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Corporate Governance and Development—An Update

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Foreword by Ira M. Millstein
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Foreword

This updated *Focus* seeks to explain the links between economic development and corporate governance, based on experiences in many countries, sectors, and business organizations (from state-owned enterprises to publicly listed companies). It draws on new evidence that has become available since the *Focus 1: Corporate Governance and Development* was published in 2003.

The authors, Stijn Claessens and Burcin Yurtoglu, have sifted through scores of academic studies to determine what matters most in how corporate governance can support economic development and what is needed to get the job done in implementing good practices. As the authors explain at the outset, the market-based investment process is even more important today to most economies than when this study was first published in 2003.

Financial deregulation and liberalization of both trade and capital markets have removed many barriers within and across countries, allowing firms to pursue business opportunities worldwide, supported by availability of accessibly priced capital. As a result, the global market for financial capital, labor, goods, and services is now an ever-present reality of commerce and trade in the 21st century.

As financial markets have developed, investor involvement has intensified. And with that trend have come more and more demands from investors for high standards of corporate governance to ensure that capital is used efficiently and effectively, produces good returns in a manner responsible to society's interests, and is protected from malfeasance and misappropriation. Investors want boards to make decisions that are free from conflicts of interest; they insist that enforcement has the necessary authority, resources, and credibility to act expeditiously and effectively. Only with better corporate governance rules and practices can higher levels of investor trust and confidence be achieved—and with this, a more robust economic development.

The evidence that the authors put on the table is compelling. Extensive cross-country research shows that financial development, such as the sophistication and quality of the banking system, is a powerful determinant of sound economic growth. Banks and financial institutions, acting as direct investors or agents on behalf of their clients, have to handle increasingly complex and sophisticated risks that transcend national boundaries and regulations. Where weak corporate governance prevails, financial markets tend to function poorly. Without access to competitively priced capital, businesses cannot finance expansion or modernization.

Poor governance also increases market volatility through lack of transparency and by giving insiders the edge on information critical to market integrity and fair trading. Investors and analysts have neither the ability nor the incentive to analyze firms, as explained by the authors. Blind faith is not a substitute for thorough, verifiable reporting by firms, led by boards of directors that clearly articulate their responsibilities and duties.

Companies' adoption of corporate governance best practice alone will not guarantee progress. Many other factors dictate the success of firms and the economies in which they operate. Well-functioning legal and judicial systems are also necessary for improving financial markets, securing external financing, and ensuring that economic development is shared by many, as demonstrated in this updated *Focus*. Property rights must be clearly defined and enforced, and key regulations covering disclosures and accounting, among other things, must be in place, with effective and competent supervision to ensure proper compliance.

The research the authors offer shows how legal and other reforms—from mandatory internal and external controls to competent, adequately staffed regulators to securities laws that strongly protect shareholders from dilutive offers, freeze-outs, and fraud—can provide benefits, since they are the necessary foundations for an effective corporate governance system.

The level of competition in a market is also a factor, given that good corporate governance behavior can distinguish one company within a crowded field. Vigorous competition imposes a discipline that supports adherence to corporate governance best practice.

As this *Focus* implies, however, entrenched owners and political leaders can build strong walls to protect their interests at the expense of others. The challenge is to build a country's institutional capabilities and train leaders in government, business, and other key parts of society to advance corporate governance reforms in a way that strengthens the attributes of the market and advances sound economic growth and development. This is an area that the Global Corporate Governance Forum is addressing through its work worldwide with Institutes of Directors, training board directors and others in good corporate governance practices and standards—to enhance the governance of firms as a means of contributing to the growth and development of economies.

For emerging markets, related-party transactions are one of the most widely used ways to misappropriate a company's capital. Founders and families tend to retain a disproportionate share of control, and, unfortunately, the laws and regulations permit so many exceptions or provide such weak enforcement mechanisms that minority investors have few protections. Addressing this area should be a high priority, if growth and profitability are to be sustained long-term. Although there is much that boards should do, it is also necessary to advance the legal frameworks—a point the authors repeatedly make, seeing the legal environment as essential to the bolstering of corporate initiatives.

Complex, opaque ownership structures are another obstacle. Controlling shareholders may have little equity stake but hold a class of shares that allows them to dominate decision making. "A pattern of concentrated ownership with large divergence between cash flow and voting rights seems to be the norm around the world," say the authors. Incentives to persuade the owners to change are hard to find when profits are good and the families content. It is largely when conditions sour—and the families fear that their source of income is in danger of failing quickly—that an appetite for good corporate governance increases. Helping family owners become more visionary is one way to change the culture. But, here too, the root of these problems goes back to the regulatory framework.

Innovation also must be part of reform efforts. We have seen how Brazil's Novo Mercado—in which companies list on a special tier of the stock market that requires high corporate governance standards—leads to good performance, more interest from foreign investors, and growth. The findings in this *Focus* could help shape the development of other innovations.

The authors leave us with some important insights into what it takes to improve corporate governance, with resulting benefits to economic growth and development. And they identify areas that have emerged since 2003 and require further evaluation. As various crises throughout the first decade of the 21st century disturbingly reveal, corporate governance is a work in progress and will remain so in the foreseeable future.

It is evident that, although corporate governance may not be the sole driver for sound economic performance, it is a significant contributor, and we have only to see the devastating consequences of poor corporate governance practices to appreciate the importance of corporate governance to economic development and its benefits for jobs and wealth creation. I encourage all involved in corporate governance to read this *Focus*. It will be time well spent.

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Abstract

This paper reviews the relationships between corporate governance and economic development and well-being. It finds that better-governed corporate frameworks benefit firms through greater access to financing, lower cost of capital, better firm performance, and more favorable treatment of all stakeholders. Numerous studies agree that these channels operate not only at the firm level, but also in sectors and countries—with corporate governance being the cause. There is also evidence that when a country's overall corporate governance and property rights systems are weak, voluntary and market corporate governance mechanisms have more limited effectiveness. Importantly, the dynamic aspects of corporate governance—that is, how corporate governance regimes change over time and what the impacts of these changes are—are receiving more attention. Less evidence is available on the direct links between corporate governance and social outcomes, including poverty and environmental performance. There are also some specific corporate governance issues in various regions and countries that have not yet been analyzed in detail. In particular, the special corporate governance issues of banks, family-owned firms, and state-owned firms are not well understood; neither are the nature and determinants of public and private enforcement. Consequently, this paper concludes by identifying major policy and research issues that require further study.

1. *Executive Summary*

Two decades ago, the term corporate governance meant little to all but a handful of scholars and shareholders. Today, it is a mainstream concern—a staple of discussion in corporate boardrooms, academic roundtables, and policy think tanks worldwide. Several events are responsible for the heightened interest in corporate governance. During the wave of financial crises in 1998 in Russia, Asia, and Brazil, the behavior of the corporate sector affected entire economies, and 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. And, the most recent financial crisis has seen its share of corporate governance failures in financial institutions and corporations, leading to serious harm to the global economy, among other systemic consequences. In the aftermath of these events, economists, the corporate sector, and policymakers worldwide recognize the potential macroeconomic, distributional, and long-term consequences of weak corporate governance systems.

The crises, however, are manifestations of several structural factors and underscore why corporate governance has become even more central for economic development and society's well-being. The private, market-based investment process is now much more important for most economies than it used to be; that process needs to be 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. The allocation of capital has also become more complex as investment choices have multiplied with the opening up and liberalization of financial and real markets. Structural reforms, including price deregulation and increased competition, have broadened companies' exposure to market forces. These developments have made the monitoring of the uses of capital more complex in many ways, enhancing the need for good corporate governance.

> Since the first *Focus* publication in 2003, many developments have unfolded that underscore the need for good corporate governance. This revised *Focus* sheds light on research advancements—on the development, implementation, and monitoring of corporate governance in developing and emerging market countries—since 2003.

For these reasons, we believed that the first *Focus* publication warranted revision. Building on the findings reviewed in the 2003 *Focus*, this updated version surveys recent research to trace the many dimensions through which corporate governance works in firms and countries. After assessing the extensive literature on the subject, this revised *Focus* then identifies areas where more study is needed. Over the last two decades, a well-established body of research has acknowledged the increased importance of legal foundations, including the quality of the corporate governance framework, for economic development and well-being. Research has addressed the links between law and economics, highlighting the roles of legal foundations and well-defined property rights in the functioning of market economies. This literature has also addressed the importance and impact of corporate governance,[1] for example, in three areas: the nature and strength of the link between good corporate governance practices and economic development; the issues that emerge for companies and countries implementing corporate governance principles and practices; and the role of political factors in driving the corporate governance framework.

Some of this material is not easily accessible to the nonacademic. Importantly, although research has expanded into emerging markets, much of it still refers to situations in developed countries, in particular the United States, and less so to developing countries. Furthermore, this literature does not always have a focus on the relationship between corporate governance and both economic development and well-being. This paper addresses these gaps.

The paper starts with a definition of corporate governance, which sets forth the scope of the issues the paper discusses. It reviews how corporate governance can be and has been defined. It briefly describes why increasing attention has been paid to corporate governance in particular and to protection of private property rights in general. Next, by reviewing the general evidence of the effects of property rights on financial development and growth, the paper explores why corporate governance may matter. It also provides extensive background on ownership patterns worldwide that determine and affect the scope and nature of corporate governance problems.

After analyzing what the theoretical literature has to say about the various channels through which corporate governance affects economic development and well-being, the paper reviews the empirical facts about these relationships. It explores recent research documenting how changes in law can affect firm valuation, influence the degree of corporate governance problems, and, more broadly, affect firm performance and financial structure. It then reviews the evidence on how several (voluntary) corporate governance mechanisms—ownership structures, boards, cross-listing, use of independent auditors—influence firm performance and behavior. It also surveys research on the factors that play a role in countries' willingness to undertake corporate governance reforms. The paper concludes by identifying several main policy and research issues that require further study—in other words, the pieces of the puzzle that are still missing. Throughout, we point out how the knowledge about corporate governance has advanced or stalled since the 2003 publication.

1. The first broad survey of corporate governance was Shleifer and Vishny (1997). Several surveys have followed, including Becht, Bolton, and Röell (2003), Claessens and Fan (2002), Denis and McConnell (2003), Holmstrom and Kaplan (2001), and more recently Bebchuk and Weisbach (2010).

2. *What is Corporate Governance, and Why is it Receiving More Attention?*

What is corporate governance?

Corporate governance is a relatively recent concept (Cadbury 1992; OECD 1999, 2004). Over the past decade, the concept has evolved to address the rise of corporate social responsibility (CSR) and the more active participation of both shareholders and stakeholders in corporate decision making. As a result, definitions of corporate governance vary widely.

Two categories prevail. The first focuses on behavioral patterns—the actual behavior of corporations, as measured by performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second concerns itself with the normative framework—the rules under which firms operate, with the rules coming from such sources as the legal system, financial markets, and factor (labor) markets. Both definitions include CSR and sustainability concepts.

For studies of single countries or firms within a country, the first type of definition is 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 roles of multiple shareholders and stakeholders. For comparative studies, the second type is more relevant. It investigates how differences in the normative framework affect the behavioral patterns of firms, investors, and others.

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

Under a definition more specific to the provision of finance, the focus would be on how outside investors protect themselves against expropriation by the insiders. This would include minority rights protections and the strength of creditor rights, as reflected in collateral and bankruptcy laws and their enforcement. It could also include such issues as requirements on the composition and rights of executive directors and the ability to pursue class-action suits. This definition is close to the one advanced by economists Shleifer and Vishny (1997): "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." This definition can be expanded to define corporate governance as being concerned with *the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders*.

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

An even broader definition of a governance system is "the complex set of constraints that shape the ex post bargaining over the quasi rents generated by the firm" (Zingales 1998). This definition focuses on the division of claims and can be somewhat expanded to define corporate governance as *the complex set of constraints that determine the quasi-rents (profits) generated by the firm in the course of relationships with stakeholders and shape the ex post bargaining over them*. This definition refers to both the determination of the 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 and institutions.

Corresponding to this broad definition, the objective of a good corporate governance framework would be to maximize firms' contributions 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 would also encompass *the issue of corporate social responsibility, including such aspects as the firm's dealings affecting culture and the environment and the sustainability of firms' operations.* Looking over the past decade, we see increased emphasis on CSR, as reflected in investor codes, companies' best practices, company laws, and securities regulatory frameworks.

In an analysis of corporate governance from a cross-country perspective, the question arises whether a common, global framework is optimal for all. With the emergence of China, India, and Brazil, among others, as global economic powers, the traditional model for corporate governance — monitoring and supervision through active investors, free and informed financial media, and so on — is not necessarily the framework that works best in the increasingly significant emerging market economies. Concepts such as accountability and safeguarding shareholders' interests have cultural moorings in addition to legal and economic foundations. Western concepts and approaches may not be translatable, easily understood, or relevant to non-Western cultures. Because corporate governance is essentially about decision making, it is inevitable that social norms and structures play a role. These vary from country to country. In Islamic countries, for example, Sharia law has a large role in many aspects of life, ethical and social, in addition to its role in criminal and civil jurisprudence (Lewis 2005). Corporate governance must operate differently in these environments. These differences underscore the necessity for some level of adaptation of corporate governance principles, an area of increasing activity in recent reform efforts, and of much research interest.

Another question arises over whether the framework extends to rules or institutions. Here, two views have been advanced. One — considered as prevailing in or applying to Anglo-Saxon countries — views the framework as determined by rules and, related to that, by markets and outsiders. The second, prevalent in other areas, views institutions — specifically, banks and insiders — as the determinants of the corporate governance framework.

In reality, both institutions and rules matter, and the distinction, although often used, can be misleading. Moreover, institutions and rules evolve. Institutions do not arise in a vacuum; they are affected by national or global rules. Similarly, laws and rules are affected by the country's institutional setup. In the end, institutions and rules are endogenous to a country's other factors and conditions. Among these, ownership structures and the state's role are important in the evolution of institutions and rules through the political economy process. Shleifer and Vishny (1997) offer a dynamic perspective: "Corporate governance mechanisms are economic and legal institutions that can be altered through political process." This dynamic aspect is especially relevant in a cross-country review, but only lately has it received attention from researchers (see Roe and Siegel 2009; Licht 2011).

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

The recent financial crisis has been a particularly severe wake-up call. Weaknesses in corporate governance structures within companies and banks were cited as reasons for excessive risk taking, skewed incentive compensation for senior managers, and the predominance of a board culture that values short-term gains over sustained, long-term performance.

Why has corporate governance received more attention lately?

One reason is the proliferation of crises over the past few decades, with the recent, ongoing financial crisis being another impetus to the realization that corporate governance affects overall economic well-being. The recent financial crisis has been a particularly severe wake-up call, because it has adversely affected employment, consumer spending, pensions, the finances of national and local governments worldwide, and the global economy. Weaknesses in corporate governance structures within companies and banks were cited as reasons for excessive risk taking, skewed incentive compensation for senior managers, and the predominance of a board culture that values short-term gains over sustained, long-term performance.

However, these crises are manifestations of several structural reasons why corporate governance has become more important for economic development and a more significant policy issue in many countries.

First, the private, market-based investment process — underpinned by good corporate governance — is now much more important for most economies than before. Privatization over the past few decades in most countries has raised corporate governance issues in sectors that were previously in the state's hands. Firms have gone to public markets worldwide to raise capital, and mutual societies and partnerships have converted themselves into listed corporations. In the aftermath of the financial crisis, though, these precrisis patterns have slowed amid projections that the cost of capital will rise as its availability becomes more scarce. This change, too, will have consequences for corporate governance.

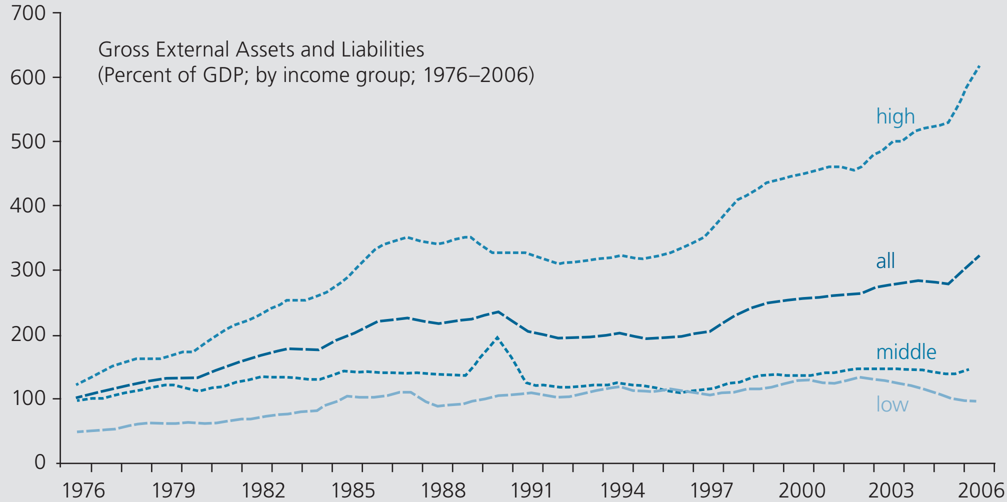
Second, because of technological progress, the opening up of financial markets, trade liberalization, and other structural reforms (notably, deregulation and the removal of restrictions on products and ownership), the allocation of capital among competing purposes within and across countries has become more complex (when financial derivative products are involved, for example), as has the monitoring of how capital is being used. These changes make good governance, particularly transparency, more important but also more difficult — particularly from an accounting perspective, to provide investors with clear, comprehensive financial statements.

Third, the mobilization of capital is increasingly one step removed from the principal-owner, given the increasing size of firms, the growing role of financial intermediaries, and the proliferation of complex financial derivatives in investment strategies. The role of institutional investors has grown in many countries, the consequence of many economies moving away from *defined benefit* retirement systems (upon retirement, the employee receives a set amount regularly) toward *defined contribution* plans (the employee contributes to a fund with a possible match from the employer, and retirement income is determined by the amount the employee has accumulated in his or her retirement savings account). This increased delegation of investment has raised the need for good corporate governance arrangements. More agents — asset management companies, hedge funds, institutional investors, proxy advisors, among others — are involved in the investment process, which means multiple steps between the investor and the final user of that investor's capital. This increases the degree of asymmetric information and agency problems and makes corporate governance at each step between the firm and its final investor even more important.

Fourth, programs of financial deregulation and reform have reshaped the local and global financial landscape. Longstanding institutional corporate governance arrangements are being replaced with new institutional arrangements, but in the meantime, inconsistencies and gaps have emerged, particularly those related to CSR and stakeholder engagement.

Fifth, international financial integration has increased over the last two decades, and trade and investment flows have greatly increased, doubling in the period from 2000 to 2008, when the global financial upheaval reversed this trend (see McKinsey 2011; Lane and Milesi-Ferretti 2007). Figure 1 illustrates the trend through 2006. This financial integration has led to many cross-border issues in corporate governance, arising from differences in regulatory and legal frameworks embodied in company laws and securities regulators' rules. What remains to be seen is how global and national responses to reduce the risks of another financial crisis will influence the direction of financial integration and, as a consequence, economic development.

Figure 1: Increasing Financial Integration



Source: Claessens et al., "Lessons and Policy Implications from the Global Financial Crisis," IMF Working Paper WP/10/44 (2010).

