

Lecture 9

Corporate Governance &
Law and Finance

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Part I

Corporate Governance

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Corporate governance- overview

- Does it matter? If it matters, why? What is the mechanism?
 - Which type of corporate governance? Many papers focus on rules
 - What is the interaction between different rules?
 - Exogenous identification is very difficult
 - Measure of an index of corporate governance and analysis of implications (Gompers et al., 2001)
- Trade off between costs and benefits of imposing rules?

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Shleifer and Vishny (1998)

- Definition of Corporate Governance by 'Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'. Shleifer and Vishny (1998)

Why do investors fear managerial slack?

Agency problems!

- Berle and Means (1932): In large modern corporations there is separation between ownership (financing) and control (managing)
- Corporate governance is a solution to that

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Shleifer and Vishny (1998)

Outline of topics in corporate governance:

- The agency problem and incentive contracts as a potential solution
- The two most common corporate governance approaches:
 - Large investors / block-holder control
 - Legal protection of investors: Law and Finance
 - We will concentrate on that
- Other solutions:
 - Debt and equity ownership
 - LBO's
- International corporate governance:
 - Which system is the best?

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Shleifer and Vishny (1998)

The Agency Problem:

- Separation between ownership and control:
 - Entrepreneurs need cash
 - Financiers need expertise
 - Contracts are incomplete:
 - one needs to decide who has control rights in all possible future contingencies
 - But because this is prohibitively costly, contracts are incomplete: some future contingencies are not specified in the initial contract
 - Corporate governance helps decide who possesses control rights

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Shleifer and Vishny (1998)

The Agency Problem (cont.):

- However, in practice, managers have residual control rights as well as effective control
 - Managers have expertise and inside information
 - Contracts between managers and investors rely on enforcement:
 - But courts rarely get involved
 - E.g. business judgement rule in the US
 - Free-rider problems between (small) investors

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Inside the black box of agency problems

Till the end of the '80s agency problems coincide with empire buildings

From the '90s on the shift is from empire building to stealing. The objective of corporate governance become to avoid expropriation. Part of the shift in focus is due to the fact that finance becomes less provincial (world based vs. US-based)

- Perks consumption
- Involvement in pet projects (non-value enhancing)
- Entrenchment
- Even outright theft!

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Shleifer and Vishny (1998)

Incentive contracts for managers:

→ Maybe a useful tool to overcome agency problems

Examples:

- Share ownership, stock options, threat of dismissal
- The optimal contract is determined by risk aversion and the importance of managerial decisions
- There is debate about the magnitude of performance incentives of CEO's:
 - Jensen and Murphy (1990): executive pay changes by \$3 for every \$1000 change in shareholder wealth
 - They argue this is small

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Shleifer and Vishny (1998)

Incentive contracts for managers (cont.):

- Yermack (2004): director pay changes by \$0.03 for every \$1000 change in shareholder wealth
 - They argue this is large

- Problem: No benchmark.

- Further debate:
 - Do incentives matter?
 - Do incentive contracts create further opportunities for self-dealing?

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Shleifer and Vishny (1998)

Although financing can occur without governance,

- E.g:
 - reputation of managers,
 - investor optimism

These two are unlikely to be the general rule.

- The two most common corporate governance mechanisms that provide incentives to investors to provide capital to corporations are:
 - The legal protection of investors
 - The possibility of taking large stakes in firms, i.e. large shareholders or building blocks

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Shleifer and Vishny (1998)

Legal protection:

According to Shleifer and Vishny (1997):

'the main reason why investors provide external financing to firms is because they receive control rights in exchange'

Shleifer and Vishny (JF, 1997) redefine the debate by focusing on stealing rather than empire building

- The principal goal of CG is to restrict expropriation of outside investors (shareholders and creditors) by insiders (controlling shareholders or managers) so as to facilitate external finance.

