Corporate Governance and Development

Stijn Claessens

The literature shows that good corporate governance generally pays—for firms, for markets, and for countries. It is associated with a lower cost of capital, higher returns on equity, greater efficiency, and more favorable treatment of all stakeholders, although the direction of causality is not always clear. The law and finance literature has documented the important role of institutions aimed at contractual and legal enforcement, including corporate governance, across countries. Using firm-level data, researchers have documented relationships between countries' corporate governance frameworks on the one hand and performance, valuation, the cost of capital, and access to external financing on the other. Given the benefits of good corporate governance, firms and countries should voluntarily reform more. Resistance by entrenched owners and managers at the firm level and political economy factors at the level of markets and countries partly explain why they do not.

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 the Russian Federation, Asia, and Brazil, the behavior of the corporate sector affected all the economies, and 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 have begun 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 Roell 2003). The private, market-based

doi:10.1093/wbro/lkj004 Advance Access publication 23 February 2006 21:91–122

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 and 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 article traces the many dimensions through which corporate governance works in firms and countries. 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.[1]

Some of this material is not easily accessible to the non-academic. Much of it refers to developed countries, in particular the United States. Furthermore, this literature does not always focus on the relationship between corporate governance and economic development and well-being. The purpose of this article is to fill these gaps.

The article is structured as follows. It starts by defining corporate governance, as that determines the scope of the issues addressed; reviewing how corporate governance can be and has been defined; and explaining why more attention is being paid to corporate governance in particular and to protection of private property rights more generally. It then explores why corporate governance may matter, by reviewing the evidence of the effects of property rights on financial development and growth. It also provides some background on 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 article 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 article concludes by identifying some main policy and research issues that require further study.

What Is Corporate Governance and Why Is It Receiving More Attention?

Before explaining why more attention is being paid to corporate governance, one needs a definition of corporate governance. Defining the concept is not obvious, as corporate governance can be, and has been, defined in different ways. One also needs to clarify how corporate governance relates to the protection of private property rights more generally.

What Is Corporate Governance?

Definitions of corporate governance vary widely. They tend to fall into two categories. The first set of definitions is concerned with a set of behavioral patterns—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 is concerned with the normative framework—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 represents the more 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. The associated analysis is interested largely in the mechanisms through which corporate governance is exercised. [Becht, Bolton, and Roell (2003) provide a general discussion of the various corporate governance mechanisms; Claessens and Berglöf (in this issue) use their classification to analyze enforcement.]

For comparative studies, the second type of definition is more logical. It investigates how differences in the normative framework affect the behavioral patterns of firms, investors, and others and analyzes how countries' legal and institutional framework shapes the use of various corporate governance mechanisms.

In a comparative review, the question of how broadly to define the framework for corporate governance arises. 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 protection 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 insiders. This would include protections of minority rights and the strength of creditor rights, as reflected in collateral and bankruptcy laws. It could also include such issues as the composition and rights of executive directors and the ability to pursue class action suits. This definition is close to the one advanced by Shleifer and Vishny (1997) in

their seminal review: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (p. 737). This definition can be expanded to address the various types of suppliers of finance. One can then define corporate governance as being concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest among various corporate claimholders.

A 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, the former 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).

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; it can be expanded to include the complex set of constraints that determine the quasi-rents (profits) generated by the firm in the course of relationships and to 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, 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 could also encompass corporate social responsibility, including such aspects as the firm's dealings with respect to culture and the environment.

When analyzing corporate governance in a cross-country perspective, the question of whether the framework extends to rules or institutions arises. Two views have been advanced. One is that the framework is determined by rules and by markets and outsiders. This view has prevailed in and been applied 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 between the two can be misleading. Moreover, both institutions and rules evolve over time. Institutions do not arise in a vacuum; they are affected by the rules in the country or the world. Similarly, laws and rules are affected by a 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 stating that "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 it has received relatively little attention from researchers.

When considering both institutions and rules, it is easy to become bewildered by the scope of institutions and rules that may matter. An easier way to understand 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 distinguishes 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 mechanisms 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 why corporate governance has recently received more attention is the proliferation of scandals and crises. These 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 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 of capital within and across countries among competing purposes has become more complex, as has monitoring the use of capital. This makes good governance more important but also more difficult.

Third, as a result of the increasing size of firms and the growing role of financial intermediaries, the mobilization of capital has become increasingly removed from the principal owner. The role of institutional investors is growing in many countries, with many economies moving away from pay-as-you-go retirement systems to

(more) funded systems. This increased delegation of investment has raised the need for good corporate governance arrangements.

Fourth, 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. Five elements of this broad literature—finance, the structure of the financial system, property rights, competition and real-factor markets, and ownership structure and group affiliation—are worth highlighting.

Finance

The importance of the financial system for growth and poverty reduction has been clearly established over the past decade. 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 per capita GDP growth. Numerous pieces of evidence have been assembled over the past few years to indicate with reasonable robustness that the relation is a causal one, not merely the result of better-performing countries both having larger financial systems and growing faster. The relationship has been established at the level of countries, industrial sectors, and firms, and it has consistently survived a rigorous series of econometric probes [as documented in World Bank (2001). For an early review see Levine (1997); for a recent review see Levine (2005).]

Banking Systems and Market Finance

The development of banking systems and market finance spurs economic growth. Banks and securities markets are complementary in their functions, although markets naturally play a greater role for listed firms. More generally, research provides support for the functional view of finance—the view that it is not financial institutions or

financial markets but the functions that they perform that matter. 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).[2] To function well, financial institutions and financial markets, in turn, require certain foundations, including good governance.

Legal Foundations

Legal foundations affect 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 work by La Porta and others (1997, 1998). These two pivotal papers emphasize 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.[3] These papers have established that the development of a country's financial markets is affected by these institutional characteristics and that institutional characteristics can have direct effects on growth. 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 the sectoral level, Claessens and 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 the investment patterns in turn affect the economic growth of a sector.

Competition and Real-Factor Markets

In addition to 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.

Competition for good corporate governance is important 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-yielding assets, for example, controlling shareholders may be better able to provide a below-market return on minority equity. Surprisingly, while this view is 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.[4]

Ownership Structures and Group Affiliation

The nature of the corporate governance problems that countries face varies over time and across countries. One factor of importance is ownership structure, which 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 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 (Berle and Means 1932). But around the world, except in the United States and to some degree in the United Kingdom, insider-controlled or closely held firms are the norms (La Porta and others 1999). These can be family-owned firms or firms controlled by financial institutions. Families such as 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; Franks and Mayer 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 1999; 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 Canada and the United States, family-owned firms are not uncommon (Morck, Stangeland, and Yeung 2000; Gadhoum, Lang, and Young 2003; Anderson and Reeb 2003).

