

CORPORATE GOVERNANCE AND GLOBALIZATION

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This survey gives an overview of the current state of knowledge on the question of whether corporate-governance structures worldwide are determinants of differences in economic performance. We look at the identities of owners, monitoring boards, and legal systems and find that some, though not all, corporate-governance structures give rise to differences in performance. The paper ends with a tentative look at the prospects of corporate-governance structures converging worldwide.

I. INTRODUCTION

One of the most important consequences of the increasing economic integration of the world's economies is an increase in the strength of competition within countries. Companies must not only compete with other firms within their country, but with firms from around the world. Schumpeter's 'perennial gale of creative destruction' blows ever more strongly as an innovation is followed by imitators not only from the innovator's own country, but from all corners of the earth. Product life cycles shorten, profit margins shrink, and companies must be continually cutting costs and innovating just to survive. Similar developments are taking place in capital markets. Firms seek out the lowest costs of capital from across the globe, forcing banks to compete

with banks in other countries. Stock and commodity exchanges find themselves competing in global markets.

As a result of this intensification of competition, there has been increasing concern about the *competitiveness* of countries' institutions (Porter, 1990). High up on the list of institutional differences that have been discussed is a nation's corporate-governance system. Indeed, the term 'corporate governance' has only entered our vocabulary in the last 25 years or so, and the increasing attention paid to differences in corporate-governance institutions across countries has accompanied the increasing attention to and, for some, concern about the spread of globalization. Intensifying international competition and the spread of globalization raise the

following questions about corporate-governance institutions. Is there a single, best corporate-governance system as judged by commonly accepted measures of economic performance? If so, will international competition force all countries to adopt this type of system? More specifically, are the systems of Continental Europe, which seek to protect multiple stakeholders, doomed to see their capital and companies migrating to countries with systems that concentrate on protecting only capital suppliers?

To answer these questions we need to identify the salient characteristics of corporate-governance institutions across countries, and the evidence that they materially affect economic performance. The term ‘corporate governance’ covers at least three categories of institutional differences: (i) the identities of the owners of corporations, and the size distribution of their ownership stakes, (ii) the governance structure of corporations—number, size, and composition of monitoring boards, and (iii) the legal and political institutions that affect managerial behaviour. In the next three sections, each of these sets of characteristics is described. As we shall see, there are striking differences across countries in each of these categories. In section V, we examine the evidence that the differences in corporate-governance institutions lead to, or at least are associated with, differences in economic performance. Some, but not all, differences in corporate-governance institutions will be found to be associated with significant differences in certain indices of economic performance. After having examined existing differences in corporate-governance systems, and their consequences for performance, we are in a position to suggest answers to the above questions. The final section must obviously be considerably more speculative than its predecessors.

II. OWNER IDENTITIES AND STAKES

One distinction drawn within the corporate-governance literature is between ‘insider’ governance systems, in which ownership stakes are concentrated and the major stakeholders are directly represented on the boards that monitor managers and perhaps in management itself, and ‘outsider’ governance systems, in which ownership stakes are

dispersed, and owners exercise indirect control on management by electing representatives to the monitoring boards, or perhaps by voting on specific proposals of management. The United States and Great Britain are the most important examples of countries with outsider governance systems, and thus this form of governance structure is often called the ‘Anglo-Saxon’ system.

Within the insider category, two rather different structures can be identified. The first system is common in Germany, Austria, Switzerland, and some other Continental European countries, and is therefore often called the ‘Germanic’ system. In this system, control is typically unidirectional. A family, bank, or Company *X* owns a substantial or controlling interest in Company *Y* and has representatives on *Y*’s supervisory board. Company *Y*, in turn, owns a controlling interest in Company *Z*, which in turn controls *W*, and so on. Companies *Y*, *Z*, and *W*, on the other hand, do not own shares in the organizations that stand above them in the corporate pyramid. In this way we can speak of control being unidirectional.

By contrast, in the ‘Japanese form’ of insider system, several companies are linked together through interlocking directorships, which are backed by cross-holdings of one another’s shares. Within these intertwined groups of firms, called *keiretsu*, there is also a main bank and typically several other banks or financial institutions, which hold shares in the companies in the group. The main bank and perhaps some of the other financial institutions have representatives on the group companies’ supervisory boards.¹ Within a Japanese *keiretsu*, therefore, control is multidirectional, with each company able to exercise some control over the companies that control it.

We now present examples of each type of corporate form, and some summary statistics across a large cross-section of countries.

(i) The Outsider Model

General Electric (GE) is an example of a Berle and Means (1932) firm with widely dispersed shareholdings (see Table 1). In 2002 the largest shareholder in GE

¹ See Aoki and Patrick (1994), Edwards and Fischer (1994), and Masuyama (1994).

Table 1
Share Ownership of Microsoft and General Electric in 2002

General Electric	%	Microsoft	%
Large shareholders and/or managers			
John F. Welch Jr	0.22	William H. Gates III	11.60
Robert C. Wright	0.06	Steven A. Ballmer	4.40
Dennis D. Dammerman	0.05	Jeffrey S. Raikes	<1
Total officers and directors	0.34		16.70
Institutional holdings (top 15)			
General Electric Co.	1.00	Barclays Global Investors Intl	3.60
Regency Centers Corp.	0.34	Fidelity Mgmt & Research Co.	3.60
Liberty Media Corp. New	0.31	State Street Global Advisors	2.70
Healthsouth Corp.	0.25	Vanguard Group	1.90
Citigroup Inc.	0.23	Alliance Capital Mgmt	1.70
Cablevision Systems Corp.	0.22	Northern Trust Co. (Chicago)	1.10
Pfizer Inc.	0.21	Putnam Investment Mgmt	0.90
Exxon Mobil Corp.	0.19	Tiaa Cref Investment Mgmt Inc.	0.90
Cisco Systems Inc.	0.19	Wellington Mgmt	0.90
Prologis	0.17	Janus Capital Corp.	0.90
Intel Corp.	0.17	JP Morgan Fleming Asset Mgmt (US)	0.90
First Data Corp.	0.17	Goldman Sachs Asset Mgmt	0.80
Vodafone Group Plc New	0.14	Morgan Stanley Investment Mgmt	0.70
Microsoft Corp.	0.14	Smith Barney Asset Mgmt	0.70
Applied Materials Inc.	0.13	Capital Research & Mgmt Co.	0.70
Total institutional holdings	10.44*		50.80

Note: * Top 1,000 institutions.

Sources: Webpages of Microsoft and GE.

was the company itself, holding 1 per cent of the outstanding shares. The largest stake held by an individual was 0.22 per cent, held by John Welch, the former chief executive officer (CEO). The combined holdings of all officers and directors summed to only 0.34 per cent. This figure, 0.34 per cent, also represents the largest holding by an institution, Regency Centers Corp. The combined holdings of the 1,000 institutions with the largest holdings summed to only a bit more than 10 per cent of GE's outstanding shares.

Even in the United States, however, concentrated ownership stakes are not unknown. The second entry in Table 1 is for Microsoft. Bill Gates alone held more than 10 per cent of Microsoft's outstanding shares in 2002, and the combined holdings of all officers and directors summed to 16.7 per cent.

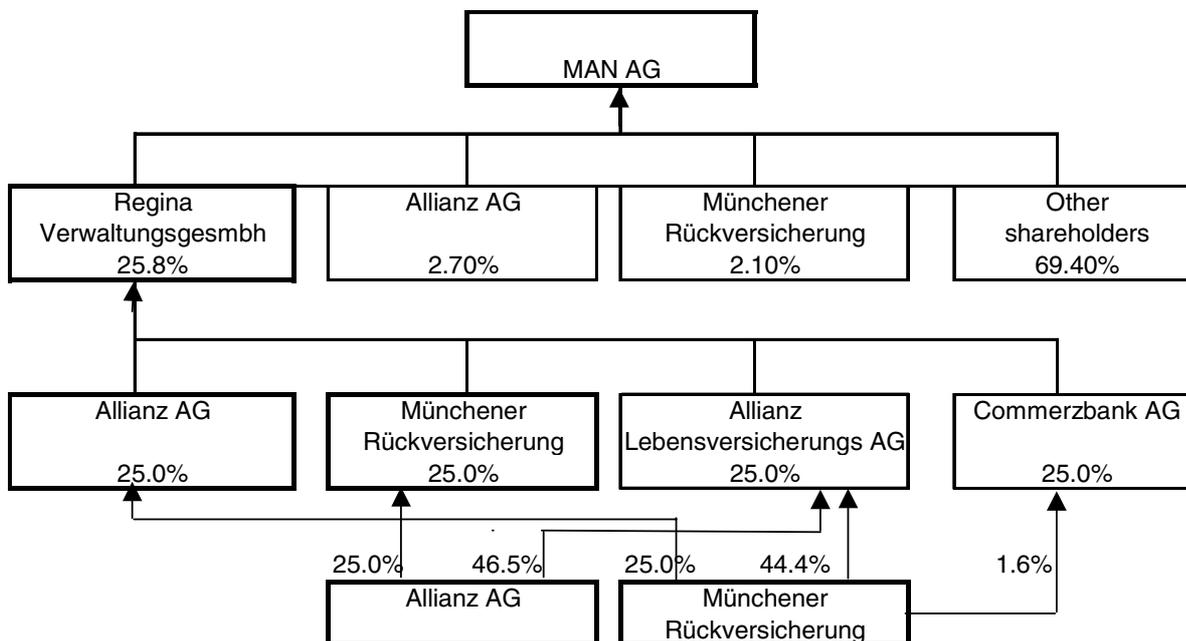
Institutional holdings were also larger on average than for GE, and cumulated to over 50 per cent of Microsoft's outstanding shares. As we shall see, the presence of a large shareholder is not unusual even in the United States, once we drop below the giant companies such as GE.

