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INTERNATIONAL FINANCE REVIEW
VOLUME 9

INSTITUTIONAL APPROACH TO GLOBAL CORPORATE GOVERNANCE: BUSINESS SYSTEMS AND BEYOND

J. JAY CHOI
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Editors

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INTERNATIONAL FINANCE REVIEW

Series Editor: J. Jay Choi

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JAI

United Kingdom – North America – Japan
India – Malaysia – China

JAI Press is an imprint of Emerald Group Publishing Limited
Howard House, Wagon Lane, Bingley BD16 1WA, UK

First edition 2008

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

ISBN: 978-1-84855-320-0
ISSN: 1569-3767 (Series)

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PART I
AN OVERVIEW – CORPORATE GOVERNANCE AND GLOBAL CONTEXT

PROBING CORPORATE GOVERNANCE GLOBALLY: IMPACTS OF BUSINESS SYSTEMS AND BEYOND

Raj Aggarwal, Jongmoo Jay Choi and Sandra Dow

ABSTRACT

Effective mechanisms for corporate governance are essential for market-based economic systems. This chapter addresses the necessity of corporate governance research to address the competing goals of various stakeholders in the firm: managers, suppliers of financial capital, and other stakeholders. The review of literature reveals that firm-level complexity, as well as diversity of national business systems, are important for understanding corporate governance practices and regulations around the world.

1. INTRODUCTION

Effective mechanisms for corporate governance are essential for market-based economic systems. Failures in corporate governance have been well publicized and spectacular (Enron in the US and Parmalat in Italy,

Institutional Approach to Global Corporate Governance: Business Systems and Beyond
International Finance Review, Volume 9, 3–31

ISSN: 1569-3767/doi:10.1016/S1569-3767(08)09001-8

for example). Deficient governance has been partly blamed for the Asian crisis as well as the current US mortgage lending catastrophe. In recognition of this, reforms of corporate governance have been implemented at both country and firm levels. At a country level, strong corporate governance has been linked to economic growth and development (Morck, Wolfenzon, & Yeung, 2005; Rajan & Zingales, 1998). Fazio and Talamo (this volume) study how investor protection, administrative openness, and the quality of institutions enhance a country's ability to attract foreign direct investment (FDI) inflows.

At a firm level, modern governance research has led to a redefinition of the boundaries of the firm to include a wider group of stakeholders beyond simply the suppliers of financial capital: Shleifer and Vishny (1997) asked "how do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects?" (Shleifer & Vishny, 1997, p. 737). While this view might have been workable in the US (especially in the past predating Enron, Worldcom, and the like), it was hardly acceptable in countries which embraced wider stakeholder models. Uchida, Udell, and Yamori (this volume) examine lending practices by Japanese banks to small and medium enterprises. These firms do not face the typical owner/manager conflicts but the authors stress the importance of "owner/manager" monitoring to prevent private benefit consumption to the detriment of a broader range of stakeholders – creditors, employees, customers, and suppliers.

The same point is made by Allen (2005) who argues that the broader view of governance which "is concerned with ensuring that firms are run in such a way that society's resources are used efficiently" (Allen, 2005, p. 165) is more appropriate when markets are neither perfect nor complete. This distinction is more than a simple way of categorizing the debate over "who is governance for?" The perspective itself is a consequence of societal norms and reflects the fact that all corporations are required to obtain social permission for their operations in their charters. Allen reports the results of a survey carried out by Yoshimori (1995) who asked managers in Japan, the US, the UK, Germany, and France; to choose between the following statements (a) a company exists for the interest of all stakeholders or (b) shareholder interest should be given the first priority.[1] Only in the UK and the US were shareholder interests overwhelmingly selected over those of other stakeholders. Chang (this volume) stresses the relevance of the enlarged stakeholder approach citing, for example, the necessity for firms to routinely address the corporate social responsibility concerns raised by activists. From a different perspective, de Jonge (this volume) discusses the obstacles to developing international corporate social responsibility standards. The benefit of considering stakeholders is emphasized by Turnbull (this volume) who examines changes in corporate governance in a start-up Australian firm. By allowing directors to bypass management and obtain information about the firm from its stakeholders, outside investors received assurances of quality governance. Consequently, the firm was able to attract US equity investors which it otherwise would not have been able to do.

Aguilera and Jackson (2003) contend that the diversity of practices around the world has made precise definition of corporate governance nearly impossible. They see the challenge in corporate governance research as one of conceptualizing cross-national diversity and identifying the key factors explaining these differences (Aguilera & Jackson, 2003, p. 447). Many would argue that the legal tradition approach developed by La Porta and his colleagues (LLSV) succeeds in doing this, while some of the newer work in corporate governance contends that LLSV over-simplify the distinctions across countries. Increasingly, attention has been directed toward not only the law but other proximate institutions that shape national business systems. Whitley (1992) observes that such institutions are "often a product of the industrialization and political processes" (Whitley, 1992, p. 19). Indeed, historical analysis suggests that legal protection of shareholders is frequently a consequence of historical crises which provoke fundamental changes in institutional context (Frentrop, 2003; Roe, 2000; Roe, 2006). These forces affect various aspects of national business systems resulting in variations in their integration and cohesion. Global differences in not only law, but in other background institutions broadly defined to include culture, business systems, and so forth as well as specific governmental and non-governmental institutions, are being investigated as likely determinants of corporate governance regulation and outcome. Pagano and Volpin (2005) are insightful in linking law and economics arguing that laws result from political processes which in turn respond to economic interests: "... legal rules and economic outcomes are jointly determined, politics being the link between them" (Pagano & Volpin, 2005, p. 1005).

Taking the argument a step further, one might wonder to what extent the media adds to the bridge between law, politics, and economics. Studies have only just begun to explore the role of the media in corporate governance. For example, Holmen and Knopf (2004) show that media pressures substitute for weak corporate governance in Sweden. In the US, Farrell and Whidbee (2002) find that media can pressure poorly performing CEOs to resign. Dyck, Volchkova, and Zingales (2008) study coverage in the western press and corporate governance violations in Russia and determine that coverage can result in reversals of corporate governance violation. It has been shown that media coverage of board ineffectiveness prompts corrective action (Joe, Henock, & Robinson, 2008). Others (Johnson, Ellstrand, Dalton, & Dalton, 2005) find that press coverage alone is sufficient to create abnormal returns for investors. They observe that both favourable and unfavourable published ratings of the board of directors leads to abnormal stock returns. Similarly, Dyck, Morse, and Zingales (2007) examine the origin of media coverage of firm scandal and find that it most frequently comes from employees (whistle blowers) – those with the least invested (monetarily) but the most to lose (their jobs). Core, Guay, and Larcker (2008) find that executive compensation is not affected by negative publicity – pay is not reduced and the CEO is not removed. They do not therefore attribute monitoring role to the press.

In this chapter we provide an overview of some of the recent developments in corporate governance research. We contend that corporate governance is generally concerned with internal and external mechanisms that ensure that insiders, such as mangers, owners, and those that influence them, reflect economic interests and other appropriate goals of other stakeholders. While this working definition may not be entirely satisfactory to all corporate governance scholars, it provides a rough and broad working definition for the purposes of organizing the wide range of literature on corporate governance surveyed in this chapter. One implication of this simple definition of corporate governance is that governance issues can be understood by recognizing a hierarchy of influence and control over the resources of a firm with managers being at the top, followed by suppliers of capital such as majority owners, minority owners, and debt holders; followed by other stakeholders such as employees, customers, suppliers, and communities. Each category of stakeholder faces challenges to its interests from those in other categories. The board, in principle, monitors, counsels, and interacts with all stakeholders, not just managers as in the US stockholder model. Corporate governance systems must address the complex web of often competing stakeholder claims on a firm's assets taking into account social, political, and legal environments faced by a firm.

