for U.S. firms is summarized by Kruse and Blasi (1995). They find that "while few studies individually find clear links between employee ownership and firm performance, meta-analyses favor an overall positive association with performance for ESOPs and for several cooperative features" (abstract).

<sup>13</sup>For the top 300 European firms, it was found that a strategy of over-weighting companies with good corporate governance and under-weighting those with bad corporate governance would have yielded an annual excess return of 2.97 percent (Bauer and Guenster 2003).

<sup>14</sup>In the Netherlands, the corporate governance reform committee suggestions in 1997 stressed self-enforcement through market forces to implement and enforce its recommendations. A review of progress in 2003 (Corporate Governance Committee 2003), however, showed that this model did not work and that more legal changes would be needed to improve corporate governance. Earlier empirical works had anticipated this effect (de Jong and others 2001) as they documented little market response when the recommendations were announced.



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