

Comments welcome

**The Changing Corporate Governance Paradigm:
Implications for Transition and Developing Countries**

(Preliminary draft)

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Abstract

The rapidly growing literature studying the relationship between legal origin, investor protection and finance has stimulated an important debate in academic circles. It has also generated a cottage industry of applied research and strong policy statements. This paper discusses the implications, in particular for developing and transition countries, from this literature. Our general conclusion is that its focus on the plight of small investors is too narrow when applied to these countries. We argue that this group is unlikely to play an important role in most developing and transition countries. External investors may still be crucial, particularly in transition countries, but they are more likely to come in as strategic investors or creditors. The paper also proposes a broader paradigm including other stakeholders and mechanisms of governance in order to better understand the problems facing these countries and generate policy implications that compensate for the weaknesses of capital markets.

1. Introduction

Corporate governance has been a dominant policy issue in developed market economies for more than a decade, lately particularly in Continental Europe and Japan. In the transition economies it took some time for corporate governance to climb the latter of policy priorities, but since the mid-90's it is one of the most hotly contested issues. In the wake of the Asian Crisis corporate governance has now also become a catchword in the development debate. Countries and stock exchanges are competing to produce corporate governance guidelines, and OECD is about to publish its own principles. But how important is corporate governance? For some, it is the single most important policy issue, others claim its effects are second order. These differences in opinion may reflect the fact that people mean different things when they use the concept. Another explanation could be that corporate governance is not always important, but that it matters very much when it matters; it certainly seems to be more important in some phases of a firm's life cycle than in others. Corporate governance is also likely to matter more in certain contexts or certain phases of economic development than in others.

Ultimately, of course, when and how much corporate governance matters is an empirical question. There is now a series of articles that begins to address these issues in a comparative empirical perspective, promising more precise definitions of the corporate governance problem and better measurements of its impact on economic growth (LaPorta et al., 1997, 1998a and 1998b; for simplicity we will refer to their three main articles as LLSV where a more precise reference is not absolutely necessary). The authors - Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny - raise a range of important issues concerning the interaction between law and finance, and more broadly about the role of institutions in economic development. Their articles have already given rise to a cottage industry. Recent contributions analyze the effects of legal rules protecting investors and general quality of the legal system on, for example, the development of the financial system (Levine et al, 1998), the impact of macroeconomic shocks (Johnson et al., 1998) and corporate behavior and industrial growth (and LaPorta et al., 1998c; Rajan and Servaes, 1998; and Rajan and Zingales, 1998). In many cases the

explanatory power of the legal variables is very strong suggesting that the potential implications for policy are important.

This article discusses how the findings in this rapidly growing literature should be interpreted. In particular, we would like to understand its implications for transition countries and developing economies. Our view is that while the contributions have raised a range of interesting questions and expanded the empirical base upon which economists form their theories and draw policy implications, the analysis is incomplete and normative conclusions are often premature. The main reason why the analysis is incomplete is that it focuses on only one group of actors, small investors, in the corporate governance problem. The fate of corporations de facto is, and possibly should be, determined by other actors inside and outside the firm as well. The net for empirical investigations must therefore be cast wider. We recognize the ingenuity and importance of this first generation of empirical corporate governance papers, but we emphasize that so far there are few general conclusions and that any recommendation for policy must be based on an analysis of the specific governance problem in the given country.

This recent literature comes from a worldview where the main corporate governance problem is an entrenched management and weak, dispersed shareholders. The need to raise external finance determines the structure of the firm and the legal framework in which it operates. In this sense the literature follows a long tradition. However, in their quest to understand the interaction between the legal framework and corporate governance the contributors have shown that the empirical context from which they derived their worldview is highly unrepresentative when taken beyond United States and United Kingdom. A rapidly increasing body of cross-sectional studies and comparable country studies demonstrate clearly that the widely held firm is a rare phenomenon in most countries (see LLSV (1998b) and Barca and Becht (1999), respectively). Most firms in the world, even listed firms, have a dominant shareholder. Moreover, this shareholder is very often involved in the management of the firm. Sometimes, but rarely, a bank will play this role, but in most cases families and the state hold such controlling stakes. This pattern is strong on the European continent, but it is even more pronounced in developing

countries. In the economies in transition ownership structures are still not well established, but widely held firms are extremely rare, even in countries that opted for mass-privatization through vouchers.

The realization that the closely held firm is the dominant form of governance profoundly affects how we conceive of the corporate governance problem and its policy implications. The focus shifts from conflicts between management and shareholders to those between owner/managers or blockholders and minority investors. Furthermore, the identity of investors becomes important, and the issue arises who monitors them, what are their incentives and how are they constrained by the legal framework. When the firm is closely held, the emphasis shifts from different governance institutions such as boards of directors, general shareholders meetings, and takeovers to the various devices for re-designing ownership and control, in particular the use of dual class shares, pyramiding of share holdings and cross-ownership. And the analysis of capital market activity must replace the paradigm of the competitive stock market in favor of models of bilateral negotiations, blockholder conflicts, and market design. In particular, with closely held companies takeover markets operate very differently. Often outright hostile offers are literally impossible when one owner controls the majority of the shares, and most control transactions take place outside the official exchanges.

LLSV also want to explain these cross-country variations in ownership concentration and financing arrangements. The argument is that when the legal framework does not offer sufficient protection for outside investors, entrepreneurs and original owners are forced to maintain large positions themselves to align their incentives with other shareholders (Shleifer and Vishny, 1997). In other words, countries with poor shareholder protection should have more concentrated ownership structures. LLSV find support for this hypothesis, and they argue that differences in investor protection have implications for corporate behavior and economic growth.

These articles have been very influential, in particular in the international organizations. There are several ways in which to understand its implications for policy. A naive and

optimistic interpretation these implications are relatively straightforward: strengthen legal rules protecting minority shareholders. These implications should be particularly uncontroversial for developing countries and countries in transition where these laws are likely to be weakest. LLSV even provide a list of features of such rules that would achieve this result. For example, forbid deviations from one-share-one vote and allow proxy voting by mail and corporations would function more efficiently, or at least controlling owners would be able to sell off some of their equity allowing them to better diversify their portfolio and making stock markets more liquid. The remaining problem would primarily be one of implementation and possibly enforcement.