(ii) The Insider Model

Germanic model

Figure 1 depicts the ownership structure of Man AG, a large German firm comprised of 192 companies worldwide, producing commercial vehicles, printing machines, diesel engines, and other transportation and industrial equipment. The largest direct shareholder is Regina Verwaltungsges. mbH, with a 25 per cent stake. The giant insurance company Allianz controls Regina through its direct

Figure 1
The Ownership Structure of Man AG



Source: *Wer gehört zu Wem?* (Capital Links in German Companies) (Commerzbank, 1998).

and indirect holdings of Regina’s shares, however, and also has a small 2.7 per cent direct stake in Man. Thus, *de facto*, Allianz is Man’s largest blockholder and ultimate control can be said to lie with Allianz, whose CEO is also one of Man’s two deputy directors.

Japanese model

Figure 2 depicts the corporate structure of the Sumitomo group. The main members of the group are presented in the large box. Companies within this box are joined to one another through cross-shareholdings. Most arrows connecting the different firms have been omitted to avoid cluttering up the figure. For example, Sumitomo Mitsui Banking Corporation, Sumitomo Life Insurance, and The Sumitomo Trust and Banking Co. possess stakes of 4.4, 3.2, and 3 per cent of NEC’s shares. The three boxes at the bottom of the figure indicate that the scale of the group goes way beyond the interlocking shareholdings of the main members of the *keiretsu*. Many of its members have numerous subsidiaries both within and outside of Japan.

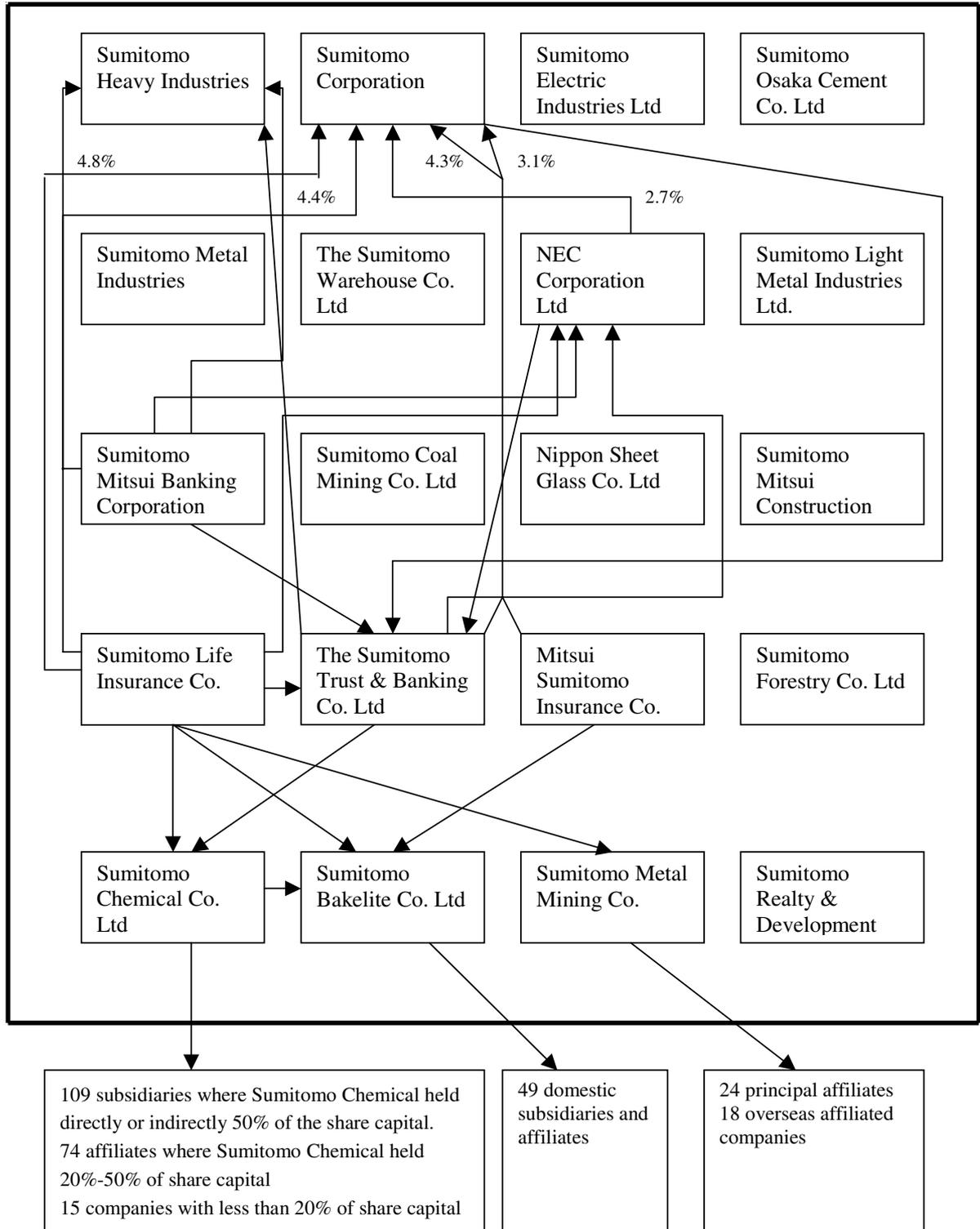
Other Asian models

What the *keiretsu* is to Japan, the *chaebol* is to Korea, only more so. In 1995 the top 30 *chaebol* accounted for 40.2 per cent of value added in Korea’s manufacturing sector (OECD, 1998). The Korean *chaebol* is in some sense a hybrid between the German corporate pyramid and the Japanese *keiretsu*. At the top of the structure sits, typically, the founding family. Unlike for the typical German corporation, however, ownership stakes in the *chaebol* are relatively small, averaging in 1997 only 9.9 per cent for the 70 largest *chaebol*-affiliated companies.² Nevertheless, these founding families can maintain control of their empires through cross-shareholdings among the member companies, which in 1997 resulted in a disparity between control and ownership rights for the 70 largest *chaebol* of almost 50 per cent (Joh, 2003, p. 293). The founding families’ ability to maintain control is further facilitated by the fact that banks and other financial institutions, unlike in Japan, do not try to play a monitoring role, and some 40 per cent of all shares are held by individuals with small stakes.³

² This is an asset weighted figure (Joh, 2003, pp. 292–4).

³ Joh (2003, pp. 292–4). See also, Claessens *et al.* (2002).

Figure 2
The Ownership Structure of the Sumitomo Group



Sources: Japan Company Handbook (2000) and the webpages of Sumitomo Corp.

The 'Asian crisis' in the late 1990s put heavy financial pressure on the *chaebol* and their affiliated banks. Some *chaebol* have spun off assets and have attempted to adopt more streamlined organizational structures.⁴ What future corporate-governance structures will look like in Korea is at this juncture difficult to predict.

(iii) Summary Statistics on Ownership for 39 Countries

Table 2 summarizes the key features of the ownership patterns in 39 countries. The countries are ordered according to the origins of their legal systems as determined by LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1998, hereafter LLSV). The importance of this categorization is discussed below.

It is readily apparent that not all countries correspond to the insider/outsider dichotomy. The mean and median largest shareholdings in Great Britain of 16 and 12 per cent are much lower than those for Germany, 54 and 52 per cent, as expected (see columns 2 and 4). The figures for Canada, however, 37 and 30 per cent, are quite similar to those for Spain, 38 and 29 per cent. The United States fits the expectations for an outsider system only when we restrict our attention to the 500 largest companies.

Among the smallest figures for the largest shareholders are those for Japan and Taiwan. As noted above when discussing Asian insider systems, these figures are misleading since they are based solely on the direct holdings of individual families and institutions. If we were to cumulate the holdings of each member of a group in Japan and Taiwan, we would see that a typical large firm in these countries is controlled by other members of its group.

The last five columns in Table 2 present the mean fractions of companies controlled by each category of owner. In Australia, for example, for 30.7 per cent of the companies an individual or family is both the largest shareholder and owns at least 10 per cent of the outstanding shares. For 21.1 per cent of the Australian sample no single family or institution holds at least 10 per cent of the outstanding shares

and the firms fall into the dispersed ownership category. The column headed 'non-financial holdings' reports the fraction of companies in each country immediately controlled by another company. It illustrates that corporate pyramids and cross-shareholdings are common across all three categories of corporate-governance systems. Among the Anglo-Saxon countries, we see that Australia, Great Britain, Ireland, and the United States (500 largest) have relatively large fractions of companies for which no shareholder owns 10 per cent or more of the shares. In Continental Europe this is also true for Denmark and the Netherlands, and in Asia for Japan, South Korea and Taiwan. The caveat regarding the importance of corporate groups still applies, of course.

III. CORPORATE BOARDS

(i) The US/Anglo-Saxon System

In the United States, authority to appoint and dismiss the managers, to approve dividend payments and acquisitions, and to make other important strategic decisions rests with the board of directors. This board is elected by the shareholders at their annual meetings, but is typically nominated by the management or at least with strong inputs from the management. Members of management hold seats on the boards, but each board is required to have some directors who are not members of management, and roughly 90 per cent of corporations have a majority of outside directors. The advantage of having members of management represented on the boards is obviously that they possess the most knowledge of their companies' operations and are thus in the best position to decide whether to acquire another firm, build a new plant, etc. The advantage of having outside directors is supposed to arise in situations where there is a conflict of interest between the managers and the shareholders. The reasoning is that the outside directors will favour the shareholders over the managers.

In the United Kingdom, the only legal requirement for a corporation is that it have at least two directors, who could be members of management or not

⁴ Chung Ju-yung, the founder of Hyundai, one of the largest *chaebol* of South Korea, has announced that his family will completely withdraw from day-to-day management of the company and restructure the entire group, placing international investors in management positions and allowing much of the company to be parcelled up and sold (*Asia Times*, 2000).