A corporation's ownership structure affects the nature of the agency problems among shareholders and between managers and outside shareholders. When ownership is diffuse, as it typically is in the U.S. and U.K. 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). 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 willing and be able to closely monitor and discipline management. Information asymmetries can also be assumed to be less of a problem, as a controlling owner can invest the resources necessary to acquire necessary information. Correspondingly, the principal-agent problems will be less likely to concern management versus owners and more likely to concern minority versus controlling shareholders. In these countries, protection of minority rights is more often the key. Countries in which insider-held firms dominate will have different requirements in terms of corporate governance framework from those in which widely held firms dominate.

Many countries have large financial and industrial conglomerates and groups. In some groups, a bank or other 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 [Khanna and Palepu 2000; Claessens, Fan, and Lang (forthcoming) document groups in East Asian countries].

Such groups can have many benefits for the firm and its investors, such as enabling 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 impose costs, however. They are often less transparent and have less clear management structures, creating the possibility of worse corporate governance, including expropriation of minority rights (Johnson, La Porta, and others 2000).

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. As with ownership structures, the direction of causality is unclear. It may be that the prevalence of groups undermines the drive to develop external (financial) markets. Alternatively, poorly developed external markets may increase the benefits of internal markets.

How Does Corporate Governance Affect Growth and Development?

The literature identifies several related channels through which corporate governance affects growth and development:

- Increased access to external financing by firms, which can lead to greater investment, higher growth, and more employment creation.

- Lower cost of capital and associated higher firm valuation, which makes more investments attractive to investors and leads to growth and employment.
- Better operational performance, through better allocation of resources and better management, which creates wealth.
- Reduced risk of financial crises, a particularly important effect, as financial crises can impose large economic and social costs.
- Better relationships with all stakeholders, which helps improve social and labor relationships and areas such as environmental protection.

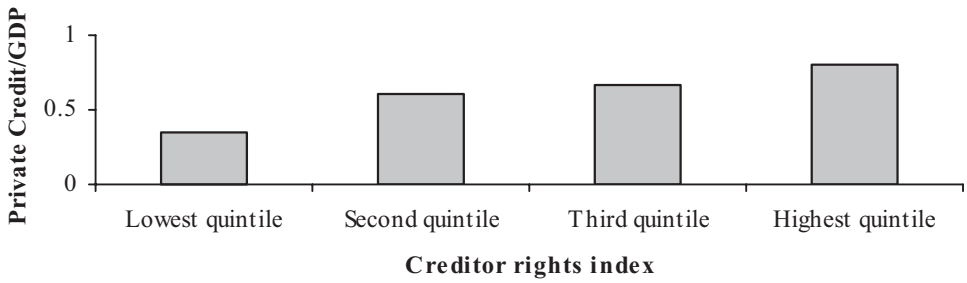
All these channels matter for growth, employment, poverty, and well-being more generally. Empirical evidence has documented these relationships at the level of the country, the sector, and the individual firm as well as from the investor perspective. While the evidence is plentiful and continuing to accumulate, many of these results are partial analyses and may not go beyond associations. Some of these studies suffer from endogeneity issues: some firms, markets, or countries that adopt better corporate governance may be more developed or perform better as a result, while others may have adopted better corporate governance because they were more developed. Missing variables can also be important. Some other factors may drive both better corporate governance and better development or performance, obscuring causality. [For discussions of the econometric problems raised by endogeneity and missing variables, see Himmelberg (2002) and Coles, Lemmons, and Meschke (2003).]

Increased Access to Financing

Financial and capital markets are better developed in countries with strong protection of property rights, as the law and finance literature demonstrates. In particular, better creditor rights and shareholder rights have been shown to be associated with deeper and more developed banking and capital markets. Figure 1 depicts the relationship between an index of creditor rights (adjusted for the extent to which the rule of law is enforced in the country) and the depth of the financial system (as measured by the ratio of private credit to GDP). The creditor rights index, developed by La Porta and others (1998), is the summation of four dummy variables, with 4 as the highest possible score.[5] The rule of law is a measure of the judicial efficiency and integrity of the legal environment, as reported by La Porta and others (1998). Countries are sorted into four quartiles, depending on where they rank on a scale based on the product of their creditor rights and on the efficiency of the judicial system. The better creditor rights are defined and enforced, the more willing lenders are to extend financing.

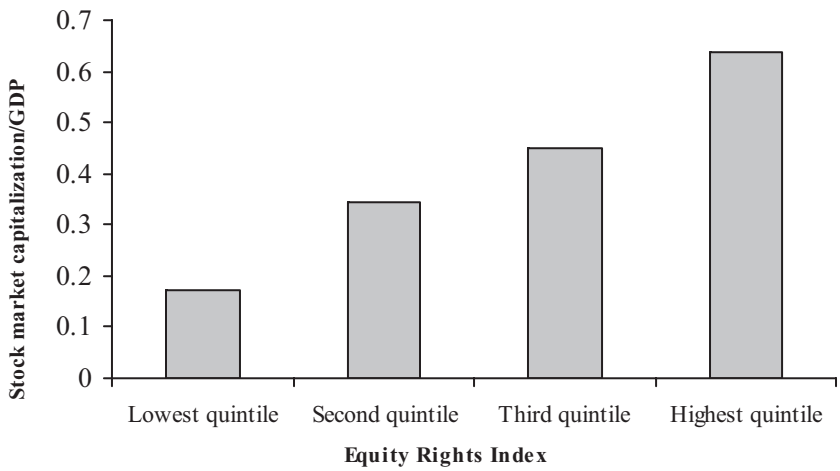
A similar relationship exists between the quality of shareholder protection and the development of countries' capital markets. Figure 2 depicts the relationship between an index of shareholder rights [the index of La Porta and others (1998),

Figure 1. The Better Creditor Rights are Defined and Enforced, the more Willing Lenders are to Extend Credit



Note: The original rule of law data comes from the International Country Risk Guide. The data used here are the averages of the monthly index for April and October between 1982 and 1995.
Source: La Porta and others (1997).

Figure 2. The Stronger the Shareholder Protection, the Larger a Country's Stock Markets



Source: La Porta and others (1997).

adjusted for the efficiency of the judicial system] and the size of the stock market (relative to GDP). The equity rights index is the summation of five dummy variables, with 5 as the highest possible score.[6] Countries are sorted into four quartiles, depending on where they rank on a scale based on the product of their equity rights and the efficiency of the judicial system.

The relationship between shareholder protection and capital market development is strong, with the market capitalization of the highest quartile of countries

almost four times that of countries in the lowest quartile. The comparison between creditor rights and the development of private credit does not correct for other factors that affect financial sector development, such as inflation and macroeconomic performance. Yet almost all studies found that these results are robust to including a wide variety of control variables in the analysis (see Levine 2005).

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 on growth of better property rights leading to greater access to financing can be large. For example, countries in the third quartile of financial development enjoy 1.0–1.5 extra percentage points of GDP growth a year compared with countries in the first quartile (Rajan and Zingales 1998). 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, particularly small firms, start up (Beck, Demirgüç-Kunt, and Maksimovic 2005).