3. *The Link between Corporate Governance and Other Foundations of Development*

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

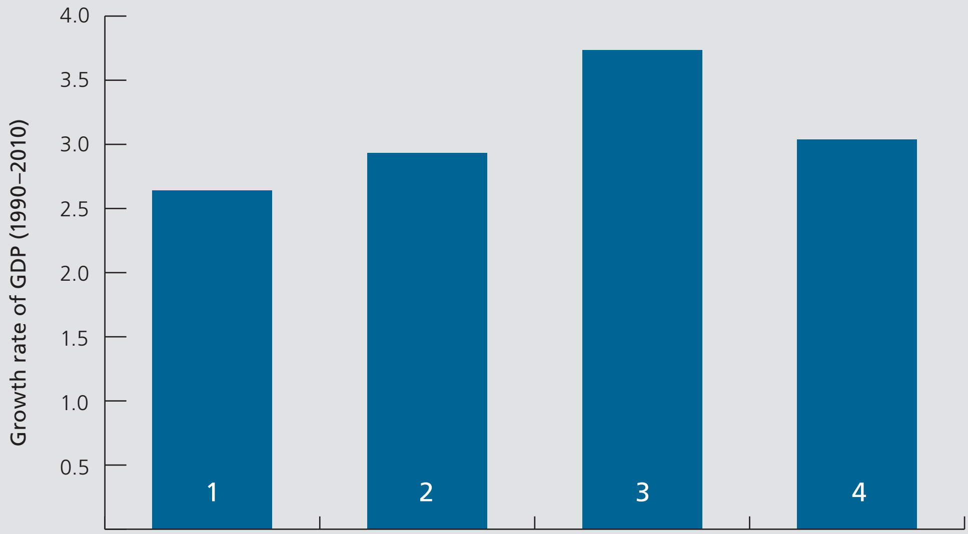
The link between finance and growth

First, over the past two decades, the importance of the financial system for growth and poverty reduction has been clearly established (Levine 1997; World Bank 2001, 2007). The recent financial crisis has demonstrated how the lack of a sound, stable financial system can lead to severe risks with adverse economic consequences that are contagious and global in scope. There is extensive cross-country evidence establishing a positive impact of financial development on economic growth. Almost regardless of how financial development is measured, there is a strong cross-country association between it and the level of growth in GDP per capita. Although early cross-country evidence does not necessarily imply a causal link, many empirical studies (for example, Rioja and Valev 2004) using a variety of econometric techniques suggest that the relation is a causal one: that is, it is not only the result of better countries having both larger financial systems and growing faster. The relationship has been established at the level of countries, industrial sectors, and firms (as reviewed in Levine 2005, and documented recently in Ang 2008). This literature has been adding more evidence to that presented in the 2003 edition of *Focus*.

Figure 2 illustrates this link, using data on economic growth for the last 20 years. It shows the relationship between the development of the banking system (private credit as a share of GDP) and GDP growth. In countries with more limited development of the banking system (private credit to GDP ratio below 30 percent), the average growth rate has been about 2.7 percent from 1990 to 2010, whereas countries with a more developed banking system have experienced growth rates exceeding 3.2 percent.

However, questions on financial sector development remain. It is well known that there are significant differences among countries' circumstances and various structural features; institutional aspects may have a direct bearing on the impact of financial development in the process of economic growth. Lin and coauthors (2010) suggest, for example, that certain types of financial structures — mix of large versus small banks — are more conducive to growth at a lower level of development. In light of the recent financial crisis, it is also argued that financial systems sometimes can grow too large and actually become a drag on economic growth and financial stability (Arcand et al. 2010). This is, in part, reflected in Figure 2, which shows that countries in the upper quartile of financial sector development actually did not grow faster than those in the third quartile in the last 20 years (whereas evidence covering earlier periods

Figure 2: Relationship between a Country's Banking System Development and GDP Growth



1 Private Credit / GDP < 30%; **2** Private Credit / GDP 30%–70%;
3 Private Credit / GDP 70%–100%; **4** Private Credit/GDP > 100%.

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

Source: Own calculations using data from World Development Indicators and Global Development Finance (2011).

had shown that there was a monotonic relation, with greater financial sector development always associated with faster growth).

Therefore, there remains a debate on the financial sector's role in general development. Some argue that much of what the financial sector is engaged in — derivatives — is not productive to the economy, creating costly systemic risks that offer few benefits for development (Stiglitz 2010; Turner 2010). Others counter that financial innovation has reduced systemic and specific (for example, those of a company or an investor) risks, lowering the cost of capital, making financing more widely available worldwide, and enhancing liquidity to give investors more flexibility and choice for their portfolio strategies (see Philippon 2010).

The link between the development of financial systems and growth

Second, and importantly for the analysis of corporate governance, the development of banking systems and of market finance helps economic growth. In many studies, the impact on growth of the development of both the banking system and capital markets is economically large.[2]

2. According to the estimates provided by Beck and Levine (2004), for example, an improvement of Egypt's level of bank credit from the actual value of 24 percent to the sample mean of 44 percent would have been associated with 0.7 percentage points higher annual growth over the period 1975–1998. Similarly, if Egypt's turnover ratio had been the sample mean of 37 percent instead of its actual value of 10 percent, Egypt would have enjoyed nearly 1.0 percentage point higher annual growth.

Banks and securities markets are generally complementary in their functions, although markets will naturally play a greater role for listed firms. Empirical research documents that those countries with liquid stock markets grew faster than those with less-liquid markets.[3] For both types of economies, growth per capita is higher where the banking system is more developed. This shows the complementarity between the two.

More generally, the findings and supporting formal research provide support for the functional view of finance. That is, it is not financial institutions or financial markets themselves that matter, but rather the functions that they perform. In particular, for *any* regression model of growth that is selected and adapted by adding various measures of stock market development relative to banking system development, the results are consistent. At least until recently, it was found that none of these measures of financial sector structure has any statistically significant impact on growth (see Demirgüç-Kunt and Levine 2001; Beck and Levine 2004).[4] To function well, financial institutions and financial markets, in turn, require certain foundations, including good governance, but not necessarily a certain mix of banks and capital markets.

The role of the financial structure is being questioned, however, in part in light of the financial crisis. Although more research is needed, there is some evidence that structure can matter for economic growth (Demirgüç-Kunt and Feijen 2011; Levine and Demirgüç-Kunt 2001).[5] The stability of those financial systems that are more market-based has also been questioned, but bank-based systems have not necessarily been stable either (IMF 2009). Questions have also been raised about the performance of financial conglomerates that provide many forms of financial services, and some work has considered that performance (see Laeven and Levine 2009). This issue has become an active policy debate, with (renewed) interest, for example, on whether there should be activity restrictions on commercial banks to assure greater financial stability (so-called Volcker rules, which restrict U.S. banks engaging in certain kinds of investment activities). More generally, there is a debate on the scope of financial activities and the perimeter of financial regulation (for example, whether hedge funds should be regulated). To date, however, research on this is limited.

Research still needs to address other questions, such as those regarding the mix between banking and capital markets, and the structure of banking and other financial markets, which has been argued to be important for economic development. Lin (2011) has suggested, for example, that small banks are more conducive to growth at earlier stages of development as they help deal with the information asymmetries and enforcement problems facing countries at those early stages. Also, the role of competition in financial stability has long been controversial (see

3. Liquid stock markets have turnover ratios (turnover in value terms divided by market capitalization) greater than the median turnover.

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

5. Using more recent data, the complementarity between structure and economic growth breaks down in that growth per capita is not necessarily higher if the banking system is more developed for those countries that had more liquid stock markets in the late 1980s.

Claessens 2009 for a review). Some argue that limits on competition can foster more stability, while others argue that competition is beneficial but that there are other tools better suited to assuring financial stability.[6] The recent financial crisis has renewed this debate, in part because excessive competition has been thought to be one cause of financial instability.

The link between legal foundations and growth

Third, the role of legal foundations for financial and general development is now well understood and documented. Legal foundations are critical to several factors that lead to higher growth, including financial market development, external financing, and the quality of investment. A good legal and judicial system is also important for assuring that the benefits of economic development are shared by many. Legal foundations include property rights that are clearly defined and enforced as well as other key regulations (disclosure, accounting, and financial sector regulation and supervision).

Comparative corporate governance research documenting these patterns increased following the works of economists La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998). Their two pivotal papers emphasized the importance of law and legal enforcement on firms' governance, markets development, and economic growth. Following these papers, numerous studies have documented institutional differences relevant for financial markets and other aspects.[7] Many other papers have since shown the link between legal institutions and financial sector development (see Beck and Levine 2005; for a survey, see Bebchuk and Weisbach 2009; for a survey of the theoretical analyses and empirical evidence of the effects of corporate governance and regulation on performance at the country and company levels, see Bruno and Claessens 2010b).

These studies have established that the development of a country's financial markets relates to these institutional characteristics and, furthermore, that institutional characteristics can have direct effects on growth. Beck and colleagues (2000), for example, document how the quality of a country's legal system not only influences its financial sector development but also has a separate, additional effect on economic growth. In a cross-country study at a sectoral level, Claessens and Laeven (2003) report that in weaker legal environments firms not only obtain less financing but also invest less than the optimal in intangible assets. The less-than-optimal financing and investment patterns both, in turn, affect the economic growth of a sector. Acemoglu and Johnson (2005) find that private contracting institutions play a significant role in explaining stock market capitalization.

6. However, the role of competition in financial sector development and stability is still being debated (see the views of Thorsten Beck versus those of Franklin Allen in one of *The Economist* debates in June 2011). Theoretically, less competition can be preferable in a second-best world, if banks expand lending under stronger monopoly rights and thereby enhance overall output (Hellmann et al. 2000). Less competition may also lead to more financial stability, because financial institutions have greater franchise value and therefore act more conservatively. On the other hand, competition leads to more pressure to reduce inefficiencies and lower costs, and it can stimulate innovation. Besides the beneficial effects of reducing inefficiencies or weeding out corrupt lending practices often associated with protected financial systems, greater competition may also reduce excessive risk taking (Boyd and De Nicoló 2005) and promote (implicit) investment coordination among firms (Abiad, Oomes, and Ueda 2008).

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

Although seminal in its approach, the work of La Porta and coauthors (1997, 1998) and their initial indexes of legal development and enforcement have been subjected to a range of critical responses both on conceptual (Coffee 1999, 2001; Pagano and Volpin 2005) and measurement grounds (Spamann 2010; Lele and Siems 2007). Partly in response to these criticisms, Djankov, Lopez-de-Silanes, La Porta, and Shleifer (2008) present a new measure of legal protection of minority shareholders against expropriation by corporate insiders: the anti-self-dealing index. Using this new measure, Djankov and coauthors (2008b) report that a high anti-self-dealing index is associated with higher valued stock markets, more domestic firms, more initial public offerings, and lower benefits of control. Thus, the general finding that better legal protection helps with capital market development is confirmed. Nevertheless, there remain some disagreements on legal aspects as important drivers of financial sector development (see Armour et al. 2009). For example, some argue that the English stock markets developed in the 18th century largely without formal property rights (Franks, Mayers, and Rossi 2009).

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

Fourth, besides financial and capital markets, other factor markets need to function well to prevent corporate governance problems. These real factor markets include all output and input markets, including labor, raw materials, intermediate products, energy, and distribution services. Firms subject to more discipline in the real factor markets are more likely to adjust their operations and management to maximize the value added. Therefore, corporate governance problems are less severe when competition is already high in real factor markets. Research since the 2003 *Focus* further confirms this point. For the United States, for example, Giroud and Mueller (2010) not only find that competition mitigates managerial agency problems, but they also report results that support the stronger hypothesis that competitive industries leave no room for managerial problems to fester.

Surprisingly, although well accepted and generally acknowledged (see Khemani and Leechor 2001), the empirical evidence on competition's role in relation to corporate governance is quite recent. In a paper on Poland, Grosfeld and Tressel (2002) find that competition has a positive effect on firms with good corporate governance, but it has no significant effect on firms with bad corporate governance. Li and Niu (2007) find that, in enhancing the performance of Chinese listed firms, there is a complementary relationship between moderate concentration of ownership and product market competition. They also report that competitive pressures can substitute for weak board governance. Bhaumik and Piesse (2004) observe patterns of change in technical efficiency from 1995 to 2001 for Indian banks, consistent with the notion that competitive forces are more important than ownership effects. Estrin (2002) documents that weak competitive pressures played a pivotal role in the poor evolution of corporate governance in transition countries. Conversely, Estrin and Angelucci (2003) find evidence that post-transition competitive pressures encouraged better managerial actions, including deep restructuring and investment.

In financial markets, too, competition is important for good corporate governance. For example, insiders' ability to consistently mistreat minority shareholders can depend on the degree of both competition and protection. If small shareholders have little choice but to invest in low-earning assets, for example, it may be easier for controlling shareholders to provide a below-market return on minority equity. Open financial markets can thus help improve, with corporate governance, one of the so-called collateral benefits of financial globalization (Kose et al. 2010).

More research is still needed to provide a better understanding of whether competition alone is sufficient to drive companies to adopt corporate governance best practices and, if so, why. Case studies of the rapid emergence of global companies from emerging market countries may offer insights into the role that corporate governance played in determining their ability to compete against well-established companies. Also, intense competition may not always be good. Cremers, Nair, and Peyer (2008) provide empirical evidence that stronger competition is linked to more takeover defenses only in relationship industries, but that there is no negative relation in such industries between defenses and firm performance. Their results suggest that shareholders themselves might want weak shareholder rights, because in those industries where a long-term relationship with customers and employees is vital, the disruption caused by takeovers could have a severe negative impact on these stakeholders.

The role of ownership structures and group affiliation

The nature of the corporate governance problems that countries face varies between countries and typically changes over time. One important factor is ownership structure, because it defines the nature of principal-agent issues. Here, the difference between direct ownership (also called cash flow rights) and control rights (who has de facto control over running the corporation, also called voting rights) is very important. In many corporations, the controlling shareholder may have little direct equity stake, but through various constructions, he or she may still exercise de facto full control. Another factor is group affiliation, which is especially important in emerging markets, where business groups can dominate economic activity. Of course, ownership and group-affiliation structures vary over time and can be endogenous to country circumstances, including legal and other foundations (see Shleifer and Vishny 1997). Therefore, 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 (Morck, Wolfenzon, and Yeung 2005).

Much of the early corporate governance literature focused on conflicts between managers and owners. But worldwide, except for the United States and to some degree the United Kingdom, insider-controlled or closely held firms are the norm (La Porta et al. 1998). These firms can be family-owned or 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; Faccio and Lang 2002). In other countries, such as Japan and to some extent Germany, financial institutions control large parts of the corporate sector (La Porta et al. 1998; Claessens, Djankov, and Lang 2000; Faccio and Lang 2002). Even in the United States, family-owned firms are not uncommon (Holderness 2009; Anderson, Duru, and Reeb 2009), with some statistics suggesting that family businesses constitute 90 percent of all businesses in the United States and generate 64 percent of the country's GDP.

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 businesses with little direct investment. Here, research is ongoing to understand how such controls affect share performance of companies controlled by families through complex, opaque structures. How costly are such structures? Are there benefits from internal markets, that is, sharing resources among firms controlled by the same people?

Most studies on emerging markets document the existence of a large shareholder that holds a controlling direct interest in the equity capital of listed companies. Table 1 (page 50) summarizes analyses of these ownership patterns in emerging markets. For East Asian countries, such as Hong Kong, Indonesia, and Malaysia, the largest direct shareholdings are generally about 50 percent, with the largest shareholders often families and also involved with management. Studies indicate that, on average, direct equity ownership of a typical firm is slightly more than 50 percent in India and Singapore, and less so in the Republic of Korea (about 20 percent), Taiwan (about 30 percent), and Thailand (about 40 percent). Financial institutions also have sizeable ownership stakes in Bangladesh, Malaysia, India, and Thailand. Some corporations in India, Indonesia, Malaysia, and Korea are foreign-owned. Some state ownership is also reported, albeit by studies from the 1990s, in India, Malaysia, and Thailand. Evidence of a large divergence between cash flow rights and voting rights of controlling owners is reported for many East Asian corporations, with this divergence mostly maintained by pyramid structures.

In Latin America, the typical largest shareholder has an interest of more than 50 percent. Direct shareholdings even exceed 60 percent in Argentina and Brazil. Similar to East Asia, most of the largest shareholders are wealthy families. In Chile, Colombia, Mexico, and Peru, financial and nonfinancial companies are also direct owners. In contrast to East Asia, where control is maintained primarily through pyramids and cross-shareholdings, nonvoting stock and dual-class shares are more prevalent in Latin America. Consequently, divergence of cash flow rights from voting rights is more common in Latin America.

Studies from such countries as Israel, Kenya, Turkey, Tunisia, and Zimbabwe also point to concentrated ownership and a large divergence of cash flow rights from control rights. Thus, a pattern of concentrated ownership with large divergence between cash flow and voting rights seems to be the norm worldwide.

There is limited research on changes in ownership structures, but most studies report that ownership structures are fairly stable over time, except in transition countries. Foley and Greenwood (2010) studied the evolution of ownership in 34 countries, including companies from emerging markets such as Brazil, Chile, Egypt, Hong Kong, India, Korea, Malaysia, Mexico, Singapore, Taiwan, and Thailand. In almost every one of these countries, firms tend to have concentrated ownership immediately following initial public offering (IPO). In countries with strong protections for minority investors and liquid stock markets, the typical firm becomes widely held within five to seven years. In the United States, for example, block ownership of the median firm drops from 50 percent to 21 percent within five years. Nearly everywhere else, however, firms remain closely held even 10 years after going public. In Brazil, for example, block holders still own half of the median firm five years after IPO. Carney and Child (2011) analyzed changes in ownership patterns in East Asia from 1996 to 2008 and report that family control remains the most common form of ownership, though there are clear differences between Northeast and Southeast Asia.[8]

These corporations' ownership structures affect the nature of the agency problems between managers and outside shareholders, and among shareholders. When ownership is diffuse, as is typical for U.S. and 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). On the other hand, when ownership is concentrated to such a degree that one owner (or a few owners acting in concert) has effective control of the firm, the nature of the agency problem shifts away from manager-shareholder conflicts. The controlling owner is often also the manager or can otherwise be assumed to be able and willing to closely monitor and discipline management. Information asymmetries can consequently be assumed to be less, because a controlling owner can invest the resources necessary to acquire necessary information.

Correspondingly, the principal-agent problems in most countries will be less *management versus owner* and more *minority versus controlling shareholder*. Therefore, countries in which insider-held firms dominate will have different requirements for developing a corporate governance framework than those where widely held firms dominate. More often in such countries, protecting minority rights is more important than controlling management's actions.

An aspect related to ownership structures is that many countries have large financial and industrial conglomerates and groups. In some groups, a bank or another financial institution typically sits at the apex. These apex institutions can be insurance companies, as in Japan (Morck and Nakamura 2007), or banks, as in Germany (Fohlin 2005). In other countries, and most often in emerging markets, a financial institution is at the center within the group. Table 1 shows that many emerging market corporations do indeed belong to business groups. For example, about 20 percent of Korean listed companies are members of one of that country's 30 largest *chaebols*, or conglomerates. The percentage is even higher in India and Turkey.

Particularly in emerging markets, group affiliation can be valuable. Being part of such a group can benefit a firm, for example, by making available internal factor markets, which can be valuable in case of missing or incomplete external (financial) markets. However, groups or conglomerates can also have costs, especially for investors. They often come with worse transparency and less-clear management structures, which opens up the possibility of poorer corporate governance, including expropriation of minority rights (Khanna and Yafeh 2007). Indeed, much evidence suggests that, in the presence of large divergence between cash flow

8. Northeast Asian firms exhibit a stronger orientation toward widely held ownership, while Southeast Asian firms exhibit varying levels of reliance on family and state-dominated ownership.

rights and voting rights, group affiliation has detrimental effects on stock valuation (Claessens et al. 2002; Joh 2003; Lefort 2005; Bae, Baek, and Kang 2007; Bae, Cheon, and Kang 2008).