A deeper, but also more pessimistic, interpretation of their findings is that investor protection is indeed very important, but that the various rules are generated by different legal systems - civil law systems and common law systems; improvements in investor protection can only be achieved by reforming the legal system. Such reforms are very complex and may not be an option even for the economies in transition; in most countries this choice has already been made, at least when it comes to corporate law. Important stakeholders may also resist legal reform.

Even if such reforms were feasible, extreme care is still warranted in drawing policy implications from this literature. The focus of corporate finance for so many years - the widely held corporation - is a rare phenomenon, in particularly developing and transition economies. Our understanding of the closely held firm and the markets in which controlling blocks are traded is still limited, and the analysis of the various mechanisms for separating ownership and control, and groups of companies has only just begun. In particular, we know rather little about how to preserve the powerful incentives of owner/managers, especially in family firms, while strengthening the protection of minority shareholders.

More generally, however, an important shortcoming of the new corporate governance literature is that it restricts attention to the issue of control by the providers of capital, often even further to equity holders. In a legalistic sense, this restriction may be justified,

because equity holders formally “own” the firm unless it is bankrupt, in which case ownership of the firm or parts of it may switch to other providers of capital. The implicit argument that who owns should control, however, is flawed in many respects. First - and this is, of course, at the heart of the traditional corporate governance literature - there is a big difference between “should” and “does”. More generally than the traditional literature, however, this difference relates not only to the conflict between top management and equity. Other groups inside and outside the firm exert de facto significant influence on at least some decisions by the firm. These include the employees as a whole (sometimes formally represented through unions or worker councils or other institutions), higher and middle management, firm-specific suppliers or buyers, large financial firms and other firms which are not linked to the given firm by equity stakes, the public, and the government.

This emerging corporate governance paradigm replaces the traditional corporate governance problem of small, dispersed investors attempting to control entrenched managers by a model of multilateral negotiations and influence seeking. This model in practice typically integrates a number of checks and balances. In fact, even if there is theoretical reason to believe in the view that ownership with all its costs and benefits belongs to equity, this view is not dominant in most economies outside the U.S. and the U.K. This broader notion of corporate governance offers some hope to developing and transition economies where small, dispersed investors are unlikely to play an important role promoting the necessary entrepreneurial activity and corporate restructuring. It suggests that other mechanisms, such as competition and pressure from suppliers and customers, may compensate for this weakness. Investor protection could still be important, in particular in transition economies where strategic investors are needed to restructure the companies inherited from the socialist period. In the long-term protecting small foreign investors may also help attract international portfolio investment, but this source of funds is highly volatile and cannot be the centerpiece of a development program.

To make policy recommendations we need to define the corporate governance problem in a particular country with regard to the prevailing institutions. In particular, the predominant corporate governance problem in a transition country is likely to be different from that of a developing economy, which in turn is different from that of a developed market economy. Corporate governance issues also vary substantially across developed market economies (see, for example, Berglof, 1997; Gugler, 1999; and Barca and Becht, 1999). These differences will affect the implementation of corporate governance recommendations. Take, for example, the problem of corporate transparency: according to the market based view of corporate governance, transparency about ownership and control arrangements is unambiguously a good thing, and several variables in LSSV indicate that many countries outside the U.S. and the U.K. are deficient in this respect. In the light of this type of criticism, the European Commission passed its Transparency Directive in 1993 to increase transparency of corporations in the EU. However, this directive has achieved little, if anything (ECGN, 1998). Most firms or even countries in Europe seem to have found ways around the restrictions imposed by the Commission. This seems to indicate that a piecemeal approach of introducing legislation advocated by the market based corporate governance view may not work in economies organized along other lines.

The policy implications from the corporate governance literature are also unclear because corporate governance and corporate law are viewed in isolation. The literature is typically silent on the role of suppliers and employees, and other bodies of law such as labor law in monitoring management and controlling owners. Corporate governance is isolated from product markets. Another interesting aspect that has been largely overlooked is the interaction between corporate governance arrangements and the political system. We argue that “crony capitalism” may indeed be a much more important problem in most developing countries than the protection of minority shareholders. In general, the literature tends to over-emphasize the importance of external finance and corporate governance in these countries; other constraints, like supply of profitable investment opportunities and ability to mobilize savings, are likely to have a stronger impact on economic development.

The outline of the paper is as follow. Section 2 briefly goes through the main findings in the literature with an emphasis on the empirical contributions. The following section (Section 3) discusses how these findings should be interpreted in the context of a broader view of corporate governance and the firms. Section 4 reviews some of the findings on the relationship between corporate governance and economic growth. Sections 6 and 7 apply the basic framework to the corporate governance problem facing developing economies and transition countries, respectively. The final section (Section 8) draws some implications for policy.

2. Law and Finance

The articles of LLSV have an ambitious agenda. They want to establish systematic, even causal, links between the legal framework and financing patterns, and ultimately corporate performance and economic growth. The causal chain could be described by Figure 1. Legal origins are classified into Anglo-Saxon, French, German and Scandinavian, or simply common law (Anglo-Saxon) and civil law (the three others), and they are viewed as exogenous, i.e., traded down from history or imposed from the outside. The legal origin shapes the corporate law, in particular the extent to which it protects external investors. Corporate law influences the choice of financial arrangements in individual firms. The implicit claim is that these financial arrangements in conjunction with the legal framework then affects corporate behavior and performance. This section summarizes the main findings and provides a first critique.

FIGURE 1



The presumption in LLSV is that the different sets of variables can be quantified and observed. In particular, the authors assume that corporate law can be meaningfully reduced to a set of, often binomial, measures, which capture the degree of investor protection. LLSV offers eight such indicators for shareholder protection and six for creditor protection (see Table 1). These measures are supplemented by more or less generally accepted indices of “rule of law” and quality of accounting standards. The authors establish a strong correlation between legal origin, investor protection and ownership concentration; when they control for investor protection the significance of legal origin disappears suggesting that legal origin primarily affects finance through investor protection. They also identify some potentially interesting differences between countries at different levels of development. We will return to these differences later.

TABLE 1: INDICATORS OF INVESTOR PROTECTION

Shareholder protection

Creditor Protection

One share – one vote

No automatic stay

Proxy by mail allowed

Secured creditors payed first

Shares not blocked before meeting

Restrictions for going into reorgan.

Cumulative voting/proportional rep.

Management leaves in reorgan.

