Chapter 11

Institutions, Corporate Governance and Firm Performance

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11.1. Introduction

In this chapter, the relation between institutions, corporate governance and firm performance is investigated. The emergence of corporate governance questions in the past decade results from accounting scandals in firms, unexpected value redistributions between investors, mismanagement, worker dismissals, excessive remuneration policies and unfair income distribution in general, etc. Hence, it can be expected that several stakeholders try to change the institutions and more specifically the polity. Corporate governance is defined as "a system of procedures and structures that is used to govern and control the firm, within a field of forces of involved stakeholders, with the goal to contribute to the utility of these stakeholders". Evidently, corporate governance regulations, practices and codes are examples of institutions, as institutions are defined as: "A way of thought or action of some prevalence and permanence, which is embedded in the habits of a group or the customs of a people. Institutions fix the confines of and impose upon the activities of human beings (Hamilton, 1932: 84)."

Before we can investigate the relation between institutions, corporate governance and firm performance in more detail, several modes of thinking about institutions will be discussed in the next section. Sections 11.3 and 11.4 deal with the phenomena of corporate governance in general and the corporate governance code in the Netherlands, respectively. In Section 11.5, the relation between institutions, corporate governance and firm performance is discussed and Section 11.6 concludes this chapter.

11.2. Institutions

11.2.1. Institutional Economics

Institutional economics specializes on the examination of institutions and institutional change. It is a complementary field to neoclassical economics that traditionally specializes

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in the marginal analyses of choices of economic subjects and that has always ignored the role of institutions. Rutherford (1994) explains that there are two important strands in institutional economics, namely old or original institutionalism (OI) and new institutionalism (NI). Both strands can be subdivided in two sub-streams. The OI has a Veblen-Ayres and a Commons wing, while the NI shows a neoclassical and an Austrian branch (from the Austrian school). The Veblen-Ayres variant of institutionalism concentrates on the distinction between technology and institutions while the Commons branch concentrates around the notion of institutions evolving out of the resolution of conflicting interests. The neoclassical branch of NI explains institutions in terms of the maximizing behaviour of individual economic agents. Maximizing behaviour here means the conscious design of institutions. The Austrian variant focuses more narrowly on the spontaneous, invisible hand development of institutions out of individual action. Insights of the Commons variant of OI, and the neoclassical and Austrian variant of NI will be used here to explain the institutional development around corporate governance practices in the sector of the publicly traded firms. In the approach of the Commons, the central idea is that out of scarcity conflicts of interest emerge and that the development of an institutionalized system of rules delivers a degree of order and certainty that is needed for productive efficiency (Rutherford, 1994: 101). The Commons does not provide any detailed analysis on how institutions evolve out of individual actions. To find an answer to this question, one could look at prominent modes of thinking in the strand of NI. One of these approaches in new institutional economics (the Austrian approach) explains the emergence of conventions and rules out of the interaction between economic agents. Spontaneously, invisible hand processes produce certain behavioural rules and with game theoretical analysis, it is possible to demonstrate that these rules generated by interaction and adaptation form a Nash equilibrium or even an evolutionary stable strategy (Rutherford, 1994: 110). The other, neoclassical approach consists of a government that rationally designs a system of property rights, and a judicial system that sets and enforces fundamental rules that govern exchange. The state maximizes wealth by assigning property rights to individuals or by redefining the structure of these rights (Rutherford, 1994: 118). With regard to the role of the government in this political process, two opinions are distinguished: namely, the naïve theory and the interest group or rent-seeking theory. This interest group or rent-seeking theory focuses on the redistributive effects of changes in property rights (Rutherford, 1994: 119). A group may invest resources in lobbying and in making political contributions in an attempt to gain a particular change in property rights in its members' favour. Changes in company law and the introduction of or changes in corporate governance codes are examples of these changes in property rights.

11.2.2. Economic and Non-economic Institutions

According to Williamson (1998; 2000: 597), there are four levels of social analysis (see Table 11.1). The first level is the level of embeddedness. Here, one finds informal institutions, customs, traditions, norms, culture and religion. The second level is the institutional environment. The formal rules of the game, for instance property rights, are determined there in the judiciary world of a polity or government bureaucracy. The third level is the sphere of governance. There the play of the game takes place by contracting parties that

Table 11.1: Embedding corporate governance in the economic theories.