→ The contract between the firm and the financiers gives financiers the right to appeal the courts to enforce their rights when managers violate the terms of the contract.

- Differences of corporate governance systems around the world stem from:
 - the differences in the nature of the legal obligations that managers have to the financiers
 - the differences in how courts interpret and enforce these obligations.

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Shleifer and Vishny (1998)

Legal investor protection alone is not sufficient to guarantee that financiers will get money back

→ Investors can get more control rights to ensure their money back by being large.

Large investors:

‘When control rights are concentrated in the hands of a small number of investors with a collectively large cash flow stake, concerted action by investors is much easier than when control rights, such as votes, are split among many of them.’

Concentration of ownership can take three forms: large shareholders, takeovers, or large creditors.

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**Great paper
Bertrand and Mullainathan (2003)**

- “Enjoying the Quiet Life? Corporate Governance and Managerial Preferences,” JPE
- Consequences of anti-takeover legislation

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Shleifer and Vishny (1998)

Which system is best?

In order to raise external funds,
→ some governance seems important
→ reputation is not enough

As we saw, two basic governance mechanisms:

- Large investors
- Legal investor protection

Corporate governance varies widely around the world!

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CG literature and other/new directions

- ❑ Shareholder value versus stake-holder society, whose value should we maximize (Tirole 1994)
- ❑ Law and finance (LLSV 1997, 1998...)
- ❑ Role of institutions, e.g. governance of mutual funds,
- ❑ Role of the media in forming reputations (Zingales 2007)
- ❑ Other:
 - ❑ Governance structures in non-US countries
 - ❑ Governance of non-profit organizations
 - ❑ Governance of regulated firms, e.g. banks
 - ❑ Management by family firms

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Gompers, Ishii and Metric (2001)

A well known paper that intends to measure whether poorly governed firms under-perform firms with good governance is by:

Gompers, Ishii and Metric (2001): "Corporate governance and equity prices"

In their paper, they use the incidence of 24 corporate governance provisions to build a 'Governance Index' for 1500 firms
-- their index is widely used by many other researchers afterwards

GIM use this index to study its relationship with several forward-looking performance measures during the 1990s.

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Gompers, Ishii and Metric (2001)

In reaction to the takeover wave in the 1980s:

- ❑ many firms adopted takeover defenses and other corporate provisions designed to reduce shareholder rights (e.g. poison pills)
- ❑ In addition to that, many states passed laws giving further protection against takeovers

→ The end result was a wide variation in governance structures across states and firms

They construct two portfolios for the shareholder rights:

- Management portfolio: firms with weakest shareholder rights
- Shareholder portfolio: firms with strongest shareholder rights

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Gompers, Ishii and Metric (2001)

The rationale for examining stock returns is that:

- If governance matters and information is incorporated by the market, then the stock price adjusts immediately (logic behind event studies), so the expected return on stock is unaffected beyond the event window
- If governance matters and information is not immediately incorporated by the market then the realized returns differ systematically.

The following tables show:

- 1) the percentage of firms with each provision between 1990 and 1998 classified by GIM
- 2) The governance index

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Gompers, Ishii and Metric (2001)