Oppressed minority

Legal reserve requirements

Preemptive rights to new issues

% of share capital to call an ESM

Mandatory dividend

Many lawyers have been critical of the classification of countries into legal origins. They find the distinction between common law and civil law particularly superficial. Common law countries have a considerable degree of codification (for example, many of the rules protecting investors under US law are described in the Uniform Commercial Code and creditor protection is in part defined by the Bankruptcy Code of 1978) and civil law countries have developed powerful bodies of case law. In classifying individual countries LLSV draw on an admittedly controversial standard textbook in comparative law. The classifications of some countries have been challenged, and others have emphasized the differences within the two groups. But even if the authors' use of labels probably can be legitimately criticized, the strong correlation remains to be explained. It is hard to see that a few reclassifications would radically change the results.

TABLE 2 INDICATORS OF ENFORCEMENT

Efficiency of judicial system

Rule of law

Corruption

Risk of expropriation

Risk of contract repudiation

Rating on accounting standards

Another criticism put forth by representatives of the law profession is that the authors are using biased or misleading measures of the quality of corporate law. Behind the measures of investor protection obviously lie qualitative judgements, but in principle it could eventually be possible to agree on the appropriate characterizations. Even if this quantification were accurate, the danger is, of course, that the quantifiable aspects of the law provide a biased picture or that the conceptual framework used for identifying these measures is flawed. Different legal systems find different ways to compensate for their weaknesses. For example, mandatory dividends are not common in Anglo-Saxon countries, but a feature of many civil law countries, particularly in the third world, indicating that this measure is intended to compensate for poor protection in other respects. The problem of investor protection could also have more dimensions, and the measures may miss one or more of these. For example, junior and senior creditors may have very different interests; laws that protect one group may harm the other. We will return to this latter problem in our discussion of the theoretical foundation for the approach. Again, even if there were these biases critics must explain the systematic and strong correlation the authors establish.

Another potentially more serious criticism concerns the causality claim, i.e., that corporate law drives corporate finance and not the other way around. It is not difficult to come up with examples of how corporate law in writing and enforcement has been shaped by existing financial structures. Countries with a tradition of strong bank involvement in corporate control have often found effective ways of accomodating this

tradition in legal practice (see, e.g., Japan and Sweden). Similarly, in countries where closely held firms predominate, legislators and regulators have often found it unnecessary to specifically regulate the composition of boards of directors. When there is a clearly identifiable controlling owner, he or she is believed to be better suited and have the right incentives to make the optimal decision. The authors' response to this criticism is that legal origin, if not corporate law as such, is highly exogenous, indeed often imposed by colonial powers. The fact that countries with one legal origin scores significantly worse along the measures used in the articles must still be explained.

The causality issue brings up another possible problem with the interpretation of the results. It could be that the correlation between legal origin and financing arrangements merely reflects the influence of a third exogenous variable, such as the role of the state or the nature of the political system. In other words, the poor performance of countries with French legal origin would reflect the strong French tradition of state intervention or the French political system; what was imposed on Latin-American countries was not just the legal tradition but the entire system of government. Another similar underlying variable could be fundamental differences in the relationships between stakeholders in society (Roe, 1999). However, it is not clear how such differences are transferred across countries and cultures. All these explanations challenge the interpretation of the results, but they still leave a strong correlation between origin, however broadly defined, and investor protection and financing arrangements.

LaPorta et al. (1998b) follows up on the previous two articles by describing in greater detail the differences across countries in ownership and control in listed firms in a smaller number of countries where data was available. The authors go to considerable trouble to document both direct and indirect control, i.e., when a firm is controlled by another firm which in turn may be controlled by a third entity and so on. This requires information on the use of various control mechanisms such as dual class shares, pyramiding and cross-ownership. The authors show that with the exception of United States and United Kingdom the overwhelming majority of listed corporations have a controlling owner who

in many cases is actively involved in management. As expected countries with a common law origin have more widely held firms.

These findings are consistent and highly complementary to those found in parallel work within the European Corporate Governance Network (summarized in Barca and Becht (1999) and Gugler (1999)). This network strives to establish data comparable across countries, at least for Europe. The contributors have the advantage of having access to better quality data than LLSV but for a smaller number of countries. The data allows a more detailed description and analysis of the corporate governance problem in individual countries. This analysis shows some shortcomings in the quality and comparability of the data used by LLSV. The picture emerging is nevertheless similar with a strong concentration of ownership and extensive use of various mechanisms for separating ownership and control. Judging from the ECGN studies, banks are more, and the State less, important in corporate governance in Europe than in the world as a whole. The country studies in Barca and Becht also suggest that LLSV underestimate bank control by missing other channels for influence than direct ownership. In particular, banks in some countries have managed to circumvent formal restrictions on ownership by establishing independent investment companies (Sweden) and informal constraints by using proxy votes (Germany). In addition, the most important source of influence of banks typically comes from their role as creditors.

However, the qualitative and quantitative assessments in Barca and Becht, and Gugler, raise some fundamental questions about the interpretation of the LLSV findings. There are undoubtedly examples of situations where better investor protection seems highly desirable; stories of controlling owners exploiting minority shareholders abound in some countries (Italy is the favorite example in the literature (Zingales, 1995)). But blockholders on the whole appear to play important roles in monitoring management and often actively participate in management themselves (these studies suffer from an obvious problem of endogeneity, i.e., does ownership determine performance or vice versa). The jury is out on whether concentration of ownership is good or bad for performance; in some countries, like Austria, Holland and Spain, companies with

concentrated ownership do worse than those with dispersed shareholdings while in others the reverse seems to be true (Gugler, 1999). Roe (1999) raises the legitimate point that, if there are any benefits to large blockholders, better legal protection should, if anything, lead to *more* large blocks being formed, not less.

It is not difficult to find examples of legislation that seem unfair to holders of minority blocks, and the ECGN studies point many of them out, but the basic legal framework is seldom challenged at least not from within the countries. Is it really probable that these countries have lived with the gross inefficiencies suggested by LLSV for decades or even centuries without realizing their fundamental weaknesses? In particular, why have controlling owner/managers been willing to absorb year after year the large costs associated with these inefficiencies without pushing for legal reform? Are these laws protecting minorities really as hard to change as LLSV seem to suggest? After all, any policymaker could walk down the list in Table 1 and propose reforms that supposedly would improve the protection of investors.