Literature surveys have helped researchers keep pace with the field. Some of these include: Denis and McConnell (2003), Gillan (2006), and Shleifer and Vishny (1997). Surveys of specific corporate governance mechanisms have also provided useful springboards for future investigation such as the review of boards by Finegold, Benson, and Hecht (2007) and Hermalin and Weisbach (2003); the effectiveness of executive compensation by, Core, Guay, and Larcker (2003), Devers, Cannella, Reilly, and Yoder (2007), and Williams, Michael, and Waller (2008); ownership structure by Holderness (2003); and the market for corporate control by Andrade, Mitchell, and Stafford (2001) and Holmstrom and Kaplan (2001). In addition meta analyses synthesizing prior empirical research provides good summaries of empirical work: on ownership structure (Dalton, Daily, Certo, & Roengpitya, 2003; Sánchez-Ballesta & García-Meca, 2007); on board characteristics (Dalton & Daily, 1998; Dalton, Daily, Ellstrand, & Johnson, 1998; Dalton, Daily, Johnson, & Ellstrand, 1999); and pay-for-performance (Daily & Dalton, 2002; Tosi, Werner, Katz, & Gomez-Mejia, 2000).

2. INTERNAL GOVERNANCE MECHANISMS

2.1. US Boards Post-Enron

What constitutes a "better board"? The answer should be straightforward: "better" boards improve firm value by making better decisions. This leads to a more specific set of questions. How do we identify a better board? Does it have greater outside representation? Is it a large board or a small board? Do directors hold equity in the company? Do directors hold multiple appointments? Do directors possess adequate financial knowledge to make decisions? In fact, we might generally ask if any of these board characteristics matter and if so under what conditions? If recent US regulation (Sarbanes-Oxley 2002 and more stringent listing requirements imposed by the NYSE in conjunction with the SEC) is any indication, better boards are larger, more independent, and directors do not hold multiple board appointments. Equity-based compensation for directors should further align their interests with those of shareholders.

Not only has the post-Enron post-SOX regulatory environment undergone change in the US, it appears the "culture" of the board has similarly shifted. Thomas and Cotter (2007) examine recent data and discover that US boards are more likely to entertain and support shareholder proposals to improve corporate governance (such as removal of anti-takeover measures) under Rule 14a-8 than was the case in the past.

Recent work by Chen, Goldstein, and Jiang (2008) examines director ownership in the US mutual fund industry. They argue that directors of mutual funds, unlike their corporate counterparts, have a much greater responsibility to monitor. This monitoring requirement and thus the incentive to monitor (director ownership) varies according to the fund characteristics. Funds with a sophisticated investor clientele require less monitoring; funds with riskier assets and/or greater information asymmetry problems require more active monitoring by directors; and funds which are actively managed similarly require greater director oversight. Their empirical evidence is consistent with this prediction. In a broader sense, it underscores the necessity of considering firm-specific variables in designing the optimal board configuration.

However, Finegold et al. (2007) find that most of the new legislative requirements are not supported by prior empirical evidence. Wintoki (2007) examines the wealth effects surrounding adoption of SOX and concludes that older and larger firms benefited but smaller firms with high growth opportunities did not. He concludes that SOX is heavy-handed in imposing "one size fits all" boards. Gillan and Martin (2007) analyse Enron and conclude that increasing board independence would not have prevented the Enron catastrophe. This finding is consistent with most pre-Enron research that did not confirm the importance of many board characteristics.

In fact, most research finds no relationship between board independence and firm performance for US firms (Dalton & Daily, 1998; Denis & McConnell, 2003; Hermalin & Weisbach, 2003); although smaller boards seemed to positively impact firm value (Dalton & Daily, 1998; Denis & McConnell, 2003; Yermack, 1996). A study of the mutual fund industry by DelGuercio, Dann, and Partch (2003) concludes that funds with smaller boards and greater director independence are more efficiently managed. Huson, Malatesta, and Parrino (2004) examine firm performance following CEO turnover and find improvement for firms with outside dominated boards and significant institutional ownership. Also the appointment of a new outside CEO is significantly associated with enhanced firm value. Yet the new legislative environment seems to mandate larger boards if they are to fulfil their independence quota on board sub-committees. Would these two not work against one another? Chhaochharia and Grinstein (2007a) note that following SOX, both board size and board independence increased, especially for large firms. Related work (Chhaochharia & Grinstein, 2007b) finds that increased board independence positively affects firm value, although not for smaller firms. This they attribute to the costs of board reorganization being greater for small firms as compared to larger ones. In contrast to the evidence regarding board independence which seems inconclusive despite its conceptual appeal for US firms, there is evidence that broader background and expertise of the board may positively affect firm performance. Xie, Davidson, and DaDalt (2003) find less earnings manipulation in firms when directors have sophisticated corporate or financial backgrounds. Defond, Hann, and Hu (2005) show that the market values the financial expertise of the audit committees of the board of directors.

As for the number of board appointments, Fich and Shivdasani (2006) report that performance is poorer in firms with outside directors holding more than three appointments. However, this contrasts with evidence provided by Harris and Shimizu (2004) who find that boards with directors holding multiple appointments tend to make superior acquisition decisions; Ferris, Jagannathan, and Pritchard (2003) who find positive effects of multiple board appointments, perhaps due to their experience and expertise of such directors; and Perry and Peyer (2005) who find that executives taking board appointments in other firms positively impacts value, although Conyon and Read (2006) develop a model which contradicts this. At the same time there are risks associated with multiple board appointments that should not be ignored. If class-actions are taken against a director sitting on another board, Fich and Shivdasani (2007) report a positive increase in firm value upon departure suggesting the importance of reputational considerations for board members. Joe et al. (2008) study the impact of negative media attention on board effectiveness. This attention typically forces the firm to take corrective actions. When CalPERS names firms for poor corporate governance, Wu (2004) finds that named inside directors are unlikely to sit on other boards.

Two studies in the present volume address board characteristics. Chakraborty and Sheikh report that smaller boards and boards with institutional investors are more likely to replace a poorly performing CEO. Their data are drawn from 1994 to 1999, the pre-Enron era. As outsiders, institutional investors exert a positive impact upon corporate governance. Upadhyay examines board size and finds that larger boards exhibit a positive impact on firm performance. He also argues that the post-Enron board demands greater expertise, sophistication, and time commitment from its directors.

2.2. International Evidence on the Board of Directors

Denis and McConnell (2003) summarize international evidence on board structure and effectiveness noting that the number of studies is relatively small. Outside directors generally have a favourable impact on performance while board size is negatively associated with performance. Newer contributions support their findings for the most part. For example, Oxelheim and Randoy (2003) find in their sample of Swedish and Norwegian firms that the appointment of an Anglo-American outside director is associated with higher Tobin's Q. Choi, Park, and Too (2007) document that outside directors instituted as a part of corporate reform in Korea have significant and positive impacts on firm performance during the aftermath of the Asian financial crisis. The fact that the positive impact of an independent board is found during the time of major changes in their study is consistent with Daily (1996) and Chatterjee, Harrison, and Bergh (2003) who report positive impacts of independent boards for US firms during the time of bankruptcies and takeovers.

Dahya, Dimitrov, and McConnell (2008) survey 22 countries and conclude that outsiders on the board positively impact performance especially in countries with weak corporate governance. Fauver and Fuerst (2006) find positive benefits to including labour representation on boards in Germany. Outsiders on UK boards positively impact value in the UK (Dahya & McConnell, 2007). Conflicting evidence for the UK, however, calls into question their findings. Guest (2008) argues that the monitoring function of boards in the UK is less important than in the US.