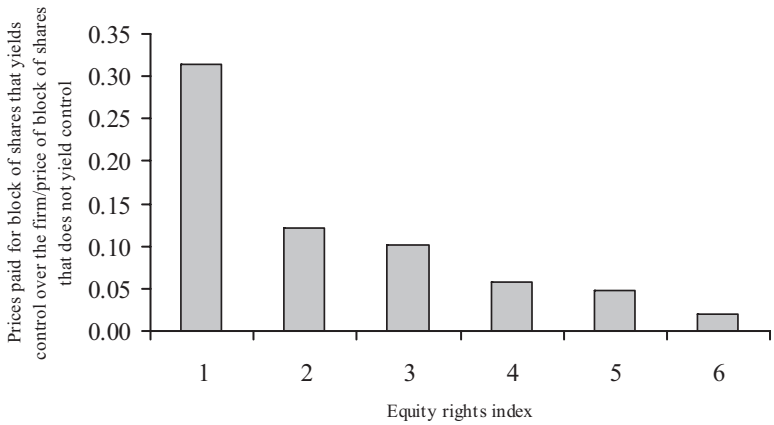
Higher Firm Valuation

The quality of the corporate governance framework affects not only access to and the amount of external financing but also the cost of capital and firm valuation. Outsiders are less willing to provide financing and more likely to charge higher rates if they are less assured that they will earn an adequate rate of return (Morck, Shleifer, and Vishny 1988). Conflicts between small and large controlling shareholders are greater in weaker corporate governance settings, implying that smaller investors receive lower rates of return.

There is clear empirical evidence for these effects. The cost of capital has been shown to be higher and valuation to be lower in countries with weaker property rights (La Porta and others 2000, 2002; Claessens and others 2002). Investors also seem to discount their valuation of firms and countries with worse corporate governance (Doidge, Karolyi, and Stulz 2004; McKinsey and Company 2002). Furthermore, in countries with weaker property rights, controlling shareholders obtain a fraction of the value of the firm that exceeds their direct ownership stake, at the expense of minority shareholders.

Weak corporate governance appears to be associated with higher costs of capital, as examination of the prices paid in actual transactions for a block of shares that implies transferring control over the firm relative to the price of shares that do not and the equity rights index reveals (figure 3). The higher cost of capital, and the corresponding lower firm valuation, translates into economic costs for countries with worse corporate governance. Consequently, less attractive investments are bypassed.[7]

Figure 3. Weak Corporate Governance Translates into Higher Costs of Capital



Source: Dyck and Zingales (2004) and Nenova (2003).

Better Operational Performance

Better corporate governance can add value by improving the performance of firms, through more efficient management, better asset allocation, better labor policies, or similar efficiency improvements. Evidence for the United States (Gompers, Ishii, and Metrick 2003), the Republic of Korea (Joh 2003), and elsewhere strongly suggests that at the firm level, better corporate governance leads to higher rates of return on equity, higher valuation, and 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 endogeneity (see Himmelberg 2002). Across countries, there is also evidence that operational performance is higher in countries with better corporate governance, although the evidence is weaker (Wurgler 2000). In cross-country comparisons, there can also be a bias due to omitted variables. The issues of endogeneity and simultaneity of the various relationships also exist (it may be, for example, that better performing countries adopt better corporate governance and not that better corporate governance countries perform better).

Plotting accounting rates of return on assets for a sample of publicly listed firms using data from Worldscape against the equity rights index reveals that the relationship is much weaker than the relationship between the quality of the governance framework and access to financing and valuation (figure 4). Other factors evidently affect operational performance to mute this relationship. Many institutions and

Figure 4. Better Corporate Governance Translates into Somewhat Higher Returns on Assets

Note: The figure excludes Mexico and República Bolivariana de Venezuela, where rates of return were heavily influenced by inflation and currency movements.

Source: Data on returns are from Claessens, Djankov, and Nenova (2001) and cover 1996–99. The index on equity rights is from La Porta and others (1998).

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 environments with worse corporate governance may be more likely to 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 comparing the rate of return on investment with the cost of capital for different corporate governance frameworks (figure 5). Plotting the rates of return on investment for a sample of some 19,000 publicly listed firms from a variety of countries against the equity rights index shows that firms in many countries do not earn the cost of capital required by shareholders; only in countries with the best corporate governance 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.

Figure 5. Higher equity rights translate into higher returns on investment relative to the cost of capital

Note: Figure depicts the marginal rates of return on new investment adjusted for the cost of capital calculated using Tobin's Q model.

Source: Data on returns come from Gugler, Mueller, and Yurtoglu (2004), who use data from Worldscope. The index on equity rights is from La Porta and others (1998).

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 economy-wide 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 10–20 percentage points lower than those of other firms (Lemmon and Lins 2003). This finding suggests 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.

A study of the stock performance of listed companies in Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand has found that performance is better in firms with higher accounting disclosure quality (proxied by the use of international auditors) and higher outside ownership concentration (Mitton 2002). There is also a similar evidence for the Republic of Korea on the importance of corporate governance for firm value during periods of financial turmoil (Baek, Kang, and Park 2004). This firm-level evidence is 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), suggesting that in these environments, hedging is done more for the benefit of insiders than outsiders. 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 the fact that managers have more discretion in emerging markets to withhold bad information or that firms share risks in these markets among themselves rather than through financial markets.

Country-level evidence suggests that weak legal institutions for corporate governance were key factors in exacerbating the stock market declines during the 1997 East Asian financial crisis (Johnson, Boone, 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 increased during bad times, as the expected return of investment was lower, and the country was therefore more likely to witness collapses in currency and stock prices. Johnson, Boone, and others (2000) found a relationship between the efficiency of the judicial system and currency depreciation between the end of 1996 and the beginning of 1999, that is, during the East Asian and global financial crises.[8] 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 (Enron), undue profit boosting (WorldCom), managerial corporate looting (Tyco), audit fraud (Arthur Andersen), and inflated reports of stock performance (by supposedly independent investment analysts) have led to crises of confidence among investors, leading to declines in stock market valuation and other economy-wide effects, including some slowdowns in economic growth. While this evidence is anecdotal, 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, for particular firms or markets as a whole, even in developed countries. Poor corporate governance practices can thus impose a negative externality on the economy as a whole in any country.

More generally, poor corporate governance can affect the functioning of a country's financial markets. One channel through which it can do so is by increasing financial volatility. When information is poorly protected—due to a lack of transparency and the fact that insiders know more about firms' activities and prospects—investors and analysts may have neither the ability to analyze firms (because it is very costly to collect information) nor the incentive to do so (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 lack of 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 (Hong Kong-based) stocks (Brockman and Chung 2003). Evidence on Canada suggests that ownership structures indicating potential corporate governance problems also affect the size of bid-ask spreads (Attig, Gadhoum, and Lang 2003).