	Percentage of firms with governance provisions in			
	1990	1993	1995	1998
<i>Antitakeover</i>	19.5	20.6	20.0	17.2
<i>Blank Check</i>	76.4	80.0	85.7	87.9
<i>Business Combination</i>	83.9	87.4	87.5	88.3
<i>Bylaws</i>	14.4	16.1	16.0	18.1
<i>Charter</i>	3.2	3.4	3.1	3.0
<i>Classified Board</i>	59.0	60.4	61.7	59.4
<i>Compensation Plans</i>	44.7	65.8	72.5	62.4
<i>Contracts</i>	16.4	15.2	12.7	11.7
<i>Control-Share Cash-Out</i>	4.1	3.7	3.6	3.2
<i>Cumulative Voting</i>	18.5	16.5	14.9	12.2
<i>Directors' Duties</i>	10.3	11.0	10.9	10.1
<i>Fair Price</i>	57.8	59.0	57.6	49.2
<i>Golden Parachutes</i>	53.1	55.5	55.1	56.6
<i>Indemnification</i>	40.9	39.6	38.7	24.4
<i>Liability</i>	72.3	69.1	65.6	46.8
<i>Poison Parachutes</i>	3.9	5.2	3.9	2.2
<i>Poison Pill</i>	53.9	57.4	56.6	53.3
<i>Secret Ballot</i>	2.9	9.5	12.2	9.4
<i>Severance</i>	13.4	5.5	10.3	11.7
<i>Silver Parachutes</i>	4.1	4.8	3.5	2.3
<i>Special Meeting</i>	24.5	29.9	31.9	34.5
<i>Supermajority</i>	38.8	39.6	38.5	34.1
<i>Unusual Voting</i>	2.4	2.0	1.9	1.9
<i>Written Consent</i>	24.4	29.2	32.0	33.1
Number of Firms	1357	1343	1373	1708

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Gompers, Ishii and Metric (2001)

Table 2
Distribution and Composition of the Governance Index
 This table provides sample statistics on the distribution of *G*, the Governance Index, over time. *G* is calculated from the 24 provisions listed in Table 1 as described in Section II. Appendix A gives detailed information on each provision. We divide the sample into ten portfolios based on the level of *G* and list the number of firms in each portfolio. The Shareholder Portfolio is composed of all firms where *G* is 5 or smaller, and the Management Portfolio contains all firms where *G* is 14 or greater.

	1990	1993	1995	1998
Governance Index				
Minimum	2	2	2	2
Mean	9.0	9.3	9.4	8.9
Median	9	9	9	9
Mode	10	9	9	10
Maximum	17	17	17	18
Standard Deviation	2.9	2.8	2.8	2.8
Number of Firms				
<i>G</i> ≤ 5 (Shareholder Portfolio)	158	139	120	215
<i>G</i> = 6	119	88	108	169
<i>G</i> = 7	158	140	127	186
<i>G</i> = 8	165	139	152	201
<i>G</i> = 9	160	183	183	197
<i>G</i> = 10	175	170	178	221
<i>G</i> = 11	149	108	166	194
<i>G</i> = 12	104	123	142	136
<i>G</i> = 13	84	100	110	106
<i>G</i> ≥ 14 (Management Portfolio)	85	93	87	83
Total	1357	1343	1373	1708

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Gompers, Ishii and Metric (2001)

- Robustness checks:
 - Change portfolio construction
 - Run Q regressions with governance index and shareholder portfolio dummy
 - Use Fama-McBeth return regressions
- All this tests lead to similar results, namely:
 - The shareholder portfolio outperformed the management portfolio by 9% per year from 1990 to 1999

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Gompers, Ishii and Metric (2001)

Interpretation and conclusion:

- Correlation between weak shareholder rights caused poor performance
- Implicit admission of market inefficiency.
- But they acknowledge that they cannot determine causality:
 - ‘... multiple causal explanations have starkly different policy implications and stand as a challenge for future research’

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Problems with the paper above

- Selection of corporate governance rule is made at the firm level – it is endogenous
- Running a correlation between the choices made by firms and the performance of the firms seem a stupid idea to start with
- However, the paper has become (in)famous for their measure of corporate finance
- If you do not want to run into a problem like this, what is a possible alternative identification strategy to uncover the effect of corporate governance?

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Possible answers

- Find exogenous rules being imposed and look at the effects;
 - Cross country
 - Rules that affect some firms and not others (Black et al. () with regression discontinuity design, but also Greenstone et al. (2006), or Hochberg et al. 2007)
 - Rules that affect some areas and not others (e.g. Bertrand and Mullainathan, 2003).