Some of the most recent contributions regarding board characteristics and firm value go substantially beyond the question of size or proportion of outsiders. Coles, Daniel, and Naveen (2008), for example, explicitly recognize the complexity of the firm as an important factor in determining the relationship between board characteristics and firm performance. They contend as a result that one size (or composition) does not fit all. They find a U-shaped relationship between board size and Q. Boards can become entrenched through staggered boards, which depresses firm value (Bebchuk & Cohen, 2005). Larger boards are more philanthropic (Brown, Helland, & Smith, 2006). However firm value is unaffected when director compensation is tied to firm performance (Mason, Chun-Keung, & Ashok, 2001).

2.3. Pay-for-Performance for US Firms

A number of studies (Hermalin, 2005) find that CEO pay has increased in recent years. Bebchuk and co-authors (Bebchuk, 2005; Bebchuk & Fried, 2005) document a significant rise in executive pay since 1993. They examine publicly traded US firms with market capitalization in excess of $50 million. Between 1993 and 2003 the top five executives of these firms were paid a total of $351 billion of which $192 billion was paid out between 1997 and 2003 (amounts stated in constant 2002 dollars). They add that the commonly used databases such as ExecuComp understate the true level of executive pay by ignoring the substantial retirement benefits contained in executive compensation contracts. They conclude that cutting pay without harming managerial incentives can substantially increase firm earnings.

Core et al. (2003) define an efficient executive compensation contract as "... one that maximizes the net expected economic value to shareholders after transactions costs (such as contracting costs) and payments to employees. An equivalent way of saying this is that we assume that contracts minimize agency costs" (p. 27). They review literature on CEO equity incentive compensation. Key findings are as follows:

(i) The complexity of the firm and its operating environment, the firm's growth opportunities, and the the size of the firm, positively impact executive compensation. These factors evolve over time and explain why firms make new grants of stock-based compensation. Moreover, recognition of the potential for such shifts indicates that stock options are included in the compensation package to discourage managers from becoming entrenched and avoiding riskier projects;
(ii) Tax implications of compensation are important. If future corporate taxes are expected to be high then there is an advantage to defer compensation. Empirical evidence finds that the use of stock options is greater among firms with lower tax rates;
(iii) There is no consensus that executive compensation is related to the wealth level of the CEO; and
(iv) Stock option repricing is not common and when it occurs there is conflicting evidence regarding whether or not the repricing is related to governance problems.

Another review by Williams et al. (2008) affirms the positive size effect in compensation contracts as well as positive pay–performance sensitivity, particularly when contracts include options-based pay. Almazan and Suarez (2003) model compensation demonstrating under what conditions shareholder wealth is enhanced by managerial entrenchment and golden parachutes. Recent work on executive compensation finds that acquiring firm CEO pay loses its pay–performance sensitivity following a merger when corporate governance is weak. Cornett, Marcus, and Tehranian (2008) examine incentive compensation, earnings management, and performance. When earnings management is factored in, the pay–performance relationship is significantly diminished. Support for this is also found in Goldman and Slezak (2006). In firms with weak governance, incentive compensation reduces the incidence of tax sheltering (Desai & Dharmapala, 2006).

Maisondieu-Laforge, Kim, and Kim (this volume) examine firms which changed the compensation contracts of CEOs to increase incentive compensation. They find that these new contracts substantially increased shareholder wealth.

The mix of executive compensation between salary, shares, and stock options may also influence firm value. For example, up to a certain limit, stock options align managerial and owner interests. However, above a threshold level, excessive executive holdings of stock options may lead to excessive risk taking that reduces firm value as options become more valuable with increasing risk of the underlying share price of the firm (Carpenter, 1999).

2.4. International Evidence on Executive Compensation

There is limited non-US evidence on executive compensation. The design of the appropriate executive compensation arrangement will depend not only on country-specific environmental variables but also on firm-specific characteristics, the degree of monitoring required, and other mechanisms such as board oversight that are employed to constrain managerial or major owner (e.g., family) self-dealing. The international study of this issue is further complicated by extensive cross-holdings of shares by other corporate members of the business family or corporate business group (e.g., the Keiretsu or Chaebol).

Denis and McConnell (2003) note that studies of executive compensation are far fewer at the international level. It seems that pay–performance sensitivity is observed most often in conjunction with the presence of a significant blockholder. In large part this is due to the fact that the pressing agency problem is not managerial self-dealing but rather self-dealing by powerful owners. Moreover, in many countries equity markets are not well developed which limits the usefulness of incentive compensation (Denis and McConnell, 2003). Nevertheless, managerial (as well as major owner) agency problems are not absent outside the Anglo-Saxon context. In Japan, for example, Morck and Nakamura (2005) suggest the presence of significant managerial agency issues. Kato, Lemmon, Luo, and Schallheim (2005) study incentive compensation in Japan and find a positive relationship between firm performance and incentive compensation. Canadian evidence by Dow and McGuire (this volume) document lower pay–performance sensitivity for Canadian firms cross-listed in the US, relative to their US counterparts.

3. EXTERNAL GOVERNANCE MECHANISMS

3.1. Ownership Structure

At the core of the original corporate governance problem is the separation of ownership and control, first recognized by Berle and Means (1932) and later developed by Jensen and Meckling (1976) into a formal agency cost theory of the firm. Holderness (2003) contends that the evolution of securities law in the U.S. since the 1930s has been based on protecting diffuse shareholders from self-serving managers. It was not until the mid-eighties that researchers in the US began to recognize that equity was commonly concentrated in the hands of managers or other significant blockholders. Nonetheless, diffuse ownership remains the norm in the US, the UK, and many other Anglo-Saxon countries. Enriques and Volpin (2007) gather ownership statistics from published studies: all of the largest publicly traded firms in the UK are widely held while 80% of US firms are widely held. These figures are in sharp contrast to what is reported for Italy (20%), Germany (50%), or France (60%). Moreover, in these three countries both family ownership and pyramidal ownership structures are common.

Early studies of ownership structure distinguished between inside and outside ownership blocks. While inside ownership can be viewed as an incentive to align managers' (and directors') interests with those of shareholders, external blockholders can fulfil either an oversight function or pursue private benefits of control. In summarizing the evidence relating firm value to ownership concentration, Holderness (2003) concludes that US evidence shows (i) no consensus on whether the impact of blockholdings on firm value is positive or negative; (ii) no indication that the effect is economically significant (in either direction); and (iii) there is debate over the direction of causality: between firm value and concentrated ownership. Overall he concludes that "... small shareholders and regulators have little reason to fear large percentage shareholders in general, especially when a large shareholder is active in firm management" (Holderness, 2003, p. 60). This perspective is supported by meta-analysis conducted by Dalton et al. (2003) who find that ownership concentration does not affect firm performance.

More recent evidence reviewed by Gillan (2006) illustrates the evolution of the literature in considering the identity of the blockholder as important in discerning the relationship between block ownership and firm value. He cites work by Hartzel and Starks (2003) which shows that institutional ownership appears to fulfil a monitoring role in regard to executive compensation. Chung, Firth, and Kim (2002) find evidence of monitoring by institutional investors in their study of earnings management. Earnings management is less likely in firms with significant institutional ownership.

Further refinement of the identity of the institutional blockholder followed. Woidtke (2002) demonstrates the importance of considering the identity of the institutional investor arguing that their interests should not be assumed to be homogeneous. She reports that Tobin's Q is positively related to ownership by private pension funds but that there is a negative relationship between ownership by activist pension funds such as CalPERS and firm value. Another study by Nelson (2006) disputes the continued importance of the CalPERS effect, while English, Smythe, and McNeil (2004) determine that favourable CalPERS effects are short-lived.