The existence of such problems and related corporate governance issues depends not only on the regulatory framework, but also on the economy's overall competitive structure and the state's role. In more developed, more market-based economies that are also more competitive, group affiliation is less common. Again, as with ownership structures, the line of causality is unclear. The prevalence of groups can undermine the drive to develop external (financial) markets. Alternatively, poorly developed external markets increase the benefits of internal markets. And, sometimes the state itself is behind the formation of groups, as in Italy and Korea, raising public governance issues.

Another aspect is the role of institutional investors, which to date is much smaller in most emerging markets than in advanced countries. Studies exist on institutional investors' roles in corporate governance, but largely for the United States (for literature reviews, see Black 1998; Gillan and Starks 2003, 2007). Existing studies focus nearly exclusively on voting by mutual funds, which is affected by conflict of interests (Davis and Kim 2007; Ashraf et al. 2009) and the corporate governance of the funds themselves (Cremers et al. 2009).

As noted, ownership by institutional investors is generally small in emerging markets and developing countries. And, the typical presence of a dominant shareholder alters the institutional investors' corporate governance role, because they have little direct influence through voting or board representation, or otherwise. They might also be more concerned about protecting themselves against expropriation, rather than with disciplining management. Only a handful of recent studies examine institutional investor activism in markets with concentrated ownership and business groups. Giannetti and Laeven (2009) studied Sweden and offer some evidence of differences of voting between pension funds affiliated with business and financial groups and other pension funds. McCahery, Sautner, and Starks (2010) found large differences in preferences for activism between institutional investors in the United States and the Netherlands, countries which differ considerably in ownership structures. But studies of institutional investors' roles in emerging markets specifically are largely absent to date, highlighting an area for future research.

4. *How Does Corporate Governance Matter for Growth and Development?*

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

- Increased access to external financing by firms can lead, in turn, to larger investment, higher growth, and greater employment creation.
- Lowering of the cost of capital and associated higher firm valuation makes more investments attractive to investors, also leading to growth and more employment.
- Better operational performance through better allocation of resources and better management creates wealth more generally.
- Good corporate governance can be associated with a reduced risk of financial crises, which is particularly important given that financial crises can have large economic and social costs.
- Good corporate governance can mean generally better relationships with all stakeholders, which helps improve social and labor relationships, helps address such issues as environmental protection, and can help further reduce poverty and inequality.

All these channels matter for growth, employment, poverty alleviation, and well-being more generally. Empirical evidence using various techniques has documented these relationships at the level of the country, the sector, and the individual firm and from investor perspectives.[9] Since the publication of the first *Focus*, more — and more robust — evidence has been found to enlarge our understanding of these relationships across a wide range of countries.

Increased access to financing

As mentioned, financial and capital markets are better developed in countries with strong protection of property rights, as demonstrated by the law and finance literature. In particular, better creditor and shareholder rights have been shown to be associated with deeper, more developed banking and capital markets. Figure 3 depicts the relationship between an index of creditor rights and the depth of the financial system (as measured by the ratio of private credit to GDP). The figure shows that the better the creditor rights are defined, the more willing the lenders are to extend financing. This relationship holds across countries and over time, in that countries that improved their creditor rights saw an increase in financial development (Djankov et al. 2008b).

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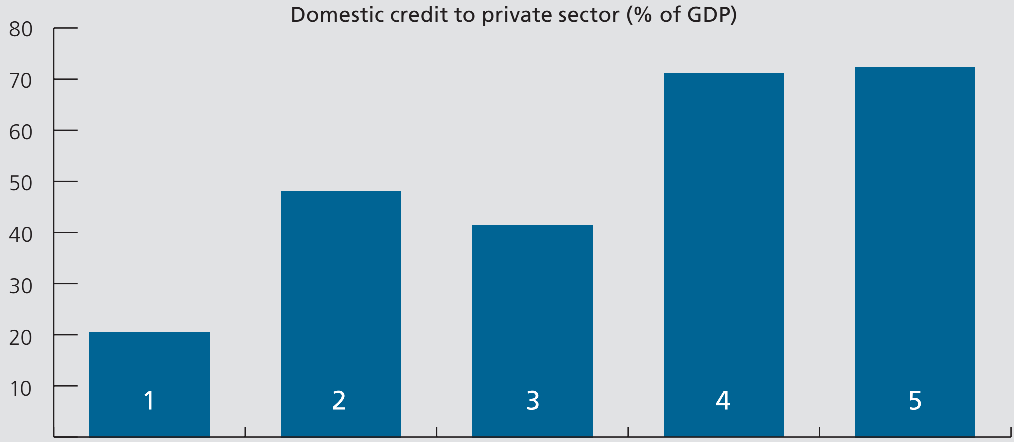
9. Some of these studies suffer from endogeneity issues: that is, firms, markets, or countries may adopt better corporate governance and perform better, but it is not from better corporate governance leading to improved performance; rather, it is either the other way around or because some other factors drive both better corporate governance and better performance. For discussions of the econometric problems raised by endogeneity, see Himmelberg, Hubbard, and Palia (1999) and Coles, Lemmons, and Meschke (2007).

Figure 3: Relationship between Creditor Rights and the Depth of the Financial System



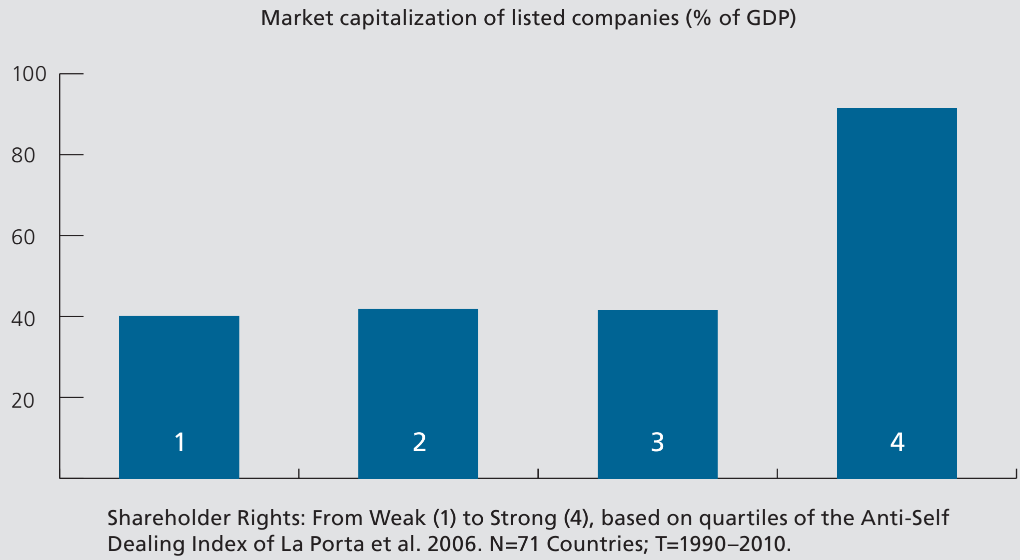
Creditor Rights: From Weak (1) to Strong (5), based on Djankov et al. 2007.
N=129 Countries; T=1990–2010.

Countries with stronger protection of creditor rights have more developed banking sectors.

Source: Own calculations using data from WDI-GDF (2011) and Djankov et al. (2008b).

A similar relationship exists between the quality of shareholder protection and the development of countries' capital markets. Figure 4 depicts the relationship between the index of shareholder rights (Djankov et al. 2008b) and the size of the stock markets (as a ratio of GDP). Countries are sorted into four quartiles, depending on the strength of shareholder protection provided by the legal system. The figure shows a strong relationship, with market capitalization doubling from the three lowest quartiles to the highest-quartile countries. Most studies find that these results hold true, or are "robust," even when a wide variety of other variables are added to regressions that may also affect financial sector development. Of course, it is not just the legal rules that count, but also, importantly, their enforcement. In this context a well-staffed and independent securities regulator becomes critical (Jackson and Roe 2009). This finding advances research to demonstrate that an effective legal system alone does not determine the quality of corporate governance in a country, but that a well-staffed regulator is a key determinant of adherence to corporate governance best practice (see Berglof and Claessens 2006; Claessens 2003).

Figure 4: Relationship between Shareholders Rights and the Depth of the Financial System



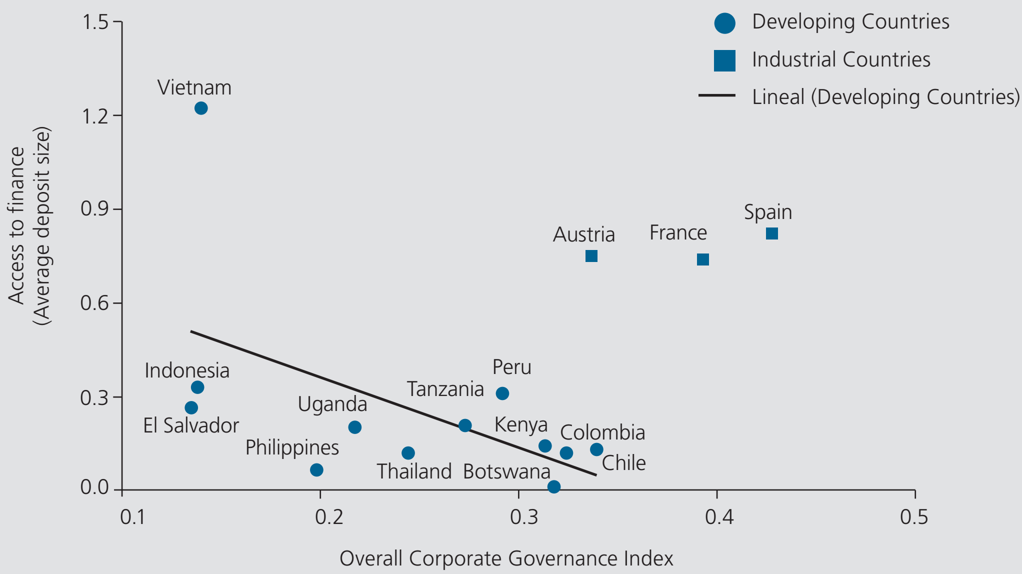
Countries with stronger protection of shareholder rights have larger stock markets.

Source: Own calculations using data from WDI-GDF (2011) and Djankov et al. (2008b).

In countries with better property rights, firms have a greater supply of financing available. As a consequence, firms can be expected to invest more and grow faster (Rajan and Zingales 1998; Levine 2005; World Bank 2007). The effects of better property rights leading to greater access to financing, which stimulates and supports growth, can be large. For example, the growth rates reported in Figure 2 (page 9) suggest that countries in the third quartile of financial development enjoy 1.0–1.5 more percentage points of GDP growth per year than countries in the first quartile. There is also evidence that, under conditions of poor corporate governance (and underdeveloped financial and legal systems and higher corruption), the growth rate of the smallest firms is the most adversely affected, and fewer new firms start up — particularly small firms (Beck, Demirgüç-Kunt, and Maksimovic 2005).

To date, research has shown that the relationship between corporate governance and access to financial services is largely indirect: better corporate governance leads to a better developed financial system, which, in turn, is associated with greater access to financial services for small and medium enterprises and poorer people. However, some recent evidence indicates the possibility of quite a strong relationship, at least in developing countries (World Savings Banks Institute 2011). See, for example, Figure 5.

Figure 5: Corporate Governance and Access to Finance, Measured as Average Deposit Size (Individual Institutions Level)



As the quality of corporate governance improves, financial outreach also improves: the average deposit decreases, which indicates a deeper banking market penetration.

Source: WSBI's elaboration from Analistas Financieros Internacionales. The average deposit is divided by GDP per capita (the lower this indicator, the higher the access to finance). The Overall Corporate Governance Index combines the country index with institution-specific components, including board composition and the existence of an external audit.

Higher firm valuation and better operational performance

The quality of the corporate governance framework affects not only the access to and amount of external financing, but also the cost of capital and firm valuation. Outsiders are less willing to provide financing and are more likely to charge higher rates if they are less assured that they will get an adequate rate of return. Conflicts between small and large controlling shareholders—arising from a divergence between cash flow rights and voting rights—are greater in weaker corporate governance settings, implying that smaller investors are receiving too little of the firm's returns. Better corporate governance can also add value by improving firm performance through more efficient management, better asset allocation, better labor policies, and other efficiency improvements.

There is convincing empirical evidence for these effects. Table 2 (page 58) gives an overview of empirical analyses of the impact of ownership structures on company valuations and operational performance. Firm value, typically measured by Tobin's *q* (the ratio of market to book value of assets), is higher when the largest owner's equity stake is larger, but lower when the wedge between the largest owner's control and equity stake is larger (Claessens et al. 2002;

Mitton 2002; Lins 2003; Core, Guay, and Rusticus 2006). Large nonmanagement control rights — block holdings — are also positively related to firm value. These effects are more pronounced in countries with low legal shareholder protection (see Douma, George, and Kabir 2006 for India; Filatotchev, Lien, and Piesse 2005 for Taiwan, China; Wiwattanakantang 2001 for Thailand; Silveira et al. 2010 for Brazil).

Better corporate governance can also add value by improving firm performance through more efficient management, better asset allocation, better labor policies, and other efficiency improvements.

Much evidence from individual countries, such as Korea (Bae, Baek, and Kang 2007), Hong Kong SAR, China (Lei and Song 2008), Brazil, Chile, Colombia, Peru, and Venezuela (Cueto 2008), confirms that less deviation between cash flow rights and voting rights is positively associated with relative firm valuation. The magnitude of this effect is substantial: a one standard deviation decrease in the degree of divergence is associated with an increase in Tobin's *q* of 28 percent (an increase in stock price of 58 percent) in Chile. Effects of a similar order are reported for Korea (Black, Jang, and Kim 2005) and Turkey (Yurtoglu 2000, 2003). A similar negative relationship is reported for Brazil (Carvalhal da Silva and Leal 2006) and for Chile (Lefort and Walker 2007).

Country-level and firm-level studies suggest that better corporate governance improves market valuations. Two forces are at work here. First, better governance practices can be expected to improve the efficiency of firms' investment decisions, thereby improving the companies' future cash flows, which can be distributed to shareholders. The second channel works through a reduction of the cost of capital, which is used to discount the expected cash flows. Better corporate governance reduces both agency risk and the likelihood of minority shareholders' expropriation, and it possibly leads to higher dividends, making minority shareholders more willing to provide external financing.

Although fewer studies analyze operating performance than valuation, the ones that do so report positive effects when there are fewer agency issues. Wurgler (2000) shows the beneficial role that well-developed financial markets play in the allocation of capital. A cross-country empirical study (Claessens, Ueda, and Yafeh 2010) shows that the responses of investment to changes in Tobin's *q* are faster in countries with better corporate governance and information systems. Douma, George, and Kabir (2006) document a positive impact of foreign corporate ownership on operating performance for India. Pant and Pattanayak (2007) find that inside owners in India improve operating performance when ownership is smaller than 20 percent and greater than 49 percent, suggesting entrenchment effects at intermediate levels. For Taiwan, China, insider ownership has a negative relationship, and institutional ownership a positive relationship, to total factor productivity. Similarly, Yeh, Lee, and Woidtke (2001) find for Taiwan adverse effects of entrenched owners. Filatotchev, Lien, and Piesse (2005) document a positive impact of institutional investors' and foreign financial institutions' ownership on performance.

Wiwattanakantang (2001) reports that controlling shareholders' involvement in management negatively affects performance in Thailand. Carvalhal da Silva and Leal (2006) for Brazil and Gutiérrez and Pombo (2007) for Colombia report higher operating performance where owners have more cash flow rights and there is no ownership disparity. Chiang and Lin (2007) report that TFP (total factor productivity) is higher in Taiwanese firms with higher institutional ownership, whereas insider ownership is negatively related to TFP. Gugler, Mueller, and Yurtoglu (2005) analyze the investment returns in a sample of more than 19,000 companies from 61 countries and report a significantly lower investment performance of firms with a divergence of cash flow rights from voting rights and for firms governed in pyramidal structures. Abdel Shahid (2003) reports better operating performance for the 90 most actively listed companies on the Cairo and Alexandria Stock Exchanges in Egypt. Research since the 2003 *Focus* is demonstrating in more depth the positive impact that adherence to good corporate governance practices has on operating performance.

There is also evidence on the importance of the cost-of-capital channel, both for equity and debt financing. Chen and coauthors (2011) find that U.S. firms with better corporate governance have a lower cost of equity capital, after controlling for risk and other factors, with the effects stronger for firms that have more severe agency problems and face greater threats from hostile takeovers. Ashbaugh-Skaife and colleagues (2004) report that firms with a higher degree of accounting transparency, more independent audit committees, and more institutional ownership have a lower cost of capital, whereas firms with more block holders have a higher cost. Hail and Luez (2006) show how legal institutions affect the cost of equity. Attig and colleagues (2008) report for eight East Asian emerging markets that the cost of equity capital decreases in the presence of large shareholders other than the controlling owner, suggesting that large shareholders outside the controlling owners help curb the private benefits of the controlling shareholder and reduce information asymmetries. Byun and coauthors (2008) show that, in Korea, better corporate governance practices relate negatively to estimates of implied cost of equity capital, with better shareholder rights protection having the most significant effect, followed by independent board of directors and disclosure policy.

Sound corporate governance has been shown to lower debt costs for U.S. firms (Andersen et al. 2004). Lin and colleagues (2011) find that debt financing costs are significantly higher for companies with a higher divergence between the largest ultimate owner's control rights and cash flow rights. They show that potential tunneling and other moral hazard activities by large shareholders are facilitated by their excessive control rights. These activities increase the monitoring costs and the credit risks faced by banks, which, in turn, raise the borrower's debt costs.

Laeven and Majnoni (2005) find that improvements in judicial efficiency and enforcement of debt contracts are critical to lowering financial intermediation costs for a large cross-section of countries. Qian and Strahan (2007) find that stronger creditor rights result in loans with longer maturities and lower spreads. Bae and Goyal (2009) show that it is enforceability, not merely the existence of creditor rights, that matters to the cost and efficiency of loan contracting. These results are mostly driven by emerging markets, which have much more variation in the enforcement of contracts than advanced countries do. Therefore, they suggest that many emerging markets and developing countries can greatly enhance judicial efficiency by clarifying and enforcing property rights, including shareholder rights.

Less volatile stock prices and reduced risk of financial crises

The quality of corporate governance can also affect firms' behavior in times of economic shocks and actually contribute to the occurrence of financial distress, with economywide impact. During the East Asian financial crisis, cumulative stock returns of firms in which managers had high levels of control rights, but little direct ownership, were 10 to 20 percentage points lower than those of other firms (Lemmon and Lins 2003). This shows the importance that corporate governance can have in determining individual firms' behavior, in particular the insiders' incentives to expropriate minority shareholders during times of distress. Similarly, a study of the stock performance of listed companies from Indonesia, Korea, Malaysia, the Philippines, and Thailand found that performance is better in firms with higher accounting disclosure quality (proxied by the use of Big Six auditors that existed at the time) and higher outside ownership concentration (Mitton 2002). This provides firm-level evidence consistent with the view that corporate governance helps explain firm performance during a financial crisis.