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Part II

Law and Finance

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The legal approach:

- The **law** and its **enforcement** are key mechanisms of investor protection.
- When investors finance firms, they receive rights or powers in exchange. Without an ability to enforce rights, investors might end up with nothing.

•Company law
•Bankruptcy law
•Securities law
•Takeover law
•Courts & Regulators



•Protect Shareholders & Creditors
•Force timely disclosure of accurate information

- Implication: Strong investor protection leads to deeper financial markets & better financing terms for firms.**

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Digression

- ❑ This debate is also profoundly related to the debate of whether finance is important for growth. During the 1990s the focus of the debate became why countries differ in the level of stock market development.
- ❑ Why ? Not necessarily most important issue, but
 - ❑ Success of market-based economies over the 1990s
 - ❑ US interest in expanding other markets
 - ❑ Finance becomes less provincial as a discipline
- ❑ Shleifer and Vishny are at the center of this shift

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LLSV (1998)

- ❑ La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) "Law and Finance," *Journal of Political Economy*
- ❑ They select some 'important' legal rules protecting shareholders and creditors, and document the availability of these rules in 49 countries around the world.
- ❑ They also create anti-director rights (shareholder protection) and a creditor rights index for each of these countries.
- ❑ They afterwards examine whether variations in these rules matter for corporate ownership patterns around the world.

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LLSV (1998)

Endogeneity problems!:

- ❑ In a country without cars, there is no driving code.
- ❑ Is the driving code causing the diffusion of cars?
→ How does the legal approach deal with endogeneity?
- ❑ The first step was to link it to legal origin (JPE,98):
 - ❑ Legal scholars divide legal systems in several families
 - ❑ There is the distinction coded law vs. common law
 - ❑ Even within coded law, there are different traditions
 - ❑ French, German, Scandinavian
- ❑ Why different countries have different traditions?
 - ❑ Invasions, colonization, etc. (note potentially exogenous!)
- If legal tradition matters, then it is a good instrument to resolve endogeneity.

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LLSV (1998)

Countries included in the different legal origins:

- ❑ Common law (english origin):
 - ❑ Australia, Canada, Hong Kong, India, Ireland, Israel, Kenya, Malaysia, New Zealand, Nigeria, Pakistan, Singapore, South Africa, Sri Lanka, Thailand, UK, US, Zimbabwe
- ❑ French civil law:
 - ❑ Argentina, Belgium, Brazil, Chile, Colombia, Ecuador, Egypt, France, Greece, Indonesia, Italy, Jordan, Mexico, Netherlands, Peru, Philippines, Portugal, Spain, Turkey, Uruguay, Venezuela
- ❑ German origin:
 - ❑ Austria, Germany, Japan, South Korea, Switzerland, Taiwan
- ❑ Scandinavian origin:
 - ❑ Denmark, Finland, Norway, Sweden

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LLSV (1998)

Example of how indexes are constructed:

-- The index of shareholder rights:

- ❑ Shareholders exercise power by voting for directors and major corporate issues
- ❑ Shareholder rights are measured by voting procedures:
 - ❑ If one-share-one vote rules, then shareholders are considered to have more rights (only 11 countries with this right)
 - ❑ Also, if you can send your vote by regular mail, then shareholders are considered to have more rights
- ❑ The index of anti-director rights is = sum of dummy variables indicating laws that protect shareholder rights

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LLSV (1998)

Measures of investor protection:

	Shareholder Rights (0-6)	Creditor Rights (0-4)	Efficiency of the Judiciary (0-10)	Accounting Standards (0-100)
Common Law	4.00	3.11	8.15	69.62
French Civil Law	2.33	1.58	6.56	51.17
German Civil Law	2.33	2.33	8.54	62.67
Scandinavian Civil Law	3.00	2.00	10.00	74.00
World (49 countries)	3.00	2.30	7.67	60.93

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LLSV (1998)

Measures of investor protection:

- ❑ Common law countries have the highest shareholder rights followed by Scandinavian Civil law
- ❑ Common law countries have the highest creditor rights followed by German civil law countries
- ❑ Efficiency of the judicial system and the accounting standards are highest in Scandinavian Civil law countries
- ❑ According to the four measures, French civil law countries are always in the last position!