Table 2
Ownership Concentration and Identities in 39 countries

Country	No.firms	Mean largest holder	Std dev. largest holder	Median largest holder	Family holdings	Financial holdings	Non- financial holdings	State holdings	Dispersed holdings
English-origin (E-o) legal system									
Australia	114	24.83	19.34	17.07	30.70	17.50	30.70	0.00	21.10
Bermuda	12	49.86	25.28	50.68	25.00	25.00	50.00	0.00	0.00
Canada	280	36.99	24.73	29.65	34.60	19.60	40.40	3.30	2.10
Cayman Islands	5	33.27	18.87	39.30	0.00	0.00	100.00	0.00	0.00
Great Britain	687	16.00	13.29	11.78	17.90	37.00	15.10	1.80	28.20
Hong Kong	43	38.61	15.52	35.55	14.00	34.90	51.20	0.00	0.00
India	37	45.07	13.83	39.90	2.70	2.70	43.20	51.40	0.00
Ireland	24	17.62	13.37	12.20	29.20	20.80	16.70	8.30	25.00
Israel	14	31.18	19.45	24.50	28.60	14.30	50.00	0.00	7.10
Malaysia	158	34.97	16.46	32.77	38.00	10.10	48.10	1.90	1.90
New Zealand	18	45.01	14.93	49.82	0.00	55.60	44.40	0.00	0.00
Singapore	97	38.45	19.47	33.95	27.80	28.90	43.30	0.00	0.00
South Africa	25	42.15	17.10	44.75	24.00	24.00	48.00	4.00	0.00
Thailand	81	34.53	13.15	35.63	7.40	56.80	32.10	3.70	0.00
United States	3,070	21.89	15.52	16.83	47.30	25.90	14.60	0.90	11.30
USA (largest)	500	15.75	14.98	10.95	12.40	43.22	18.60	0.20	42.60
E-o average	4,665	34.03	17.35	31.63	21.81	24.87	41.85	5.02	6.45
Scandinavian-origin (S-o) legal system									
Denmark	40	23.13	20.42	15.00	25.00	12.50	25.00	2.50	35.00
Finland	34	26.90	19.80	20.70	5.90	17.60	38.20	23.60	14.70
Norway	42	29.92	16.95	26.92	16.70	23.80	47.60	7.10	4.80
Sweden	54	28.33	16.23	25.00	16.70	38.90	33.30	3.70	7.40
S-o average	170	27.07	18.35	21.91	16.08	23.20	36.03	9.23	15.48
German-origin, European (G-o, E) legal system									
Austria	30	59.37	21.72	54.50	6.70	23.30	53.30	16.70	0.00
Germany	240	54.01	24.73	51.72	26.70	15.40	48.80	7.00	2.10
Switzerland	66	45.63	27.73	48.00	33.30	10.60	42.40	4.60	9.10
G-o, E average	336	53.00	24.73	51.41	22.23	16.43	48.17	9.43	3.73
German-origin, Asian (G-o, A) legal system									
Japan	1,036	15.08	13.30	8.85	5.90	6.60	58.10	0.20	29.20
South Korea	16	19.10	17.60	12.84	25.00	6.30	25.00	12.40	31.30
Taiwan	11	15.75	19.50	5.41	18.20	9.10	9.10	9.10	54.50
G-o, A average	1,063	16.64	16.80	9.03	16.37	7.33	30.73	7.23	38.33
G-o average	1,399	34.82	20.76	30.22	19.30	11.88	39.45	8.33	21.03
French-origin (F-o) legal system									
Belgium	41	44.54	21.03	43.00	9.80	34.10	53.70	0.00	2.40
France	187	48.88	24.32	50.00	25.10	17.60	51.30	2.30	3.70
Greece	5	52.44	21.73	51.00	0.00	0.00	80.00	20.00	0.00
Italy	57	45.24	18.59	47.52	3.50	40.40	47.40	3.40	5.30
Netherlands	66	27.13	25.02	16.00	6.10	13.60	43.90	6.10	30.30

Table 2 (continued)

Country	No.firms	Mean largest holder	Std dev. largest holder	Median largest holder	Family holdings	Financial holdings	Non-financial holdings	State holdings	Dispersed holdings
Portugal	10	42.48	19.21	51.35	0.00	20.00	30.00	50.00	0.00
Spain	59	37.76	25.85	29.10	1.70	23.70	57.60	8.50	8.50
Turkey	5	41.49	19.30	37.12	20.00	40.00	40.00	0.00	0.00
Indonesia	41	50.00	18.14	51.00	34.10	9.80	48.80	7.30	0.00
Antilles (Neth.)	5	30.45	14.71	32.46	20.00	20.00	60.00	0.00	0.00
Argentina	8	40.18	14.89	41.34	12.50	25.00	50.00	0.00	0.00
Brazil	25	58.64	22.61	59.40	12.00	12.00	56.00	20.00	0.00
Chile	9	35.22	24.66	30.15	11.10	44.40	33.30	0.10	11.10
Mexico	8	47.42	11.76	50.78	50.00	0.00	50.00	0.00	0.00
F-o average	526	42.99	20.13	42.16	14.71	21.47	50.14	8.41	4.38
All	6,760	34.73	19.15	31.48	17.97	20.36	41.87	7.75	11.83

Sources: The sample of firms consists of Global Vantage firms, which are listed on a public stock exchange. The various sources of ownership include Worldscope, Amadeus, SEC, *Wer gehört zu Wem?*, etc. Most entries refer to 1995/6; Germany: 1985–2000; USA: 1991–8; Japan: 1987–98; UK: 1992–8.

(Charkham, 1994, p. 262). In fact, quoted companies in the UK do have boards of directors as in the United States and, since the adoption of the Cadbury Code in 1990, outsider directors are effectively a mandatory requirement in the UK, although their number on the board varies considerably from company to company (Charkham, 1994, pp. 262–71).

(ii) The Germanic System

The other major variant of governance system is the German two-board system. The *Vorstand* is responsible for the day-to-day decisions of the firm. It decides whether to introduce a new product or not, whether to cut prices, and so on. It contains the management of the firm.

No managers are members of the *Aufsichtsrat*. It is responsible for appointing the members of the *Vorstand*, approving the dividend, approving the company's accounts, and major capital investment decisions such as acquisitions and plant closings. It

is composed of directors elected by the shareholders and representatives of the employees and unions. In corporations (*Aktiengesellschaften*) with 2,000 or more employees, 50 per cent of the seats on the *Aufsichtsrat* are occupied by representatives of the shareholders and 50 per cent by representatives of the employees. Thus, the *Aufsichtsrat* in a German corporation is supposed to play in part the role of outside directors on the board of directors of a US/UK company—represent the interests of the other stakeholders in the firm, when they conflict with those of management. The fact that employees have equal representation on these supervisory boards obviously suggests that it is not only the interests of the shareholders which are upheld against those of the management. Moreover, the limited range of authority possessed by the *Aufsichtsrat* implies that it can really only control the managers of a corporation in extreme circumstances by not renewing their contracts, blocking a proposed merger, and the like.⁵ Variants on the German two-board system can be found in Austria, the Netherlands, Switzerland, and France.⁶

⁵ For further discussion of the German system, see Charkham (1994, ch. 2) and Franks and Mayer (2001).

⁶ French corporations can actually choose between two systems. Since 1966, they have been allowed to adopt something like the German two-board system. The more traditional structure might also be characterized as a two-tier system, except that the management board (*Vorstand*) consists of a single, most powerful person—the *président directeur-général*. See Charkham (1994, ch. 4).

(iii) The Japanese System

Japan has a single board of directors, as in the United States and Great Britain, but unlike in these countries it is dominated by members of management. On average over three-quarters of a board's members are managers. As a consequence, Japanese shareholders can expect little protection from the board of directors of their company in situations involving conflicts with management (Charkham, 1994, pp. 85–6).

IV. LEGAL SYSTEMS AND OTHER INSTITUTIONS

(i) Legal Systems

Country legal institutions differ from one another with respect to the protections that they afford shareholders. In some countries, for example, shareholders can demand access to the names and addresses of all other shareholders for the purpose of calling a special meeting of the shareholders; in others they cannot. In some countries managers must publish their shareholdings and their compensation packages; in others they do not have to do so. Provisions like these obviously strengthen the shareholders *vis-à-vis* the management, and help to align shareholder and managerial interests.

LLSV (1997, 1998) examined the content and development of legal institutions in different countries to determine which ones best align shareholder and managerial interests. They concluded that the common law systems found in the Anglo-Saxon countries and former British colonies offer outside and minority shareholders greater protection against managerial abuse of their position than do civil law systems. Within the civil law systems, LLSV distinguish French, German, and Scandinavian systems, with the French system, according to LLSV (1997, p. 1132), offering the shareholder the least protection among the three civil law systems, and the Scandinavian system providing the most protection.

In the Jensen and Meckling (1976) model of the firm, an owner-manager who decides to issue equity bears all of the agency costs from this action. Potential shareholders, possessed with rational ex-

pectations, recognize that the owner-manager will engage in more on-the-job consumption of various sorts, once he is no longer the firm's sole owner, because the costs of such consumption are now shared with the new owners. They lower their bid for the firm's shares, therefore, so that all of the costs of the on-the-job consumption fall on the owner-manager. This reasoning leads to two predictions. First, the greater are agency costs in a country (the weaker are shareholder protections), the less incentive founders of firms have to issue equity. In the extreme, agency costs convert the equity market into Akerlof's (1970) market for lemons, and lead to its disappearance. The first prediction is, therefore, that equity markets will be thinner in countries with poor shareholder protection. The second prediction follows immediately, namely that ownership concentration is higher in countries with poor shareholder protection.

Evidence supporting the second prediction can be seen in Table 2, column 2. The mean holdings of the largest shareholders in the English-origin and Scandinavian legal-system countries are 34 and 27 per cent, respectively, considerably below the figures for the German-origin European (53 per cent), and French-origin countries (43 per cent). Moreover, the figure for the English-origin countries is pulled up by countries such as Bermuda and New Zealand, for which we have data for only a handful of companies. Weighted means, using numbers of firms as weights, would give the English-origin countries the lowest figure. The three Asian countries with German-origin systems are again exceptions for the reasons given above. Evidence supporting the first prediction is discussed below.

Mention in this subsection should also be made of a somewhat different explanation for why legal institutions affect the economic performance of countries. Paul Mahoney (2001) argues that it is not the protection common-law systems afford to *stockholders* that explains their superior economic performance in terms of things such as growth, but rather the protection they offer to the *citizens* of these countries. By providing stronger protection of property rights, common-law systems protect citizens from the arbitrary expropriations of property that occur in civil-law systems. This protection provides greater incentives to start businesses, enter into contracts, make investments, and the like,

and thus leads, according to Mahoney, to greater growth. This argument is somewhat related to that presented in the next subsection.