	Level (L)	Frequency of change: (in years)	Purpose
L1: Social theory	Embeddedness: informal institutions, customs, traditions, norms, culture and religion	100–1000	Often non-calculative, spontaneous
L2: Economics of property rights/positive political theory	Institutional environment: formal rules of the game, especially property rights (polity, judiciary, government bureaucracy)	10–100	Get the institutional environment right (first order economizing)
L3: Transaction cost economics	Governance: play of the game, especially contract (aligning governance structures with transactions)	1–10	Get the governance structures right (second order economizing)
L4: Neoclassical economics/agency theory	Resource allocation, asset deployment and utility maximization: (prices and quantities, incentive alignment)	Continuous	Get the marginal conditions right (third order economizing)

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align governance structures with transactions. Finally, the fourth level of analysis looks at resource allocation, asset deployment and utility maximization. Marginal analysis of costs and benefits determines prices and quantities such that they align the incentives of the economic agents.

Another distinction Williamson (2002: 171) makes is the possibility at look to economic science from two different viewpoints: namely, economics as a science of choice and economics as a science of contract. Neoclassical economics is the science of choice and institutional economics is the science of contract. After that the science of contract is separated in public-ordering and private-ordering. The public-ordering domain looks at the rules of the game, and these are developed by and incorporated in political, legal and thus non-economic institutions. Politics is a structure of complex exchange among individuals, a structure within which persons seek to secure collectively their own privately defined objectives that cannot be efficiently secured through simple market exchanges (Buchanan, 1987: 296). Private-ordering mechanisms are economic institutions that can also be split into two related branches. One branch concentrates on front-end incentive alignment (security design, formal agency theory and formal property rights theory) and the other branch highlights the governance of ongoing, back-end, contractual relations (contract implementation). The private-ordering arrangements or economic institutions are all situated at the third level of social analysis, while the public-ordering mechanisms that contain the non-economic institutions are placed at level two of the social analysis framework. The investigation of these second-level institutions is concentrated in the field of constitutional economics. Traditional neoclassical economics can be characterized as a fourth-level type of analyses of economic problems.

With the help of the social analysis framework, we can explain that the neoclassical branch of NI has the opinion that levels three and two phenomena are deeply influenced by level four forces. OI also states that level one informal institutions determine the resource allocation and need satisfaction process of level four via economic and non-economic institutions. So the difference of opinion between the adherents of OI and NI is about the direction of causality between the distinguished levels in the social analysis framework.

The contractual relation between the firm and its stakeholders can be interpreted as a variation on a theme. In this theme one of the important concepts, namely general- or special-purpose technology, plays an important role via a measure of asset specificity. Also the safeguarding of specific investments measured by the magnitude of safeguards is incorporated as an important concept to develop a simple contracting schema of governance mechanisms.

Williamson (2002: 182) suggests that in a situation where transactions make use of a general-purpose technology, the suitable solution is the unassisted market transaction. For parties who transact without safeguarding specific investments, a special-purpose technology is the optimal technology. In this case, contractual supports take the form of inter-firm contractual safeguards. Credible contracting is then the topical governance mechanism. However, if the contractual supports break down, then it is more efficient to take the transaction out of the market and organize it internally. The general message of the transaction cost theory is: try markets, try hybrids and have recourse to the firm and its hierarchy, and internal organization only when all else fails. This insight can be applied to the relationship

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of the firm with its sources of finance. In the situation of general-purpose technology, the capital suppliers and the firm can opt for debt contracts because the bankruptcy procedure gives the bondholders the possibility in the case of default to exercise their pre-emptive claims against the assets in question. Additional safeguards are not necessary here. If special-purpose technology is traded in the transaction then the capital suppliers and the firm should choose equity contracts. Still, if they do not want to be in a situation of unrelieved hazard then contractual support to the equity contracts is required. A safeguarding feature that arises in support of the contract for equity finance is the board of directors. This private-ordering institution can contribute to credible contracting between firm and shareholders.

