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Corporate governance, investor protection, and performance in emerging markets

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Abstract

We use recent data on firm-level corporate governance (CG) rankings across 14 emerging markets and find that there is wide variation in firm-level governance in our sample and that the average firm-level governance is lower in countries with weaker legal systems. We explore the determinants of firm-level governance and find that governance is correlated with the extent of the asymmetric information and contracting imperfections that firms face. We also find that better corporate governance is highly correlated with better operating performance and market valuation. Finally, we provide evidence that firm-level corporate governance provisions matter more in countries with weak legal environments.

JEL classification: G3; F3
Keywords: Corporate governance; International finance; Law and finance

1. Introduction

Previous research studying the link between law and finance has concentrated on corporate governance (CG) around the world and focused on differences in legal systems across countries and legal families. This rapidly developing body of literature began with the finding that the laws that protect investors differ significantly across countries, in part because of differences in legal origins (see La Porta et al., 1998). Recent literature finds that cross-country differences in laws and their enforcement affect ownership structure, dividend payout, availability and cost of external finance, and market valuations.[1]

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[1] For example, La Porta et al. (1999, 2000, further referred to as LLSV), Claessens et al. (2000), Berkowitz et al. (2003), Lombardo and Pagano (2000), and Beck et al. (in press).

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However, many provisions in country-level investor protection laws may not be binding because firms have the flexibility in their corporate charters and bylaws to either choose to "opt-out" and decline specific provisions or adopt additional provisions not listed in their legal code (see Easterbrook and Fischel, 1991; Black and Gilson, 1998). For example, firms could improve investor protection rights by increasing disclosure, selecting well-functioning and independent boards, imposing disciplinary mechanisms to prevent management, and controlling shareholders from engaging in expropriation of minority shareholders, etc. Therefore, it is likely that firms within the same country will offer varying degrees of protection to their investors.

A number of recent papers have studied firm-level corporate governance mechanisms, but most of these studies have concentrated almost exclusively Organization for Economic Cooperation and Development (OECD) member countries and U.S. firms (see Shleifer and Vishny, 1997; Maher and Andersson, 2000, for comprehensive surveys). For example, a recent paper by Gompers et al. (2002) used differences in takeover defense provisions to create a corporate governance index of U.S. firms and found that firms with stronger shareholder/antidirector rights have better operating performance, higher market valuation, and are more likely to make acquisitions. However, until recently, there was no empirical evidence on the differences in firm-level governance mechanisms across firms in emerging markets. An exception is Black (2001), which found that the governance practices of Russian corporations are strongly related to implied value ratios.

In addition to the recent attention given to differences in legal systems across countries, another interesting empirical question is whether there is variation in firm-level governance standards within countries and the relationship between firm-specific governance mechanisms and country-level laws governing investor protection. The relationship between the country-level legal infrastructure and firm-level corporate governance mechanisms is far from obvious. One supposition is that firms in countries with weak laws would want to adopt better firm-level governance to counterbalance the weaknesses in their country's laws and their enforcement and signal their intentions to offer greater investor rights. This would suggest a negative correlation between the strength of firm-level governance and country-level laws. A second possibility is that in countries with weak laws, the degree of flexibility of firms to affect their own governance is likely to be smaller (that is, the firm is likely be constrained by the country-level legal provisions), which would imply a positive correlation. This question has not previously been empirically studied.

The second question that we address is *which* firms within countries have relatively better governance? La Porta et al. (1998) argued that greater investor protection increases investors' willingness to provide financing and should be reflected in lower costs and greater availability of external financing. This suggests that we should find that firms with the greatest needs for financing in the future will find it the most beneficial to adopt better governance mechanisms today. Finally, we address the most important, and difficult, question, which is whether or not firm-level differences in corporate governance matter for performance, market valuation, and access to external finance. This paper is a first attempt to address some of these questions and suggest avenues for future research.

The surge of interest in the topic of corporate governance among investment banks, rating agencies, and other specialized financial institutions has made it possible to address these questions empirically as a number of private firms have started to collect firm-level