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LLSV (1998)

With the above measures the paper proceeds to examine the implications of the quality of investor protection for firms' ownership concentration.

Idea:

If a negative relationship between the quality of investor protection and ownership concentration is found,

this means that countries develop substitute mechanisms for investor protection.

→ A negative pattern is indeed confirmed in their data.

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TABLE 8
ORDINARY LEAST SQUARES REGRESSIONS: CROSS SECTION OF 49 COUNTRIES
Dependent Variable: Mean Ownership

Independent Variable	Basic Regression	Shareholder and Creditor Rights
Log of GNP per capita	.0077 (.0097)	.0397 (.0242)
Log of GNP	-.0442* (.0119)	-.0428* (.0118)
Gini coefficient	.0024*** (.0014)	-.0027 (.0023)
Rule of law		-.0143 (.0148)
Accounting		-.0029*** (.0010)
French origin	.1296* (.0201)	.0733 (.0802)
German origin	-.0113 (.0666)	-.0025 (.0728)
Scandinavian origin	-.0496 (.0371)	-.0430 (.0428)
Antidirector rights		-.0315** (.0160)
One share-one vote		-.0497 (.0496)
Mandatory dividend		-.2197*** (.0713)
Creditor rights		-.0128 (.0174)
Legal reserve required		-.2937** (.0765)
Intercept	.7785* (.1505)	.8686 (.2952)
Number of observations	45	39
Adjusted R ²	.5582	.7348

NOTE.—Variables are defined in table 1. Robust standard errors are in parentheses.
* Significant at the 1 percent level.
** Significant at the 5 percent level.
*** Significant at the 10 percent level.

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LLSV (1998)

The above results show two regressions:

1. Ownership concentration on legal origin dummies and several controls
2. Add to the first regression several measures of legal protection.

Results show that:

- French civil-law countries have higher ownership concentration (and lower protection!)
 - Countries with:
 - better accounting standards
 - better anti-director rights
- ... have lower ownership concentration

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More LLSV...

With their 'Law and Finance' paper in mind, LLSV write a series of follow up papers, two of them are:

LLSV: "Legal determinants of external finance" (JF 1997)

And

LLSV: "Investor protection and corporate valuation" (JF 2002)

In which they examine the implications of the laws that shape investor protection, for financing patterns in the different countries.

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LLSV (1997)

In the paper 'Legal Determinants of External Finance' they show that,

- Using a sample of 49 countries
 - Countries with poorer investor protection, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets.
 - These apply to both debt and equity markets
- French civil law countries have the weakest investor protections and the least developed capital markets!

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LLSV (1997)

Consequences of investor protection for the development of capital markets :

	External Cap / GNP	# Firms / Mill. Pop.	# IPOs / Mill. Pop.	Price / Sales	Debt / GNP
Common Law	60%	35.45	2.23	1.01	68%
French Civil Law	19%	11.89	0.28	0.64	56%
German Civil Law	46%	16.79	0.12	0.56	97%
Scandinavian Civil Law	30%	27.26	2.14	0.73	57%
World (49 countries)	40%	21.59	1.02	0.79	59%

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LLSV (1997)

Consequences of investor protection for capital markets.

Results:

- Common law countries are the strongest in raising external capital followed by the German civil law countries
- Number of firms, number of IPOs and price over sales are highest in Common law countries followed by Scandinavian tradition
- As regarding debt, German civil law countries are in the highest position followed by common law countries.
- Again, French civil law countries have in general the lowest scores in all the measures!

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LLSV (1997 & 1998)

→ What's wrong with the French?