Gaspar and Massa (2007) find that local institutional investors positively impact the quality of corporate governance. They attribute this to local mutual fund managers being better informed about the firm's activity and its economic environment. They further suggest that one of the advantages enjoyed by local owners derives from their social interactions with local managers. However, this creates a set of better-informed institutional investors (versus non-local investors) who can trade on their private information. Consequently uninformed investors are disadvantaged which reduces the liquidity of the firm's shares. This can explain the lack of significance in the ownership–value relationship. While informed owners positively affect governance and hence firm value, this effect is offset by worsened liquidity due to the presence of uninformed investors which depresses firm value.

Equity ownership by managers is supposed to align managerial-shareholder interests. Yet there is evidence to suggest that managers become entrenched, favouring consumption of private benefits over the interests of shareholders. There is empirical evidence supporting both viewpoints. Holderness (2003) concludes that external blockholders monitor executive compensation and insiders do not use their position to extract higher compensation. Core and Larcker (2002) provide evidence consistent with the incentive effects of managerial equity ownership. Stulz (1988) develops a theoretical model to explain both incentive and entrenchment effects of managerial ownership. In this model, when managers reach a critical ownership level they become risk-averse and adopt strategies contrary to the interests of other shareholders.

However, recent empirical work highlights how managerial entrenchment may manifest itself. Lasfer (2006) finds greater inside ownership leads to poorer corporate governance. Harford, Mansi, and Maxwell (2008) conclude that managers of poorly governed firms tend to spend cash quickly through acquisition activity and stock repurchases. Although low inside ownership negatively affects firm value, firms with greater inside ownership hold more cash. They note this result runs counter to international evidence (Pinkowitz, Stulz, & Williamson, 2006). Cronqvist, Heyman, Nilsson, Svaleryd, and Vlachos (2008) report that entrenched managers pay their employees more, which results in less effort expended in wage negotiations and heightens the popularity of the manager. Both of these aspects can be viewed as private benefits consumed by the manager.

In summarizing international evidence on block ownership, Denis and McConnell (2003) begin by observing that regardless of the impact on firm value, block ownership is valued in the US. They cite evidence on block trades occurring at a premium, which indicates that investors value private benefits of control associated with significant ownership. However, they point out that the degree to which consumption of private benefits results in destruction of firm value is open to question.

Outside the US and the UK, investor protection is often poorer, and concentrated ownership is more common (La Porta, Lopez-De-Silanes, & Shleifer, 1999). While Denis and McConnell (2003) support the positive role of blockholder monitoring, this view is not unanimous. La Porta, Lopez-De-Silanes, Shleifer, and Vishny (2002) conclude that concentrated ownership depresses firm value when strong legal protection of minority owners is absent. Corroborating this is work by Claessens, Djankov, Fan, and Lang (2002), who find that firm value is positively influenced by the presence of blockholders in eight East Asian economies but when multiple voting rights accompany these shareholdings (which is usually the case as noted by Claessens, Djankov, & Lang, 2000), value is depressed. Faccio, Lang, and Young (2001) document concentrated ownership in both Europe and East Asia, and report that expropriation of minority shareholders occurs in the latter setting while higher dividends in Europe counter expropriation. Within Europe, Faccio and Lang (2002) find few variations in the separation of ownership and control. Significant owners have an incentive to monitor and to the extent this results in value maximization, both influential and minority owners reap benefits. Thus concentrated ownership can reduce managerial agency costs due to "blockholder governance."

Blockholder governance, however, might require additional blockholders to keep dominant owners in check. Maury and Pajuste (2005) find that multiple blockholders are positively associated with firm value. Laeven and

Levine (2008) investigate an even more subtle distinction between firms with a single blockholder versus multiple blockholders. In their sample of European firms they report that over one-third have more than one major blockholder, although this is less common in large firms. Firms with multiple blockholders who exhibit only a small deviation between cashflow and control rights have significantly higher valuations than do firms with a single significant blockholder. However, when multiple blockholders have a large dispersion of cashflow and control rights their firms have a significantly smaller valuation. Therefore, a critical element in determining ownership effects may be not only the number of multiple blockholders but also the extent to which cashflow rights diverge from control rights. In this volume Attig examines the effect of ticker symbol changes in Canada to make multiple voting rights more transparent, concluding that such additional disclosure is valued by investors.

International evidence has focused upon how concentrated family ownership blocks frequently result in pyramidal ownership of multiple firms loosely formed into business groups. In a recent review of business groups in emerging markets Khanna and Yafeh (2007) wonder whether they are "paragons" or "parasites." The answer to this question depends upon the level of investor protection at the country level as well as the type of business group (family-owned or not) and indeed their historical antecedents. Other work by Almeida and Wolfenzon (2006) view business groups in emerging markets as detrimental and call for their dismantling. Numerous studies have also examined the response of business groups to economic crisis (e.g., Bertrand, Mehta, & Mullainathan, 2002; Lemmon & Lins, 2003) concluding that expropriation of minority shareholder wealth is heightened during crisis. Conflicting evidence from Friedman, Johnson, and Mitton (2003) points to Asian firms being propped up by fellow group members during the crisis.

However, not all business groups are family dominated nor are they characterized by a significant blockholder. In Japan cross-shareholding between banks and firms is common (McGuire & Dow, 2003) although it may be diminishing in importance following regulatory change throughout the 1990s (Miyajima & Kuroki, 2007). Typically no single shareholder has a dominant ownership stake. A number of scholars suggest that Japanese business groups contributed to the length and degree of recession in Japan throughout the 1990s (e.g., Hoshi, 2006). Kim and Jung (this volume) demonstrate a positive role for bank monitoring in stronger economic times which subsequently dissipated when the Japanese economy fell into recession.

3.2. Market for Corporate Control

The market for corporate control is an important external governance mechanism in business systems where managerial agency problems are significant. Under-performance induces a market discipline in the form of the firm being acquired by or merged into another firm. The management of the target firm is often dismissed, albeit with an attractive severance package. The question is whether such mergers can create value for shareholders, and what the motivations are for an acquiring firm to undertake mergers and acquisitions.

Theoretically, the merger can create synergy between the target and acquiring firms by modifying the scale and scope of the firm (Bradley, Desai, & Kim, 1988). The survey of the literature by Andrade et al. (2001) indicates that short-term shareholder returns on the target have been about 16–24% for domestic acquisitions by US firms. However, gains for acquiring firms are not statistically different from zero. This raises the issue of why the bidding firm initiates acquisitions in the first place. In addition to synergy, acquisitions can take place due to hubris or self-interest of management. That is, management of the acquiring firm can be overconfident (Roll, 1986). Alternatively, acquisition enhances private benefits of management: as Jensen and Murphy (1990) note, managerial compensation and perquisite consumption may increase with an increase in firm size.

Still, given the possibility of these managerial mishaps, appropriate incentives should exist to entice management to act in the interest of shareholders rather than themselves. This type of agency cost is given prominence in the corporate diversification literature. Various authors report value destruction with respect to industrial diversification of US firms (see the survey by Martin & Sayrak, 2003). The discounts are attributed to the costs of agency and control. Denis, Denis, and Yost (2002) report similar value discount for internationally diversified US firms. However, such findings are disputed by Villalonga (2004) and others on methodological grounds, and are inconsistent with the mainstream international business literature which suggests the benefits of internalization and multinational networks. Reflecting these gains, the evidence on international acquisition is more positive than that on domestic acquisitions. Doukas and Travlos (1988) and Morck and Yeung (1992), for instance, find generally positive (not always statistically significant though) abnormal returns for US acquiring firms during the 1980s. Similarly, Harris and Ravenscraft (1991) report that foreign firms pay 10% more to US targets than do domestic acquirers. However, more recent studies by Seth, Song and Pettit (2000) and

Moeller and Schlingemann (2005) show less significant impact or even value discounts for internationally diversified firms relative to domestic firms.