The financial crisis brought out that the corporate governance of financial institutions has received insufficient attention in advanced countries, because there were massive failures at major financial institutions. Yet, the research that emerged following the 2007–2009 financial crisis is ambiguous on this point. Fahlenbrach and Stulz (2011) find some evidence that banks with chief executive officers whose incentives were better aligned with the shareholders' interests actually performed worse during the crisis — and no evidence that they performed better. And, Beltratti and Stulz (forthcoming) find evidence inconsistent with the argument that poor governance of banks made the crisis worse. But, Alan Blinder, past vice chairman of the U.S. Federal Reserve, argued that poor corporate governance incentives are "one of [the] most fundamental causes" of the credit crisis (Blinder 2009). And, OECD (2009) and Becht (2009) offer further evidence that weak corporate governance affected financial institutions during the crisis. More work is needed in this area, for emerging markets as well, in part related to the banks' role in business groups.

Related work shows that firms' practice of hedging — strategies to manage risks and thereby protect against adverse consequences — is less common in countries with weak corporate governance frameworks (Lel 2006), and to the extent that it happens, it adds very little value (Alayannis, Lel, and Miller 2009). The latter evidence suggests that, in these environments, hedging is not necessarily for the benefit of outsiders, but more for the insiders. There is also evidence that stock returns in emerging markets tend to be more positively skewed than in industrial countries (Bae, Wei, and Lim 2006). This difference can be attributed to managers in emerging markets having more discretion in releasing information — disclosing good news immediately, and releasing bad news slowly — or that firms in these markets share risks among each other, rather than through financial markets. This evidence suggests, however, that stock markets in countries with weak corporate governance frameworks are less effective in providing signals for the efficient allocation of resources.

There is also country-level evidence that weak legal institutions for corporate governance were key factors in exacerbating the stock market declines and currency depreciations during the 1997 East Asian financial crisis (Johnson et al. 2000). In countries with weak investor protection, net capital inflows were more sensitive to negative events that adversely affect investors' confidence. In such countries, the risk of expropriation increases during bad times, because the expected return on investment is lower and the country is therefore more likely to witness collapses in currency and stock prices. So, a well-functioning financial and legal system can help stabilize countries during periods of financial stress and help reduce financial volatility.

The view that poor corporate governance of individual firms can have economywide effects is not limited to developing countries. In the early 2000s, the argument was made that in developed countries corporate collapses (such as Enron), undue profit boosting (WorldCom), managerial corporate looting (Tyco), audit fraud (Arthur Andersen), and inflated reports of stock performance (by supposedly "independent" investment analysts) led to crises of confidence among investors, fueling declines in stock market valuation and other economywide effects, including some slowdowns in economic growth (see also Acharya and Volpin 2009).

Evidence from financial crises suggests, too, that weaknesses in corporate governance of financial and nonfinancial institutions can affect stock return distributions. Consistently, Bae and coauthors (2010) find that, during the 1997 Asian financial crisis, firms with weaker corporate governance experience a larger drop in their share values, but during the postcrisis recovery period, such firms experience a larger rebound in their share values. And, during the recent financial crisis, firms that had better internal corporate governance tended to have higher rates of return (Cornett et al. 2009). Importantly, in the recent financial crisis, corporate governance failures at major financial institutions, such as Lehman Brothers Holdings Inc. and American International Group, Inc., contributed to the global financial turmoil and the subsequent recession. While this is more anecdotal evidence, it demonstrates that corporate governance deficiencies can carry a discount, specific to particular firms or markets, in developed and developing countries, and even lead to financial crises. Therefore, poor corporate governance practices pose risks and costs to a country's economy.

Better functioning financial markets and greater cross-border investments

More generally, poor corporate governance can affect the functioning of a country's financial markets and the volume of cross-border financing. For instance, weaker corporate governance can increase financial volatility. When information is poorly protected — due to a lack of transparency and insiders having an edge on firms' activities and outlook — investors and analysts may have neither the ability to analyze firms (because it is so costly to collect information, or the information is difficult to collect regardless of costs) nor the incentive (because insiders benefit regardless). For example, in such an environment, inside investors with private information, including analysts, may profit on "material news" before it is publicly disclosed.

More generally, poor corporate governance can affect the functioning of a country's financial markets and the volume of cross-border financing. For instance, weaker corporate governance can increase financial volatility.

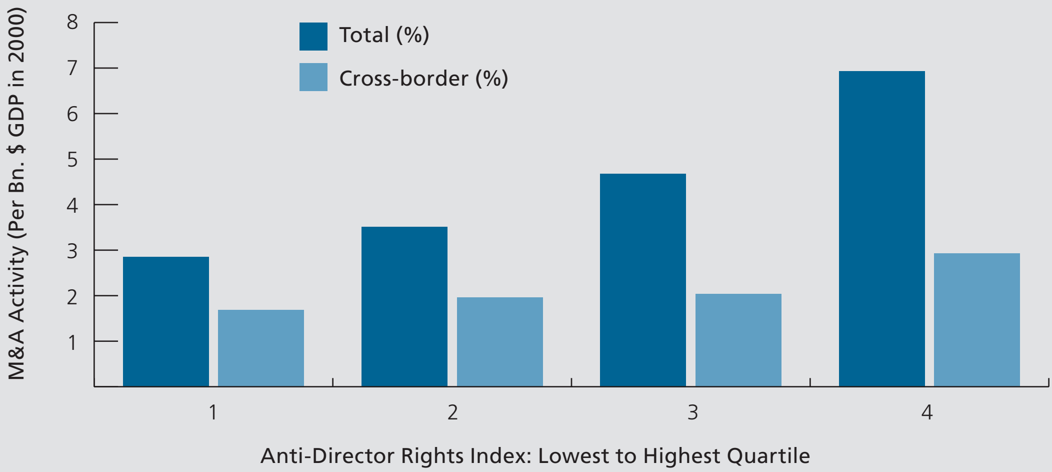
There is evidence that the insufficient transparency associated with weaker corporate governance leads to more synchronous stock price movements, limiting stock markets' price discovery role (Morck, Yeung, and Yu 2000). A study of stock prices within a common trading mechanism and currency — the Hong Kong Stock Exchange — found that stocks from environments with less investor protection, such as those based in China, trade at higher bid-ask spreads and exhibit thinner depths than do the more protected stocks, such as those based in Hong Kong SAR, China (Brockman and Chung 2003). Evidence for Canada suggests that ownership structures indicating potential corporate governance problems also affect the size of the bid-ask spreads (Attig, Gadhoum, and Lang 2003). This behavior imparts a degree of positive skewing to stock returns, making stock markets in well-governed countries better processors of economic information than are stock markets in poorly governed countries.

Another area where corporate governance affects firms and their valuation is mergers and acquisitions (M&A). Indeed, during the 1990s, the volume of M&A activity and the premium paid were significantly larger in countries with better investor protection (Rossi and Volpin 2004). This indicates that an active M&A market — an important component of a corporate governance regime — arises only in countries with better investor protection (Figure 6). Also, in cross-border deals, the acquirers are typically from countries with better investor protection than the countries of the targets have, suggesting that cross-border transactions play a governance role by improving the degree of investor protection within target firms and aiding in the convergence of corporate governance systems. Starks and Wei (2004) and Bris and Cabolis (2008) also report a higher takeover premium when investor protection in the acquirer's country is stronger than in the target's country. And, Ferreira, Massa, and Matos (2010) show that foreign institutional ownership significantly increases the probability that any firm will be targeted by a foreign bidder, with economically significant effects: an increase of 10 percentage points in foreign ownership doubles the fraction of cross-border M&As (relative to the total number of M&As in a country). Their research also suggests that foreign portfolio investments and cross-border M&As are complementary mechanisms for promoting corporate governance worldwide. But, questions remain about the nature of these links, similar to those discussed in the next section regarding cross-listing.

Better relations with other stakeholders

Besides the principal-owner and management, public and private corporations must deal with many other stakeholders, including banks, bondholders, labor, and local and national governments. Each of these stakeholders monitors, disciplines, motivates, and affects management and the firm in various ways — in exchange for some control and cash flow rights, which relate to each stakeholder's own comparative advantage, legal forms of influence, and

Figure 6: Relationship between Merger and Acquisition Activity and the Strength of Corporate Governance



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

Note: The chart uses data on international mergers and acquisitions used in the paper by Erel, Liao, and Weisbach (2011), sorted by the level of legal protection of minority shareholders against expropriation by corporate insiders (Djankov et al. 2008b). Total M&A activity is the number of total deals in a country from 1990 to 2007, scaled by the size of the economy (per $ billion GDP in 2000). Cross-border ratio is the number of cross-border M&A transactions from 1990 to 2007, scaled by the economy's size. Source is SDC Platinum, provided by Thompson Financial Securities Data, and the World Development Indicators.

Source: Erel, Liao, and Weisbach (2011); Djankov et al. (2008b).

types of contracts. Commercial banks, for example, have more inside knowledge, because they typically have an ongoing relationship with the firm. Formal influence of commercial banks may derive from the covenants that banks impose on the firm—for example, in dividend policies, or in 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 the event of financial distress, they acquire control rights, and they can even acquire ownership rights in cases of bankruptcy, as defined by the country's laws.[10] Debt and debt structure can be important disciplining factors, since they can limit free cash flow and thereby reduce private benefits. Trade finance can have a special role, because it will be a short-maturity claim, with perhaps some specific collateral. Suppliers can have particular insights into the firm's operation, because they are more aware of the industry's economic and financial prospects.

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

Labor has several rights and claims, too. As with other input factors, there is an outside market for employees, thus putting pressure on firms to provide not only financially attractive opportunities, but also socially attractive ones. Labor laws define many of the relationships between corporations and labor, which may have some corporate governance aspects. Employee rights in company affairs can be formally defined, as they are in Germany, France, and the Netherlands. In larger companies, it is mandatory for labor to hold some board seats (the co-determination model).[11] Employees, of course, voice their opinions on firm management more generally. There are also market forces exerting discipline on poor performance; badly performing chief executive officers and other senior managers are fired, or well-performing managers leave weakly performing corporations.

Two forms of behavior can be distinguished in corporate governance issues related to other stakeholders: *stakeholder management* and *social issue participation*.

- ***Stakeholder management***

The firm has no choice but to behave "responsibly" toward stakeholders: the firm cannot operate without them, and stakeholders have other opportunities if the firm does not treat them well. For example, labor typically can work elsewhere, if economic conditions permit. Better employment protection can improve the incentive structure and employees' relative bargaining power, potentially leading to more output. So, acting responsibly toward stakeholders is likely to benefit the firm as well, financially and otherwise.

Acting responsibly toward other stakeholders may also, in turn, benefit the firm's shareholders and other financial claimants. A firm with a good relationship with its workers, for example, will probably find it easier to attract external financing. Bae, Kang, and Wang (2011) report that U.S. firms that treat their employees more fairly maintain lower debt ratios (that is, use less risky financing), in part because employees want to preserve their jobs. This suggests that insiders can affect a firm's financial policies. A high degree of corporate responsibility can ensure good relationships with all the firm's stakeholders and thereby improve the firm's overall financial performance. Of course, the effectiveness of good stakeholder management depends heavily on information and reputation, because it is not always easy to determine which firms are more responsible to stakeholders. Country-level ratings, such as a ranking of the "best firms to work for," can help.

- ***Social issue participation***

Interest in corporate social responsibility (CSR) is growing, both from academia (McWilliams and Siegel 2001; Margolis and Walsh 2003; Orlitzky, Schmidt, and Rynes 2003; Riyanto and Toolsema 2007) and from businesses (UN Global Compact-Accenture 2010; see also Morrison Paul and Siegel 2006 for a review of some theoretical and empirical research on

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11. Employee ownership is the most direct form in which labor can have a stake in a firm. The empirical evidence on the effects of employee ownership for U.S. firms is summarized by Kruse and Blasi (1995). They report that "while few studies individually find clear links between employee ownership and firm performance, meta-analyses favor an overall positive association with performance for ESOPs [employee stock ownership plans] and for several cooperative features." A more recent study by Faleye, Mehrotra, and Morck (2009) finds that labor-controlled publicly traded firms "deviate more from value maximization, invest less in long-term assets, take fewer risks, grow more slowly, create fewer new jobs, and exhibit lower labor and total factor productivity."

CSR). This trend can be interpreted as a shift in the interaction among firms, their institutional environment, and important stakeholders, such as communities, employees, suppliers, and national governments, as well as in broader social issues (Ioannou and Serafeim 2010).

Despite this greater involvement, it is not fully clear whether participation in social issues is also related to good firm performance. For instance, involvement in some social issues carries costs. These costs can be direct, as when expenditures for charitable donations or environmental protection increase and so result in lower profits. Costs can also be indirect, as when participation in CSR has the effect of reducing the firm's flexibility, causing it to operate at lower efficiency. From the standpoint of costs, then, socially responsible behavior could be considered "bad" corporate governance, because it negatively affects performance. (Note: The possibility that government regulations may require certain behavior, such as safeguarding the environment, is not considered here.)

The general argument has been that many forms of CSR can still pay: that is, they can be good business for all and go hand-in-hand with good corporate governance. For example, although there may be fewer direct business reasons to respect the environment or donate to social charity, such actions can still create benefits, such as better relationships with other stakeholders, recognition of the company's values, or being seen as good citizens. The willingness of many firms to adopt high international standards, such as ISO 9000,[12] which clearly go beyond the narrow interest of production and sales, suggests that there is empirical support for the assertion of positive effects of CSR at the firm level.

The general empirical findings are either mixed or fail to demonstrate a relationship between CSR and financial performance. As with many other corporate governance studies, the challenge is, in part, to demonstrate the correlation, or endogeneity, of the relationships. At the firm level, for example, does good corporate performance beget better CSR, because the firm can afford it? Or, does better CSR lead to better performance? The firms that adopt ISO standards, for example, might well be the better-performing firms even if they had not adopted such standards. At the country level, a higher degree of development may well allow — and create pressures for — better CSR, while improving corporate governance.

So far, there have been few formal empirical studies at the firm level to document these effects, highlighting a priority for more research. Empirically, it is extremely difficult to find satisfactory proxies of corporate social performance (CSP). Consequently, indicators show tremendous variation and tend to capture either a single specific dimension or very broad measures of CSP. A recent study (Ioannou and Serafeim 2010) uses a unique dataset from ASSET4 (a Thomson Reuters business), which covers 2,248 publicly listed firms in 42 countries for 2002–2008. Firms are ranked along three dimensions: social, environmental, and corporate governance performance. It reports a significant variation in CSP across countries and a negative association between insider ownership and social and environmental performance at the firm level. This suggests that better corporate governance is associated

12. ISO 9000 standards (published by the International Organization for Standardization) relate to quality management systems and are designed to help organizations ensure that they meet the needs of customers and other stakeholders. More information is available at http://www.iso.org.

with better CSP, even though the research does not establish the direction and causal nature of this link.

At the country level, developed countries tend to have better corporate governance as well as rules requiring more socially responsible behavior for corporations. These stronger rules can benefit firm performance, if they induce stakeholders to contribute more to the firm. As evidence for this, Claessens and Ueda (2011) find that greater employment protection in U.S. states promotes knowledge-intensive industries by inducing workers to make firm-specific human-capital investments and thereby boost overall output. There is some evidence, however, that government-forced forms of stakeholdership may be less advantageous financially. In Germany, one study found that workers' co-determination, whereby the employees have a role in management of a company, reduced market-to-book values and return on equity (Gorton and Schmid 2000). Kim and Ouimet (2008), investigating the effects of employee ownership plans in the United States, find that small employment share ownership increases firm value, but not when larger than 5 percent of outstanding shares. And, there is ample evidence that very strong labor regulations hinder economic growth. In a cross-country analysis, Botero and coauthors (2004) show that heavier labor regulation is associated with lower labor force participation and higher unemployment. Other cross-country regressions also generally find such negative effects (see, for example, Cingano et al. 2009).

Overall, the effect of country institutions on CSR appears to be larger than the effect of industry and firm factors (see Amaeshi, Osuji, and Doh 2011; Paryani 2011). Political institutions (in the absence of corruption) in a country and the prominence of a leftist ideology are the most important determinants of social and environmental performance. Legal institutions, such as laws that promote business competition, and labor market institutions, such as labor union density and availability of skilled capital, are also important determinants. Capital market institutions do not seem to play an important role (Chapple and Moon 2005; Ioannou and Serafeim 2010). Overall, and similar to other stakeholders' roles, the analysis of employee representation, interactions with suppliers and civil society institutions, and CSR-related issues are almost empty research fields in emerging market countries.

5. *Corporate Governance Reform*

The analysis thus far suggests that better corporate governance generally pays—for firms, markets, and emerging market and developing countries. The question then arises: why don't firms, markets, and countries 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 imperfectly, and involve considerable costs. And, there is often little progress; sometimes, it takes a major crisis to trigger reforms. The main reasons for the lack of sufficient reforms are entrenched owners and managers at the firm level and political economy factors at the market and country levels. To understand more, we start by documenting examples of important corporate governance reforms and their effects. We then examine the various voluntary mechanisms of governance adopted by firms. And, we conclude with a review of the political economy factors that promote or constrain sufficient reform.

Why don't firms, markets, and countries 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 imperfectly, and involve considerable costs. Sometimes, it takes a major crisis to trigger reforms.

Recent country-level reforms and their impact

In the last decade, many emerging markets have reformed parts of their corporate governance systems. Many of these changes have occurred in the aftermath and as a response to crises (Black et al. 2001). Although some reforms have been major and introduced fundamental changes in capital market laws and regulations (for example, Korea), others, such as Turkey, were only partial and changed just a few specific aspects. Many countries, for example, have adopted voluntary corporate governance codes. Nevertheless, these reforms can be useful for identifying the importance of corporate governance. Indeed, researchers have analyzed the specific features of these reforms and other actions to quantify their impact on firm-level performance measures. (See Table 3 on page 65 for an overview.) This has been an area of interest for many donors and international financial institutions. The Forum, for example, has worked in 30 countries to develop such codes and provides a toolkit, *Developing Corporate Governance Codes of Best Practice*, which sets out a step-by-step approach that stakeholders can follow to develop, implement, and review a code (Global Corporate Governance Forum 2005).

Legal reforms

Korea has been much studied as it has undertaken dramatic reforms in the aftermath of the 1997 Asian crisis. Nontransparent management and excessive expansion of Korean firms were important reasons for the crisis (World Bank 2000), and the government consequently adopted a series of major reforms targeting internal and external control mechanisms (World Bank 2006). First, the board's role was strengthened by introducing a mandatory quota for outsiders, with at least one-quarter of the board members for listed companies required to be independent outsiders, starting in 1999. Since outside directors were uncommon prior to 1997, postcrisis Korea presents a natural laboratory for testing the effect of board independence enforced by authorities. Other policies were aimed at weakening the ties among group-affiliated firms through the elimination of cross-debt guarantees, restrictions on intragroup transactions, elimination of restrictions on foreign ownership, and removal of restrictions on exercising voting rights by institutional shareholders.

These reforms triggered restructuring activities of Korean firms (Park and Kim 2008). Researchers Choi, Park, and Yoo (2007) document important effects on valuation and operating performance. And, Black and Kim (2012) report that value increases for firms that are either required by law to have 50 percent outside directors or voluntarily adopt this practice. They also find some evidence of a positive impact from the creation of an audit committee.

Similar analyses exist for other countries. Black and Khanna (2007) analyze Clause 49 of the Listing Agreement to the Indian stock exchange (Bombay Stock Exchange), a major governance reform in India in 2000, which resembles the U.S. Sarbanes-Oxley Act.[13] Clause 49 requires that companies have, among other things, audit committees, a minimum number of independent directors, and chief executive officer and chief financial officer certification of financial statements and internal controls.[14] Initially, the reforms applied only to larger firms; they reached smaller public firms after a several-year lag. Black and Khanna document that this reform was of greater benefit to firms that need external equity capital and to cross-listed firms, suggesting that local regulation can complement, rather than substitute for, firm-level governance practices.