Another area in which corporate governance affects firms and their valuation is mergers and acquisitions. During the 1990s, the volume of merger and acquisition activity and the premiums paid for such activity 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 good investor protection. 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.

Better Relations with Other Stakeholders

In addition to 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 groups monitors, disciplines, motivates, and affects 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 comparative advantage, legal forms of influence, and form of contracts.

Commercial banks, for example, have more inside knowledge, as they typically have a continuing relationship with the firm. The 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; in case of bankruptcy, they may obtain ownership rights, as defined by the country's laws.[9] Debt and debt structure can be important disciplining factors, as they can limit free cash flow and thereby reduce private benefits. Trade finance can play 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, an outside market for employment exists, which puts pressure on firms to provide not only financially attractive but also socially attractive opportunities. Labor laws define many of the relationships between corporations and labor, which may have some corporate governance aspects. The rights of employees in firm affairs can be formally defined, as they are in France, Germany, and The Netherlands, where large companies are required to give labor some seats on the board (the co-determination model).[10] Employees, of course, voice their opinion on firm management more generally. The market for senior management, in which poorly performing CEOs and other senior managers get fired, exerts some discipline on poor performance.

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

Acting responsibly may also benefit the firm's shareholders and other stakeholders. For example, a firm with a good relationship with its workers 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, thereby improving the firm's overall financial performance. Of course, the effects depend on information and reputation; knowing which firms behave more responsibly to stakeholders will not always be easy.

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

Socially responsible behavior could be considered "bad" corporate governance, as it negatively affects performance. (If government regulations require certain behavior, such as safeguarding the environment, 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 little direct business justification for respecting the environment or donating to social charity, for example, such actions can create positive externalities in the form of better relationships with other

stakeholders. The willingness, for example, of many firms to adopt high international standards, such as ISO 9000, that go beyond the narrow interest of production and sales suggests that there are perceived positive effects at the firm level.

Few empirical studies have documented these effects. The general evidence is either mixed or shows no relationship between corporate social responsibility and financial performance. At the country level, 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 stakeholdership may be less advantageous financially. One study of Germany finds that workers' co-determination reduced market-to-book values and return on equity (Gorton 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, or does better social corporate responsibility lead to better performance? Firms that adopt ISO standards, for example, may well have performed better than firms that did not even before adopting such standards. At the country level, a higher level of development may well allow and create pressures for greater social responsibility, while at the same time improving corporate governance.

Reform of Corporate Governance

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 voluntarily adopt 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 reforms are entrenched owners and managers at the firm level 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, who can serve as effective monitors of the primary controlling shareholders. This may convince minority shareholders of the firm's willingness to respect their rights. A firm may adjust its dividend behavior if it has been having 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, they may agree to conduct an audit only if the firm is making sufficient efforts to enhance its corporate governance. The more reputable the auditor, the more the firm needs to improve its corporate governance. A firm can also issue capital or list its shares abroad, thereby subjecting itself to a 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 finds that the more the firms adopt voluntary corporate governance mechanisms, the higher their valuation and lower their cost of capital (Gompers, Ishii, and Metrick 2003). Similar evidence exists for the Republic of Korea (Black, Jang, and Kim 2002), the Russian Federation (Black 2001), and the top 300 European firms (Bauer and Guenster 2003).[11] Gompers, Ishii, and Metrick (2003) report that these firms have higher profitability and sales growth and that they lower their capital expenditures and acquisitions to levels that are presumably more efficient.

Evidence also suggests that the voluntary corporate governance adopted by firms matters more in weak corporate governance environments. Two studies compare 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 2005; Durnev and Kim 2005). They found that the 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, among which firms can choose. 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, in addition to 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. Klapper and Love (2005) and Durnev and Kim (2005) show that voluntary corporate governance adopted by firms only partially compensates for weak corporate governance environments.

There are also elements of self-selection, with weaker firms choosing to list in weaker 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. Coffee (1999, 2001) argues that family-owned firms prefer to list in weak corporate governance environments (with

perhaps higher trading costs). These markets have little incentives to improve their corporate governance standards. By contrast (large) firms with diversified ownership structures prefer to list in international markets. 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 and employees.

The Role of Political Economy Factors

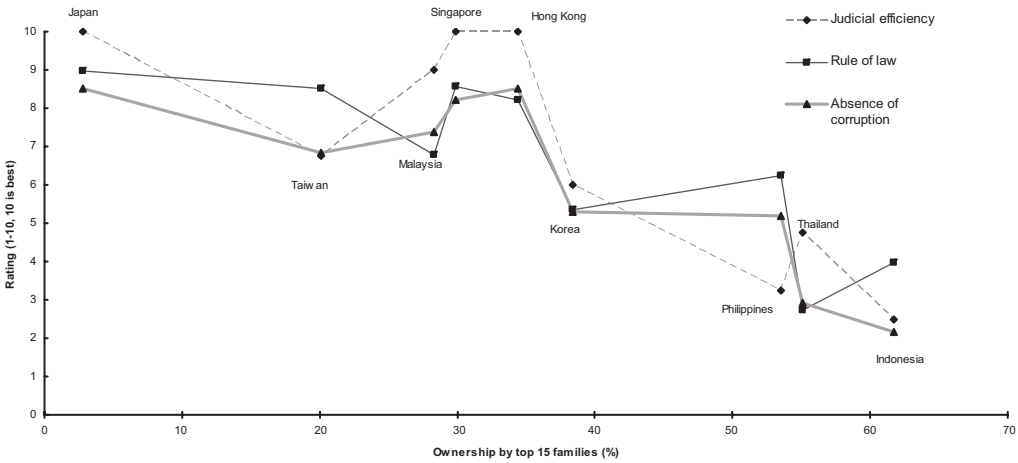
Countries do not always reform their corporate governance frameworks to achieve the best possible outcomes. In some sense, this is shown by the pervasive importance of the origin of the legal system in a particular country. Whether a country started with a certain legal system or acquired it as a result of colonization has a systematic impact on its legal system, 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 easily and move to 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 progress difficult and slow. 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 of a country's legal framework.

The Novo Mercado in Brazil is a notable exception in which 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, such as those in The Netherlands, have often not been successful.[12] 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 protection of minority rights (see Siegel 2005 for the case of Mexico).

Corporate governance reforms involve changes in control and power structures. As such, they can depend on ownership structures. In parts of East Asia, for instance, where a small number of families hold a large share of corporate sector wealth, 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).

Ownership concentration and institutional development are inversely correlated in a sample of East Asian countries (figure 6). Causality is unclear, however, as weak

Figure 6. The concentration of wealth and institutional reform are inversely correlated in East Asia



Note: Figure depicts indexes of the quality of the institutional environment, from 1 to 10 with 10 best, that assess the efficiency and integrity of the legal environment and the absence of corruption as they affect business, particularly foreign firms, against the corporate sector ownership by the top 15 families, expressed as a percentage of total market capitalization.