Suppose that contractual support is given to the equity contract by the introduction of a board of directors which:

- is elected by the pro-rata votes of those who hold tradable shares,
- has the power to replace the management team,
- decides on management compensation,
- has access to internal performance measures on a timely basis,
- can authorize audits in depth for special follow-up purposes,
- is apprised of important investment and operating proposals before they are implemented,
- bears a decision review and monitoring relation to the firm's management.

Consequently, the residual claimant status of the shareholders in both earnings and asset liquidation is brought into line with their residual and ultimate control rights. Hence, this construction reduces the cost of capital given the safeguards for the equity holders. If this board of directors is not strong enough to operate as a safeguard for the equity investors (as the required penalties, information disclosure and verification procedures) are not instituted or enforceable, then this theory suggests integration of the capital suppliers with the firm under one hierarchy. If this solution is not applicable, the firm and its capital suppliers remain in a situation of unrelieved hazard. It is to be expected that the parties concerned, attempt to change the formal institutional rules (like property rights) such that they are able to protect their position and the unrelieved hazardous situation is cancelled. This situation will especially arise for specific-purpose transactions where credible contracting is not possible because of the uncooperative behaviour of one or more involved stakeholders. Examples of changes in formal institutions are changes in company law and the introduction of corporate governance codes. The emergence of these institutional changes via a spontaneous process of stakeholders or via the conscious design of the government under political pressure are captured by the theories of the new institutional economists of the Austrian and the neoclassical wing, respectively.

11.3. Corporate Governance

11.3.1. Introduction

In the previous section, we have defined corporate governance as "a system of procedures and structures that is used to govern and control the firm, within a field of forces of involved stakeholders with the goal to contribute to the utility of these stakeholders". This

field of forces contains the mutual monitoring and disciplining of stakeholders to look after the fulfilment of the agreements that were made about achievements and remuneration of each party. Characteristic for these agreements (are shaped in a nexus of contracts) is that employees and bondholders generally have fixed compensation, managers have fixed and variable components in their remuneration, and shareholders are entitled to the residual cash flow rights. Rent-seeking behaviour is the behaviour of economic agents who try to appropriate a larger compensation in comparison to their achievements than is agreed on when the contract was negotiated with the firm. The stakeholder that is best positioned to expropriate the wealth of the firm is the management team, because of its informational advantage. The employees and their unions try to protect themselves by asking for job and income security, bondholders want capital protection and little bankruptcy risk, and shareholders require a rate of return that compensates their exposure to fluctuating cash flows. All these monitoring and disciplining activities ask for institutions that enable these activities and contribute to the utility of the stakeholders. The institutions that facilitate employee and investor protection can emerge either from spontaneous, invisible hand processes via markets and contracts, or they can be designed by a government that changes the property rights under the influence of lobbying activities of interest groups in political processes.

Rent appropriation and rent expropriation are a demonstration of principal-agent problems that can exist between managers and shareholders, between majority, controlling shareholders and minority shareholders, between shareholders and bondholders, and between the employing firm and its employees. If the residual cash flow rights and the residual control rights are not distributed symmetrically between shareholders and management, then there is an important source for an agency problem between these two stakeholders. This rent extraction problem is the basis for the definition of corporate governance by Shleifer and Vishny (1997: 737): "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." And they add several questions to this definition like: "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? How do suppliers of finance control managers?" Also Shleifer and Vishny state that corporate governance mechanisms are economic and legal institutions that can be altered through the political process. Through private- or public-ordering arrangements, stakeholders intend to get a fair return on invested capital.

11.3.2. The Structure and Evolution of Corporate Governance

Corporate governance is an institutional arrangement that organizes the disciplining and monitoring mechanism within the firm (Table 11.2). This mechanism can be separated in an internal and an external disciplining mechanism and you can divide the system of procedures and structures in three aspects: namely, in a legal, an economic and a social angle.

The corporate governance mechanism is a safeguard mechanism in addition to the equity contract, which makes it for equity holders better possible to earn a return on their investment. We can conclude that the managerial power position has increased substantially during the last decade because this group was able to increase its remuneration level

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Table 11.2: Corporate governance disciplining mechanisms.