(ii) Politics

Mark Roe (2000) has offered an alternative explanation for the differences in ownership and capital-market structures between Europe and the United States to that of LLSV. Roe questions the legal-institutions explanation, on the grounds that Europe's laws in other relevant areas such as contract law are every bit as good as America's (Roe, 2000, p. 590). Moreover, constructing the institutions that would support large equity markets and protect minority shareholders is not 'rocket science', and thus one expects that countries such as Germany and France would take this step to achieve the economic advantages claimed for the Anglo-Saxon model of corporate governance (Roe, 2000, p. 602). The reason that they do not, according to Roe, lies in their politics and not in their legal systems:

In social democracies—nations committed to private property but whose governments play a large role in the economy, emphasize distributional considerations, and favor employees over capital-owners when the two conflict—public policy emphasizes managers' natural agenda and demeans shareholders' agenda. The pressure on the firm for low-risk expansion is high, the pressure to avoid risky organizational change is substantial, and the tools that would induce managers to work in favor of invested capital—such as high incentive compensation, hostile takeovers, transparent accounting, and acculturation to shareholder-wealth maximization norms—are weak. . . .

Hence, managerial agency costs have been higher in social democracies than elsewhere, and we have . . . a deeper, richer political explanation not only for the persistence of family ownership in France, Germany, Italy and Scandinavia, but also for the rise of the public firm in the United States. Social democracies do not strongly control public firm agency costs because they do *not* want unbridled shareholder-wealth maximization, and, hence, by weakening shareholder-wealth maximization institutions, they widen the gap between managers and dispersed shareholders. When the gap is wide enough, the large American-style public firm is rendered unstable. (Roe, 2000, p. 543, footnote omitted, italics in original)

Thus, people who might become small shareholders, if they were afforded better protection against managerial agency costs, in social democracies opt for fixed-income forms of investments over com-

mon equity. Those people who do own common equity in social democracies prefer large blocks, which offer them some protection against managers' opportunistic behaviour.

V. WHAT DIFFERENCES DO THEY MAKE?

(i) Ownership Identity and Concentration

As in almost all areas of economics, the literature on corporate governance has been dominated by studies focusing on the USA. In this country, Section 8 of the Clayton Act prohibits interlocking directorates, and has effectively prevented the creation of the kinds of corporate pyramids and cross-shareholdings that are common in much of the rest of the world. Until recently, the Glass–Steagall Act prevented commercial banks from exercising the same sorts of ownership and monitoring roles that they have undertaken in Germany, Japan, and some other countries. The free-market ideology of the USA has ensured a limited role for the state as an outside owner of companies. Thus, in the USA only three categories of owners are important—insiders (managers), outside individuals and families, and institutional holders such as pension and mutual funds. To distinguish these sorts of institutions from other financial institutions, such as banks, or non-financial institutions (other firms), we refer to them as 'institutional portfolio holders'. We begin by describing the literature for the three dominant groups of shareholders in the USA.

Inside owners

In the standard textbook treatment, the managers of firms are their sole owners. No conflict between manager and owner can exist, and the owner-manager is assumed to maximize the firm's profits. The possibility of a conflict of interests between managers and owners can be traced back at least as far as the classic study of Berle and Means (1932) documenting the existence of a 'separation of ownership from control'. Since their study appeared, numerous articles and books have been written about the nature of the conflict between managers and owners, and/or which attempt to measure the economic consequences of this conflict. This literature, implicitly or explicitly, has assumed an 'Anglo-Saxon' corporate-governance structure. The own-

ers of the firm are shareholders; the shares are widely dispersed, so that no outside shareholder has a strong incentive to monitor managers carefully; managers do not hold large numbers of their companies' shares, and thus do not share the same financial interest in the firm with the shareholders. Should the managers hold a large fraction of their company's shares, it was assumed that they would act in the interest of the shareholders maximizing shareholder wealth.⁷

In a seminal article Morck, Shleifer, and Vishny (1988) (hereafter MSV) emphasized that an increase in insiders' shareholdings actually has two, conflicting effects on their incentive to maximize shareholder wealth.

- (i) As the number of shares held by insiders increases, the effect on their wealth from a rise in the market value of the firm increases.
- (ii) As the number of shares held by the managers increases, the likelihood of their being replaced through a proxy fight or takeover declines, and the managers have more discretion to pursue their own goals.

MSV presented evidence of a non-linear relationship between insider ownership and Tobin's q . It rose from around 0.75, when the board of directors holds no shares, to roughly 1.0, when it holds 5 per cent of the shares, and then fell, reaching a value of only 0.7, when the board holds 25 per cent of the outstanding shares. Starting at a board holding of 25 per cent, q again began to rise. MSV accounted for this non-linear pattern with the argument that each of the two conflicting effects of insider share ownership tends to be dominant over different ranges of insider ownership concentration.

Several subsequent studies have reported the same up/down/up again relationship between performance and ownership concentration (Cho, 1988; Short and Keasey, 1999; Cosh *et al.*, 2001; and Gugler, Mueller, and Yurtoglu, 2003a) (hereafter GMYa). McConnell and Servaes (1990, 1995) observed only

the first part of the curve—an inverted parabola—in their US data, as did Thomsen and Pedersen (2000) for European corporations.

In a recent paper, we have attempted to eliminate the awkward non-linear relationship between firm performance and ownership concentration by using two variables to capture the two effects of ownership concentration (Gugler, Mueller, and Yurtoglu, 2003b) (hereafter GMYb). To capture the positive financial incentive effect of stock ownership by managers, we use the total value of their shareholdings. With the positive incentive effect of managerial shareholdings removed, the fraction of outstanding shares held by insiders can be interpreted as an appropriate measure of managerial entrenchment. These two variables do disentangle the conflicting effects of managerial ownership. The fraction of shares held by insiders is found to have a direct negative relationship with firm performance, as predicted by the entrenchment hypothesis, while the value of insider shareholdings has a significant positive effect on performance.⁸

Claessens *et al.* (2002) have also tried to separate the wealth and entrenchment effects of insider ownership by taking advantage of the fact that cash flow and control rights often differ in East Asian countries for shareholders with highly concentrated shareholdings. They find evidence of positive wealth effects from cash flow rights, and negative entrenchment effects from the control rights of large shareholders.

In yet another study from outside the United States, Lai and Sudarsanam (1997) found evidence of adverse effects from managerial entrenchment using a sample of 297 UK companies. When a company's performance declines, entrenched managers are more likely to resist restructuring and, not surprisingly, the replacement of management.

Thus, there is ample evidence that managerial entrenchment worsens the performance of companies from the point of view of their shareholders, but that management's holdings of shares do give it some

⁷ For surveys, see Benston (1985) and Short (1994).

⁸ As measures of firm performance we use both an average (Tobin's) q , and a marginal q , i.e. the ratio of the return on investment to a firm's cost of capital. Marginal q has the advantage as a measure of performance that it is unlikely to be endogenous to ownership, as might be true of average q (see also Gugler and Yurtoglu, 2003a). We find a negative entrenchment effect and a positive wealth effect using both the average q and marginal q measures of performance.

positive incentive to improve its company's performance.⁹

Outside individuals as blockholders

There is little disagreement over the proposition that outside shareholders with small stakes are solely interested in seeing the value of their shares maximized—and that they are largely powerless when it comes to achieving this goal.

Many studies do not differentiate between individuals as large outside blockholders, and institutional blockholders. One UK study that does concludes that individual 'blockholders have a weak influence on a limited range of turnaround strategies' (Lai and Sudarsanam, 1997, p. 231). Diane Denis (2001, p. 205) reaches a similar conclusion in her recent survey of the literature: 'In sum, there currently exists some evidence that outside blockholders and other activist shareholders have an impact on firm actions but little evidence that they have any impact on firm performance.'

Institutional portfolio holders

Between 1950 and 1994 the fraction of shares held by institutional portfolio holders in the United States rose from 10 per cent to over 50 per cent (Friedman, 1996). Our figures in Table 2 are a bit lower than this, but this discrepancy probably arises because our data source does not report very small holdings. The managers of institutional portfolios obviously possess sufficient voting authority to intervene in shareholders' meetings and affect outcomes. The question remains, however, whether they use this power. Although examples of funds intervening to block or promote a merger can be found, most systematic studies of the effects of the identities of shareholders on the performance of firms conclude that these identities *do not matter*.¹⁰ Since Denis's (2001) conclusion about the effects of blockholders on performance, quoted above, applies to all types of blockholders, she too implicitly concludes that portfolio managers do not materially affect the companies in their portfolios.

Some exceptions to this generalization exist, however. Nickell *et al.* (1997) found a positive relation-

ship between institutional holdings and performance for UK companies. GMYb found that both average and marginal qs were positively related to institutional shareholdings in the USA. More research on this topic is clearly needed.

Banks

The two countries in which banks have supposedly been most important in corporate governance are Germany and Japan. In Germany, it has been claimed that the big universal banks have played the kind of monitoring role for the companies that they lent to or owned shares in that the central management teams of multi-division form organizations were supposed to play in the UK and USA (Cable, 1985). In Japan, a *keiretsu's* main bank is thought to become important when a member firm gets into trouble, intervening with a cash infusion, a plan for restructuring, or engineering a change of management (Aoki *et al.*, 1994; Berglöf and Perotti, 1994).

Recently, observers have become sceptical about the roles played by banks in Germany and Japan.¹¹ This scepticism may have been engendered by the poor overall performance of their economies over the last 15 years or so. One reason why one might not expect banks to play an important, *positive* monitoring role is that banks themselves are managed by professionals who may have their own goals to pursue. Indeed, in Germany through their direct ownership of shares and their authority to vote shares deposited with them, the major banks essentially *control themselves*, and thus are free to pursue whatever goal they choose (Edwards and Fischer, 1994). Boehmer (2001) contends that German banks are not interested in shareholder value.