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

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. In Indonesia, for example, there are many direct relationships between the government and the corporate sector. These considerations notwithstanding, the correlation does suggest that ownership structures can impede significant corporate governance reform.

Morck, Wolfenzohn, and Yeung (2004) review the literature on how, at the economy level, extensive control of corporate assets by a few families can distort capital allocation and reduce the rate of innovation. They argue that families appear to influence the development of both public policy, such as property rights protection and enforcement, and institutions such as capital markets. They show that per capita GDP growth is faster in countries in which the ratio of self-made billionaire wealth to GDP is larger but that per capita GDP growth is slower in countries in which inherited billionaire wealth represents a larger share of GDP. Morck and Yeung (2004) show that there is a strong correlation between the degree of family control and measures of entry barriers, judicial system inefficiencies, and political and tax system corruption. They also found that the separation of ownership and control—through pyramids, differential voting, and other arrangements—contributes to inefficiencies.

The samples studied are often too small to make any statistical inference, and the evidence is based too much on cross-country evidence to make strong causal statements. Nevertheless, it does suggest that wealth structures may need to change to bring about significant institutional reform. This can happen through legal changes over time or as a result of direct interventions, such as privatization and nationalization, as during financial crises.

Reforms can be impeded by a lack of understanding, which can be affected by political economy factors. Some of these, such as tight control over the media, may be directly related to ownership structures. And it is not just ownership that matters. The theoretical literature on the political economy of finance has highlighted a likely coincidence of interests between large shareholders (inside capital) and workers in the formal sector (inside labor) to the detriment of more dispersed interests, such as outside investors or consumers (Pagano and Volpin 2005; Perotti and von Thadden 2003). The intuition is that an implicit alliance aimed at limiting external challenges to local producers generates rents that can be shared between inside capital and inside labor. This alliance can grant extensive control benefits to large shareholders at the cost of outside investors, supported by higher rents for inside labor. It creates, however, serious rigidities, which undermine promoting the most efficient producers; attracting external financial resources to fund entry, renewal, and growth; and reallocating resources across sectors and producers.

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 (as Acemoglu and others 2003 show for a cross-section of countries). Both the origin of a country's legal systems and its initial endowments are important determinants of the degree of private property rights protection (Pistor 2000; 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).

More generally, the dynamic aspects of corporate governance reform are not yet well understood. Rajan and Zingales (2003a) study the underlying political economy factors that may drive changes in the legal frameworks over time. They highlight the fact that many European countries had more developed capital markets in 1913 than for a long period after World War II. In 1913, capital markets in many of these countries were more developed than in the United States. A review of ownership structures at the end of the nineteenth century in the United Kingdom shows that most firms there had widely dispersed ownership before they were floated on the stock exchanges (Franks, Mayer, and Rossi 2003). In Italy, the ownership structures were more diffuse in 1940 than in the 1980s (Aganin and Volpin 2003). These three studies cast some doubt on the view that stock market development and ownership concentration are monotonically related to investor protection.

These studies identify the issue, but they do not clarify the channels through which institutional features alter financial markets and corporate governance over time or show how institutional features change. They 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), who highlight the many areas about which little is known.[13]

Conclusions and Areas for Future Research

The importance of corporate governance for access to financing, the cost of capital, valuation, and performance has been documented at the firm level 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, researchers have documented relationships between countries' corporate governance frameworks on the one hand and performance, valuation, the cost of capital, and access to external financing on the other.

While the general importance of corporate governance has been established, knowledge is still weak in a number of areas:

- *Corporate governance of banks*. Corporate governance of banks has been shown to be different from that of corporations, but the ways in which it differs (other than the important role of prudential regulations) are not clear. Clarifying this issue is important, because banks are important providers of external financing, especially for small- and medium-size firms. In addition, in many countries, banks play important corporate governance roles, as they are direct investors themselves or act as agents for other investors. Creditors, including banks, can see their credit claim change into an ownership stake when a firm runs into bankruptcy or financial distress.
- *Role of institutional investors*. The importance of institutional investors is increasing throughout the world, and their role in the 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 been assigned little role in corporate governance, for fear of endangering their fiduciary obligations. The governance of institutional investors

themselves is also an issue, as they will not exercise good corporate governance without being governed themselves properly. Moreover, the form through which more activism of institutional investors can be achieved is not clear, as they typically hold small stakes in individual firms. Some form of coordination is thus necessary, but too much coordination can be harmful, as the financial institutions start to collude and political economy factors start to play 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 it 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 some forms of privatization more attractive in weak corporate governance settings? What are the dynamic relationships between corporate governance changes and changes in the degree of state-ownership of commercial enterprises?
- *Family-owned firms.* Family-owned firms predominate in many sectors and economies. They raise a set of issues related to liquidity, growth, and transition to a more widely held corporation, as well as issues related to internal management, such as intra-familial disagreements, disputes about succession, and exploitation of family members. Where family-owned firms dominate, as in many emerging markets, they raise system-wide 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. The research that has been conducted has been on firms in developed countries.
- *Impact on poverty alleviation.* Although the general importance of property rights for poverty alleviation has been established (De Soto 1989, North 1990), the channels through which improved corporate governance can help the poor have not been documented. This is in part because much of the corporate governance research has studied listed firms. Much of the job creation in developing countries and emerging markets comes from small- and medium-size enterprises, which face different corporate governance issues.
- *Dynamic aspects of institutional change.* 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.

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 every country or 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. Corporate governance reform thus depends on local capacity in terms of data, people, and other resources.

Notes

Stijn Claessens is professor of international finance policy at the University of Amsterdam, senior adviser to the Financial Sector Vice-Presidency of the World Bank, and a fellow of the Centre for Economic Policy Research; his e-mail address is sclaessens@worldbank.org. This article is based on a presentation to the Global Corporate Governance Forum donors meeting held in The Hague, March 13, 2003. The author would like to thank the participants for their comments, and the editors and both reviewers for their comments.

1. The first broad survey of corporate governance was by Shleifer and Vishny (1997). Several surveys followed, including Becht, Bolton and Röell (2003), Denis and McConnell (2003), Holderness (2003), and Holmstrom and Kaplan (2001). Tirole (2001) provides an analytical review. Claessens and Fan (2002) survey the literature on Asia corporate governance.

2. There appears to be no effect on the sectoral composition of growth or on the proportion of firms growing more rapidly that could be financed from internal resources; even bank profitability does not appear to be affected (World Bank 2001). This is the case regardless of whether the ratio employed relates to the volume of assets (bank deposits, stock market capitalization) or to efficiency (net interest margin, stock turnover).