System of procedures and structures:(→) Disciplining mechanisms:(↓)	Legal	Economic	Social
Internal	Board of directors	Remuneration structure	Internal behaviour codes
	General meeting of shareholders	Composition board of directors:	Board of directors:
	Work council	Executives and non-executives	• Remuneration committee
		Internal labour market	• Nomination committee
		Ownership structure	• Audit committee
		Control structure	• Strategy committee
			Corporate culture
External	Structure regime	Capital market	Corporate governance committee
	Listing requirements stock exchanges	Take over market	Associations of investors, firms
	Corporate law	Purchasing market	Monitoring authorities
	Disclosure act financial stakes	Sales market	Political process
	Corporate governance code	External labour market	Culture society

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substantially in a lot of countries with very much different characteristics. Due to the increased power position in management teams, one can expect a counter reaction by equity investors, creditors, employees and other stakeholders by putting more efforts in disciplining and monitoring activities, by renegotiating contracts and by bringing this topic in the political process. This conflict of interest around the remuneration of managers directed us to a situation where the control rights shifted more in the direction of the shareholders. Another development is the increase in the concentration degree of the ownership structure of firms. Large shareholders are better equipped to monitor firms than a large group of small shareholders. The disadvantage of the emergence of large shareholders is that this type of shareholder can expropriate minority shareholders. So, one agency problem is solved by the introduction of another one. That is a frequently returning dilemma in the world of corporate governance. Also, more and more objections against the use of dual-class shares, pyramid/cascade structures in ownership structures and crossholdings which take away the control rights from the shareholder and put it in the hands of management teams which are more entrenched in this way.

Due to this conflict around executive remuneration we register a shift from management-controlled firms to more owner-controlled firms (Grazell, 1992; 1997). The contractual safeguards that support the equity contracts are not sufficient to redress the increased rent extraction effort by the management teams. In many countries, political means are used to try to change the public-ordering mechanism that organizes the relation between the firm and its stakeholders. Proposals from interest groups have arisen to create corporate governance committees, which consist of representatives of the most important stakeholders. In these corporate governance committees negotiations take place between the several stakeholders of the firms and the compromises are moulded in codes of best practice. Even the status of these corporate governance codes is a topic of discussion. Sometimes these corporate governance codes are incorporated in company law, sometimes these codes get a semi-public status and are not enforceable because firms only had to follow the "comply or explain principle". This depended for instance on the legal tradition in these countries. So during a decade of increasing conflict around management remuneration, we witness the development of and the dynamic interaction between private-ordering mechanisms and public-ordering mechanisms to solve the various agency problems.

11.3.3. The Scandals

The increasing conflict around executive compensation was not the only problem that drew the attention of the public. There were also a number of striking scandals in the business world: Maxwell Corporation (1991), Enron (2001), Parmalat (2003) and Ahold (2003). All these scandals were characterized by fraudulent activities of executives who cumulated too many functions within one person. Especially the combination of executive tasks and supervision tasks or even the combination of executive and financial management tasks were unacceptable practices which brought managers at the top into temptation to act without honesty and integrity. Managers who noticed that they could not meet their too ambitious targets searched for escape routes and found these routes in fraudulent activities in their financial reporting systems. All these scandals were similar

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in this sense that auditors failed to pick up the fraud. Auditing functions and executive tasks were not separated from each other. These scandals were triggers to start an intensive societal debate in a lot of countries on corporate governance practices. This gave an impulse to the design of additional public-ordering devices.

11.3.4. The Development of Codes Around the World

The corporate scandals and fraudulent accounting practices combined with the debates about managerial remuneration led governments and regulators to introduce stronger regulation to reinforce investor confidence in the financial markets. In some countries, legislation and codes addressing corporate governance problems have been in existence for decades, in others governments are just embarking on the development of these codes. In the Anglo-Saxon world the Cadbury report (1992) was one of the first codes of best practice with recommendations on a range of governance practices like the structure and composition of the board of directors and the board committees, and highlighted the importance of non-executive directors (Maier, 2005: 3). Reason for the development of this code was the collapse of the Maxwell Publishing Group. The "comply or explain principle" was established in this code. Other codes were added which resulted in the Combined Code (1998; 2003).

Due to the Enron and WorldCom scandals in the USA, reforms were agreed by the US Congress and the New York Stock Exchange (NYSE). The result was the introduction of the Accounting Industry Reform Act 2002, widely known as the Sarbanes-Oxley Act, and the insertion of corporate governance rules in the listing requirements of the NYSE (Maier, 2005: 4).