3.3. Shareholder Protection and Legal Tradition

In Denis and McConnell (2003), international corporate governance research is categorized as "first-generation" research aimed at determining whether US style firm-level governance mechanisms were equally applicable outside the North American context. Their general conclusions were that both board characteristics as well as CEO pay–performance sensitivity were mostly consistent across countries, although they noted the scarcity of international studies. It seems, however, that the similarities stop there. The presence and impact of concentrated ownership on firm performance differs importantly in North America and the rest of the world. This observation led to international corporate governance studies which aimed to determine why the ownership-performance links were different around the world – enter the "second-generation" studies which focused on the legal protection framework developed by La Porta and his colleagues.

La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1997) initiated this stream of research by observing a strong relationship between the quality of investor protection and the extent of capital market development. In their view investors in common law countries enjoy stronger protection than those in civil law countries. Their subsequent analysis (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1998) demonstrates that ownership tends to be concentrated in countries with poor investor protection. La Porta et al. (2002) report higher valuation for firms in common law countries and that the greater firm valuation is the higher are the cashflow rights of the controlling owners.

Poor investor protection goes hand-in-hand with concentrated ownership, often business group or family dominated. In his investigation of family ownership in Europe, Maury (2006) finds that family ownership reduces managerial agency conflict but heightens the conflict between minority and majority owners. The benefits of family control are primarily present in countries with strong legal protection (see Anderson & Reeb, 2003, for US firms). Djankov, La Porta, Lopez-De-Silanes, and Shleifer (2003) examine enforcement more closely and conclude enforcement of investor protection is similarly poorer in civil law countries as compared to those of common law origin. Djankov, McLiesh, and Shleifer (2007) stress the importance of both legal origin and creditor rights to promoting credit markets in 129 countries. Hall and Jorgensen (this volume) finds that when creditor rights improve, firms respond by increasing leverage.

The legal protection lens has achieved paradigm status in the corporate governance literature. Pozen (2007) notes that "... La Porta and colleagues have been cited more times since 1997 than any other economists, and policymakers worldwide have been scouring their articles for usable insights" (Pozen, 2007, p. 1). Various authors use the LLSV framework as a springboard to examine other country-level variables useful to explaining cross-national differences in corporate governance. Licht, Goldschmidt, and Schwartz (2005) argue that the LLSV paradigm oversimplifies legal regimes. They find a correlation between the LLSV legal tradition with the "litigation" culture of a country. Cools (2005) finds that the investor protection indices of LLSV are correlated with a number of substitute mechanisms omitted by LLSV. When these factors are taken into consideration, there is no statistical difference between common law and civil law countries. Coffee (2001) challenges the legal protection paradigm by noting that despite weaker investor protection, countries in Europe have rapidly developed equity markets. He also contends that LLSV have it backwards: legal follows economic change and not the reverse. This coincides with Pagano and Volpin (2005) who view politics as an important link between the law and economic outcomes. They argue that politics respond to economic forces which in turn result in legislation. Their examination of electoral systems around the world reveals that proportional voting systems are negatively correlated with investor protection and positively correlated with employment protection. The electoral system variable subsumes the LLSV legal origin variable in regard to investor protection although it remains significant in relation to employment protection.

Despite recent criticisms, the LLSV legal protection framework has nonetheless afforded rich insight into the importance of investor protection and how this varies across countries. For example, Zattoni and Cuomo (2008) show that when codes of good governance are adopted in English legal origin countries, they impact corporate behaviour more so than in civil law countries. Newer research has sought to identify distinctions within and across legal traditions that might improve our understanding of differences in corporate governance regulation and outcome. For example, the US and the UK are often grouped as a monolith yet important differences exist between them: Guest (2008) compares board reform rules in the US and the UK. Although the legalities appear similar, in fact in the UK they are "guidelines" rather than legislated and many firms have opted not to adopt these measures. Similarly Dow and McGuire (this volume) discuss the Canadian context of governance guidelines rather than governance law. They find that Canadian firms which are cross-listed in the US continue to exhibit "made-in Canada" ownership effects which differ from their US counterparts. Reisberg (this volume) discusses changes in British law which allows a shareholder to bring action on behalf of his company. He concludes that these measures are unlikely to result in a rise in derivative claims, citing the discretionary power of the courts in allowing such claims; the high cost of pursuing claims; as well as other rules in place that prevent claims against directors for "ordinary negligence". His work shows the subtle differences in legal regimes in countries (the US and UK) that otherwise in the LLSV framework are considered quite similar.

The quality of enforcement is an important element of investor protection but it also poses significant challenges for cross-national studies of corporate governance. While cross-national studies of corporate governance typically account for an enforcement factor in corporate governance regulation, the necessity to use comparable data across countries can result in measures that do not accurately capture what it is we want to measure. In the UK, Guest (2008) reports that some firms do not comply with governance guidelines yet perform very well. Cheung and Jang (this volume) contrast adoption of OECD governance measures with survey results which asked fund managers to rank the quality of corporate governance in nine Asian economies. Their results are quite startling – the Philippines and China rank highest "on paper" – they have regulation on the books closest to the OECD guidelines, but investor perception of the quality of corporate governance places these two countries at the bottom of the list. Yet even with this ranking reversal we are missing something. One need only to look at the Chinese example to understand this point. Chinese corporate governance is weak, yet China has the fastest growing private sector in the world. Franklin, Jun, and Meijun (2005) attribute this to private companies depending upon relationships to overcome weak corporate governance at the country level. Holmen and Knopf (2004) find in Sweden that despite a situation ripe for expropriation of minority shareholder rights (dual class shares, pyramidal ownership, etc.), the incidence of expropriation of minority shareholder rights is limited. They conclude that extra-legal factors including the media are mitigating factors. Chirinko, vanEes, Garretsen, and Sterken (2004) examine corporate governance in the Netherlands. They do not find a link between performance and ownership, neither do they uncover linkages with the regulatory quality of markets – in fact, just the opposite – markets perform better when less regulated. In their study of Mexican firms, Bergman and

Nicolaievsky (2007) find corporate governance undertaken by private firms improves performance but that this is rarely the case for public firms. Dyck and Zingales (2004) examine private benefits of control around the world. They conclude that media and taxes are as important if not more so than legal protection and enforcement. The importance of extra-legal institutions is addressed by Boubakri, Guedhami, and Sy (this volume). They show that both legal and extra-legal factors are important checks on the ability of powerful shareholders to expropriate minority shareholder wealth.

4. BUSINESS SYSTEMS AND BEYOND

Our overview of recent developments in corporate governance research underscores firm-specific as well as national factors as relevant to understanding both regulation and outcome. At the firm level, Gompers, Ishii, and Metrick (2003) illustrate that better governed firms are worth more. International evidence (Durnev & Kim, 2005, and the LLSV studies) agrees with this. However, what constitutes appropriate regulation will differ across firms and across countries.

At the country level, the agency problems that corporate governance attempts to resolve are very different. Corporate governance regulation in the US has been designed to reduce the agency costs associated with the separation of ownership and control. Outside the US and UK, ownership is frequently concentrated and often coupled with divergent cashflow and control rights. Consequently the relevant agency problem becomes one of minority versus majority investors (Morck et al., 2005). Enriques and Volpin (2007) argue that the adoption of US style governance regulation in non-Anglo-Saxon contexts may be inappropriate. US rules attempt to curb self-dealing by managers but the problem outside of the US is more likely to be one of attenuating expropriation of minority shareholder wealth by powerful and influential owners. They suggest the US style rules may be ineffective in addressing these kinds of problems.