3. All these applications are important, although not novel. Coase (1937, 1960), Alchian (1965), Demsetz (1964), Demsetz and Lehn (1985), Cheung (1970, 1983), North (1981, 1990), and subsequent research on institutions have long stressed the interaction between property rights and institutional arrangements in shaping economic behavior. The work of La Porta and others (1997, 1998), however, provided the tools with which to compare institutional frameworks across countries and to study the effects in a number of dimensions, including how a country's legal framework affects firms' external financing and investment. Since then, many other studies have documented institutional differences.

4. In a paper on Poland, Grosfeld and Tressel (2002) found that competition had a positive effect on firms with good corporate governance but no significant effects on firms with bad corporate governance.

5. The dummy variables describe the legal system for creditors in the country. The dummies are as follows: restrictive reorganization, equal to 1 if the time table for rendering a judgment during the restructuring phase is less than 90 days and 0 otherwise; mandatory management turnover (in reorganization), equal to 1 if incumbent management does not stay during a restructuring or bankruptcy and 0 otherwise; no automatic stay, equal to 1 if there is no automatic stay on assets (that is, no moratorium on payments) and 0 otherwise; secured creditors priority, equal to 1 if secured creditors have the highest priority in payment and 0 otherwise. See also Claessens and Klapper (2005).

6. The equity rights index includes the following dummy variables, with each dummy equal to 1 if the provision is present in the law and 0 otherwise: the country allows shareholders to mail their proxy vote; shareholders are not required to deposit their shares before 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.

7. A number of country studies corroborate the cross-country evidence on the costs of poor corporate governance. Johnson, Boone, and others (2000), Bae, Kang, and Kim (2002), and Bertrand,

Mehta, and Mullainathan (2002) analyze the siphoning-off of funds by controlling shareholders in the Czech Republic, the Republic of Korea, and India, respectively. The misuse by controlling shareholders translates into higher cost of capital.

8. This may have been a specific phenomenon experienced only in this time period, when many emerging markets were faced with financial stress. It is not observed in other periods. The perverse effects of weak corporate governance may thus depend on the state of the economy.

9. 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. They therefore assume the position of a junior claimholder in case of a bankruptcy (the doctrine of equitable subordination). This greatly limits the incentives of U.S. banks to get involved in corporate governance issues, as such involvement could lower their credit claim standing. Other countries allow banks a greater role in corporate governance.

10. Employee ownership is, of course, the most direct way in which labor can have a stake in a firm. Kruse and Blasi (1995, p. 1) summarize the empirical evidence on the effects of employee ownership for U.S. firms. They found that "while few studies individually find clear links between employee ownership and firm performance, meta-analyses favor an overall positive association with performance for employee stock ownership plans (ESOPs) and for several cooperative features."

11. For the top 300 European firms, a strategy of overweighting companies with good corporate governance and underweighting those with bad corporate governance would have yielded an annual excess return of 2.97 percent (Bauer and Guenster 2003).

12. Suggestions by The Netherlands' corporate governance reform committee in 1997 stressed self-enforcement through market forces to implement and enforce its recommendations. A review of progress in 2003 (Peters Report 2003), however, showed that this model had not worked and that more legal changes would be needed to improve corporate governance. Earlier empirical work (De Jong and others 2001) anticipated this effect, documenting the mild market response when the recommendations were announced.

13. In a study investigating the effects of institutional factors more generally, Glaeser and others (2004) found that many of the institutional variables used to establish the proposition that institutions cause growth are either not appropriate or are not robust empirically.

References

Acemoglu, D., S. Johnson, J. Robinson, and Y. Thaicharoen. 2003. "Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth." *Journal of Monetary Economics* (Netherlands) 50(1):49–131.

Aganin, Alexander, and Paolo Volpin. 2003. "History of Corporate Ownership in Italy." Finance Working Paper 17/2003. European Corporate Governance Institute, Brussels.

Alayannis, George, Ugur Lel, and Darius Miller. 2003. "Corporate Governance and the Hedging Premium." Darden Business School, University of Virginia, Charlottesville.

Alchian, A. A. 1965. "Some Economics of Property Rights." *Il Politico* 30:816–29.

Anderson, Ronald C., and David M. Reeb. 2003. "Founding-Family Ownership and Firm Performance: Evidence from the S&P 500." *Journal of Finance* 58(3):1301–28.

Attig, Najah, Yoser Gadhoum, and Larry H. P. Lang. 2003. "Bid-Ask Spread, Asymmetric Information and Ultimate Ownership." Chinese University of Hong Kong, Department of Finance.

Bae, K. H., J. K. Kang, and J. M. Kim. 2002. "Tunneling or Value Addition? Evidence from Mergers by Korean Business Groups." *Journal of Finance* 57(6):2695–740.

Bae, K. H., Chanwoo Lim, and K. C. John Wei. 2003. "Corporate Governance and Conditional Skewness in World's Stock Markets." Hong Kong University of Science and Technology, Department of Finance.

Baek, Jae-Seung, Jun- Koo Kang, and Kyung Suh Park. 2004. "Corporate Governance and Firm Value: Evidence from the Korean Financial Crisis." *Journal of Financial Economics* 71(2):265–313.

Barca, Fabrizio, and Marco Becht, eds. 2001. *The Control of Corporate Europe*. Oxford: Oxford University Press.

Bauer, Rob, and Nadja Guenster. 2003. "Good Corporate Governance Pays Off! Well-Governed Companies Perform Better on the Stock Market." Algemeen Burgelijk Pensioenfonds, Heerlen, Netherlands. [http://www.deminorrating.com].

Becht, Marco, Patrick Bolton, and Alisa Roell. 2003. "Corporate Governance and Control." In George Constantinides, Milton Harris, and René Stulz, eds, *Handbook of the Economics of Finance*. Amsterdam: North-Holland.

Beck, Thorsten, Ross Levine, and Norman Loayza. 2000. "Finance and the Sources of Growth." *Journal of Financial Economics* 58(1–2):261–300.

Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine. 2003. "Law, Endowments, and Finance." *Journal of Financial Economics* 70(2):137–81.

Beck, Thorsten, Asli Demirgüç-Kunt, and Vojislav Maksimovic. 2005. "Financial and Legal Constraints to Firm Growth: Does Size Matter?" *Journal of Finance* 60(1):137–77.

Berle, A. A., and G. Means. 1932. *The Modern Corporation and Private Property*. New York: Macmillan.

Bertrand, M., P. Mehta, and S. Mullainathan. 2002. "Ferreting Out Tunneling: An Application to Indian Business Groups." *Quarterly Journal of Economics* 117(1):121–48.

Black, Bernard. 2001. "The Corporate Governance Behavior and Market Value of Russian Firms." *Emerging Markets Review* 2(2):89–108.

Black, Bernard S., H. Jang, and W. Kim. 2002. "Does Corporate Governance Matter? Evidence from the Korean Market." Working Paper, Stanford Law School, Stanford, Calif., and Korea University and KDI School of Public Policy and Management, Seoul.

