

# INTERNATIONAL CORPORATE GOVERNANCE

**Marc Goergen**



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heavily on path dependence. La Porta et al. justify the static nature of their theory by stating that law only changes slowly over time and that it is very difficult for a country to carry out significant reforms of its legal system within a short amount of time. However, if one studies recent developments, Japan springs to mind as it has reformed its takeover regulation by adopting a US Delaware case-based approach despite the fact that it is part of the German civil law family which would assume a code-driven rather than a case-based approach to law and regulation.

Apart from this fairly general criticism, more specific critiques of La Porta et al. have also been made. The main four critiques concern the way La Porta et al. measure investor protection, encoding errors in their antidirector rights index, the possibility that law and legal families are merely proxies for other factors, such as culture, that are the true drivers behind the differences in corporate governance across countries, and that ownership dispersion in the UK could be observed before investor protection was in place. The first critique has been formulated by Michael Graff.<sup>21</sup> He argues that La Porta et al. have included criteria in their antidirector rights index that are irrelevant whereas other, clearly relevant, criteria have been omitted. Two criteria that should not have been included are whether shareholders can mail their proxy votes and whether shareholders are not required to deposit their shares before the AGM. Two criteria that should have been included, according to Graff, are the existence of mandatory dividends and whether the rule of one-share one-vote is upheld. When La Porta et al.'s antidirector rights index is adjusted as proposed by Graff, then the link between investor protection and legal origin disappears. Holger Spamann's critique is based on errors of encoding. Spamann revisits the encoding of the antidirector rights index and finds errors for 33 out of the 49 countries covered by La Porta et al.<sup>22</sup> After the errors have been corrected, there is no longer a link between legal origin and the level of investor protection. In other words, La Porta et al.'s main result that legal families differ in terms of the rights they confer to investors is no longer upheld. Spamann argues that the encoding errors have been caused by the fact that La Porta et al. have based themselves on secondary sources rather than on the law texts themselves. According to the third critique, legal families are a proxy, i.e. an indirect measure for the true drivers of the differences in corporate governance across countries. For example, Amir Licht, Chanan Goldschmidt and Shalom Schwartz argue that culture is the true driver behind these differences.<sup>23</sup> Based on survey data on cultural attitudes, they find that countries that were under British rule are much more willing to deal with conflicts of interests in the courts of law and are much more litigious countries than the rest of the world. They find a strong correlation between cultural attitudes and investor and creditor protection. Importantly, as cultural attitudes tend to persist over time they may prevent law reforms from succeeding and bringing about true change. Licht et al. argue that this may be the reason why most of the countries from the former Communist Bloc have failed to improve investor protection in practice despite wide-ranging changes to their legal codes. Finally, Julian Franks, Colin Mayer and Stefano Rossi perform a historical study of ownership dispersion in the UK covering the period of 1900 to 2000.<sup>24</sup> They find that ownership dispersion was already high before 1930 despite the absence of investor protection. They argue that the separation between ownership and control occurred in the absence of strong shareholders' rights and was made possible by the existence of local stock exchanges which were close to the shareholder base of the firms that were listed on these markets. In other words, the proximity of the firm to

its shareholders created trust between its managers and shareholders, substituting for the lack of legal investor protection.

René Stulz and Rohan Williamson also investigate the role of culture behind the differences across countries in terms of corporate governance.<sup>25</sup> They measure differences in culture by religion and language. They find that generally differences in investor rights cannot be explained by differences in culture. However, within a given legal family differences in culture explain differences across the countries of that legal family in terms of investor protection. This relationship is particularly strong for creditor rights. For example, Catholic countries provide much weaker creditor protection than Protestant countries. Interestingly, La Porta et al., in a much less frequently cited paper than their papers on investor protection, find a strong link between trust within a society, i.e. how much citizens of a society trust complete strangers, and economic outcomes (see also Chapter 6).<sup>26</sup>

Similarly to legal origin, culture is also fairly static across time. However, Marco Pagano and Paolo Volpin argue that politicians can change laws and can also improve the enforcement of existing laws if enforcement in the past has been low.<sup>27</sup> Hence, changes in governments as well as more general changes in the political system are able to explain changes over time across countries.

Steve Bank, Brian Cheffins and Marc Goergen test Roe's proposition that corporate governance characteristics can be explained by the political orientation of a country's government.<sup>28</sup> They use the dividend payouts of UK listed firms as a measure of corporate governance. Their period of study is 1949 to 2002, a period characterised by successive changes in the political orientation of the government. Bank et al. argue that, if Roe's theory is correct, dividends should have been higher during Conservative governments and lower during Labour governments. However, they do not find any such evidence.

There has also been criticism of the simple version of the VOC literature which is based on only two types of capitalist systems, i.e. liberal market economies or LMEs and coordinated market economies or CMEs. For example, Bruno Amable<sup>29</sup> as well as Mark Harcourt and Geoffrey Wood<sup>30</sup> argues that this bipolar taxonomy fails to account for the distinct character of the Rhineland economies of Continental Europe, the Nordic social democracies and the economies of Southern Europe (see also Section 10.3 of Chapter 10). Hence, Bruno Amable proposes, in addition to the fairly homogeneous group of LMEs, three distinct types of CMEs. These are the social democratic economies of Denmark, Finland and Sweden, the Southern European economies of Greece, Italy, Portugal and Spain, and Continental European capitalism found in Austria, Belgium, France and Germany.