GMYa have examined the effects of control by banks and other financial institutions for a large sample of companies from different countries. They group the countries according to the LLSV categories and measure company performance by marginal q (the ratio of returns on investment to company costs of capital). In none of the three European countries with a Germanic legal system (Austria, Germany, and Switzerland), nor in the three Asian countries with Germanic legal systems (Korea,

⁹ For an alternative view, see Holderness (2003).

¹⁰ See, for example, Holderness and Sheehan (1988) for the USA, Górriz and Fumás (1996) for Spain, and Goergen (1998) for Germany and the UK.

¹¹ With respect to Germany, see Baums (1994), and for Japan Ramseyer (1994).

Japan, and Taiwan), were companies controlled by a financial institution observed to have significantly different marginal q s from other companies.¹² Only in countries with a French-origin legal system were companies controlled by a financial institution observed to have significantly higher marginal q s than other companies. The French-origin countries had the lowest marginal q s of any country group, however, so that the estimated marginal q for companies controlled by a financial institution (0.69) was far below the 1.0 that would be consistent with shareholder-wealth maximization. In no group of countries did control by a financial institution achieve this goal.¹³

Other firms

(a) Pyramids

When company A owns a controlling interest in company B , it would seem plausible that A 's managers want to see B maximize profits and pay the value-maximizing amount out as dividends, as this gives A 's managers the maximum resources to pursue their own goals, whatever they may be. Thus, upon first consideration it seems reasonable to expect the usual principal-agent problems to be minimal with respect to any company owned by another company.

Upon further consideration, however, there are several reasons to expect companies controlled by other firms to exhibit worse performance than independent firms. First, in a long pyramidal chain, the managers of A may only be able to monitor B effectively, and managers further down in the chain may enjoy sufficient discretion owing to 'control loss' to pursue their own goals (Williamson, 1967; Franks and Mayer, 2001). Second, if the managers at the top of the pyramid are empire builders, they may wish to see all parts of the pyramid growing rapidly. Third, the firm at the top may introduce policies to benefit it at the expense of companies it controls, so that the latter appear to be performing poorly, even if they are not. As is often the case, the issue of whether a company controlled by another company performs better or worse than other firms is an empirical one.

Three studies document a negative impact of pyramids on firm performance. Volpin (2002) finds that Italian firms indirectly controlled through a pyramidal structure have significantly lower Tobin's q ratios. Yurtoglu (2000) obtains similar results for a sample of publicly listed Turkish firms. Gugler and Yurtoglu (2003b) find that German firms lower down in a pyramid pay out less in dividends than other firms.

GMVA did not find a single case of companies directly controlled by other companies having significantly *higher* marginal q s in their cross-national comparison. They did find, however, that companies located two or more levels from the top of a corporate pyramid in Continental Europe had significantly *lower* marginal q s, as did companies involved in cross-shareholdings. Cross-shareholdings are essentially what defines the Japanese *keiretsu* and Korean *chaebol*, of course, and we turn now to an examination of their performance.

(b) *Keiretsu* and *chaebol*

Several explanations for the spectacular success of Japanese firms following the Second World War have emphasized the importance of cross-shareholdings of members of a *keiretsu* and of its main bank. One argument sees cross-shareholdings as complements to the long-run supplier-purchaser relationships of member firms. In the presence of asset specificity, these relationships might be vulnerable to opportunistic behaviour on the part of one or both sides of an exchange (Williamson, 1975). Mutual shareholdings help to curb such opportunistic behaviour (Gilson and Roe, 1993).

A second set of arguments sees cross-shareholdings as a way to mitigate agency problems by inducing mutual monitoring by members of a group. All members are essentially involved in a repeated prisoners' dilemma, and cross-shareholdings help induce each member to choose the cooperative strategy, as, for example, by not tendering its shares when offered a substantial premium for them by an outsider seeking a hostile takeover.¹⁴ Of course, whether protection from a hostile takeover im-

¹² Control by a financial institution was defined as a financial institution having the largest block of shares and this block exceeding 10 per cent of all outstanding shares. In these countries financial institutions are typically either banks or insurance companies.

¹³ The estimate of marginal q for companies controlled by financial institutions in the Anglo-Saxon origin countries was greater than 1.0 (1.002), but it was significantly less than the estimated marginal q for all other firms in these countries, so that one could hardly claim that financial institutions were doing a superior monitoring job in these countries.

¹⁴ For variants on this argument see, Aoki (1990), Berglöf and Perotti (1994), and Osano (1996).

proves or worsens the overall performance of the *keiretsu* depends on the motivation behind the takeover. Given the dominance of inside managers on the *keiretsu* boards of directors, elimination of the threat of takeovers implies that *keiretsu* managers as a group are completely isolated from any disciplinary controls. The Japanese *keiretsu* is an archetype of an organization in which managers monitor themselves or, as Itami (2001, p. 93) expresses it, employees exercise sovereignty, which 'means that pursuit of the economically rational is carried out for the benefits of core employees, including those in management positions, and... the profits of the stockholders must sometimes take second place'. Whether the advantages of this structure outweigh the disadvantages is again an empirical question.

In addition to the evidence that *keiretsu* are better able to weather financial distress than independent firms (Hoshi *et al.*, 1990), a positive feature of cross-holdings in *keiretsu* appears to be that they eliminate asymmetric-information problems that can lead to under-investment in independent firms (Hoshi *et al.*, 1991).¹⁵ However, GMYa have presented evidence of over-investment by *keiretsu* firms relative to independent firms prior to the financial crisis.¹⁶

A Korean *chaebol* looks very much like an American conglomerate of the 1960s, and one can make the same sorts of positive and negative arguments with respect to them as were made about the conglomerates. An early study of 182 Korean firms over the 1975–84 period found that the largest *chaebol* outperformed other companies (Chang and Choi, 1988). A study covering a somewhat later period (1985–93) concluded that the profit rates of the *chaebol* in the early 1990s did not differ from those of other companies (Choi and Cowing, 1999). Two more recent studies covering 1992–7 (Campbell

and Keys, 2002) and 1993–7 (Joh, 2003) conclude that the *chaebol* have performed *significantly worse* than other firms in Korea. Moreover, Campbell and Keys present evidence directly linking poor performance to agency problems. Top executive turnover in the largest *chaebol* is unrelated to company performance, while in other Korean firms poor performance increases the chances that top managers lose their jobs.

These results clearly suggest a decline in the relative performance of the *chaebol* over time. One reason for this, which may apply to Korea and Japan, is that agency problems that take the form of high rates of investment and growth are not associated with poor performance so long as the investment opportunities of firms are attractive (Mueller, 1972). In the 1960s, 1970s, and 1980s, *keiretsu* and *chaebol* managers could pursue growth and still produce attractive results for their shareholders owing to the attractiveness of their investment opportunities. As these opportunities have declined, the agency problems associated with the *keiretsu* and *chaebol* have become manifest.¹⁷

Here it is worth noting that the results of Campbell and Keys, and Joh are based on data from *before* the Asian crisis, and so the relatively poor performance of the *chaebol* cannot be attributed to that event. As discussed below, Johnson *et al.* (2000) present evidence linking the severity of the Asian crisis for a country and the weakness of its corporate-governance institutions. Korea and India had the lowest scores for corporate-governance institutions of all Asian countries.¹⁸

The state

A state-owned company is typically assigned to some ministry, say transportation for the state's airline, which has the responsibility for monitoring it. The long-run nature of this relationship, however,

¹⁵ Miwa and Ramseyer (2002) question this and other arguments concerning the significance of the *keiretsu* for the Japanese economy.

¹⁶ Over the period 1985–95 the estimated marginal q for group firms was 0.92, which was significantly less than the estimate of 1.07 for independent firms. The financial crisis drove both estimates below 1.0 and eliminated the statistically significant difference between them.

¹⁷ Shin and Park (1999) also present evidence based on investment decisions suggesting an increase in agency problems among the *chaebol* in recent years.

¹⁸ Although the results for Korea and Japan seem to imply fairly clearly that group membership has worsened performance in recent years, Khanna and Palepu (2000a,b) have presented evidence of positive effects from group membership in India and Chile.

creates the danger that the ministry becomes ‘captured’ by the company (Stigler, 1971). Although Stigler’s capture hypothesis was developed in the context of state-regulated rather than state-owned firms, its logic applies equally well in the latter situation. A ministry is monitored by the parliament, which in turn is monitored by the citizens who discipline it at each election. Thus, in a democracy, the citizens can be regarded as the ultimate owners of state companies. They confront a triple principal–agent problem (citizen selects parliament, parliament monitors ministry, ministry monitors state company). If managers of private firms have considerable discretion to pursue their goals, because of the principal–agent relationship between managers and shareholders, then managers of state firms are likely to have enormous discretion to pursue their goals.

The effects of state ownership on performance are sometimes difficult to measure, because state-controlled companies are often monopolies. Where comparisons are possible, the evidence overwhelmingly points to superior performance by privately owned companies.¹⁹ Perhaps the most relevant for our purposes are those studies that examine the effects of state ownership in sectors such as manufacturing and mining, that are dominated by privately owned companies. Six such studies all report significantly better performance for private-controlled than for state-controlled companies, where performance is measured either in terms of profit rates or efficiency indices.²⁰

GMYa obtained the *lowest* estimate of marginal q (0.37) of all ownership and country groups for state-controlled companies in Austria, Germany, and Switzerland. In contrast, state-controlled companies in countries with French-origin legal systems had significantly *higher* estimated marginal q s than did other companies in the French-origin sub-sample. All in all, however, the evidence points in the direction of worsened performance with state control.

(ii) Corporate Boards

The effects of board characteristics on board actions

Two characteristics of corporate boards have received the most attention: their size and composition. Significant relationships have been found between certain board actions and these characteristics. CEOs are more likely to be removed when their firm is performing badly, if the board of directors is small (Yermack, 1996) and is dominated by outside directors (Weisbach, 1988). Firms with higher fractions of outside directors are less likely to become the targets of hostile takeovers (Shivdasani, 1993), to undertake acquisitions that are harmful for their shareholders (Byrd and Hickman, 1992), and to be sanctioned by the Securities and Exchange Commission (SEC) for poor accounting practices (Dechow *et al.*, 1996). The link between CEO pay and firm performance is weaker, the larger the size of the board of directors (Yermack, 1996). These results indicate that the kinds of board actions which should improve a company’s performance are positively related to the fraction of outside directors on the board, and negatively related to its size.