Major corporate scandals, and regulatory and legislative responses from governments and regulators are felt worldwide. The principles of good governance that all countries try to develop for their situation converge after a certain time to a kind of standard corporate governance code, which starts to function as a benchmark. The Organization of Economic Cooperation and Development (OECD) took the initiative to summarize all these principles in an OECD Code of Principles of Corporate Governance (1999, 2004). Corporate governance codes address a wide range of structural and behavioural elements, including board accountability, shareholder rights, financial disclosure and internal controls, executive remuneration, and board structure and functioning. The principles of the OECD incorporate all these elements are non-binding but represent common corporate governance standards of good practice, intended to reflect and inform the corporate governance debate internationally. The principles cover the following issues:

- the basis for an effective corporate governance framework,
- the rights of shareholders and key ownership functions,
- the equitable treatment of shareholders,
- the role of the stakeholders in corporate governance,
- disclosure and transparency,
- the responsibilities of the board.

Rather than advocating particular structures or types of behaviour, the principles identify common elements that underlie good corporate governance everywhere (Maier, 2005: 5).

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11.3.5. The Role of Investors

Although the development of a good corporate governance framework as a safeguard to the equity contract is of vital importance the behaviour of the actors itself and the way they fulfil their role cannot be neglected because only the combination of institutions and behaviour makes good governance practices possible. This issue is known in social theory as the agency structure problem (Hodgson, 2004; Scott, 1995). The institutions are the structure within which actors can fill in their actions. These structures constrain but also enable the actions the agent can choose. The principal-agent problem in economic theory is a problem within the agency structure firmament. A good corporate governance structure demands within the possibilities of the agency structure framework from investors as well as managers an active attitude towards their task. From investors is expected that they are active monitors of the firm and that they exhaust every possibility to monitor their company. Especially the large institutional investors have a responsible role to play, because they manage the wealth of millions of stakeholders. From managers a high ethical standard is expected. Only then the residual loss (Jensen & Meckling, 1976) will be limited to a minimum and the trust and confidence in the good working of the institutions of society, that was shaken by the scandals, can be restored.

11.4. Corporate Governance in the Netherlands

In the second half of the 1990s, the Dutch business community felt the need to institute a code of best practice in the field of corporate governance. In 1997, the Committee Corporate Governance produced a report with 40 recommendations. In 2002, a follow-up report was published that reflected the current state of affairs with respect to corporate governance reforms implemented in the Dutch business environment during the earlier 5 years.

In December 2003, a newly installed Corporate Governance Committee published the final Dutch corporate governance code containing principles of good corporate governance and best practice provisions.

11.4.1. Control Issues and Defensive Measures

Dutch listed companies are traditionally well protected against (hostile) takeovers. Since the beginning of the 1990s, however, this protection has been under attack. In 1997, a bill to restrict these measures was sent to parliament, but never became law. At present, a new bill is being prepared, with a view to implementing the 13th European Union (EU) Directive on takeovers. In addition to the pressure coming from the new legislation, Dutch employers are also calling for the dismantling of defensive measures against takeovers. The debate has focused on the extent to which defensive measures should be allowed. In the listing requirements of the Euronext Stock Exchange Amsterdam, a rule is included which limits firms to accumulate defensive measures. Since 1992, firms are not allowed to have more than two of these anti-takeover devices.

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11.4.2. The Two-Tier Structure Reform Act of 2004

According to the Dutch Civil Code, a statutory two-tier regime exists in the Netherlands since 1971, consists of a system in which the supervisory board appoints its own members. At the beginning of the 1990s, this issue was readdressed by several stakeholders such as the Dutch Investors' Association. After advice of the Social Economic Council the Dutch Government decided to change the law by introducing the Two-Tier Structure Reform Act of 2004. The main characteristics of this Act are that the powers of the works council have been altered by an increased right of recommendation and the disappearance of the right to object to certain candidates for the nomination of supervisory board members. In addition, the general meeting of shareholders has been granted the right:

- to appoint the members of the supervisory board,
- to reject any nomination for the appointment of supervisory directors,
- to dismiss the entire supervisory board.