## 4.8 Conclusions

The rise  
of global  
capitalism

While the last few decades have seen major political, economic and technological upheavals on a global level, giving rise to global capitalism, national systems of corporate governance and capitalism nevertheless are still characterised by a series of idiosyncrasies. This chapter has reviewed the various taxonomies of national systems that have been proposed by business historians, as well as financial, legal and management scholars.

The first attempts at categorising national corporate governance systems were grounded in historic analysis and were made by John Hicks and Alfred Chandler Jr.

First attempts at categorising corporate governance systems

Hicks distinguished between market-based capitalism and bank-based capitalism. A more recent attempt by Julian Franks and Colin Mayer distinguishes between insider and outsider systems of corporate governance. In insider systems, stock markets are relatively underdeveloped, corporate control is highly concentrated and badly performing managers are disciplined by the large shareholder. In outsider systems, organised capital markets are highly developed, most companies are listed on the stock market and have dispersed ownership and control and managerial disciplining is done via the market for corporate control.

Path dependence

Lucian Bebchuk and Mark Roe have formalised the way history shapes current corporate governance via their concept of path dependence. They distinguish between structure-driven path dependence and rule-driven path dependence. Structure-driven path dependence relates to how the original structures of a country have influenced its current structures. Rule-driven path dependence refers to how current regulation was influenced by the structures or economic actors that initially dominated the country's economy.

The law and finance literature and the hierarchy of corporate governance systems

A new strand of the academic literature is the so-called law and finance literature. This literature proposes taxonomies based on legal families (La Porta et al.) and political determinants, i.e. the country's way of achieving social peace and the government's political orientation (Mark Roe) as well as the type of electoral system (Marco Pagano and Paolo Volpin). At the core of most of the taxonomies originating from the law and finance literature is the premise that highly flexible and liquid markets, such as capital markets and labour markets, are better at allocating resources than other mechanisms, such as informal networks and governments. According to this school of thought, corporate governance systems, which put in place regulation that facilitates rather than constrains the operation of markets, are superior to those that do not.

The VOC literature and the concept of complementarities

In contrast, the varieties of capitalism (VOC) literature is based on the notion of complementarities. This notion implies that very different sets of institutional arrangements may generate similar levels of economic growth and output. Importantly, the VOC literature does not assume that well-developed capital markets and weak employee rights are the only way of achieving strong economic growth.

## 4.9 Discussion questions

- 1 Compare the assumptions and the predictions of the varieties of capitalism (VOC) literature with those of the law and finance literature.
- 2 Critically review the La Porta et al. (1997, 1998) taxonomy of corporate governance systems in the light of recent corporate scandals and academic research.

## Notes on the chapter

- 1 Berle, A. and G. Means (1932), *The Modern Corporation and Private Property*, New York: Macmillan.
- 2 Dore, R. (2000), *Stock Market Capitalism: Welfare Capitalism. Japan and German versus the Anglo-Saxons*, Oxford: Oxford University Press.