The effects of board characteristics on firm performance

The results of the previous subsection lead one to expect a positive relationship between company performance and the fraction of outside directors on the board, and a negative relationship to its size. However, three large surveys of the literature find that ‘there is little to suggest that board composition has any cross-sectional relationship to firm performance’.²¹ One explanation for this somewhat surprising finding may be that having large fractions of outside directors generally worsens the performance of companies, because they lack the detailed knowledge of its operations that insiders have,²² but that outsiders are more likely to replace bad managers, which increases the performance of a company. The net effect of these two tendencies is to

¹⁹ For a review of this literature, see Mueller (2003, pp. 373–80)

²⁰ See, Funkhouser and MacAvoy (1979), Boardman and Vining (1989), Picot and Kaufman (1989), Vining and Boardman (1992), Gugler (1998), and Majumdar (1998). See also the account by Barca and Trento (1997) of how the initially good performance of state-owned enterprises in Italy after the Second World War deteriorated as a result of increasing pressure from the state for the firms to pursue various ‘political goals’.

²¹ Hermalin and Weisbach (2003, p. 12). See also, Dalton *et al.* (1998) and Bhagat and Black (1999, 2000).

²² Klein’s (1998) results are somewhat consistent with this interpretation.

eliminate any systematic relationship between board composition and firm performance.

The results on board size are consistent with those of the previous section. Board size is inversely related to various measures of firm performance.²³

(iii) Legal Systems

The microeconomic effects of country legal institutions

In Table 3 we list a large group of countries according to the LLSV classifications (LLSV, 1997, p.1138). Disagreement over the desirability of paying dividends lies at the heart of the conflict between managers and shareholders (LLSV, 2000). Column 3 presents mean dividend-to-sales ratios for each country, and averages for the country groups. The pattern of dividend pay-outs across countries corresponds to the prediction that strong legal protection for shareholders leads to higher dividend pay-outs.²⁴ Dividend pay-outs are highest in the Anglo-Saxon countries, almost double the average for the countries with French-origin legal systems.

Although the pattern of dividend payments suggests that the conflict between managers and shareholders over the use of company cash flows is less serious in Anglo-Saxon countries, dividends are an imperfect signal of whether managers are maximizing shareholder wealth. For a company with attractive investment opportunities, the optimal dividend payout from the point of view of a shareholder can be zero. A more accurate measure of the quality of investment decisions is the ratio of a company's returns on investment to its cost of capital—marginal q . This q should be equal to or slightly greater than 1.0, if the investments are maximizing shareholders' wealth. Column 4 of Table 3 presents estimates of marginal q for the countries for which GMYa had data for the period 1985 through 2000. In many of the developing countries data were available for only a few firms and for the last few years of the sample period. Column 2 reports the number of firms used to calculate the marginal q s. When this number is small, the estimates are not very reliable. As with the figures in column 3, the

estimates of marginal q follow the pattern implied by LLSV's ranking of legal systems. For the pooled sample of English-origin countries marginal q 's estimate is 1.02, for the French-origin countries it is only 0.59. Where each dollar invested in an English-origin country produced \$1.02 worth of assets, each dollar invested in a French-origin country created only 59 cents worth of assets. The four Scandinavian and six Germanic countries fall in between these two extremes. With respect to the countries with Germanic-origin legal systems, however, a dramatic difference between the three Asian countries and their three European counterparts can be observed. The average of the marginal q s for the three Asian countries is 0.94, for the European countries it is only 0.64, barely above that for the French-origin countries. These differences in investment performance between the Asian and European members of the Germanic-origin group may be due to differences within their legal systems that have emerged over time, or they may reflect differences in investment opportunities between Asia and Europe. The latter explanation is consistent with the dramatic differences in growth rates reported in the last column discussed below.

The figures in column 4 are estimates of the returns on company investments relative to their costs of capital. They need have no relationship to the returns shareholders earned on their investments in these countries. Indeed, under the efficient capital-market assumption, no such relationship should exist. Once shareholders in a country with weak legal protection realize that they are vulnerable to the opportunistic behaviour of managers and large blockholders, they adjust their willingness to pay for shares accordingly and can be expected to earn the same returns on their investments as do shareholders in English-origin countries. Column 5 of Table 3 reports geometric means of returns on equity for the period 1970–97 for a sample of countries as reported in Lombardo and Pagano (2000). As can be easily seen, the pattern of returns does not match the ordering of LLSV. Quite to the contrary, shareholders in the French-origin countries earned the highest returns on equity, those in English-origin countries earned the lowest returns. Lombardo and Pagano

²³ See Yermack (1996) and discussion in Hermalin and Weisbach (2003, p. 13).

²⁴ See also Faccio *et al.* (2001) and Gugler and Yurtoglu (2003b).

Table 3
Differences across Countries in Legal Systems and Various Economic Statistics

Country	No. of firms	Dividend pay-out (% sales)	qm = r/i	Return on equity	External capital/GDP	Domestic firms/pop.	IPOs/pop.	GDP growth
Australia	346	0.048	0.94	0.082	0.49	63.55	—	3.06
Bermuda	215	0.046	0.91	—	—	—	—	—
Canada	1,478	0.027	1.16	0.097	0.39	40.86	4.93	3.36
Cayman Islands	42	—	0.58	—	—	—	—	—
Great Britain	1,331	0.035	0.85	0.129	1.00	35.68	2.01	2.27
Hong Kong	127	0.113	0.78	0.177	1.18	88.16	5.16	7.57
India	246	0.022	0.80	0.122	0.31	7.79	1.24	4.34
Ireland	63	0.017	1.10	0.138	0.27	20.00	0.75	4.25
Israel	56	0.008	1.27	—	0.25	127.60	1.80	4.39
Kenya	—	0.053	—	—	—	2.24	—	4.79
Malaysia	381	0.039	0.86	0.021	1.48	25.15	2.89	6.90
New Zealand	66	0.040	0.86	0.059	0.28	69.00	0.66	1.67
Nigeria	—	—	—	0.059	0.27	1.68	—	3.43
Pakistan	46	0.021	0.40	0.116	0.18	5.88	—	5.50
Singapore	208	0.034	0.97	0.123	1.18	80.00	5.67	1.68
South Africa	118	—	1.07	0.146	1.45	16.00	0.05	7.48
Sri Lanka	—	—	—	0.002	0.11	11.94	0.11	4.04
Thailand	243	0.037	0.64	0.079	0.56	6.70	0.56	7.70
United States	8,591	0.026	1.05	0.118	0.58	30.11	3.11	2.74
English-origin average	—	0.038	1.02	0.098	0.60	35.45	2.23	4.30
Denmark	101	0.014	0.65	0.138	0.21	50.40	1.80	2.09
Finland	79	0.015	0.96	0.088	0.25	13.00	0.60	2.40
Norway	103	0.018	1.04	0.123	0.22	33.00	4.50	3.43
Sweden	156	0.019	0.65	0.152	0.51	12.66	1.66	1.79
Scandinavian average	—	0.017	0.78	0.125	0.30	27.26	2.14	2.42
Austria	82	0.031	0.71	0.105	0.06	13.87	0.25	2.74
Germany	425	0.015	0.57	0.117	0.13	5.14	0.08	2.60
Switzerland	160	0.022	0.64	0.136	0.62	33.85	—	1.18
European-Germanic average	—	0.023	0.64	0.119	0.27	17.62	0.16	2.17
Japan	2,219	0.007	0.86	0.126	0.62	17.78	0.26	4.13
South Korea	82	0.006	0.70	0.064	0.44	15.88	0.02	9.52
Taiwan	126	0.016	1.26	0.179	0.88	14.22	0.00	11.56
Asian-Germanic average	—	0.010	0.94	0.123	0.65	15.96	0.09	8.40
Germanic-origin average	—	0.016	0.74	0.121	0.46	16.79	0.12	5.29

Table 3 (continued)

Country	No. of firms	Dividend pay-out (% sales)	qm = r/i	Return on equity	External capital/GDP	Domestic firms/pop.	IPOs/pop.	GDP growth
Argentina	24	0.027	0.78	0.223	0.07	4.58	0.20	1.40
Belgium	79	0.026	0.51	0.144	0.17	15.50	0.30	2.46
Brazil	133	0.013	0.25	0.103	0.18	3.48	0.00	3.95
Chile	73	0.029	1.24	0.251	0.80	19.92	0.35	3.35
Colombia	15	0.025	0.43	0.283	0.14	3.13	0.05	4.38
Ecuador	—	—	—	—	—	13.18	0.09	4.55
Egypt	—	—	—	—	0.08	3.48	—	6.13
France	495	0.020	0.57	0.116	0.23	8.05	0.17	2.54
Greece	49	0.036	0.54	0.043	0.07	21.60	0.30	2.46
Indonesia	132	0.022	0.84	-0.128	0.15	1.15	0.10	6.38
Italy	150	0.014	0.64	0.067	0.08	3.91	0.31	2.82
Jordan	—	—	—	0.086	—	23.75	—	1.20
Luxembourg	12	0.010	0.70	—	—	—	—	—
Mexico	81	0.003	0.50	0.155	0.22	2.28	0.03	3.07
Netherlands	174	0.034	0.69	0.155	0.52	21.13	0.66	2.55
Antilles (Neth.)	19	0.014	1.19	—	—	—	—	—
Panama	4	—	1.25	—	—	—	—	—
Peru	20	0.001	0.11	0.207	0.40	9.47	0.13	2.82
Philippines	83	0.028	1.00	0.226	0.10	2.90	0.27	0.30
Portugal	49	0.010	0.46	0.231	0.08	19.50	0.50	3.52
Spain	117	0.035	0.54	0.098	0.17	9.71	0.07	3.27
Turkey	29	0.026	0.52	0.233	0.18	2.93	0.05	5.05
Uruguay	—	—	—	—	—	7.00	0.00	1.96
Venezuela	10	0.001	0.58	0.156	0.08	4.28	0.00	2.65
French-origin average	—	0.020	0.59	0.147	0.21	10.00	0.19	3.18

Sources: Columns 2–4: Global Vantage Database; 1985–98. Column 5: Lombardo and Pagano (2000); 1970–97 for most countries. Columns 6–9: LLSV (1997); columns 6–8: 1994–6; column 9: 1960–92.