Implicit in the LLSV articles is a political economy story where managers and large blockholders effectively block legal reform. In some cases such interpretations seem highly plausible. For example, dual class shares is a crucial ingredient in the exercise of control in many countries (such as Sweden) and preventing deviations from one-share-one-vote would seriously undermine the influence of existing holders of high-voting stock and result in substantial redistribution of wealth (voting shares typically trade at a substantial premium). It is understandable that reforms meet with strong resistance when applied *ex post*, but *ex ante* legislation could also have important redistributive effects (see Zingales (1999) for an argument for why inequality may feed resistance to stronger investor protection).

The political economy story may explain why inefficient laws remain in place for long periods of time, but the many remaining puzzles suggest that we need to understand the conceptual framework underlying the LLSV studies better before interpreting the observations and drawing policy conclusions.

3. Corporate Governance and The Firm

Corporate governance can be defined as the mechanisms transmitting signals from product markets and input markets into firm behavior. This definition focuses on two elements: the signals generated and the control structures in place to ensure that management implements the right decision based on these signals. Despite its theoretical flavor this way of looking at corporate governance has important practical implications. It opens up the firm, and its management, to pressures other than that from shareholders. It also emphasizes the need to look at the issue of corporate governance in a wider context of product market competition and vertical linkages. The definition further suggests that the various forces may be substitutes as well as complements in pushing the firm towards efficiency. This section discusses the LLSV worldview in the context of the modern theory of the firm.

Even when we limit attention to shareholders, the analysis may not be as straightforward as is often claimed. When firms are closely held, conflicts are likely between controlling owners and minority shareholders; the meaning of the notion “shareholder value” is no longer clear. On the one hand, maximizing the value of small shareholders may have negative impact on the incentives to start-up firms in the first place or deter firms from ever seeking outside finance. On the other hand, taking the value of controlling owners as the single guiding principle is likely to make external finance prohibitively costly, even though it is not clear why the controlling owner would not like himself to find contractual arrangements that ensured small shareholders adequate compensation for their contribution. This tradeoff may look quite different in transition countries and developing countries as compared to developed market economies.

This discussion already suggests that ownership structure, and more generally financing arrangements, influence the nature of the corporate governance problem. There are two extreme forms of ownership structures: the widely held firm and the firm fully controlled by a family without outside ownership. In between there is a continuum of firms with

more or less concentrated ownership. The corporate governance problem of the widely held firm is reasonably well understood both in theory and practice. Mark Roe (1994) has characterized it as “*Strong Managers, Weak Owners*” in the US case. This type of firm relies on anonymous finance relying primarily on arm’s-length contracts and third party intervention through the market for corporate control.

The family firm has essentially no, or at least a different, corporate governance problem; there may be conflicts between owners and hired managers, but owners are generally believed to have the right incentives to take investment decisions. The corporate governance problem in the family-held firm arises when there is a succession problem or when the firm decides to raise funds outside the family. It is very rare that a pure family-held firm goes directly to a widely held ownership structure; the corporate governance problem facing these firms in these important situations is therefore essentially that of a closely held firm but we choose to separate the two types of firms. The corporate governance problem in the pure family firm could be characterized as “*Strong Family Owners, No Outside Investors*”.

The corporate governance problem in the closely held firm is rather different. The predominant conflict is that between the controlling owner and minority shareholders. The financing pattern is different in the sense that it mixes arm’s-length finance provided by minority investors with control-oriented finance, i.e., when an outside investor takes a controlling stake to directly affect investment decisions. When ownership of financial instruments is concentrated, there are fewer traders in the markets for these instruments making them less liquid. Illiquid markets are bad for minority investors, since the value of the outside “exit” option is reduced. To caricature the corporate governance problem in the closely held firm, it is one of “*Strong Blockholders, Weak Minorities*” (originally coined by Patrick Bolton).

So far we have focused on the relationship between the firm and its shareholders, and between controlling and non-controlling shareholders. However, it is worth noting that shareholders are only one class of investors. Creditors obviously also contribute funds to

the firm, but less appreciated is the fact that suppliers, and sometimes even employees (as currently in Russia), also provide external finance. The State often offers outside funding, either voluntarily, by default (unpaid taxes) and through disbursements after stakeholder pressure.

The objectives of the law become more complex in the case of creditor protection. There are at least four potential inefficiencies. Debtor-creditor law may be excessively hard (or too soft) on management or controlling owners, but the law can also lead to inefficient liquidation (when continuation would be optimal) or inefficient continuation (when liquidation is the optimal decision) (Berglof, Roland and von Thadden, 1999). In addition, there may be conflicts between creditors ex post, and probably ex ante. All these inefficiencies cannot be characterized along a single dimension. Simply maximizing creditor protection does not provide much guidance as a general policy.

The discussion so far has focussed on external finance, but internal finance is the most important source in most developed countries and particularly important in countries with widely held firms (Mayer, 1993). The distinction between external and internal finance may no longer be straightforward in the closely held firm. The owner's own contribution to the firm is typically viewed as internal, even the firm and its owner are legally separated through limited liability. But when the owner/manager turns to distant family members or friends and acquaintances, at which point does internal finance turn into external finance? And what about the group bank in the financial keiretsu in Japan or bank-led corporate groups elsewhere, should the finance it provides be regarded as internal or external?

The focus in LLSV is on the protection of external investors, but should the law also protect management and owner/managers? The protection of external investors comes at the expense of managerial incentives and discretion. When managers are severely constrained, their willingness to exert effort is weaker, and they may opt for suboptimal decisions (e.g., take less risks than desirable). In the closely held firm this tradeoff also

applies to the owner/manager or large blockholder. Restrictions on their discretion are costly; maximum protection of minority investors can never be optimal.

If internal finance is such an important source of capital, it could be argued that management (possibly as a representative of other stakeholders) should in fact have a role in preventing outside investors from grabbing. Such reasoning obviously could be used to justify managerial entrenchment and exploitation of outside investors, but the point is that it cannot be rejected outright. According to this widely held view, outside investors do not necessarily take into account the long-term interest of the firm, i.e., that financial markets are excessively short-term (an argument that is hard to square with the hype in recent years over internet stocks on many of the world's stock exchanges).