- 3 Vickers, J. and G. Yarrow (1988), *Privatization. An Economic Analysis*, Cambridge (MA): The MIT Press. See also Useem, M. (1990), 'Business and politics in the United States and United Kingdom', in S. Zukin and P. DiMaggio, *Structures of Capitalism*, Cambridge: Cambridge University Press.
- 4 Visser, J. (2006), 'Union membership statistics in 24 countries', *Monthly Labor Review* 1, 38–49.
- 5 See note 3.
- 6 Ezzamel, M., Xiao, J.Z. and A. Pan (2007), 'Political ideology and accounting regulation in China', *Accounting, Organizations and Society* 32, 669–700.
- 7 Hicks, J. (1969), *A Theory of Economic History*, Oxford: Clarendon Press. Chandler, Alfred D., Jr (1977), *The Visible Hand: The Managerial Revolution in American Business*, Cambridge, MA: The Belknap Press of Harvard University Press. Chandler, Alfred D., Jr (1984), 'The emergence of managerial capitalism', *Business History Review* 58, 473–503.
- 8 Mayer, C. (1988), 'New issues in corporate finance', *European Economic Review* 32, 1167–1189.
- 9 Roe, M.J. (1994), *Strong Managers. Weak Owners. The Political roots of American Corporate Finance*. Princeton: Princeton University Press.
- 10 Diamond, D.W. (1984), 'Financial intermediation and delegated monitoring', *Review of Economic Studies* 51, 393–414.
- 11 Allen, F. and D. Gale (2000), *Comparing Financial Systems*, Cambridge, MA: MIT Press.
- 12 Franks, J. and C. Mayer (2001), 'Ownership and control of German corporations', *Review of Financial Studies* 14, 943–977.
- 13 Bebchuk, L. and M. Roe (1999), 'A theory of path dependence in corporate governance and ownership', *Stanford Law Review* 53, 127–170.
- 14 See e.g. La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and R. Vishny (1997), 'Legal determinants of external finance', *Journal of Finance* 52, 1131–1150. La Porta, R., Lopez de-Silanes, F., Shleifer, A. and R. Vishny (1998), 'Law and finance', *Journal of Political Economy* 106, 1113–1155.
- 15 There is also an updated version of the La Porta et al. study which covers 72 countries (Djankov, S., La Porta, R., Lopez-de-Silanes, F. and A. Shleifer, 'The law and economics of self-dealing', *Journal of Financial Economics* 88, 430–465). However, this study no longer includes the measure for creditor protection.
- 16 Roe, M.J. (2003), *The Political Determinants of Corporate Governance*, Oxford: Oxford University Press.
- 17 Pagano, M. and P. Volpin (2005), 'The political economy of corporate governance', *American Economic Review* 95, 1005–1030.
- 18 Hall, P.A. and D. Soskice (2001), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, Oxford: Oxford University Press.
- 19 Strictly speaking, Hall and Soskice's work is the culmination of a tradition of work by Dore and by Lincoln and Kalleberg advocating a more stakeholder-oriented approach to corporate governance. In contrast to Hall and Soskice, Dore, Lincoln and Kalleberg argue that more stakeholder-oriented varieties of capitalism are superior to other varieties. In part, their view as to the superiority of stakeholder-based systems is based on the better economic performance of Germany and Japan relative to the UK and the USA in the 1980s. See e.g. Dore, R. (2000), *Stock Market Capitalism: Welfare Capitalism*, Cambridge: Cambridge University Press; and Lincoln, J. and A. Kalleberg (1990), *Culture, Control and Commitment: A Study of Work Organization in the United States and Japan*, Cambridge: Cambridge University Press.
- 20 Pagano, M. and P. Volpin (2001), 'The political economy of finance', *Oxford Review of Economic Policy* 17, 502–519.
- 21 Graff, M. (2008), 'Law and finance: common law and civil law countries compared: an empirical critique', *Economica* 75, 60–83.



- 22 Spamann, H. (2008), 'Law and finance revisited', *Harvard Law School John M. Olin Center Discussion Paper No. 12*.
- 23 Licht, A., Goldschmidt, C. and S. Schwartz (2005), 'Culture, law, and corporate governance', *International Review of Law and Economics* 25, 229–255.
- 24 Franks, J., Mayer, C. and S. Rossi (2009), 'Ownership: evolution and regulation', *Review of Financial Studies* 22, 4009–4056.
- 25 Stulz, R. and R. Williamson (2003), 'Culture, openness, and finance', *Journal of Financial Economics* 70, 313–349.
- 26 La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and R. Vishny (1997), 'Trust in large organizations', *American Economic Review* 87, 333–338.
- 27 See note 17.
- 28 Bank, S., Cheffins, B. and M. Goergen (2009), 'Dividends and politics', *European Journal of Political Economy* 25, 208–224.
- 29 Amable, B. (2003), *The Diversity of Modern Capitalism*, Oxford: Oxford University Press.
- 30 Harcourt, M. and G. Wood (2003), 'Under what circumstances do social accords work?', *Journal of Economic Issues* 37, 747–767.

## Reading list

### Key reading

- Andres, C., Betzer, A., Goergen, M. and D. Metzger (2010), 'Corporate governance systems' in H. Kent Baker and Ronald Anderson (eds), *Corporate Governance. Companions to Finance Series. Kolb Series in Finance*, New York: John Wiley, Chapter 3.
- Franks, J., Mayer, C. and S. Rossi (2009), 'Ownership: evolution and regulation', *Review of Financial Studies* 22, 4009–4056.
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- Pagano, M. and P. Volpin (2005), 'The political economy of corporate governance', *American Economic Review* 95, 1005–1030.
- Spamann, H. (2008), 'Law and finance revisited', Harvard Law School John M. Olin Center Discussion Paper No. 12.

### Further reading

- Chandler, Alfred D., Jr (1977), *The Visible Hand: The Managerial Revolution in American Business*, Cambridge, MA: The Belknap Press of Harvard University Press.
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- Goergen, M. (2007), 'What do we know about different systems of corporate governance?', *Journal of Corporate Law Studies* 8, 1–15.

- Hall, P.A. and D. Soskice (2001), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, Oxford: Oxford University Press.
- Price, R. and G. Bain (1983), 'Union growth in Britain: retrospect and prospect', *British Journal of Industrial Relations* 21, 46–68.
- Roe, M.J. (2003), *The Political Determinants of Corporate Governance*, Oxford: Oxford University Press.

*Additional resources*

Andrei Shleifer's website at Harvard Business School contains most of the data, including data on their antidirector rights index, used in the La Porta et al. studies. The data on offer also include indices on politics and electoral systems.

<http://www.economics.harvard.edu/faculty/shleifer>