Cross-national research has shown that extra-legal institutions may be as important, if not more so, than formal regulation. Seemingly weak institutional arrangements are not necessarily inconsistent with economic growth. For example, many firms in emerging markets are organized in business groups. These business groups can substitute their own internal capital markets in the absence of well-functioning external markets. Friedman et al. (2003) report that powerful owners will prop up weaker distressed firms often through inter-group loans. This may partially explain why emerging markets have developed so rapidly despite their institutionally weak environment. Gopalan, Nanda, and Seru (2007) show that firms affiliated with Indian business groups support weaker members through intra-group loans to distressed members which reduce their bankruptcy probability. Consequently their access to external capital markets is enhanced.

Even with well-functioning capital markets differences exist in the quality of corporate governance. Ferris, Jandik, Lawless, and Makhija (2007) examine board characteristics and derivative lawsuits. They find that derivative lawsuits are more likely to occur (i.e., minority shareholders will press their rights) as the proportion of outsiders on the board increases. Similarly in a cross-national study, Dahya et al. (2008) find that the presence of a dominant shareholder on the board can mitigate weak investor protection at the country level. However, Doidge, Karolyi, and Stulz (2007) find that country-level variables far outweigh firm-level corporate governance rankings. Klapper and Love (2004) also find that weaker firm-level corporate governance occurs in countries with poor legal protection. In the same spirit, the emphasis on country-specific variables is acknowledged by Fauver, Houston, and Naranjo (2003) who conclude that "the optimal organizational structure and corporate governance may be very different for firms operating in emerging markets than they are for firms operating in more developed and internationally integrated countries."

Countries differ not only in formal regulation but also exhibit significant cultural heterogeneity. Guiso, Sapienza, and Zingales (2006) note the reluctance of scholars to consider the role of culture in economic outcomes. They ask to what extent culture influences institutions and vice versa. There are some newer efforts to examine how culture can affect economic outcomes which may prove useful in understanding divergences in corporate governance around the world. Aggarwal and Jiao (2008) show that international variations in social trust as measured by the World Values Survey is a substitute for the national quality of bank regulations and governance. Wong (this volume) argues for the importance of cultural context in addressing issues of global corporate governance. In particular culture may be useful in understanding why some powerful owners have a positive influence on firm value, while others engage in self-dealing to the detriment of minority investors. Cultural expectations regarding the ability and legitimacy of large shareholders to take advantage of their position may partially answer this question.

Large ownership blocks are associated with social prestige, as well as rights and responsibilities as part of the elite. Morck and Steier (2005) discuss the role played by families, often politically connected, in corporate governance around the world. Specific studies of the role of elites in corporate governance however are quite rare. Faccio, Masulis, and McConnell (2006) and Faccio (2006) find in an international study that politically connected firms are more likely to be bailed out by government when in financial distress and that firms in countries with relatively weak investor protection frequently had major shareholders and/or managers with current or former connections to government or powerful political parties. The influence of political elites in China is examined by Jiang (this volume) who provides the intriguing result that while overall the relationship between firm value and the political connections of the CEO in China is not significant, the relationship is stronger upon re-examination of the type of connection. Inherited connections depress firm value while developed connections are value enhancing.

5. CONCLUSIONS

Our discussion of recent developments in corporate governance research starts from the simple point that corporate governance is generally concerned with mechanisms that ensure that insiders and those who influence them reflect economic interests and other appropriate goals of other stakeholders. Our approach implies that governance issues can be understood by recognizing a hierarchy of influence and control over the resources of a firm with managers at the pinnacle, followed by suppliers of capital, followed by other stakeholders such as employees, customers, suppliers, and communities. The interests of each category of stakeholder compete with those in other categories. The board interacts with internal and external stakeholders, not just with management. Consequently, corporate governance systems must address the complex web of stakeholder claims on a firm's assets taking into account economic, political, social legal, and institutional environments faced by a firm.

It has been increasingly recognized that a ''one size fits all'' approach to corporate governance is not effective. Firms differ in their complexity and composition as do national environments. While some firms benefit from large boards with independent directors, smaller firms in less complicated industries probably function better with smaller boards. Similarly, evidence suggests that incentive compensation is more important in complex business environments.

Firm-level governance is important but research indicates that national context is the over-riding element in understanding corporate governance regulation and outcome in a global world. Comparative studies of corporate governance must consider the types of agency problems to be addressed. In the Anglo-Saxon context, corporate governance is designed to reduce the conflict of interest between owners and managers occasioned by the separation of ownership and control. Elsewhere, the relevant agency problem is more often the conflict between majority and minority shareholders. Others are concerned with the conflict between debt and equity holders and still others note the more general conflict between insiders and those who control corporate assets and other stakeholders. Several scholars have questioned whether the rush to adopt US style regulation outside of North America is appropriate to resolve these kinds of problems.

In this volume we take an institutional approach and stress the importance of national business systems, broadly defined to include culture, law, and politics, as relevant to assessing the efficacy of corporate governance regimes. Increasingly research has looked toward interconnections among managers, owners, and outside board members. Extra-legal institutions can alleviate or exacerbate agency conflicts. Political elites have been shown to result in "blockholder governance" in some settings while generating significant self-dealing in others. Newer research suggests that culture may determine the extent to which elites behave in one way or the other. The evidence we have reviewed indicates that transplanting US style governance may not resolve the issues associated with concentrated ownership structures.

NOTE

1. See Allen (2005) for a more complete analysis of these survey results.

ACKNOWLEDGEMENTS

Aggarwal and Dow gratefully acknowledge the financial support of the Social Sciences and Humanities Research Council of Canada (grant number 861-2007-3009) and the Fonds Québécois de la recherche sur la société et culture (grant number 2007 SE 111772). Choi acknowledges partial support from CIBER at Temple University. The opinions expressed here are those of the authors and do not necessary reflect those of the granting agencies.

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HOW "ATTRACTIVE" IS GOOD GOVERNANCE FOR FDI?

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ABSTRACT

In this chapter, we investigate empirically the role of corporate and institutional governance in attracting FDI compared to forms of incentives, such as lower taxes and wage costs. In particular, we use a two-step gravity approach, where in the first step we control for a number of determinants traditionally used in gravity models and in the second we test explicitly for the significance of a set of indicators measuring institutional and corporate quality. Our results seem to validate the hypothesis that corporate governance and institutional quality are important attractors of FDI.

1. INTRODUCTION

During the 1980s and 1990s, multilateral organizations have actively promoted greater integration as a means to foster growth through the opening of the current and capital accounts of the Balance of Payments. Terms like trade liberalization, structural adjustment, privatization, governance, transparency, macroeconomic stabilization have been high in the agenda of domestic and international policymakers with the goal to

Institutional Approach to Global Corporate Governance: Business Systems and Beyond
International Finance Review, Volume 9, 33–54

ISSN: 1569-3767/doi:10.1016/S1569-3767(08)09002-X

increase market integration at a global level and foster growth in developing countries. However, while the (moderate) optimism on the relationship between trade and growth seems to find greater support in the empirical evidence, the signals that greater financial integration may also be beneficial are still blurred. Indeed, some authors have now started to acknowledge that capital markets liberalization may have been an additional source of instability especially for developing countries. In particular, the financial and currency crises of the 1990s have underlined the role of short-term capital flows in precipitating developing countries efforts to reach greater prosperity.