Bodie, Zvi, and Robert Merton. 1995. "A Conceptual Framework of Analyzing the Financial Environment." In Dwight B Crane, Zvi Bodie, Kenneth A. Froot, Andre F. Perold, and Robert C. Merton, eds, *The Global Financial System: A Functional Perspective*. Boston: Harvard Business School Press.

Brockman, Paul, and Dennis Y. Chung. 2003. "Investor Protection and Firm Liquidity." *Journal of Finance* 58(2):921–37.

Cadbury Committee (Committee on the Financial Aspects of Corporate Governance). 1992. "The Report of the Committee on the Financial Aspects of Corporate Governance." London.

Cheung, S. N. S. 1970. "The Structure of a Contract and the Theory of Nonexclusive Resource." *Journal of Law and Economics* 13(54):49–70.

———. 1983. "The Contractual Nature of the Firm." *Journal of Law and Economics* 26(1):1–21.

Claessens, Stijn, Simeon Djankov, and Larry H. P. Lang. 1999. "Who Controls East Asian Corporations and the Implications for Legal Reform." Public Policy of the Private Sector Viewpoint Note 195, World Bank, Private Sector Development Department, Washington, D.C.

———. 2000. "The Separation of Ownership and Control in East Asian Corporations." *Journal of Financial Economics* 58(1–2):81–112.

Claessens, Stijn, Simeon Djankov, and Tatiana Nenova. 2001. "Corporate Risk around the World." In Reuven Glick, Ramon Moreno, and Mark Spiegel, eds, *Financial Crises in Emerging Markets*. Cambridge: Cambridge University Press.

Claessens, Stijn, and Joseph P. H. Fan. 2002. "Corporate Governance in Asia: A Survey." *International Review of Finance* 3(2):105–29.

Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang. 2002. "Disentangling the Incentive and Entrenchment Effects of Large Shareholdings." *Journal of Finance* 57(6):2741–71.

Claessens, Stijn, and Luc Laeven. 2003. "Financial Development, Property Rights, and Growth." *Journal of Finance* 58(6):2401–36.

Claessens, Stijn, and L. Klapper. 2005. "Bankruptcy around the World: Explaining Its Relative Use." *American Law and Economics Review* 7(1):253–83.

Claessens, Stijn, Joseph P. H. Fan, and Larry H. P. Lang. Forthcoming. "The Benefits and Costs of Group Affiliation: Evidence from East Asia." *Emerging Markets Review*.

Coase, Ronald C. 1937. "The Nature of the Firm." *Economica* 4(16):386–405.

———. 1960. "The Problem of Social Cost." *Journal of Law and Economics* 3(1):1–44.

Coffee, John C. 1999. "The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications." *Northwestern University Law Review* 93(3):641–708.

———. 2001. "Convergence and Its Critics: What Are the Preconditions to the Separation of Ownership and Control?" Columbia Law and Economics Working Paper 179, Columbia University, New York.

Coles, Jeffery L., Michael L., Lemmon, and J. Felix Meschke. 2003. "Structural Models and Endogeneity in Corporate Finance." Arizona State University, Department of Finance, Tempe.

De Jong, Abe, Douglas V. DeJong, Gerard Mertens, and Charles E. Wasley. 2001. "The Role of Self-Regulation in Corporate Governance: Evidence from the Netherlands." Simon School of Business Working Paper FR 00–20, University of Rochester, N.Y.

De Soto, Hernando. 1989. *The Other Path*. New York: Harper and Row.

Demirgüç-Kunt, Asli, and Ross Levine, eds. 2001. Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets, and Development. Cambridge, Mass.: MIT Press.

Demsetz, Harold. 1964. "The Exchange and Enforcement of Property Rights." *Journal of Law and Economics* 3(October): 11–26.

Demsetz, Harold, and K. Lehn. 1985. "The Structure of Corporate Ownership: Causes and Consequences." *Journal of Political Economy* 93(6):1155–77.

Denis, D. K., and J. J. McConnell. 2003. "International Corporate Governance." *Journal of Financial Quantitative Analysis* 38(1):1–27.

Djankov, Simeon, Edward L. Glaeser, Rafael La Porta, Florencio López-de-Silanes, and Andrei Shleifer. 2003. "The New Comparative Economics." *Journal of Comparative Economics* 31(4):595–619.

Doidge, C., A. Karolyi, and R. Stulz. 2004. "Why Are Foreign Firms Listed in the U.S. Worth More?" *Journal of Financial Economics* 71(2):205–38.

Durnev, A., and E. H. Kim. 2005. "To Steal or Not to Steal: Firm Attributes, Legal Environment, and Valuation." *Journal of Finance* 60(3):1461–93.

Dyck, Alexander, and Luigi Zingales. 2004. "Private Benefits of Control: An International Comparison." *Journal of Finance* 59(2):537–600.

Faccio, Mara, and Larry H. P. Lang. 2002. "The Ultimate Ownership of Western European Corporations." *Journal of Financial Economics* 65(3):365–95.

Franks, Julian, and Colin Mayer. 2001. "Ownership and Control of German Corporations." *Review of Financial Studies* 14(4):943–77.

Franks, Julian, Colin Mayer, and Stefano Rossi. 2003. "The Origination and Evolution of Ownership and Control." ECGI Finance Working Paper 09/2003, European Corporate Governance Institute, Brussels.

Gadhoum, Yoser, Larry H. P. Lang, and Leslie Young. 2003. "Who Controls US?" Chinese University of Hong Kong, Department of Finance.

Glaeser, Edward L., Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer. 2004. "Do Institutions Cause Growth?" *Journal of Economic Growth* 9(3):271–303.

Gompers, P. A., J. Ishii, and A. Metrick. 2003. "Corporate Governance and Equity Prices." *Quarterly Journal of Economics* 118(1):107–55.

Gorton, Gary, and F. A. Schmidt. 2000a. *Class Struggle inside the Firm: A Study of German Codetermination*. NBER Working Paper 7945. Cambridge, Mass.: National Bureau of Economic Research.

———. 2000b. "Universal Banking and the Performance of German Firms." *Journal of Financial Economics* 58(1–2):29–80.

Grosfeld, Irena, and Thierry Tressel. 2002. "Competition and Ownership Structure: Substitutes or Complements? Evidence from the Warsaw Stock Exchange." *Economics of Transition* 10(3):525–51.

Gugler, Klaus Peter, Dennis Mueller, and Burcin Yurtoglu. 2004. "Corporate Governance and Returns on Investment." *Journal of Law and Economics* 47(2):589–633.

Himmelberg, Charles P. R. 2002. "Measuring the Real Effects of Corporate Governance: A Note for the GCGF Research Meeting." Working Paper, Columbia University, Department of Economics, New York.

Holderness, Clifford. 2003. "A Survey of Blockholders and Corporate Control." *Economic Policy Review, Federal Reserve Bank of New York* 9(1):51–63.