1. General Stance of Government

- French legal origin seems to be associated with
 - More regulation of entry
 - More government ownership of banks
 - More interventionism
- > lower security of property rights
- Is legal origin or colonization the mechanism?

2. Structure of the Legal System

- French Legal Origin associated with state-employed judges, procedural and substantive codes, and generally 'politicized' judiciaries.
- This may be bad for security of property rights.

3. Common Law Principles

- Principles, such as Fiduciary Duty, enable judges to use 'smell tests' to ferret out investor expropriation and tunneling.
- Codification and lack of broad legal principles such as fiduciary duty in civil law countries accommodate more conduct detrimental to investors.

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LLSV (2002)

In the other related paper, 'Investor Protection and Corporate Valuation', LLSV exploit again the differences in legal origins to examine the effects of investor protection for corporate valuation.

Results show that:

- Poor shareholder protection is penalized with lower valuations, and that higher cash-flow ownership by the controlling shareholder improves valuation, especially in countries with poor investor protection.
- This evidence indirectly supports the importance of expropriation of minority shareholders by controlling shareholders in many countries, and for the role of the law in limiting such expropriation.

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LLSV papers...

The missing links:

The basic line of argument in all the papers hinges on the conjecture that:

- I. *the differences in investor protections against expropriation by insiders frame the differences in the nature and effectiveness of financial systems around the world*
 - better protection → less private benefit extraction → more external financing.
- II. *Both the quality of investor protection and the legal enforcement vary systematically by legal origin, which is either English, French, German, Scandinavian.*

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LLSV papers...

The missing links (cont.):

However, some unresolved questions:

- i. What is the direct evidence?
- ii. Why legal origin generates better protection of investors?
 - Original paper looks at statutory laws
 - But statutory protections:
 1. A priori more important in civil law countries, why more present in common law ones?
 2. Potential (unconscious) data snooping bias
 3. Can be easily copied by civil law countries
 - Why is not copied?

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Is it really the law?

- ❑ Besides the law, there are several mechanisms to constrain authority of controlling shareholders:
 - ❑ *External*: product market competition, public opinion pressure
 - ❑ *'Internal'*: moral norms, labor as monitor, state as monitor
- ❑ Extra legal institutions - External mechanisms
 - ❑ product market competition
 - ❑ In competitive markets, diversion will lead to loss of market share and bankruptcy. Extent of competition in markets has a national dimension (enforcement of competition laws, market failures in financial sector (e.g. Korea) as well as IO dimension)
 - ❑ Arguments against link: Product market penalties can take a long time to work.

Is it really the law?

- ❑ Public opinion pressure (media)
 - ❑ Several new papers on the role of the media and media ownership.
 - ❑ Penalties for abuse not only through courts but also through public opinion
- ❑ Norms as 'internal police' against taking advantage of situation.
 - ❑ Coffee (2001): In Scandinavian countries lower private benefits not driven by prospect of external penalties but by strong norms/ internal police
 - ❑ Arguments against: not clear that can measure moral norms, not clear that this is a powerful force
 - ❑ Proxies: Coffee (2001): Extent of violent crime
 - ❑ Stulz and Williamson (2001): Catholic culture

Is it really the law?

- ❑ Labor as monitor through threat of strikes, situation on boards
 - ❑ Arguments for link: labor has capability to monitor and ability to impose penalties without going to courts.
 - ❑ Arguments against link: labor could align with entrepreneur against outside investors. (e.g. Pagano and Volpin (2000))
- ❑ The state as monitor through tax enforcement
 - ❑ Arguments for link: In monitoring and outlawing certain diversionary tactics indirectly benefit investors in company.
 - ❑ An example: Where tax authorities notoriously lax, as in Russia, significant evidence of diversion.
 - ❑ Argument against link: state may only disallow for tax purposes, not stop behavior, information from tax audits may not be made available.

Is it really the law?