The Two-tier Structure Reform Act came into effect on 1st September, 2004, and will have an important impact on the Dutch corporate governance culture (Groenewald, 2005: 297–300).

11.4.3. The Dutch Corporate Governance Code

The Code contains five chapters with principles and best practices on the role of the managing board, the supervisory board, the shareholders, the general meeting of shareholders, and the internal and the external auditors. One of the provisions on the managing board is that they are appointed for a maximum of 4 years and that they cannot be tenured employees. There are also restrictions on remuneration (such as the conditional grants of stock options to managing directors). The maximum severance pay in the event of dismissal of a managing director is equal to 1 year's salary. With the exception of one supervisory director, all supervisory directors have to be independent. Detailed criteria to ensure such independency are described in the code. The supervisory board will appoint an audit committee, a remuneration committee and a nomination committee. The chairman of the supervisory board will be responsible for the proper functioning of the supervisory board and its committees.

The shareholders can play a role in decisions affecting the identity of the company or concerning large acquisitions and divestments. Depository receipts for shares will no longer able to be used as anti-takeover mechanism. Proxy voting and proxy solicitation will be facilitated. Equal treatment of all shareholders will be secured in the informational contacts of firms with the financial markets. An external auditor is appointed by the general meeting of shareholders on the recommendation of the supervisory board. The audit committee assesses how the external auditor is engaged in the content and publication of financial information. Apart from the external auditor, the internal auditor will work under the responsibility of the managing board. The managing board and supervisory board are together responsible for the company's corporate governance structure and the company's compliance with the code. The annual report should explicitly state whether the company

complies with the code and, if it does not, the reasons for its non-compliance (Groenewald, 2005: 301–305).

The "apply or explain" provision has been given a legal basis in the Two-Tier Structure Reform Act of 2004. The enforcement of the "apply or explain" principle will not take place exclusively in the annual report but may also be achieved by an inquiry before the Enterprise Chamber of the Supreme Court into the affairs of the company in the event of an infringement of the code's provisions. In that case, both the managing board and the supervisory board may be held liable for improper management and may be held personally responsible. Even though the code is meant to apply exclusively to listed companies the corporate governance committee has stated that the principles may also be relevant for large non-listed companies (Groenewald, 2005: 307–309).

11.5. Institutions and Corporate Governance Practices as a Determinant of Firm Performance

Firm performance can be measured in diverse ways: accounting returns or market-to-book ratios (q-ratios). We can distinguish three strands of theory by type of firm activity. Information theories state that investments in new technology benefit from the existence of securities markets while traditional investments benefit from the monitoring that banks can provide. In commitment theories, concentrated ownership is associated with activities that involve also investments by stakeholders other than the investors, and dispersed ownership is optimal in investments in new technologies. In control theories, long-term investments are more promoted in concentrated banking systems, while short-term investments are financed in systems with fragmented banking relations. High-risk R&D investments are financed by dispersed ownership systems and lower-risk, and more imitative investments with concentrated ownership systems (Mayer, 2002: 314–315).

The relation between investor protection and corporate valuation is investigated by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2002). They find 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. Investor protection can be regulated in a code (civil) law system and in a common law system. Code law is according to the concepts of Williamson (2002) a public-ordering device and common law, a private-ordering mechanism. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2002) find in their study that in countries with common law systems Tobin's q is significantly higher than in countries with civil law systems. Also, the anti-director rights are significantly higher in common law countries. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) distinguish three legal traditions, namely the French, the German and the Scandinavian. Common law countries have the strongest protection of outside investors via the enforcement of private contracts through the court system. Financial markets do not require regulation as long as the contracts are enforced. In many countries such enforcements cannot be taken for granted. In that case, other forms of protecting property rights are considered, such as judicial-enforced laws or even government-enforced regulations because they may be more efficient. At that moment, the country shifts to a code or civil law system. The French civil law countries

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have the weakest protection for both shareholders and creditors. German civil law and Scandinavian countries fall in between, although they have stronger protection for creditors (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000: 7–8). Remarkable is that the emergence of corporate governance codes takes place in all the countries of the diverse law traditions but that it is to be expected that in the civil law countries the principles of these codes will be integrated in the law itself while in the more common-law-oriented countries the codes play a supportive role in the financial contracts. Whether contracts, court-enforced legal rules or government-enforced regulations are the most efficient form of protecting financial arrangements is largely an empirical question and depends on asset specificity. The consequences of better investor protection are that more dispersed ownership of shares is possible and that the fundamental agency problem between outside investors and controlling shareholders is solved. The existence of controlling shareholders mitigates also the Berle and Means variant of agency problems between outside investors and managers. These equilibrium ownership structures facilitate certain investment policies as we saw earlier in this paragraph when we studied types of activities.