A similar positive impact from improvements in the regulatory regime in China is documented by Beltratti and Bortolotti (2007). Nontradable shares (NTS) were long recognized by investors as one of the major hurdles to corporate governance. During 2005–2006, Chinese regulators, through a decentralized process, eliminated NTS in the capital of listed firms. The equity market's response was positive. After more than doubling in value over the period, the equity market rose another 40 percent in the first four months of 2007, immediately after the reform's completion. Another reform in China, in January 2002, was the introduction of mandatory cumulative voting in director elections. Qian and Zhao (2011) show that those

13. The Sarbanes-Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002) sets new standards or enhances standards for all U.S. public company boards, management, and public accounting firms. The law protects shareholders and the general public from accounting errors and fraud.

14. For more information about Clause 49, see the website of the Securities and Exchange Board of India: http://www.sebi.gov.in/sebiweb/.

firms with cumulative voting experienced less expropriation as well as improved investment efficiency and performance relative to other firms.

Another example is the change in the Bulgarian Securities Law in 2002, which provided protection against dilutive offerings and freeze-outs. Atanasov and coauthors (2006) document that, following the change, share prices jumped for firms at high risk of tunneling, relative to a low-risk control group. Minority shareholders participated equally in secondary equity offers, whereas before, they had suffered severe dilution, and freeze-out offer prices had quadrupled. For Israel, Yafeh and Hamdani (2011) find that legal intervention can play an important role in inducing institutional investor activism.

Corporate governance codes and convergence

In recent years, a large number of countries have issued corporate governance codes that corporations can adhere to voluntarily (Nestor and Thompson 2000; Guillén 2000). Globalization and the worldwide integration of financial markets, combined with limited local legal reforms, are the main drivers of this process (Khanna and Palepu 2010). Indeed, Aguilera and Cuervo-Cazurra (2004, 2009) show that corporate governance codes more likely emerge in more liberalized countries with a strong presence of foreign institutional investors and in countries with weak legal protections, and that civil law countries less often revise and update their codes.

As part of a worldwide convergence of corporate governance standards, an important question is whether these codes, and the integration of product and financial markets more generally, help with convergence in actual corporate governance practices or just lead to formal convergence.[15] The evidence to date suggests more the latter. Several authors argue that strong path dependence (where current options are severely limited due to past choices, and path choices radically alter the relationships between inputs and outcomes) will prevent the convergence of corporate governance systems (Bebchuk and Roe 1999; Coffee 1999; Gilson 2001; Bebchuk and Hamdani 2009).[16] In a survey article, Yoshikawa and Rasheed (2009) show that there is only limited evidence of convergence of systems to date, with convergence observed in form more than in substance. They also suggest that convergence, where it occurs, is often contingent on other factors, such as the country's institutional and political environment. Using a sample of corporations from various countries, Khanna, Kogan, and Palepu (2006) similarly report evidence of formal convergence at the country level, but find actual corporate governance practices to remain heterogeneous. This brings us to the role of firm-level corporate governance practices.

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15. Gilson (2001) differentiates among three kinds of convergence: functional convergence, when existing institutions are flexible enough to respond to the demands of changed circumstances without altering the institutions' formal characteristics; formal convergence, when an effective response requires legislative action to alter the basic structure of existing institutions; and contractual convergence, where the response takes the form of a contract, because existing institutions lack the flexibility to respond without formal change, and political barriers restrict the capacity for formal institutional change.

16. Bebchuk and Roe (1999) identify two causes for this path dependence: structure-driven and 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, 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.

The role of firm-level voluntary corporate governance actions

Evidence shows that firms can and do adapt to weaker environments by adopting voluntary corporate governance measures. A firm may adjust its ownership structure, for example, by having more large secondary block holders that can serve as effective monitors of the primary controlling shareholders. This may convince minority shareholders of the firm's willingness to respect their rights. Or, a firm may adjust its dividend behavior to convince shareholders that it will reinvest properly and for their benefit. Voluntary mechanisms can also include hiring more reputable auditors. Since auditors have some reputation at stake as well, they may agree to conduct an audit only if the firm itself is making sufficient efforts to enhance its own corporate governance. The more reputable the auditor, the more the firm needs to adjust its own corporate governance. A firm can also issue capital abroad or list abroad, thereby subjecting itself to 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. Meanwhile, the country's legal and enforcement environment can still reduce their effectiveness. We review each of these mechanisms.

• *Voluntary adoption of corporate governance practices*

Over the last decade, many researchers have linked firms' corporate governance practices to their market valuation and performance. Typically, such studies score firms on their corporate governance practices, using indexes based on shareholder rights, board structure, board procedures, disclosure, and ownership parity. Early studies were mostly for advanced countries and within a single country, not allowing for studying differences in legal and enforcement regimes. An influential study of a sample of U.S. firms found that the more firms adopt voluntary corporate governance mechanisms, the higher their valuation and the lower their cost of capital (Gompers, Ishii, and Metrick 2003). Similar evidence exists for the top 300 European firms (Bauer, Guenster, and Otten 2004).[17] Other studies (see Table 4 on page 67 for a summary of key studies) generally showed as well that improved firm corporate governance practices increase firm share prices; hence, better-governed firms appear to enjoy a lower cost of capital.

Improved firm corporate governance practices increase firm share prices; hence, better-governed firms appear to enjoy a lower cost of capital.

Improvement in valuation derives from several channels. Evidence for the United States (Gompers, Ishii, and Metrick 2003; Cremers and Ferrell 2010; Bebchuk, Cohen, and Ferrell 2009), Korea (Joh 2003), and elsewhere strongly suggests that, at the firm level, better corporate governance leads not only to improved rates of return on equity and higher valuation, but also to higher profits and sales growth, and it lowers firms' capital expenditures and acquisitions to levels that are presumably more efficient. This evidence is maintained when controlling for

17. For the top 300 European firms, it was found that 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, Guenster, and Otten 2004).

the possibility that "better" firms may adopt better corporate governance and perform better for other reasons. Across countries, there is also evidence that operational performance is higher in better corporate governance countries, although the evidence is less strong.

The magnitude of the effects can be quite substantial. For example, Black, Jang, and Kim (2005) report that a worst-to-best change in their corporate governance index for Korean firms predicts a 0.47 increase in their Tobin's *q*, which corresponds to an almost 160 percent increase in the share price. Black, de Carvalho, and Gorga (2012) report similar results for Brazil. Comparing effects in India, Korea, and Russia, they find that different practices are important in different countries for different types of companies. Country characteristics thus influence which aspects affect market value for which firms.

There is some evidence that voluntary practices matter more in weak environments. Two studies (Klapper and Love 2004; Durnev and Kim 2005) find that firm-level practices matter more to firm value in countries with weaker investor protection. Other studies suggest that legal regimes can also be too strict. Bruno and Claessens (2010a) find that adopting specific practices improves firm valuation in weak and strong legal protection countries. The impact varies, however, by countries' legal systems, with practices having less impact on valuation in strong legal regimes, suggesting that strong legal regimes may not necessarily be optimal. This again supports a flexible approach to governance, with room for firm choice rather than a top-down regulatory approach (see further Bruno and Claessens 2010b).

Comparing effects in India, Korea, and Russia, different practices are important in different countries for different types of companies. Country characteristics influence which aspects affect market value for which firms.

Markets can adapt, too, partly in response to competition—for example, as listing and trading migrate to competing exchanges. Although 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 (Santana et al. 2008). Firms can choose the level they want, and the system is backed by private arbitration measures to settle corporate governance disputes. Efforts such as these have been shown to improve corporations' corporate governance at low costs—less, for example, than those costs incurred through cross-listing (Carvalho and Pennacchi 2011).

There is evidence, however, that these alternative corporate governance mechanisms, apart from being costly, have their limits. In a context of weak institutions and poor property rights, firm measures cannot and do not fully compensate for deficiencies. The work of Klapper and Love (2004), Durnev and Kim (2005), and Doidge, Karolyi, and Stultz (2007) shows that voluntary corporate governance adopted by firms only partially compensates for weak corporate governance environments.

• ***Boards***

Boards constitute an important corporate governance mechanism. Several studies find a strong connection between board composition and market valuations of emerging market companies. Table 5 (page 70) provides an overview of studies on this topic. Although some studies suffer from endogeneity problems (factors supposed to affect a particular outcome depend on that outcome themselves) in that better firms are more likely to adopt more independent boards, others control for this problem by looking at how reforms affected firms differentially. Findings suggest that companies with boards composed of a higher fraction of outsider or independent directors usually have a higher valuation. Black, Jang, and Kim (2005) report that Korean firms with 50 percent outside directors have 0.13 higher Tobin's q (roughly 40 percent higher share price). Some evidence also shows that stronger board structures reduce the likelihood of fraud (Chen et al. 2006) and expropriation through related-party transactions (Lo, Wong, and Firth 2010).

Positive effects of board independence are documented for Korea and India, countries where governance reforms mandate a substantial level of board independence. On the other hand, boards appear ineffective, or even damaging to minority shareholders, in countries, such as Turkey, where some arbitrarily low level of board independence is recommended by existing codes of governance (Ararat, Orbay, and Yurtoglu 2011). Overall, results suggest that board independence plays an important role in developing countries and emerging markets as well, where other control mechanisms on insiders' self-dealing are weaker. There is also some evidence that board independence has to reach a certain threshold and be mandated to be effective. Research since the 2003 *Focus* has led to a clearer understanding of aspects such as board composition and gender diversity in determining whether a company is well-governed. Other research has clarified the factors necessary for boards to successfully function in both advisory and monitoring roles. These findings advance the work surveyed in the 2003 publication.

• ***Cross-listings***

Firms that have access to foreign capital markets are more likely to obtain capital at more favorable terms, so they have greater incentives to adopt good governance (Stulz 1999). Correspondingly, Doidge, Karolyi, and Stulz (2007) argue that financial globalization should reduce the importance of the country-specific determinants of governance and increase firm-level incentives for good governance. Indeed, there is some evidence that globalization has improved corporate governance (Stulz 2005).

Cross-listing securities on foreign markets is a specific way to access international financial markets and can relate to and affect firms' corporate governance practices. There are several reasons why companies may decide to cross-list. One argument is that firms can get cheaper external financing (Karolyi 1998). But, more recent studies consider various other motives for cross-listings (see Table 6 on page 72 for an overview). One is that, by cross-listing in a stronger environment, firms commit to tough disclosure and corporate governance rules. This has been called the "bonding" argument (Coffee 1999, 2001). Doidge, Karolyi, and Stulz also present this view (2004), and later analyze it (2009). The 2009 study finds support for this view, because controlling shareholders who consume more private benefits of control are more reluctant to cross-list their firms on a U.S. exchange, despite the financial benefits of a cross-listing.

Three country-specific studies (Licht 2001; Siegel 2005; Chung, Cho, and Kim 2011; see Licht 2003 for a review) challenge the bonding argument, however, by showing that firms are more likely to choose cross-listing destinations that are less strict on self-dealing or exhibit higher block premiums relative to the origin country, with this tendency more pronounced after enactment of Sarbanes-Oxley in 2002. Other studies also point out that corporations' ability to borrow the framework from other jurisdictions by listing or raising capital abroad, or even incorporating, is limited, to the extent that some local enforcement of rules is needed, particularly concerning minority rights protection (see Siegel 2009 for evidence from Mexico). So, firms and shareholders gain little benefit from cross-listing.

Therefore, there remains considerable debate on the corporate governance motivations for and benefits of cross-listing. Some research suggests that companies from emerging markets and developing countries seek listings in developed countries' markets to improve corporate governance. Others argue the bonding theory, that they just do so when raising capital; after that phase, companies tend to neglect listing requirements, and some eventually delist when they no longer require access to foreign capital (Doidge, Kraolyi, and Stulz 2010). Still others argue that the main benefits come from increased liquidity, and less from corporate governance bonding (Gozzi et al. 2010).

• ***Other mechanisms***

Adoption of IAS (International Accounting Standards) enables firms in emerging and other markets to provide financial information in a form that is more reliable and more familiar to foreign investors. This should reduce information asymmetries and help with signaling to shareholders the firms' willingness to adhere to sound corporate governance practices, thus making the firms more attractive to investors. Covrig, Defond, and Hung (2007) analyze firm-level holdings of more than 25,000 mutual funds worldwide and find that average foreign mutual fund ownership is significantly higher among IAS adopters. Firms that adopt IAS not only attract a significantly larger pool of investors by reducing foreign investors' information processing and acquisition costs, but they also achieve a lower cost of capital (Chan, Covrig, and Ng 2009).

In line with this mechanism, Fan and Wong (2005) show that hiring high-quality, reputable external independent auditors enhances the dominant shareholders' credibility with investors. They find that East Asian firms that are subject to greater agency problems, indicated by high control concentration, are more likely to hire Big Five auditors (currently Big Four) than firms less subject to agency problems. This relationship is especially evident among firms that frequently raise equity capital in secondary markets. Additionally, hiring Big Five auditors mitigates the share price discounts associated with agency problems.

Reforms and voluntary corporate governance practices have led to many de facto changes in corporate governance. De Nicoló, Laeven, and Ueda (2008) analyze these changes and their effects. Using actual outcome variables in the dimensions of accounting disclosure, transparency, and stock price behavior, they construct a composite index of corporate governance quality at the firm level, document its evolution for many corporations worldwide during 1994–2003, and assess its impact on growth and productivity of the economy and its corporate sector. They report three main findings:

- First, actual corporate governance quality in most countries has improved overall, although in varying degrees and with a few notable exceptions.
- Second, the data exhibit cross-country convergence in corporate governance quality, with countries that initially score poorly catching up with countries with high initial corporate governance scores.
- Third, the impact of improvements in corporate governance quality on traditional measures of real economic activity — GDP growth, productivity growth, and the ratio of investment to GDP — is positive, significant, and quantitatively relevant, and the growth effect is particularly pronounced for industries that are most dependent on external finance.

The role of political economy factors

It would seem that any country would reform its corporate governance framework to achieve the best possible outcomes, but in actuality not all countries do. In some instances, it is important to understand the origin of a particular country's legal system, which may go back to the country's beginning or perhaps was acquired as a result of colonization. A legal framework that has been around for a century or more still has systematic impact on the legal system's features today, the judicial system's performance, the labor market's regulation, entry by new firms, the financial sector's development, state ownership, and other important characteristics (Djankov et al. 2008; Acemoglu, Johnson, and Robinson 2001). Evidently, not all countries adjust easily to changing conditions and move to better standards to fit their own circumstances and needs.

Partly, this reluctance is because reforms are multifaceted and require a mixture of legal, regulatory, and market measures, making for difficult and slow progress. Efforts may have to be coordinated among many constituents, including foreign parties. Legal and regulatory changes must take into account enforcement capacity, often a binding constraint. In these countries, financial markets face competition and can adapt themselves, but they must operate within the limits of a country's legal framework.

The Novo Mercado in Brazil is a notable exception, where the local market has improved corporate governance standards by using voluntary mechanisms — with much success, as seen in new listings and increases in firm valuation (Santana et al. 2008; Carvalho and Pennacchi 2011). 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. Other experiments with self-regulation in corporate governance, as in the Netherlands, have often not been successful.[18] More generally, the move toward greater public oversight and tighter regulation — in advanced and other countries, following the recent financial crisis — is a reflection of the limits to the effectiveness of the previous prevailing model of more self-regulation and self-supervision.

So, why don't countries reform their institutional systems? Part of the reason lies in the values and rents that political and other insiders receive from the status quo. Studies that try to quantify the value of political connections show that the size of these rents can reach substantial amounts (see Table 7 on page 74 for an overview of this literature). In Indonesia, for example, there were direct relationships between the government and the corporate sector. Using announcements concerning the health of former Indonesian President Raden Suharto, Fisman (2001) estimates the value of political connections to Suharto's regime to be more than 20 percent of a firm's value. Claessens, Feijen, and Laeven (2008) show that Brazilian firms that provided contributions to (elected) political candidates in the 1998 and 2002 elections experienced higher stock returns than firms that did not do so. These contributing firms were also able to subsequently access bank finance more easily.

Faccio (2006) shows that political connections are more frequently found in countries with higher levels of corruption, more barriers to foreign investment, and systems that are less transparent. She also reports that the announcement of a new political connection results in a significant increase in firm value, and that connections are diminished when regulations set more limits on official behavior. In a cross-country study, Faccio, McConnell, and Masulis (2006) find that politically connected firms are significantly more likely to be bailed out than similar nonconnected firms, with the bailed-out connected firms exhibiting significantly worse financial performance than their nonconnected peers at the time of the bailout and over the following two years.

Other evidence also suggests that political connections can influence the allocation of capital through financial assistance when connected companies confront economic distress. For example, in many countries, politically connected firms borrow more than their nonconnected peers (see La Porta, López-de-Silanes, and Zamarripa 2003 for Mexico; Chiu and Joh 2004 for Korea; Charumilind, Kali, and Wiwattanakantang 2006 for Taiwan, China). Collectively, these studies show that "cronyism" can be an important driver of borrowing and lending activities in many markets, with high costs. Khwaja and Mian (2005) show that political connections, which increase financial access for selected Pakistani firms through government-owned banks, imply economywide costs of at least 2 percent of GDP per year.[19]

By identifying the impact of political relations on firm-level and country-level performance measures, this literature offers an explanation as to why countries with higher concentrations

18. In the Netherlands, the corporate governance reform committee suggestions in 1997 stressed self-enforcement through market forces to implement and enforce its recommendations. A review of progress in 2003 (Corporate Governance Committee 2003) showed that this model did not work and that more legal changes would be needed to improve corporate governance. Earlier empirical works had anticipated this effect (de Jong et al. 2005) as they documented little market response when the recommendations were announced.

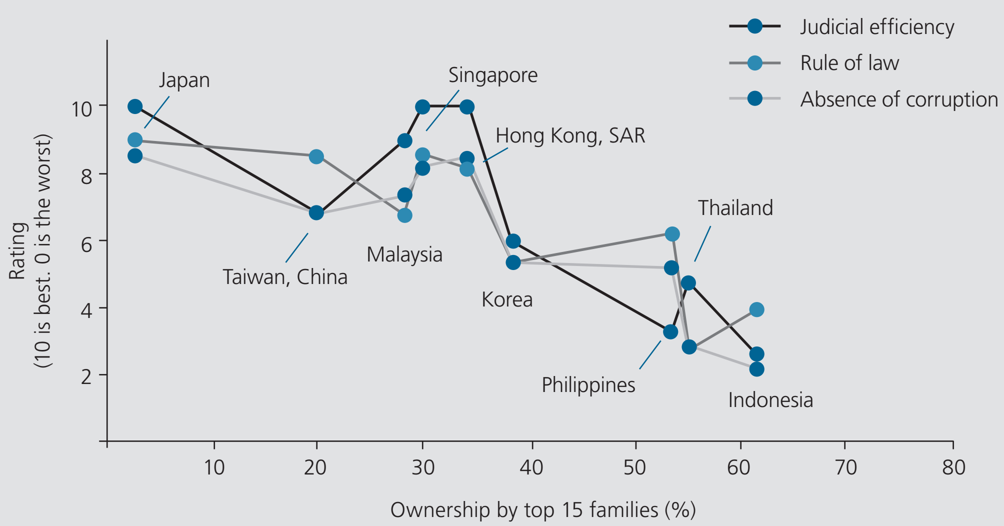
19. They identify connected firms as those with a board member who runs for political office, and find that connected loans are 45 percent larger and carry average interest rates, although they have 50 percent higher default probabilities. Such preferential treatment occurs exclusively in government banks; private banks provide no political favors.

of wealth show less progress in reforming their corporate governance regimes. Corporate governance reforms involve changes in control and power structures, with associated losses in wealth. Thus, reforms can depend on ownership structures. Insiders' reluctance to reform is largely attributable to their concern about losing rents after reforms (see also Claessens and Perotti 2007). In parts of East Asia, for instance, considerable corporate sector wealth is held by a small number of families. Figure 7 compares ownership concentration and institutional development across a sample of East Asian countries. It shows the degree to which enhancements in corporate governance standards are negatively correlated with the share of corporate sector wealth held by families (Claessens, Djankov, and Lang 2000). Causality is unclear, because weak corporate governance standards could have led to more concentrated corporate sector wealth; conversely, a high concentration of wealth could have impeded improvements in corporate governance.