In an interesting paper,

Dick and Zingales: "Private benefits of control: an international comparison" (JF, 2004)

Construct a measure of private benefits of control in 39 countries.

They analyze:

1. What are the consequences of larger vs smaller private benefits of control
2. What institutions are more important in curbing these private benefits

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Measure of the private benefits of control

- Barclay and Holderness (1989) – block premia:
- The price per share an acquirer pays for the controlling block reflects the cash flow benefits from his fractional ownership and the private benefits stemming from his controlling position in the firm.
- The market price of a share after the change in control is announced reflects only the cash flow benefits non-controlling shareholders expect to receive under the new management.
- The difference between the price per share paid by the acquiring party and the price per share prevailing on the market reflects the differential payoff accruing to the controlling shareholder.

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From Dick and Zingales (2004)

Table 1
Institutional Determinants of Private Benefits of Control – Univariate analysis

The dependent variable is the block premia as a percent of firm equity. The explanatory variables include all of variables introduced in Table 1 except the country fixed effects, but including a dummy to indicate the presence of a mandatory tender offer law. In place of the country fixed effects, we introduce one at a time several institutional variables: (1) accounting standards index; (2) anti-director rights index; (3) rule of law index; (4) tax compliance index; (5) diffusion of the press as measured by the newspaper circulation/population; (6) an index of the extent of competition laws; (7) incidence of violent crimes; (8) extent of legal protections for labor; (9) a dummy variable if primary religion is Catholicism. More complete descriptions of variables are provided in Table 1. Standard errors, which are reported in parentheses, are robust and clustered by country.

Independent Variables	Dependent Variable: Risk Premium								
	Legal Institutions			Extra-Legal Institutions					
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Accounting standards	0.028** (0.002)								
Anti director rights		-0.031* (0.013)							
Rule of law			0.028*** (0.009)						
Competition laws				-0.130** (0.042)					
Newspaper circulation/pop					-0.033** (0.012)				
Violent crime incidence						0.000 (0.000)			
Labor protection							0.030 (0.021)		
Catholic is primary religion								0.106* (0.062)	
Tax compliance									-0.079*** (0.003)
Variables Controlled for:									
Buyer bargaining power	Y	Y	Y	Y	Y	Y	Y	Y	Y
Ownership variables	Y	Y	Y	Y	Y	Y	Y	Y	Y
Financial distress	Y	Y	Y	Y	Y	Y	Y	Y	Y
Foreign acquirer	Y	Y	Y	Y	Y	Y	Y	Y	Y
Buyer identity	Y	Y	Y	Y	Y	Y	Y	Y	Y
Seller identity	Y	Y	Y	Y	Y	Y	Y	Y	Y
Industry group	Y	Y	Y	Y	Y	Y	Y	Y	Y
Tangibility of assets	Y	Y	Y	Y	Y	Y	Y	Y	Y
Incidence of relative strength of anti-director rights (home-target nation) and foreign acquirer	Y	Y	Y	Y	Y	Y	Y	Y	Y
presence of takeover law	Y	Y	Y	Y	Y	Y	Y	Y	Y
consistent	Y	Y	Y	Y	Y	Y	Y	Y	Y
number of observations	350	412	412	412	412	308	246	412	412
Countries included	36	39	39	39	39	36	18	39	39
R squared	0.203	0.169	0.244	0.244	0.245	0.203	0.188	0.179	0.218

** significant at 10% level; *** significant at 5%; **** significant at 1% level

Dick and Zingales (2004)

Dick and Zingales (2004) find that:

A lower level of private benefits of control is associated with:

- A high degree of statutory protection of minority shareholders
- A high degree of law enforcement
- A high level of diffusion of the press
- A high rate of tax compliance
- A high degree of product market competition

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What matters?