Another related argument for why a focus on suppliers of capital may be misleading starts from the fact that many stakeholders, in particular employees or customers and suppliers, make firm-specific investments. Shareholders cannot credibly commit not to breach these contracts, at least not as long as the firm can be sold (Shleifer and Summers, 1988). According to this reasoning, stakeholders will not invest sufficiently if they are not also given a share in revenues and protection against breaches of contract.

Others have pointed to the dangers of the stakeholder perspective (see, for example, Tirole (1998)). Deviations from "shareholder value", however defined, easily allows management to hide behind diffuse objectives and opens up for individual stakeholder groups to capture excessive rents. Sharing control, e.g., through codetermination arrangements, obviously could also slow down and distort the decision-making process.

Our point is that independent of whether a good normative argument could be made for a stakeholder perspective it is a fact that in many, if not most, countries stakeholders do share in rents and take part in the decision-making process. This pattern is particularly striking in many transition countries, often the outcome of the privatization process, but it is also a feature of most continental European countries. In fact, employee participation is very strong in the firms considered by many to be the most advanced corporate

arrangement in the capitalist world, the firms with venture capital finance (for analyses of these arrangements in a corporate governance perspective, see Aoki (1998) and Rajan and Zingales (1998)).

4. Corporate Governance and Economic Growth

LLSV implicitly claim that the legal system and the investor protection it provides to external investors strongly influence the behavior of firms and ultimately corporate performance and economic growth. Figure 2 attempts to make explicit an enlarged causal model allowing for other exogenous factors than legal origin and a two-way causal relationship between the legal and financial systems. It also incorporates the influence from input and product markets as suggested by our definition of corporate governance. As of yet, there is little work empirically testing the claim in LLSV directly, but a number of contributions have studied individual links in the figure. This section discusses some of these empirical studies in the context of a broader model relating corporate governance to economic growth.

FIGURE 2: THE ENLARGED CONCEPTUAL MODEL (see Appendix)

The discussion in the previous section focused on the balance between different classes of investor and management, but our definition of corporate governance suggest that there are many pressures ensuring that signals from input and product markets affect investment decisions. Obviously, the intensity of these signals themselves should be important, i.e., the more competitive are product markets and the stronger the bargaining power of suppliers, the more likely they are to influence the firm's behavior. If management or the controlling owner for some reason is shielded from these pressures, the strength of the signals may not matter. Corporate governance, market competition and pressures from suppliers may be both complements and substitutes. The legal framework may thus have a double role, i.e., in reinforcing the signals as such and improving the mechanism whereby they are channeled into investment decisions. In evaluating the

impact of legal mechanisms and drawing policy implications both functions should be taken into account.

Whether competition in product markets and corporate governance are substitutes or complements is ultimately an empirical issue. Some recent research has addressed this question. Nickell et al. (1997 and 1998) study the relative importance of the shareholder pressure (the existence of a leading shareholder), debt pressure (measured as leverage) and intensity of competition and whether these forces substitute for or reinforce each other in a sample of British firms. They find some support for the substitution hypothesis. A study of Russian firms finds little, or even negative, impact of competition on restructuring (Earle and Estrin, 1998). Unfortunately, the authors did not have access to data on corporate governance, but the general impression from this study is that this mechanism was very weak at the time. Brown and Brown (1998) suggest that when the regional fragmentation of markets is taken into account, the effect of competition should be stronger. One interpretation of the Russian experience is that competition requires at least a minimum of corporate governance to have an impact on firm behavior. Beyond such a minimum the question of whether product markets and corporate governance are substitutes or complements may not be crucial for policy considerations, as long as they both have a positive impact; competition policy becomes even more important if corporate governance is weak.

Another literature has studied the impact of the financial system on economic growth. In one of the articles King and Levine (1993) show that measures of various aspects of the financial system are the economically most significant among a large number of variables related to growth. More specifically, the authors use the share of private institutions in financial intermediation and the size of the banking sector. Later contributions have refined these measures and attempted to better control for reverse causality (Levine et al., 199X). If anything, the strength of the impact of financial variables increase when scrutinized more closely. Levine et al. also attempt to link their earlier findings to those of LLSV. They suggest that the degree of investor, more specifically creditor, protection

explains the development of the financial sector. Indeed, the measures used by LLSV come out strongly significant.

Another set of contributions have focused on the impact of the legal and financial system on corporate behavior rather than performance. Rajan and Zingales (1998) show that under certain assumptions industries dependent on external finance are more developed in countries in systems with better protection of external investors. Rajan and Servaes (199X) present evidence that corporate governance affects the degree of diversification of firms. LaPorta et al. (1998c) show that firms in common law system pay more dividends than in their counterparts in civil law countries.

All these findings suggest that investor protection has an important impact on firm behavior and probably on economic performance and growth. However, any policy recommendations must be country-specific based on the analysis of the dominant ownership and control structures and larger economic system in which they operate. In the following two sections we discuss some preliminary implications for developing economies and transition countries, respectively.

5. Implications for developing countries

Developing countries is probably an even more heterogeneous group than developed market economies in terms of basic legal framework, ownership and control and structure of financial system. This fact already suggests that few general implications can be drawn for these countries, but there are other important considerations when taking the insights from the literature inspired by LLSV to the developing world. This section discusses some of these considerations.

LLSV are not focussing on the development problem, but they provide data for 22 countries (excluding the Asian NICs), respectively, and they do control for GDP per capita in their regressions. There are some interesting observations in this data. As expected, there is a development effect in that several variables, such as rule of law and quality of accounting standards, are positively correlated with GDP per capita. However,

investor protection does not seem to improve with level of development. In fact, creditor protection is strongest in the least developed countries. LLSV interpret the latter observation as a reflection of the reliance on collateral in these economies. The fundamental issue is, of course, whether the text of the law really matters when enforcement is poor.

In general, there are relatively few listed firms in developing countries, and in these firms ownership and control is strongly concentrated (LaPorta et al., 1998b; for Asia see also Claessen et al., 1998). The variation across countries is substantial, but with few exceptions firms have a controlling owner and family-controlled firms play a very important role in most countries.