The sample is too small to make any statistical inference either way. Nevertheless, it does suggest that wealth structures need to change to bring about significant corporate governance reform. This can happen through legal changes (gradually or, more typically, following financial crises or other major events) and as a result of direct interventions (such as privatizations and nationalizations, as during financial crises).

Reforms can also be impeded by a lack of understanding. Partly, this information deficiency will be linked to political economy factors, perhaps directly related to ownership structures, as when the media are tightly controlled. Little research exists on this subject, but the policy

Figure 7: Ownership Concentration and Institutional Development



Countries with higher corporate ownership concentrations make less progress toward achieving institutional reforms.

Note: Data are based on ownership structures in 1997.
Source: Claessens, Djankov, and Lang (2000).

implications are clear; indeed, limited government control over media is a fundamental principle in most democracies.

The various relationships between institutional features and countries' more permanent characteristics — including culture, history, and physical endowments — warrant more extensive research. Institutional characteristics (such as the risk of expropriation of private property) can be long-lasting and relate to a country's physical endowments (Acemoglu et al. 2003). Both a country's initial endowments and the origin of its legal system are important determinants of the degree of private property rights protection it affords (Beck, Demirgüç-Kunt, and Levine 2003). Also important is the role of culture and openness in finance, including in corporate governance (Stulz and Williamson 2003). Cultural differences have also been shown to affect the flows of foreign direct investment and international mergers (Siegel et al. 2011), loan characteristics and the extent of risk sharing in international syndicated bank loan contracts (Gianetti and Yafeh 2011), and dividend payout ratios (Bae, Chang, and Kang 2010). More generally, financial globalization is thought to be an important force for reform (Kose et al. 2010; Stulz 2005). The exact influence and weight of each of these factors is still unknown.

In general, the dynamic aspects of corporate governance reform are not yet well understood. Rajan and Zingales (2003a) examine the underlying political economy factors that may drive changes in the legal frameworks over time. They note that the capital markets of many European countries were more developed in the early 20th century (in 1913) than they were for a long period after the Second World War. Importantly, many of these countries' capital markets in 1913 were more developed than the U.S. market at that time. A review of ownership structures at the end of the 19th century in the United Kingdom (Franks, Mayer, and Rossi 2009) shows that most U.K. firms had widely dispersed ownership before they were floated on stock exchanges. And, in 1940 in Italy, the ownership structures were more diffused than in the 1980s (Aganin and Volpin 2005). These three studies cast doubt on the view that stock market development and ownership concentration are monotonically related (positively and negatively, respectively) to investor protection.

These papers identify the issues but do not clarify the channels through which institutional features alter financial markets and corporate governance over time, and how institutional features change (see also Rajan and Zingales 2003b). Therefore, these papers are part of an ongoing research agenda on the political economy of reform. Work has shown the large political economy role in financial sector development (see Haber and Perotti 2008 for a review; Haber, North, and Weingast 2007 for many case studies), particularly regarding how political economy determines property rights protection (for example, Roe and Siegel 2009). Roe (2003) shows specifically the political determinants of corporate governance in the United States.[20] The general direction of this literature is that, although governments play a central role in shaping the operation of financial systems through macroeconomic stability and the operation of legal, regulatory, and information systems, there are some deeper constraints that cannot so easily be overcome. More general reviews of this literature (for example, La Porta et al. 2008; Fergusson 2006) draw attention to many unknown areas.

20. See also Roe and Siegel (2009).

6. *Conclusions and Areas for Future Research*

At the firm level, studies have documented the importance of corporate governance for access to financing, cost of capital, valuation, and performance for several countries, using various methodologies. The research shows that better corporate governance leads to higher returns on equity and greater efficiency. The law and finance literature underscores the important role of institutions aimed at contractual and legal enforcement, including corporate governance, across countries. At the country level, various papers document several differences in institutional features. Across countries, the research brings out the relationships between institutional features and development of financial markets, relative corporate sector valuations, efficiency of investment allocation, and economic growth.

Using firm-level data, studies have documented relationships between countries' corporate governance frameworks, on the one hand, and performance, valuation, cost of capital, and access to external financing, on the other. Yet, research gaps persist. The Emerging Markets Corporate Governance Research Network, supported by the Global Corporate Governance Forum, is addressing these gaps by promoting dialogue and shared research initiatives among leading scholars working in the field and by disseminating publications. (For more information, please visit www.gcgf.org/research.)

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Although the general importance of corporate governance has been established, knowledge on specific issues or channels is still weak in several areas, including: ownership structures and the relationship with performance and governance mechanisms; corporate governance and stakeholders' roles; and enforcement, both public and private, and related changes in the corporate governance environment.

Ownership structures and relationships with performance

Much research in this field establishes that large, more concentrated ownership can be beneficial, unless there is a disparity of control and cash flow rights. Too little is known, however, about ownership structures in complex groups, the role of multiple shareholders, and the dynamics of ownership structures. More precise studies analyzing the links between outside shareholders and their board representation deserve further attention, specifically in the following areas:

- *Family-owned firms* predominate in many sectors and economies, raising a separate set of issues related to liquidity, growth, and transition to a more widely held corporation. They also raise issues related to internal management, such as intra-family disagreements, disputes about succession, and exploitation of family members. Where family-owned firms dominate, as in many emerging markets, they raise systemwide corporate governance issues.

- *State-owned firms* have specific corporate governance issues, with related questions that include: What is the role of commercialization in state-owned enterprises? How do privatization and corporate governance frameworks interact? Are there specific forms of privatization that are more attractive in weak corporate governance settings? What are the dynamic relationships between corporate governance changes and changes in degree of state ownership of commercial enterprises? Are there special corporate governance issues in cooperatively owned firms?

- *Financial institutions' corporate governance* has been underemphasized, as the financial crisis brought to light, revealing massive failures at major institutions in advanced countries. We know that corporate governance at financial institutions differs from that of corporations, but in which ways is not yet clear — apart from the important role of prudential regulations, given the special nature of banks. More work is needed in this area for emerging markets, too, in part related to the banks' role in business groups. Other than some research on state ownership of banks, the corporate governance of banks in emerging markets is little analyzed. Clarifying this topic will be key, because banks are important providers of external financing, especially for small and medium firms. The Forum is addressing the need to build capacity in banks through its Financial Markets Recovery Project (Global Corporate Governance Forum 2010).[21]

- *Institutional investors' role* in firm's corporate governance is becoming more important as the number of institutional investors increases worldwide. But, their role in corporate governance is not obvious and surely not clearly understood in emerging markets. In many countries, companies have purposely limited the role of institutional investors in corporate governance, the assumption being that more activism would risk a company's fiduciary obligations. In some countries, though, institutional investors are encouraged to take a more active role in corporate governance, and some do. What is the right balance? Under which conditions can institutional investors be most productive in advancing corporate governance best practice?

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21. The Financial Markets Recovery Project builds on the Forum's successful Board Leadership Training initiative. It deploys a sector-specific supplement, *Governing Banks*, to train bank board directors in emerging markets and developing countries. The training module narrates a journey taken by a newly appointed director of a fictional bank's board to acquire the understanding, skills, and insights needed to meet the particular challenges faced by bank directors and to make decisions. It is based on an extensive review of literature, international consultations, peer reviews, case studies, and interviews with directors, bankers, chief risk officers, regulators, and independent experts. It also incorporates current practices of real banks that performed well during the financial crisis of 2007–2009. A sample of the supplement can be downloaded at http://www.ifc.org/ifcext/cgf.nsf/Content/FMRP.

- *Institutional investors' self-governance* deserves more attention. Institutional investors will not exercise good corporate governance without being governed properly themselves. Moreover, the forms through which more activism of institutional investors can be achieved are not clear. For example, institutional investors typically hold small stakes in any individual firm. So, on the one hand, some form of coordination is necessary, but, on the other hand, too much coordination can be harmful, if the financial institutions start to collude and political economy factors start playing a role. And, what are the best means to exercise corporate governance, for example, voting or exit?

- *Corporate governance mechanisms*—how corporate governance actually takes place—require more research, even though data are hard to obtain. Most evidence shows that truly independent boards clearly contribute to better firm performance and higher valuations. Relatively little evidence exists on executive compensation and managerial labor market mechanisms. Also deserving more attention is the role of internal markets in business groups: when do they help support, or not, the efficient allocation of financial resources across the group's members?

Corporate governance and stakeholders' roles

A similarly underresearched area is the role of other stakeholders. The analysis of employee representation, interactions with suppliers and civil society institutions, and issues related to corporate social responsibility are almost empty research fields in emerging market countries (and in many advanced countries as well). The following are specific subtopics that fall under this heading:

- *Best practice in relation to other stakeholders*. Little empirical research has been conducted on the relationships between corporate governance and other stakeholders, such as creditors and labor. To the extent that such research does exist, it refers largely to firms in developed countries.

- *Corporate social responsibility and environmental performance.* Under the general heading of corporate governance and stakeholders, there is a need for more research on the role of corporate governance for social and environmental performance, including green financing. Many firms have expressed a keen interest in this area, but little rigorous analysis has been conducted to date on how it relates to overall performance.

- *The impact on poverty alleviation*. There are few studies on the direct relationship between better corporate governance and greater alleviation of poverty and inequality. Although the general importance of property rights for poverty alleviation has been established (De Soto 1989; North 1990) and the role of financial sector development for poverty alleviation has been documented (World Bank 2007; Demirgüç-Kunt and Levine 2009), the specific channels through which improved corporate governance can help the poor have not been documented so far. This lack of documentation is in part because much of the corporate governance research has been directed toward the listed firms. Yet, much of the job creation in developing countries and emerging markets comes from small and medium enterprises, which face different corporate governance issues. These issues require different approaches, which so far have not been well researched.

Enforcement, both private and public, and dynamic changes

Enforcement is key to actually making corporate governance reforms work, but little is known about what drives enforcement. There is some evidence that when a country's overall corporate governance and property rights systems are weak, voluntary and market corporate governance mechanisms have limited effectiveness. But only a few studies have analyzed how to enhance enforcement in such environments. In general, enforcement needs to be studied more to find answers to the following questions:

- *How can enforcement be improved in weak environments?* How can a better enforcement environment be engineered? The degree of public-private partnership in enhancing enforcement is presumably important but underexamined, from both a theoretical and an empirical perspective. What factors determine the degree to which the private sector can solve enforcement problems on its own, and what determines the need for public sector involvement in enforcement?

- *What is the role of voluntary mechanisms?* More evidence is needed on how voluntary mechanisms (such as cross-listings, codes of best practices, or international accounting standards) can be most valuable. The interaction of cross-listings with domestic financial development is a further potentially useful research area, since it could be that cross-listing undermined domestic financial sector development.

- *What is the corporate governance role of banks?* In many countries, banks have important corporate governance roles, because they are direct investors themselves or act as agents for other investors. And, as creditors, banks can see their credit claim change into an ownership stake, as when a firm runs into bankruptcy or financial distress. Enhancing banks' corporate governance in specific ways may thus be an effective means of improving overall corporate governance. One area of focus of the Financial Stability Board and others has been the design of compensation for traders, risk managers, credit officers, and others in financial institutions (see Financial Stability Board 2009).

- *What are the lessons from corporate governance research that can be applied to regulatory corporate governance*? Clearly, there were, and continue to be, many failures in the oversight and performance roles of regulatory and supervisory agencies in advanced countries. This is not a new research topic, but there is much to be learned here—from corporate governance research in general, and specifically from emerging markets—that can offer useful lessons on how to improve regulatory governance, for advanced countries as well. What are the best arrangements that assure the independence, accountability, transparency, and integrity of agencies such as securities market regulators and banking supervisors? Analysis of this is quite recent (see Quintyn 2007 for a review).

- *What are the dynamic aspects of institutional change?* Little is known about whether change occurs in a more evolutionary way during normal times or more abruptly during times of financial or political crisis. In this context, 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 and situation. Local data need to be used to make a convincing case for change. Local capacity is needed to identify the relevant issues and make use of political opportunities for legal and regulatory reform. Therefore, progress with corporate governance reform depends on local capacity—data, people, research, and other resources. The Forum addresses capacity building through several programs, including board leadership training, media training, the Financial Markets Recovery Project, and targeted programs to help countries develop and implement codes.

Areas for Future Research

Ownership structures and relationships with performance:
Too little is known about ownership structures in complex groups, the role of multiple shareholders, the dynamics of ownership structures, and the links between shareholders and their board representation. How do these issues affect family-owned firms, state-owned firms, financial institutions, and institutional investors (and their own governance structures)?

Corporate governance and stakeholders' roles:
The analysis of employee representation, interactions with suppliers and civil society institutions, and issues related to corporate social responsibility are almost empty research fields in emerging market countries. Three specific subtopics are: best practice in relation to other stakeholders; corporate CSR and environmental performance; and the impact on poverty alleviation.

Enforcement—private and public—and dynamic change:
Little is known about the factors that drive and enhance enforcement in environments with weak property rights, poor legal systems, and limited market-driven forces for adopting corporate governance reforms. Key questions are: How can enforcement be improved in weak environments? What is the role of voluntary mechanisms? What is the corporate governance role of banks? What lessons can be applied to regulatory corporate governance? How do the dynamics of institutional change influence corporate governance reform?

7. *Commentary*

Those responsible for ensuring a company's success often see academic research as largely irrelevant to the practical issues they must address. They are skeptical of what scholars have to say, because the researchers typically lack the experience of earning profits, beating fierce competition, and managing the behavioral dynamics of people.

In reading this *Focus*, I adopted the vantage point of a chief executive officer to see what practical relevance I would find in a synthesis of research that examines the links between corporate governance and economic development. Economic development is the hook to attract chief executive officers, given their interest in growth and their need for an ever more prosperous macroenvironment to supply capital and to fuel demand.

As I did when I read the 2003 version, I found plenty to learn about—all made easier by the effectiveness with which Stijn Claessens and Burcin Yurtoglu bridged the gap between academia and the public, skillfully zeroing in on the key findings and explaining them with accessible language and simplicity.

The public glimpses the complex discourse of law and economics from a distance; intimidated by the language and jargon of academia, they shy away from engagement with the issues. This is a pity. The insights and knowledge should be made available to a wide readership, because theory and praxis should go together. The Forum's work in bridging the two is laudable, and this publication signals the Forum's continuing commitment to bring scholarship to the public.

The first thing that stands out for me is the business case for corporate governance. Although the authors do caution that research does not state affirmatively that corporate governance causes economic development, the evidence is overwhelming that, as best practices are established and adhered to, many of the factors that drive economic development take hold. Investors become more confident in a company, because its operations, including its financial statements, are more transparent and it respects minority shareholders' rights. The costs of capital for well-governed companies are lower, too, in line with the quality of the risk-management process that best practice demands. This development is in tandem with the growing sophistication of the financial sector's development to meet the more complex needs of companies and their investors. That, in turn, improves, for example, liquidity (the ability of an investor to convert an equity holding, for instance, into cash). Investors want choice and flexibility; liquidity is a tool to achieve these goals.

Particularly interesting, too, is the volatility of shares for well-governed companies, particularly during a financial crisis. Performance is better for companies with high levels of accounting disclosures and high levels of outside ownership concentration. Some may wonder what has to come first—the corporate governance reforms or investors' desire to buy shares? I think the answer is that both need to occur, with each encouraging advancements by the other's progress, a mutually reinforcing process.

For me, the synthesis of the research in this publication shows the particular importance of strong, capable, and credible legal frameworks — ones that have sound laws and regulations, effective enforcement mechanisms, highly qualified staff, adequate resources, and courts that process cases efficiently and fairly, basing their decisions on laws and precedents. Business decisions need predictability, clarity, and certainty. Competition also has a positive effect, as the more recent research is confirming in specific countries. And, rules for market control, providing equality for shareholders' entry and exit, would certainly be a catalyst for growth.

Board chairmen and chief executive officers worry about how their companies are organized, a concern made more complex if family ownership is involved, as is the prevailing case in emerging markets and developing countries. Unfortunately, as the authors note, "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 businesses with little direct investment." They note that studies show that "a pattern of concentrated ownership with large divergence between cash flow rights and voting rights seems to be the norm worldwide." Although there may be benefits to large conglomerates, including economies of scale and branding, the modus operandi may be to siphon off capital (tunneling) and profits through complex related-party transactions and obtuse ownership regimes single-mindedly aimed at enriching the controlling interests at the expense of all others.

This is, to be sure, an unsurprising claim, as is the finding that "countries with higher concentration of wealth achieve less progress in institutional reform," which is borne out empirically in many emergent countries. These ownership structures result in many conflicts of interest, and the challenge of how to manage those conflicts is a major concern for a company's board and senior management.

Without casting doubt on the foregoing, there are contrarian examples where some family-controlled enterprises have returned fair and incremental shareholder value, because family controllers have adopted good governance practices (for example, in Korea, Thailand, and Malaysia). Reference to some studies demonstrating this trend would have been a useful addition to this valuable study.

The authors argue for a functional approach to unbundling the complex interface between rules and institutions, distinguishing six major functions of corporate governance: pooling of resources and subdividing shares; transferring resources over time and space; managing risks; generating and providing information; dealing with incentive problems; and resolving competing claims on wealth generated by corporations.

Good corporate governance is not just about an impressive architectural edifice of rules or a façade of institutional framework. The critical elements are processes and outcomes. This is not to say that the foundations are unimportant, but beyond that, specific mechanisms (such as rules for prevention of self-dealing) have to be implemented to engender better governance outcomes.

The paper's conclusion sets out key areas that still require the illumination of further research and analysis. And, a useful listing of references updates the extant literature for scholars and lay readers alike.

Read this paper. Ponder its rich and nuanced reflections. It will reward the careful reader, and policy framers, regulators, lawmakers, and judicial and legal actors all ought to give heed to its analysis. It has been observed that law and economics are too important to be left to lawyers or economists — so, this paper succeeds if the wide readership it deserves extends beyond the ambit of its disciplines.

As we eavesdrop on the conversations and convergence of discourse, we can become part of the emergent deliberative consensus. This will surely contribute to sounder rules, reform, and a strengthening of the fabric of our fragile society and institutions. We are grateful to Stijn Claessens and Burcin Yurtoglu for their contribution toward such an end.