(2000) present evidence that the pattern reverses, however, once one adjusts for risk differences across companies in the different countries.

Virtually all research on corporate-governance institutions has been cross-national. Gompers *et al.* (2003) have shown, however, that corporate governance can also affect company performance within a country. They construct an index of the strength of shareholder rights for US companies, and show that shareholders of companies in the highest decile of shareholder rights earned significantly higher returns on their shares than did shareholders of companies with weak shareholder rights. Among the institutions that go into the index are

provisions in state laws governing corporate governance, and provisions in corporate charters governing things such as the existence of golden parachutes and poison pills, voting rules, compensation plans, and the like.

The macroeconomic effects of country legal institutions

(a) The size of external capital markets

The more confidence an individual has that a company's management will invest its capital wisely and pay sufficient dividends to yield attractive returns for the shareholders, the more willing the individual will be to become one of those shareholders. Thus, the demand schedule for corporate shares in a

country should be further to the right, the greater the protection a country's legal system offers shareholders; *ceteris paribus* this should lead to larger markets for corporate securities in countries with legal institutions that protect shareholders against managerial exploitation.

Columns 6–8 in Table 3 present evidence from LLSV (1997) consistent with this prediction. Column 6 measures the size of the external capital market as the ratio of stock-market capitalization in a country to its GDP in 1994. According to the LLSV evaluation of legal systems, we should expect the relative sizes of external capital markets in the four country groups to be English > Scandinavian > Germanic > French. This ranking appears if we restrict our attention to the three European countries with Germanic legal systems. The average for the Germanic-origin countries is higher than for the Scandinavian countries, when the three Asian countries with Germanic-origin legal systems are included. Clearly, legal institutions are not the only determinants of the size of the external capital market.

Column 7 measures the size of the external capital market as the ratio of the number of domestic firms listed in a country to its population in millions in 1994. Here the numbers correspond to the predicted ranking exactly, and there are no discernible differences between European and Asian countries in the Germanic-origin group.

Column 8 measures the size of the external capital market as the ratio of initial public offerings (IPOs) of equity in a country to its population in millions for the 1-year period beginning July 1995. The English-origin and Scandinavian-legal-system countries have slightly more than two IPOs per 1m inhabitants, a figure which is more than ten times larger than the numbers of IPOs in the Germanic- and French-origin countries. Although the number of IPOs in a country varies over the business cycle, we believe that the rankings of the different countries will remain the same for different phases of the business cycle. Thus, all three sets of comparisons suggest that English-origin legal systems lead to the largest external capital markets and French- and German-origin systems to the smallest markets, with the Scandinavian countries generally coming closest to the English-origin group.

Two additional studies have emphasized the importance of legal institutions as determinants of the size of external capital markets. Modigliani and Perotti (1997) develop a model in which legal protections for minority shareholders influence the size of a country's equity market, and present some evidence consistent with their model. Demirgüç-Kunt and Maksimovic (1998) present evidence linking the efficiency of a country's legal system to the size of its external capital markets, where efficiency is measured using several indices of the ease with which suppliers of credit can write and enforce debt contracts.

(b) Legal systems, the size of external capital markets, and economic growth

One obvious consequence of having thin external capital markets is that firms with attractive investment opportunities may have difficulty raising investment funds. Rajan and Zingales (1998) present evidence that this is the case. Industries that require large amounts of capital, such as pharmaceuticals, develop relatively more rapidly in countries with larger external capital markets. More generally, Levine and Zervos (1998) have established a positive link between the size of a country's equity market and its rate of growth.

If legal institutions affect the size of a country's external capital markets, and the size of a country's external capital markets affects its growth rate, then there should be a relationship between the characteristics of a country's legal system and its growth rate. Column 9 of Table 3 suggests that such a relationship exists, once one takes into account the significant differences between the European and Asian members of the Germanic-origin group. The three Asian Germanic-origin countries have the highest average growth rates in GDP per capita over the 1970–93 period. They are followed in order by the English-origin, Scandinavian, French-origin, and, last of all, the three European countries with Germanic legal systems. French-origin and, at least within Europe, German-origin countries have the slowest growth rates; English-origin and Scandinavian countries have the fastest growth rates.

Paul Mahoney (2001) has confirmed the importance of legal institutions in explaining country growth

rates. He restricts his attention to the common-law/civil-law distinction.²⁵ Holding other variables constant, countries with civil-law legal institutions grew more slowly over the 1960–92 period than did countries with common-law systems. As discussed above, Mahoney argues that in common-law systems there is a greater respect for individual rights, and greater legal protections against arbitrary state actions to redistribute income and wealth. Thus, according to Mahoney, it is the protection common-law systems give to individual citizens against expropriations of property by the state that explains their better economic performance, not the protection common-law systems give to shareholders against expropriations of their wealth by company managers. Neither explanation rules out the other, of course. The results in Table 3 can also be interpreted as offering support for Mark Roe's (2000) prediction that the ideological differences between Europe and the United States, as they manifest themselves in the politics of the various countries, affect the corporate-governance structures and relative sizes of external capital markets on the two sides of the Atlantic.

Although the results presented in Table 3 establish a close link between the strength of a country's corporate-governance institutions and its rate of growth, an important exception to this pattern must also be noted—China. Its corporate-governance institutions are weak by any measure, and yet it has managed to achieve quite spectacular levels of growth over the last quarter of a century. Allen *et al.* (2002) argue that this has been possible because, in China, informal reciprocal relationships and reputations for fair dealing substitute for formal governance institutions to ensure that contracts are fulfilled and loans repaid. Strong formal corporate-governance institutions may come close to being a sufficient condition for successful growth, but they are not a necessary condition.

(c) The Asian crisis

One of the most dramatic macroeconomic events of the last quarter century was the collapse in 1997–8 of many Asian economies during the so-called 'Asian crisis'. A variety of macroeconomic explanations for the crisis have been offered, but it would appear that a microeconomic explanation may be

just as important. Johnson *et al.* (2000) have presented evidence linking the severity of the crisis in an Asian country to the strength of its corporate-governance institutions. The sizes of the depreciation of a country's exchange rate and the decline of its stock market were inversely related to the strength of its corporate-governance institutions. Thus, the overall weakness of corporate-governance institutions in Asia helps to explain why there was a crisis, and the differences in corporate-governance institutions across countries explain differences in the extent to which countries were affected by the crisis.

VI. IMPLICATIONS FOR GLOBALIZATION

We are now in a position to offer some answers to the questions posed in the Introduction and some additional questions raised by the literature. We begin with the most important question.

(i) Is there a Best Corporate-governance System?

As Dowrick and Golley point out in their contribution to this issue, *levels* of national income might be regarded as very long-run measures of economic growth under the assumption that all countries essentially started off at the same low level of income. Using this measure of performance, all of the main forms of corporate-governance systems described above must be deemed to be good, since the countries which typify each system—the United States and United Kingdom, Germany and Switzerland, and Japan—have all become very rich. This is essentially the conclusion drawn by Shleifer and Vishny (1997) in their comprehensive survey of the corporate-governance literature. Each system has its particular strengths and weaknesses.²⁶

Although we agree with this statement, we do not draw from it the implication that no system is better than the others. For much of the twentieth century, companies in the major industrial countries did not face domestically the intense international competition that they do today. Japan still has a fairly closed economy. The *relatively* weaker internal competitive environment over the first three-quarters of the

²⁵ See also GMY (2003c) for such a distinction and its effects on marginal q.

²⁶ For a similarly equivocal assessment, see Kester (1992).

twentieth century may have concealed weaknesses in corporate-governance institutions that have only become apparent in the last couple of decades. The evidence reviewed in the previous section, which comes from this most recent period, clearly implies that Anglo-Saxon systems are better at protecting shareholders than other systems, and that they lead to superior macroeconomic performance. This superior performance suggests that countries which do not possess Anglo-Saxon type corporate-governance institutions might achieve better economic performance by adopting them.

The populations of all of the major industrial countries of the world, except for a few Anglo-Saxon countries such as the United States and Australia, are aging rapidly, and their governments will face great pressure in the future to raise tax revenue to subsidize pensions. If government leaders become convinced that changes in corporate-governance institutions may lead to greater economic growth, introducing such changes will become increasingly attractive over time. We first look at some evidence suggesting that such changes are already taking place, and then address the question of whether a full convergence is likely.

(ii) Are Corporate-governance Systems Converging?

We address this question by looking at recent developments in several countries.

The United States

Even before the Enron and WorldCom scandals at the beginning of the twenty-first century, several changes had taken place in the United States that tended to strengthen the hands of shareholders *vis-à-vis* managers. Some of these have been precipitated by the increasingly important role of institutional investors, while some have been the results of SEC rulings and court decisions (see Bradley, Schipani, Sundaram, and Walsh, 1999, pp. 67–8) (hereafter BSSW).²⁷ The Enron scandal sped these changes along and brought the US Congress into the

picture. Thus, the Anglo-Saxon corporate-governance model, as it is embodied in US institutions has, if anything, been becoming more Anglo-Saxon.

Germany and Continental Europe

Several countries have introduced new corporate-governance codes in the last few years, and these generally entail a movement towards the Anglo-Saxon institutions.²⁸ Often the movement is only partial, however. In the recently issued corporate-governance codes of Austria and Germany, for example, it is only *recommended* that managers report their compensation. Nevertheless, the direction of change is unmistakable. Prohibitions against insider trading are on the increase, and companies are being forced to make their financial statements more transparent. Indeed, a large majority of the world's leading countries has adopted accounting standards that are either identical to or come close to those formulated by the International Accounting Standards Committee. The necessity to raise large amounts of capital to finance cross-border acquisitions has also led many Continental European firms to list their securities on the London or New York stock exchanges, thereby subjecting them to Anglo-Saxon corporate-governance constraints even though their main headquarters remain outside of these countries.²⁹

Japan

Similar developments have been afoot in Japan. In response partly to the weakness of its economy, partly to external pressures, the Japanese government has been deregulating the financial sector. Over the last 15 years, members of *keiretsu* have been reducing their holdings of one another's shares. Some 100 Japanese companies are also listed on either the London or New York stock exchanges.³⁰

(iii) Can One Expect a Full Convergence in Corporate-governance Systems?