The presumption of LLSV and in many of the related articles is that external finance really constrains the growth of firms. In most developed market economies this is probably true; internal finance is more important and new issues of equity and debt are relatively rare events in firms, but bank debt is frequently used. In developing countries the actual or potential role of external finance is not as clear. Finance, internal or external, will only help when firms have access to profitable projects with low enough risk; the risk premium is high in many developing countries (weaknesses in investor protection, the rule of law, enforcement and transparency are, of course, part of this premium). Even if such projects are available, firms will most likely draw on internally generated funds before pursuing external sources. Furthermore, such external capital must be available, either generated within the country or supplied from foreign sources. This is not obvious in most developing countries either. In particular, most people will not have excess savings to invest in stocks and bonds, or place in bank accounts, and the people with capital may not be interested in investing in other people's businesses. Of course, unwillingness of domestic and foreign investors to contribute funds may reflect the weak protection offered external investor under the existing legal system.

The evidence on the relative importance of different sources of finance is weak, but aggregate flow-of-funds statistics show internal finance to be the most important source

of finance (source?). Equity is relatively more important as a source of external finance than in developed market economies, but it typically comes from the extended family and circle of friends and market-based finance plays a limited role. Financial markets, in particular for control, are less liquid leading to rigid ownership and control patterns.

One feature that stands out from most studies of ownership and corporate control in developing countries is the close ties between business interests and government, so-called crony capitalism. This is not a corporate governance problem in a strict sense, family owners are likely to have the right incentives in their firms. However, these investors often use their influence to limit competition, obtain favorable finance from the government and in other ways alter the game in their favor. Soft budget constraints are common in these arrangements. “Crony capitalism” can be a strong deterrent to outside investors, in particular when a country is exposed to negative macroeconomic shocks. Johnson et al. (1998) demonstrate that the measures used by LLSV explain a significant part of the variation across countries in how much they were affected by the Asian crisis. An interesting question worth exploring is why the similar ownership structures that lead to “crony capitalism” in developing economies do not lead to the same results in Continental Europe. The answer to this question should be closely related to the issues addressed by LLSV. The strength and quality of government is likely to be part of this answer. “Crony capitalism” requires other remedies than investor protection, but it may be that corporate law can play a role in dismantling some of these unhealthy structures by offering opportunities for a broadening or phasing out of current ownership.

We suggest that the predominant corporate governance problem in developing countries can be summarized as “*Strong Owner/managers, Related Investors*”. This characterization suggests that the main problem is family succession and finance beyond related investors. “Crony capitalism” is a common byproduct of these financing patterns. But all these problems may be second-order to the availability of profitable projects and external capital.

6. Transition Economies

The research program of LLSV was largely triggered by the transition experience; several of the authors have been deeply involved in Russian institutional reform. Yet there are no transition economies in their data set. While this omission is understandable given the state of the data for these countries, it is nevertheless unfortunate. We argue that the lessons from this body of work are most powerful in transition economies. This section discusses some of these implications, focusing on Central and Eastern Europe and former Soviet Union.

The transition countries also vary considerably in history and current institutional setup, but they do share certain important features. They all have a large sector of former state-owned enterprises that need to be restructured and in many cases phased out. These countries also need new enterprises to emerge in underdeveloped parts of the economy, in particular in the service sector. These two sectors of the economy pose different governance problems. In addition, the transition economies inherited a dysfunctional legal system, and in many cases they had to construct basic institutions from scratch.

The de novo enterprises have very much the same problem, or lack of problem, as those of developing countries. They are in an early part of the firm life cycle unlikely to face the problem of intergenerational transfers any time soon; liquid markets are therefore less important. It is not even clear that they are financially constrained. The problem of the emerging private sector is rather the lack of functioning corporate governance in much of the former state-owned sector. These enterprises require strong outside investors to implement painful restructuring, but the dominant pattern in Central and Eastern Europe and former Soviet Union is one of insider control. In the absence of well-functioning laws managers with or without shares can effectively expropriate minority investors (who often entered more or less by default through mass-privatization or insider privatization schemes). In this situation the protection of external investors is of crucial importance; outsiders must have a possibility to accumulate stakes and exercise control.

While better investor protection as advocated by LLSV is likely to be very important in many transition countries, in particular in the former Soviet Union, the legal text as studied by them is likely to matter much less than in developed market economies. The Russian corporate law could serve as an example. The original document was prepared under influence from Western advisors close to LLSV and strongly inspired by Anglo-Saxon thinking. The approach taken in the law is also very similar to LLSV, in fact the legal text comes out as close to perfect according to their criteria as listed in Table 1 (Linnarud, 1998). The drafters of the law clearly recognized the limited capacity of the Russian legal system and the need for flexibility. Thus, they focused on self-enforcing legal rules and left large holes in the legal text to be filled by case law. The problem is that the cumbersome procedures and weak enforcement powers of the courts deter investors from bringing suits (Russia ranks fourth from the bottom in the world in terms of enforcement). The lack of cases means that the large holes in the legal text remain, and investor protection is weak.

Poor investor protection and concentration of ownership also undermine the liquidity of equity markets. The designers of privatization programs in many countries appear to have underestimated this problem. The emphasis was on speed and equity, appropriate corporate governance structures would emerge in due course. But when markets for corporate control are illiquid, initial ownership and control structures become very sticky, something that seems to be at the core of the governance problem in many transition economies. The overwhelming finding from transition economies, at least in Central and Eastern Europe, is that outside, preferably foreign, investors are crucial in bringing about active and deep restructuring (for an early survey, see EBRD Transition Report 1996).

Another important feature of the economic environment in many transition economies, in particular in the former Soviet Union, is the persistence and even worsening of the problem of soft budget constraints (Berglof and Roland, 1998; and Schaffer, 1998). The lack of financial discipline often stems from the size or number of formerly state-owned enterprises forcing the government to give in to pressures to refinance them loss-making entities. Another source of soft budget constraints in enterprises is weaknesses in the

banking sector. The softness of budget constraints weakens the need to seek outside finance and thus the pressure to restructure; inefficient governance structures are sustained. For corporate governance to have an effect on investment decisions budget constraints must be hardened.

The predominant corporate governance problem in transition economies can thus be summarized as “*Insider Control, No Outside Finance*”. Improved investor protection can play an important role in attracting outside capital and forcing restructuring. The overriding issue in most countries seems to be enforcement, in the absence of enforcement suits are not brought to courts and case law does not develop. But to be effective measures to strengthen investor protection must be combined with efforts to harden budget constraints.

7. General Implications

LLSV have highlighted a number of issues of crucial importance for our understanding the relationship between the laws, financing arrangements and economic growth. The literature shows strong correlation, both statistically and economically, between these variables. While the issues of causality and the possible existence of underlying factors explaining these observations have not been resolved, these contributions present a challenge to academics and policymakers alike.