High investor protection encourages also the development of financial markets. When investors are protected from expropriation, the cost of capital decrease, making it more attractive for entrepreneurs to issue securities.

Financial development accelerates economic growth in three ways. First, it increases savings. Second, it fosters through real investment capital accumulation. Third, to the extent that the financiers exercise control over the investment decisions, financial development allows capital to flow towards the more profitable and productive uses, and thus improves the resource allocation (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000: 13–17). Carlin and Mayer (2003) report a strong relation of information disclosure, fragmentation of banking systems and concentration of ownership with the growth of equity-financed and skill-intensive industries. The growth of equity-dependent industries is particularly high in advanced countries with good information disclosure, investor protection and dispersed banking systems. Gugler (2001: 201–205) reports that direct shareholder monitoring has a positive impact on corporate performance. Large shareholders are active monitors in the corporations they control. They have both the incentives and the means to discipline management. Some studies do report beneficial effects of large shareholder monitoring for firm performance, but there are also some that find insignificant or unclear results. This result from the fact that large shareholders are not only effective monitors but also consume private benefits from control at the cost of minority shareholders. Institutional structure does not always mitigate this problem. The conflict between managers and owners, and between controlling shareholders and minority shareholders will only grow in importance. That is why institutional investors like pension funds or mutual funds will play a key role in channelling private savings to productive investment. Efficient allocation processes will be stimulated thanks to these institutional investors by the successful implementation of good governance practices on the European financial markets. An important finding is that all constellations of ownership and control structure (Scott, 1997: 56) involve costs and benefits. Relying on one or a few tools to solve agency conflicts is not optimal. Sole reliance on one mechanism is not optimal but the right mix of direct monitoring by shareholders and board of directors, efficiently designed managerial compensation packages and tight competition in the managerial and product markets yields a better solution (Gugler, 2001: 204–205).

Corporate governance regulation and other legislation are intimately linked to each other. Anti-trust policy, competition policy and regulations about corporate governance influence each other and must be viewed in conjunction. If competition in product markets is weak, managerial discretion over free cash flows is more likely to emerge and corporate governance practices become more important in monopolistic or oligopolistic environments. Since monitoring is a public good in dispersed ownership structures, a carefully composed mix of additional corporate governance means (like monitoring management by board of directors, efficient remuneration contracts, well-functioning takeover markets and clear corporate governance codes) to the individual equity contract is needed. All these services together improve the performance of firms in a lot of countries (Gugler, 2001: 205–212).

11.6. Conclusions

The emergence of corporate governance codes is an important institutional element in a lot of countries and contributes significantly to protection of investors. In civil law countries these codes are public-ordering mechanisms which operate like court-enforced legal rules or government-enforced regulations contract, whereas in common law countries it functions as a private-ordering mechanism that is a contractual safeguard to the equity contract. This encourages the transparency and development of financial markets, increases savings and real investment, and improves the resource allocation and the accumulation of capital. Still, the introduction of these codes imposes transaction costs on firms, which have to comply to all these rules. The frauds and scandals destroyed an important component of immaterial capital namely trust. To rebuild an informal institution like trust between parties on the financial markets will take a lot of time and in the mean time societies have to invest more means in investor protection so that the efficient allocation of savings to the most profitable investment is guaranteed. The disappearance of an informal institution like trust consequently has severe effects on the development of formal institutions and the transaction costs in the financial system. The topicality of this causal direction today makes that it is still possible to gain additional insights from the old institutional economists.

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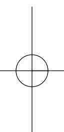
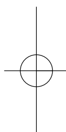
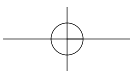

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