In this respect, it has been stressed the difference between alternative forms of financing. Typically, longer term flows, such as Foreign Direct Investment (FDI), have been identified as ''good cholesterol'' for emerging economies, as opposed to the ''bad cholesterol'' of speculative flows. Direct investment from abroad is in general associated with greater economic growth (see De Gregorio, 1992), raising factors productivity, introducing new know-how and forcing local firms to improve their managerial standards, generating positive spillover effects, both within the sector of entry (*communication externalities*) and across sectors (*jacobian externalities*).[1]

In this context, the efforts of multilateral organizations and national governments have been directed at attracting and retaining foreign investment. However, the issue of how durable foreign investment can be attracted into the country and how best the beneficiary can reap the benefits of the presence of foreign investors is still open. Yet, these issues require special attention. Many governments have opened their capital accounts and have put into place a number of incentives to induce foreign firms to invest in their countries, such as fiscal advantages, financial benefits and monopoly rights. According to UNCTAD (1996), these measures have become so common that only a few countries compete for foreign investment without any form of subsidy. While a part of the literature on FDI underlines the importance of incentives and subsidies to attract multinational enterprises, it is yet a matter of debate whether incentives and subsidies are really justified. Some authors have even argued that in a context where countries compete aggressively by offering subsidies to potential investors, the expected benefits of FDI for the host countries may ultimately accrue to the foreign investors. Furthermore, many commentators have feared that the process of competition for FDI can lead to a ''race-to-the-bottom'' with the progressive worsening of international standards and potentially harmful social and economic consequences for the host economies.

More recently, the Asian crisis has prompted a debate among researchers and policymakers on the role that the quality of a country's governance and its institutions can have to stabilize financial flows and improve the country economic performance. Borensztein, De Gregorio, and Lee (1998), for example, highlight how a country needs a certain degree of "absorptive capacity" (e.g. in terms of human capital) in order to seize the positive spillovers embedded in FDI. Despite the increasing volume of papers looking at the determinants of FDI, there is still scope for further studies into the role of institutional quality and governance.

This chapter attempts to fill this gap by running an empirical investigation on the nature of FDI patterns. Building on the solid ground of the gravity model, we investigate the determinants of FDI flows with a special focus on the institutional factors. After controlling for a number of traditional variables, we focus on the role of a set of "interest variables" pertaining the degree of shareholder protection, quality of governance and openness to FDI in attracting FDI. These factors can make countries more attractive to foreign investors, more absorptive of the FDI spillovers, more resilient to international crises and able to promote growth, representing the "healthy recipe" for development in an increasingly globalized economy. The rest of the chapter is organized as follows: the next section presents a discussion on the relationship between institutional quality and FDI; Section 3 provides an overview of the empirical methodology. Section 4 presents and comments on the econometric results. Section 5 concludes.

2. INSTITUTIONAL DETERMINANTS OF FDI

Increasing international economic integration creates new investment opportunities for enterprises[2] and raises new challenges for national governance. In an increasingly globalized environment, countries end up competing in order to attract foreign investment of the good quality.

2.1. Incentives or Governance?

According to UNCTAD (1996), investment incentives have become a dominant strategy in the world economy, as "*... more than 100 countries provided various FDI incentives already in the mid-1990s, and dozens more have introduced such incentives since then – few countries compete for foreign investment without any form of subsidiaries today*". However, whether incentives are really justified is an issue still open in the literature. Many authors are cautious in considering as positive the effects of incentives and claim that competition between governments to attract direct investments by removing restrictions on the activities of multinationals and lowering fiscal, labor and social standards may have negative welfare implications for the host economies. In this direction, some authors (see, for example, Hausmann & Fernandez-Arias, 2000) have even considered a higher share of FDI flows as a sign of the institutional weakness of a country in terms of poor property rights, inefficient markets and weak legal and financial system. According to this view, investors facing alternative investment possibilities opt for direct investment, as a strategy to reduce the legal and economic risks of doing business in a particular country. However, other authors also consider FDI inflows as a potential signal of lowering domestic distortions, such as crony capitalism.

According to an alternative view, international investors are only in part lured by cost-reducing strategies and a more important role in first inducing and then retaining FDI into the country is played by the quality of physical and social infrastructures, human capital and good governance. Therefore, as an alternative to providing incentives in the form of subsidies and lower restrictions on multinational activities, countries could attract FDI by improving their investment climate. As a bonus, a country should also be more able to seize the positive spillovers of FDI flows if endowed with a certain amount of absorptive capacity in terms of human capital, quality of governance and sound macroeconomic policies.[3] Kaufmann and Kraay (2002) and Kaufmann, Kraay, and Mastruzzi (2004) identify a strong and positive correlation between per capita incomes and the quality of governance in a cross-country empirical analysis. This view has recently found some support in papers stressing the relevance of the investment climate (smoother administrative procedures, lower corruption, a sounder system of legal rules and enforcement, investment openness and transparency) for the decision of multinational enterprises to locate in a particular country (see Drabek & Payne, 2002; World Bank, 2001; OECD, 1999). However, lack of transparency and widespread corruption seem to have a strongly negative effect on FDI inflows and growth. In particular, a higher degree of corruption may affect the composition of a country's capital inflows and make the economy more vulnerable to the risks of speculative attacks and contagion effects.

Wei (1997, 2000), for example, finds that corruption, as well as the uncertainty related to corruption, have a significant and negative effect on FDI location. Hausmann and Fernandez-Arias (2000) use panel data on

Latin America, Eastern Europe and Asia to investigate the role of institutional quality, measured using a set of indicators compiled by Kaufmann, Kraay, and Zoido-Lobaton (1999), as well as indices of creditor and shareholder rights from La Porta, Lopez de Silanes, Shleifer, and Vishny (1998). They find that better institutions and stronger shareholder rights lead to an increase in the total volume of capital flows, but reduce FDI as a share of total flows. They also conclude that, compared to FDI, other forms of capital flows are more sensitive to the quality of institutions.

Alesina and Dollar (2000) consider a panel of countries observed during the period 1970–1994 to assess the impact on FDI of conventional explanatory variables, such as market size, measured by Gross Domestic Product (GDP) and population, and further test for a number of additional variables, such as current account openness, democracy, religion and political alliances with the source country, rule of law and colonial ties. They find that FDI responds to economic incentives embedded in the nature of the trade regime and the system of property rights, more than to political incentives (e.g. colonial and political linkages).

2.2. Corporate Governance and Openness to FDI

Recently, and especially after the Asian crisis, researchers and policymakers have focused their attention on the relationship between corporate governance and economic performance. In this context, a country's corporate governance system and practices emerges as a crucial element to increase the returns on investment and reduce the degree of risk. The growing interest in corporate governance codes and rules may also reflect the understanding that foreign and domestic investors consider the quality of corporate governance alongside financial performance and other factors. The implementation of corporate governance mechanisms makes companies more accountable to both society and investors, but a sounder system of corporate governance can also give greater ability to domestic companies to gain a competitive advantage over their foreign counterparts[4] and lead to greater productivity as well as positive long-term benefits for industrialization, growth and overall corporate performance (OECD, 1999).

La Porta et al. (LLSV, 1997, 1998, 2000) consider the interaction between law and finance and in particular how international differences in investors' legal protection are related to financial development in 49 countries. They classify countries' legal origins as Anglo-Saxon (common law), French, German and Scandinavian (civil law), and attribute the differences between the Anglo-Saxon and the Continental European system to the countries' legal systems and to the role of the State.[5] This is because the degree of investor protection determined by the country's legal origin is negatively related to the degree of involvement of the state in the economy when business law was first introduced. Additionally, LLSV create eight indicators for shareholder protection and six for creditor protection. LLSV argue that the interaction of financial markets with the legal framework may affect corporate performance. Additionally, they establish a strong correlation between legal origin, investor protection and ownership concentration.[6] When they control for investor protection, however, the significance of legal origin disappears, indicating that legal origin affects finance through investor protection.