We defined corporate governance as the mechanisms transmitting signals from product and input markets into corporate behavior. The pressure generated by external investors is just one of these mechanisms, others include monitoring by employees, suppliers, competitors, and within corporate networks; the government also exercise also influence the transmission of signals either directly or through the framework it provides for the corporation. The fact that all these stakeholders do influence decisions in firms has strong normative implications for the role of law in general and investor protection in particular. The various pressures may push the corporation away from efficiency and profit-maximization in which case strengthened investor protection may serve as a

countervailing force. But the different mechanisms can also substitute for weaknesses in, or complement, monitoring by external investors.

Any statement about corporate governance and possible intervention through the legal system must be preceded by careful analysis of the specific institutions of the country concerned. The optimal governance arrangements reflect delicate tradeoffs between the benefits and costs of concentrated holdings. Concentration of ownership improves incentives to monitor management and align incentives of owner/managers with those of the rest of shareholders. The costs come from the agency problems between controlling owners and minority owners, and the reduced liquidity of shares (fewer traders in secondary markets). The liquidity of shares can be improved by issuing shares with different voting power. However, improved liquidity comes at the cost of separation of ownership and control, and the resulting worsening of the agency problem.

The law can affect these costs and benefits. Law in general, and corporate law in particular, should protect not only external investors but also management. In the closely held firm the distinction between internal and external finance is not clear, and the law has to anticipate and adjudicate conflicts between controlling owners and minority investors.

Table 3 brings together our, perhaps overly simplistic, characterizations of the predominant governance problems in different types of firms.

TABLE 3: THE CORPORATE GOVERNANCE PROBLEM DEFINED – SOME CARICATURES

Widely Held Firm	Closely Held Firm	Family Firm
Strong Managers, Weak Owners	Strong blockholders, Weak Minorities	Strong Owner/managers, No Outside Shareholders
	Transition Firm	Development Firm
	Strong Insiders, No Outside Investors (plus <i>de novo</i> sector and soft budget constraints)	Strong Owner/managers, Related Investors (plus “crony capitalism”)

We argue that the lessons from LLSV primarily apply to systems where widely held firms dominate and transition economies, i.e., where the predominant conflict is between managers and external investors. Whether the protection of external investors in Anglo-Saxon systems is too strong, or too weak, is hard to say in general, and there is likely to be important variation across countries with such systems. In many transition economies, in particular those of the former Soviet Union (excluding the Baltic countries), external investors appear excessively weak and the law should aim to strengthen them. However, for improved corporate governance to have an effect on restructuring budget constraints must also be hardened. Strengthening investors and improved financial discipline should help reinforce signals from product markets.

The conceptual framework underpinning LLSV is less well-suited to the analysis of corporate governance in countries with mostly closely held firms, even though most of the measures of investor protection also apply to conflicts between controlling owner/managers and minority investors. In terms of whether the protection provided is

excessive or insufficient the evidence is inconclusive. LLSV find significant differences between countries with civil law systems, e.g., between France and the Netherlands; in fact, the variation among this group of countries may be at least as interesting as that the difference between common law and civil law countries. The literature suggests that certain countries in Continental Europe have too weak protection of minority investors (Italy is the most frequently used example, even if the evidence is somewhat weak). In other countries, e.g., Sweden or Belgium, the verdict seems less clear. There is, however, a general perception that corporate governance is weak in many countries. The pressure to reform is particularly strong from US-based institutions desiring to diversify their portfolios internationally. Again, policy recommendations must be preceded by careful empirical investigations.

It is less clear that corporate governance is a first order problem in most developing countries. Family ownership is the predominant form of control in most countries, and in many countries families have become closely intertwined with government leading to the syndrome “crony capitalism”. While this problem is not primarily one of corporate governance, better protected investors and functioning financial markets may be part of solution. In general, availability of good investment projects and accumulated capital are likely to be more the first-order problems in many developing countries. However, in some countries, like South Korea, there are serious corporate governance problems where reforms of corporate law and enforcement mechanisms may play an important role. In all countries, the problem is likely to be one of enforcement rather than mere changes in the legal text.

In the optimistic interpretation of LLSV these reforms of corporate law and investor protection can be achieved by simply changing the legal text and improving enforcement. A deeper and more pessimistic interpretation of their findings is that legal origin determines investor protection and that changes of this protection requires changes in the basic legal system, even going from civil law to common law. Needless to say, such reforms are not carried out over night; they involve radical changes in legal thinking, the role of different legal institutions and the training of the law profession, just to mention a

few. A possibly even more pessimistic interpretation is that there is some other more fundamental variables explaining the observed correlation between legal origin, corporate law and investor protection. If these variables involve the role of the state or deeply ingrained relationships between different stakeholders in society, reforms are even harder to undertake.

For many developing countries the choice of legal system has already been made for them, often through their colonial history. Transition countries may have more freedom of choice, even though most of them have also already taken many of the important decisions. In fact, for many countries in Central and Eastern Europe many of the choices are implicitly or explicitly given by the criteria imposed on them in the accession process to the European Union.

9. Policy Implications

The LLSV papers have stimulated an important debate in policy circles, but their policy implications are not as immediate as a superficial reading would suggest, in particular not for developing and transition countries. While we do not subscribe to the fatalistic interpretation that, somewhat caricatured, legal origin determines destiny, we recognize that fundamental corporate governance reform is an extraordinarily complex policy challenge. History and tradition weighs heavily on legal institutions also in developing countries and probably more than is commonly recognized in transition economies. Weak enforcement and a general lack of the rule of law are also part of the heritage. Mere changes in the letter of the law are not going to have much impact. Governance practices are also deeply rooted in existing stakeholder relationships and governments are typically weak.

Despite all these constraints we are convinced that there is scope for policy intervention. We do not embrace the naïve interpretation of LLSV as providing a checklist list for policymakers, but it is important to translate the emerging corporate governance paradigm into concrete recommendations. It has become very popular to adopt corporate

governance guidelines. Many OECD countries have such documents, and OECD itself is about to issue its own set of principles (most guidelines are available from the Web Page of the European Corporate Governance Network at <http://www.ecgn.ulb.ac.be>). The current draft of the OECD guidelines is an interesting document. While its focus is still on minority shareholders and the rare species of the widely held corporation, it shows a clear evolution in thinking, in particular as compared to earlier versions and other documents produced by the organization. The preamble recognizes the contextual nature of corporate governance and its dependence on the legal, regulatory, and institutional environment. Moreover, the guidelines do acknowledge the need to consider other stakeholders than minority shareholders; one of the five basic principles deals with this issue.