No

Ownership structures change very slowly over time. The best predictors of the identity of a firm's

²⁷ Also, there is an ongoing discussion in the USA over how one can increase shareholder participation in nominating corporate directors. The American Bar Association (ABA) has delineated five possible alternatives that the SEC might pursue, each differing in the scope of shareholder involvement (see Pozen, 2003).

²⁸ For the codes of nearly 40 countries, see http://www.ecgi.org/codes/all_codes.htm

²⁹ For further discussion of these developments and references to the literature, see BSSW (pp. 69–74).

³⁰ For further discussion and references to the literature, see BSSW (pp. 74–5).

largest shareholder and the size of her/its shareholding today are the identity and size of the largest shareholder's shareholding last year. Bebchuk and Roe (1999) identify two causes for this path dependence. One they label *structure-driven* and the other *rule-driven path dependence*. Structure-driven path dependence can arise either because an organization has adapted to a particular ownership structure and thus would sacrifice efficiency by changing, or because certain stakeholders—such as the managers or the dominant shareholder—would lose from a shift to a more efficient structure, and thus resist such a change. Rule-driven path dependence can arise for similar reasons. A country may adopt laws and regulations that are designed to make companies with the existing ownership structures most efficient, and/or influential managers and shareholders may be able to induce the political system to maintain a set of rules, which, although inefficient, is to their advantage.

Barca and Trento (1997) give an account of why banks in Italy play such a modest role in its corporate-governance structure, which illustrates the importance of path dependence.³¹ During the first part of the twentieth century, banks in Italy played much the same role in financing and monitoring firms as they did in Germany. The stock-market crash at the end of the 1920s produced a crisis for the banks, however. The state rescued the banks by buying out their industrial holdings and placed them into a newly created state-owned company—the Institute for Industrial Reconstruction (IRI). At the same time the government passed legislation, resembling the Glass–Steagall Act in the United States, limiting banks' involvement in the industrial sector. Thus, the weak role played by banks in corporate governance in both the United States and Italy can be traced to essentially the same event at the same point in time.

Yes

If the best-practice technology in an industry is characterized by a U-shaped average cost function, then perfect competition will ensure that every firm in the industry adopts the best-practice technology,

and that every firm is of the size defined by the bottom of the U. If globalization is increasing competitive forces in every country, then the obvious implication would seem to be that countries should converge on the 'best-practice' corporate-governance system. Such a prediction has been made by Hansmann and Kraakman (2001), who see the efficiency-enhancing aspect of competition in capital markets driving convergence on the Anglo-Saxon system.³²

Maybe

Although one certainly cannot rule out the possibility of a full convergence of corporate-governance institutions on a single, Anglo-Saxon model, the analogy between competition within an industry leading to convergence among firms and competition across countries leading to convergence among countries is somewhat problematic. In a competitive environment inefficient firms go bankrupt and disappear. Countries seldom go bankrupt, and only disappear if they are defeated in war. The greater efficiency and faster growth that are likely to follow reforms in corporate governance should tempt politicians to introduce these reforms, but there are likely to be counter pressures resisting these reforms, and it is by no means clear that all country governments will resist these counter pressures. The wave of hostile takeovers in the United States during the 1980s arguably benefited shareholders by making managers more attentive to their companies' share prices. The collective response of managers was, however, to demand legislation from state legislatures that protected them from takeovers, and to back up their demands with threats of reincorporating in other states. Forty-nine of the 50 state legislatures obliged (Romano, 1987; Roe, 1993; Bebchuk and Ferrell, 1999). Good corporate-governance structures benefit shareholders by reducing managers' discretion to pursue their own goals. If national parliaments are more sensitive to the interests of corporate managers than to shareholders, reforms in corporate-governance systems may not take place. A recent EU Commission proposal to make takeovers easier has been significantly weakened by pressures from member-country gov-

³¹ Mediobanka has been an exception to this generalization, however.

³² Palepu *et al.* (2002) find evidence of *de-jure* convergence at the country level. This result is, however, not driven by convergence to US standards. Rather, pairs of economically interdependent countries appear to adopt common corporate-governance standards, especially if the pairs of countries are in the same geographic region and are relatively developed countries.

Table 4
Cross-listings within Europe and between Europe and the United States

By companies within:	On:	At year end		
		1986	1991	1997
European countries	European exchanges	267	339	309
European countries	London Stock Exchange	41	47	47
European countries	US stock exchanges	320	429	516
USA	European stock exchanges	465	418	316

Notes: The nine European countries were Austria, Belgium, France, Germany, Italy, the Netherlands, Spain, Sweden, and the UK.

Source: Pagano *et al.* (2004).

ernments, which in turn were presumably responding to pressures from their largest companies (*The Economist*, 2003a).

(iv) Will Countries that Fail to Adopt Strong Corporate-governance Systems Suffer a Flight of Capital and Corporations?

As noted in the previous paragraph, although shareholders and maybe society at large benefit from a country's having strong corporate-governance institutions, managers may lose. Since the decision to reincorporate in another country must be made by a firm's managers, it is by no means clear that many will choose to relocate in countries where their discretion is tightly constrained. Indeed, one might even predict a 'race to the bottom', with managers preferring countries with *weak* corporate-governance systems, which allow them to pursue their own goals unperturbed by the demands of shareholders. Claims have been made that a race to the bottom with respect to state laws governing corporations has taken place in the United States, with tiny Delaware being the clear winner (Carey, 1974). Others have argued, however, that a race to the top has occurred, with Delaware being the home to some 50 per cent of all US corporations because of its superior laws and experienced core of judges (Winter, 1977; Romano, 1993). This debate is of limited relevance for the issue at hand, since federal law and national stock-exchange regulations are the most important institutions of corporate governance in the United States, and all US corporations are subject to them.³³ Nevertheless, the experience in

the United States underscores the importance of legal institutions in a company's decision as to where to relocate.

Of course, relocating outside of a country is a much bigger move than relocating within it, and one expects fewer companies to take this type of step. Partial movements abroad have been taking place, however, in the form of companies choosing to list their shares on foreign stock exchanges. Here the evidence, at least for Europe and the United States, is pretty clear. Table 4 presents data on cross-listings of shares on foreign stock exchanges for nine European countries and the United States. Cross-listings within the nine European countries show no clear pattern, rising between 1986 and 1991 and then falling by 1997. Britain increased its number of cross-listings from the eight Continental countries between 1986 and 1991, and saw this number remain unchanged between 1991 and 1997. In contrast, the number of European companies choosing to list their shares in the United States increased by two-thirds over the 12-year period, while the number of US companies listed on European exchanges fell dramatically. Despite the generally more stringent requirements for listing shares in the United States than in Europe, the trend has been towards the United States.

Will listing abroad be followed by moving abroad? In answering this question, we must keep in mind that there are many factors beyond corporate-governance institutions that affect company location decisions—tax levels, wage rates, labour laws, the

³³ Roe (2003) downplays the importance of competition among states for corporations because of the importance of the federal government in this area. See also Bebchuk and Hamdani (2002).

strength of unions, and transportation costs, to name but a few. In many of these areas, Europe is also at a disadvantage in comparison with the United States, however. Having listed its shares in the United States, a European company has already incurred one of the costs of relocating to the United States. The likelihood of such a move has to go up.

At the same time, one must recognize that the managers of many firms will not wish to subject themselves to US corporate-governance standards and will choose to stay put. Here one must note an important asymmetry between countries with strong corporate-governance systems and large capital markets, and countries with weak corporate-governance systems. A company in a country with a strong corporate-governance system can avoid subjecting itself to this system by not going public. It does not have to leave the country.³⁴ In contrast, a company in a country with a weak corporate-governance system, which is in need of large amounts of capital and wishes to go public, can only tap into the large capital markets of the countries with strong corporate-governance systems by listing its shares in one of these countries. To the extent that relocations follow share listings, the movement of firms will be from countries with weak systems to those with strong ones.

These considerations lead us to the following, admittedly somewhat speculative, predictions as to how the globe's corporate landscape might appear as globalization continues to advance. Should corporate-governance systems not converge on some

variant of the Anglo-Saxon system, the world will be populated by two types of companies—large multinationals with widely dispersed shares, and relatively small family-controlled firms with national identities. The multinationals will have access to capital in the world's largest equity and bond markets, and are likely to be listed on a US stock exchange. For all practical purposes they will be Anglo-Saxon companies, even when their corporate headquarters are in countries with weak corporate-governance institutions. The Anglo-Saxon countries are likely to be the home of many of their headquarters, however. The family firms will either remain entirely private, or will be listed on their country's stock exchange along with small numbers of other domestic companies. Share ownership will be concentrated in the hands of the founding family with the remaining shareholders being fellow nationals who are familiar with the company. Eventually some of these family firms may 'gain access' to international capital markets by being acquired by multinationals.³⁵

Should corporate-governance institutions converge, the same two categories of firms will exist. Only the dispersion of the locations of their corporate headquarters is likely to differ. With Japan, Europe, and the United States all having strong corporate-governance systems, all three should have large external capital markets. Companies which go public and seek large amounts of capital would be able to obtain them without having to cross continents. Corporate-governance systems, capital markets, and companies would tend to look about the same at all points around the developed world.

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³⁴ Indeed, several US public companies have responded to the more severe constraints on managers imposed by the Sarbanes–Oxley Act by going private (*The Economist*, 2003b).

³⁵ Here the experience in the United States may be predictive. Roughly half of the companies that incorporate in the United States first do so in the same state where they operate and remain incorporated in that state. Those that relocate overwhelmingly choose Delaware (Bebchuk and Cohen, 2003). Internationally, one might expect somewhat the same pattern with nation states playing the role of states, and the United States the role of Delaware.

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