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8. Tables

Table 1: Summary of Key Studies on Ownership Structures

Study	Country	Data	Period	N	BG	LS
Al Farooque, Zijl, Dunstan, and Karim (2007)	Bangladesh	HC	1995–2002	~100		
Cheung, Connelly, Limpaphayom, and Zhou (2007)	Hong Kong SAR, China	HC	2002	168		53b
Lei and Song (2008)	Hong Kong SAR, China	HC	2000–2003	707		44.7
Jaggi and Leung (2007)	Hong Kong SAR, China	HC	1999–2000	399		
Balasubramanian, Black, and Khanna (2008)	India	Survey, HC	2006	370	53	
Black and Khanna (2007)	India	PROWESS	1999	791	50.8	
Douma, George, and Kabir (2006)	India	Capitaline 2000	1999–2000	1005		
Gopalan, Nanda, and Seru (2007)	India	PROWESS	1992–2001	824	32.28	
Kali and Sarkar (2005)	India	PROWESS	2000–2001		32.24	
Kumar (2008)	India	PROWESS	1994–2000	2478		
Marisetty, Marsden and Veeraraghavan (2008)	India	PROWESS	1997–2005	67		
			1993–1995			
Mohanty (2003)	India	IBID, Vans and Prowess	2001–2002	2363		
Pant and Pattanayak (2007)	India	PROWESS	2000–2003	1833		
Patibandla (2006)	India	RBI	1989–2000	148		
Sarkar and Sarkar (2005b)	India	PROWESS	1996–2003	~1200	56.36	
Sarkar and Sarkar (2008)	India	PROWESS	2003	500	77.6	
Bunkanwanicha, Gupta, and Rokhim (2008)	Indonesia	ECFIN	1997	180		
Zhuang, Edwards, and Capulong (2001)	Indonesia	HC	1997	42		48.2 67.5b

IO	Man.	Family	NFC	FC	FOR	State	WH	Cross/Dual/ Pyramid	CO-OWN [CO/OWN]
38.8*				19.7		2.9	31		
		45.8							
		38.6							
49.11					8.38				
37					2.9				
	17.28		28.47	7.13	3.62				
36.7									
~48									
17.29			26.12	1.7	10.84				
44.98				20.22			26.35g		
				4.8					
50									
				16.96	21.39		22.40g		
47.74				4.53	6.27		31.87g		
		78.3d				3.3d	11.1d		1
					25.4				

Table 1 (continued)

Study	Country	Data	Period	N	BG	LS
Bae, Baek, and Kang (2007)	Korea	KLCA	1996–1999	644		18.94
Bae, Cheon, and Kang (2008)	Korea	KLCA		30	100	
Baek, Kang, and Park (2004)	Korea	KIS, KLCA	1997–1998	644	22.9	17.81
Black and Kim (2007)	Korea	TS-2000	1998–2004	583	20	
Black, Jang, and Kim (2006a)	Korea	KSE	2001	515	20	19.67
Choi, Park, and Yoo (2007)	Korea	KLCA	1999–2002	457	19	
Joh and Ko (2007)	Korea	TS-2000	1995–2005	590 (in 1995) 649 (in 2005)	21	
Park and Kim (2008)	Korea	TS-2000	1993–2004	251		
Chu (2007)	Malaysia	KLSE	1994–2000	256		
Fraser, Zhang, and Derashid (2006)	Malaysia	HC	1990–1999	257		
Haniffa and Hudaib (2006)	Malaysia	KLSE	1996, 2000	347		61.58a
Tam and Tan (2007)	Malaysia	KLSE	2000	150		43
Chau and Gray (2002)	Singapore	HC	1997	62		
Mak and Kusnadi (2005)	Singapore	HC	1999–2000	271		58
Zhuang, Edwards, and Capulong (2001)	The Philippines	HC	1997	43		33.5 65.2a
Chiang and Lin (2007)	Taiwan, China	HC	1999–2003	232		
Sheu and Yang (2005)	Taiwan, China	HC	1996–2000	333		
Yeh and Woidtke (2005)	Taiwan, China	HC	1998	251		
Bunkanwanicha, Gupta, and Rokhim (2008)	Thailand	Thailand St.Ex.	1992–1998	320		
Kim, Kitsabunnarat, and Nofsiger (2004)	Thailand		1987–1993	133		
Kouwenberg (2006)	Thailand	Worldscope	2002–2005	320		

IO	Man.	Family	NFC	FC	FOR	State	WH	Cross/Dual/ Pyramid	CO-OWN [CO/OWN]
29.24					4.82				[3.85 in 1996 2.15 in 1997]
					8.98				
	11.19								[3.85 all firms,5.83e
		20.67			8.27				
					0.07				
		31		5	6				
29		19			6				
				14.25	7.15				
35									
				62		11			
	34.53								
		65.33d		15.33d	12.66d	6.66d			
57.31									
21				5					
		5.5	71.1	20.7		2.6			
26.3				29.9					
39.40									
									8.66
		69.06d				8.7d	19.68d		3
38.56									
56.46									

Table 1 (continued)

Study	Country	Data	Period	N	BG	LS
Bebchuk (2005)	Argentina	BASE	2003–2004	54		63.14
Lefort (2005)	Argentina	Economatica, 20-F	2002	15		61 82a
Cueto (2007)	Brazil Chile, Colombia Peru Venezuela	Economatica Bloomberg	2000–2006	170		53
Lefort (2005)	Brazil	Economatica, 20-F	2002	459		51 65a
Silva and Subrahmanyam (2007)	Brazil	Economatica	1994–2004	141		72.32
Silveira, Leal, Carvalhal-da-Silva, and Barros (2007)	Brazil	CVM	1998–2002	~200		59.1
Lefort (2005)	Chile	Economatica, 20-F	2002	260		55 74a
Lefort and Walker (2007)	Chile	Economatica, SVS	1990/94/98/ 2002	200	70	49.1 58.4a
Martínez, Stöhr, and Quiroga (2007)	Chile	HC	1995–2004	175		
Santiago-Castro and Brown (2007)	Chile	20-F, HC	2000–2002	28		96
Silva, Majluf, and Paredes (2006)	Chile	HC	2000	177		
Gutiérrez, Pombo, and Taborda (2008)	Colombia	SVAL, SSOC	1996–2002	140		40.87 68.9b
Lefort (2005)	Colombia	Economatica, 20-F	2002	74		44 65a
Babatz (1997)	Mexico	HC	1996	121		>50
Lefort (2005)	Mexico	Economatica, 20-F	2002	27		52 73a
Macias and Roman (2006)	Mexico	HC	2000–2004	107		
Santiago-Castro and Brown (2007)	Mexico	20-F, HC	2000–2002	35		57
Cueto (2008)	Peru	Economatica Bloomberg	2000–2006	171		
Lefort (2005)	Peru	Economatica, 20-F	2002	175		57 78a
Cueto (2008)	Venezuela	Economatica Bloomberg	2000–2006	46		

IO	Man.	Family	NFC	FC	FOR	State	WH	Cross/Dual/ Pyramid	CO-OWN [CO/OWN]
								0 / 89d /	[1.125] 37n
								3.9m	93n
									[1.33]
								86.9m	89n
								85m	[2.66]
		51.5			17.5	6.6			16.5
								7.2m	68n
		57.14d							
		48d	25d	23d		3d		7k	
									[1.22]
		56d		10d	8.9d		6.7d		[1.06]
								7.1m	50n
65.6								60m	
								37.8m	72n
54*		51							
		79d	13d	1d		0d		48k	
		21.05d	50.8d	23.4d		4.7d			
								61m	100n
		8.7d	56.5d	34.8d		0d			

Table 1 (continued)

Study	Country	Data	Period	N	BG	LS
Abdel Shahid (2003)	Egypt	CASE	2000	90		
Hauser and Lauterbach (2004)	Israel	Meitav Stock Guide	1990–2000	84		>50
Lauterbach and Tolkowsky (2007)	Israel	HC				>50
Barako (2007)	Kenya	HC	1992–2001	43		72c
Mehdi (2007)	Tunisia	HC	2000–2005	24		
Yurtoglu (2003)	Turkey	ISE, HC	2001	305	39.6	45.8 63.6a
Mangena and Tauringana (2007)	Zimbabwe	HC	2002–2003	67		84.2c

Notes to Table 1:
N=Number of firms in the sample; BG=Fraction of the sample part of business groups; LS=Largest shareholder; IO=Insider Ownership; Man.=Managerial shareholdings; NFC=Nonfinancial corporations; FC=Financial corporations; For=Foreign; WH=Widely held; [CO-OWN]=Control rights minus ownership rights; [CO/OWN]=Control rights/ownership rights; HC=Hand-collected from annual reports.

*Board ownership.

Inside ownership (shares held by officers, directors, their immediate families, as well as shares held in trust and shares held by companies controlled by the same parties).

a: Top 3 shareholders; b: Top 5 shareholders; c: Top 10 shareholders; d: Fraction of the sample; e: Fraction of group firms; f: External unrelated block holdings; g: Dispersed shareholdings; h: Cross; k: Fraction of firms with dual class shares; m: Fraction of firms with nonvoting shares; n: Fraction of firms controlled through pyramids.

BASE: Buenos Aires Stock Exchange; BCS: Bolsa de Comercio de Santiago; CASE: Cairo & Alexandria Stock Exchanges; CVM: Brazilian Securities Exchange Commission; KSE: Korea Stock Exchange; IALC: Investment Analysis for Listed Companies; ACH: Asian Company Handbook; NICE: National Information and Credit Evaluation database; KLCA: Korea Listed Companies Association Listed Companies Database; FSS: Financial Supervisory Service (Korea); KSD: Korean Securities Depository; ISE: Istanbul Stock Exchange; SVS: Superintendencia de Valores y Seguros; SHSE: Shanghai Stock Exchange; SZSE: Shenzen Stock Exchange; CSRC: China Securities Regulatory Commission; TASE: Tel-Aviv Stock Exchange; TSE: Tunisian Stock Exchange.

IO	Man.	Family	NFC	FC	FOR	State	WH	Cross/Dual/ Pyramid	CO-OWN [CO/OWN]
	15		20	7		35	20g		
									[1.08]
			3.47						
				58.4	28.3				
47.85	26.30			18.56					
		79.3d		8.5d	7.2d	3.9d			[4.57]
				40	11.1				

Table 2: Overview of Selected Studies on the Relationship between Ownership Structures and Corporate Performance

Study	Sample	Key Results
Claessens, Djankov, Fan, and Lang (2002)	1,301 publicly traded corporations in eight East Asian countries (Hong Kong SAR, China, Indonesia, Korea, Rep., Malaysia, the Philippines, Singapore, Taiwan, China, and Thailand) 1996	Firm value is higher when the largest owner's equity stake is larger, but lower when the wedge between the largest owner's control and equity stake is larger.
Haw, Hu, Hwang, and Wu (2004)	Nine East Asian countries	Income management that is induced by the wedge between control rights and cash flow rights is significantly limited in countries with high statutory protection of minority rights and effective extralegal institutions (the effectiveness of competition laws, diffusion of the press, and tax compliance).
Lang, Lins, and Miller (2004)	2,500 firms from 27 countries	Analysts are less likely to follow firms with potential incentives to withhold or manipulate information, such as when the Family/Management group is the largest control rights blockholder. Increased analyst following is associated with higher valuations, particularly for firms likely to face governance problems.
Lemmon and Lins (2003)	Over 800 firms in eight Asian emerging markets	Divergence of the cash flow/voting right has a negative impact on firm value and on share returns.
Lins (2003)	1,433 firms from 18 emerging markets 1995–1997	Deviations of cash flow rights from voting rights by management shareholdings lower firm value. Large nonmanagement control rights blockholdings are positively related to firm value. These two effects are significantly more pronounced in countries with low shareholder protection.
Mitton (2002)	398 firms from Indonesia, Korea, Malaysia, the Philippines, and Thailand during the Asian crisis	Divergence of the cash flow/voting right has a negative impact on firm value. Large nonmanagement blockholders improve firm value, especially during crisis.

Study	Sample	Key Results
Chen, Firth, and Xu (2008)	China 6,113 firm-year observations from listed companies, 1999–2004	The following controlling shareholders in China's listed companies are identified: state asset management bureaus (SAMBs), SOEs affiliated with the central government (SOECGs), SOEs affiliated with the local government (SOELGs), and private investors. Private ownership of listed firms in China is not necessarily superior to certain types of state ownership. The operating efficiency of Chinese listed companies varies across the type of controlling shareholder. SOECG-controlled firms perform best, and SAMB- and private-controlled firms perform worst. SOELG-controlled firms are in the middle
Hu and Zhou (2008)	China 83 firms with managerial ownership and a control group of 148 size- and industry-matched firms	Firms with significant managerial ownership outperform firms whose managers do not own equity shares. The relation between firm performance and managerial ownership is nonlinear, and the inflection point at which the relation turns negative occurs at ownership above 50%.
Lei and Song (2008)	Hong Kong, SAR All firms listed on the main board of HK except the mainland Chinese companies 2000–2003	Builds a corporate governance index covering the areas of board structure, ownership structure, compensation, and transparency. Firms with better CG ratings have higher firm value. Family-based and small firms have poor internal CG mechanisms and tend to pay themselves slightly higher. However, top-10 family groups appear to strongly hold to CG fundamentals. It implies that Hong Kong investors are willing to pay a substantial premium for better-governed companies.
Douma, George, and Kabir (2006)	India 1,005 firms listed on the BSE 1999–2000	Foreign ownership both by institutions and corporations improve Tobin's *q*. Only foreign ownership by corporations improves ROA. Although both types of foreign shareholdings improve ROA, only domestic corporations' shareholdings improve Tobin's *q*. Group membership has a substantial negative impact on both ROA and Tobin's *q*.

Table 2 (continued)

Study	Sample	Key Results
Pant and Pattanayak (2007)	India 1,833 firms listed on BSE; 2000–2001 to 2003–2004	Ownership by insiders/promoters exhibits an up/down/up pattern with a negative effect in the range of 20%–49% using several performance measures (ROA/ROE/Tobin's *q*) Tobin's *q* increases with foreign promoters' stakes.
Almeida, Park, Subrahmanyam, and Wolfenzon (2007)	Korea 1,085 firms and 47 business groups	Proposes new metrics of ownership structure. Central firms and firms in cross-shareholding loops have lower valuations than other public Chaebol firms. Firms owned through pyramids have lower profitability than similar firms placed at the top of the group.
Black, Jang, and Kim (2006a)	Korea 515 listed firms (20% chaebol-affiliated) 2001	Builds a Korean Corporate Governance Index (KCGI) based on a survey of corporate governance practices by the KSE. A worst-to-best change in the governance index (KCGI) predicts a 0.47 increase in Tobin's *q* (about a 160% increase in share price); IV estimates suggest larger effects. Firms with 50% outside directors have 0.13 higher Tobin's *q* (roughly 40% higher share price), after controlling for the rest of KCGI.
Bae, Baek, and Kang (2007)	Korea 1996–1999, 644 listed firms	Controlling shareholders' expropriation incentives derives a link between corporate governance and firm value. During the 1997 crisis, firms with weak corporate governance experience a larger drop in the value of their equity, but during the postcrisis recovery period, such firms experience a larger rebound in their share values.
Chu (2007)	Malaysia 256 manufacturing firms listed on Bursa Malaysia 1994–2000	Managerial or director ownership has a U-shaped impact on changes on Tobin's *q*; the minimum occurs in the range of 46%–62%. Large shareholders also have a U-shaped influence, the impact becoming positive at about 6% of ownership by large shareholders.

Study	Sample	Key Results
Haniffa and Hudaib (2006)	Malaysia 347 companies listed on the KLSE 1996 and 2000	Concentrated ownership (by top five shareholders) are negatively (positively) significant in the Tobin's *q* (ROA) equation. Managerial shareholdings have a negative impact on ROA.
Javid and Iqbal (2007)	Pakistan 50 nonfinancial firms listed on the KSE (more than 70% of market capitalization) 2003, 2004, and 2005	Builds a Corporate Governance Index based on 22 governance indicators covering boards, ownership and transparency, disclosure, and audit. There is a positive and (weakly) significant relationship between CGI and Tobin's *q*.
Chiang and Lin (2007)	Taiwan, China 232 companies listed on the Taiwan Stock Exchange, which have issued prospectuses from 1999 to 2003	The productivity of conglomerate, high-tech, and non-family-owned firms is higher than in their counterparts. Insider ownership is negatively and institutional ownership is positively related to TFP (total factor productivity).
Filatotchev, Lien, and Piesse (2005)	Taiwan, China 228 firms listed on the Taiwan Stock Exchange	Family and corporate ownership have no impact on performance. Share ownership by institutional investors, and foreign financial institutions in particular, is associated with better performance (measured by ROA and return on invested capital).
Yeh, Lee, and Woidtke (2001)	Taiwan, China 208 companies listed on Taiwan Stock Exchange; 1994–1995	Family firms with low levels of control have lower relative performance (Tobin's *q* and ROA) than both other family firms and widely held firms. Negative relation between performance and the fraction of seats held by the controlling family.
Wiwattanakantang (2001)	Thailand 270 companies listed on the Stock Exchange of Thailand 1996	The presence of controlling shareholders is associated with higher performance (ROA and the sales–asset ratio). The controlling shareholders' involvement in the management, however, has a negative effect on the performance. The negative effect is more pronounced when the controlling shareholder's and manager's ownership is 25–50%. Foreign-controlled firms as well as firms with more than one controlling shareholder also have higher ROA, relative to firms with no controlling shareholder.

Table 2 (continued)

Study	Sample	Key Results
Cueto (2008)	About 170 (mostly) listed companies from Brazil, Chile, Colombia, Peru, and Venezuela. 2000–2006	Higher voting rights held by the dominant shareholder are associated with lower Tobin's *q*. Higher ratios of cash flow rights to the voting rights held by the dominant shareholder are significantly associated with higher q values. The second effect is twice as large in the fixed effects regressions.
Carvalhal da Silva and Leal (2006)	Brazil 236 financial and nonfinancial companies listed on Bovespa 1998, 2000, and 2002	Firm valuation and ROA are positively related to cash flow concentration, and negatively related to voting concentration and to the separation of voting from cash flow rights. Firms controlled by the government and by foreign and institutional investors generally have significantly higher valuation and performance when compared with family-owned firms.
Silveira, Leal, Carvalhal-da-Silva, and Barros (2007)	Brazil About 200 firms 1998–2004	Overall firm-level CG quality is slowly improving but is still poor. Voluntary adoption leads to greater heterogeneity of corporate governance quality. Voluntarily joining stricter listing requirements, either by cross-listing in the United States or by joining Bovespa's Novo Mercado, is positively associated with firm-level CG quality. Control rights concentration and family ownership are associated with poorer practices; the presence of large blockholders agreements are associated with better practices.
Gutiérrez and Pombo (2007)	Colombia 108 nonfinancial listed firms 1998–2002	Large blockholders exert a positive influence on Tobin's *q* (and ROA) at lower levels. The relationship has an inverted U shape, the squared term implying a negative impact at 58% (57%–66% GLS or fixed effects estimation for ROA).

Study	Sample	Key Results
Gutiérrez and Pombo (2008)	Colombia 233 nonfinancial listed firms 1996–2004	Higher contestability of the largest blockholder's control helps limit tunneling and private extraction of rents. Control contestability (a more equal distribution of control rights among the four largest blockholders) is positively related to Tobin's *q*. The ratio of voting rights to equity insignificant.
Lefort and Walker (2007)	Chile About 200 firms 1990–1994, 1998–2002	Higher ownership concentration by the three largest shareholders is negatively associated with Tobin's *q*. U-shaped relationship with a minimum 68% of ownership. Lower levels of deviation of cash flow and voting rights is positively associated with Tobin's *q*. A one standard deviation increase in the degree of coincidence is associated with an increase in q of 28% (an increase in stock price of 58%). Pension funds as minority shareholders increase Tobin's *q*.
Macias and Roman (2006)	Mexico 107 listed nonfinancial firms 2000–2004	Builds a Governance Score (GS). GS improves over the 2000–2004 period; however, firm performance (ROA) is not related to GS. Tobin's *q* is negatively related to GS.