Pagano and Volpin (2001) adopt a new political economy approach to investor protection where they consider the linkages between political decisions and economic interests, claiming that this approach allows a better understanding of the existing international differences in financial regulation. In Pagano and Volpin (2005), they analyze the political determinants of the degree of investor and employment protection starting with the assumption that under proportional voting, the likely political outcome is lower shareholder protection and higher employment protection. Thus, a system characterized by stronger worker protection (i.e. Germany) presents a weak shareholder protection level. Conversely, a system characterized by stronger shareholder protection will present a weaker worker protection (i.e. USA, United Kingdom). Using a panel of 21 OECD countries, the LLSV shareholder protection index and other political variables, these authors find that the proportionality of the voting system is positively correlated with employment protection. In a panel of 45 countries, they find that the proportionality of the voting system is significantly and negatively correlated with shareholder protection (LLSV updated data).

Another important determinant related to corporate governance practices is the degree of openness to FDI. Hausmann and Fernandez-Arias (2000) investigates the role of this critical variable in attracting international capital flows and concludes that openness is positively related to the total volume of capital flows, but negatively related to the share of FDI over capital flows.

Shatz (2000) reviews the changes in investment policy of 57 countries receiving US investment from 1986 to 1995 and creates a new rating system for investment openness. The openness of a country to FDI is rated annually on a scale from 0 to 5 with an emphasis on administrative openness.[7] The rating has three components. The first rates a country on the simplicity of its approval process, the ability of foreigners to invest in a wide variety of sectors and the level of ownership foreigners may take. The second rates a country on the ability of foreigners to acquire domestically owned firms. The final component rates a country on the freedom to remit profits and repatriate capital.[8] Shatz (2000, 2001) concludes that countries that reformed their investment policies facilitated inflows of foreign investment.

To explore the role of corporate governance and institutional governance as determinants of FDI, in this chapter we investigate FDI flows and stocks from a number of OECD economies towards foreign recipients. We build on the empirical success of the gravity model and test for the residual impact of our variables of interest after controlling for a number of conventional alternative determinants using variables drawn from different sources. In particular, our main interest is on the degree of openness to foreign investment (Shatz, 2000), the level of shareholder protection (La Porta et al., 1998; Pagano & Volpin, 2005) and a set of indicators of governance quality (Kaufmann, Kraay, & Mastruzzi, 2003; Kaufmann, Kraay, & Mastruzzi, 2005).

3. EMPIRICAL ANALYSIS

A considerable stream of research has built on the empirical success of the gravity model of trade to investigate the determinants of international flows of capital. This model owes its popularity to its applicability to a wide array of experiments. According to the gravity model for international trade, the amount of trade between two countries is explained by their economic size (GDP, population), geographical distance (physical distance and border effects) and a set of variables that capture proximity/similarity (language, preferential agreements, common currency, colonial ties, legal system) and institutional characteristics (literacy, religion). In analogy with the Newtonian law of gravitation, the amount of trade between two countries is assumed to increase with their size and proximity and decrease in their distance. After the early ad hoc justifications, the gravity model has recently become, according to Frankel (1998) "embarrassingly rich" of theoretical foundations.[9]

In the analysis of FDI patterns, the model is applied in analogy with the literature on trade. However, a word of caution is needed with respect to some of the familiar suspects of gravity equations. The implied role of factors such as geographic distance, for example, requires additional thinking, as the weightless nature of capital means that distance cannot be immediately interpreted as a proxy for the cost of transportation.

Some authors have claimed that if foreign investment is used by firms as a means of overtaking the higher costs of transporting the home-produced goods to the foreign market (horizontal FDI), we should expect a greater amount of flows accruing to farther away countries. If, however, the acquisition of direct ownership in a foreign country were directed at the vertical integration of production (vertical FDI), we would be expecting investment to flow towards nearer countries with the same intent to reduce the cost of transportation, but with the opposite result on the expected relationship between distance and FDI.

For multinational enterprises, geographic distance is also likely to capture the costs involved in the process of gathering information, which may affect negatively the choice of long-term investment in farther away countries (see Loungani, Mody, & Razin, 2002; Mody, Razin, & Sadka, 2003). Clearly, the role of distance in determining FDI flows remains more elusive than in the familiar international trade framework.

The focus of this chapter is on governance. Therefore, while we exploit what is now the conventional specification of the gravity model, we add a set of indicators of governance. The first index considered is a measure of shareholder protection developed by Pagano and Volpin (2005) on an expansion of La Porta et al. (1998). This variable is an indicator varying from 1 to 5, with higher values indicating stronger protection for shareholders. Moreover, we consider two further sets of variables in order to capture the degree of openness of a country to FDI and the general quality of institutional governance. For the first of these two, we use the index of administrative openness to FDI constructed by Shatz (2000).[10] To control for the quality of the investment climate in terms of governance, we use the set of governance indicators developed by Kaufmann et al. (2003), referring to six indicators capturing different dimensions of institutional quality or governance (*Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption*).

Furthermore, we use a set of indicators due to Kaufmann (2004), which challenge the traditional legalistic and formal view of corruption and try to capture forms of "legal" corruption that may be dominant in developed countries as well. This form of corruption stems from undue influence on the government from the most important socio-economic groups. These indicators (*Corporate Illegal and Legal Corruption, Corporate Ethics Index, Public Sector Ethics Index, Judicial/Legal Effectiveness Index, Corporate*

Governance Index) are constructed from the answers given to the Executive Opinion Survey of the World Economic Forum and are therefore more able to capture de facto corruption, as opposed to de jure corruption.

Additionally, we control for other variables, such as the corporate tax rate and the wage level. Both variables may condition a firm localization decisions, but are commonly considered as "non-quality" incentives to FDI, raising concerns that increasing competition may lead to a race-to-the-bottom. To test for the role of quality versus these type of incentives, we have considered these together with all the other traditional gravity variables.

3.1. Model Specification

In the international economics version of Newtonian physics, the gravity model takes the following form:

$$F_{ij} = \alpha \cdot \frac{Y_i Y_j}{D_{ij}} \tag{1}$$

where, F_{ij} represents the amount of flows between i and j, α a constant, $Y_{i,j}$ the measures of size of i and j and D_{ij} the distance between them. In the earliest representation, F_{ij} would be the level of total trade[11] between i and j, Y their GDP and D the distance between most populous or capital cities. The model is usually *augmented* with a number of other country-specific and pair-specific variables and log-linearized:

$$\log(F_{ij}) = \alpha_0 + \alpha_1 \log(D_{ij}) + \alpha_2 \log(Y_i \cdot Y_j) + \sum_{k=3}^{K} \alpha_k x_{k,ij} + \varepsilon_{ij} \tag{2}$$

where the set of variables x_k will include K country and pair-specific factors (contiguity, language, regional trade agreements, currency unions, etc.). Given that there will be country pairs with zero flows, in order to keep the zeros that would be lost by the log transform, a 1 is added to the left hand side, i.e. $\Phi_{ij} = 1 + F_{ij}$ and Eq. (2) is estimated via OLS, by pooling observations over time and incorporating time dummies. Moreover, since Mátyás (1997, 1998) fixed effects for the country as an importer and as an exporter have been introduced into the equation:

$$\log(\Phi_{ijt}) = \alpha_0 + \alpha_t + \alpha_i + \alpha_j + \alpha_1 \log(D_{ij}) + \sum_{k=3}^{K} \alpha_k x_{k,ijt} + \varepsilon_{ijt} \tag{3}$$

where α_t is a time effect, α_i and α_j are the country fixed effects, also considered as terms of "multilateral trade resistance" (see Anderson & Van