Holmstrom, Bengt, and Steven N. Kaplan. 2001. "Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s." *Journal of Economic Perspectives* 15(Spring): 121–44.

Jensen, M. C., and W. H. Meckling, 1976. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3(4):305–60.

Joh, S. W. 2003. "Corporate Governance and Firm Profitability: Evidence from Korea before the Economic Crisis." *Journal of Financial Economics* 68(2):287–322.

Johnson, S., P. Boone, A. Breach, and E. Friedman. 2000. "Corporate Governance in the Asian Financial Crisis." *Journal of Financial Economics* 58(1–2):141–86.

Johnson, Simon, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer. 2000. "Tunneling." *American Economic Review* 90(2) (*Papers and Proceedings*): 22–27.

Khanna, T., and K. Palepu. 2000. "Is Group Membership Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups." *Journal of Finance* 55(2):867–91.

Khemani, R. Shyam, and Chad Leechor. 2001. "Competition Boosts Corporate Governance." World Bank, Private Sector Development, Washington, D.C.

Klapper, L., and I. Love. 2005. "Corporate Governance, Investor Protection, and Performance in Emerging Markets." *Journal of Corporate Finance* 10(5):703–28.

Kruse, Douglas, and Joseph Blasi. 1995. *Employee Ownership, Employee Attitudes, and Firm Performance*. NBER Working Paper 5277. Cambridge, Mass.: National Bureau of Economic Research.

La Porta, Rafael, Florencio Lopez-De-Silanes, and Andrei Shleifer. 1999. "Corporate Ownership around the World." *Journal of Finance* 54(2):471–518.

La Porta, Rafael, Florencio Lopez-De-Silanes, Andrei Shleifer, and Robert Vishny. 1997. "Legal Determinants of External Finance." *Journal of Finance* 52(3):1131–50.

———. 1998. "Law and Finance." *Journal of Political Economy* 106(6):1113–55.

———. 2000. "Investor Protection and Corporate Governance." *Journal of Financial Economics* 58(1–2): 3–27.

———. 2002. "Investor Protection and Corporate Valuation." *Journal of Finance* 57(3):1147–70.

Lel, Ugur. 2003. "Currency Hedging, Corporate Governance and Financial Markets Development." Working Paper, Department of Finance, Indiana University, Bloomington.

Lemmon, M. L., and K. V. Lins. 2003. "Ownership Structure, Corporate Governance, and Firm Value: Evidence from the East Asian Financial Crisis." *Journal of Finance* 58(4):1445–68.

Levine, R. 1997. "Financial Development and Economic Growth: Views and Agenda." *Journal of Economic Literature* 35(2):688–726.

———. 2005. "Finance and Growth: Theory, Evidence, and Mechanisms." In P. Aghion, and S. Durlauf, eds. *Handbook of Economic Growth*. Amsterdam: North-Holland/Elsevier Publishers.

Lins, K. V. 2003. "Equity Ownership and Firm Value in Emerging Markets." *Journal of Financial and Quantitative Analysis* 38(1):159–84.

McKinsey and Company. 2002. "Global Investor Opinion Survey." [www.mckinsey.com/governance].

Mitton, T. 2002. "A Cross-Firm Analysis of the Impact of Corporate Governance on the East Asian Financial Crisis." *Journal of Financial Economics* 64(2):215–41.

Morck, Randall, Andrei Shleifer, and Robert Vishny. 1988. "Management Ownership and Market Valuation: An Empirical Analysis." *Journal of Financial Economics* 20(1):293–315.

Morck, R., B. Young, and W. Yu. 2000. "The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?" *Journal of Financial Economics* 58(1–2):215–60.

Morck, Randall, David Stangeland, and Bernard Yeung. 2000. "Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease." In Randall Morck, ed., *Concentrated Corporate Ownership*. National Bureau of Economic Research Conference Volume. Chicago: University of Chicago Press.

Morck, Randall, and Bernard Yeung. 2004. Family Control and the Rent-Seeking Society. *Entrepreneurship: Theory and Practice*. 28(4):391–409.

Morck, Randall, Daniel Wolfenzon, and Bernard Yeung. 2004. *Corporate Governance, Economic Entrenchment and Growth*. NBER Working Paper 10692. Cambridge, Mass.: National Bureau of Economic Research.

Nenova, T. 2003. "The Value of Corporate Votes and Control Benefits: Cross-Country Analysis." *Journal of Financial Economics* 68(3):325–51.

North, Douglass C. 1981. *Structure and Change in Economic History*. New York: Norton.

———. 1990. Institutions, Institutional Change, and Economic Performance. Cambridge: Cambridge University Press.

Pagano, Marco, and Paolo F. Volpin. 2005. "Managers, Workers, and Corporate Control." *Journal of Finance* 60(2):841–68.

Perotti, Enrico, and Ernst-Ludwig von Thadden. 2003. "The Political Economy of Bank and Equity Dominance." CEPR Discussion Paper 3914, Centre for Economic Policy Research, London.

Peters Report. 2003. *Corporate Governance in the Netherlands: Forty Recommendations*. Secretariat Committee on Corporate Governance. [www.ecgi.org].

Pistor, Katharina. 2000. "Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies." *European Business Organisation Law Review* 1(1):59–108.

Prowse, Stephen D. 1990. "Institutional Investment Patterns and Corporate Financial Behavior in the U.S. and Japan." *Journal of Financial Economics* 27(1):43–66.

Rajan, Raghuran G., and Luigi Zingales. 1998. "Which Capitalism? Lessons from the East Asian Crisis." *Journal of Applied Corporate Finance* 11(3):1–48.

———. 2003a. "The Great Reversals: The Politics of Financial Development in the 20th Century." *Journal of Financial Economics* 69(1):5–50.

———. 2003b. Saving Capitalism from the Capitalists. Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity. New York: Crown Business.

Rossi, Stefano, and Paolo Volpin. 2003. "Cross-Country Determinants of Mergers and Acquisitions." Working Paper 3889, Centre for Economic Policy Research, London.

Shleifer, Andrei, and Robert Vishny. 1997. "A Survey of Corporate Governance." *Journal of Finance* 52(2):737–83.

Siegel, Jordan. 2005. "Can Foreign Firms Bond Themselves Effectively by Submitting to U.S. Law?" *Journal of Financial Economics* 75(2):319–59.

Stulz, René, and Rohan Williamson. 2003. "Culture, Openness, and Finance." *Journal of Financial Economics* 70(3):313–49.

Tirole, Jean. 2001. "Corporate Governance." *Econometrica* 69(1):1–35.

World Bank. 2001. Finance for Growth: Policy Choices in a Volatile World. Washington, D.C.

Wurgler, Jeffrey. 2000. "Financial Markets and the Allocation of Capital." *Journal of Financial Economics* 58(1–2):1187–214.

Zingales, Luigi. 1998. "Corporate Governance." *The New Palgrave Dictionary of Economics and the Law*. London: Macmillan.