Table 2 (continued)

Study	Sample	Key Results
Abdel Shahid (2003)	Egypt 90 most actively listed companies on Cairo & Alexandria Stock Exchanges	Significant effects of ownership characteristics on ROA and ROE but not on stock market indicators P/E and P/BV ratios. Ownership by holding companies has an economically and statistically positive effect on accounting performance measures.
Lauterbach and Tolkowsky (2007)	Israel 144 firms traded on the Tel-Aviv Stock Exchange	Tobin's *q* is maximized when the control group vote reaches 67%. This evidence is strong when ownership structure is treated as exogenous, and weak when it is considered endogenous. Other ownership structure variables do not significantly affect firm valuation.
Mehdi (2007)	Tunisia 24 firms listed on the Tunisian Stock Exchange 2000–2005	Higher CEO and directors shareholdings are positively associated with better investment performance (measured by marginal Tobin's *q*). Blockholder and institutional shareholdings have a negative impact.
Yurtoglu (2000)	Turkey 257 companies listed on the Istanbul Stock Exchange 1997	Ownership concentration and deviations of voting rights from control rights have a negative effect on ROA, market-to-book ratio, and dividend pay-out ratios.

Table 3: Overview of Selected Studies on the Effects of Legal Changes

Study	Sample	Legal Change	Key Results
Beltratti and Bortolotti (2007)	China	Nontradable Share Reform in 2005/2006: Elimination of nontradable shares (a special class of shares entitling the holders to exactly the same rights assigned to the holders of tradable shares but which cannot be publicly traded).	After more than doubling in value throughout the program, the market rose 40% in the first four months of 2007, immediately after the completion of the NTS reform for the entire stock market.
Qian and Zhao (2011)	China 381 firms (SHSE and SZSE)	Mandatory use of cumulative voting in director elections (Section 31 of the Code of Corporate Governance for Listed Companies issued in January 2002).	Firms that used cumulative voting experienced a significant decrease in expropriation activities by the controlling shareholder.
Black and Khanna (2007)	India	Clause 49 in 2000: Requirement of audit committees, a minimum number of independent directors, and CEO/CFO certification of financial statements and internal controls.	Reforms especially benefited firms that need external equity capital and cross-listed firms, suggesting that local regulation can sometimes complement, rather than substitute for, firm-level governance practices.
Black and Kim (2007)	Korea 248 firms 1998–2004	Requirement that large firms (with assets over 2 trillion won, about $2 billion) have 50% outside directors, an audit committee with an outside chairman and at least two-thirds outside directors as members, and an outside director nominating committee.	A positive share price impact of boards with 50% or more outside directors, and weaker evidence of a positive impact from creation of an audit committee.
Choi, Park, and Yoo (2007)	Korea ~450 firms 1999–2002	Introduction of a mandatory quota for outsiders. Starting in 1999, at least one-quarter of the board members for listed companies are required to be independent outside directors.	Outside directors have a significant and positive effect on firm performance.
Park and Kim (2008)	Korea 251 firms 1993–2004	Government policies to weaken the ties among group-affiliated firms: elimination of cross-debt guarantees; restrictions on intra-group transactions; elimination of restrictions on foreign ownership; removal of restrictions on exercising voting rights by institutional shareholders.	The effectiveness of governance factors on firms' activities is bound to the institutional context created by government regulations. Institutional ownership and regulatory changes in CG had significantly influenced Korean firms' restructuring. Regulatory changes have positively moderated the relationship between business group affiliation and restructuring, and between institutional ownership and restructuring.

Table 3 (continued)

Study	Sample	Legal Change	Key Results
Atanasov, Black, Ciccotello, and Gyoshev (2006)	Bulgaria 800 firms 1999–2002	Securities law changes in 2002: Provides protection against dilutive offerings and freeze-outs.	Following the legal changes, share prices jump for firms at high risk of tunneling, relative to a low-risk control group; minority shareholders participate equally in secondary equity offers, whereas before they suffered severe dilution; and freeze-out offer prices quadruple.
Nenova (2005)	Brazil	Law 9457/1997 lifts disclosure of the prices of block sales and mandatory offers for voting shares at control sale, and weakens withdrawal rights, leaving ample room for expropriation by controlling parties. Instruction 299 amends the Corporate Law and reinstates and enhances the minority rights revoked by Law 9457/1997.	Firm control values of Brazilian listed companies are directly affected by changes in the legal protection for minority shareholders. Control value increases more than twice in the second half of 1997 in response to Law 9457/1997, which weakens minority shareholder protection. Control values drop to pre-1997 levels in the beginning of 1999 in response to CVM Instruction 299/1999, which reinstates some of the minority protection rules scrapped by the previous legal change.

Table 4: Overview of Selected Studies on the Relationship between CG Indexes and Performance

Study	Sample	CG Index Properties	Key Results
Cheung, Thomas Connelly, Limpaphayom, and Zhou (2007)	Hong Kong SAR, China	Rights of shareholders (15%); equitable treatment of shareholders (20%); role of stakeholders (5%); disclosure and transparency (30%); and board responsibilities and composition (30%). CGI ranges from a low of 32 (out of 100) to a high of 77.	Companies' market valuation (but not their ROE) is positively related to the overall CGI score.
Lei and Song (2008)	Hong Kong SAR, China	CGI using a principal component analysis that covers the areas: board structure, ownership structure, compensation, and transparency.	Firms with better CG ratings have higher firm value. Family-based and small firms have poor internal CG mechanisms and tend to pay themselves slightly higher. Top-10 family groups appear to strongly hold to CG fundamentals.
Balasubramanian, Black, and Khanna (2010)	India	An overall India Corporate Governance Index (ICGI) based on the following subindexes: Board Structure, Disclosure, Related-Party Transactions, Shareholder Rights, and Board Procedures.	A positive relationship for the overall ICGI and for an index covering shareholder rights and firm performance.
Mohanty (2003)	India	An index based on 19 measures taking into account shareholders' and stakeholders' interests.	Institutional investors own a higher percentage of the shares of better-governed firms, based on this index.
Black, Jang, and Kim (2006a)	Korea	Korean Corporate Governance Index (KCGI) based on a survey of corporate governance practices by the Korean Stock Exchange (KSE).	A worst-to-best change in KCGI predicts a 0.47 increase in Tobin's *q*, which corresponds to an almost 160% increase in the share price.
Javid and Iqbal (2007)	Pakistan	Corporate Governance Index based on 22 governance indicators with three main themes: Board (8 factors), Ownership (7 factors), and Transparency, Disclosure, and Audit (7 factors).	A positive but weakly significant relationship between CGI and Tobin's *q*.
Kouwenberg (2006)	Thailand	Voluntary adoption of the corporate governance code introduced in 2002.	A one standard deviation increase in a firm-level code adoption index is related to a 10% increase in firm value in the period 2003–2005.

Table 4 (continued)

Study	Sample	CG Index Properties	Key Results
Bebchuk (2005)	Argentina	A transparency and disclosure index (TDI) comprising a total of 32 binary items on boards, disclosure, and shareholders.	TDI and its components are significantly positive in OLS (ordinary least squares) equations explaining accounting performance and Tobin's *q*.
Black, Carvalho, and Gorga (2011)	Brazil (India, Korea, and Russia)	A broad Brazil Corporate Governance Index (BCGI) and its subindexes.	A positive and statistically significant association between BCGI (measured at year-end 2004) and firm market value (measured at year-ends 2005 and 2006). Different subindexes are important in different countries (for different sets of companies).
Leal and Carvalhal da Silva (2005)	Brazil	Governance Practices Index based on a set of 24 survey questions.	A worst-to-best improvement in the CGI in 2002 would lead to a 0.38 increase in Tobin's *q* (or a 95% rise in the stock value).
Macias and Roman (2006)	Mexico	Governance Score (GS): GS is a composite measure of governance based on 55 items (with subsections on board structure, external auditing, transparency in financial reporting, and disclosure and shareholders' rights) and it is scaled to be in the range of 0 to 1, with higher values indicating better governance.	GS improves from 0.66 in 2000 to 0.82 in 2004; however, both accounting and market measures of firm performance are unrelated to the GS.

Study	Sample	CG Index Properties	Key Results
Kowalewski, Stetsyuk, and Talavera (2007)	Poland	Transparency and Disclosure Index (TDI).	An increase in the TDI or its sub-indices that represent corporate governance practices brings about a statistically significant increase in the dividend payout ratio.
Black (2001a) and Black (2001b)	Russia	Corporate governance rankings of a small sample (16 and 21) of major Russian firms developed by the Brunswick Warburg investment bank.	A one standard deviation improvement in governance ranking predicts an eightfold increase in firm value; a worst (51 ranking) to best (7 ranking) governance improvement predicts a 600-fold increase in firm value.
Black, Love, and Rachinsky (2006)	Russia	Six corporate governance indexes, from five different providers, on Russian companies.	A combined index is economically and statistically related to market valuations.
Guriev, Lazareva, Rachinsky, and Tsouhlo (2003)	Russia	A corporate governance index based on a survey including six questions (concerning accounting standards, shareholder relations, and independent directors) related to corporate governance, using principal components analysis.	No link to performance.
Lazareva, Rachinsky, and Stepanov (2008)	Russia, Ukraine, and Kyrgyzstan	A corporate governance index based on a survey including six questions (concerning accounting standards, shareholder relations, and independent directors) related to corporate governance, using principal components analysis.	Neither the need for outside finance nor the actual outside investment have any relationship to the corporate governance index.
Zheka (2007)	Ukraine	An overall index of corporate governance (UCGI) and subindexes of corporate governance, including: shareholder rights, transparency/information disclosure, board independence, and chairman independence.	A one-point-increase the UCGI index would result in around 0.4-1.9% increase in performance; and a worst to best change in UCGI predicts about 40% increase in company's performance.

Table 5: Summary of Key Empirical Studies on Boards of Directors

Study	Country	Sample	Dependent variables
Chen, Firth, Gao, and Rui (2006)	China	169 enforcement actions in 1999–2003	FRAUD: A dummy variable for firms subject to an enforcement action
Lefort and Urzua (2008)	Chile	160 listed firms in 2000–2003	Tobin's *q*
Lo, Wong, and Firth (2010)	China	266 listed companies in 2004	Gross profit ratio on related-party transactions
Peng (2004)	China	49–405 listed firms in 1992–1996	ROE, sales growth (SGR)
Chen and Nowland (2010)	Hong Kong SAR, China Malaysia, Singapore, and Taiwan, China	185 listed firms in 1998–2004	ROA and Tobin's *q*
Ramdani and Witteloostuijn (2010)	Indonesia, Malaysia, Korea, Rep., and Thailand	61 firms in Indonesia, 75 in Malaysia, 111 in Korea, Rep., and 61 in Thailand over 2001–2002	ROA
Black, Jang, and Kim (2006)	Korea	515 companies in 2001	Tobin's *q* and profitability
Black and Kim (2007)	Korea	248 listed companies in 1998–2004	Cumulative market-adjusted returns and Tobin's *q*
Choi, Park, and Yoo (2007)	Korea	~450 listed firms in 1999–2002	Tobin's *q*
Mak and Kusnadi (2005)	Malaysia and Singapore	230 firms listed on the SGX and 279 on the KLSE in 1999 or 2000	Tobin's *q*
Ararat, Orbay, and Yurtoglu (2011)	Turkey	108 firms listed on the Istanbul Stock Exchange	Tobin's *q*, ROA, related-party transactions
Dahya, Dimitrov, and McConnell (2008)	22 countries, including 7 emerging markets in 2002	799 firms with dominant shareholders	Tobin's *q*

Independent Variable (mean)	Estimation Method	Main Results
Proportion of outside (or nonexecutive) directors (13%)	Probit	Negative significant
Proportion of independent directors (20%)	OLS, fixed effects, and 3SLS (three-stage least squares) regression	OLS and fixed effects: not significant 3SLS: significantly positive
Proportion of independent directors (34.5%)	OLS	Negative significant
Proportion of affiliated (30%) and nonaffiliated outside directors (11%)	OLS	Positive significant (affiliated outside directors on SGR)
Proportion of independent directors (23% family firms, 34% other firms)	Fixed effects	Concave relationship with an optimal level of board independence at 36%
Proportion of outside directors (69%)	OLS, robust regressions (RR), and quartile regressions (QR)	OLS: Not significant RR: Positive significant QR: Positive significant at the median and 75th percentile
Dummy variable indicating whether firms have 50% or more outside directors	OLS and 2SLS (using asset size dummy as an instrument)	Positive significant
Board independence index based on the existence of 50% or more outside directors	Event study, differences in differences, 2SLS, 3SLS, and fixed effects	Positive significant
Proportion of outside directors (31.2%) Proportion of independent directors (21.3%)	OLS and 2SLS	Not significant Positive significant
Proportion of independent directors (34%)	OLS	Not significant
Proportion of independent directors (7.5%)	OLS, fixed effects, 2SLS	Not significant/significantly negative
Proportion of outside directors (69%)	OLS, country random effects, 2SLS	Positive significant

Table 6: Overview of Selected Studies on Cross-Listings

Study	Motive of Cross-Listing/Key Results
Bacidore and Sofianos (2002)	Increasing stock liquidity.
Bailey, Karolyi, and Salva (2006)	Absolute return and volume reactions to earnings announcements typically increase significantly once a company cross-lists in the United States. These increases are greatest for firms from developed countries and for firms that pursue over-the-counter listings or private placements, which do not have stringent disclosure requirements. Additional tests support the hypothesis that it is changes in the individual firm's disclosure environment, rather than changes in its market liquidity, ownership, or trading venue, that explain these findings.
Baker, Nofsinger, and Weaver (2002)	Accessing foreign analysts' expertise.
Chung, Cho, and Kim (2011)	Evidence that contradicts the bonding hypothesis. Firms are more likely to choose cross-listing destinations that are less strict on regulating self-dealing or exhibit higher block premiums relative to the origin country, and this tendency is more pronounced after Sarbanes-Oxley in 2002.
Coffee (1999) Stulz (1999)	Firms from poor investor protection regimes can effectively use or borrow better investor protection mechanisms by cross-listing in such exchanges, e.g., in the United States. This voluntary commitment serves as a "bonding" mechanism through which firms can persuade outside investors to provide capital by protecting minority shareholders from management's extraction of private benefits.
Doidge, Karolyi, and Stulz (2004)	Commitment to tough disclosure and corporate governance rules.
Foerster and Karolyi (1999) and Sarkissian and Schill (2004)	Expansion of the potential investor base.
Halling, Pagano, Randl, and Zechner (2008)	Cross-listings can affect the level of domestic trading volume. Domestic trading volume declines for companies from countries with poor enforcement of insider trading regulation.
Karolyi (2003) and Tolmunen and Torstila (2005)	To improve a firm's ability to effect structural transactions abroad such as foreign mergers and acquisitions, stock swaps, and tender offers.
Lang, Lins, and Miller (2003)	Firms that cross-list on U.S. exchanges have greater analyst coverage and increased forecast accuracy relative to firms that are not cross-listed.

Study	Motive of Cross-Listing/Key Results
Licht (2001)	Evidence that contradicts the bonding hypothesis for Israel. Most issuers were listed only in the United States without having previously listed on the Tel Aviv Stock Exchange. Israeli U.S.-listed issuers resisted any increase in their corporate governance-related disclosure beyond the suboptimal level they are subject to in the United States.
Lins, Strickland, and Zenner (2005)	A U.S. listing enhances access to external capital markets by showing that the sensitivity of investment to cash flow decreases significantly for firms from emerging capital markets, whereas it does not change for developed markets firms following a U.S. listing.
Liu (2007)	Foreign cross-listings in the United States enhance home-market stock pricing efficiency, net of marketwide efficiency shifts in the concurrent period. The efficiency benefit applies equally well regardless of home-market development status or cross-listing location.
Miller (1999)	Firms that announce ADR (American Depository Receipt) programs experience a positive change in shareholder wealth. This effect is larger for firms from countries where legal barriers to capital flows are prevalent. Cross-listings can mitigate barriers to capital flows and result in a higher share price and a lower cost of capital.
Pagano, Röell, and Zechner (2002)	Visibility to customers in product markets.
Sami and Zhou (2008)	Chinese cross-listed firms have lower information asymmetry risk, lower cost of capital, and higher firm value than their non-cross-listed counterparts.
Saudagaran and Biddle (1995)	Foreign listing locations are influenced by financial disclosure levels and the level of exports to a given foreign country. Firms are reluctant to cross-list in destinations with strict accounting and regulatory disclosure requirement that could affect the management's pursuit of private benefits.
Siegel (2005)	Reputational bonding (rather than legal bonding). In the Mexican case, listed ADRs did not always serve as an effective bonding mechanism for deterring malpractices such as fraud, outright theft, embezzlement, and legal asset taking.

Table 7: Overview of Selected Studies on Political Connections

Study	Key Results
Charumilind, Kali, and Wiwattanakantang (2006)	Thai firms with connections to banks and politicians before the Asian crisis of 1997 had greater access to long-term debt than firms without such ties. Connected firms needed less collateral and obtained more long-term loans.
Claessens, Feijen, and Laeven (2008)	Brazilian firms that provided contributions to (elected) political candidates experienced higher stock returns than firms that didn't, during the 1998 and 2002 elections. These firms are also able subsequently to access bank finance.
Du (2011)	Chinese firms' political connections are positively associated with debt offering amounts and issuer credit ratings, but only in the subsample of firms with poor information environments, such as non-publicly listed firms and non-Beijing headquartered firms. The role of political connections in providing preferential access to debt is relevant to both state-owned enterprises and privately held firms.
Faccio (2006)	Politically connected firms are more frequently found in countries with higher levels of corruption, with barriers to foreign investment, and with more transparent systems. The announcement of a new political connection results in a significant increase in value.
Faccio, McConnell, and Masulis (2006)	Politically connected firms are significantly more likely to be bailed out than similar nonconnected firms. Among firms that are bailed out, those that are politically connected exhibit significantly worse financial performance than their nonconnected peers at the time of the bailout and over the following two years.
Fisman (2001)	The value of political connections to the Suharto regime in Indonesia. Using announcements concerning Suharto's health, the study documents that over 20% of a politically connected firm's value is derived from its political connections.
Khwaja and Mian (2005)	Political connections increase financial access for Pakistani firms. Politically connected firms (those with a board member who runs for political office) have loans that are 45% larger and carry average interest rates, although they have 50% higher default probabilities. Such preferential treatment occurs exclusively in government banks—private banks provide no political favors. The economywide costs of the rents afforded to politically connected firms through government-owned banks is about 2% of GDP per year.
La Porta, López-de-Silanes, and Zamarripa (2003)	Related lending is prevalent in Mexico (20% of commercial loans) and takes place on better terms than arm's-length lending (annual interest rates are 4% points lower). Related loans are 33% more likely to default and, when they do, have lower recovery rates (30% less) than unrelated ones. Related lending is a manifestation of looting.
Qian, Pan, and Yeung (2011)	Expropriation by controlling shareholders in China through tunneling or self-dealing is far more severe in politically connected firms than in nonpolitically connected firms. This results more from the formers' lower concern with capital market punishment than from the possibility that such firms tend to establish political connections for protection.
Ramalho (2003)	Politically connected firms' stock values drop around dates of an anti-corruption campaign in Brazil.

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