Law matters

- Shareholders' rights
- Law enforcement
- Accounting standards

Extra legal institutions matter as much

- Tax compliance
- Press diffusion
- Competition

In a horse race (do you trust it?), extra legal institutions matter more

- Tax compliance
- Press diffusion

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Summary

In countries with common law, private benefits are smaller and this seems to have contributed to the development of markets. But unclear whether the mechanism is really the law.

Even less clear that the cause is legal origin

Is legal origin simply proxying for better law and order tradition or is it adding something else?

If it is proxying for something else, what is it?

Do countries need common law to become financially developed?

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How can we tell whether law really matters for financial development?

- Look historically. Two very interesting papers:
 - Rajan and Zingales (2003) "The great reversals: the politics of financial development in the 20th century" (JFE 2003).
 - Legal origin fixed. Is it also true that the cross sectional pattern of financial development is fixed across different time periods?
 - Look at the evolution of financial systems over the 20th century
- They propose an interest group theory of financial development where incumbents oppose financial development because it breeds competition.
- The theory predicts that incumbents' opposition will be weaker when an economy allows both cross-border trade and capital flows.
- This theory can go some way in accounting for the cross-country differences in, and the time series variation of, financial development.
 - Franks, Mayer, and Rossi (2005)
 - Legal norms are not fixed. If it is all about British legal origin why do not we examine the evolution of corporate and creditors' law in Britain
 - Breach of trust (i.e. change in the beliefs that you could trust without the legal enforcement of the law) changed in UK due to large scale immigration and inability of the elite to keep outsiders out of the system

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Continued debate...

- The political economy explanations of financial development is a very active area.
- Related to the broader debate on the ultimate causes of economic development
 - Institutions
 - But which institutions?
 - Legal
 - Political
 - Education
- References:
 - Acemoglu et al. (AER, 2001): long lasting effects of colonial powers.
 - Acemoglu and Johnson: "Unbundling institutions".
 - Beck et al. (2002) most of the effects of legal origins is in the institutions left behind.
 - Glaeser et al. (Journal of Economic Growth, 2005)

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More evidence on the political view - I

Roe (1994) and Bebchuck and Roe (1999):

- The composition of the group of company "insiders" (employees, managers and controlling shareholders) differs across countries.
 - American companies do not have controlling shareholders. Without a controlling shareholder, managers have considerably more power and can protect their rents by lobbying politicians. This may explain the U.S. regulatory effort in the 20th century to restrain the power of large blockholders and banks and prevent the emergence of controlling shareholders. (Roe, 1994).
 - In Continental Europe ownership has historically been concentrated and managers have always been weak. Hence, no such regulation has been introduced. This explanation naturally predicts path dependence because the corporate structures created by a certain political balance
- This may explain the divergence in corporate governance

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More evidence on the political view - II

- Pagano and Volpin (2000): the relevant stakeholders are controlling shareholders, noncontrolling shareholders, and employees. Controlling shareholders (“entrepreneurs”) want low investor protection to extract larger private benefits of control, and may obtain it with the political support of workers. To win support in electoral competition, they have to make some concession to workers (limiting firing ability).
- The feasibility of this “corporatist” agreement – or “stakeholder society” depends on the distribution of equity ownership (and other things) in the economy. If workers own little equity, entrepreneurs and workers will strike a political agreement whereby workers trade low shareholder protection for high job security.
- Path dependence.

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Summing up

On the political view:

- Historical pattern of development is inconsistent with legal origin theory
- Consistent with a private interest view, but not with LLSV.
- Are legal origin and political evolution of private interests connected?
- How do institutions get transmitted? May be through education?
- Is *culture* heritage the link between the two?

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Conclusion

- The cross-country avenue of studying corporate governance has uncovered many differences across countries and it has opened up an even more interesting debate on the causes of financial development and growth
- It has not been successful in highlighting the causal effect of corporate finance.
 - Main limitations:
 - It relies on cross-sectional comparison – hard to claim causality
 - The cross country approach is exposed to the Mankiw’s critique!
 - Nonetheless, this area of research had some very important side effects...

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