The problem with the OECD guidelines, in particular when applied to developing and transition economies, is that they cover a broad range of rules and principles without specifying clear priorities among them. Given that the guidelines assume many of the institutions that are lacking in these countries they also do not provide priorities across policy areas. Furthermore, even the watered-down language of these prescriptions is often too ambitious for policymakers. Nevertheless, we believe the OECD guidelines provide a useful start. In the following we indicate how we view the priorities for developing and transition countries.

- **Any international guidelines must recognize the international differences in governance systems.** Generalizations are often more harmful than helpful. Ownership and control structures differ tremendously and so do the basic mechanisms for correcting governance failures and the roles of different governance institutions. However, general principles do exist and should be articulated, in particular when they are unlikely to be so locally. At least, they force domestic actors to make explicit their own preferences.
- **The general accounting rules and transparency requirements of the OECD guidelines should serve as a benchmark.** Transparency concerning ownership and control arrangements are particularly desirable, in particular in improving the

liquidity of shares and attracting foreign investors. It is hard to see that there should be any significant social costs to such disclosure, and the benefits seem substantial. The puzzle is to explain why companies in need of external finance have not implemented these guidelines at their own initiative. Doing so would presumably lower their cost of capital. The failure of the Transparency Directive of the European Union also shows that resistance or inertia is considerable. Either companies do not need (or want) outside funds or there are substantial private costs to disclosure. One hypothesis is that insiders to these arrangements are concerned that their legitimacy would be undermined.

- **Protection of external investors is more important in transition economies than in developing countries.** The emphasis in LLSV is most appropriate in transition economies where insiders, in particular managers, have entrenched themselves in the formerly state-owned companies. However, the necessary pressure for change will have to come from strategic investors with controlling stakes or large minority positions, not from small shareholders or takeover threats in anonymous equity markets.
- **The development effect from any program that focuses solely on the plight of small shareholders is likely to be very small.** It is not clear that access to external funds is a binding constraint for most firms in developing countries. Even where it is, small, anonymous shareholdings will in most cases not be the dominant source. Protection of strategic equity investors could play an important role, but most finance is likely to come through family ties or, possibly, peer group arrangements. The conclusion is equally valid for transition economies. This is not to say that small shareholder protection should not be part of corporate governance, it just should not be the main focus.
- **Protection of creditors is more important than that of shareholders in developing and transition economies.** Debt is the most important external source of finance in developed market economies. In relative terms equity currently plays a more

substantial role in developing countries. However, equity is typically not raised in public markets but through family ties or personal relationships. In the short-term substantial increases in external finance are likely to take the form of debt, probably from banks. Recent studies show a strong link between creditor protection and the development of the banking sector. In most transition economies companies have not been successful in raising external finance, but the need is great. Strategic shareholders are crucial to achieve restructuring, but most external capital is likely to come as debt.

- **The short and medium-term emphasis on investor protection should not be on creating liquid markets for shares and corporate bonds.** The reason is not that liquid markets and liquidity, as is sometimes argued, are undesirable. Liquid markets play an important role in generating information and facilitating control transactions in many developed market economies. However, in the developing economy context liquidity would be most important when families have to sell out, but this does not seem to be a first-order problem in the short and medium-term. In some transition economies liquid equity markets could play a role in helping strategic investors build position, but it is not clear that insiders will issue shares to let this happen.
- **In the long-term, liquid securities markets could play an important role in attracting foreign portfolio investment.** These markets are hard to create, take time to develop and difficult to sustain. In most countries they do not play an important role as a source of finance. The recent problems in Asia and Russia have also demonstrated how volatile these markets are, but that the vulnerability of individual countries seems to be closely related to how well protected small investors are. This may be the type of investment where investor protection matters most. Foreign portfolio investment has important benefits in relieving domestic capital constraints, and the lure of such investment can be important in the implementation of governance reform.

- **Reforms focusing on enforcement are more important, and more difficult, than are changes to the letter of the law.** This obvious point needs to be made.

Unfortunately, we have not had much to say about how to strengthen enforcement and promote the rule of law. Self-enforcement must play an important role given the weakness of the legal institutions, but as the experience from Russian corporate law reform demonstrates this is not enough.

- **In many contexts the most immediate concern is to protect other stakeholders than shareholders.** In many transition countries, Russia in particular, the main governance problem is entrenched managers' outright theft from, or at least lack of payment to, the government and employees. Ruthless managers also exploit suppliers and customers locked into inherited technological relationships. Weak labor laws in many developing countries discourage firm-specific investment by employees and could also undermine general skill formation. Obviously, a stakeholder approach can allow managers and individual stakeholders to exploit blurred corporate objectives and paralyze decision-making. The emphasis should be on protecting exit options and creating flexibility, not on promoting codetermination.

- **Implementation and enforcement of fundamental corporate governance reform will in many cases require external conditionality.** Governments in developing and transition countries are generally weak. This weakness has many sources, but one important reason, in particular in transition economies, is the political deadlock over central parts of reform. These deadlocks arise out of the distribution effects of reforms. External conditionality can play an important role in relieving these political constraints. The role of the European Union as an outside anchor to the reform process has been crucial to institutional reform in Central and Eastern Europe. Unfortunately, EU membership has not been in the cards for most of the former Soviet Union (the Baltic countries excluded). Conditionality from the international financial institutions could also go some way and should be systematically used, but it can never have the same leverage effect. For corporate governance reform explicit or implicit conditions formulated by foreign investors is also important, but this pressure

is likely to be less consistent and less coordinated. Here OECD and other guidelines may play a useful role.

- **Effective corporate governance reform will often require a combination of threats and co-optation of the main actors.** Given the weakness of governments and the absence of credible outside anchors in most developing and transition economies fundamental reform will not be implemented against the will of the main actors. Pivotal groups will somehow have to be co-opted. In other cases, threats may be necessary. In the extreme case of Russia, renationalization of strategic assets followed by renewed privatization may be the only way to break resistance. This measure has obvious reputation consequences and the government may not be strong enough to act on such a threat.

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